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Capital Management

May 26th 2016

Overview

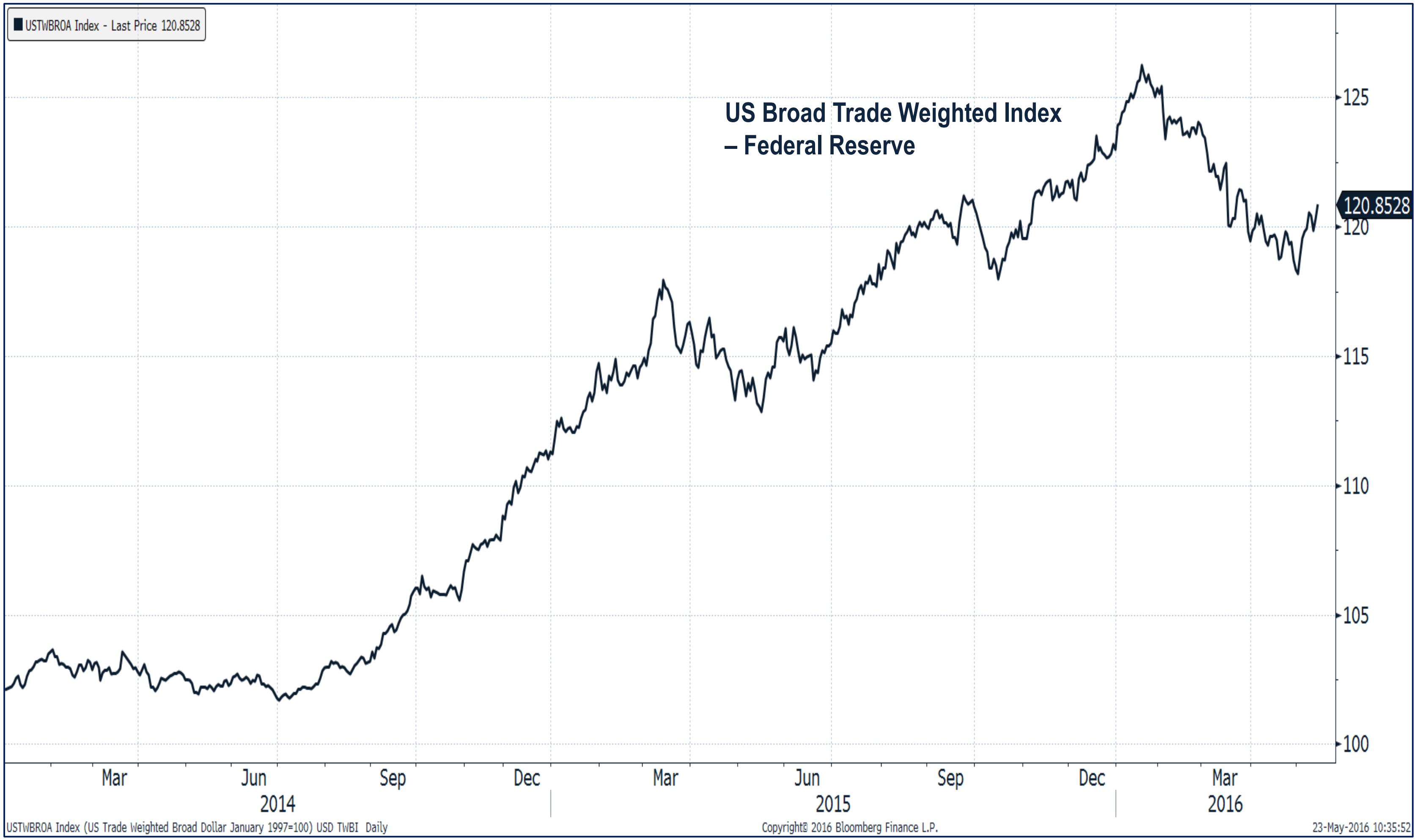
- By late 2015, early 2016 USD strength had become a source of instability.

- A coordinated effort appears to have been in place since mid-February to constrain the USD

- The subsequent stabilisation of ‘international risks’ and easing in financial conditions allows the FOMC room to recommence policy normalisation

- The market may be underestimating FOMC intentions

USD Trade Weighted Broad Index – Federal Reserve



Source: Bloomberg

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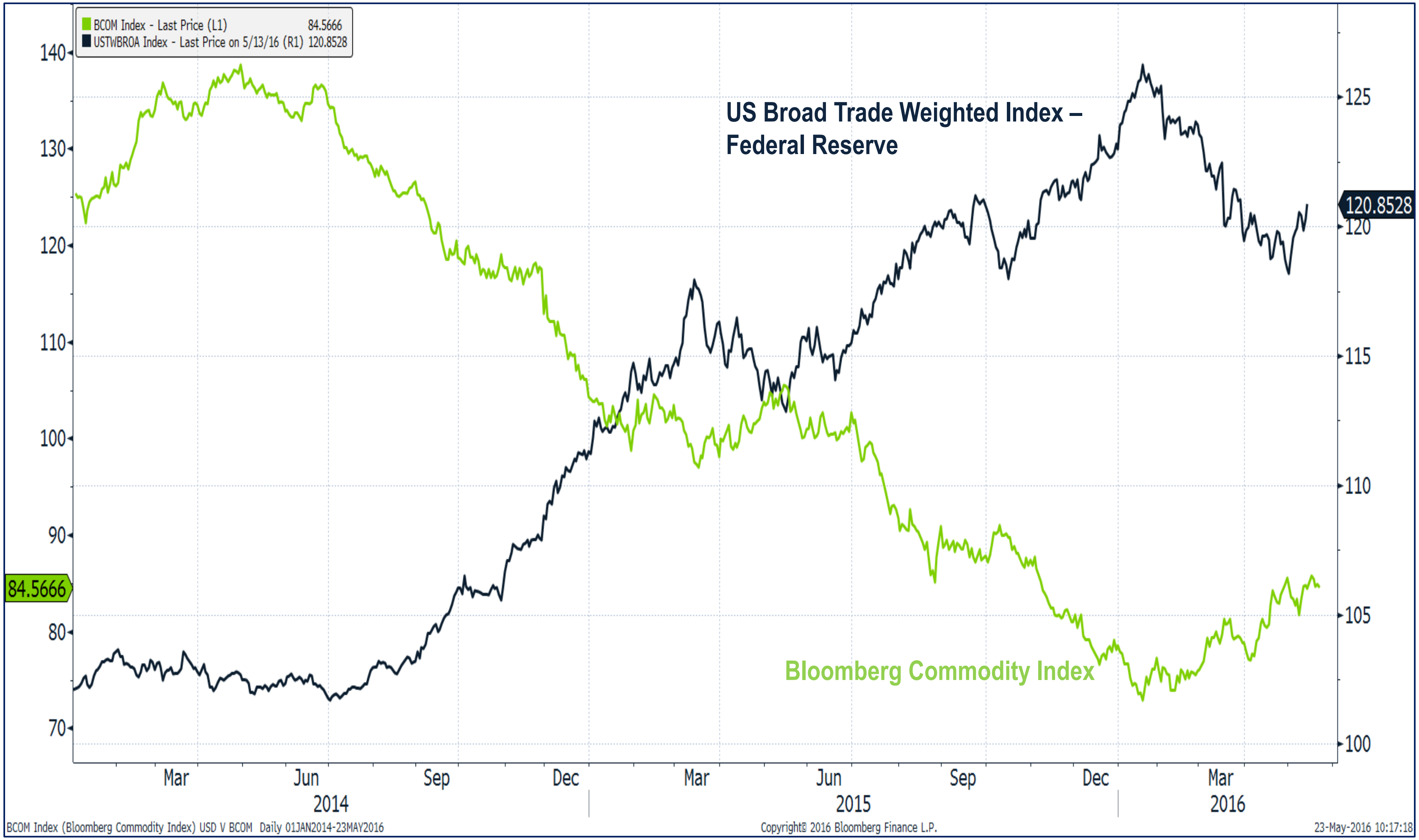
USD strength and commodity bear market served to reinforce one another



Source: Bloomberg

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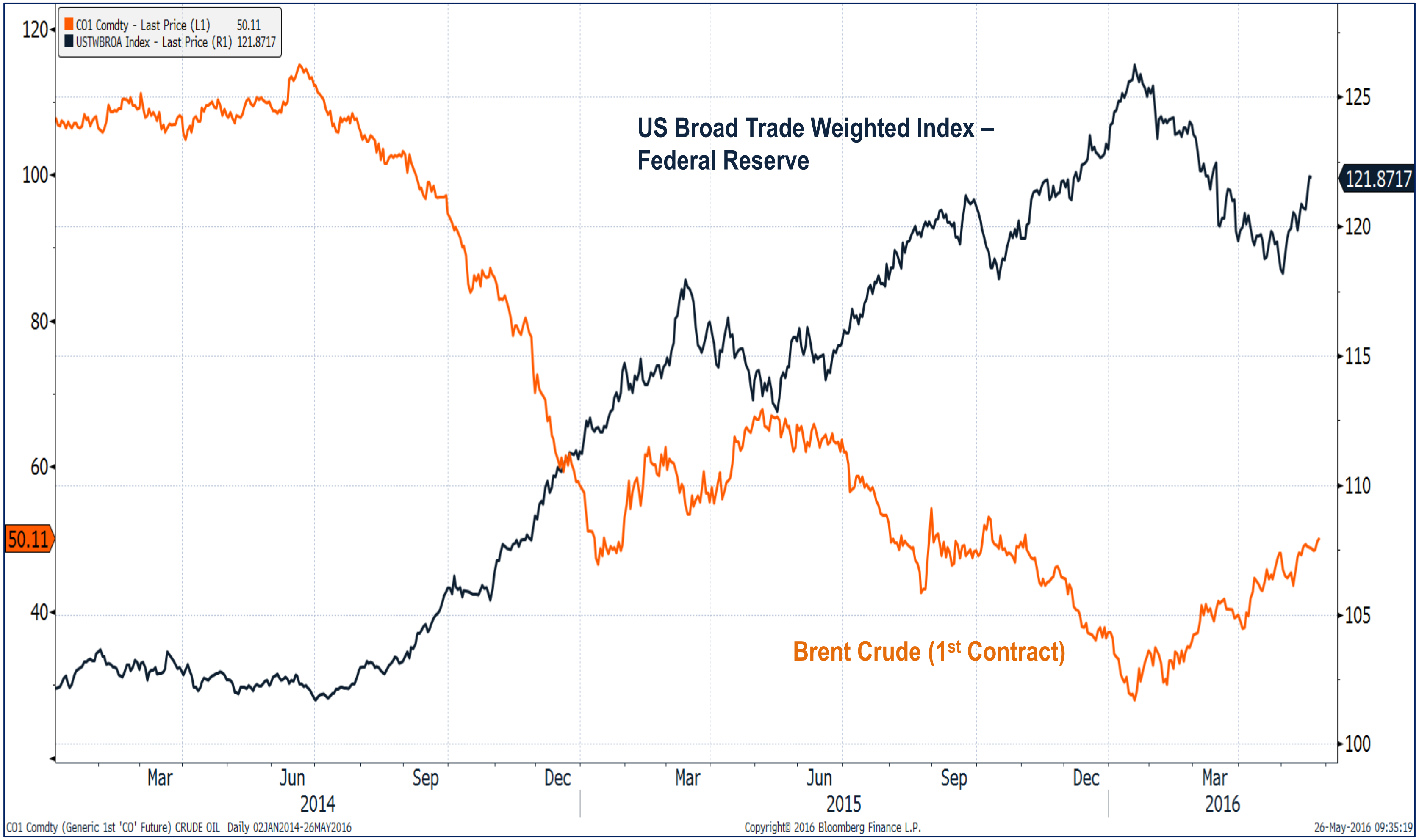
Most significantly in energy markets



Source: Bloomberg

Commodities Down, Emerging Markets Down

Source: Bloomberg

At the same time strong USD dragged CNY higher

Source: Bloomberg, Westpac

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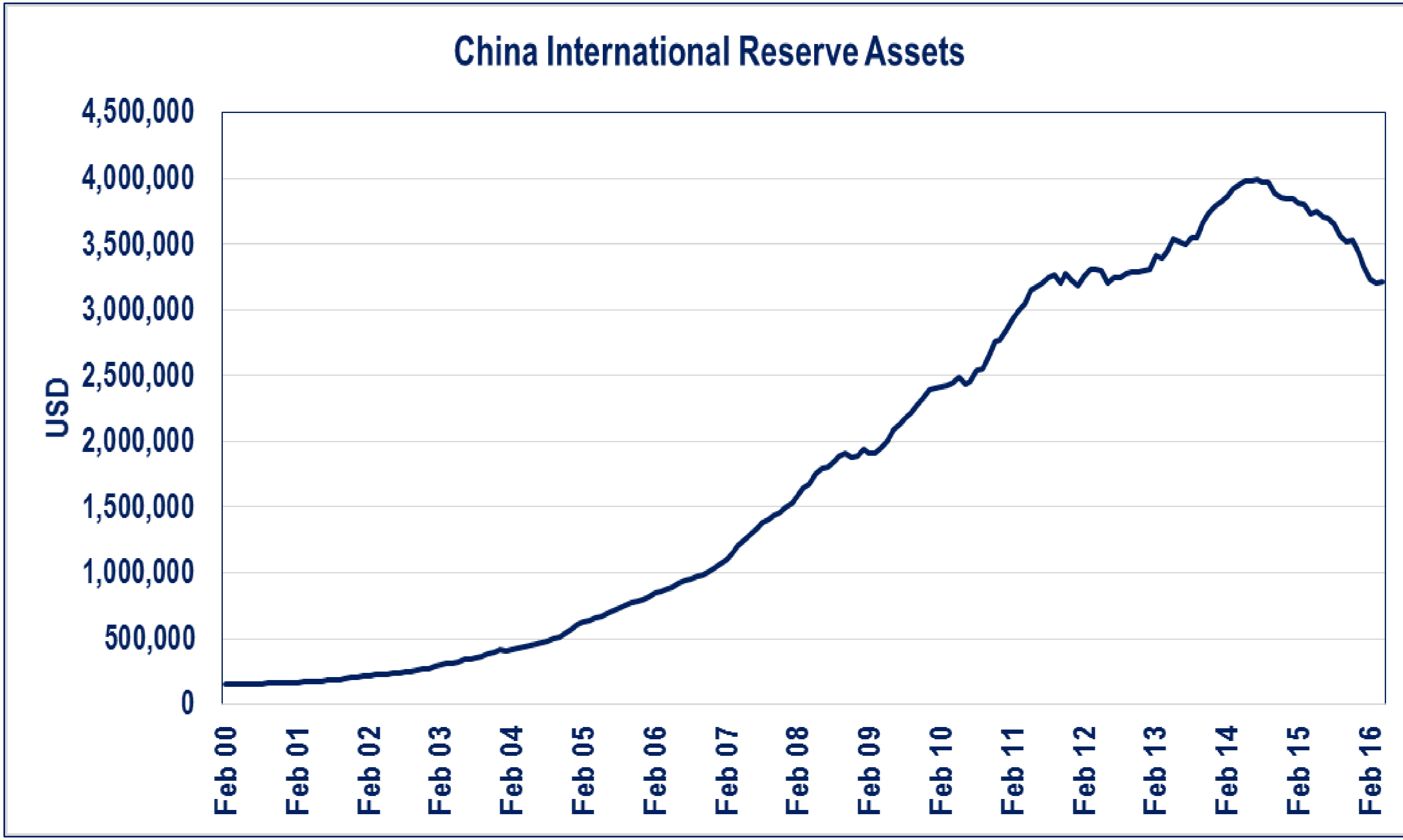
China Reserves



Source: Bloomberg, Three Rock Capital

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PBOC reacts in August and again in January

Source: Bloomberg

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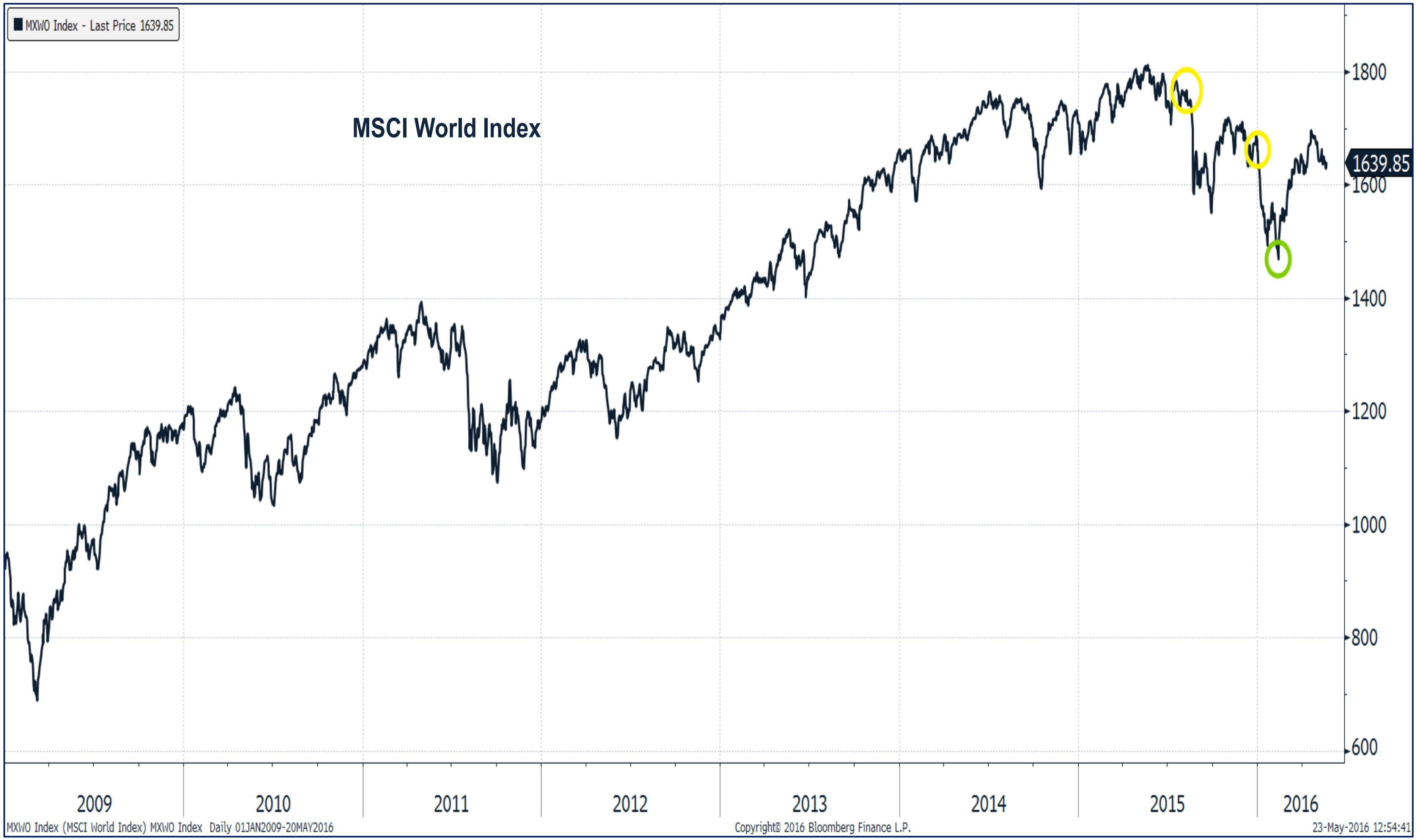
Prompting mild panic in global risk assets



Source: Bloomberg

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A negative feedback loop had developed

Negative Feedback Loop

USD strength – Commodity / EM bear market – USD-CNY peg pressuring China to devalue - reinforcing commodity / EM bear market – Feeding back into developed markets – reinforcing USD strength

Feb 13th – PBOC Zhou – 'no requirement to devalue'
Feb 15th – Russia – Saudi agreement in principle to freeze output
Feb 27th – Shanghai G20 – 'Solemn' agreement not to devalue
Mar 10th- ECB – Draghi - policy actions not designed to depreciate the Euro
Mar 16th – FOMC – Dovish FOMC cited international risks, strong USD
Mar 29th – Yellen NY speech reinforces message

Negative Feedback Loop Reversed

Softer USD – Recovery Commodities / EM - easing of pressure on China - recovery in developed markets

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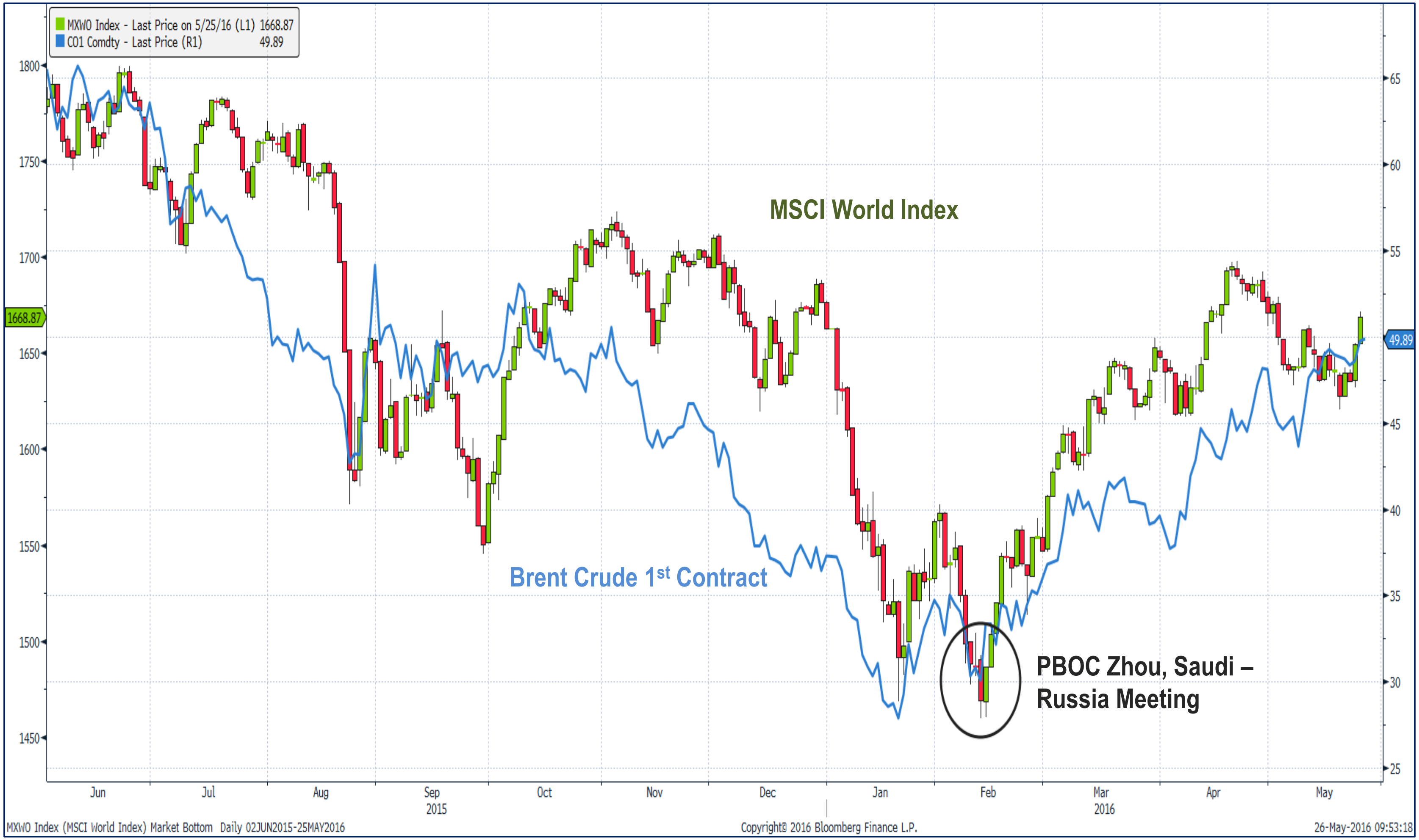
Risk assets and oil bottom



Source: Bloomberg, Federal Reserve, Goldman Sachs

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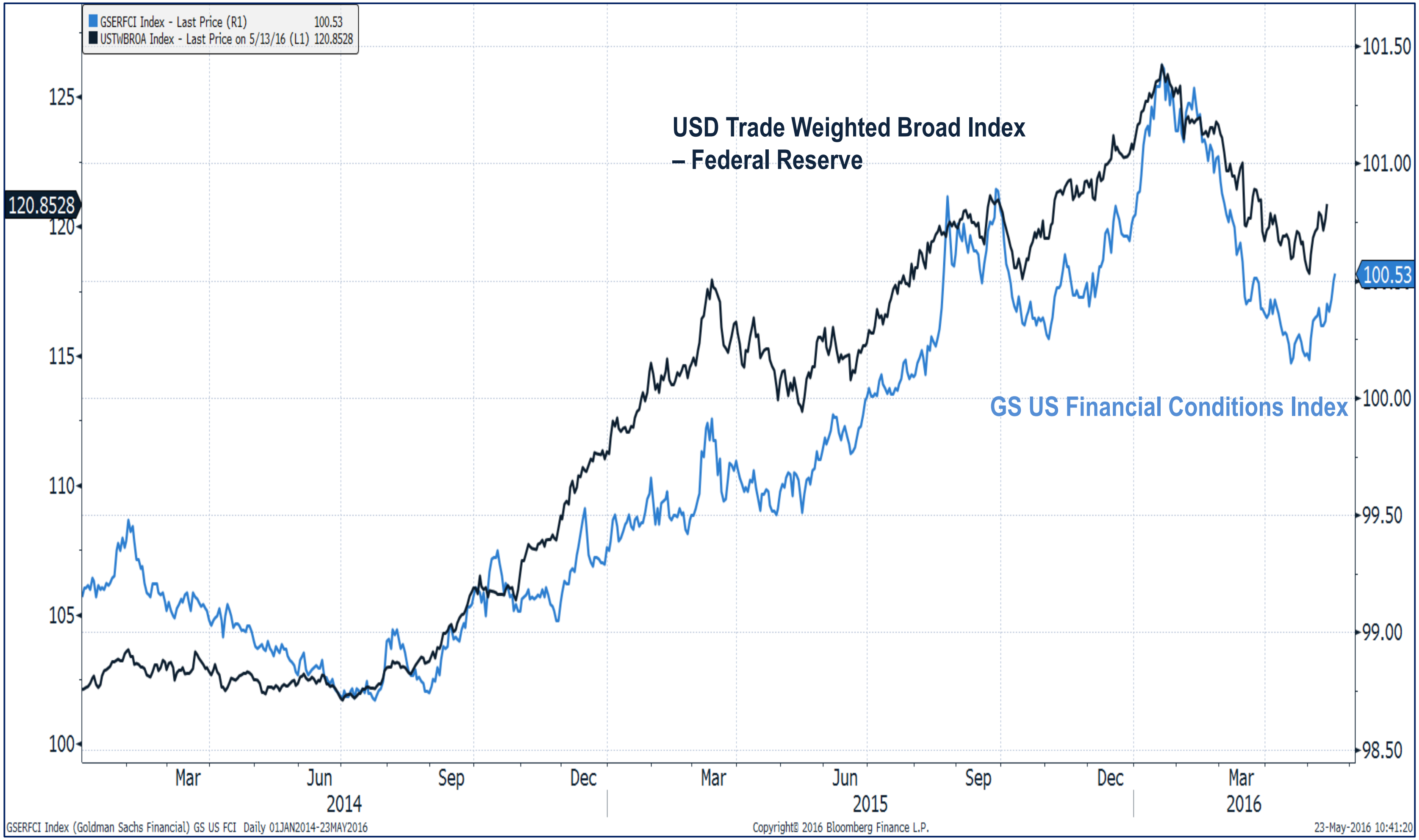
Subsequent stabilisation of 'international risks' and easing of financial conditions allow FED to recommence policy normalisation



Source: Bloomberg, Federal Reserve, Goldman Sachs

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FED preparing for June / July hike

May 18th - FOMC Minutes April 27/28th

"Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June."

Since May 16th

*FED'S HARKER SAYS `CAN EASILY SEE' TWO, THREE RATE HIKES IN '16
*DUDLEY: MKT PRICING OF FED HIKE ODDS WAY TOO LOW PRIOR MINUTES
*DUDLEY: JUNE IS DEFINITELY A LIVE MEETING
*LACKER: MKTS TOOK WRONG SIGNAL FROM FED IN MARCH AND APRIL
*FED'S LACKER: I SUPPORTED RATE INCREASE AT APRIL FOMC
*LACKER: STRONG CASE TO RAISE RATES IN JUNE
*LACKER SAYS HE'S COMFORTABLE WITH FOUR FED RATE HIKES IN 2016
*LOCKHART SAYS 2 OR 3 FED RATE HIKES THIS YEAR ARE POSSIBLE
*FED'S WILLIAMS SAYS JUNE FOMC A LIVE MEETING IN HIS VIEW

June 6th

Yellen likely to reinforce this message

Source: Federal Reserve, Bloomberg

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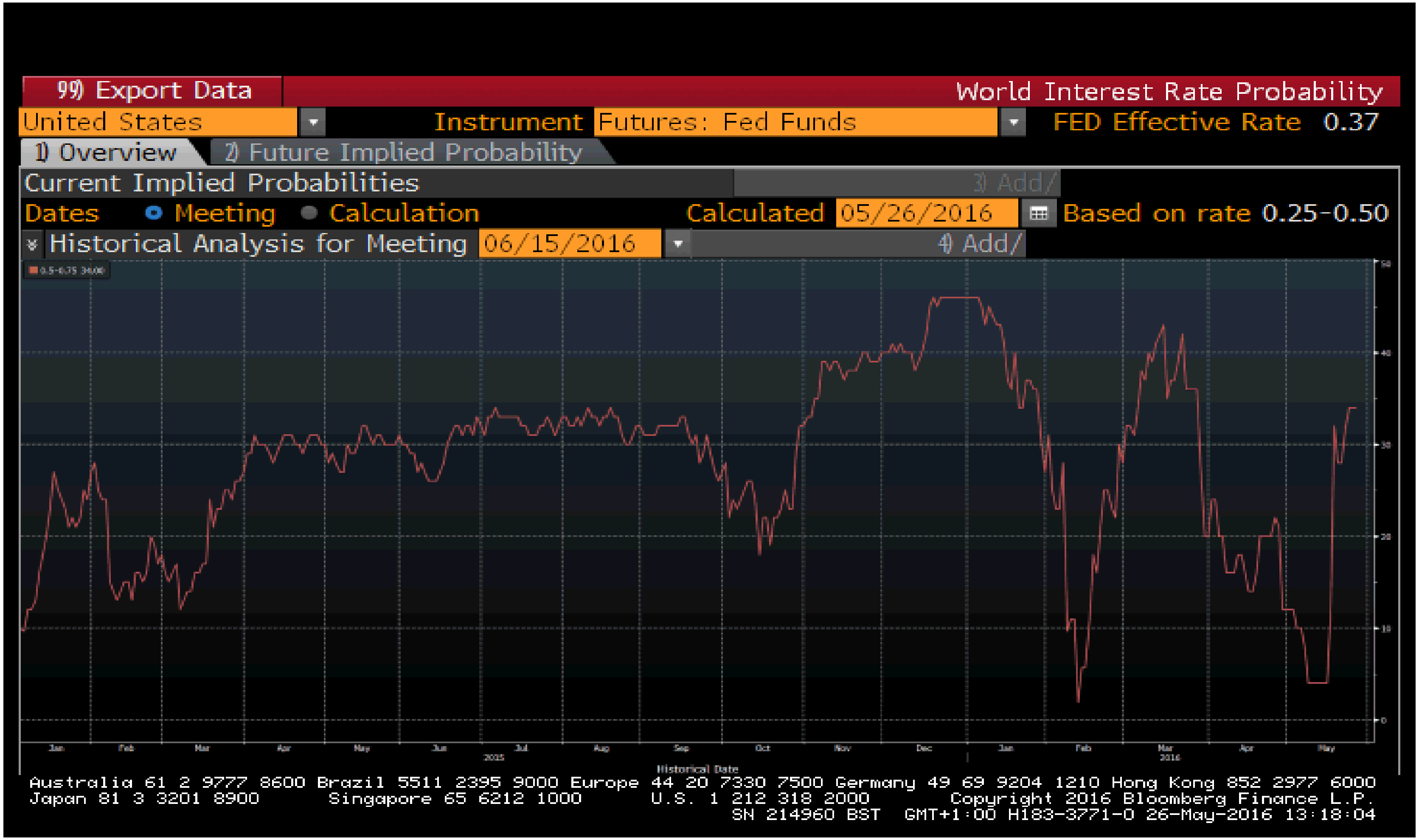
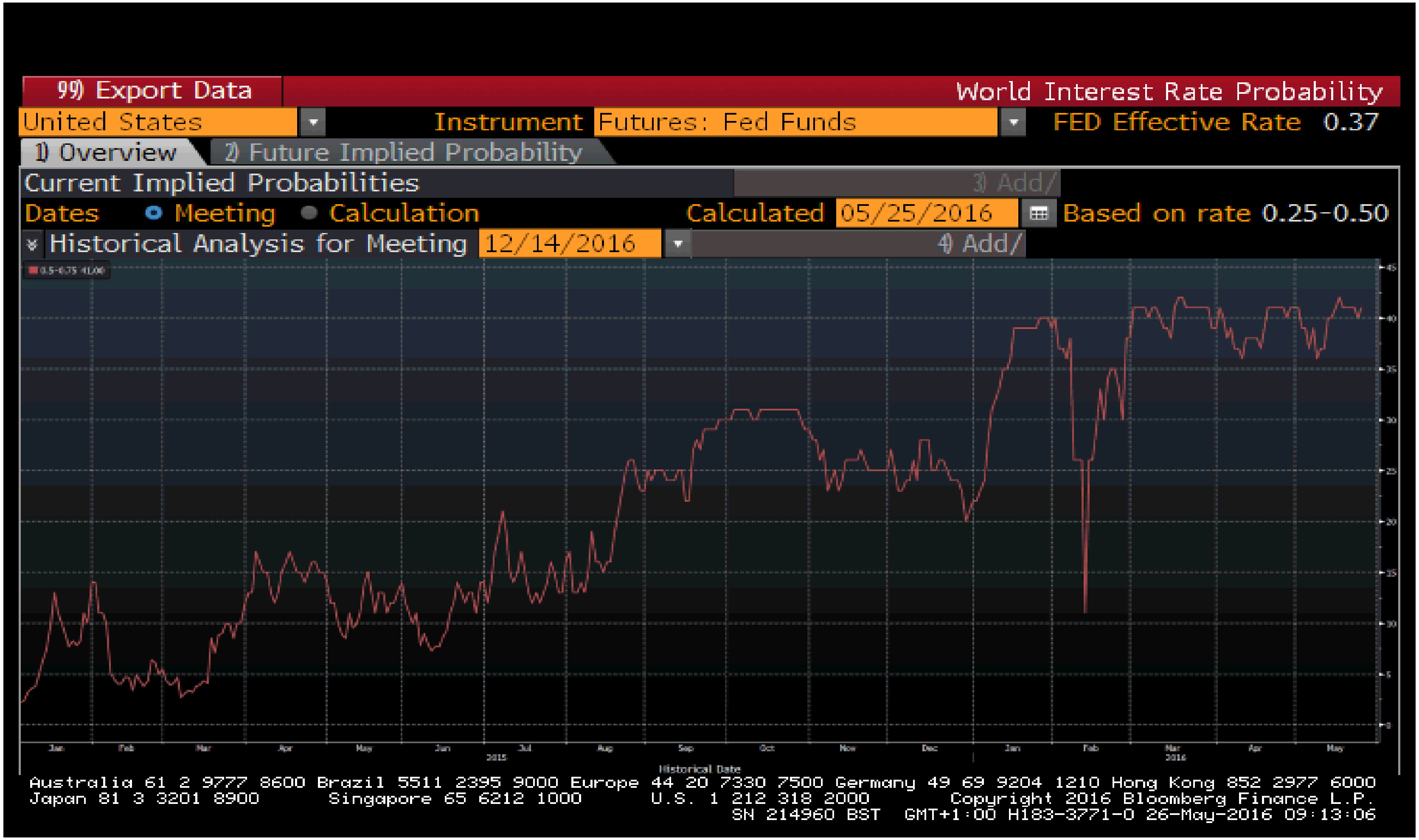
Expectations Adjusting – 34% probability of 25bp increase in June v 4% on May 16th



Source: Bloomberg

Expectations of more than one increase in 2016 have barely changed

Probability Fed Funds Target will be 0.50 – 0.75% after Dec FOMC



Source: Bloomberg

A single hike is priced in 2016….not consistent with Fed's current tone

FFN6 99.535 -.005 ic99.530/99.535ic 6428x6023 Prev 99.540
At 17:26 Vol 31612 Op 99.535 Hi 99.535 Lo 99.525 OpenInt 239188

FFN6 COMB Comdty | 1) Actions | 2) Settings | Futures Contract Table

FED FUND 30DAY As of 05/25/16 Session COMB First Leg All
7) CBT | CEM » Contracts 36 Aggr Vol 98,472 Aggr Open Int 954,886 Length 0

4) Futures | 5) Spreads | 6) Strategies

Display ● Quoted Val ● Rate 9) Color Legend

Description	Last	Chg Settle	Time	Bid	Ask	Open Int	Volume	Yest Settle
21) May16	.3675	+.0025	16:51	.3675	.3650	115932	187	.3650
22) Jun16	.410	--	17:12	.415	.410	86661	5983	.410
23) Jul16	.465	+.005	17:26	.470	.465	239188	31612	.460
24) Aug16	.545	+.010	17:26	.545	.540	178999	35201	.535
25) Sep16	.565	+.010	17:19	.565	.560	37376	6323	.555
26) Oct16	.595	+.010	17:24	.595	.590	87111	11670	.585
27) Nov16	.610	+.005	16:18	.615	.610	38582	2506	.605
28) Dec16	.650	--	16:17	.655	.650	30306	481	.650
29) Jan17	.690	--	17:24	.690	.685	52388	2704	.690
30) Feb17	.715	+.005	17:23	.715	.710	21579	561	.710
31) Mar17	.735	--	16:13	.740	.735	21407	219	.735
32) Apr17	.765	+.005	16:13	.770	.765	10585	214	.760
33) May17	.790	+.005	17:17	.795	.785	8388	117	.785
34) Jun17	.810	+.005	16:58	.815	.805	8379	43	.805
35) Jul17	.845	+.015	13:20	.845	.835	4755	114	.830
36) Aug17	.865	+.015	13:57	.865	.855	3539	175	.850
37) Sep17	.890	+.020	13:21	.885	.875	3714	16	.870
38) Oct17	.910	+.020	13:28	.910	.895	485	33	.890
39) Nov17	.925	+.015	15:38	.925	.915	1271	62	.910
40) Dec17	.935 s	--	5/24	.950	.940	1648	131	.935
41) Jan18	.970 s	--	5/24	.985	.970	1322	101	.970

Source: Bloomberg

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FED after June / July

- The catalysts for the August and January sell-offs (China devaluation threat and collapsing energy prices) are off the table now and unlikely to reemerge with anything like the same force. Other ‘shocks’ may emerge but in their absence and assuming:

- Financial conditions do not tighten aggressively i.e

  - the USD does not ‘take off’ to the upside

  - Equities / risk assets broadly ‘hold in’

FED will be free to do what they are SIGNALING THEY WANT TO DO, ‘normalise’ policy.

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Expect Higher US Yields

Source: Bloomberg, Three Rock Capital

USD likely to be supported in the range but major strength will be resisted by policymakers

Source: Bloomberg, Three Rock Capital

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Precious Metals – Less interesting now that USD has recovered and Fed rhetoric has become more assertive

Source: Bloomberg, Three Rock Capital

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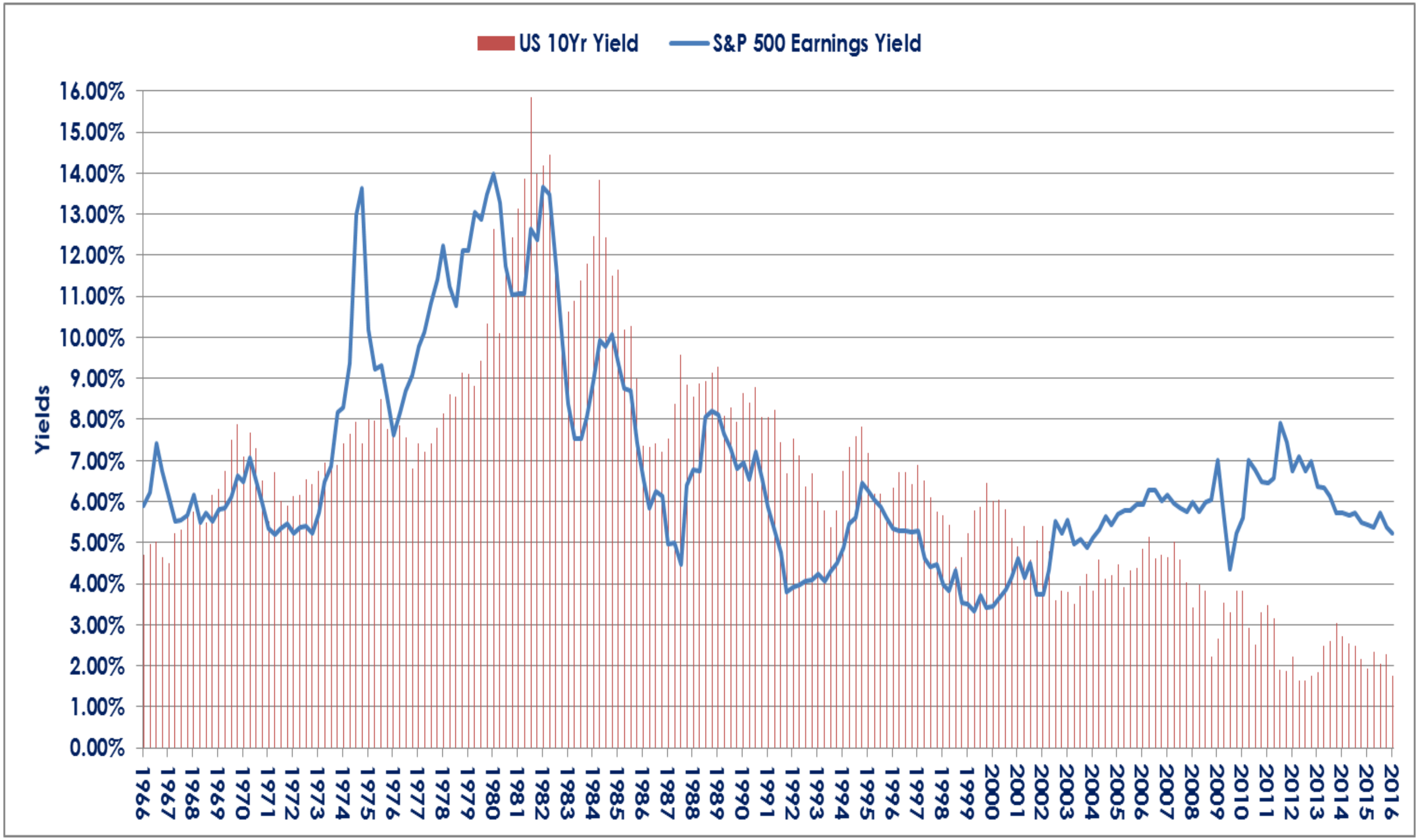
Equities earnings yield still attractive relative to the alternatives



Source: Bloomberg, Three Rock Capital

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