

A View from the Trenches Toronto, Tuesday, September 22nd, 2009

Good morning,

The week started with the Japanese markets closed, and I have the sense there is a bit of anxiousness out there. There are multiple issues shaping the outlook on capital markets, which may be an indication that it will be difficult for the equity market to keep rallying from here. Thus, friends, for the record, on September 22nd 2009, "A View from the Trenches" turns neutral on equities.

Do I mean the S&P500 will fall? Do I mean that the S&P500 cannot keep rallying? Not necessarily. Let's see...

I do not think that the S&P500 will sell-off because the market will grow impatient on macro stats, or lower-than-expected revenue or earnings or even increased probabilities of default. No! I do not share the rationale of the bears. As we have been writing lately, I believe Central Banks still have a lot of firepower in their hands to stop a run for cover. My fear is that precisely the same Central Banks may screw up with the unwinding of their existing liquidity programs. In fact, no matter how softly they unwind them, the impact on relative prices in the foreign exchange, rates and credit markets will affect equities. On political grounds, then, the S&P500 can sell off. This differentiates my scenario from that of the bearish voices on the street.

For the same reason, I do not think equities can keep rallying on fundamentals alone. (For the sake of honesty, I note that some months ago, I held the same view on the potential for equities to shoot higher. I was wrong then, because the self-feeding mechanism of lower spreads, more refinancings and lower jump-to-default risk was a virtuous spiral that got us where we are now. I underestimated the secondary effects of liquidity!) However, maybe I am right this time. My view is that the equity market would need some policy measure that would bring clarity, confidence to the picture. So far, I cannot think of any.

Therefore, two main 2009 themes that we have extensively discussed here come to mind:

1. - We are in the middle of an inflationary process and inflation never brings growth. As we wrote countless times, the stagnation is caused by the uncertainty in relative prices. Inflation is non-neutral, affecting certain prices first, and other prices later and in the end, when everybody realizes it is there to stay, inflation is evident through CPI readings. For those who still believe in the CPI mystique, I offer this comparison: As much as you cannot claim that a baby is not alive yet when you see a mother pregnant, you cannot claim inflation has not arrived yet because consumer prices and wages have not increased. Trillions of debt have been monetized, lifting the equity, credit and fixed income markets. The pregnancy started months ago and we are going to have that baby! In the meantime, the changes in relative prices and outlooks are still significant.

2. - All shocks have been exogenous so far, driven by politics. Therefore, we must pay attention to all things political. The details on an exit strategy from Central Banks are still unclear. Yes, it's almost October and nobody really knows what the next steps are going to be. However, while equities stagnate (hence we are neutral), in the interest rates and credit markets, the situation is different. Speculation is rampant on the impact of the run-off of the Supplementary Financing Program, the end of the Mortgage Purchase Program (expected to be extended) and the Treasuries Purchase Program on curves, liquidity, and spreads. Perhaps the liquidity aspect of these changes is the most critical. I will not describe it here, because it is all rumors so far, but promise to elaborate on it once we have more details. In the meantime, the bottom line is that liquidity will be negatively affected and some kind of panic may arise, which will (if it is not already doing so) negatively touch equities and commodities, strengthening the USD.

In Credit we had the launch of Series 13 yesterday, in the CDX North American indices. I will have more to say about the macroeconomic implications of the current levels (CDX IG13 closed at 91/92, IG12 at 98.75/99.75) and above all, curves in the credit space. But we can safely say that increasing fiscal deficits worldwide and a steep credit curve with 50%+ of issuances maturing within a couple of years is close to what Paul Krugman warned us about: The postponement of the end of the world.

Yesterday, we wrote about the recent USD denominated sovereign issuances in developed markets. We did further research and came across a September 18th note on the subject by Bank of America's Rates team. It appears that approximately \$13.6BN has been issued by European governments in September alone. I asked an informed analyst whether these issuances have actually been hedged against currency risk, but I was not given a clear answer back. However, my understanding is that the interest rate risk would not be eliminated. As we wrote yesterday, one wonders if giving up seigniorage in exchange of a few bps upfront is a sound policy. How big is \$13.6BN? Not that much, if we think about them as a single event in time. However, if the trend picks up, it will be significant.

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