

Good morning,

Back from a brief vacation to the land of Niccolo and Marcvs Tullivs, here is an update on my last comments.

On September 22nd, I had turned neutral on the S&P500 and, given the activity in early October, on the 6th, I said that should the S&P500 close above 1,044 pts on three consecutive sessions, I would review my opinion. The S&P500 of course did that and we are now on the 1,090+ level.

Perhaps a good way to start here is to remember the reasons for my view. I explicitly mentioned three reasons: No clarity on exit strategies, dispersion in monetary policy answers and increasing political instability. I did also mention that the central banks, through their liquidity programs, were denying us the right to “measure” fundamentals. I wrote that our world looked like an undetermined algebraic system, where we have more unknowns than equations and that the determinant for the system was going to be the release of Q3 earnings (=productivity).

The Q3 earnings releases are taking place and so far, results look positive. In my view however, the reflected productivity growth is not behind the recent increase in asset prices, which brings me to the three reasons I mentioned above. Since my last letter, I think there is more clarity on them. In terms of political instability, things in the Persian Gulf seem to have quieted down a bit. Perhaps an interesting message to Iran was the visit King Abdullah paid to Syria’s President Bashar Assad on October 9th. Within the European Union, there also seems to be a shift from the concern on internal weakness to USD weakness. And along this line as well, the perceived opinion of potential weakness in emerging markets may have radically changed. So much so, that yesterday, Brazil decided to impose a tax on foreign purchases of equities and bonds (Of course, this measure was complete idiocy of the first degree!).

In terms of dispersion in monetary policy, things are also getting clearer. The world is splitting between those who prefer to import USD inflation (i.e. Canada, Brazil) and those who do not (i.e. European Union, Australia). The case of Canada is sad. Canada has undoubtedly decided to pass on a unique chance to leverage its relatively undamaged capital markets to foster dramatic productivity changes. This is already costing a lot to Canadians, but the savings confiscation mechanism is so subtle that it goes unnoticed. You see, say two hundred years ago, if a government had wanted to take purchasing power off the table, it would have sent soldiers to confiscate cattle or burn farms. That would have brought (and in many cases did bring) a revolution, with the uprising of peasants. Why? Because the damage was very noticeable. If they took your cows and chickens and burned your warehouse, you knew you had lost purchasing power. Today, things are easier. For instance, it only takes the Bank of Canada to do a few repurchase transactions every week to keep the value of the CAD low. If it is not enough, we still have Mr. Carney saying that the CAD strength more than fully offsets recent signs of growth, to chop 2 cents off its value in a session, as he did yesterday! If this was not a plain confiscation of savings (illegal, given that Parliament did not vote on it), I don’t know what it is. In any case, the point here is that there is more clarity on the issue of dispersion in monetary policy.

The last point, the clarity of exit strategies, presented us with a major change last Monday. Indeed, the New York Fed admitted on Monday that it is working with counterparties on reverse repo tests. This is a major issue and one on which a lot has already been written and rumored about. Briefly, the Fed will eventually need to take liquidity off the market. One of the tools to achieve this is the reverse repos, where the Fed exchanges Treasuries in its balance sheet for cash (that leaves the market). The problem with this is that the volume required is so huge, that the current dealer infrastructure is not enough. Thus, money market funds, for instance, would have to participate in the effort. But if money market funds were to hold these Treasuries, the crowding out effect on the commercial paper market would be significant, affecting rates. Should this be bullish on equities? I think I would be a bit of a contrarian if I said it would. In general, policies like this one, which seek to lead the way towards sound money are positive for the market, in the long run. Was it a coincidence that on Monday, as the news on the tests by the Fed was released at 10am, the VIX index fell 6.8% a few minutes afterward? If it wasn’t, should we not be bullish again on the S&P500? In USD terms? I think I should.