A View from the Trenches

Toronto, Thursday, July 9th, 2009

Good morning,

Many years ago, when I had to sell my first car to buy a newer one, I was a bit anxious. I could not find buyers. I went to my mechanic's shop looking for some advice. Perhaps he would be able to place the car with one of his customers. When I told him I was having trouble selling my car, which was in good condition, he plainly replied: "You don't sell your car because you don't want to". "What do you mean?" I asked back. "Well, I will actually buy the car, if you accept $5,000". That sum was really low and, of course, I put a polite smile, showing I had understood the message.
Today, as I remembered my first big selling experience, I wondered if the same is relevant to stocks. Precisely, I asked myself why stocks are not plunging. Why are equity investors not selling more violently? Is it because they also don't want to? Are prices already too low? With respect to what? Fundamentals? What fundamentals?

The fundamental story we hear of late goes a bit like this: Upcoming earnings releases may disappoint, showing a lower than expected marginal consumption. The increasing unemployment rate and ongoing energy inventory build up suggest that equity prices may have gotten a bit ahead of themselves.

The obvious question is whether prices should go back to their earlier lows or even lower, based on fundamentals. Did the S&P500 reach 666pts in early March because of liquidity problems or because of weak earnings expectations? If the cause was weak earnings expectations, why did the bond market rally after the Fed's purchase announcements in mid March? If the cause was liquidity problems and these seem to have eased substantially, why would stocks test the lows again? If the March lows are not going to be tested again, does it mean we are merely witnessing a correction?

Back on June 8th (http://sibileau.com/martin/2009/06/08/the-answer-is-political-exogenous/), I proposed the thesis that a sell-off would possibly be triggered due to an exogenous event, namely political. If I had to name one today, I would attribute it to the Fed's reticence to increase the current Treasuries purchase program. Yes, it is an inflationist policy but it is the only way out of this financial crisis. Will it create growth and produce full employment? No! It will merely redistribute wealth, dictate new winners and losers, but at the end of the day, it will have turned the page to another chapter!
On June 8th, I also wrote that should the sell-off be driven by endogenous causes, commodities would underperform. Commodities are actually underperforming. What makes me think that there may still be some hope? The fact that we are not seeing deflation, the fact that the Libor-OIS spread keeps compressing, that companies are swapping the maturities of their debt, that they are also getting away with negotiating amendments to their bank debt covenants and obviously, that the yield curve remains steepened.

However, there are still possible exogenous factors that in my view may aggravate the picture: a) the structural US federal deficits, b) the insolvency of US states/municipalities that would eventually require federal intervention, and c) the heavy burden of foreign debt to Eastern Europe's private sector, which would affect Western Europe's financial sector.

But at the end, what really worries me is that if panic takes place and the sell-off spirals, whatever liquidity we see out there will not be enough, and central banks will find themselves helpless. And as you may have noted, I am not even considering a scenario where in addition to the panic, loan losses effectively increase vs. expectations.

"...It was a serious blunder to believe that the reserve's task is to provide the means for the redemption of those banknotes the holders of which have lost confidence in the bank. The confidence which a bank and the money-substitutes it has issued enjoy is indivisible. It is either present with all its clients or it vanishes entirely. If some of the clients lose confidence, the rest of them lose it too. No bank issuing fiduciary media and granting circulation credit can fulfill the obligations which it has taken over in issuing money-substitutes if all clients are losing confidence and want to have their banknotes redeemed and their deposits paid back. This is an essential feature or weakness of the business of issuing fiduciary media and granting circulation credit. No system of reserve policy and no reserve requirements as enforced by the laws can remedy it…" L. v. Mises, "Human Action", 1949.

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