A View from the Trenches

Toronto, Wednesday, July 29th, 2009

Good morning,

This is turning out to be a tedious week, with a mix of different readings on macro data about the housing market, the shape of the (US) consumer and the validity of the signals we are getting from earnings releases. But, above all, it is also an interesting week for rates, as the enormous amount of Treasury bills and coupons test their demand. Yesterday we had a $42BN issue of 2-yr notes. It appears the demand was not that enthusiastic about it, and the interest of the market is piqued.
Everyone is already speculating on when and how violently interest rates, short-term rates, will increase. My feeling is that it will not be as violent or as soon as most analysts believe. We live in a global economy and liquidity will have to reach every corner and raise every price before it comes back to haunt us with increased consumer prices and wages.

With this in mind, I want to discuss two investment theses, which are becoming more and more popular:

1. - In structured credit, correlation (of defaults) should be falling, as systemic risk falls
I am not going to deal here on how to play this thesis, which is currently debated in many forums (shorting equity tranche, equity steepeners, mezz steepeners, etc.). The point I want to bring up today is whether the most fundamental assumption underlying this view is valid: **Is it true that systemic risk will fall?**
Perhaps what misleads investors here is that systemic risk **may not be falling, but evolving**, switching from liquidity risk in its purest form (lack of financing) to inflation risk (lack of profitability, as costs rise or don't fall as quick as revenue and short-term financing becomes more expensive due to a crowding-out effect created by fiscal deficits). This is consistent with my view that the equity markets will remain stagnant. Why? Because with inflation (=distortion in relative prices), there is enough leverage to avoid asset deflation, but at the same time, there is a lack of growth opportunities.
Back to my point on correlation, let's take the structural approach: If you believe that correlation of defaults are a product of correlation in equities (in their expected returns) and their respective volatility, it will be easier to get the picture: **If inflation (distortion in relative prices) and the crowding-out effect destroy growth opportunities WORLDWIDE, expected returns and volatility should remain highly correlated. If expected returns and volatility remain highly correlated, correlation in structured credit should also remain high** (Please, feedback is very welcome on this point).

How do I know there is a global crowding out effect unfolding? I don't, but…did you look at the recent action in sovereign credit default swaps? Do you think this tightening in their credit spreads is sustainable? (I know we can always argue that this asset class is not liquid and cannot reveal meaningful information. However, this is a wide phenomenon affecting ALL sovereigns and their respective public debt issues, which in turn sets a floor for corporate credit. Therefore, I don't think we can afford to ignore its message: Coordinated worldwide currency debasement.)

2. – *China's role in replacing the US as the world's engine of growth (for instance, ref. Bank of America's Situation Report of July 27th, 2009: "Savings substitution").*
This is an increasingly relevant issue and I will be blunt here: China is merely importing inflation, and this is not sustainable. I also see the current debate as very "mercantilist" (http://en.wikipedia.org/wiki/Mercantilism). Investment demand is not necessarily financed by the generation of higher savings. **Saving or restraining consumption to have resources available to invest and increase a nation's stock of capital is very inefficient**. In fact, that was how Stalin conceived the growth path for Russia, for instance. So, what is an alternative and efficient way? **Reassignation of existing resources! However, how do investors know how to reassign resources? How do investors know when their resources are not efficiently assigned? In theory, when they lose money. But for them to lose money, the pricing system must be very flexible. Flexibility is critical.**

Back to my point, China will not replace the US until the genuine driver of capital formation is there: A good, free, pricing system. The fixed exchange rate regime China has only accentuates the agony for the world, as it allows the US to keep running their deficits and creates bubbles in China.
Finally, for the sake of intellectual honesty, I want to refer an interesting note on this, from a great economist, Ronald McKinnon: (http://www.stanford.edu/~mckinnon/briefs/policybrief_mar09.pdf).

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

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