Tincho's letter

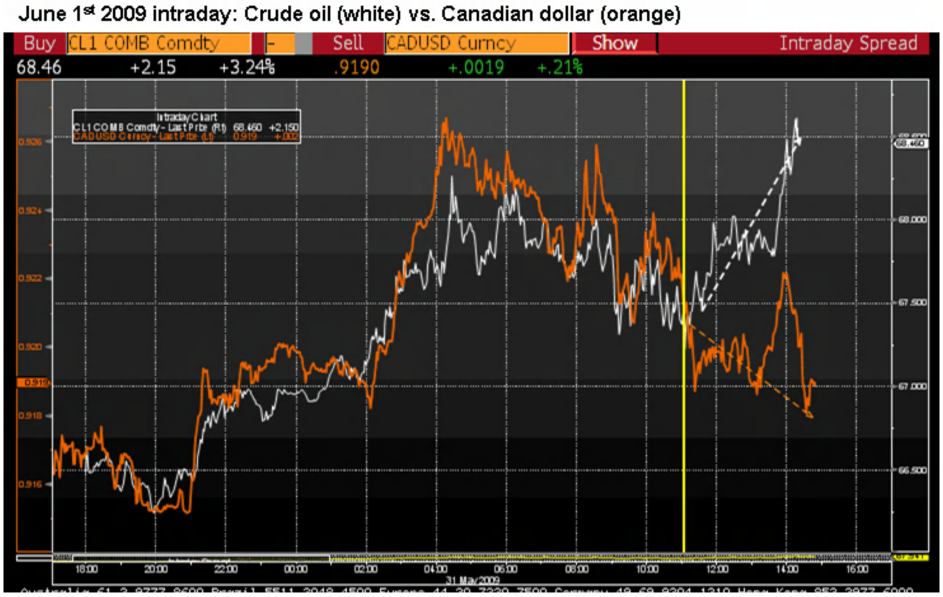
Toronto, Tuesday, June 2nd , 2009

Good morning,

Most of yesterday's news is related to the continuing sell-off in Treasuries. This phenomenon is something relatively recent for the public, but certainly not at Tincho's letter, where we have been dealing with the topic every day since March 18th. For the record, let's just recall the three factors fueling the fire sale in Treasuries: 1) US deficits (**structural, fundamental factor**. There **<u>cannot</u>** be a REAL exit strategy if this factor is not extinguished); 2) Mortgage convexity hedging (**technical but very strong factor**) and 3) Central Banks (China) trading (selling of reserves and/or term restructuring: Selling long-end and buying front-end).

Today however, I think that there is value in discussing the latest events in Canada. I believe these events did not catch enough attention, but if we pay attention ourselves, we may profit from it. Early yesterday, the Canadian dollar had reached 92.72 USD cents (or 1.0785 CAD = 1USD), following crude on its way up. After 10:30am, as the chart below shows, this intraday correlation broke. Crude managed to spike higher, beyond $68.50 a barrel. But the Canadian dollar declined.

June 1st 2009 intraday: Crude oil (white) vs. Canadian dollar (orange)



Source: Bloomberg Analysis: Tincho's letter

Why? The two conditions (for Canada to profit from this crisis) mentioned in previous letters were challenged. First, early in the morning, the news of a C$10.5BN government bailout for GM Canada was out. Yes, it was expected, but still…it is a fact now. This challenged condition no. 2: *"The government should not distort relative prices by running into deficits to save unprofitable businesses"*. Second and most important, at 10:30am the Bank of Canada bought C$3BN of securities in a 363-day Purchase and Resale Agreement. This additional liquidity pushed the value of the Canadian dollar down. It is absolutely clear in the chart above. **Yes, the transaction had been announced on Friday, but on Monday, it was a fact**. And yes, it was also helped by Moody's rating update on Bank of Montreal (Moody's pointed to rising loan losses to change its Aa1 rating outlook on BMO to "negative" from "stable"). The Bank of Canada's intervention was decisive and… **The Bank of Canada is showing itself as interventionist**. This challenges condition no. 1: "*The Canadian dollar should remain within a **free and flexible exchange regime** (including no further regulation on Canadian banks)"*. **The stronger the intervention is, the weaker the Canadian dollar ends. EVENTUALLY, THIS IS BAD FOR CANADIAN STOCKS. Canadian stocks will <u>not</u> rise (as in the US), if the Bank of Canada relaxes its monetary policy…Canadian stocks are rising because foreign money is flowing in! And for foreign money to keep flowing in, Canada must show it can provide a stable currency. The world is starving for stability! All Canada needs to do is to remain quiet, while the rest of the world misbehaves and voices its anti capitalistic rhetoric. In the world of the blind, the one-eyed country gets the big bucks!**

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