

A View from the Trenches Toronto, Wednesday, October 28th, 2009

Good morning,

“A View from the Trenches” is back, after some health complications... A lot has happened since I last wrote last week, and at the same time, there is really nothing too meaningful that we can single out.

Indeed, the market seems to be drifting toward some correction, particularly in equities, but at the same time, one has to wonder what would cause a dramatic correction, in light of the continuous liquidity injections from central banks, overall “acceptable” Q3 earnings and a controlled USD devaluation. Can there be a correction? Of course, but at this point I believe there are too many yield-hungry investors that would immediately put a damp to any significant move.

Having said this, I can think of two main themes dominating the macro picture these days. The first one is the idiotic rhetoric campaigns carried out by monetary authorities worldwide. The same is based on two pillars: The continuous threats on potential unanticipated rate movements and the further intervention/regulation of capital markets to build a “solid” system.

A good example of this disgraceful situation can be found in the Bank of Canada. Its Governor, Mr. Carney, insists on reminding us he may choose to intervene the foreign exchange market at any time (although he already does so via repurchase agreements), while he simultaneously makes redundant comments on the capitalization of the banking system. He is not alone, as this propaganda takes place in other monetary areas.

The main concern seems to be the possibility of asset bubbles. These asset bubbles are the other side of the capitalization equation. By definition, if they are bubbles, when they go bust, the drag on the system is painful. They are right about this one, but the truth is that mudding the waters with hostile comments does not make matters any better. With central banks, there are asset bubbles. There is no way around it. It is very simple. Without central banks, if investors want liquidity, they need to sell assets. When these assets are sold, their prices fall in relation to the assets they want to buy with the liquidity they purchased. Therefore, without central banks, there can never be a financial/liquidity crisis like the one we just had (and the ones will keep suffering) but only violent relative price movements, at the most.

With central banks however, if investors need liquidity, central banks provide it by purchasing assets that nobody in the market was buying until that moment. The marginal asset purchases used to inject liquidity is what generates the bubbles. For instance, in the US, the market for agency debt and mortgage-backed securities is a good example. Hypocrisy (i.e. the talk about asset bubbles) therefore is a calamity, because it triggers events like Monday’s sell off in banks’ shares.

The second theme is the future potential interest rate (and foreign exchange crosses) dynamics. Interest rates have no place to go but up. The speed at which this process will unfold is therefore the big question. Will this speed be faster than the marginal efficiency of capital (=strength of the recovery, in more pagan language) in the different countries that face the challenge? Indeed, this is hardly any news at all. But the market is extremely focused on this topic, as the maturity schedule of corporate debt (and default and recovery trends) is now clearer, capital expenditure programs can no longer be postponed and the housing sector in the US necessarily finds a bottom at some point. Again, are interest rates a problem? No, the problem is not with interest rates, but with the force that drives and restricts future policy: The size of fiscal deficits.

Almost all of the macro trades recommended these days are based on the relative sizes and outlook on fiscal deficits. These trades involve foreign exchange crosses, benchmark curve views or relative performance views within credit classes (i.e. investment grade vs. high yield) and instruments (i.e. derivatives indices vs. bonds). Interestingly enough, everybody quietly agrees on this: fiscal deficits will not be addressed, but financing strategies will. As these financing strategies are disclosed, we will learn about new winners and new losers, competing for a decreasing liquidity. But that’s another story, for another time...