

Good morning,

One has the feeling the markets are sort of “castling”, as in a chess game. Castling is an interesting move. It allows reassigning resources (the rook) but also, in my opinion, it puts the ball back in your opponent’s court (the Fed). So, the recent rally in Treasuries, mortgages and the USD looks like castling to me. Castling is a defensive move. Thus, equities are lower (S&P500 closed at 910.71pts or -0.14% and credit is wider (the CDX IG 12 index has widened 17bps so far this week). But we should never compare the capital markets with a chess board. They are not a zero-sum game and they are not determined, but are instead full of uncertainty. Therefore, I question the efficiency of castling this time!

Perhaps the most bizarre thing is the performance of Canadian risk assets. Only a few weeks ago, there was euphoria with Canada and the Canadian dollar. Today, the 2.33% drop in the S&P TSX Composite index to 10,067.26 was remarkable, when compared to the US action. It is clear by now that the insinuation of the official party to run a deficit is hurting. But maybe the rumor, the speculation that the Bank of Canada will manipulate the foreign exchange market is hurting more. On top of that, pessimistic economic data fuels the idea that the government will welcome demagogic policies. Which brings me to my next thought: How can the Fed dream of (as reported by Bloomberg yesterday) committing to a period of stable rates, while it simultaneously has to monetize deficits with purchases of uncertain final size? It is inconsistencies like this one that in the long term generate conflict...

As we outlined on June 2nd (“Meanwhile in Canada”, www.sibileau.com/martin/2009/06/02) and June 1st (“What can China do?”, www.sibileau.com/martin/2009/06/01), Canada will only profit from this crisis as long as two 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. Both conditions have NOT been met so far. We have heard from the Governor of the BOC concerns on the appreciation of the Canadian dollar and we have seen taxpayers’ monies being compromised to save unsustainable jobs in the automotive industry first, and in the pulp and paper sector now.

Why is Canada afraid of a strong currency? A strong currency means we can consume more of that the rest of the world produces. It means we can obtain capital goods from overseas at cheaper prices to improve our productivity. We deserve it! We earned it! Canada is presented with a great opportunity, but refuses to take it. The equity and foreign exchange markets are speaking loudly of this.

Yesterday’s announcement on enhanced regulation in the US financial markets brought the equity price of financials down, as we naturally expected. While the BRIC nations meet, engage in stronger multilateral trade and capital flow exchanges, the reaction in the US is to continue the hostility towards capital markets. Special reference is always made to the credit derivatives market. Even defenders of capitalism like George Soros, who has also been influenced by the Austrian School of Economics (thanks to Karl Popper), believes that credit derivatives are instruments to blame for this crisis. Let me say this about the issue: **Bureaucrats hate the credit derivatives market because derivatives tell it like it is!** Derivatives provide transparency; allow a multiplicity of investors to express a view. Therefore, the full force of regulation is going to fall hard upon non-banks.

Credit derivatives are necessary, add value, provide efficiency and speed economic recovery. How? The current deleveraging process has generated a lot of idle capacity. To make sense of this extra capacity, companies need to achieve economies of scale. **To get this scale, firms usually merge with or acquire competitors, to reduce costs and defend the prices of their output...**

Who is going to finance the necessary M&A activity when the time comes? Banks? With what capital? If banks are denied capital relief by hedging leverage buy-out transactions in the credit derivatives markets, large syndicated deals will become very expensive or avoided at all. And that, friends, that is a **huge** burden on any economic system, particularly those that depend heavily on leverage. The burden is ridiculous, because after so many years of financial innovation, human beings are not going to profit from it. Rejection of credit derivatives based on volatility concerns sounds as idiotic as rejecting marriage to avoid the risk of having a divorce!