A View from the Trenches Toronto, Friday, February 12th , 2010

Good morning,

(This is the last day of the week and **"A View from the Trenches" will not be published again until February 25th**, as we will traveling.)

The statement released by European authorities yesterday was a mere expression of support for Greece, explicitly denying a request by Greece, for financial aid. The markets accordingly sold all things European, including and in particular Spanish financials. The picture does not look so good and yet, stocks ***outside*** the Euro zone (except for Athens, of course) rallied yesterday.

What do we make of this?
On one hand, we had another Treasuries auction yesterday. This time for $16BN 30-yrs, with the yield rising to 4.72%. The UST 2y10y curve ended 4bps steeper at 285bps. The Czech Republic was also deceived when it raised 15-yr debt on Wednesday and Greek banks seem to be facing funding problems. We also face significant uncertainty with the latest developments in Iran. But on the other hand, the markets received some "optimistic" releases too. Continuing job claims in the US kept their downward trend, Australia also saw an improvement in its labour market and the CPI reading in China was stronger than expected.

Briefly, of one thing we may be certain: Capital is flowing out of the Eurozone and into the rest of the world. But at the same time, capital seemed yesterday to also be preferring commodities and basic materials, which puzzles us, because the macroeconomic backdrop is bearish for us.

In our view, we should not see yesterday's rally in North American stocks and credit, as well as in crude and oil, as a bullish signal, after the EU meeting's statement. Why? Because for this rally to be interpreted as bullish, the Euro should have rallied as well! It didn't and in fact plunged from a tall cliff, specially against the Canadian dollar. A reduction in the purchasing power of the Eurozone should not be seen as something positive for global growth (= for oil demand and hence for the Canadian market!)

Interestingly enough, Freddie Mac yesterday announced that it will buy practically all 120+days delinquent mortgage loans from its fixed rate and adjustable rate mortgage Participation Certificate securities. We had foreseen a move of this type and discussed it in December and on our first letter of 2010 (www.sibileau.com/martin/2010/01/04). This is what we wrote then:

"…As credit spreads are already very low again, the increase in sovereign risk (yield) should make debt a less profitable investment, when compared against equity. In December, I associated this process with USD strength. **Now, I am not so sure**. ***Since my last letter of 2009, the US Treasury announced it would lift the cap on the Preferred Stock Purchase Program*** (refer Michael Cloherty's "Removing the PSPP ceiling: Treasury's unlimited support", Bank of America' "US Agencies" report of Dec 29/09). ***This explicit show of support for agency debt (which I assumed it was going to smoothly disappear in 2010) tells me that the USD strength will be only a relative notion in 2010. I say relative because the strength should show vs. those countries that explicitly decide to import USD inflation (i.e. Brazil) or face serious fiscal problems (i.e. Euro zone), while the weakness should show vs. those countries that will profit from the credit-inflated recovery (Emerging markets or commodity currencies, like the CAD)…"***

Back to the impressive strength shown yesterday by the Canadian Dollar. At yesterday's open, you needed 1.0621 CAD to buy 1 USD. At close, 1.05 were enough. The CAD was even stronger of course vs. the Euro, finishing at 1.4383 CAD/EUR, from 1.4591 at open. What granted such a move? In our view, the strength in the CAD was not fully reflected in the stocks market (TSX 60), which closed +1.32% higher, at 11,435.49pts. **We think instead this movement may have mostly reflected a shift in central banks' reserves, out of the EUR and into the CAD**. What makes us think so? The relatively flat performance of crude oil, which still doesn't break through its bearish trend.

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