

Tincho's letter

Toronto, Tuesday, May 5th, 2009

Good morning,

Yesterday was a busy day. The S&P500 broke through the 900 pts (closed at 907pts) on reiteration of positive fundamentals coming from the real estate sector, in spite of numerous rumors on banks capital needs. Remember that the stress test results are released this Thursday. Month over month, Pending Home Sales were at 3.2% (up, from 2.1%), while Construction Spending was 0.3% (up from -0.9%, expected was -1.6%). **Where do we go from here?**

As I said before, I believe the market needs some indication of an exit strategy by the Fed. One way would be to say the announced Treasuries purchase plan is enough. No further purchases are needed. This was in the statement of the Federal Open Market Committee last week. In any Macroeconomics textbook, this is called a "once-and-for-all" monetary expansion. But for this to work, the market must believe in the intentions of the Fed. **Do you think the market believes?** I think the market is looking for fundamentals, economic data, not to disappoint. Because they **would signal that there will be a demand for the increasing supply of money.** Thus, mainstream economics teaches us that the price level would remain stable. **Therefore, if you agree with this approach, risk assets should keep being bid, as long as fundamentals don't disappoint.** Please, note that I am not saying that the market wants **good** fundamentals. I am saying the market wants fundamentals **not to disappoint.** I hope I am clear here.

Another way would be to find an alternative buyer of US govt. assets. I always thought that creditor countries (Asia) could assist on this front. If the Fed can't protect the value of the USD, it is as useful to weaken other currencies against it. Yesterday, the Association of Southeast Asian Nations, together with Japan, China and South Korea announced they will start a **\$120 billion foreign-currency reserve pool** by year-end. Japan will contribute \$38.4 bn to the pool, plus \$60 bn of yen-denominated swap facilities separately. With a reserve fund, other central banks bid for assets the Fed is going to monetize. In this fashion, a further steepening of the benchmark curve is delayed, but not avoided. This pool is composed of bilateral currency swaps. I guess you have to smile here. A reserve fund for 13 nations that together have more than \$3.6 trillions of currency reserves? This initiative by itself is bullish of the USD and USD denominated assets (because it weakens the yen), but the markets did not operate on it yesterday. **In conclusion**, we are seeing central banks anticipating problems. The Fed is keeping the status quo, and creditor countries are cooperating with the supply of USD assets, helped by non-disappointing fundamentals. **Will the stress tests results disappoint?** Disappointment is a function of expectations, and expectations are low on this issue. However, the market remains vigilant. The chart below (source: Bloomberg) shows how Treasuries (30-yr active, in white) reacted on the different news yesterday. Stocks (orange) keep their trend, as in 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).



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