

Good morning,

Yesterday was an uneventful day in Treasuries, equities, mortgages and commodities. But not in credit, where the IG12 further compressed to finish at 122bps, 7 bps tighter.

The markets (and I) are trying to figure out the features, the shapes of the next phase. How will US manage to conserve its dominant monetary position in the world? What will the currency crosses look like within the next 6 months? How much tighter can credit get? Will there be a solid recovery? Will we see a return to normal conditions, with governments of the G7 returning the economic space they are taking today? How will emerging markets react to a lower USD and higher commodity prices? Which emerging markets will profit? Which ones will be hurt?

Most of these valid questions, I think, depend on the Fed's next steps. Some analysts are already elaborating on possible paths in the interest and mortgage-backed securities markets. One line of thought, for instance, suggests that the Fed cannot tackle both markets simultaneously. The potential intervention in the mortgages market is expected to be more powerful and successful than in the Treasuries market. Given the weak position in the latter, the Fed may trigger a gigantic devaluation of the USD. Therefore, the opinion is that the Fed will be better off intervening in the mortgage market only, which means the current \$300Bn purchase program will not be sized up.

Can the Fed then manage the mortgages market? Will the Fed then cap rates? No! What they can and would seek to do is create a "window of opportunity" for debtors to refinance their mortgages...while it lasts. It will not last too long. A lot of liquidity would be thrown in the market, to create a timid refinancing wave, that is hoped will snowball into a recovery of house prices:

LIQUIDITY IN MORTGAGES → REFINANCING WAVE → HOUSE PRICES STABILIZE → BALANCE SHEETS HEAL

Where is the catch?

The US government, as this process takes place, continues to issue debt. But, given that the Fed does not upsize its purchase program, debt issuances flood the market. Right now, the Fed has been buying, monetizing, about 1/3 of all issuances. That 1/3 will no longer be there. Will the 2/3s be there at least? I don't think so. I think that there is the catch. **This analysis assumes the Treasuries market will not spiral. But it will take a mere lack of buying to create a run against Treasuries.** The curve will further steepen and we will find ourselves facing again a spiraling process, where rising long-term yields force mortgage convexity hedging, which fuels more long-term Treasuries selling... (I am assuming central banks don't try to run for cover in this context).

What is the lesson here? There seems to be only one sure thing: The yield curve has more room to steepen and perhaps that expected refinancing wave will not take place as intended. As well, during this process, a huge dislocation between Treasuries and mortgages will surface, which will be reflected in the swaps market (as it is now, by the way!).

How should equities react to this? If interest rates reach a significant level, capital expenditures will not be on sight, except in the energy sector. But even here, I believe capital expenditures will only take care of normal equipment amortization schedule. The liquidity that is and will continue to leave the Treasuries market and lands in commodities is already perceived as such: Mere liquidity. On this basis, energy firms would not necessarily engage in expensive exploration programs that require high break-even prices. **Without capital expenditures, there is no growth, but stagnation. Under this context therefore, I expect equities to simply stagnate, orbit within a certain range. The harsh side of this coin will be a high unemployment.**

How should credit react? Let me make this analogy: Growing up in the Argentina of the '80s, living under high and hyper inflation, I remember this: Everyone had a huge inventory of every necessity. Why? Because everybody knew that even if today was worse than yesterday...it was still nicer than tomorrow! I think that the issuances that we see today, the capital raising initiatives, the maturity swapping we are witnessing are exactly about that: Inventory growth. Why? Because we don't know what prices will look like tomorrow. Could some firms be buying inventory (liquidity) at a high cost? Absolutely! In other words, credit can further rally (the near term jump-to-default risk is arbitrated) in the near term, but in the long term, as yields spiral, delayed defaults can no longer be contained. **Will these delayed defaults matter?**