

Tincho's letter

Toronto, Monday, June 8th, 2009

Good morning,

Since last Thursday (Tincho's letter is not published on Fridays), the world has gotten a bit more complex. We have been saying since March that we do not take the myopic, mainstream view, that inflation is an increase in the general level of prices, or that it depends on the level of capacity utilization (the so called output gap, as abused by Paul Krugman) or that it is a function of something called "velocity of circulation". Since March, we have proposed the view that inflation is a "process". It is a chain reaction set out by an exogenous event, the issuance of liquidity that affects a particular market (Treasuries and mortgages in 2008/09). Inflation is not an increase in the general level of prices, but the distortion of relative prices (i.e. Treasuries vs. equities and credit). It has NOTHING to do with capacity utilization or output gaps, since regardless of their respective levels, the intervention of the central banks affects the fixed income markets all the same (otherwise, you end up not understanding how you can see the S&P500 index rallying from 667pts to 940pts).

Finally, the concept of velocity of circulation is also misleading. Most analysts are now amazed that the Fed may not only not size up its initial \$300BN Treasuries purchase program, but also not even complete it! What is the reason? The yield curve is too steep! What amazes these analysts? That if the Fed carried out the announced Treasuries, Agency debt and mortgage-backed securities purchase, it would still have to add another \$1,075BN (excluding other TALF, etc.). The velocity has not picked up yet, they still have another \$1,075BN to go AT LEAST, and the yield is already bastardized with what they call "inflation expectations", as in Friday's front-end sell off in Treasuries.

Inflation is like pregnancy. You cannot be just a little pregnant (= you cannot target inflation). And just as you cannot say a baby was born without pregnancy, you can also not say that inflation was born all of a sudden. It started way before.

What we've been saying for months, is in the newspapers now. It's history. So, what do we focus on now? Let's see...

I cannot give you a precise forecast. I do not profess to call the markets. But I can tell you this much: Most analysts may be up for a surprise. Why? I think they are reading the news the wrong way. In the past trading sessions, we have started to see the markets reacting to fundamentals. Let's forget for a moment about the fixed income markets and credit (Credit is perhaps the new bubble, the new price distortion being fueled by the ongoing liquidity creation). Let's focus on equities. There is a widespread, mainstream view that we may well see lower lows in equities. This means that the S&P500 may fall below the 667pts March low. How? These analysts believe that because we have not yet seen positive activity data, but only "less bad" data, in the second half of 2009, when earnings are reported and the real ugly picture proves to still be there, equities will sell off. This sell off will also trigger a sell off in credit (bonds, loans) and the crisis will look even worse, with no other solution at hand than a bath of good old asset deflation...I respect this view. However, when you dig deeper, you realize this view explains future events in an "endogenous" way. The best way to show how it is endogenous is by negation: Because it is not exogenous. It does not involve, it does not include an external force. Central banks, politics, have no say in this. **And I think this is wrong. The rally was due to an exogenous force: The Fed's intervention. The sell-off, if any, may also well be due to an exogenous event. And if the cause of the problem is different, the results of the problem may also be different. Under an endogenous sell off, commodities underperform. Under an exogenous sell off, commodities outperform!(because if the cause is exogenous, investors can only vote with their feet)**

Mainstream economists are so blinded by the mathematical approach of their analysis, that when you suggest a political influence in macroeconomics, they refer with despise to it as a "soft" explanation. Yet, their "hard" explanations have horribly failed them (They predicted a depreciation of the Canadian dollar to C\$1.34/USD only a month ago, they recommended short positions in credit, etc.). **Thus, in answer to the question above ("What do we focus on now?"), I think the answer is easy: "Politics".**

What will decide if the Fed sizes up its purchase program (devaluing the USD) or not (increasing rates)? Politics! What will decide the GBP/Euro cross? Politics! What will drive the asset allocations of China's central bank? Politics! Will the Bank of Canada start quantitative easing to soften the Canadian dollar's appreciation? Politics is the answer! Which emerging markets will be most favored by easy USD-backed lines provided by the IMF to delay devaluations? Will banks in the US ever reach independence from the government, even after they repay their TARP debt? Will deposits at Citigroup be used to fund the Treasury's deficit, now that Citi is government owned? Again, politics will answer this...If I deceived you with a lack of details on what we may see next, I have succeeded. Often times, questions are more important than answers.

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