Tincho's letter

Toronto, Tuesday, May 26th, 2009

Good morning,

Markets were closed yesterday in the USA and UK. In yesterday's letter, I indicated that the only viable exit strategy is to cut spending. In a more formal way, the always impeccable analysis of Michael Cloherty (Bank of America/Merrill Lynch, "Global Rates Strategy", May 21st 2009) suggested that an exit strategy, in its first phase (Cloherty identifies three necessary phases) will consist in the Fed stopping its purchases. It's true, it needs to start there. However, for purchases to stop, we also need fiscal deficits to stop. **Why?**
This is connected to my view of how the system will adjust to the ongoing monetary expansion: Higher prices, lower USD (**only temporarily, until REAL interest rates pick up again)**, higher unemployment. I know I threw this thesis out, without explaining myself. I also implied credit can rally within this context. Let's see how this can happen:

-Higher prices:
As mentioned numerous times, the sell off in Treasuries leaves investors with capital that needs to be put to use. The proceeds of the sale are further allocated away from US risk: In commodities, emerging markets (equities and credit) and eventually stocks. The capital flowing out of the USA challenges the speed at which the Fed creates new money. New money is being printed, new money leaves the country. As long as the speed is higher than that of other currencies (our case now), the USD depreciates. With this outflow too, NOMINAL interest rates begin to rise (Yield curve steepens: http://sibileau.com/martin/2009/05/07/). This is a spiraling process.

-Credit rallies:
As NOMINAL interest rates and prices increase, REAL interest rates decrease. The higher NOMINAL stock valuations open a window of opportunity for firms to deleverage by accessing the equity markets (this is for instance the case with REITS (real estate income trusts) in April: See the letter from April 29th: http://sibileau.com/martin/2009/04/29). Firms also have access to debt refinancing, as banks count with liquidity. The refinancing consists in pushing maturities to longer terms, to make the EXPECTED REAL interest rate as low as possible. This is also a spiraling process: As firms successfully deleverage, they are more likely to obtain capital expenditures financing. New projects, as prices stabilize (=no longer fall), add further value to stocks, although not for all firms at an equal pace. Here is where inflation shows its unfairness, as the problem is not rising prices, but some prices rising more than others.

-Higher unemployment:
The aforementioned process drives a complete MISALLOCATION of resources. New projects, debt refinancing, equity issuance, prices not falling…all these amazing things can only happen because they are supported by a STEADY SPEED of money supply (remember the new metric: newly printed USD per week). However, as firms were caught in the deleveraging process not so long ago, they are not willing to either bring hiring to pre-crisis levels or even increase it, regardless of their late increase in output. Firms are aware of the distortion in RELATIVE prices (The same distortion they took advantage of to refinance their liabilities or deleverage via equity issuances.).

But the constant increase in money supply finds an outlet valve in the foreign exchange market. As the USD further depreciates, this trend also spirals and USD note holders run for the exit. Ultimately, the Fed loses the battle and reality sets in. Treasuries purchases stop and real interest rates increase. This is when the resource misallocation is exposed naked. A new, much harder reallocation has to take place now. Labour has to accommodate. Unemployment remains high. Discontent is everywhere, a new policy is sought. Liberals lose. The right takes over, wins the election and starts selling government assets (privatization), fighting hated unions, and cuts costs to create surpluses. **The USD appreciates and takes everyone by surprise.** Suddenly, emerging markets are no longer so interesting. Money leaves these countries and flees back to the USA.

Emerging markets realize that while they had the easy money, they missed the chance to improve their productivity, the chance to "use the capital to push forward the much needed structural reforms", as we will certainly read from an IMF report some day into the near future. But really, how can you not miss such opportunity. The No. 1 rule in Economics is that that which is free is wasted…You should never blame the pigs, but the hand that feeds them!
Will Canada be one of those commodity markets that a few years from now will wake up to realize the party is over? No, as long as two necessary and perhaps sufficient conditions are confirmed: 1) The Canadian dollar remains within a free and flexible exchange regime (and this includes no further regulation on Canadian banks) and 2) The government does not distort relative prices by running into deficits to save unprofitable businesses (i.e. Automotive).

Martin Sibileau martin@sibileau.com **(647) 999-2055**