

Tincho's letter

Toronto, Monday, May 11th, 2009

Good morning,

It's May and the sailing season started in Lake Ontario. With the Thursdays regattas on the "Agent 86" (and our team working hard to reach 1st place this year), I will not be able to write Tincho's letter on Fridays, until October. Thus, we start the week where we left it, i.e. last Thursday. Please, accept my apologies again.

It's been a very interesting week, and it will get more interesting. From talks to friends from different backgrounds and reading reports from different sources over the weekend, I have seen a very broad spectrum of opinions on the markets' future. This may indicate that when we closed last week, we left significant milestones behind: a) The stress tests point to approx. an additional \$75BN of capital needs for the US banking sector (capital that doesn't seem to have trouble being raised); b) The Fed is done 1/3 of its Treasuries purchase program and 10-yr and 30-yr yields closed at 4.267% and 3.284% respectively c) LIBOR has compressed beyond anyone's imagination (3-mo at 0.94%); d) Credit (Inv. Grade and High Yield) and equities seem to conclusively tell us that there are no wider wises or lower lows, **for now at least** (On Friday, they closed at 144bps, 82 $\frac{1}{8}$ respectively, with the S&P500 at 929.23 (+2.41%)). Oil closed at \$58.47 (Nymex). The change in Nonfarm Payrolls was -539k (vs. 600k exp.)

Let me then start with my chain of thoughts, in a Socratic manner. Where is the difference of opinions stemming from? Some find it hard to believe that with recent updates on default expectations (Global and US speculative-grade rate at 8.3% and 9.2% respectively in April, according to Moody's), the bond issuance we are seeing and which we discussed on Thursday, can find investors. **I think this view is based on fundamentals, but when did fundamentals matter in an illiquid world anyway? Am I saying that fundamentals WILL matter when liquidity is back? Should we first define liquidity? To me, liquidity is just the ability to trade assets, which is not necessarily associated with a stable currency.** (Perhaps, a comparison of the Brazilian and Argentine markets is a good example of this. Brazil's capital markets have always been way bigger and more dynamic than Argentina's, but Brazil has comfortably lived with inflation, while in Argentina, inflation is always repudiated). **Some analysts believe that once liquidity further increases, systemic risk will give way to idiosyncratic (=individual, specific) risk and as defaults show up, investors will retreat. I don't necessarily share this view. I believe that the fact that high yield issuance finds investors at high coupons is a SYSTEMIC problem, and the respective future defaults will ALSO BE OF SYSTEMIC nature.** Why? Because I see these issuances as one more component of the inflationist process that is very well underway. Which brings the question: **Why will these issuers default? Perhaps the answer lies in thinking that inflation is not a problem because prices rise, but because not all prices rise at the same rate/speed (=non neutrality of money) and the differences in this rate is not driven by differences in industry productivities, but by the arbitrariness of governments. Default should visit those issuers whose markets will not be favored by inflation = issuers whose products' prices will not be able to rise as fast as their costs. Inflation = Malinvestments and Malinvestments = Defaults** (<http://en.wikipedia.org/wiki/Malinvestment>)

Thus, some analysts are still bearish (long Treasuries), while others think the rally can continue (short Treasuries), especially in credit. Michael Cloherty (Bank of America/ Merrill Lynch) wrote an interesting note in *Global rate focus*, on May 7th. Mr. Cloherty immediately connects the situation we face with the **foreign exchange** market, but without explaining the reason for this connection. This is an extremely relevant connection and certainly **not** new at all. (As far as I know, M. Jacques Rueff was the first one to exhaustively elaborate on this issue, in **March 1933** (refer [Part One](http://mises.org/books/monetarysin.pdf) of "The Monetary Sin of the West": <http://mises.org/books/monetarysin.pdf>). See...it doesn't matter if you can't be the most beautiful, as long as your competitors are uglier than you. For the Fed, it doesn't matter if the USD is backed by \$300bn of debt from an insolvent Treasury or \$1.25trn in distressed mortgages, as long as other currencies do not represent a threat. How can the Fed ensure other currencies don't represent a threat? **How can the Fed ensure that investors in USD assets will not be compelled to move their capital out of the US?** With a trade called *foreign exchange swap*. With the decision to buy \$300bn of Treasuries, the Fed also closed a \$285bn currency swap agreement with European central banks, to ensure there would be enough Euros or Pounds for everyone wanting to say "thanks, but no thanks" to the Fed's issuance of USD. However, there is a currency that **was not** in the latest swaps with the Fed. Yes, you guessed it right! **The Canadian dollar!** Therefore, the Canadian dollar **provides an alternative to reallocate capital back to commodities (=away from the system), in a liquid manner (=via stock market) and AWAY from the USD.** Besides the Bank of Canada did some sterilization last week (C\$424MM and C\$65MM in one-day lending operations). Unseen in these markets! This is all **very bullish for Canadian risk assets.** But, how much longer can Canada avoid being dragged into the inflationist model? **The answer to this lies not in the Economics textbooks, but on Parliament Hill...**

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