

Tincho's letter

Toronto, Thursday, May 28th, 2009

Good morning,

The Fed is being challenged. Let's mince no words here. The Fed yesterday bought a \$6BN in May/12 to Aug/13 securities. By now, the Fed has reached \$131BN of the scheduled \$300BN. At close, all yields except at the front end were touching new highs and the curve continued to steepen. The S&P 500 closed at 893.06 (-1.90%), while credit was not so hurt: The CDX IG12 was only a bit wider at 147, even after GM bondholders rejected the Treasury's plan to wipe their rights, leaving little options but an expected bankruptcy.

As we have endlessly discussed, I always believed in two things: 1) The Fed will have to size up its Treasury purchase program; 2) This is a spiraling situation (spiraling of what? Of everything! Remember Newton's First Law of Motion: Every body persists in its state of being at rest or of moving uniformly straight forward, **except insofar as it is compelled to change its state by force impressed** (Philosophiæ Naturalis Principia Mathematica, 1687). Any object today, as soon as it is subject to an external force, spirals. **The Fed impresses a force on Treasuries and their yield spirals, which triggered the spiral sale in mortgages, which triggers an increase in mortgage rates, which triggers a decrease in mortgage refinancing, which triggers a slow down in the housing market recovery, which triggers a sale of equities that need to reprice activity recovery assumptions, which triggers stop losses, which triggers FURTHER liquidity requirements, which triggers repatriation of USD....which requires a bigger intervention of the Fed, fuelling the spiral again...** This is nothing new for us, since in this letter, we have been boringly and relentlessly repeating that the further the Fed will buy, the further the market will sell. We even called this Thesis No. 1! All of a sudden, this is news this week everywhere. Yet, there are analysts recommending long Treasury positions, and amazed at reality. Amazed at oil increasing to \$63.14/barrel! The yield curve steepened big time yesterday, with a lot of buying in the front-end by foreign central banks...Some friends asked me how this all affects us Canadians. When foreign central banks put these dubious US Treasury notes in the asset side of their balance sheets, they do so by increasing their liabilities (their own notes, the foreign country's respective currency) at the same time. These irresponsible central banks are importing inflation to their respective countries. They are debasing the medium of exchange used by their countries' citizens, the same citizens that on top of this fraud have to pay their taxes. This is the ruin of global savings. I know I sound bitter here, but the situation does warrant it. Now, back to the question: How is Canada affected? Positively. Why? By default! What do I mean? I mean that because Canada does NOT buy into this, does not hoard US notes, we....for now at least, keep saving ourselves and our kids' future.

I attach below two charts. On the left side, we can see how once the 30-yr Treasury price fell to \$95, the Canadian dollar lost vs. the USD. What happened? This price or support level was critical and when it was broken, it triggered a sell-off and a liquidity call: USD had to be purchased. Thus, the Canadian dollar did not respond to fundamentals here. On the right side, we can see that equities (S&P500 index) closely followed Treasuries. What was the link? The housing market. Two factors defined that link: The sell off in mortgages, which started a few days ago, and the news yesterday that the Mortgage Bankers Association's weekly mortgage applications survey had fallen 14.2%.

May 29, 2009 Intraday: 30-yr Treasury vs. Canadian Dollar



May 29, 2009 Intraday: 30-yr Treasury vs. S&P 500 Index



Source: Bloomberg

Analysis: Tincho's Letter

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