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**Optima Fund Management
A Mid-Year Perspective
July 10, 2009**

“Economic progress, in capitalist society, means turmoil.”

-Joseph A. Schumpeter

“Money alone sets all the world in motion”

- Publilius Syrus

**A volatile
macro-economic
environment
will reward
managers that
position
themselves for
the next wave.**

Velocity is a theme that permeates today’s financial markets. Reversals and cycles have always been with us, but the time periods in which they transpire has become steadily compressed and has reemphasized the importance of developing a robust macroeconomic viewpoint. Economic cycles and markets can reverse course violently in the blink of an eye, and as they do, it is key that managers and portfolios need to reflect the trend at hand, and prepare for the one that is ahead.

So where are we now? From a macroeconomic perspective, approximately where we expected.

Central to our overall view in our 2008 year-end letter was the following:

“Figures released in 2009 for the end of 2008 will indicate a steep contraction in real GDP, potentially larger than the current market consensus. The US is and will be in a recession. However, we do expect that the return of the economy to a respectable, if somewhat below potential, growth path will be visible by our mid-year letter.”

On Inflation:

“With inflation sure to be lulled by this slowdown (but not defeated, we fear), the FOMC will likely leave rates at ultra low levels. And although this has been an extraordinary crisis, it is difficult to picture a severe, multi-year downturn given such ultra-accommodative policy. Indeed, inflation-led pressure afterward is much more plausible, though that will depend on how deftly the Fed reverses course....”

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On Commodities:

“Supply has not adjusted to the demands that will be present when economies return to normal growth, much less any economic boom. The result will be higher prices and another violent price cycle.”

On the Dollar:

“The dollar has benefited from ‘safe haven’ status. It is a powerful statement that the dollar has rallied on foreign purchases despite short-term rates that are effectively zero in nominal terms and are negative after inflation. As the crisis abates, the dollar will lose some of that ‘safe haven’ premium, and weaken.”

Fundamental asset analysis, the stock-in-trade of hedge fund managers, was of little use in a market that did not differentiate the solvent from the bankrupt. That has now changed.

Unfortunately, as we expected, deficit spending *was* the driving factor mitigating further economic decline, with this spending effectively putting *“all the world in motion.”*

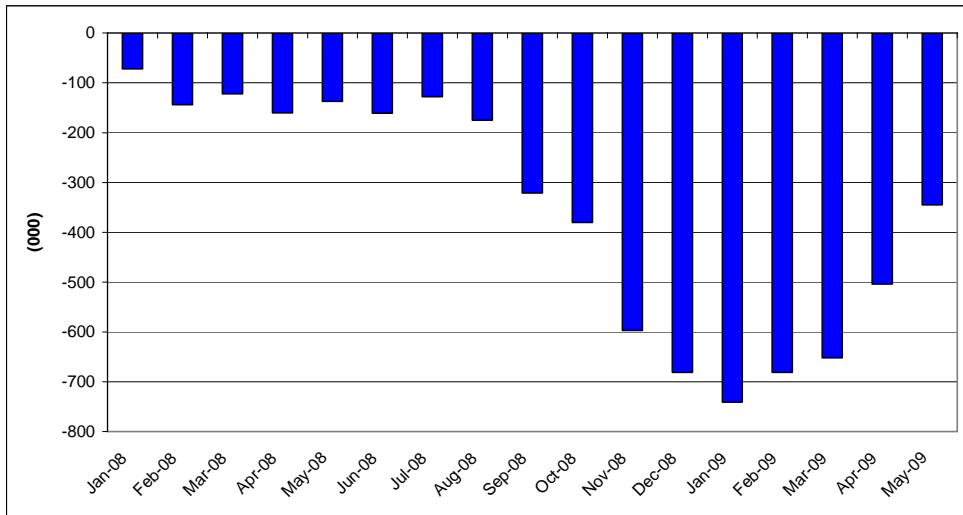
The depth of the global markets’ fall in the recent past resulted from a confluence of events, unfortunately some of which were controllable. The resultant decline in global stocks was not only needlessly deep, but also perhaps unnecessarily difficult for hedge fund market participants as fundamentals fell by the wayside and correlations spiked due to massive liquidity pressures. Performing companies sold off in line with potential bankruptcy candidates. Within the automobile sector GM and Ford both fell exactly the same amount (-72%) from August 29, 2008 to November 19, 2008. Yet Ford needed no government assistance while GM filed for bankruptcy on June 1, 2009. Fundamental asset analysis, the stock-in-trade of hedge fund managers, was of little use in a market that did not differentiate the solvent from the bankrupt.

There is truly nothing the markets hate more than uncertainty and with better clarity, much of the decline could have been avoided. For all the talk that we heard in the fourth quarter of 2008 regarding the need for stimulus, the reality is that government spending actually ***declined*** over the first quarter. Federal government spending, without defense spending, accounts for about 6.5% of GDP and actually fell -3.1% as programs were debated. Military spending is approximately 4.5% of GDP, and it dropped -6.7%. Even state and local government (a substantial 11% of total GDP) was a ***net drag*** on the economy, ***falling -2.2%***.

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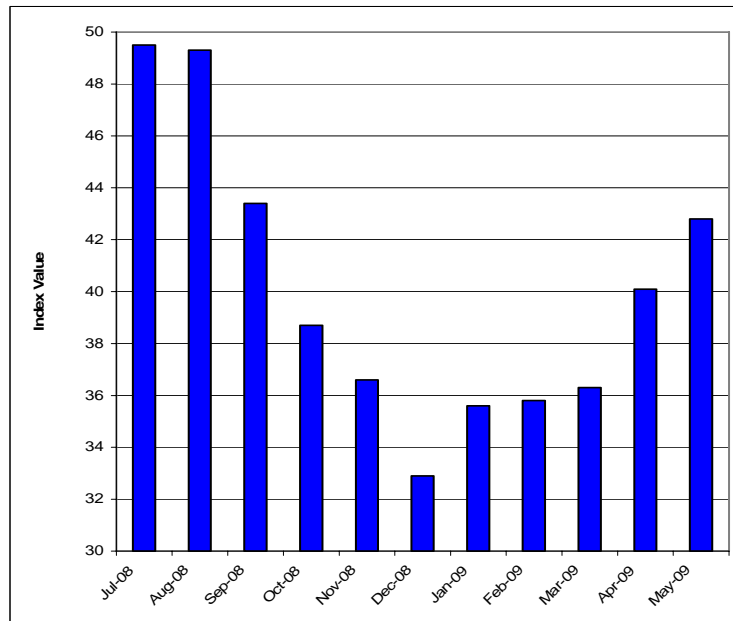
However, the signs of reversal we sought when we wrote our New Year's Perspective are now extant in many forms, as can be seen in the charts below. This includes the stabilization of indicators ranging from employment data to manufacturing orders and even consumer goods.

US Nonfarm Payroll Employees Total Monthly Net Change



Source: US Bureau of Labor Statistics

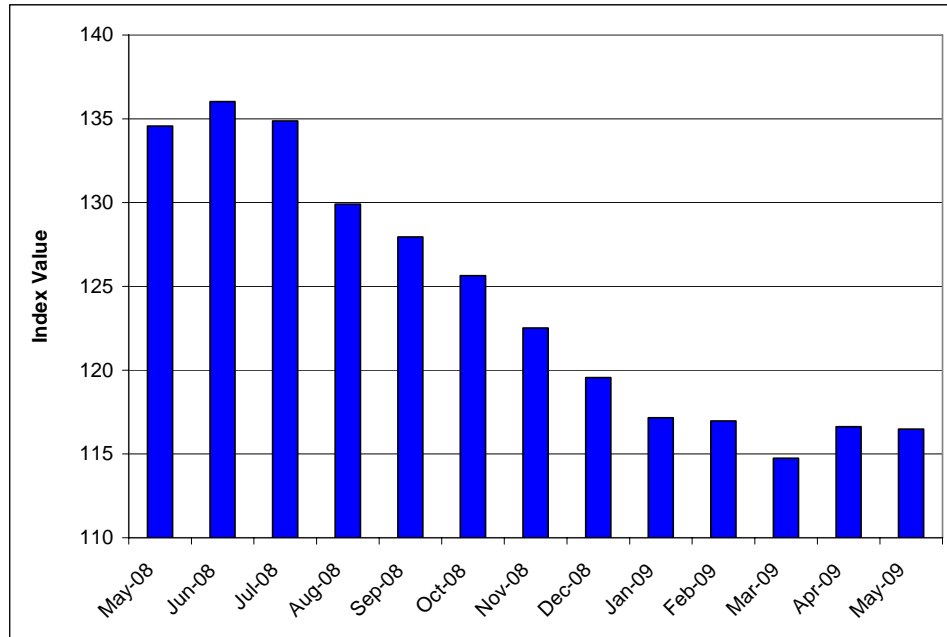
ISM Manufacturing Purchasing Managers Index



Source: Institute for Supply Management

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Manufacturers' New Orders for Consumer Goods & Materials



Source: US Census Bureau

And looking forward?

Strong declines in GDP have traditionally been followed by strong increases in GDP. We expect selected data to surprise the market on the upside.

Traditionally, the sharper the GDP decline, the stronger the reversal. In the mid-1970s and early 1980s episodes as well as in the 1957-58 downturn, severe declines in real GDP (-3% or so peak-to-trough) were followed by strong rebounds when real growth averaged +4.5 to 6.5% in the first two years of the subsequent expansions. In contrast, the very mild 1990-91 and 2001 recessions were followed by sluggish recoveries, just under +3% average real growth. This tendency to rebound symmetrically is not a hard rule, especially given today's highly unusual conditions. Typical post-war cycles were driven by monetary policy that was tightened to choke off inflation and eased to stimulate growth with the Fed taking a proactive, rather than reactive, role. The present recession was by no means created by a desire of the Fed to slow economic activity or choke off inflation. Indeed the Fed's dramatic easing measures are a reaction to years of an overly lax credit environment that proved unsustainable.

While we may see a spectacular quarter or two, perhaps the first or second quarter of 2010, these results are likely to be aided by temporal factors such as inventory cycle nuances, timing of government stimuli and easier

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year-over-year comparisons. These tailwinds will only obfuscate the longer run track for an expansion that is still likely to be distinctly subpar, and we will see sharp reversals of growth sentiment. Furthermore, a recovery is by no means assured to be sustainable, as the outlook is, in the words of the IMF's Chief Economist John Lipskey, "*unusually uncertain.*"

Deficit financing as a driver of economic growth is not sustainable. Asset values can only stay detached from economic realities for a finite period of time. The realization of slower growth prospects will eventually weigh on asset prices in the longer run.

There is much relief that the financial system did not completely crash and rightly so. After the nadir the markets rallied strongly. Still, asset values can only stay detached from economic realities for a finite period of time. We would look for a continuation of the current positive market for financial assets, supported by reported growth spurts in the economy. The strength of these deficit-financed growth phases will eventually fade, and we look for asset prices to give back some gains at that point. While the debate over what letter fits the recovery ('V', 'U', or 'W' shape?) continues, we look for a pattern more akin to a lightning bolt, with the growth phases offset by sharp reversals. The excesses of a decade will not be undone in two weak quarters.

What is the Basis for this Assessment?

Recessions end when a country either increases domestic demand (the traditional European and American solution) or exports its way out (the traditional Asian and Emerging Markets solution).

All short-run stimuli have a long-run cost.

For domestic demand the long-run rate of growth is determined by the potential growth, which is determined by the growth in the labor force and increases in productivity; basically, it is how many people are working multiplied by how much they produce per person. Potential GDP growth has fallen from above +3.5% at the tail end of the Baby Boom to about +2.5% now. There are also expanding impediments to growth in the future. The late American economist Milton Friedman popularized a classic phrase that certainly applies: "*There is no such thing as a free lunch.*" Ultimately, all short-run stimuli have a long-run cost. The deficit-funded fiscal stimulus package and soaring non-emergency spending must be repaid. In our last piece, we wrote about the program (including guarantees) reaching the size of US GDP. Since then, it has, if anything, expanded to the point where it becomes more difficult to put in any kind of context. As seen in the Historical Bear Markets table below, the monetary and fiscal stimulus dwarfs any past effort, from post-war rebuilding to the "New Deal."

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Combined monetary and fiscal stimulus, at 29.9% of GDP, dwarf any past efforts ...

Historical Bear Markets							
---- Stimulus as % of GDP ----							
Peak	Trough	Length (Months)	Decline in Real GDP	Monetary	Fiscal	Combined	
Aug-29	Mar-33	43	27.0%	3.4%	4.9%	8.3%	
May-37	Jun-38	13	3.4%	0.0%	2.2%	2.2%	
Nov-48	Oct-49	11	1.7%	-2.2%	5.5%	3.3%	
Jul-53	May-54	10	2.7%	0.0%	-1.4%	-1.4%	
Aug-57	Apr-58	8	3.2%	0.0%	3.2%	3.2%	
Apr-60	Feb-61	10	1.0%	0.7%	1.0%	1.7%	
Dec-69	Nov-70	11	0.2%	0.3%	2.4%	2.7%	
Nov-73	Mar-75	16	3.1%	0.9%	3.1%	4.0%	
Jan-80	Jul-80	6	2.2%	0.4%	1.1%	1.5%	
Jul-81	Nov-82	16	2.6%	0.3%	3.5%	2.8%	
Jul-90	Mar-91	8	1.3%	1.0%	1.8%	2.8%	
Mar-01	Nov-01	8	0.2%	1.3%	5.9%	7.2%	
Dec-07		15	1.8%	18%*	11.9%*	29.9%*	

Source: Bloomberg, Pertrac, Optima Analysis

... at the cost of doubling the national debt

To highlight the sheer size of this activity, by some estimates, deficit borrowing over the next eight years will be greater than all deficit spending since George Washington combined. There is no doubt that this stimulus will impact, in waves, the economic data, and that it will show growth, sometimes spectacular growth, in the near term. How much of that is “borrowed” from future growth will be the key in the longer run.

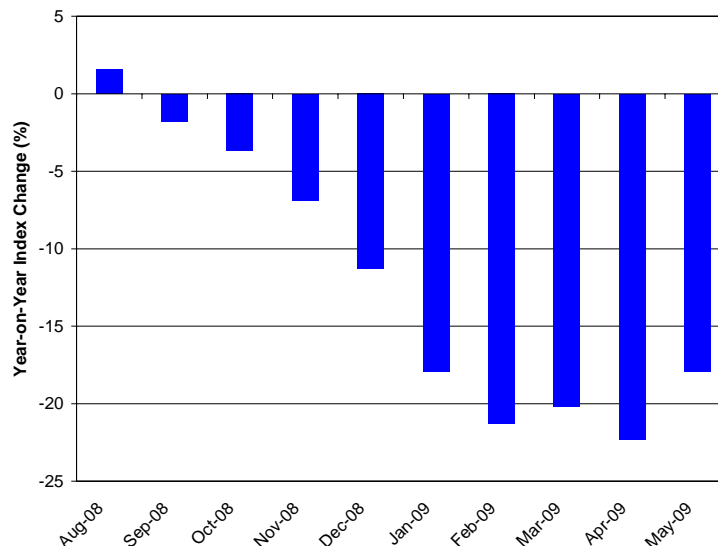
Short-run consumer deleveraging, along with longer acting domestic policy changes, will be impediments to a domestic demand-led rebound...

Other structural impediments to domestic growth, beyond the inevitable rise in taxes and bond issuance, are also occurring. Growth will be limited by increased financial regulation, by “cap-and-trade” environmental standards and potentially by an expanding role of government in industrial policy. While politics and philosophy will cause individual observers to argue whether these limits are beneficial or appropriate, in our apolitical view, they are likely to cause impediments to growth, at least in the intermediate term. All of these structural impediments will occur on top of a more cyclical reduction in spending as global consumers delever.

Internationally, the picture is simply not clear enough for us to expect an export-based recovery. Germany, the industrial heart of Europe, is seeing a sharp decline in industrial production as shown below, although it too is bottoming.

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German Industrial Production Year-over-Year Change



Source: German Economy Ministry

**... while
Germany will
prevent Europe
from leading an
export-driven US
recovery.**

Germany will likely see a -6% contraction in GDP this year alone. However, this is based on backward-looking data and our concern is what may lie on the horizon. German banks were claiming €400 billion in toxic assets as recently as February, yet that number is now reaching €800 billion and rising. Combined with bad loans to Eastern Europe the number could reach €1 trillion, approximately the amount of the entire outstanding German Federal Government debt. Southern European banks do not have the Eastern European default risk but have their own substantial real estate overhang. The US will not export its way out of the recession on the back of European demand.

Having said that, trade has undeniably provided significant support during the recession and should do so again one last time this quarter. After adding about +0.5% to real GDP in the second quarter of 2009, net exports will likely become a modest negative as recovery begins earlier in the US than in many key trading partners.

The dollar, which has been falling significantly recently, will likely remain weak given fiscal and monetary policy. This should help shore up exports, but the full effects will not be manifested for at least several quarters.

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Fiscal stimulus by China and Japan, which dwarfs US efforts (relative to GDP) in 2009, will also help US exports.

April is indicative as both imports and exports continued to decline, causing the trade deficit to deteriorate a bit in both nominal and real terms. Exports fell about -\$3 billion to -\$121 billion, a two-year low. Imports fell -\$2 billion in April to -\$150 billion, the lowest level in nearly five years. The oil import bill edged up \$300 million despite a double-digit percentage increase in the average price paid. Crude spot prices have been running much higher, so the oil bill is sure to increase going forward. Overall, trade will help but is an unlikely driver of long-term growth beyond some near-quarter anomalies.

What about China?

China remains a bright spot for global growth, and may be the first major nation to see an increase in growth rate.

China and countries with related growth are undeniable, much-needed bright spots on the global economic horizon. However, caution is recommended as China's economic environment holds its fair share of challenges. Exports declined by -22.6% year-over-year in April, building upon March's already sobering -17.1%. This demand weakness is disconcerting given it stems from China's major trading partners. Moreover, China's imports also slowed, dropping -23% year-over-year, reflecting China's vulnerability to the global deceleration. That said, China is not quite subject to the same cycle as the rest of the world given it retrenched more than two years ago. The government has and is capitalizing on the fact that China has a policy-driven economy and thus strong, proactive fiscal and monetary measures are employed to bolster economic activity, neutralizing some of the weakness beyond China's borders. Record loan growth during the first quarter of 2009 has been crucial, primarily for government-backed infrastructure projects, representing multiples of prior year levels. Fixed asset investment increased +33.9% year-over-year in April, improving upon +30.3% in March; the recovery in real estate has been an important ingredient in this progression. The government's commitment to economic strength combined with the recovery in financial investments is not to be underestimated. It nonetheless remains to be seen whether a domestic demand-driven recovery is firmly underway. Data does suggest that China is the first major economy to stabilize (e.g. the Purchasing Manager Index (PMI) bottomed first and recovered first) and will be poised to lead world growth when trade rejuvenates.

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And other Emerging Market Countries?

While variable by region, we remain positive on opportunities in emerging markets.

We generally hold a positive outlook for global emerging markets. A number of the largest constituent economies potentially bottomed and have shown improving trends in PMI, new orders and industrial production—to name a few metrics. We acknowledge that this strength simultaneously underlines a markedly unique challenge: recovering in a climate gasping for reinvigorated trade. While in previous times of stress, emerging economies had the luxury of exporting goods to growing developed economies, this is not the case today. Time will heal this wound. Meanwhile, China’s massive stimulus measures and the positive impact that India’s general election had in unclogging the pipeline for much-needed economic reform may help stabilize the foundation in emerging markets. This is because China and India represent approximately 35% of the world’s population and global economic growth potential.

Admittedly, not all emerging markets experienced such positives or command positions enabling them to advance with greater ease. Latin American economies are improving, but unlike China and India’s positive growth expectations, their economic challenges will be more prolonged. Policy rate cuts, low external debt levels and modest inflation are but a few counteracting positives. Eastern Europe is managing difficult access to foreign credit, meaningful current account deficits and a notable growth dependency on non-domestic debt (refinancing and foreign exchange risk). In short, emerging markets are not without their concerns. But given the relatively and generally healthier balance sheets (national and corporate), experience of past emerging markets crises and faster, more effective reactions to the downturn (Central Bank, coordinated global and IMF efforts) especially with respect to bolstering domestic activity, a potential pathway back to healthy, economic growth is provided for.

What is the Outlook for Inflation?

One thinks of the words of former President Truman: “*Give me a one-handed economist! All my economists say, ‘On the one hand this...on the other hand...’*”. The outlook divide is as wide as we have ever seen on a key issue. To continue in the theme, “on the one hand,” Nobel Prize winner Paul Krugmann states “*Yes, we have a long-run budget problem, and we need to start laying the groundwork for a long-run solution. But when it comes to inflation, the only thing we have to fear is inflation fear*”.

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Excessive money typically leads inflation by 3.5 years. The Fed has time to act. Short-run deflationary experiences will transition to longer run inflation concerns.

itself.” The low inflation or even disinflation camp points to flat consumer prices, a record high jobless rate and the fact that capacity utilization is at record lows. “On the other hand,” the inflation camp points to global monetary expansion and hence to gold and oil prices soaring, global inflation-linked note prices discounting higher inflation and the rise in longer term interest rates as all being indicators that inflation is looming. As investors, we can only be “one-handed” economists and we are siding with the “inflation risk is very real” camp, but it is a more distant concern. Once the recovery is clearly underway, the Fed will have to begin removing the potentially massive amount of fiscal and monetary stimulus fast enough to avoid monetary inflation, but also slow enough for the credit markets, which are still addicted to easy money, to continue to function. With the amount of fiscal drag (in the form of higher taxes at the city, state and Federal levels) sure to grow, the Federal Reserve will be under intense political pressure from Congress and the Administration to maintain ‘easy money.’ There is never a good time to remove stimuli from an economy and the risk is that they start the process too late, rather than too early. That said, it is important to note the typical lag between increased monetary creation and inflation tends to be around 3.5 years. We are confident that inflation will stay low until well after our year-end letter and well beyond, but the long-run danger is to the upside, not deflation.

...and the Outlook for Employment?

We do not see the feared “jobless recovery.” Employers will hire at a moderate rate.

In this recession, firms have been reducing workers at the fastest rate since World War II as total employment has fallen by more than -5.7 million jobs since December 2007. Productivity growth usually drops in recessions as firms engage in labor-hoarding practices and hold on to employees in hopes of an upturn. However, in this recession, firms have sharply and deeply cut their workforces, leading to an increase in non-farm business productivity of almost 2% over the past four quarters. Given that the recession appears to be winding down, we expect that positive real growth will emerge toward the end of this year and that payrolls will begin picking up at or just after the start of 2010.

In short, rather than a “jobless recovery” with payroll losses extending well past the end of the recession, as so many are predicting (e.g.. what happened after 2001-03) we will likely experience a “jobs-light” recovery, in line with a return to growth, but at a moderate pace.

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Where are we on the Dollar?

It is hard to be very positive on the US dollar in the short run. The “safe haven” boost it enjoyed is being removed as expectations of financial Armageddon leave the currency. It should naturally drift lower to true value. Also weighing on the dollar is the desire on the part of investors globally, and Central Banks in specific, to rebalance their risk, although this is a long-run issue. A rise in global activity will also support the currency of both final goods exporting countries in Asia, and those countries who are most active exporters of commodities.

Europe has yet to fully deal with its banking crisis, and low growth makes the euro more vulnerable than the yen.

Against the euro, the probability of an extensive dollar decline is less clear. The United States has very publicly discussed problems in the financial system, perhaps to the edge of inciting panic. In Europe, there are certainly more issues to come forward, and, as the US is more likely to resume growth before the eurozone, we do look for relative dollar strength there, and a distinct rise is possible.

In Japan, the yen has truly been the victim of global flows. Driven by carry traders and central banks looking to devalue their way out of recession, the yen was driven up by nearly 30%, only to reverse back around -20%. Overall, however, as the global economy strengthens, and the relative strength of the Japanese banking system is recognized, the yen will continue to be attractive to investors.

...and how about Commodities?

The initial surge in commodity prices was driven primarily by recovery expectations which are a better source of buying pressure than dollar declines or a pickup in global inflation. This is reassuring, but is the rally only based on recent economic upticks? To us, the answer is “no.” As we wrote in our New Year’s piece, the law of supply and demand will apply to commodities. The entry of emerging markets is not a cyclical rise or fall in demand, but a systemic one. That said, we also feel the rise we were looking for at year-end has run much of its course. Industrial metals such as zinc, copper and nickel are up 30% over year-end prices and grain prices are also up over year-end levels. Commodity prices will, at best, consolidate at this higher level, before rising again should the inflationary pressures we fear become more evident.

We look for consolidation in commodity prices, transitioning to continued rises after the markets look beyond shorter term deflationary pressures.

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What is the Bigger Picture? What are the Resultant Issues in US Financial Markets?

The seismic wave emanating from the crash of the credit markets, as well as the effects of the “solutions” to the problem will echo within the markets for years. Yet those of us who have experienced the “Crash of 1987”, the “Bond Collapse of 1994”, the events of 2001 and so on and so forth have become somewhat jaded when hearing prognosticators say “*this will cause a permanent change.*”

“*Regulate the culprits behind the Crash*” 2008? No 1987, Time Magazine.

“I am shocked at the size of the bets they made and the leverage,” said (the House Panel’s chairman). “It cries out for regulation, and we will ensure it never can happen again” 2008? No, August 1998.

Some Long-run Changes are, However, More Probable and We Discuss a Few Below.

More investors re-discover “hard assets”, and move out of more structured “paper.”

1. *A Move Toward Hard Assets:* Permanent changes are very rare, and very unlikely. But there may be some longer term changes in investor behavior as a result of this collapse. Perhaps most prominent could be a shift from long-only paper assets to hard assets. As “real assets”, equities should not be impacted by inflation; however, this supposed protection from inflation is based entirely on a company’s ability to pass through price changes, keeping real income unaffected. It also assumes the market will discount earnings consistently. For long-only investors looking to equities as a hedge for inflation, these are heroic assumptions, at least in the short or medium term.

We look for a systemic shift in how portfolios are constructed and risks are evaluated.

Ultimately, the mountains of collateralized sub-prime loans were only paper, stacked on top of the paper loans themselves, stacked on an obligation to pay that was, again, only viewed as a piece of paper by the borrower, and often the mortgage originator. Investments in so called “hard assets”, such as land, commodities or even gold, were viewed as old fashioned and dead money. Every traditional, uncorrelated, “anchor to windward” asset from US municipal bonds to commodities and even hedge funds had to be “improved” by leveraged notes or derivatives to make them more attractive to the point where they no longer performed the expected role in the portfolio, and became so “wrapped” in paper as to become another risk asset. A portfolio of hedge funds, which is traditionally by its very name a

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more conservative investment, was no longer sufficient; some felt that it needed to be leveraged four times to properly extract all the manager skill. Yet for many investors the quiet diversification and stability of asset prices that hard assets offered through this crisis will be rediscovered, and we may see a shift in portfolios, out of paper to holding everything from gold to farmland and commodities.

Government regulation will expand, and risk financial innovation that, despite recent failures, has been a key to the success of the US financial markets.

2. Government Regulation vs. Financial Innovation: Another large shift will be seen in the role of government in regulation and government support. This regulation is certainly coming, and runs the risk of being a short-term benefit as well as a longer term detriment. The American view on any given innovative financial product has always been that, as long as it was not fraudulent and the deal occurs between knowledgeable investors, it is basically *legal* until proven otherwise. In Continental Europe and other markets the basic structure is that it is *illegal* until it is approved. While it may not feel this way now, financial innovation has been a key driver of growth in the United States. From greater access to capital to the ability to spread risk, innovation has been the key to the success of the US financial markets. Regulations that stymie that innovation rarely succeed (money can go anywhere in the world) and usually only serve to slow or impede the process.

Unclear application of “too big to fail” introduces risk, uncertainty and a hindrance to growth.

3. “Too Big to Fail”: As the doctrine that certain organizations are “too big to fail” spreads across sectors, so too will the notion that all these organizations carry an implicit government guarantee. Thus, they can borrow funds cheaper than competitors but take the same or even greater risk. This distortion is very real and becoming more common. While Citibank has been a repeat member of the “protected club,” it now appears that this club includes insurance companies, the finance divisions of domestic auto manufactures and others. This introduces risk, uncertainty and a hindrance to growth. The risk comes from the fact that management at those institutions may have, at worst, substantial benefit from taking risk and, at best, an unclear objective. In money-loosening years, the role of the Federal National Mortgage Association (Fannie Mae) was described by management as being that of a ‘social institution’ to encourage home ownership. In money-making years, and when handing out bonuses, they were considered a ‘successful private sector financial institution.’ The uncertainty of this fuzzy “too big to fail” status is also serious. The membership of the ‘protected club’ is kept secret, so market participants do not know the effective credit status of the organizations to whom they are lending.

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We know General Motors Acceptance Corp is “protected.” Is GE Finance? American Honda Finance Corp? Producing a “formal list” will be an impossible political fight, but the “whisper list” extant today is generating uncertainty in the already shaky credit markets. Clarity is as important as regulation in these times, and the resultant of misallocation capital will hinder growth.

Internationally, What are the Bigger Issues?

The dollar’s role as the main reserve currency of the world is under pressure as never before. A lack of a credible alternative will protect it.

Undoubtedly, the largest issue globally is the role of the dollar as a reserve currency especially as it relates to our relationship with China and its currency. It was long held that US government debt did not matter, as the government basically sold debt to its citizens so the country as a whole stayed in equilibrium. “A loan from your child does not make the family richer or poorer” was the phrase in the textbooks. However, foreign ownership of US bonds is approaching 30%, more than double the level of twenty years ago, and 47% of all foreign-owned debt is held by China or Japan. The loans are by no means only from our children, but increasingly from outside the United States. As long as foreign central banks hold their reserves in dollars, there is a crucially important set of forced buyers for our debt.

Increasing debt decreases the role we can play in global trade.

But the trend is not favorable. Over the last three years, Russia, Italy, Sweden and the United Arab Emirates formally reduced allocations by their respective central banks to dollar holdings. Furthermore, Brazil, Russia, and more worryingly, China are increasingly moving toward reducing their dollar-related trade exposure. This not only reduces demand for the bonds the United States is increasingly selling, but also reduces our ability to exert influence on our trade partners. China transparently manipulates its currency to favor its exporters at the expense of the rest of the world, but there is not much the United States can do about it. As a candidate for President, then-Senator Clinton rhetorically asked, “*Why can't we get tough on China?*” Clinton’s correct reply: “*How do you get tough on your banker?*” As a Secretary of State needing to fund record deficits, she has had to change course, reduced to imploring China to keep buying our bonds: “*So by continuing to support American Treasury instruments, the Chinese are recognizing our interconnection. We are truly going to rise or fall together ... We are in the same boat and, thankfully, we are rowing in the same direction.*” It is not difficult to disagree that China is, when it comes to trade, “rowing in the same boat.”

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A shift away from the dollar is by no means inevitable, as the euro has yet to gain the credibility needed to supplant the dollar, and no Asian currency and bond market has emerged as a surrogate. Despite calls from various countries, we do not see the dollar's demise as the world's central reserve currency.

How are Managers Reacting to the New Environment?

Hedge fund managers are reacting and finding both long and short opportunities.

We are seeing managers react and change to a degree consistent with the historic volatility we are experiencing. In the equity space many managers are looking at the world differently, and changing their short book criteria. Old shorts often consisted of companies that needed to access the credit markets. However, solvency is no longer as relevant when the government is pumping unlimited liquidity into the system. Other managers have been adding higher beta names to the long book while using liquid and less volatile index hedges on the short side, as lower quality equities have moved up so quickly. One prominent emerging markets manager decided to avoid the risk of stocks in the hedge book "melting up" by using options, rather than individual names, to protect the investments.

Shorts are rotating away from companies with solvency risk.

Credit markets are proving attractive, as risk in individual credits is still often overestimated

The opportunities created by the havoc in the credit markets are still being captured by investors. One prominent manager has been increasing his distressed debt exposure as default rates increase, and continues to add to the portfolio's high quality residential mortgage long exposure. This same manager is also long the debt of finance companies that have government support (TARP, TALF and TLGP) as he believes their likelihood of default is low, and that the depth of government support is not fully discounted in the yield.

Individual countries also have challenges, and these too provide opportunity.

The private sector credit market problem is being transferred to governments and some may be unable to carry the load. One fund is taking the position that some countries' debt will fall in value as a result, most notably, Ireland. Ireland has five million people and has more than doubled its GDP in about ten years, driven, for the most part, by three engines: 1) a local real estate boom that rivals our own; 2) providing tax shelters to eager foreign corporations, with "investments" similarly doubling in an even shorter time span; and 3) thinly capitalized banks accumulating assets on a global scale, with the highest "toxic" appetite of all the EU countries, with higher risk loans amounting to between 3 and 8 times Irish GDP by different measures. The manager sees Irish credit

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The echoes of the unintended consequences from recent actions will create opportunities for hedge funds for years to come.

spreads rising as their three engines shut down simultaneously, with the economic contraction potentially in the 15-30% range.

Adam Smith, the influential Scottish philosopher, wrote about the “*unintended consequences of intended action*” as a benefit for society. The *intended* consequences of massive short-term stimulus are clear, and will drive the period ahead. It is the management of the *unintended* consequences that will shape the more distant years beyond. One certainty, however, is that the dislocations in the world asset markets will offer hedge fund investors unprecedented opportunities.

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