Tincho's letter

Toronto, Thursday, May 21st, 2009

Good morning,

Under a common textbook approach, if someone would have told me that the 2pm release of the April FOMC minutes yesterday made reference to continued weakness and that the Fed had considered boosting its purchases of assets to secure a stronger economic recovery, I would have expected the following chain reaction: 1) Sell-off in equities, 2) rally in Treasuries, 3) higher USD due to deleveraging and repatriation (given how correlated international markets are = other equity indices would have also sold off too) and 4) lower commodities (energy in particular). That's the norm, that's what you get under a typical "walrasian" method (León Walras, 1834-1910, pioneered the method to analyze the markets under the ideal of a general equilibrium, where the markets' excess demands (or cash flows, in our case) must equal zero).
No, the markets did not behave that way. The S&P500 did sell after 3pm, closing at 903.47 (-0.51%), Treasuries did rally, **but** the USD weakened and crude oil reached $62/bl and gold broke through the $930's/oz. **Does this make sense to you?** To me, it does. I hear the message. It is a clear message: Given the ongoing political risk in the USA, if money is going to stay in that country, it will be allocated to those assets that get a clear bid by the Fed: Treasuries, Mortgages, Agency debt. Otherwise, money is going to leave the country. The market does not want to take private sector risk. The USA is not a country to "accumulate" stock of capital. The USA is not capitalist = it does not seek to grow by building on its stock of capital. I thought I would show the chart below, from yesterday. It is vox populi that the Canadian dollar follows the price of crude oil. It is therefore thought that the relation weaker USD → higher crude oil → higher Canadian dollar holds. Yesterday, after the release of oil inventories data at 10:30 am, the Canadian dollar did not react. You may say it traded higher before the data release, but that is speculation. What is not speculation is the reaction to the FOMC minutes after 2pm… Perhaps we actually have two independent relationships? Weaker USD → higher crude oil and riskier US → higher Canadian dollar…

May 20, 2009 Intraday: USD/CAD (orange) vs. on-the-run 30-yr Treasury

Source: Bloomberg Analysis: Tincho's letter

Yesterday, the Fed bought approx. $10.8BN of Treasuries and GSE debentures through the two purchases in the 4-10- yr range: $3.079BN of the 4yr to 6yr (GSE) maturities and $7.7BN of the 7yr – 10yr (UST). The 2yr-10yr curve steepened 1 bp. As we have discussed at length here, I don't believe the Fed will just stop at the $300bn Treasuries purchase program. And I think by now, the market is starting to share this view. **Should credit continue to rally then? Can we see a sell off in Treasuries and wider credit spreads, as the Fed steps up? What would prevent this scenario? An exit plan?**

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