Good morning,

(A brief announcement before we start with our comments today: Going forward, "A View from Trenches" will not be published on a daily basis. Over the past year, we enjoyed writing every day. However, we are very busy of late, undertaking another project that hopefully will end by next Fall. We will write as often as possible, but not on a daily basis. Thank you so much for your support and understanding)

Since our last comments on Tuesday, we have had a few updates on policy. The most important indeed is Greece's announcement of revenue-raising and budget-cutting measures . Since last week, the 5-yr unsecured sovereign credit default swap spread has dropped dramatically, from 400bps to 294bps (at close). If this issue was, as Mr. Jeffrey Rosenberg sustains, a short liquidity problem, things should be left there, with us waiting for the results yielded by the budget plan. But as we clearly made the case before, this problem goes beyond the sphere of liquidity. It is an institutional problem, and as such, we will have to follow Germany's reaction vis a vis Greece's initiatives. So far, Prime Minister Merkel made it clear yesterday that the next meeting this Friday will not be about aid commitments.

In our view, these budget announcements have no purpose but to set the necessary conditions towards a more sustainable institutional framework, where either or both Germany and France guarantee Greek issuances. However, an impressive opposition is growing in Germany against this move. On this issue, Mr. Otmar Issing (Economist, former member of the board of the Deutsche Bundesbank (1990–1998) and of the Executive Board of the European Central Bank (1998–2006) couldn't have been more explicit: "Garantien für die Käufer griechischer Anleihen durch die bundeseigene Förderbankgruppe KfW kommen überhaupt nicht in Frage", reported the online edition of Frankfurter Allgemeine (Our translation: Guarantees for the buyers of Greek liabilities through a KfW Bank Group are out of the question).

On a separate but related note, we have not been bullish of gold lately. In our opinion, gold in terms of Canadian dollars was a poor investment decision. In hindsight, we believe this was a correct view. And looking forward, we maintain such view. In Chart 1 below (source: Bloomberg), we show the ETF "XIU.TO", that tracks the S&P TSX 60 composite (white) vs. the ETF "IGT.TO", which tracks the price of gold, in Canadian dollars. As can be seen, since Feb. 8th, when sovereign risk out of Europe escalated, gold has barely risen, vs. the S&P TSX 60. Why take the risk of a single asset vs. the Canadian equity market?

Chart 1

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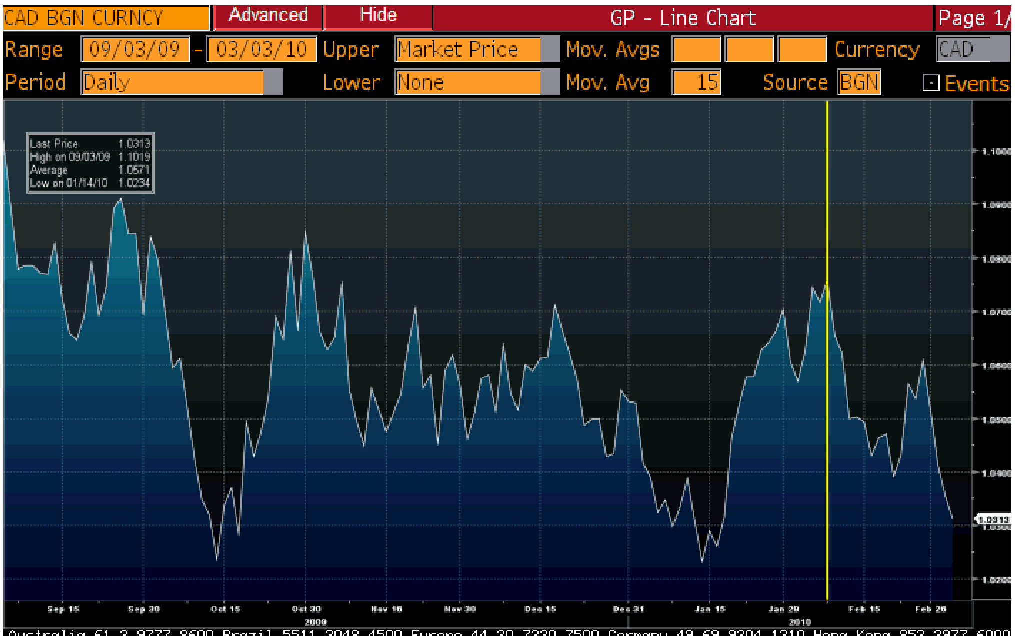
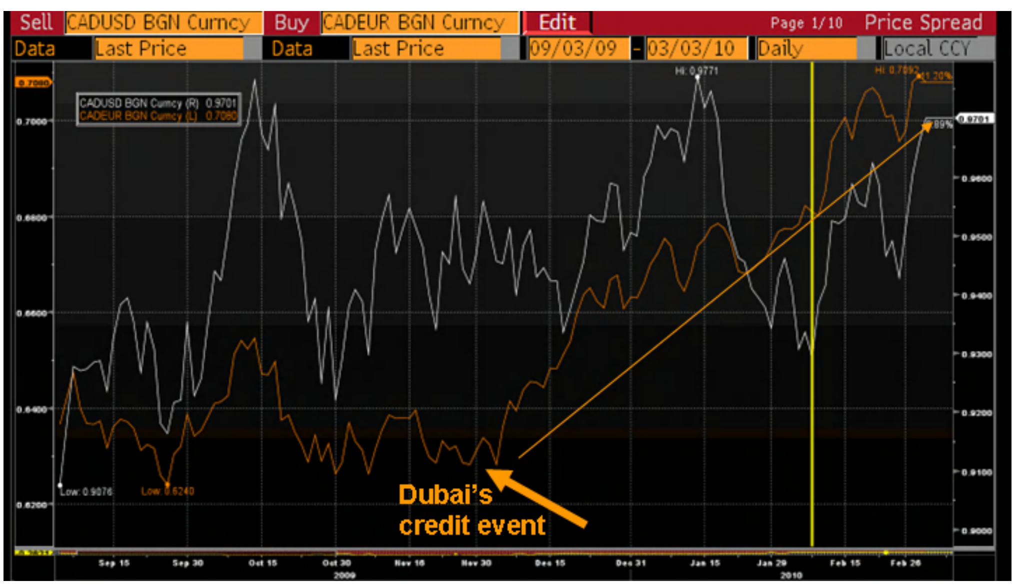
Furthermore, February 8th would seem to be a relevant date. Thus we take a look from a different market, the FX market (which never lies). This time, we wanted to look at the EUR/CAD cross. Indeed, this cross moved significantly in CAD's favor since February 8th, as shown in Chart 2 below (source: Bloomberg):

Chart 2



But Chart 3 below (source: Bloomberg) provides us with a more fertile conclusion. It shows the EUR/CAD cross (orange) vs. the CAD/USD (white). It is very apparent to us that the shift out of the Euro and into the CAD started at the end of November, immediately after the Dubai credit event, and as rumors on Greece's fiscal weakness were starting. This move out of the Euro and into the CAD has been slow but sure! The CAD/USD has been visibly more volatile, almost breaking the trend (remember the resistance at 1.075 CAD/USD?)

Chart 3



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We have consistently held that the strength in the CAD did not spill over to Canadian assets, suggesting that it was driven by central banks' reserve purchases. We believe this is now clearer than ever. Yesterday also, with bearish oil inventory data, the Canadian dollar kept its strength intact, touching 1.0275 CAD/USD intraday.

What to make of this?

Canada is receiving an important flow of capital. Going forward, those mainstream economists (which we could also fairly brand as "mercantilists") that focus on commodities performance based on the global recovery path to understand the Canadian story will be disappointed. In our view, Canada is no longer just a commodity exporter. Canada is now starting to export "peace of mind", which the world seems unable to find elsewhere. We made this prediction long ago, when on June 2nd , 2009 wrote:

"*... The Canadian dollar should remain within a free and flexible exchange regime (including no further regulation on Canadian banks)". The stronger the intervention is, the weaker the Canadian dollar ends. (…) Canadian stocks will not rise (as in the US), if the Bank of Canada relaxes its monetary policy…Canadian stocks are rising because foreign money is flowing in! And for foreign money to keep flowing in, Canada must show it can provide a stable currency. The world is starving for stability! All Canada needs to do is to remain quiet, while the rest of the world misbehaves and voices its anti capitalistic rhetoric. In the world of the blind, the one-eyed country gets the big bucks!..."* ("Meanwhile in Canada", in: www.sibileau.com/martin/2009/06/02)

We think this process in favor of Canada is in full force, unless Parliament Hill derails it, which is always, always possible. Two days ago, the Bank of Canada made clear (at least to us) that at the end of its conditional commitment period, in June 2010, an upward revision of policy rates will follow. This does nothing else but reinforce the appreciation of things Canadian.
With these winds, we fail to see weakness in Canada's real estate sector and we want to be long Canadian equities, as they are driven by mining in precious metals, basic resources and boring banks. Our propensity to fear that slack in global growth will indirectly punish Canadian valuations via lower commodities prices, is lower and lower, as the world comes to Canada to deposit their savings in a safe place.

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