A View from the Trenches Toronto, Thursday, September 3rd, 2009

Good morning,

The last 24 hours have been marked again by policy. As we wrote yesterday, by now (after Geithner's statement) the market has accepted the idea that interest rates may well remain untouched (at least in the most relevant currency areas). Two additional elements here: 1) in the dollars bloc (Australia, Canada and New Zealand), as the recession is milder, the easy money may have to be pulled out earlier than later, and 2) in emerging markets (debt-loaded emerging markets) there may be a need to keep monetizing stimulus packages, particularly if China slows down to more sustainable activity levels, but such over monetization would bring a run against their currencies. This last point is relevant. A run against an emerging market's currency would not necessarily be supportive of the USD, if the same is triggered by a wave of defaults affecting the country's financial system. It could potentially be supportive of gold, if the big guys (G-8 countries) don't lend a timely hand.

Thus, prices continue to adjust to this new outlook, first drafted by "*A View from the Trenches*" on August 19th, , ahead of the curve. We therefore see the dollars not depreciating but trading in range, as risk assets correct (consequence of element #1 above) and we start to see an interesting arbitrage within emerging markets. Although money at this stage seems on aggregate to leave emerging markets, the fact is that there is a lot of differentiation. There is no better example than the cross Brazilian Real /Mexican Peso, to reflect this point. The same is evident in sovereign credit default swaps, which have already begun to communicate this view. I have more to say about this new paradigm of global monetary coordination and in the coming week, I will present a "bonus" research note on it, proposing an analytical method to the problem.

In my view, the relevant action yesterday took place in Fixed Income, as stocks ended almost flat (chart 1 below, S&P500 intraday vs. 30-yr Treasury) and the CDX IG12 index closed at 125bps, (+3bps). I looked at my screens and could not understand why (as you see in the chart below, source: Bloomberg) Treasuries (long-end) rallied in the absence of a broad sell-off. This could not be a flight-to-safety trade, with the 3-mo Libor- OIS spread (chart at the bottom, source: Bloomberg) making a lower low, at 15.35bps. So, here's my two cents (and am open to feedback): Given the new outlook for low rates, a new refinancing wave in mortgages could be on the way, even more so if the constructive macro backdrop remains. Under this scenario, mortgage investors would need to unwind their previous duration hedges: They had sold Treasuries (long-term) and now need to buy them back. This could explain the flattening move yesterday. An interesting article from Morgan Stanley's Janaki Rao "Convexity Update: The Rally Is Not the Pain Trade", published yesterday in the afternoon doesn't side with my view, which makes me think that maybe the sell off in Agencies by Central Banks in the last weeks and yesterday's news on Capmark are actually the answer to this counter intuitive action. I am only following Occam's razor principle here…

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