A View from the Trenches

Toronto, Tuesday, July 21st, 2009

Good morning,

At 15:06 yesterday, Bloomberg was reporting that CIT was obtaining a $3BN financial rescue from bondholders, temporarily avoiding bankruptcy ($2BN committed, $1BN needs to be raised within the next 10 days). The S&P500 touched 950pts (back to Nov/08 levels) and oil continued to regain lost ground, reaching $64/bl.

It certainly feels like we are about to get to the next act in this drama. In a few weeks, we have the Federal Open Market Committee meeting taking place. Given the higher likelihood that we may have seen the bottom in March, investors are now concentrated in guessing (and understanding) the Fed's next steps. It may be too early to force a definition, but at the same time, the Fed is increasingly pressed to speak up.

How do we know? Because Mr. Bernanke just published an article on this issue, in the Wall Street Journal ("The Fed's Exit Strategy", July 20, 2009) discussing the issue….Ok, ok, seriously now, how do we know? Because the USD is selling off, not only against equities, but also against other currencies. And the latter takes place in the face of increasing rates expectations.

On July 16th, Bank of America's Michael Cloherty published a very interesting note (Situation Room: "How to Tighten (When it's time)") speculating on the different options the Fed has, as well as their respective impact on markets. In conclusion, Mr. Cloherty expects the Fed to push a mix of all of the mentioned options (i.e. higher interest on reserves, reverse repo transactions, Supplementary Financing Program (SFP) bills issuance, asset sales, and higher reserve requirements). Such operation would bring cheaper bills, Treasuries and a steeper curve. Another important effect could be a substantial repo cheapening (because the Fed would be oversupplying the market with Treasury debt, to get liquidity out of the system).

In light of this, should we not expect the USD to appreciate? Yes, absolutely. What could prevent the USD from appreciating? The market's belief that the fiscal (federal, state and municipal) deficit is an ongoing problem, while at the same time, the administration that incurs in them increases regulation on capital flows. Under such scenario, capital leaves... Yes, you are right, other nations should promise better prospects for that capital too, but if there is certainty about hostile conditions at home, there is a permanent driver for capital to leave.

In the meantime, we are also witnessing a compression in credit spreads, more debt refinancings taking place and the question now is whether or not we can get past the 1,000 pts in the S&P500 and reach 1,200. It's too early to tell and if you ask me, I don't think we can have that leap on good earnings alone. Capital friendly actions from governments are required. What do I mean by capital friendly actions? Essentially, anything that allows and encourages a flexible price system, without distortion in relative prices, and anything that does that with certainty.

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