

A View from the Trenches Toronto, Thursday, February 25th, 2010

Good morning,

We are back from a relaxing vacation and strangely glad to see that not much has happened since we last wrote. Indeed, the markets bounced from the lows we went through earlier this month, and we were stopped out on our short positions, as we invest on fundamentals, but trade like technicians.

Why do we insist that nothing really changed?

We have not witnessed a single catalyst on the Greek/Euro-zone situation. In the US, Bernanke only continued to confirm the Fed's view of a weak recovery but recovery at last, while at the same time, he asked Congress to think about a fiscal exit strategy. China continues to expand output on its pegged currency and commodities, in our view, are starting to price unavoidable currency collapses.

We believe that by now, it is self-evident that the world has lost one of the most important functions money provides: Its use as a unit of account. Please, take a moment to think about this, but not in the standard way you have been taught to. Do not think of the USD as a unit of account. Do not think of the EUR for the same reason, or any other currency. Why? Because production, distribution, sales, collections, etc. today are global processes. If you don't believe this, just look around you. Look at where your watch was manufactured and think of all the different components that had to be assembled, the raw materials that had to be used, where they came from, how they were purchased, paid for and, as important, think about what each of the entrepreneurs responsible for these operations did with their respective profits. What currency did they invest them in? What was the volatility of those profits, after adjusting them for their currency crosses (inputs vs. output)?

If the world wants to continue growing, it will need a strong reserve currency. There is no such a thing today. Yes, the USD continues to be the world's reserve currency, but by default. And this does not and will not foster economic growth. Hence, our bearish outlook.

We recommend the reader to watch a recent interview (Feb. 21st) with Greece's Prime Minister George Papandreou, by Andre Marr, at: <http://www.youtube.com/watch?v=EJP1Z85Hs9g>. This interview painfully reminded us of Argentina's Plan Blindaje, in 2000-01, when it was announced by the then President De La Rúa. We wrote before that Greece' situation is not comparable with Argentina (refer: www.sibileau.com/martin/2009/12/17), but the similarities are striking.

This brings us to our final point. We read today's Morgan Stanley's Global Monetary Analyst research note titled "*Default or Inflate or...*". In this note, Morgan Stanley's Global Economics Team suggests that neither defaults nor inflation are likely or even optimal for sovereigns. There are many reasons for this conclusion, which we will not deal with here. However, because of this conclusion, the authors of the note propose that governments in developed countries will push banks to purchase and hold their upcoming debt issuances, "as a prudential measure". This did actually occur in Argentina and it was precisely what led to the financial collapse of 2001. We admit we had thought about this many times before in 2008. We even thought that the US ownership of banks after their respective bailouts had no other final purpose but to later have the power to steer their portfolio allocation decisions. In particular, we thought that by owning Citi, the US government could raise deposits outside the US to buy Treasuries. Call us crazy, but stranger things have happened...

However, we believe there is merit to this suggestion, although it is a bit early to worry. Under this scenario, there are two issues that concern us. First, this would have an immediate and meaningful crowding-out effect on the private sector. If this was the case, we would even consider another jump in default rates, particularly in the high yield space, which according to Bank Of America ("*HY Maturity Wall – How big a Worry*", in "*Situation Room*" Report, Feb. 23rd, 2010) will see over 85% of all loans outstanding mature between 2012 and 2014. Second, we are concerned about the sovereign credit default swap market, which we think is the real weapon of mass destruction. Strangely enough, no regulator has set its eyes upon it yet and honestly, we don't think they ever will. It is in the sovereigns best interest, as issuers, to ensure that investors buy their issuances comfortably, under the misleading belief that the systemic risk entailed in such purchases is hedged away with these swaps. But we ask who in his/her right mind would feel safe buying sovereign risk protection from banks that a few months ago could only obtain liquidity under the guarantee of the same sovereigns they now sell protection on, banks which would be forced to invest up to a considerable percentage of their portfolios in sovereign debt? Is this not as crazy as having children sell insurance on their parents' financial risk?

Martin Sibileau

martin@sibileau.com

(647) 999-2055

Disclaimer: The comments expressed in this publication are my own personal opinions only and do not necessarily reflect the positions or opinions of my employer. I prepared and distributed this publication as an independent activity, outside my regular salaried work. No part of the compensation I receive from my current employer was, is or will be directly or indirectly related to any comments or personal views expressed in this publication. All comments are based upon my current knowledge. You should conduct independent research to verify the validity of any statements made in this publication before basing any decisions upon those statements. The information contained herein is not necessarily complete and its accuracy is not guaranteed. If you are receiving this communication in error, please notify me immediately by electronic mail or telephone. The comments expressed in this publication provide general information only. Neither the information nor any opinion expressed constitutes a solicitation, an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments. The comments expressed in this publication are not intended to provide personal investment advice and they do not take into account the specific investment objectives, financial situation and the particular needs of any specific person. All rights reserved.