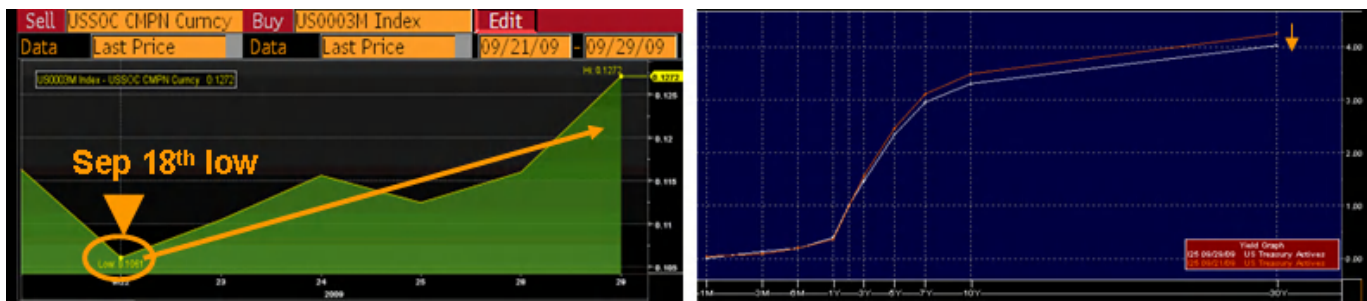


A View from the Trenches Toronto, Wednesday, September 30th, 2009

Good morning,

Below, I show two charts (source: Bloomberg). On the left, we can see the 3-mo Libor – Overnight Index Swap spread. As we repeated countless times, in the past, we were confident that the rally in stocks and credit was going to continue as long as we saw this spread compress. We followed it from its 83+bps level at the end of April to its 2009 low of 10.29bps, reached on September 18th. Since then, the trend has been unequivocally from the lower left to the upper right. On the 22nd, we turned neutral on equities. To the right, we can see the change in the US yield curve, from Sep 21 to date. It is visibly flatter.



Are we witnessing a retreat, a flight-to-safety? The USD index (DXY), which indicates the general international value of the USD has risen from 76.42 to 77.08. It is not much, but it is a signal and since September 18th, the DXY seems to be very correlated with the 3-mo Libor – OIS spread. I do not want to make straightforward conclusions out of the 3-mo Libor – OIS spread, because there are excessively many parts moving around in the rates space lately, which diminish the predictive power of the trend. One of them, for instance, is the speculation (ref. Bank of America's Global Rate Focus report, Sep 25/09) that in 2010, as part of its exit strategy, the Fed will need to take on \$500BN in reverse repo transactions. This volume is too high, when compared with the average \$219BN in Treasuries, Agency and MBS, which suggests a huge crowding out effect on Commercial Paper, out of which Libor is based. Thus, depending on how near and how violently the market forecasts the reversal move take place, the recent trend highlighted in the charts above may or may not continue. The impact on the equities and forex markets is noticeable. The impact on credit, not so much.

Corporate credit seems to be enjoying the benefit of some sort of inertia. The flow of cash out money funds and into credit has not stopped, as investors keep crowding the boat in search of whatever yield is left to take. I do not blame them. After all, that was the purpose of the quantitative easing policies. The hope that this flow of capital will trigger a wave of investments is perhaps a long way from materializing. However, the flow is the necessary condition. It is not a sufficient, but a necessary condition.

In conclusion, the trend in the 3-mo Libor – OIS spread, Treasuries, the value of the USD and, last but not least, the political changes taking place in Europe and the Middle East continue to make me comfortable with my position on the sidelines. If the aforementioned trends show continued strength, I will have no choice but to turn bearish...

Lastly, the Fed bought yesterday \$3.BN in Treasuries (May/12- Nov/13 maturity range), leaving only \$7BN to complete its \$300BN purchase plan. It seems it was yesterday when I first wrote that I was convinced the Fed would upsize this program. Was it successful though?