A View from the Trenches

Toronto, Monday, July 20th, 2009

Good morning,

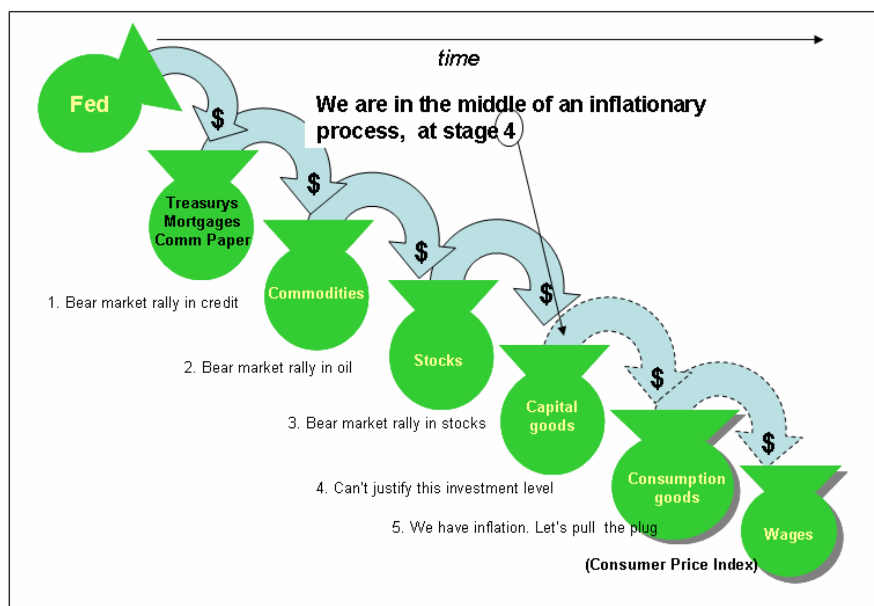
What do we make of last week's events? Investors had been speculating on horrible macro data. A positive (close to 1%) CPI Index, decreasing jobless claims and increasing housing starts challenged their view. Personally, given that I could care less about government-manipulated macro figures, I think the most impressive flags are:

-Price indexes, regardless of their absolute values, are telling us that there is no deflation. We've witnessed the greatest destruction of wealth in decades, we are flirting with two digit unemployment rates, continuing weakness in home prices and yet, we have no deflation…If prices (and interest rates) are moderately increasing with so many negatives, how high do you think they will go, when the positives show up?

-The Libor-OIS spread (i.e. the cost of renting a bank's balance sheet to invest in risky assets) has been decreasing in the face of CIT's bankruptcy. Is this mere negligence from investors? Analysts are accordingly quick to recommend "asymmetric" trades, trades that benefit from the new fact that systemic risk seems to have muted, leaving losers (to short) and winners (to go long). Decompression trades between indexes are advertised everywhere. There was an interesting research note (from Morgan Stanley's Credit Derivatives team) marketing the intrinsic option-like nature of index tranches to profit from this asymmetric view. I wish everyone good luck on these quant trades. It will be needed in uncharted waters. But if you are an observer seeking to follow the scientific method, you cannot ignore these events.

-The astonishing recovery in equities and sell-off in Treasuries, taking us back to where we left things at the end of May. When we first started publishing "A View from the Trenches" (under the name of "Tincho's letter"), we proposed the waterfall chart below (www.sibileau.com/martin/2009/04/14). This chart, updated for July 20th, should be our guide during the inflationary process brewing up worldwide. I think we are now ahead of stage 3 and in early stage 4. Why? Because stocks have not only rallied, but they have done so together with the most dramatic debt maturity swap ever (i.e. companies have been issuing long-term bonds to repay short-term debt) and companies are now focused on acquisitions (not necessarily capital expenditures). In the resource sector, we are seeing a nascent wave of mergers and acquisitions that will lead to more concentration and rigidity in commodity prices down the road. These acquisitions are all about gaining economies of scale and negotiating power. The latter will be necessary when, in the middle of two-digit interest rates, small businesses die like flies and big financial institutions put pressure on survivors. (Yes, you are right: I don't think you should try your luck with small cap equity funds. When governments decide who wins and who dies, it is usually the rich that get richer and the poor that get poorer…Il n'y a que le pauvres qui partagent!)

-Finally, municipal and state finances are increasingly pressing. I don't think California will default, but California is not alone out there. Nor should we rest comfortably while liquidity keeps flooding emerging markets.



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