

A View from the Trenches Toronto, Wednesday, September 16th, 2009

Good morning,

In the last 24 hours, I think the markets may have focused on two things:

1.-Stronger than expected retail sales and Producer Price Index (PPI) figures for August, released at 8:30am

With the news, the 30yr on-the-run Treasury plunged 1% and the immediate assault upon the USD began. I don't know about retail sales, but when I realized this morning that the PPI ex-Food & Energy year-over-year was up 2.3%, I was very impressed. The past 12 months since August 2008 were one of the worst in our history since the Great Depression, with Lehman falling, Citigroup's share price plunging to 99 cents, the S&P500 losing a decade of accumulated value, foreclosures, etc., etc...and yet, the index managed to be up? I don't care here about the absolute figure, for these are usually not precise. I care about the trend, and the trend is up. Where will this index be once the recovery is in full force? The market seemed to ask the same question this morning and acted swiftly. No prisoners were taken.

2.-President Obama's speech in Pittsburgh and Bernanke's declaration that recession is "likely over".

I confess I did not hear Obama's speech entirely. However, I believe I heard enough (in particular his thoughts about his healthcare plan and its corresponding financing) to go back to my Bloomberg screen and confirm that the USD continued to be under assault. No surprises here...

In the end, the S&P500 closed higher (in terms of USD, of course!) at 1052.63 (+0.31%), the CDX IG12 at 103/104bps and Treasuries managed to bounce back at the end, helped by a \$2.05BN purchase by the Fed. Short rates endured best. The day also witnessed a heavy corporate bond issuance, which brings me to my next point:

At the beginning of May, we addressed the renaissance that was taking place in the debt markets (www.sibileau.com/martin/09/05/07). If today we are still uncertain about the strength and pace of the economic recovery, back then we were in complete and hopeless darkness. Back then, we wrote that: *"... issuers' fundamentals have not improved, let alone bottomed. We may understand the issuers' reasons for settling at any cost, but how do we explain investors' appetite for these issuances? Are investors being compensated for the risk taken? ..."* We then suggested that: *"...If the market believes issuers can pay these coupons, the expectation is they will sell assets, restructure or increase prices. Selling or restructuring requires that management have a strategic view, and I find it hard to believe there is a solid understanding of what the future keeps for us. If I am right, the recent steepening of the yield curve may be indicating that inflation expectations are to take a leading role, bringing REAL interest rates down...."*

My opinion was that the US Treasuries' curve had to steepen. And steepen it did, particularly fuelled by the negative convexity needs of mortgage investors. Thereafter, both the self-feeding recovery process via expectations and central banks' hypocritical assurances that "liquidity will be there" but "there is also an exit strategy", gave back some perspective to an anxious market, and allowed for some bull flattening movement. Months went by and we have made it to September with equities, credit and rates all rallying at the same time. As someone suggested, one of them has to be wrong... Or not. We have been explaining how, thanks to international coordination of monetary policies, with central banks swapping assets among themselves and the threat of a powerful IMF thwarting any currency run in emerging markets, the world can reach this state of dynamic equilibrium among debt, equities and rates. In a simple words, their rally is nothing else than a slow and steady flight from the USD.

But the consequences of the May renaissance are now visible and challenge the prospect of an easy exit strategy. According to Bloomberg, this wave of refinancings in 2009 deferred all the tension to the future, with 52% of the high yield bond and bank debt maturing between 2012 and 2014, exactly when everyone expects central banks to have started their respective exit strategies, with abrupt increases in interest rates and fiscal savings (if you believe them)!

Will activity have picked up so much that earnings at the companies that are today refinancing, carrying out acquisitions or financing capital expenditures will justify refinancings at high yields? You can bet most banks will have no choice but to lend to these companies, in the hope that defaults are pushed further out the curve. But if they do not succeed, will governments not step in again? At what (reputational) cost? Would it not be much, much simpler to merely accept the fact that we will live with two-digit inflation?

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