

# Tincho's letter

Toronto, Wednesday, May 27<sup>th</sup>, 2009

Good morning,

Yesterday's action clearly seems to give merit to our main thesis so far: That the sell off in Treasuries leaves investors with liquidity that needs to be put to use. With the 2-yr \$40BN auction that took place yesterday, the yield curve steepened 5.5bps to 258.9bps. The auction went well, with \$117.5BN in bids for the issue and foreign official (i.e. central banks) bidders were not alone. However, the S&P500 closed at 910.33 (+2.63%), while crude and the Canadian dollar ended at \$62.32 (+1.1%) and 1.1170 CAD/USD respectively. The charts to the right show how synchronized this trend is becoming. There are other forces at play here of course. The so called convexity hedging in mortgages is present and this market is suffering from the increasing long-term yields. The 30-yr swap spread compressed further and now is at -27.02bps. But this analysis is beyond the scope of our letter. Finally, the Fed bought \$1.55BN in TIPS yesterday.

In summary, investors are leaving sovereign risk in search of risk assets, to avoid the cost of the debasement of the USD. This is a perfectly rational behavior. It would be irrational not to leave Treasury bay and sail forth.

Our thesis, first proposed in March is now news. What is the next rumor to buy then? How can we get ahead of the curve? Repeat with me: "Emerging markets". But we have to be VERY careful here. Not all emerging markets are made equal. To begin with, something like the famous BRIC (Brazil, Russia, India and China) is to me the most heterogeneous lot you can ever find and makes a horrible EMPIRICIST, INDUCTIVE investment thesis (Repeat with me: "Induction is sterile"). And yet, induction is the worst cancer Western Thought has had since the end of World War II. Without further ado, in upcoming letters we will seek to propose a new investment thesis for Emerging markets. It will be DEDUCTIVE. It will be TESTABLE. For instance, I believe that consistent with the flight from the USD, the market may want to adopt a beta neutral approach to emerging markets investing.

What do I mean by this? Well, if you think of beta as the relationship between (covariance) the emerging markets' risk and US sovereign risk, to be neutral, you may want to invest in a long/short pair trade: Long emerging markets that will benefit from this situation and short emerging markets that will suffer (eventually) from this situation. What criteria may make the difference here? I am still working on this. But remembering the '70s and '80s, I can suggest these: Foreign exchange regime (flexible = good, pegged/fixed = bad), Private debt/GDP, Public debt/Tax revenue, (Imports + Exports)/GDP (Higher = better), Commodities exporters vs. importers (exporter = good, importers = not so good).

May 26<sup>th</sup> 2009 Intraday: 30-yr active Treasury vs. S&P500



May 26<sup>th</sup> 2009 Intraday: 30-yr active Treasury vs. Crude oil



May 26<sup>th</sup> 2009 Intraday: 30-yr active Treasury vs. Canadian dollar



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