A View from the Trenches

Toronto, Monday, July 12th, 2009

Good morning,

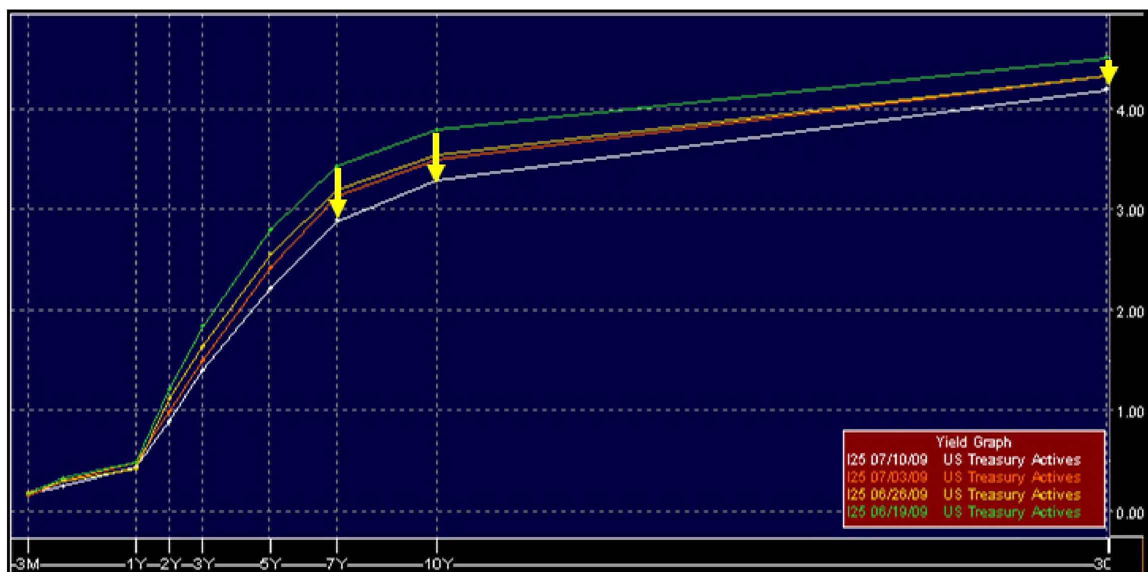
In the chart below (source: Bloomberg) I show the changes in the (on-the-run) Treasury yield curve, since June 19th. I wanted to visualize these changes since the retrenchment in equities and credit (which started last week) began. The most notable change is in the 7 and 10-year issues, which have appreciated (yield decreased) substantially. I find it interesting, very telling, to see that both the short-end and long-end of this curve have not followed the strong appreciation. This may signal caution, the lack of a strong view from the market on where and how the situation is unfolding. Should Q2 earnings surprise on the upside, the short end of the curve would depreciate quickly, driven by the return to a risk friendly mood. Consistently, given the ongoing monetization of deficits, a risk friendly environment would only be the other side of asset inflation, bringing inflation expectations back on stage (together with mortgage convexity hedging) and driving the long-term yield back again towards 5% (In the meantime, the reverse process in the mortgage world is taking place).

As Q2 earnings are released, the present danger, therefore, is new, lower lows in equities. This time, disappointing earnings would signal a weak consumer (finally higher savings rate) that may or not trigger more violent defaults, and hence loan losses. In our Thursday letter (www.sibileau.com/martin/2009/07/09/) I suggested that although the retrenchment is based on endogenous factors, there were still relevant exogenous ones to keep in mind.

Given the steady decrease in Libor, the narrowing of swap spreads and the shape of the yield curve, I am now more inclined to believe that lower lows can only take place as a result of exogenous/political events. It is a confusing notion, because the problems affecting the world have not changed; they have merely been transferred from the previously free, unregulated, marked-to-market balance sheet of the private sector to the political, regulated, amortizing balance sheets of government.

There are only two possible outcomes, not mutually exclusive, from this situation: A crowding-out effect (that would do justice to David Ricardo) or an inflationary process (that would give posthumous fame to Keynes). Right now, the market is precisely gauging the balance between the two. When the Fed doesn't insinuate further action, the market remembers Ricardo. When the Fed does insinuate it, the market remembers Keynes. To me, the key here is to remind ourselves that Mr. Obama will understandably seek reelection, which is years away. Inflation (Keynes) will be delayed, leaving more chances for the crowding-out effect. In the times of Ancient Rome, the Senate avoided the crowding-out effect by sending troops to conquer new countries, confiscating the wheat harvests of Egypt, the source of savings of the Ancient World. In 2009, China can certainly not be accounted for something of the sort. Therefore, the S&P500 could still go lower!

US Treasury yield curve (on the run issues): From June 19th 2009 (green) to July 10th, 2009 (white) **(Source: Bloomberg)**



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