

Good morning,

We will be brief today, for nothing of macroeconomic consequence has taken place in the past 24hrs. The action that caught our attention yesterday was in the foreign exchange market (the market that never lies). In particular, we refer to the action in the Canadian dollar. The cross with the Euro gained (i.e. the CAD rose against the Euro) 2.3 cents intraday, and although (or because) the TSX composite closed +0.85% higher, we can only deduct that the demand for Canadian dollars did not reflect a pari-passu demand for Canadian assets. Therefore, our intuition is that with yesterday's calm, the demand for Canadian dollars that did not end in assets was a demand for reserve purposes, at a central bank. We are open to alternative suggestions to explain this phenomenon but any of these explanations would also have to address how the Canadian dollar did so perform on a day where neither oil nor gold rallied.

Was the CAD rally based on the news that the Canadian economy expanded at a 5% annualized rate in the fourth quarter (faster than forecasted by the Bank of Canada)? We doubt it because a) the CAD's sensitivity to interest rate gap (i.e. with the higher than expected growth rate the market revises its forecast on policy rates) has been low, and b) the strength was not uniform but clearly against the Euro.

On another note, in an interesting report, Bank of America estimated yesterday that approximately \$160BN will flow to private investors by the end of 2010, as a result of the buyout of delinquent mortgage loans by Fannie Mae and Freddie Mac (refer: "The long and short of delinquency buyouts", in *Situation Room*, Bank of America Merrill Lynch Credit Strategy, March 1, 2010). At "*A View from the Trenches*" we had anticipated the consequences of this operation back on January 4<sup>th</sup>, when we wrote:

*"...Since (our) 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 (us) that the USD strength will be only a relative notion in 2010. (We) 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)..."*

We stand by these comments and the market is proving us right. What we did not grasp back then was the magnitude of this operation (\$160BN of private liquidity) under certain loan delinquency level assumptions that can further deteriorate, if the recovery process disappoints. We invite readers to closely monitor activity in the GSE market for this is serious enough to keep the dream of asset inflation alive.

(Note: Mainstream economists use the term "asset inflation" to refer to bubbles, because their theory of inflation is wrongfully based on the non-neutrality of money, as implied by the exchange equation:  $M*V = P*Q$ . Therefore, they treat bubbles as an aberration that can only be addressed with regulation)