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Commodities Monthly Roundup -- October 2010

Market Highlights for October: Since we came out with our last monthly report in late September, the markets have been on fire. As we note from the circled area in our chart below, the Reuters-Jeffries CRB index capitalized on September's dramatic gain and continued to rally for much of October, although lately, it has been showing signs of wobbling. US equities were also firm this month, building on a the record percentage gain seen in September (the highest in 60 years).

Among the commodity complex, base and precious metals were very strong in October, with gold hitting a record high, silver a 30-year high, and copper a two-year high. The grains, as well as sugar and coffee, also soared as supply concerns hovered over all these markets. Crude's trading range shifted higher as well, although on a relative basis, it was a notable laggard. Natural gas prices headed in the opposite direction altogether, hitting fresh lows and having the dubious distinction of being the worst commodity performer year-to-date.

TABLE OF CONTENTS

Energy 2
Energy Inventories........................... 3
Energy, Emissions, Uranium 4
LME Metals....................................... 5
LME Metals, Steel, Iron Ore 6
Precious Metals............................... 7
Grains, FFA...................................... 8
Tropicals.. 9
Currencies....................................... 10
Financials 11

On the currency front, the dollar continued to stumble this month, providing an important impetus for the dramatic gains. The greenback is understandably under attack from a number of fronts. First, other markets have stabilized over the last few months, allowing sidelined money to leave the dollar's relative safety. Secondly, long-investors are refocusing on the greenback's fundamentals, and here, the picture is not pretty. Not only are US budget deficits still out of control, but the Fed is about to embark on another "quantitative ease" with no one quite sure what the consequences will be. Most worrying, is the possibility that the Fed may print money in order to buy debt as opposed to what it has been doing recently, which is buying impaired paper from financial institutions. Not surprisingly, governments in a countries, led by China, are viewing the Fed's move with considerable alarm, since the massive amounts of money that could now enter the system could very well end up fueling even more inflation in their markets, with higher commodity prices being the delivery vehicle.

Outlook: Although the backdrop outlined above continues to make the case for the "short dollar/long commodities" strategy, we are of the opinion that a rather sizable correction lies ahead, and indeed, we may be in the midst of it as of this writing. For one thing, we think investors are still somewhat over-optimistic about what the Fed will announce on QEII. Although this week's *WSJ* story seems to have somewhat dampened the more rosier expectations in this regard, we suspect the markets may be in store for further disappointment. Alternatively, we could also see a "sell-the-news" type of reaction to the Fed move, since the recent run-up in a number of markets has been already been attributed to it. Most importantly, the fact that commodities have now become investment proxies for "anti-dollar plays" is all well and good, but should prices continue to race higher, they could bring lead to more pressing problems, such as demand destruction, higher inflation, and slowing growth, particularly in developing countries.

Source for Chart: Futuresource.com

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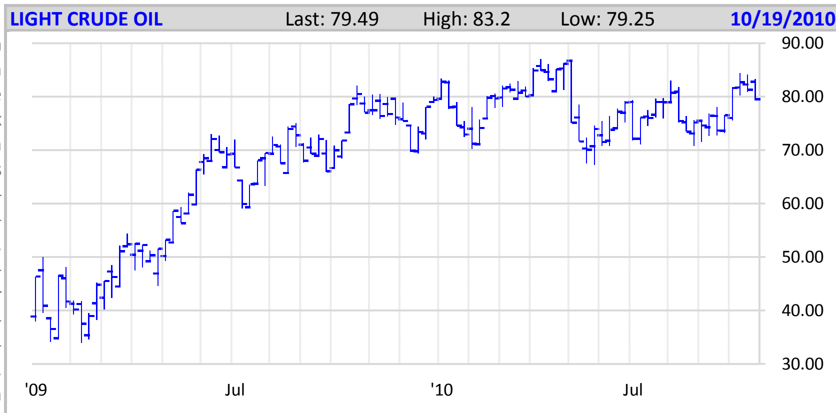
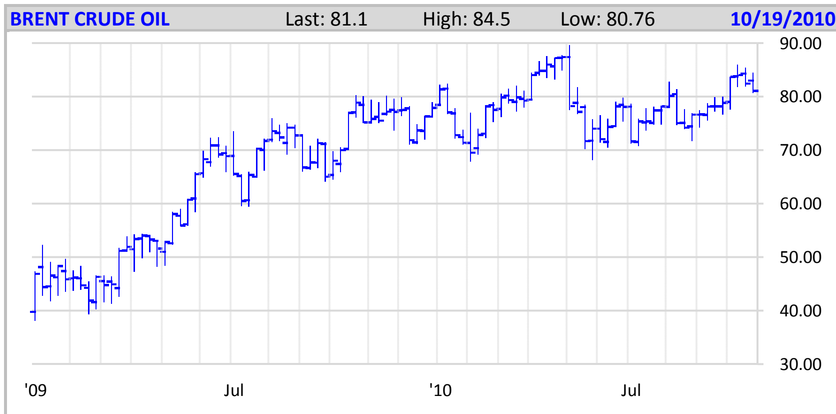
WTI NEARBY CONTINUATION

The trading range in crude has shifted over the course of October, with prices fluctuating between $79.50-$84.50, about $5 a barrel higher than what was seen in September. The move higher has surprised us, since we thought there would have been more downside pressure on the complex now that the hurricane season is winding up. Instead, prices have been buoyed by the rest of the commodity complex, while the weaker dollar is also providing support. The fundamentals of the complex on its own remain uninspiring, with oil inventories still high. However, there is evidence that OPEC's compliance levels have improved somewhat of late, and this is occurring just as a number of agencies are upping their demand forecasts for 2011. Nevertheless, we see prices tracking the dollar and the US equity markets for the moment, and given that both these influences are not as supportive as they were earlier in the month, we likely will see further downside pressure on crude oil going into November, with a good chance that the narrow trading range would likely break on the downside.



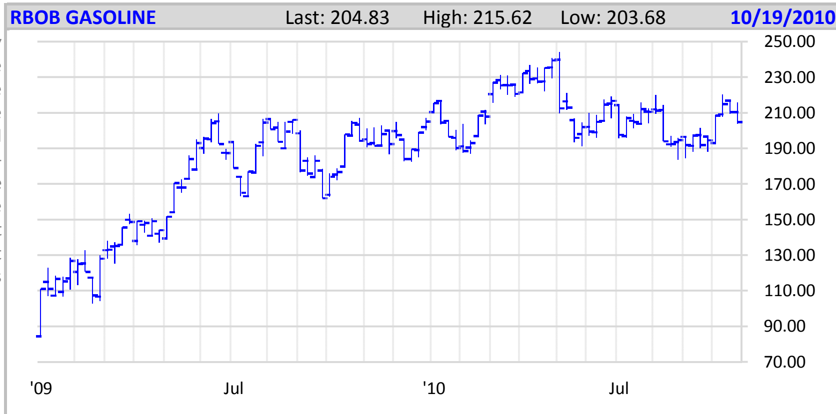
BRENT NEARBY CONTINUATION

Brent prices have pretty much shadowed what is going on in WTI, and here too, we have seen a slight shift higher in the trading range. However, Brent oil prices have been struggling over the last two weeks as the French strikes are now lasting for longer than anyone had suspected, leading to a sharp decline in refinery demand. The arb is not as much of a factor as it was last month, with the differential between the nearby contracts now only standing at $1. We suspect that, similar to WTI, Brent will be hard-pressed to break out of its relatively wide trading range of between $76-$86 at least through the end of the year. Price forecasts from various analysts have shifted higher as far as 2011 is concerned, and we would agree with this upward bias, but would suspect that the rise will not be as dramatic given the high inventories at hand, coupled with the likelihood of still sluggish growth here in the US.



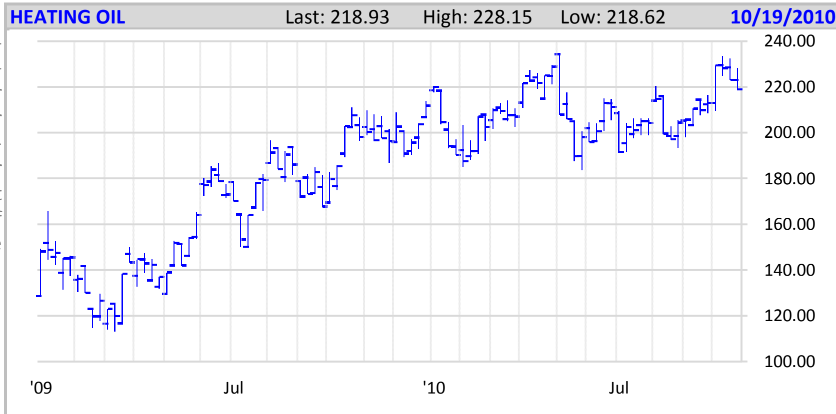
RBOB NEARBY CONTINUATION

With the US driving season behind us and gasoline entering its seasonally weakest quarter, we thought we would see more price weakness in the complex during October. Instead, prices have pushed higher, with crude oil providing much of the lift. However, over the last two weeks we have seen a noticeable price retracement, and another five cents of losses will practically wipe out all of October's gains. We suspect that this will eventually happen, and we likely will even get to the low-$1.90 range by late November. Our bearish view is predicated on the notion that US gasoline demand remains lethargic. This is in stark contrast to the distillate market which is far more buoyant in terms of offtake. Technical resistance is at $2.20, a level that was tested multiple times since June, but which has held on each occasion.



HEATING OIL NEARBY CONTINUATION

Similar to gasoline, heating oil prices have also retraced much of their October gains, and are now within striking distance of $2.20, former resistance and now support. We like heating oil on a relative basis far better than we do gasoline, in that the complex should benefit from a far rosier US distillate demand picture, where we note that offtake has been consistently showing either high single-digit or low double-digit gains for much of the last several months. In addition, heating oil should benefit from a seasonal pickup as we head into the fourth and first quarter of 2011, and we therefore would be looking to position ourselves on the long side after an appropriate pullback.



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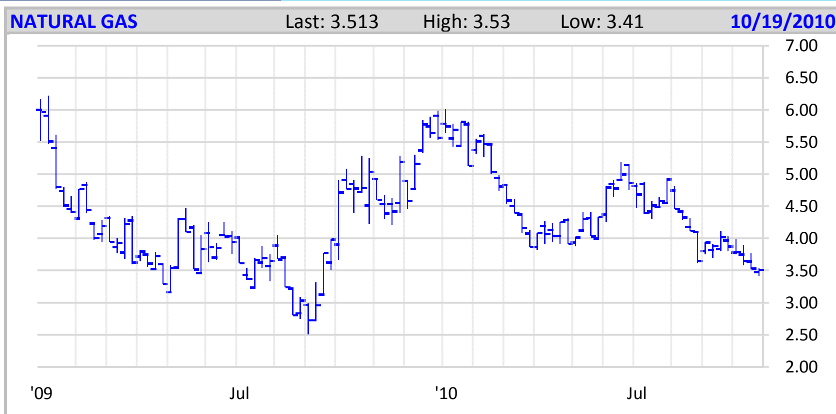
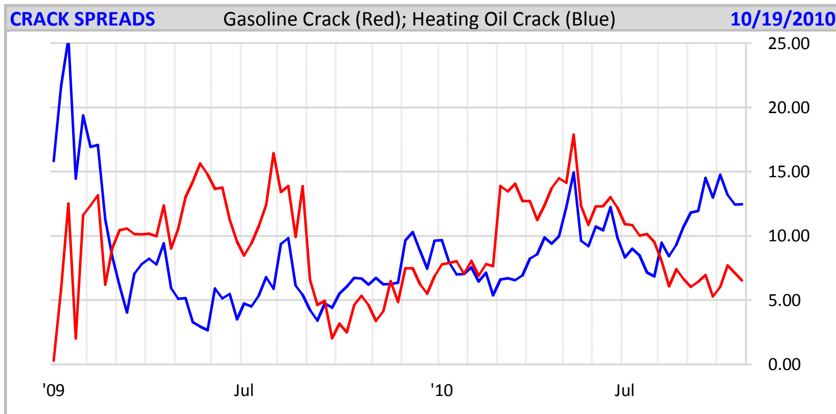
NATURAL GAS NEARBY CONTINUATION

We were quite surprised that natural gas prices broke below its August low of $3.62 this month, and our charts indicate that we could sink even further from here. The complex is simply saddled with too much inventory, while on the supply side, there are few signs that production is declining meaningfully. We suspect that instead of cutting back on output, producers are likely hedging their natural gas sales further down the curve, and therefore not feeling the pressure of cheaper spot prices. On the demand side, the weather has been quite mild in the US Northeast, thus postponing any weather-related push that could conceivably materialize. In addition, although some utilities have switched over to cheaper natural gas from coal, they have not done so in significant numbers to have much of an impact. Over the short term, we could see prices drift down to the $3 mark, while $4.20 is resistance.



CRACK SPREADS

Both sets of crack spreads have come in over the last few weeks, but because the gasoline spread has not done as much as heating oil, its relative decline has been much less. Given our own bias favoring heating oil vs. gasoline, we suspect that the heat crack should do better somewhat better going forward, and would look to put it on should it get to around 10.



EMISSSIONS

Emission prices have not done much in October, retracing slightly to currently trade around €15 basis the EUA price. The market may be in wait-and-see mode, as the EU decides whether or not to increase its emissions reduction target to 30% by 2020 compared to the current goal of 20%. The debate has been postponed for the time being, and nothing is expected imminently. As a result, we likely will see rather restrained trading activity through the balance of the year. In the meantime, the spread between EU permits and UN credits for 2010 (traded as a separate contract) increased to roughly $3 a metric ton, the widest gap since mid-August, as a large overhang of allowances have dampened demand. In addition, investors in emissions projects under the auspices of the UN are cashing in on credits to take their profits before year-end. UN offsets for December are now hovering around €13, down 4.5% so far on the month.

URANIUM

Uranium prices continue to surprise to the upside, and have tacked on another $3 a pound over the course of October. Spot demand has been fairly decent, as a nearly balanced market is making the market vulnerable to new build announcements or any short-term supply disruptions. Looking further out, uranium is increasingly dependent on production from Kazakhstan, which produced just over 14,000 tons of uranium last year, surpassing Canada as the world's largest producer. China figures importantly on the demand side, as it plans to increase its nuclear capacity six-fold by 2020, while India aims to construct at least 20-30 nuclear reactors over the same period. For the time being, it looks like we will be pushing somewhat higher, with a likely test and eventual break of the $50 mark a distinct possibility.

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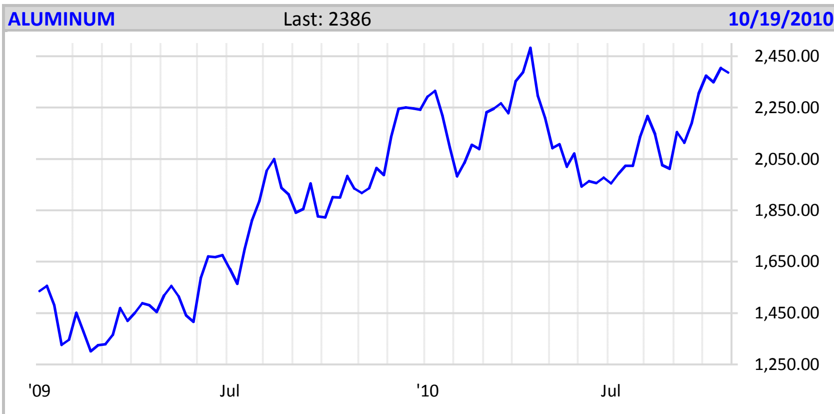
LME BASE METALS

3-MONTH LME COPPER

Copper has been rallying sharply this month, with prices hitting two-year highs in the process. Fundamentals remain quite bullish; supply/demand projections suggest another deficit is looming for next year, this occurring against a backdrop of already low stocks. Chinese imports remain strong, and although they are off by 10% year-over-year, this is not an alarming decrease. Scrap imports, on the other hand, are up roughly 10% over last year. Looking further out, although the Chinese government is trying to slow the economy down, we don't think they will materially impact copper consumption going into 2011. As we prepare this note, there is also talk that copper ETF are in the cards, and these could likely ring-fence more inventory, and conceivably provide more price support -- at least initially. We see $8800 as being a reasonable resistance target for 2010, while next year, we have a decent shot at getting to $9,800. Short-term, however, things could turn sloppy in the wake of the Fed decision and a likely short covering rally in the dollar.

3-MONTH LME ALUMINUM

Aluminum prices have been firm over the past several weeks, although the move higher is not as impressive as some of the other metals. The backwardation that set in over the summer has now fizzled, although the far forwards remain tight, telling us that additional cash and carry financing programs may not be as lucrative as they once were, best evidenced by the fact that LME inventories have been declining of late. Price-wise, given the large inventory overhang, we are not as upbeat on aluminum's prospects; stocks still have the potential to snuff out any sizable rally, especially if inventories leave warehouses amid persisting backwardations. Talk of possible ETF's are providing support, as are energy-induced Chinese production cutbacks, where the most notable announcement in this regard came out of Chalco, which said it would idle 400,000 tons of production. However, we do not see ETFs as being a panacea for the market, while on the Chinese side, it remains to be seen how long government directives to cut back on output remain in place. We reiterate our view that hedges placed between $2500-$2700 are good levels to lock in.



3-MONTH LME ZINC

Zinc has rallied strongly over the past month, as once again, supply-side pressures seem to be pushing prices higher. In this regard, China's third-largest zinc producer closed its smelter completely in late October in order to comply with a provincial government pollution investigation. In addition, there have been a number of other closures on account of power related directives put forth by the government, likely prompting investors to conclude that China will have to step up its imports. So far this year through to September, China's imported about 24% more zinc than it did last year, and in fact, zinc was the only metal among the six we follow that experienced this type of increase. As of last week, zinc was poised to test its 2010 peak of $2760, but its attempt to break out as fallen short as metals have been engulfed by the Fed-induced selloff as of this writing. In addition, the market is well-stocked from an inventory point of view, and is running at a comfortable surplus this year, estimated by the ILZSG to be around 166,000 tons (through August).

3-MONTH LME LEAD

Similar to zinc, lead has also been moving sharply higher, hitting 10 month highs in October on the back of continued reports of smelter closures in China. In this regard, lead smelters in the city of Lingbao closed this month, taking out about 200,000 tons of production in order to comply with government directives on curtailing power use. Although these directives have involved a number of other metals besides lead, we still don't know how long will these restraints remain in place. In the meantime, lead demand is showing signs of picking up in both China and the US. The Chinese have reported very strong car sales over the last two months, as government tax incentives have been reintroduced, while the US market has also seen a pickup, with retailers stocking up on lead acid batteries for the winter. In this regard, Battery Council International reports that August shipments were up some 24% versus year ago. However, the market is still saddled with excess inventory, with the ILZSG estimating the market to be in a 49,000 tons surplus through August.

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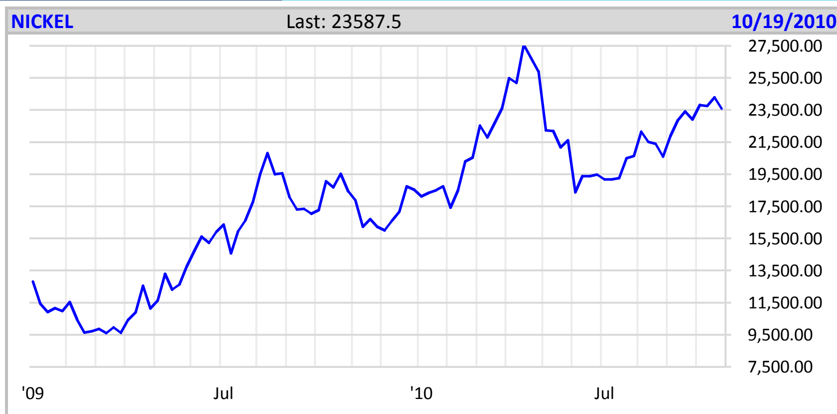
BASE METALS, STEEL, IRON ORE

3-MONTH LME NICKEL

Nickel has been a relative laggard in the LME space this past month, as it has yet to take out its early October high of $25,200. The complex is being weighed down by a rather poor fundamental outlook, as participants brace for a potentially sharp spike in production next year, with both Vale's strike-bound Canadian operations and Goro nickel units possibly hitting the market with large quantities. On the demand side, things are fairly quiet. Asian stainless steel demand was relatively subdued in the third quarter, while pig iron continues to compete with nickel itself. In addition, we are seeing a growing shift to stainless steel containing no nickel, as ferretic grades continue to take market share. We see nickel prices continuing to struggle for the balance of the year, and are unlikely to break meaningfully above $25,000. On the downside, we see support between $18,000-$19,000, likely reached in the next sustained correction.



3-MONTH LME TIN

Tin's performance has been stellar so far this year, with prices recently getting to around $27,000 a ton -- a record high. With only a handful of producers controlling the bulk of production, the market is quite vulnerable to supply shocks. This year's surprise came about when it became apparent that Indonesian production was badly lagging last year's levels because of heavy rains. PT Timah, the country's largest producer, is exporting 11% less tin then it did last year, while other smaller Indonesian producers are faring much worse. Because demand remains strong (expected to be up 15% year-on-year, this according to ITRI) we are seeing a noticeable decline in tin inventories, as well as a sizable 24,000-ton 2010 deficit expected by the Institute. LME stocks are now down to about 12,600 tons, equivalent to about two weeks of consumption. We see prices on track to hit $30,000 by the year-end, and if supply remains as unresponsive as it has been in 2010, another likely deficit could propel prices to somewhere between $40,000-$45,000 next year.

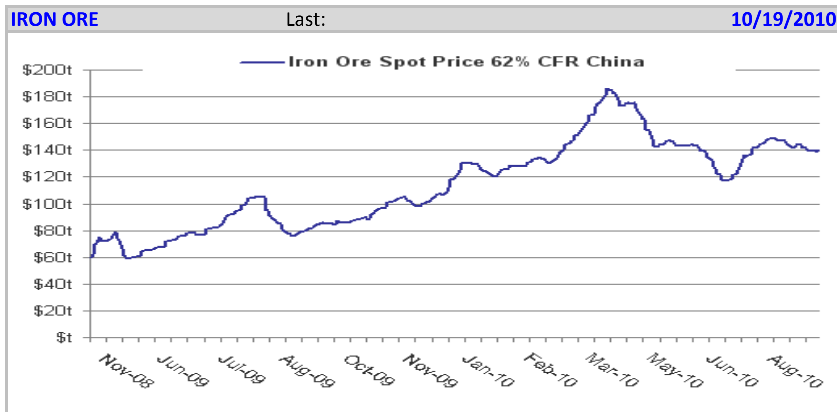
LME STEEL

LME billet prices have moved higher over the course of October mainly on account of regional shortages, but the overall market still has a soft tone to it best reflected by the fact that a number of producers, led by the Chinese, have cut back on production in the wake of softer demand. China's crude steel output in September, for example, dropped 7.1% from August levels, and industry officials say that the decline may now extend into the fourth quarter. On the demand side, ArcelorMittal said in its latest earnings release that it is seeing "muted demand" as margins are getting squeezed by rising raw material costs (iron ore) and falling end-user prices. We do not expect to see much change in prices over the next several months, and if anything, the bias will remain on the downside as markets are still oversupplied. In this regard, the World Steel Association estimates that global crude steel production is up almost 20% year on year despite Chinese cutbacks. Demand, on the other hand, is expected to slow to 5.3% next year from 13% in 2010.

IRON ORE

Iron ore's strength caught many by surprise towards the end of September, with spot prices rebounding by $14/ton to levels last seen in May. Chinese iron ore imports rose to a record level this month, and iron ore majors were running flat out to satisfy demand, which has remained extremely resilient despite various attempts by the Chinese government to phase out excess capacity and energy-intensive production. There has been some price moderation over the last week after the recent flurry, but we suspect that seasonal restocking, which typically takes place over the next month or so, will likely keep protracted declines from setting in. However, with end-market steel prices quite sluggish, as outlined by the recent earnings statements from a number of the world's largest producers, we should see iron ore prices start to level off going into the year end, and perhaps even ease by the first quarter of next year.

Contribution by Andrew Gardner in our Sydney office…



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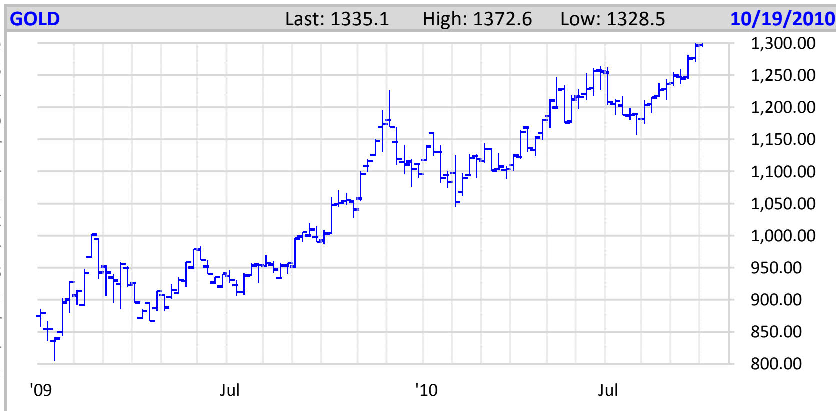
GOLD COMEX NEARBY CONTINUATION

Gold prices have been on a tear lately, and it is impossible to tell from the charts where the current run could conceivably end, although the $1385 level (the recent intraday high) does mark temporary resistance. Short-term, although the complex is still quite overbought, the metal seems to encounter good buying on any setbacks, particularly when the dollar starts to weaken, as it has been doing for much of October. In our last report, we wrote that the current rally could take us to $1420 by year-end, and although this target is still feasible, it may now get pushed back somewhat given what we think could be a rather sharp, but rather short-lived correction that is currently setting it. Looking further ahead, gold's appeal seems intact, as we are seeing very little sign of a retrenchment in Indian jewelry demand, while central banks are also stepping up their purchasing. However, there is some sluggishness noted in demand for exchange traded products, where net inflows have been declining for much of the last month.



SILVER NEARBY CONTINUATION

Silver got to the $25 mark in this latest run, but we have retraced slightly in line with the recent retreat seen in gold. Nevertheless, prices have done remarkably well all in all, and even exceeded our year-end target of $24 rather comfortably. For the time being, the market should shadow gold quite closely, and given our general view of a broad market retracement, we would be looking to pare some length here, and reenter at somewhat lower levels. Support seems to be around the $21.50 mark, while next logical resistance is at $30.

PLATINUM NEARBY CONTINUATION

We were quite friendly to platinum in our last write-up, and were expecting the metal to push somewhat higher, which it ultimately did for much of October. Nevertheless, prices are still below their 2010 high of $1750 and well below the $2300 record reached in 2008. Part of the reason behind platinum's relative sluggishness is due to the fact that gold seems to be the preferred choice among investors seeking an inflation or anti-dollar hedge. Furthermore, platinum is viewed as a manufacturing metal, and is therefore influenced by the business tone in the automobile market. Here, the rate of US sales has leveled off from the higher levels apparent earlier in the year, although emerging market auto demand is holding up better. We still would be looking to buy platinum on a sustained dip, as it does provide some of the "safe haven" attributes that gold does, with the important difference being that it is not as heavily overbought. Short-term, resistance is at $1750, and a breakout above that level could be quite bullish, as there is not much else showing on the charts until much higher levels.

PALLADIUM NEARBY CONTINUATION

Palladium has been on fire this past month, hitting a 10 year high. Moreover, with its 50% gain for the year, palladium has easily outpaced the rest of the precious metals. Although palladium's fortune, like that of platinum, is tied to the catalytic converter market, the fact that the metal is significantly cheaper than platinum gives it an entry advantage in some applications, particularly in selected emerging markets. In addition it's cheaper price may be another reason why investors are choosing it as a "hard-asset" hedge that can be bought through a number of popular ETP's. Technically, the complex decisively broke through key double-top resistance at $570 in October, and we suspect that this set off a number of buy programs that propelled prices higher. There is no apparent resistance now showing on the charts, although we have to suspect that the $700 mark is the next logical target, and one which could be hit by the first quarter of next year, after we get the current selloff behind us.

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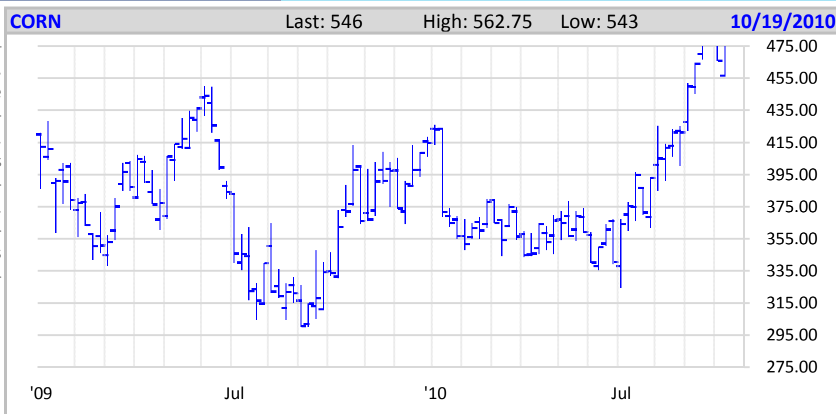
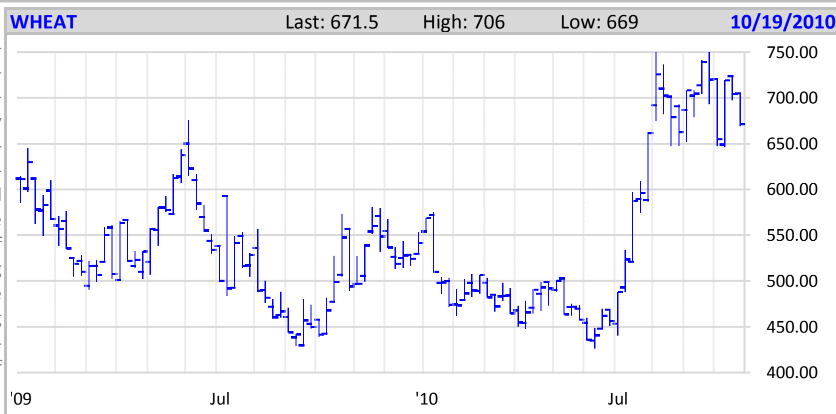
CORN NEARBY CONTINUATION

Corn prices have been moving impressively higher during much of October, and there is little sign that the complex is in much technical trouble, except for the fact that a large gap will likely be ultimately filled at the $5.22 mark basis the nearby contract left in the wake of several consecutive limit-up days. On the fundamental side, things remain quite bullish. On October 8, the USDA shocked the markets by lowering yield estimates on the 2010-2011 corn crop to 155.8 BPA, well below the 160 BPA expected. Ending stocks were also lowered to just over 900 mln bushels, creating an extremely tight 6.7% stock-to-ending use ratio. Next resistance on the charts is at the $6 mark, but we suspect that the markets will first see a modest pullback on currency-related factors before regrouping to eventually test that level, possibly by year-end



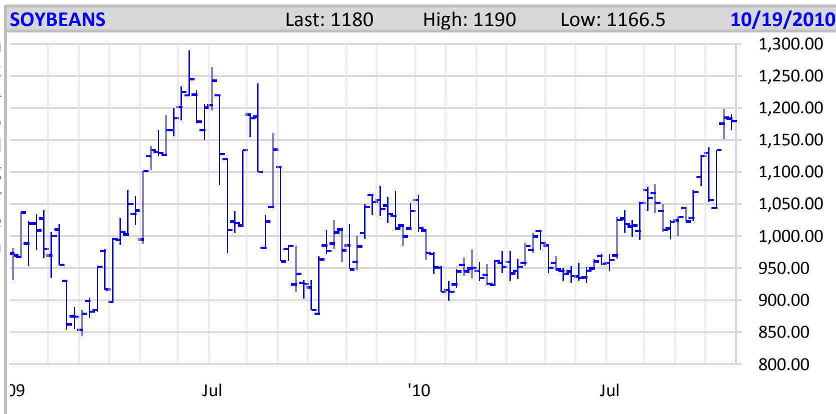
WHEAT NEARBY CONTINUATION

Wheat was unable to stage the same impressive gains as corn and soybeans in October despite the most recent USDA report reducing 2010-2011 ending stocks to 853 million bushels. This may be because the ending stock figure is still quite high, and constitutes the largest inventory holding of the past 20 years. Nevertheless, prices are holding up relatively well in light of the fact that tighter corn stocks could potentially increase demand for feed wheat. In addition, roughly a third of the hard red winter wheat belt is seeing significant moisture deficits, and we would need to see more rain in the months ahead to lower the chance of damage. Despite this, wheat still has the weakest fundamentals among the grains, and will likely take its cue from corn and soybeans, with the dollar also acting as an important influence. Technically, we see a trading range market in wheat between $6.50-$8.00, but given the complex's inability to build on previous gains, the short-term bias seems to be one of heading lower into the trading range.



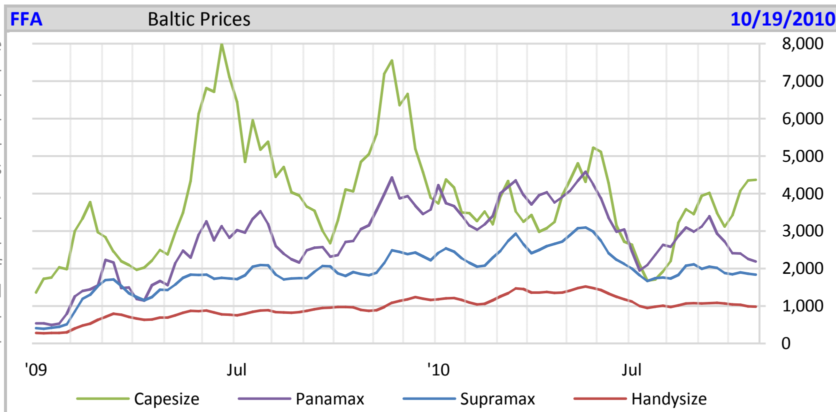
SOYBEANS NEARBY CONTINUATION

Soybeans also followed corn higher during October on the back of bullish USDA yield estimates, particularly after the agency projected a large 1.2 million bushel cut to acreage, coupled with a slight downward adjustment in soybean yields. The USDA report also saw exports rising by 35 million bushels, as China was singled out as a willing buyer that remained undeterred even at these lofty prices. The USDA has lowered ending stocks as well in its last report, suggesting that we could be in a tighter environment than what was previously envisaged. Charts suggest that we are now on track to hit the $13 mark, which was the June 2009 high. On the downside, there is a gap that needs to be filled around $11.40.



FFA

Ratios for the index on the Cape Panamax spread have risen over the course of the month from 1.68 to 2.33 after the end of the Chinese holidays at the start of the month. There had been trepidation that the improvements in the Cape market at the end of September would not follow through into October, but the cape market defied the odds and continued to rally on the back of strong iron ore demand. Panamax drifted as demand eased. The Supramax curve is flat going out to calendar 2011, with a slight decline priced into 2012 and 2013. The TD3 route has suffered from an overhang in supply in the Middle East and a dearth of cargoes, as has the TD5 market, with the index coming off 95 at the start of the month to circa 65 right now. Looking ahead, the dirty market still seems quite subdued, with tanker supply a concern and American demand not being replaced by Chinese bookings – Contribution by our London-based FFA desk.



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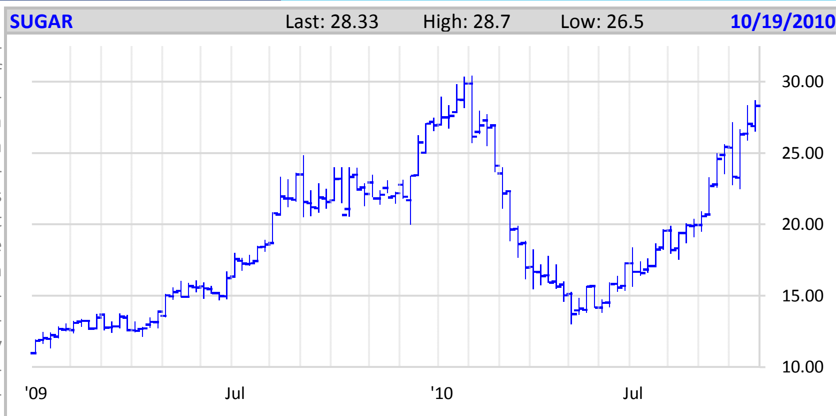
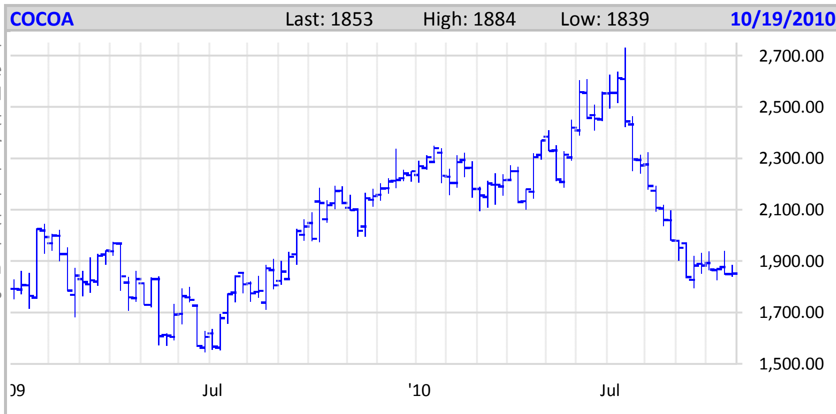
SUGAR NEARBY CONTINUATION

Sugar prices have put in a stunning U-shaped reversal ever since bottoming out in June, and we are now poised to retest the early 2010 highs of just over $.30 a pound. As is the case with many of the other agriculturals, the complex has been responding to very bullish fundamentals. In this regard, the world production surplus is now projected to come in at a balance or even at a deficit this year, with earlier projections of a 2.5 million ton surplus now scratched. Recent production cuts for this year's crop in Brazil and concern that La Niña may cause another draught next season have also underpinned the recent advance. In addition, there are reports of shipping delays from Brazilian ports and potential typhoon damage in China, while India is experiencing flood damage in a key producing region. For the moment, charts suggest that we likely will be retesting the early 2010 highs, at which point there could be a potentially bearish double top forming. However, if we take $.30 resistance out, sugar could potentially move much higher, since the breakout will likely attract more technical buying.



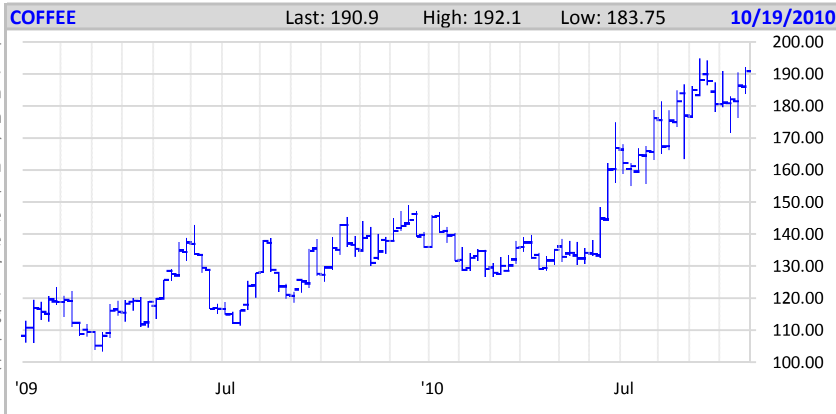
COCOA NEARBY CONTINUATION

Cocoa prices have been range-bound since mid September oscillating between $1800-$1950. Recent improved weather for drying the crop in the Ivory Coast and a low prevalence of black pod disease has alleviated supply related worries. However, the main harvest for the Ivory Coast just happens to coincide this year with national elections scheduled for October 31, making traders nervous over potential transportation difficulties if fighting is to break out. The country remains divided into a government controlled south and a rebel-held north following a civil conflict in 2002. On the demand side, the picture does not look that inspiring either. Cocoa grinding in the US rose 1.4% in the third quarter, down from a 12% jump seen in the second. European processing similarly fell by 4% in Q3.



COFFEE NEARBY CONTINUATION

Coffee prices experienced a wobble in late September and into early October, but prices have since regrouped and we are now at 13-year highs. The recent advance is attributable to growing concern about the crop in Brazil, now thought to come in at about 36 million bags, the lowest in some four years. Costa Rica also lowered its output estimates by 3.5% for the season that began this month. Markets are currently waiting for a government stockpiling plan from Vietnam, which may take a considerable amount of Robusta off the markets. Furthermore, the Vietnamese crop has its own issues, as excessive rains in the central highlands have hurt production. With coffee exchange stocks now approaching a 10-year low, the fundamentals certainly suggest that higher prices may lie ahead. However, technically, open interest has diverged significantly from rising prices over the last few weeks, indicating that the market is failing to attract fresh longs. We should see some toppiness around the $2 mark, but still retain a friendly bias to the market on pullbacks to around $1.90.



COTTON NEARBY CONTINUATION

Cotton is another commodity that is in record territory, but it is extremely overbought as of this writing, with an RSI off 88, one of the highest readings of this indicator that we have seen. The market has been rallying this month on strong Chinese buying, a weak dollar, strength in the grains complex, and its own constructive fundamentals. With respect to the latter, there are legitimate concerns about weather damage to Chinese crops and worries about damage to the West Texas crop, where hail-like conditions may have caused quality losses. In addition, the USDA said that cotton stockpiles in the US could drop by 8.5%, further aggravating a tight inventory situation. For the moment, it is hard to see where the current rally will top out, but given the extremely overbought conditions, we would not want to stick our neck out at these levels despite appealing fundamentals and would rather wait for an inevitable correction to better position ourselves.

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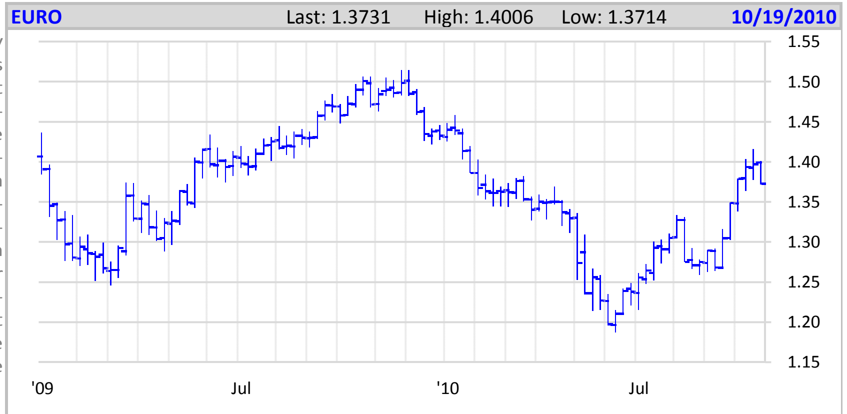
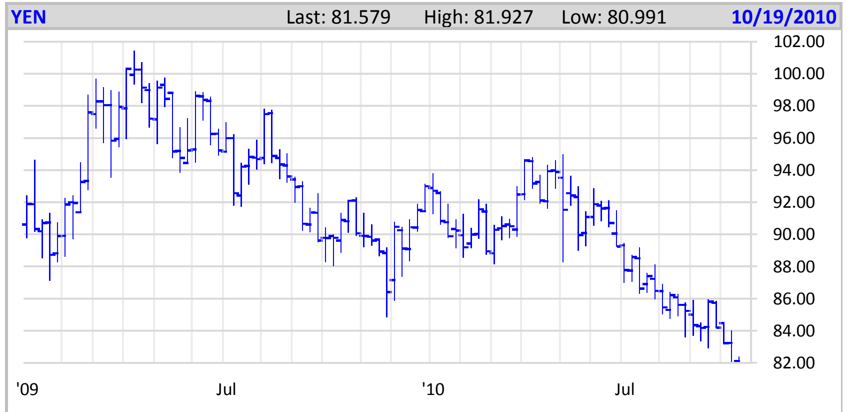
EURO

The Euro has continued to gain ground in October, soaring to an intraday high $1.4160 at one point in the month before retracing to $1.3734 this week on perceptions that the Fed's quantitative easing program may not be as "Euro-friendly" as first thought. Nevertheless, the currency still retains a certain appeal in that its spring-time credit crisis now seems to be under control, while more importantly, the region is growing despite austerity moves by a number of governments and an ECB that is intent on trimming its balance sheet. Growth in Germany has been particularly impressive, with unemployment falling, while consumer and business confidence are both hitting multi-year highs. Although we have taken a bullish stand on the Euro in recent commentary, we have to wonder whether exchange levels of $1.40 and higher will eventually start to impact the region's competitiveness. Nevertheless, as long as the Chinese yuan is not available to be easily purchased for those seeking refuge outside of the dollar, the Euro, (along with the Yen), should fill the role of an alternative default currency despite the short-term selloff we anticipate for it.



YEN

The Japanese yen has been soaring during October, hitting 15-year highs against the dollar, this despite $24 billion that was spent in a unilateral attempt by the government to stem its rise. In our last commentary, we wrote that the yen should hold above the 84 mark, since we reckoned that investors would be apprehensive about getting caught up in the crosshairs of yet another intervention. However, we were wrong on that count, as the markets called the government's bluff, and once again showed the futility of a single central bank attempting to prop up its currency. Although Japan has its own fiscal problems, with a debt to GDP ratio that exceeds all the G-20 countries, the yen is perceived to be relatively immune from selling pressures, as it benefits from a strong current account surplus, coupled with the fact that the debt is held mainly by local Japanese institutions. If and when the dollar decline resumes, we do see an eventual test of an 80 print on the yen.

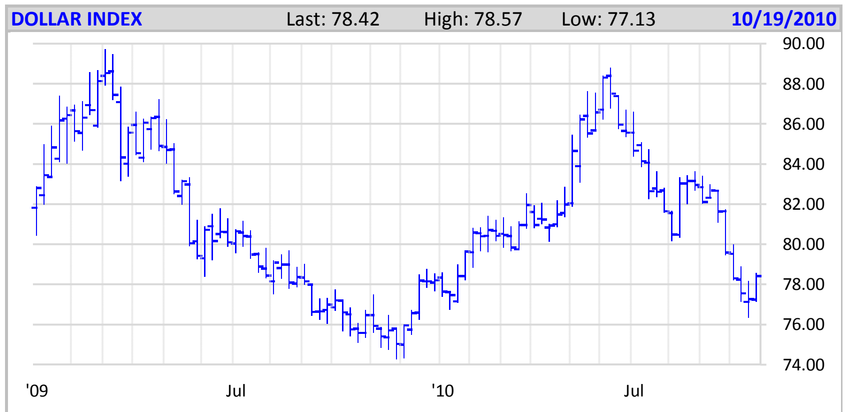


STERLING

Sterling has been fairly stable over the course of the month against the dollar, ending October pretty much unchanged, although it continues to sink against the euro, where it is now at six-month lows. For some reason, sterling is always associated with the dollar, and therefore tends to weaken whenever the greenback is under pressure. This is somewhat ironic, as the British government under Prime Minister David Cameron is towing a drastically different line than Washington is by instituting widespread cuts in the budget, and resisting further spending. Some payoffs may already be trickling in; as examples, third quarter GDP came in at +.8% this week, substantially ahead of estimates, while Standard & Poor's also revised its outlook on the UK's AAA rating, changing it to stable from negative. For the time being, and at least through the end of the year, we see a slightly higher trading range set in on sterling, roughly between $1.56-$1.60. More importantly, we would not be surprised to see more decoupling away from the dollar.

DOLLAR INDEX

The dollar index continued to lose ground over the course of October, hitting a 10 month low at one point, although it did briefly strengthen in the middle of the month on account of a short-lived "mini panic" caused by the Chinese rate hike. It also strengthened somewhat this week on account of the Fed's QEII move being perceived to be falling short of expectations. We expect a temporary dollar rally to last for a few more weeks as a short-covering bounce is long overdue. Longer term, however, the currency's prospects do not look that inspiring, with US deficits firmly entrenched, while the growth outlook is anemic at best. In last month's piece we wrote that support at 80 would likely give way, which it ultimately did, and we now see an eventual test of 74, last reached one year ago.



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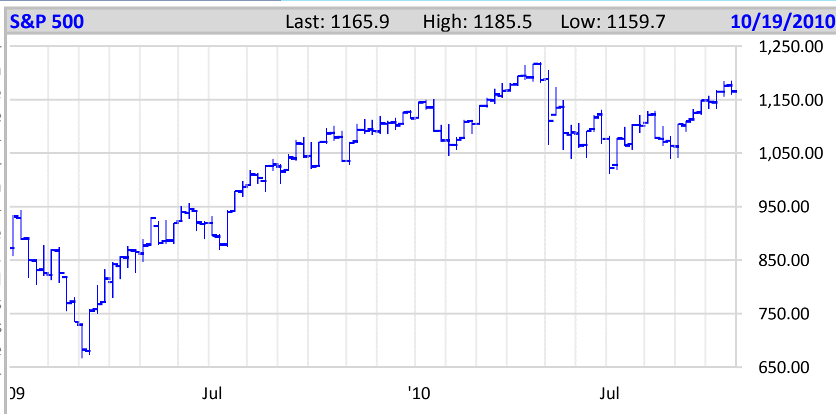
FINANCIALS

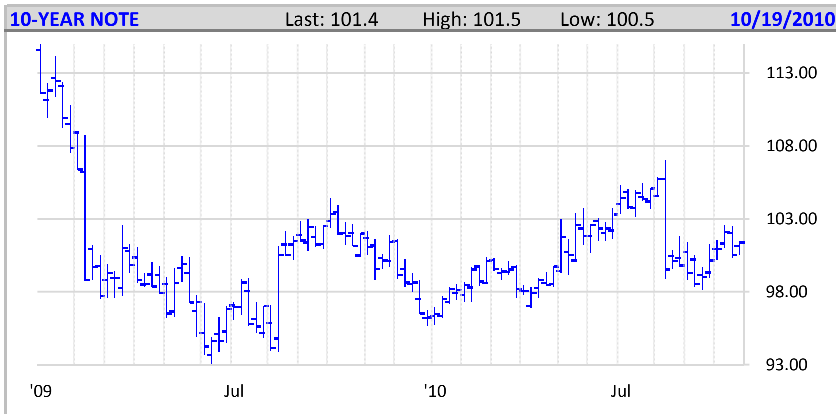
S&P 500

After rallying strongly in September in what constituted the S&P's strongest monthly advance in some 60 years, the market continued to gain ground in October, although not at the same heady pace. Stocks have been benefiting from the fact that third-quarter earnings have been quite strong. In this regard, of the total number of companies that have reported earnings thus far, 84% have beaten estimates. Two key developments will establish the short-term trend for stocks, and these will kick in as early as next week. In the first case, the congressional elections on November 2nd will be closely watched, as likely Republican control of the House and possibly the Senate could spark another sizable advance. However, we expect disappointment over the Fed announcement and ongoing concerns about the economy in general to override any gains that could be generated on the political front. Technically, our charts show next resistance at 1230, which if taken out, could lead to a sizable breakout heading into year-end. By the same token, it could be a formidable double-top as well.



10-YEAR NOTE

The price of the 10-year note has eased over the past month, as investors felt more comfortable leaving the safety of the treasury market, venturing instead into equities and commodities. In addition, when the Fed first announced its quantitative ease, treasuries rallied sharply, but with lingering questions about the size of the operation now somewhat different from what the market was initially expecting, ($500 billion- $1 trillion), we are seeing more price weakness set in. Right now, yields are around 2.714%, the highest they have been since September, but given the short-term sloppiness we are expecting to see in the equity and commodity markets over the next few weeks, we would not be surprised to see a measure of buying return, which conceivably result in a retest of the 2.5%-2.6%% level setting in by year-end.



Source for charts: Bloomberg

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