

Good morning,

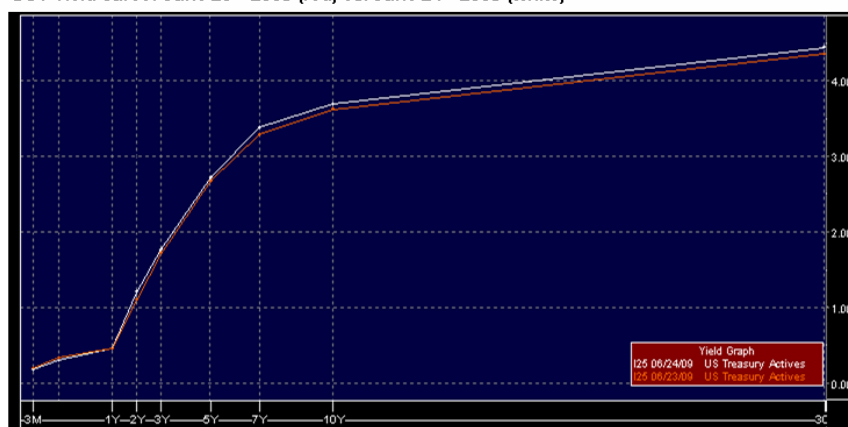
Growing up in an arid ranch in northwestern Patagonia (Province of Neuquén), I remember that one summer evening, I noticed a very small crack in one of the many irrigation channel gates that we had for the alfalfa lots. Only a thin thread of water was running through it. I was too tired to fix it and went to bed thinking I would take care of it, first thing in the morning. In the middle of the night, I heard somebody knocking on the door. This person had come to tell me the thin thread of water had grown into a river, flooding the whole field, and compromising the foundation of one of the warehouses. By the time I arrived to scene, the small crack looked like a strait in the ocean; and I had to fix it in the darkness of night. This happened about 22 years ago, but the lesson was well learned and is still remembered. Today's FOMC's statement (<http://federalreserve.gov/newsevents/press/monetary/20090624a.htm>) reminded me of that night 22 years ago. The Fed knows it has a problem, but seems to have decided to ignore it. Or have they? I don't want to waste intellectual capital here, but **an alternative way to interpret this is to think that the Fed wants to keep some freedom to surprise us.** There are literally thousands of papers in the Theory of Games that analyze the benefits and disadvantages of predictability in monetary policy. In my humble opinion, **when policy makers engage in these games, investors are left with only one winning move: Not to play!** Certainly, not everyone has the luxury of choosing to abandon. However, the verdict was unanimous. With yesterday's announcement, the yield curve steepened (see chart below). Besides this, the markets are trying to recover from last Monday's plunge: The S&P 500 ended 0.65% up at 900.94, while the CDX IG 12 tightened 4 bps to 141 bps. Oil is trying to get back to the \$70/bl level (closed at \$68.52). The recovery was helped with the release yesterday, of Durable Goods orders coming higher than expected, up 1.8% month/month in May Vs. consensus of -0.9% month/month.

More generally and following the concept above, it looks like the "not-to-play" move is becoming popular. I can think of the share price of Citigroup, for instance. In my view, we could see this price way higher, if Citi was not so sensitive to the US government. It is, and the market does not want to play with Citi. Another example is the latest shows of wisdom by Mr. Carney, governor of the Bank of Canada. He surprised the markets first with his public concerns on the sudden appreciation of the Canadian dollar and later (on Tuesday), with the declaration that "Canada's recession is as deep as in the US". What did the market do? Decided not to play and the Canadian dollar plunged.

When investors decide not to play, naturally, investments are delayed. What follows is an interesting comment on this issue, from John M. Keynes, in his famous work "The General Theory of Employment, Interest and Money" (Ch. 12): *"...The state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analysed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its important influence on the schedule of the marginal efficiency of capital. There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment demand-schedule..."*

(I will be traveling next week and will not be able to write this daily letter. "A View from the Trenches" will be distributed again on **July 6th**. Have a nice week!)

UST Yield curve: June 23rd 2009 (red) vs. June 24th 2009 (white)



Source: Bloomberg

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