

Good morning,

This is a relevant week in the story of the crisis. I therefore think there is merit in taking a break to examine where we are at:

## **-Treasuries, agency debt and mortgages:**

As I wrote yesterday, I think a big milestone in this story will be the repayment of TARP funds by banks. Approximately \$68BN of the \$200BN used to capitalize banks will be repaid. The big problem the US government has is the lack of an exit strategy. As an exit strategy can only be reliable if it comes from the fiscal side (lower spending), the US Treasury could take advantage of the circumstance to use TARP repayment proceeds to cancel debt. It would send an encouraging signal. BUT, at the same time, if they don't send that signal, they will be sending another one, the wrong one. There is no midpoint here. If Mr. Geithner is not part of the answer, he can only be part of the problem. There really is no margin here. As for agency debt or mortgages, my view is that their respective pricing dynamics will be increasingly dominated by the scenarios laid out in Treasuryland. We saw a big sell off yesterday in the long end, pressing mortgages and swap spreads. The impact on main street is visible: Mortgage applications fell once again (although less than last week), by 7.2%.

On top of this, as we wrote on Monday (<http://sibileau.com/martin/2009/06/08>), politics is playing an increasingly relevant role. Yesterday, a substantial part of the action was driven by Russia's concern on their US Treasury holdings and their public interest in reducing them. There will be a meeting next week in Yekaterinburg, Russia, where officials from Brazil, India, Russia and China will discuss the role of the USD as reserve currency. In the meantime, Bloomberg reported that Russia and Brazil announced plans to buy \$20BN of bonds from the IMF, to diversify their currency reserves. On April 16<sup>th</sup> (<http://sibileau.com/martin/2009/04/16>), we quoted Jacques Rueff's article on Special Drawing Rights, published on June 6<sup>th</sup>, 1969. It's worth revisiting it. Let me add this: **If the IMF starts issuing bonds to back reserves of creditor countries, they will be only acting as the "clearinghouse" for currency swaps between central banks. Why would the world need a clearinghouse? To better coordinate a smooth debasement of currencies. Like any other clearinghouse, the IMF would monitor "margins". If they keep them low enough, the leverage party can go on...Not forever, but for a longer time. WHO WOULD BE THE BIG LOSER IF THE INITIATIVE TAKES OFF? GOLD!**

## **-Corporate credit:**

Given the lack of space, please let's go back to yesterday's letter, where I posted a chart with the balance sheets of the main stakeholders in the TARP mechanism: <http://sibileau.com/martin/2009/06/10>. As you can see, from step 1 to 4, the net position of the Non-financial sector resulted in an increase in their holdings of Treasuries and bank bonds and a decrease in cash. It was so, because when the crisis started, the flight to safety drove this sector to buy Treasuries, which were supplied to capitalize banks. And after the March 18<sup>th</sup> announcement by the Fed, when the refinancing window opened, Treasuries became expensive vs. corporate debt (and still are), which triggered profit taking. Given the dim prospect for Treasuries, the NEXT STEP may well be the net exchange of Treasuries for bank bonds. Even more so, if more institutions announce the intention to repay TARP funds. Ok, I know what you're going to ask next...Who will buy then the Treasuries? My guess is governments, central banks. It must be so, to globalize, to diversify losses. This stands in sharp contrast with the aforementioned meeting of the BRIC nations to coordinate a smooth sell off of their Treasury holdings. What is the bottom line here? Credit can still rally, as the described reallocation out of govt. debt into financials takes place.

## **-Equities:**

We're repeating that: a) *Equities will not plunge* as long as the Fed/ Central banks keep pumping liquidity. On this, I stand out as contrarian vs. mainstream economists, who focus on statistic data and believe in the neutrality of monetary expansion (i.e. changes in relative prices don't matter, what matters is the changes in the general level of prices, which depends on the output gap of an economy); b) *For equities to give another jump, we need to see a reliable exit plan from the Fed*; and c) *we will know equities can leap higher, when we see a change in the purpose of debt refinancing: less money for restructuring of maturities and more money for capital expenditures and acquisitions*. In the absence of (a), equities will plunge. In the absence of (b) and (c), equities will stagnate and orbit into oblivion. It will be agony and expensive range trading!

## **-Commodities (or the opposite face of the USD):**

The value of the USD is determined by the relative speeds of the Fed's purchases of securities, vs. that of other Central banks'. It would seem other Central Banks want to take a break. However, the increasing yield in Treasuries is starting to play a counterbalancing force. What is the bottom line? There will be more volatility in FX crosses. In the meantime, we may see crude oil outperforming. Yesterday, the inventories data release were bullish (-4832k vs. +100k expected), which took oil to \$71+/bl.