

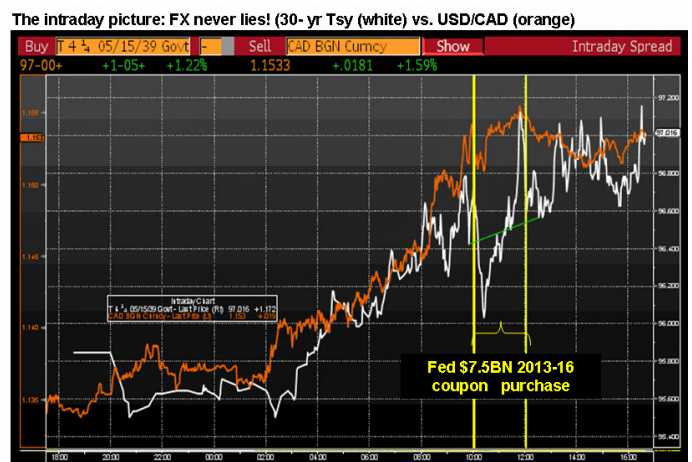
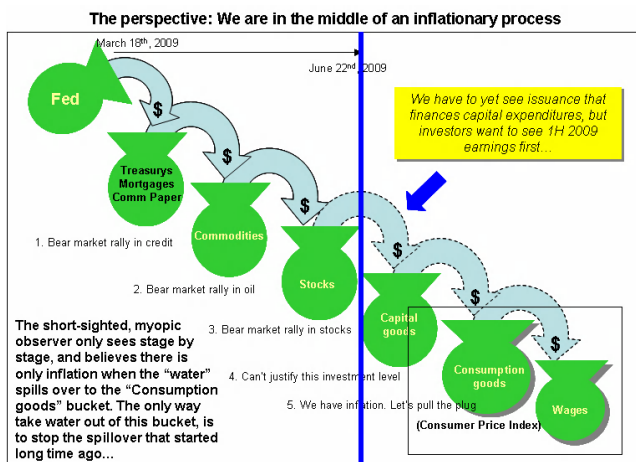
Good morning,

This week, the Fed is scheduled to buy \$104BN in Treasuries. Yesterday, it bought \$7.5BN. As our last week's letters suggested, the Fed has run out of time, governments are playing déjà vu policies, the markets "castled" on Thursday and yesterday, they retrenched... The chart below shows a "panoramic" view of the situation (left side) and the micro view of it (right side, source: Bloomberg). The left side of it was already described on April 14<sup>th</sup> ([www.sibileau.com/martin/2009/04/14](http://www.sibileau.com/martin/2009/04/14)). Unfortunately, since the beginning of the month, in the absence of clarity (on an exit strategy) and the presence of regulatory noise (stress tests, TARP funds, credit derivatives markets, regulatory frameworks, etc.), the inflationary process has reached a plateau. We **absolutely** need to see, as soon as possible, bond issuances that will finance capital expenditures or M&A. Yesterday's announcement of Xstrata's proposal for a "merger of equals" with Anglo American was a good start (Anglo's board rejected it already). But it was not enough to prevent the massive flight to Treasuries. Equities sold off (S&P 500 dropping 3.06% to 893.04pts), as crude had a serious plunge, from \$73/bl last week to \$66.93. Volatility spiked, with the VIX index jumping 11.36%, from 27.99 to 31.17...

**Is there any hope left? If so, we will have to look at the action in the credit markets.** Both the CDX Inv. Grade and High yield indices finished unchanged yesterday (at 4pm). But they are certainly wider compared to last week. The right side of the chart below shows how the USD strengthened vs. the Canadian dollar, a commodity currency, as the 30-yr Treasury rallied. There was not a lot of volume in Treasuries and, yes, it is true that the Canadian dollar in particular owes its weakness to Mr. Carney's public concerns on the impact of the currency's appreciation. We cannot blame Mr. Carney, since his is a difficult task (if not inconsistent): The Bank of Canada's Act of 1934 ([http://www.bankofcanada.ca/pdf/act\\_loi\\_boc\\_bdc.pdf](http://www.bankofcanada.ca/pdf/act_loi_boc_bdc.pdf)) says that Mr. Carney's goals are: 1) To control and protect the external value of the national monetary unit; 2) To mitigate by its influence fluctuations in the general level of production, trade, prices and employment and 3) To promote the economic and financial welfare of Canada! Thus, expressing his concerns on goal no. 2, Mr. Carney failed us on goal no. 1. His public declarations since last week have very much depreciated (by my account at least) our currency 7 US cents/CAD (from 1.08 to 1.15). This mark-to-market "tax" on our purchasing power, was not approved by Parliament, obviously!

**If credit is the last line of defense, can we see credit rally with Treasury yields rising?** (As you notice, I am already assuming that yields will continue to rise) In JP Morgan's June 19<sup>th</sup> issue of "Credit Market Outlook & Strategy", the question is raised. In the report, it is suggested that as Treasuries yield rise, bond yields rise too. This increase in bond yields should encourage investors to invest in credit. The increase in Treasury yields, suggests the report is due to "increased inflationary concerns".

**What is the main assumption behind this thesis? Defaults don't increase, as yields increase. Therefore, we are left to believe that the increase in bond yields is only reflecting future inflation. Under which circumstances does inflation NOT lead to defaults? In the theoretical construction of mainstream economists, inflation does not lead to defaults because it is neutral: The "general" level of prices rises, as ALL prices rise at the same time... But this is not realistic. Therefore, if inflation does bring defaults, do you think credit can rally with Treasury yields rising?**



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