

A View from the Trenches Toronto, Wednesday, September 2nd, 2009

Good morning,

Yes, the markets sold off yesterday. Are we seeing a correction or is there something more ominous at stake? I am inclined to believe this is a policy driven correction. S&P500 closed at 998.04pts and the next key level may now be 980pts. There are mixed signals here. If we look at the macro data releases from yesterday (ISM, autos, home building), I think they were positive. Yet, the market decided to throw stocks overboard and anchor at Treasury Bay. I will discuss then these signals and will let you decide (I am a big believer in the Socratic Method).

To start with, let me say that I don't buy into the now popular notion that "...equities got ahead of themselves (earnings), vs. credit..." Let's leave induction to the "Populus" and instead discuss ideas; ideas that must be verified or rejected by facts. We're deductive here, we like rationalism, Cartesian deduction and Popper's scientific method...

Before most research (in Credit and Rates) teams would tell us that interest rates may stay lower for longer than most of us anticipate, "*A View from the Trenches*", on August 19th, was proposing this thesis: www.sibileau.com/2009/08/19. Not only did we go on record writing this, but we also wrote on the possibility that Credit, Sovereign risk and Equities could rally at the same time. And not only did we throw the idea, but we also did propose an explanation: Central banks (Asian) changing the composition of their assets (currencies reserves) from Agency debt to Treasuries and from the long end to the short end. This shift in assets has been by now widely corroborated with end-of-month data.

Ladies and gentlemen, the vomit that started this week is, in my view, the result of some indigestion caused by that shift in central banks' asset allocation (a change in diet, one could say, which proves once more that monetary expansion is non-neutral, really) plus,...plus some early exits from emerging markets...Being familiar with Latin America, the case of Mexico and to some degree Brazil has caught my attention. The fiscal outlook of Mexico in addition to Brazil's intervention in Petrobras (reminiscent of Chavez policies, if I may add) is starting to cause some concern. But then again, I don't buy into the notion that these events are independent. There is a deeper and stronger root here, which brings me back to the topic of central banks coordination. Short and brief, while we are seeing the coordination being led by China's move to tighten liquidity, emerging markets are the Achilles' talon here.

Let me explain: We can perfectly see a G-8 central bank coordinate assistance with another G-8 member, but investors are wondering who is going to pay the bill, a fiscal problem unfolds in an emerging market. The IMF? Maybe, but given that history suggests otherwise, the onus is on policy makers. In the meantime, money is flowing out of emerging markets (As an aside comment, sometimes one gets the sense that the German language is more precise than others. When I remember that in German, the word for IMF is "Internationaler Währungsfonds", I feel I am in the presence of one of those times...).

In the case of Mexico, since mid August, the USD has appreciated from MXP12.85 to MXP13.68, at close. Is this driven directly by commodities? I don't think so, because the non-US dollars have not followed this sharp path.

Lastly, two other signals make me think we may be watching a policy driven correction: The IG12 index closing at 122bps, the 3-mo Libor- OIS spread making yet another low at 15.69bps yesterday (but the Libor curve is steep), the CAD trading range bound and the 30-yr Treasury closing unchanged. Against this data, we have the EUR/JPY breaking the 132.50 support and the VIX gapping to 29.15 at close.

These are all mixed signals, and I leave you to decide. In my view, the market can keep selling off until there is certainty on two key points:

1.-Stability of interest rates (at low levels): If it takes more quantitative easing, let there be more of it. But let it be announced upfront! If it takes an explicit commitment, please speak up, central bankers! No more games, no more insinuation!

2.-Existence of a contention mechanism for potential emerging markets crisis: If China is going to slow down and the fiscal outlook of commodity-based emerging economies deteriorates, we want to know that the "Währungsfonds" will be there to push the problem further out the curve!

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