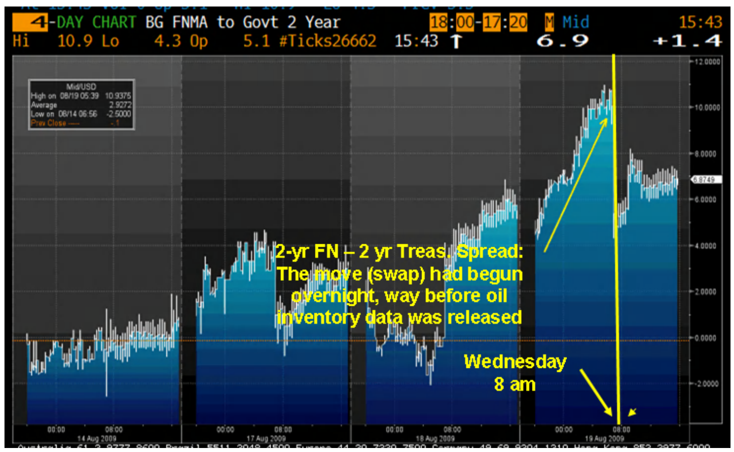
A View from the Trenches

Toronto, Thursday, August 20th, 2009

Good morning,

(This is the last letter of the week. A View from the Trenches will not be distributed until the end of next week, as I will be traveling). What a day! As we wrote on Tuesday that it was possible to have both treasuries and stocks rallying, we saw exactly just that happening in front of our eyes a day later, to the surprise of many. Who would have thought that with stocks losing 4.86% in Shangai overnight we were going to see a weaker USD and stronger stocks? Don't let the herd fool you! Don't listen to those who say that the surprise in oil inventory data is what drove stocks higher yesterday. Here's the facts, you decide: The swap from Agency debt to Treasuries continued to play overnight yesterday, as shown in the chart below (source: Bloomberg), with the 30-yr Treasury rallying from 102-16 to 104+ by 8:30am (the yield curve flattened vs. last Friday close). The 3-mo Libor-OIS spread continued to collapse to 23.17bps yesterday, as the 3-mo Libor reached 41.87bps! This is hardly a normal situation of course, but to finish, let's also remember that after 8:12am the EUR/JPY cross began to shoot up from 132.12. Thus, stocks were flat until obviously, the oil inventory data was released at 10:30am. But again, the wave had begun much earlier than that. Oil did not save the day, but it fuelled the push to higher levels:



For those not familiar with the spread shown above, here's the math: Spread = Agency debt spread – Treasury spread
Given that Treasuries rallied (=Treasury spread ↓) and the Spread widened (=↑), the Agency debt spread either remained unchanged or went up (it actually went up). Thus: Spread ↑ = Agency debt spread ↑ - Treasury spread ↓

Now, let's go to the difficult part: Understanding what happened. In my view, we need to focus on China. The waves are coming from there. I will make an assumption here: Given that activity in Agencies took place overnight, I will assume the purchase of Treasuries is coming from Asia. Why would someone buy Treasuries? The only explanation I find is that that someone believes or perhaps KNOWS that interest rates are going to remain low longer than what most of us anticipate. Suppose that someone was the central bank of China. The swap from Agencies to Treasuries represents a change in the composition of the asset side of the bank's balance sheet. But if Treasuries (which are reserves to the central bank) rally:

1. Would it not be easier for the central bank to appreciate the Renmimbi?
2. And if the Renmimbi gained vs. the USD, should Chinese stocks not fall, as the appreciation affects the export sector? (Did this actually not happen since the start of the swap trade?)
3. And if China is richer in terms of USD, could it also not afford more commodities traded in USD terms, like oil? (Did a rise in oil prices not happen in the last days?)
4. Should the USD not only fall vs. the Renmimbi but against the EUR as well? (As it did today)
5. Should a weaker USD not affect stocks in the US in a positive way, at least in the short-term? (As it happened today?)
6. Should it also not allow firms to refinance their debt, driving credit spreads tighter? (*As it may happen later on?)*

The question is how this would be coordinated, if coordination is possible. What is in the works? A new stimulus package? Is this sustainable? And if it makes sense (or not…I am not sure myself), why was it not done earlier?

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