

A View from the Trenches

Toronto, Thursday, July 30th, 2009

Good morning,

This is the last letter of the week (“A View from the Trenches” is not published on Fridays) and in Canada, next Monday is a civic holiday. A View from the Trenches will be published again on Tuesday. With this in mind, I thought it appropriate to summarize the main thoughts/theses so far, to clarify views and consistently approach the markets:

-Equities:

I have been sticking to the view first proposed on June 3rd (www.sibileau.com/martin/2009/06/03) that equities will stagnate, orbiting within a certain range. In the chart below (source: Bloomberg), we can see that since then, the S&P500 has been trading in a range of approx. +/- 5%. Why has it not fallen more? Because the Fed’s purchases of Treasuries and Agency debt/mortgages have provided liquidity. Why has the S&P500 not risen higher? Because there is a lack of growth opportunities and firms’ revenues continue to fall, on aggregate. Returns do not compensate for the risk taken in Equityland. On the other hand, without a clear resolution in the housing market, any hopes of witnessing a Pigou-effect based recovery (http://en.wikipedia.org/wiki/Pigou_effect) are put to sleep. Concern is thus growing around retail/consumer credit losses...

-Corporate Credit:

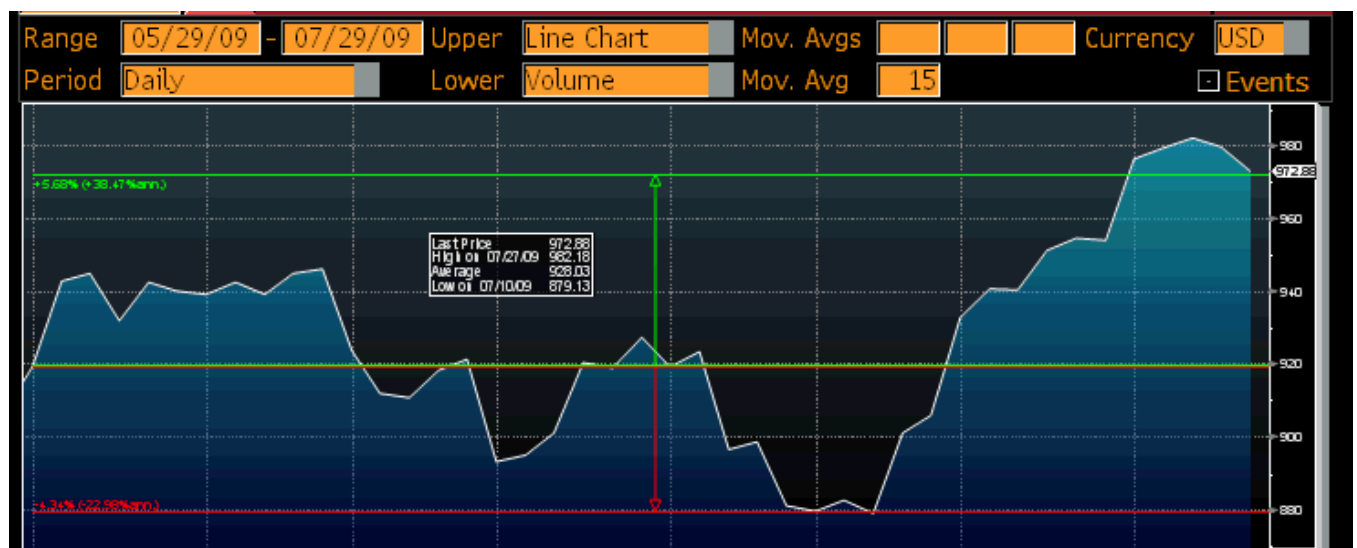
Given the ample liquidity (LIBOR today set another record, at 48.75bps) and the poor prospects in Equityland, credit spreads have been compressing, as we expected at the beginning of June. This trend still has some more rope. But government intervention here has a more direct impact, which brings me to the next point,

-Treasuries:

By now, it appears that the Fed and other Central Banks (except in Canada) can no longer engage in balance sheet expansion, and there may only be one way for rates to go: Up! As we said on July 22nd (www.sibileau.com/martin/2009/07/22), the Fed has hinted that an increase in short-term interest rates will be a fundamental aspect of their exit strategy. My view is that when short-term interest rates are increased the US Treasury validates these higher rates, regardless of their level, as it continues to issue debt. The average small firm will not be able to cope with the higher cost of capital, and many of them will go bankrupt, increasing concentration. Tax revenue would fall as a consequence, further boosting the fiscal deficit, in a spiraling process. Unemployment will remain high, and the Treasury will be forced to fund more and more fiscal imbalances.

-Gold:

I have not touched on this issue for a while. But I maintain my view, that the value of gold is negatively correlated to the level of global coordination in monetary policies. And coordination is high, making this crisis unique in that respect (<http://sibileau.com/martin/2009/07/27/this-time-is-different/>). Coordination also keeps the Canadian dollar under anesthesia. I suspect the existing coordination will remain, unless the world decisively repudiates the US fiscal deficits.



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