A View from the Trenches

Toronto, Wednesday, October 7th, 2009

Good morning,

Yesterday's action was in line with our latest comments: The world is leaving the USD. Nothing else can be affirmed with higher certainty than this. Everything else is pure speculation. I can think of three levels to analyze the fall of the USD:

1. - The short term
The fall of the USD necessarily triggers relative price adjustments. For one, it appears that it got stronger after the "cash" rate increase announcement by the Reserve Bank of Australia (from 3.00% to 3.25%). Thus, the first relation that has been adjusted is in the rates market. The rates differential triggered a steepening of the US benchmark curve, which may/should drive negative convexity hedging flows in the mortgage-backed securities space. The other side of a lower USD is what the market might have interpreted as an export or Main Street friendly backdrop. Equities had to rise and did rise. Of course, it is nothing else but the reflection of a weakening currency, a deflator. Lastly, it was interesting to see that the CDX IG13 index was on a solid widening trend, while the S&P500 at mid-session was struggling to keep above 1,050pts. In credit thus, shorts won the day, which brings me to my next level…

2. – The near term
Can we see a recovery in the US driven by the depreciation of its currency? I am sure that by now there is enough historical evidence to suggest that depreciating one's currency leads nowhere. However, before we reach this conclusion, we may as well ask ourselves whether we can actually blame the US for this depreciation. In my view, that is the case. The Fed and/or the Treasury could have communicated a more convincing story on this matter. Whatever assurances the market received that the US is better off with a strong USD came from the most unexpected characters in this play, like the president of the European Central Bank. Silence on the part of US authorities led to confusion, and confusion led to deception. Nevertheless, the bottom line here is that currency depreciations never solve problems. And there are lots of them, beginning with a high unemployment rate. Currency manipulations in the global economies of the 21st century, where goods are made of components manufactured in a diversity of currency areas, represent a real and tangible distortion in relative prices. The result is the misallocation of resources, with labor being one of them. The other important misallocated resource is capital, regardless of whether it is supplied in the form of debt, hybrids or equity. In the case of capital supplied via debt, the credit market unanimously spoke up yesterday, when it saw an opportunity to get net short in investment grade. Interestingly enough, emerging markets sovereign risk tightened significantly, reminding me of the sweet '70s, which led to the sovereign defaults of the early '80s.

3. - Longer term
The fall of the USD must also be considered as a relevant milestone. It shows a crack in what was until now a common, united international front against the financial crisis. Right now, it is of no consequence. However, as monetary and fiscal policies become less internationally coordinated, the world loses a tool that is necessary to confront a future potential increase in bankruptcies. The 2009 refinancing wave has only shifted default risk a couple of years away. Its success will depend on the speed and strength of the recovery that we can enjoy until then.

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