

A View from the Trenches Toronto, Wednesday, November 18th, 2009

Good morning,

Perhaps yesterday was an opportunity to take a break and think matters over more carefully. Although equities closed almost flat in the US, there was some intraday volatility. The underperformance in mortgage-backed securities (some overseas trading at 7am ET exactly) caught my attention, as it would not be the first time that such overseas/overnight trading sets the stage for the day or week...

There are a few themes (not thesis) being discussed lately, that I think may anticipate a tough 2010:

-Global Imbalances, the USD and rates:

This issue has been on the table for decades already. It has gained more airtime with Obama's recent visit to China and Bernanke's comments at the Economic Club of New York. The short summary of its 2009/10 version is something like this: China's monetary policy of fixed exchange rates has forced the Bank of China to buy the dollars the Fed has been issuing. Some analysts (see Bank of America's "Situation Report" of November 16th) call this "China's vendor financing". I think the term is spot on. When the Bank of China buys dollars, it issues Renminbi, which have been used to buy local assets, among which real estate has a prominent place.

While China worries about the USD devaluation, the other side of the coin is that if the US was to stop what I am now convinced is an intentional devaluation, it would only need to raise rates. That would kill many bubbles, would it not? This is worrying investors, who see the asset bubbles in China as a potential time bomb, when rates start rising in the US. I am a bit less pessimistic on this issue. First, this is nothing new. It has been going on for a long time and with different countries, as it was denounced back in the '30s by Jacques Rueff. Secondly, the Bank of China, like any other central bank, always has unlimited means to debase its currency, if they deem it necessary. Please, note that if this scenario played out, the biggest loser here would be gold...

-Emerging Markets:

There is increasing concern on the public finances of Mexico and Brazil. The potential future problems, like the global imbalances that grow by the hour, are still far ahead on the horizon. But the issue with these economies, in my view, is not potential shocks, but their leaders' sudden and unpredictable reactions to them. In any case, if there were a financial panic, the contagion effect across the globe would be very painful.

-Rates, credit and stocks:

By now, I guess the market has come to understand that stocks have been driven by rates, via the credit markets (Rates decrease as central banks buy securities, the liquidity so injected goes to refinance short term debt, firms delever and together with cost cutting measures, the value of the call option on the firms' assets (=value of their equity) rises). The market now seems to accept the futility of seeking fundamentals to justify valuations; the irrelevance of calling an asset class over or undervalued. Liquidity injections distorted all relative prices and relative value comparisons work at best, in my view, within the same asset class. Having said this, what if rates rose? I don't want to answer this question, because I am convinced rates will not rise until activity picks up meaningfully. The other side of this is the high risk of inflation that would come out of such scenario. Would bonds not sell off? I need to think more about this, but for now, I am not convinced to take either side...