

A View from the Trenches Toronto, Thursday, September 17th, 2009

Good morning,

Let's be upfront: Yesterday's session was all about a run on the USD. In an emerging market or developed country whose currency lacks international weight, a run against that country's currency is expressed in terms of devaluation vs. an international currency. This is the case in Latin America, when the pesos lose against the USD. But, when the currency run takes place against an international currency, it may be expressed as a devaluation against equities, corporate bonds, treasuries (ironically), gold and yes, other currencies as well. This is what is happening this week. This is what was reinforced today, after bullish economic data releases: The CPI index, Industrial production, Capacity utilization and last but not least, the NAHB Housing Market index. Also relevant, the Department of Energy weekly inventory data showed a higher than expected drop in crude oil inventories (4.729k vs. 2.5k) and gasoline (547k vs. 700k).

All this obviously allowed equities to shoot higher, with speculators throwing their chips on natural gas, cement, etc. In terms of our liquidity metrics, the 3-mo Libor – OIS spread is now at 11.29bps, as if nothing would have ever happened here. Volatility dropped as well and we saw the CDX IG12 index closing at 97.5/98.5, losing 5.5bps.

Interestingly and in line with the trend, Bloomberg reported Venezuela's Chavez announcing that China will invest \$16BN in the Orinoco. If this is the case, the run against the USD is really, really in full force. The People's Bank of China will ultimately be lending (=getting rid of) its US Treasuries to a joint venture with PDVSA, Venezuela's state-run oil company. Thus, the flight out of the USD takes the most unusual forms, although we should not be surprised, as this reminds us of the outflows of capital from the Middle East to Switzerland and from there further to Latin America during the '70s. We all know how the story ended. These US dollars are being spread all over the planet and will end up providing depreciating incomes to salaried workers in commodity-based markets... Il n'y a que les pauvres qui partagent! Gold thus looks increasingly like a symbol of liberty in a world held hostage by central banks.

The market for corporate credit seems to be getting back to normal. We are starting to see more and more M&A deals, which will ultimately crystallize into a spiral of issuances to fund new capital expenditures programs. As we suggested in yesterday's letter, the corporate credit market is sailing on a course that will lead to a direct collision with the rates (=government debt) market (Anyone wants to guess who will sink first?). Academics call this the "crowding out" effect, which if acute, can lead to something called the "Olivera effect" (http://en.wikipedia.org/wiki/Olivera-Tanzi_effect), in honor of Julio H. G. Olivera.

The market is already becoming aware of this, but from another perspective. The market is concerned about the course rates are taking. Analysts are trying to forecast interest rate paths, quantitative easing policies, interest rate futures... Bank of America's US Rates team published an interesting note on this subject, that touches on the political aspects of this problem ("*SFP: A lull, not an end*", September 16th, 2009). The political side of this in the United States is represented by the need the Treasury currently has to wind down the Supplementary Financing Program, in order to meet its debt ceiling constraints. The Treasury will have to receive authorization from the Congress to increase its borrowings. How much more? The report suggests that AT LEAST \$4 EXTRA TRILLION may be required to finance the sum of the fiscal 2010 deficit (\$1.5 Trillion), social security plans (\$0.5 Trillion) and an explicit guarantee (not funded, but which counts towards the ceiling) on outstanding Agency debt (\$1.7 Trillion). Until we have certainty about the political support for this, we may bet on a sell off in long end Treasuries and Agency debt. This is the perspective on interest rates' sailing course. But what about the sailing course of corporate credit?

I think that we must not lose sight over the fact that perhaps the two factors that drove credit spreads tighter so far are: a) Quantitative easing policies (=creation of liquidity) and b) refinancings (=maturity swaps), where borrowers issued long term debt to repay short term debt. Both factors have a mutually reinforcing dynamics, but the first factor is not sustainable and the second one can only lead to a good port if the issuers of debt manage to recover their liquidity within the timeframe they just bought with their refinancings. The first factor is not sustainable because it requires political stability internally and globally, a manageable fiscal deficit and coordination of supply among central banks to prevent gold from becoming a reserve currency.

The second factor is perhaps the most underestimated, in my view. Firms will have to work hard to regain the liquidity they lost, but in the upcoming stages of this inflationary process, we will see giant distortions in relative prices, including foreign exchange crosses, and increasing difficulties on the labor side. Usually, these factors lead to bankruptcies (loan losses) even before interest rates rise.

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