

Tincho's letter

Toronto, Tuesday, June 9th, 2009

Good morning,

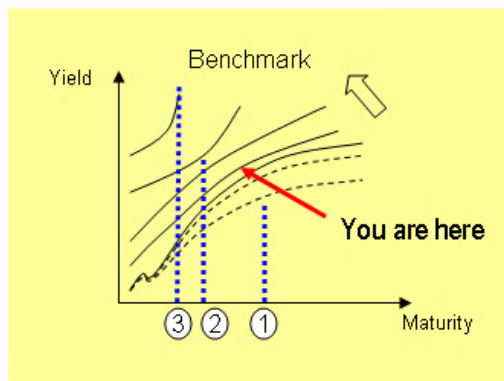
The week started on a bearish note. Frankly, it is a note I don't understand. It is based on the fear that the Fed will raise interest rates. Didn't the same analysts that now price a rate increase say that deflation was the problem? Why is it that all of a sudden, they now fear inflation and interest rates? Unemployment remains high, at approx. 9%. The funniest thing is that after so much inconsistency, we had a late rally in equities, with the S&P500 closing only -0.1% at 939pts, as Bloomberg reported Mr. Krugman's prediction of a possible recovery by the end of the year.

This bearish view corresponds to the "endogenous" theory we made reference to yesterday. It looks like the market really subscribes to it, which makes me a contrarian by definition. I don't like being a contrarian. I try to be consistent, acknowledging the consequences of the endogenous theory. Yesterday, we said that: "*Under an endogenous sell off, commodities underperform. Under an exogenous sell off, commodities outperform!*" (Is this actually not rather related to USD movements?). Yesterday, on the bearish sentiment, commodities underperformed. Gold reversed to about \$945/oz, while crude has taken a break since it reached \$70/bl last Friday. In the oil market, we must add the contango is widening, sending a clear and bearish signal. If a plunge in price doesn't materialize, the market will take inflation even more seriously.

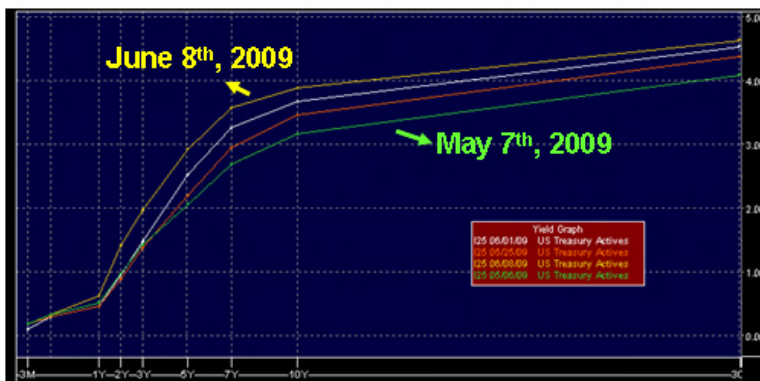
In credit, the situation is more optimistic. Spreads have already tightened both in investment grade and high yield at close to pre-Lehman levels, but more tightening is still expected. Thus, the question is now not if but when we should see a reversal. In the meantime, yesterday, the Fed put some \$7.5BN extra at our disposal, buying Treasuries in the Dec/13 and Apr/16 range. Yes, in credit, the market is looking for some clues in stats, as analysts run regressions between interest rates and key macro variables, without a firm theory, a solid guide to base their theses. This is dangerous. Things are different this time. Politicians have taken the extreme Keynesian view that we are going to print our way out of this mess and express this view openly, shamelessly. The sense of ridiculous has been lost forever. Another proof of this difference is the Chrysler affair. As an update, the Supreme Court delayed yesterday the Chrysler sale to Fiat, after it was appealed by Indiana pension funds. As well, GM secured bondholders (owed \$27BN) only got a 10% equity stake plus a 15% in stock warrants. Yes, it's better than the original 1% in GM vs. the UAW share (owed \$20BN): \$10BN in cash + a 39% equity stake, but still, this is a change!

Suddenly, the world is concerned about inflation and the USD has appreciated since last week, as higher rates are anticipated. At Tincho's letter, exactly a month ago, we proposed that the benchmark curve was going to steepen, as market participants incorporated inflation expectations. We proposed that the credit rally was not a renaissance, it was not a recovery, but merely a window of opportunity (refer: <http://sibileau.com/martin/2009/05/07>). Below the chart I drew a month ago and the yield curve today:

Tincho's letter, May 7th 2009



June 8th 2009



Source: Bloomberg

A month ago, we had also warned that investors fleeing cash would buy bonds (debt) and hedge them by selling Treasuries, adding fuel to the fire. This is what has been driving the credit rally. It has been a retro feeding mechanism that has mostly hurt mortgages, where yields stand now above 5%. I will write more on this in next letters, but let me leave you with one thought that I think matters here: Don't pay attention to what you read or hear. EXPECTATIONS HAVE NOTHING TO DO WITH THIS MESS OR ITS SOLUTION. Focus on who has the money and where it is put to use. Just follow the cash!

Martin Sibileau

martin@sibileau.com

(647) 999-2055

Disclaimer: The comments expressed in this publication are my own personal opinions only and do not necessarily reflect the positions or opinions of my employer. I prepared and distributed this publication as an independent activity, outside my regular salaried work. No part of the compensation I receive from my current employer was, is or will be directly or indirectly related to any comments or personal views expressed in this publication. All comments are based upon my current knowledge. You should conduct independent research to verify the validity of any statements made in this publication before basing any decisions upon those statements. The information contained herein is not necessarily complete and its accuracy is not guaranteed. If you are receiving this communication in error, please notify me immediately by electronic mail or telephone. The comments expressed in this publication provide general information only. Neither the information nor any opinion expressed constitutes a solicitation, an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments. The comments expressed in this publication are not intended to provide personal investment advice and they do not take into account the specific investment objectives, financial situation and the particular needs of any specific person. All rights reserved.