

A View from the Trenches

Toronto, Thursday, July 23rd, 2009

Good morning,

Another boring day of range trading...Equities (S&P500) managed to stay almost flat at 954.07pts (-.05%). As you can imagine, we start reading everywhere how overbought the market is, including the CDX IG12 at 124/125bps, for instance. Overbought with respect to which level? Investors in the developed world, the world that leaves us no time to think, are so used to inductive reasoning (http://en.wikipedia.org/wiki/Inductive_reasoning and <http://www.uncg.edu/phi/phi115/induc4.htm>) that they are quick to make all kinds of statistical inferences referring to past events. How dare they? When was the last time we had a balance sheet crisis with central banking coordination, a trillion plus in monetary expansion, emerging markets with trade surpluses, a credit derivatives market and a superpower issuing debt on a weekly basis the size of an average country's GDP? When? Anyway, it's of great comfort to know that we (still) have futures and derivatives markets to hedge the mistakes of all those experiments in statistical inference.

Overbought or not, there are two things, two flags that in my view call for caution:

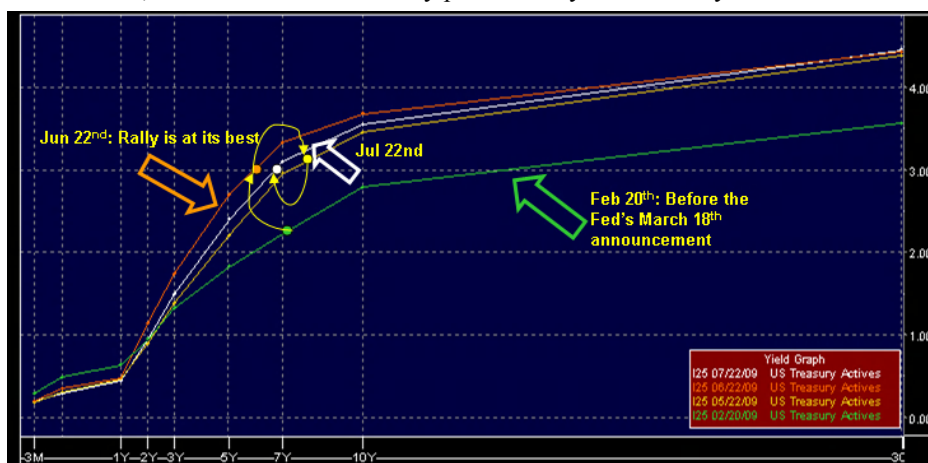
1.-The USD is depreciating on the expectation of higher interest rates (Bernanke is on the record on this one) down the road and the fact, apparently, that we may already past the bottom of this crisis.

This is not consistent. If you think activity will pick up and monetary stimulus is going to slowly (very slowly) disappear, the USD should be (very slowly) appreciating, particularly against the Canadian dollar, for instance, as the Bank of Canada remains committed to its lowest overnight rate. Some analysts associate this depreciation to investors' appetite for risk assets. Why are we supposed to believe for a moment that risk assets are found outside the US only? Why not inside the US? Especially in a context of higher interest rates...The only thing that comes to mind here is that the FX market may be telling us that activity may not pick up as much as we think, and that defaults are still looming on the horizon...What does this mean? That there is more to accommodative policy on the horizon than it meets the eye. But Bernanke did not hint at further purchases, on the contrary, he started to lay out the next steps of the exit strategy. This would make perfect sense, because it would be telling us that the Fed here is helpless and Treasuries will need to get a bid from somebody else (leading to higher defaults in the private sector, financially crushed by a horrible crowding-out effect). This would tell us that, ceteris paribus, equities cannot leap further by themselves but, at the same time, it doesn't necessarily mean that they are overbought.

2.-Crude oil is appreciating in the face of a widening contango, and without a clearly stronger demand.

Some would say that this is perfectly consistent with the weakening USD, yet one wonders why would investors put money here, when the market is bidding for storage. Today's break over \$65/bl was on higher than 90-day average volume. If the mainstream explanation that the USD is weaker as the bid for risk assets grows and activity is about to pick up, we should not be seeing a widening contango. Maybe the USD is weaker on the omen of stagflation, which would support a higher price for oil, but I feel it is too early for this, given that, on aggregate, capital expenditures are down, the official CPI figures are still very low and the increase in activity is months away.

In my view, these two flags are symptoms of stronger currents under the surface, and they can be well explaining the agony in equities (and soon credit too? around 120-130bps?). I leave with an interesting chart below (source: Bloomberg), on the yield curve, to see where we are, after 216.7BN in Treasury purchases by the Fed. Any comments?



Martin Sibleau

martin@sibleau.com

(647) 999-2055

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