Tincho's letter

Toronto, Thursday, June 4th, 2009

Good morning,

Yesterday, the markets found the excuses they were looking for to retreat into the so-called safety of Treasuries. I find it ironic, because there is nothing as fundamentally clear as Treasuries are the debt instruments of an insolvent debtor. Nevertheless, the excuses were essentially these:
-Mortgage applications: -16.2% vs. prior of -14.2%. Subito, the window of mortgage refinancing seems to have disappeared.
-Employment change: -532k vs. expected of -525k
-Weekly oil inventory data: +2.66MM bb vs. expected -1.5MM bb + lower refinery utilization (1.5% vs. 3.3%), sent oil down to $66s.
Beyond these excuses, the fact is the air is becoming rarefied. There are a lot of political manifestations that force investors to demand a premium on their liquidity. Everybody is by now aware of the precedents set by the General Motors' bankruptcy process. Mr. Obama's belief in the role of the Federal government to efficiently allocate its taxpayers' moneys is even concerning Mr. Bernanke, who yesterday said that "large U.S. budget deficits threaten financial stability" and that "the government can't continue indefinitely to borrow at the current rate to finance the shortfall". This is nothing particular to the U.S. I am afraid. Perhaps a good example of how widespread the problem is can be found in the inevitable devaluation of the Latvian currency, the lati. On Wednesday, the Latvian Treasury failed to sell about 50 million lati ($99.9MM) in Treasury bills at auction. They got no bids! Zero! This situation immediately compromised the financial system of Estonia, the currencies of other Eastern European nations and the share prices of Swedish banks.

In Canada, we are playing with fire. I cannot believe how lightly the bailout of GM was taken by the public. Are the Conservatives so weak that they need to run into major deficits to hold power? Or are Canadians not represented at Parliament Hill, where the opposition claims to own such representation and pushes Conservatives into deficits? The pullback in the Canadian dollar to $0.9009 (or C$1.11/$) was mainly driven by oil data and USD repatriation. However, it has become evident that at the speed Treasuries are issued, the Canadian dollar will reach parity. This fact and the current 25bps target rate prevent the Bank of Canada (BoC) from taking any action. If the BoC wants to stop the Canadian dollar from further appreciating, it will have to raise rates. Politically, this is not feasible. If the BoC wants to further relax its policy, it cannot bring rates lower. The only way out is to play the Quantitative Easing rhythm. Is Canada prepared for it?

Back to yesterday's letter, I want to repeat this: The market does not share my view that if the Fed was not to upsize its $300Bn Treasuries purchases, a horrible, ugly sell-off in this market will take place, with devastating consequences. The Fed currently buys approx. 1/3 of the issuances (Yesterday, a $7.5BN purchase of 7 to 10-yr, in line with previous buying in this range. The Fed already bought $138BN). **Do you think the other 2/3rds of the issuances the market is currently demanding will still be there once the Fed stops buying?** If you do, please, I'd love to hear why. Strategists at Bank of America/Merrill are contemplating the wisdom of the Fed not stepping up on the current program (Refer: "Situation Room", BofA, May 29, 2009), while at Morgan Stanley, they conclude yields are only back to normal, as if this crisis could be approached by a "reversion to the mean" methodology (Refer: "The Global Monetary Analyst", MS, June 3, 2009).

Finally, let's push ourselves to think the unthinkable, that which can happen so sudden, we won't have time to react:
1) Assumptions:
-The current political developments push protectionism to new levels, monetary policy coordination fails (this is not too far from reality lately).
-The transfer of risk from the private to the public sector has effectively taken place worldwide. **The previous situation of IMBALANCES within the private sector is now extrapolated to the public sector. Until 2007, financial institutions had misallocated private sector's savings into unprofitable leveraged investments. In 2009, the property rights of such unprofitable ventures have been transferred to governments, creating IMBALANCES among nations. There are now creditor nations and insolvent debtor nations (or currency zones).**
2) Thesis:
If one nation defaults on its debt (or cannot place it even in local currency) and/or pushes other nations into default, given the current shape of public finances, a real trade war would begin and we can see: a) Lower lows in equity; b) Wider wides in credit; c) lower commodity prices (oil back to $30s?) d) Gold's best performance so far. FROM TODAY, I GIVE THIS SCENARIO A REASONABLE PROBABILITY. If it doesn't take place by October/November (based on the Fed's purchases schedule), that probability will sharply decrease.

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