A View from the Trenches

Toronto, Wednesday, July 15th, 2009

Good morning,

Analysts are striving to understand the action in equities in the last two days and in credit and Treasuries since yesterday. As I wrote before, I am not a big fan of statistics, indexes and all the ammunition mainstream economists use. My dislike for them is based on the assumptions; the methodologies used to measure, and last but not least, their respective goals. But this goes beyond the scope of this letter. Enough is to say that regardless of what was excluded or included in the calculation of the Producer Price Index released yesterday, the same was higher than expected and, most importantly, showed that there is no deflation.

In Canada, another relevant flag is that on July 13th and yesterday, the Bank of Canada had offered to purchase up to $3BN and C$1BN respectively, under the Purchase and Resale Agreements (PRAs). These short term transactions are meant to provide liquidity to the market. The news is that for the $3BN 84-day offer, only C$2.25BN was sold (for an average yield of 0.254%), while for the C$1BN 28-day offer, only C$700MM was sold (for an average yield of 0.50%). This in itself shouldn't have caught my attention. What was so special then? Between July 13th and today, the Canadian dollar appreciated approximately 2.5 US cents. To me, this is bullish of Canadian "stuff", for not only have commodities followed the reversal in stocks (S&P500 closed at 905.84pts) this week, but there is also an important amount of Canadian savings on the sidelines. However, let me be clear here: It is never wise to take a rally for granted because there is money on the sidelines!

Finally, let's recap here what I think is unfolding. I acknowledge I have been a contrarian since June, but the markets appear to be with me here. On June 3rd, I said that: "…***I expect equities to simply stagnate, orbit within a certain range. The harsh side of this coin will be a high unemployment***…" (www.sibileau.com/martin/2009/06/03). I also maintain that in order for us to see a fire sale in risk assets, we need some exogenous, political event to trigger it. **Therefore, I might as well be on the wrong side of the bet, because the last two sessions have ended up based on positive (or better than expected) data. (I may be right for the wrong reasons) although it is too early for a final conclusion.**

Thus, given the general confusion, let me repeat why I am inclined to expect agony in the markets, together with high unemployment: Because of the ongoing inflationary process. To most people, this is extremely counter intuitive, as they have been educated into the mainstream theory of inflation, which sees this phenomenon as a one-act play: A high CPI announcement. For us, educated under the Austrian school, inflation is the distortion in relative prices. This distortion can last many, many years, before it translates into a high CPI reading. This distortion also generates enormous imbalances, obstacles to firms and uncertainty. The uncertainty is what keeps unemployment high. **What then could get us on a steady growth path? A reliable fiscal budget in the developed world! Why? It would bring a reliable benchmark issuance schedule, and demand would consequently adapt to it.**

July 14th 2009, Intraday: **S&P500 Index (orange) vs. 30-yr Treasury (white)** (Source: Bloomberg)

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