# Cales Investments, Inc.

Member NASD / Member SIPC

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## Shot Across the Bow

Investors in nearly all asset classes were caught wrong-footed in May and have yet to recover their balance. Markets around the world have succeeded once again in its timeless functions: to do that which will confound the greatest number of market participants. It certainly seems like the unwinding of troublesome positions was/is going on. The margin calls were being issued every day throughout the past two weeks and affected all “hot” positions, not only in emerging-market stocks, but also in energy and metals as well. The reason seems to be that the cost of the carry, just about no matter what currency you're borrowing, is going up. Seven central banks raised interest rates last week, including the European Central Bank by 25 basis points to 2.75%; Denmark by 25 basis points to 3.00%, India by 25 basis points to 5.75%, South Africa by 50 basis points to 7.50%, Thailand by 25 basis points to 5% and Turkey by 175 basis points to 15%. The Bank of Korea surprised with a 25-basis-point hike to South Korea's overnight rate to 4.25%. All stock indices tied to the countries that raised interest rates fell. The idea that the carry trade is unwinding is not new (we talked about it in May last year), but there are carry trades and there are *carry* trades. Borrowing in yen to invest in Iceland may have ended in March 2006, but that was just the beginning. Going short volatility and making a long leveraged bet on other risky assets was popular throughout the bull market of the past few years. Several hedge funds shorted volatility in a variety of forms to fund their leveraged bets in various markets over the past couple of years, hedge fund sources say. Investors were hurt on this trade in May, when volatility spiked, as measured by the CBOE Market Volatility Index (an index of implied volatility based on S&P 100 options). But the trade got popular again when the markets showed strength on the first couple of days in June. "Everyone did the usual, thinking that 'It was just a bad market in May,' and put on the same trade, and now they're getting hurt," says one hedge fund manager who declines to be named. He adds that several funds have been deeply dented by this mistake, and have had trouble covering their positions. Still, it's not as if the more speculative hedge fund players are going to abandon the carry trade altogether. Turkey's 175-basis-point rate hike makes the nation just another destination for investors to put on a carry trade given the (still) relatively low rates they can borrow in Japan and other markets.

| Market (Number of Stocks) | May. 2006 (U.S. $) | Apr. 2006 (U.S. $) | % Change One Month | Market (Number of Stocks) | May. 2006 (U.S. $) | Apr. 2006 (U.S. $) | % Change One Month |
|---|---|---|---|---|---|---|---|
| **Latin America** | | | | **Europe** | | | |
| Argentina (16) | 1323.83 | 1591.50 | -16.8 | Czech Republic 6) | 248.85 | 273.96 | -9.2 |
| Brazil (85) | 960.16 | 1144.37 | -16.1 | Hungary (9) | 852.89 | 976.75 | -12.7 |
| Chile (44) | 1001.04 | 1071.56 | -6.6 | Poland (33) | 1280.89 | 1462.34 | -12.4 |
| Mexico (45) | 1773.13 | 1983.74 | -10.6 | Russia (44) | 541.52 | 606.98 | -10.8 |
| Peru (11) | 530.81 | 582.82 | -8.9 | Turkey (45) | 411.61 | 561.17 | -26.7 |
| **Asia** | | | | **Mideast/Africa** | | | |
| China (142) | 79.19 | 83.55 | -5.2 | Egypt (20) | 203.70 | 245.97 | -17.2 |
| India (135) | 205.58 | 240.70 | -14.6 | Israel (63) | 234.86 | 251.04 | -6.4 |
| Indonesia (35) | 63.86 | 74.25 | -14.0 | Morocco (12) | 249.16 | 279.99 | -11.0 |
| Korea (200) | 206.96 | 223.06 | -7.2 | South Africa (113) | 482.57 | 564.88 | -14.6 |
| Malaysia (98) | 149.22 | 153.70 | -2.9 | | | | |
| Philippines (19) | 93.00 | 94.20 | -1.3 | | | | |
| Taiwan (143) | 133.15 | 141.79 | -6.1 | | | | |
| Thailand (56) | 126.87 | 139.57 | -9.1 | | | | |

**Source: S&P Global**

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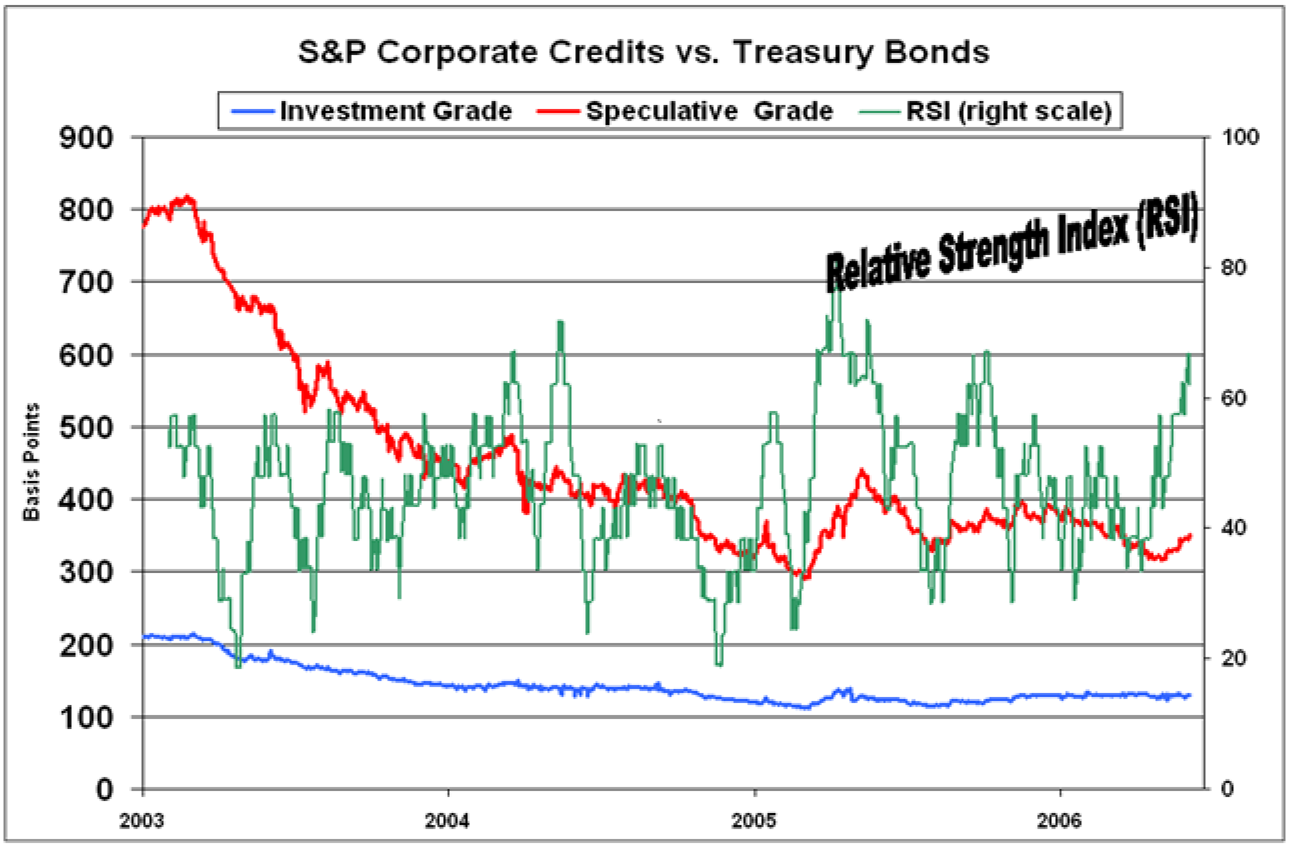
The table above shows the one month return of each equity market between the end of April and the end of May. The sell-offs continued of course for two more weeks and therefore were even greater in points and percentage terms than the table shows. The point here is to demonstrate that this sell-off was not caused by our Federal Reserve Chairman or by the politicians in Washington. Just like the hunt for promising returns occurred for three years on a global scale, so did this subsequent retrenchment affect all countries and all markets. What actually caused this sudden cautiousness and risk aversion is hard to say. Markets (market participants that is) overdo it all the time and fear and greed lie not that far apart at any given moment. In this particular case, greed turned into fear within a mere 4 weeks. One of the best places to look for an assessment of risk attitudes is the corporate bond market. When investors become squeamish about anything, they sell corporate bonds in favor of safer assets such as U.S. Treasuries. The yield spread between corporate bonds will hence tend to widen when investors become anxious. While there is clear evidence of increased fear apparent in the corporate bond market, the depth of that fear is not yet substantial. Current yield spreads reflect more a reversal of high levels of risk taking rather than any meaningful fear about the economic outlook.




If one thing is clear from recent market gyrations, it is that hedge funds using derivatives play an outsized role in driving stock prices. Every move in the market seems to be exacerbated by the panicked reactions of trading desks. This week, several strong data points convinced the fast money that the threat of a massive economic slowdown had eased. In its place returned fears that the Fed must keep raising rates into perpetuity. Luckily for the bulls, the paranoia lifted long enough on Wednesday and Thursday for the indices to stage their best two-day performance in more than a year. In the end, despite flying all over the place on each piece of news, the stock market's major indices ended narrowly mixed on the week.  I believe that we have seen the worst for now and that the recent lows should become solid support for the time being. Bernanke is aware of the lagging effects of interest rate policy and as long as economic indicators show us a gently slowing economy (soft landing), we are going to have a constructive summer.

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