

A View from the Trenches

Toronto, Monday, June 15th, 2009

Good morning,

We continue the discussion from Thursday (“A View from the Trenches”, a.k.a “Tincho’s letter”, is not published on Fridays during the sailing season in Lake Ontario). Since the start of the month, my tone has been more and more negative. On June 2nd (published on June 3rd: www.sibleau.com/martin/2009/06/03), I first proposed the idea that equities (S&P500) should stagnate. The notion was fleshed out again on Thursday. The chart below shows the market is telling us we’re right on this one... **I wonder how long this can be sustained.** We cannot say this market call was “luck”, for the suggestion was fully rationalized. I do not profess to call the markets, but whenever I propose a thesis, I fully elaborate on the reasons that drive me to such proposal. In this particular case, I said that behavior in equities is driven by a) Fed’s action and b) corporate credit’s dynamics. We thoroughly described this on June 10th (www.sibleau.com/martin/2009/06/10) in terms of balance sheet transfers among the main stakeholders and summarized it all back again last Thursday. Let’s see...

- a) **Fed’s action:** Perhaps the best way to characterize the Fed in June so far is by its “lack” of action. The market is tired of rhetoric and wants certainty. Participants want to know whether the Fed will or will not upsize its Treasuries purchase program. The longer it takes to announce this, the more painful it will get. Speculation in this front gives birth to and also nurtures the perception that debt refinancing (maturities swapping) is nothing but a window of opportunity, which brings us to the next point:
- b) **Corporate credit’s dynamics:** The debt refinancing process has diminished the jump-to-default risk, which created a relative gap between Treasuries and corporate credit, pushing investors to sell Treasuries and buy credit. But again, this was only to account for the decrease in short-term default risk. In the long term, defaults caused by over leverage are still waiting for us, and it may not be pretty. Delays often give way to sudden and violent drama. (For the theoretical background of this, please refer to the concept of “malinvestments”, by the Austrian school of Economics. We elaborated on this idea on May 11th: www.sibleau.com/martin/2009-05-11)

Now, let’s ask again: How long can the stagnation in equities last, without a resolution (either up or down)?

I don’t think equities will plunge as a result of the Fed not pushing liquidity. Simply, because I don’t think the Fed will stop pushing liquidity. But in the next weeks, we may realize that investment demand did not pick up. And then? Well, then investors would really push the line, forcing an exit strategy from the Fed. But I think they will be disappointed, because a true exit strategy would have to be announced by Mr. Geithner, instead of Mr. Bernanke. And it should read a bit like this: “We will cut spending on the following areas...” If this scenario unfolds, the ugly picture of corporate defaults around the corner would show up, fueled by higher Treasuries yields. **Equities would start to sell.**

WHAT WOULD BE DIFFERENT THIS TIME VS. 2008? THE SELL OFF IN EQUITIES MAY NOT BE DRIVEN BY FINANCIALS; IT WOULD NOT BE ABOUT ILLIQUIDITY. WHY IS THIS RELEVANT? BECAUSE DEFAULTS COULD NOT BE CORRELATED, CORPORATE CREDIT CURVES COULD NOT BE INVERTED.

S&P500 Intraday: From May 26 to June 12, 2009



Source: Bloomberg

Analysis: "A View from the Trenches"

Martin Sibleau

martin@sibleau.com

(647) 999-2055

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