

Good morning,

I know this will sound bizarre, but sometimes I believe in conspiracy theories ... When I saw the 30-yr Treasury rally on Friday (on Thursday, it closed at 95-30 or a yield of 4.498% and on Friday, it did so at 98-17 or a yield of 4.337%) on the base of no clear explanation and when I read the news on Secretary Geithner visiting China this week (see: "Geithner Visits China With Reassurances on Deficit, Treasuries": <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ah39LPw9pePU>), I thought profit taking in non-US markets was to be seen... And it was. The TSX, which had intraday reached 10,493 with oil flirting in the \$66s/bl, closed -0.21% at 10,370.07. Geithner is visiting his creditors. You and I, as long as we hold USD, are unsecured creditors. China's central bank, as long as it holds US Treasuries is also an unsecured creditor. But, for obvious reasons, Geithner visits China, instead of you or me...

How can China strengthen its position? Could China ask for "security", more collateral? They could, if they bought mortgage-backed securities themselves. This sounds politically impossible. Yet, a few 2,058 years ago, the crossing of the Rubicon also sounded impossible. In 1775, republicanism was unheard of. In 2009, the "Chrysler solution" to transfer wealth out of bondholders had also been unheard of. **But, this is no longer a financial crisis. This is a political crisis. Solutions will be political.** It's about a struggle for power between debtors and creditors. **Solutions will not be about wealth creation. They will be about wealth transfer. There will be winners and losers.**

What difference would it make if China, for instance, exchanged Treasuries in its Central Bank for Agency debt? The USD would not be offered. The USD would immediately strengthen. Think of this: Right now, when Treasuries are sold, liquidity leaves the US and the USD is sold too, which is what drives the USD down and oil or, to a much lesser extent gold, up. But if China would exchange its Treasuries holdings for Agency debt (mortgages), the positive effect on mortgages would still be there without USD being sold. Why would China not do this? China would lose the difference in value between the Treasury-supported Agency debt and Treasuries themselves. But... **how much more does China stand to lose otherwise? What if the rise in yields goes exponential?**

Are we going to see China buying Agency debt? NO (Big No!). But an intermediate solution is surely being thought out. And therefore, the week ends with yields down, as explained by my conspiracy theory.

Continuing with conspiracy theories, it also worries me of late to read in newspapers about the necessity of having the Bank of Canada weaken the Canadian dollar. I cannot afford to think that the recent media campaign on this issue is mere coincidence. As we discussed before (<http://sibileau.com/martin/2009/05/26/a-short-description-of-the-process/>), Canada will only profit from the current situation as long as two conditions are confirmed: 1) The Canadian dollar remains within a **free and flexible exchange regime** (and this includes no further regulation on Canadian banks) and 2) The government does not distort relative prices by running into deficits to save unprofitable businesses (i.e. Automotive). Condition no. 2 is under a lot of pressure these days. Let's be clear: A few billions into GM's black hole is utmost idiocy, it is theft. No taxpayer had a say into this and yet, in the years to come, we will be taxed to finance an unprofitable business. However, as long as the experiment is contained within a few billions, the bigger picture will not change. Will the Conservatives experiment be contained? Let's all hope that the price of crude keeps increasing, for that will shut the mouth of the Left.

On the fundamental front, since Thursday (when crude oil inventory data was released) it seems crude not only rises driven by the USD-hedge trade, but because of its short supply vs. demand. Crude oil inventories were expected to have fallen by about 150k. Instead, they fell by 5,413k, while refinery utilization increased by a 3.3%. Is this not inflationary?

Another trend I continue to believe in is the rally in corporate credit. Again, both oil and credit don't just rally as yields rise... they rally BECAUSE yields rise, BECAUSE Treasuries are sold and liquidity is allocated. The rally in credit is the typical step in the inflationary process where capital is misallocated, bringing worse consequences in the long term. In this case, these consequences will be reflected in higher than historical defaults and recoveries.