A View from the Trenches

Toronto, Tuesday, August 18th, 2009

Good morning,

Inevitably, we need to discuss yesterday's events. I must confess I read and reread all sorts of comments dating back to two weeks ago, encompassing a wide spectrum of opinions. There are the uber bears, telling us we are going to revisit the March lows, the optimist who point at macro data (i.e. New York Empire Manufacturing Index above consensus estimate of +4, rising to +12.1), and the cautious, who look for catalysts for a move on either direction. I want to believe I can include myself in the last category.

The optimist case is the easiest to grasp. In the case of the ultra bearish, the logic is flawless. Therefore, if we do not agree with it, we must disagree with their assumptions. The main assumption seems to be that government intervention will not change anything. But the rally we had since March 18th started precisely with the announcement of the Fed's quantitative easing policies (and died when the Fed declared last week they would not extend the Treasuries purchase program). It may be true (it actually is) that, in the end, in the long term, the intervention we see will be sterile. We cannot see sustainable economic growth when fiscal deficits are monetized. But at the same time, if we appreciate that the intervention since March (to be more precise, since Dec 5th 2008, when the Fed first started purchasing securities, in a very muted way though) did generate the asset inflation of 2009, we must at least not ignore that increased intervention in the face of a generalized sell-off is still a possibility. We saw the Bank of England opting for such alternative only a few days ago.

On Thursday ("A visible inconsistency", www.sibileau.com/martin/2009/08/13) I wrote that, in my view, as long as the US fiscal deficit continues with the resulting supply of Treasuries, the monetization is likely to continue, but in another form. I think we can safely say that today's announcement on the extension of the Term Asset-Backed Securities Loan Facility (TALF) to Jun/10 for new Commercial mortgage-backed securities (CMBS) and to Mar/10 for other assets, constitutes an alternative way to monetize. After all, what does the US Treasury borrow money for, if not to bail out private failures (i.e. in the real estate market)?

Another interesting development is the announcement or should I say rumor (by Reuters early yesterday. Bloomberg, at 7:40am, reported that it could neither be confirmed nor denied) that the China Investment Corp. would buy $2BN of US mortgages under the Treasury-backed Public-Private Investment Plan. In any case, we first proposed this alternative on June 1st ("What could China do?" www.sibileau.com/martin/2009/06/01), which would make sense as a coordinating policy to avoid the collapse of the USD. I never thought it would be implemented and the fact that is now a rumor raises a flag. However, let's be clear: A $2BN transaction in a trillion-dollar market is laughable. But $2BN is better than nothing.

Thus, in general, although governments may not be all that successful in avoiding a feared sell-off, I don't think we can just ignore the weight of their interventions. Having said this, another fact that makes me not so ultra bearish (for now at least!) is the low levels of the 3-mo Libor – OIS spread. This spread was 1.16% higher yesterday, but at the 24bps mark it is certainly not signaling stress yet. We'll closely look at its evolution in the coming days.

Lastly, I could not help noticing that unlike previous sessions, when the S&P500 was always closing to the upside in the last hour, yesterday, it didn't. Sometimes, I am superstitious too! Please, see the chart below (source: Bloomberg)

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