

A View from the Trenches Toronto, Monday, January 4th, 2010

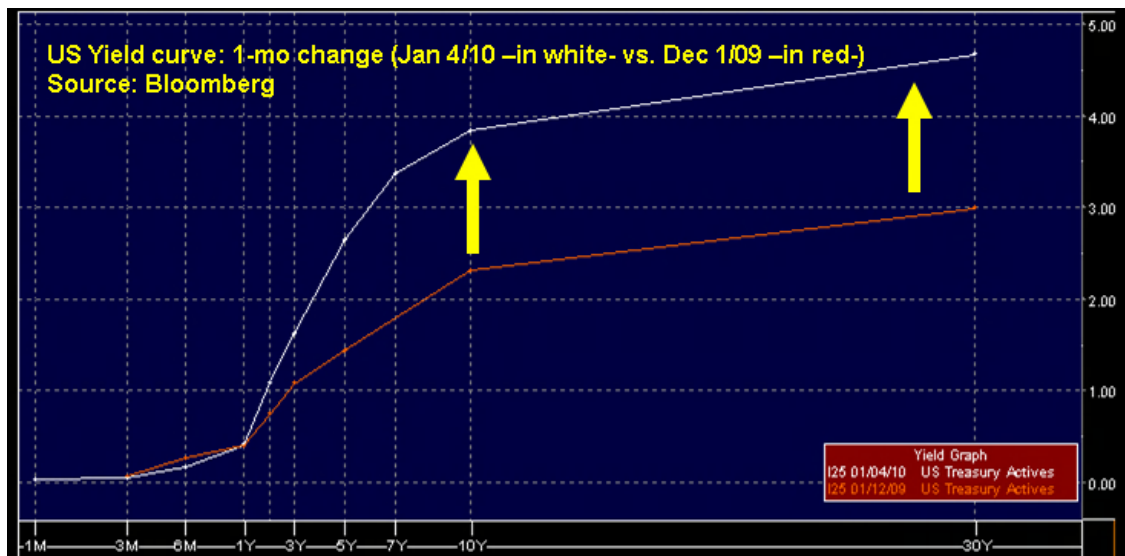
Good morning,

The year started with a very straightforward session of USD weakness. To me, the trade was very simple. At 10am yesterday, with the release of the macro data of the day (ISM Manufacturing Index at 55.9 vs. 54.3 expected and 53.6 prior; ISM Prices Paid at 61.5 vs. 57.2 expected and 55.0 prior), the market received confirmation that credit expansionary policies are elbowing their way through the markets.

When you overflow a bucket with water, if it spills over to a next one underneath, Archimedes' principle says that a body immersed in the bucket underneath will be buoyed up by a force equal to the weight of the displaced fluid. Think of the buckets as markets and the fluids as liquidity... However, what happens if the overflow is not a one-time event but a constant stream of liquidity? This is what the markets thought yesterday. If the macro data would have been the confirmation of only a one-time event, I don't think we would be seeing the steepening of the US yield curve shown in the chart below (Source: Bloomberg), since the beginning of last December.

Indeed, investors seem to disagree with the notion that the credit expansion was a 2009 event only. Until proven wrong, the credit expansion should continue in 2010. To this point, on yesterday's letter, I briefly mentioned my concern over the US Treasury's announcement on GSE (Government-sponsored enterprises) debt. Briefly, the Treasury made it clear that it will stay behind (i.e. inject capital in the form of preferred stock) the GSEs (i.e. Fannie Mae, Freddie Mac) should their net worth deteriorate in 2010, as delinquent loans (mortgages) increase and these Agencies buy these out. (Why? Precisely, because delinquent loans are expected to increase!)

In order to carry out these buyouts, Agencies need not only to be capitalized, but also to borrow to fund the purchases. This is why investors may be right, if they think the current overflow will not be a one-time event. While market participants expect the US Treasury to keep issuing more debt with longer average duration, it is now more evident that Agency paper will also be in supply. Thus, the USD weakened and oil, gold, equities and credit rallied. Sometimes, it is best to leave things as simple as that. (Feedback here is welcome = If you don't think that was the catalyst for USD weakness yesterday, please, share your views on what other factors might be behind this. Also, please, note that my view disagrees with the mainstream one that attributes the rally in equities to the release of bullish economic data out of China. If this was the case, higher rates should have been expected, lifting rather than weakening the USD, and keeping equities in check, but not rallying).



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