

A View from the Trenches

Toronto, Monday, November 2nd, 2009

Good morning,

The week is starting on bad news. To begin with, last Friday's close was horrible in equities. Not so much in credit, where spreads did not widen more than they had on Wednesday. However, the overall picture is fragile, from a technical perspective. I am attaching this morning a graph of the VIX Index (source: Bloomberg), which measures the implied volatility of the S&P500 Index options. You can see that the recent spike is indeed relevant. Is this necessarily bearish of risk assets? No, not necessarily, but given the situation the world is in, volatility is expensive and usually demands a discount...

The other not so good news is the bankruptcy of CIT. This should not surprise anyone, to be fair, but the truth is that unfortunately it is taking place in not so good a week. It should not matter, because in my view this correction is still manageable.

In short, all I want to leave with you this morning is the following: As long as central banks and governments of the G-8 "play it cool", quiet and do not screw up with unnecessary hostile rhetoric, the market should take profits, the late longs should get their lesson and things should get back to normal. Normal these days includes lots of leverage, because if there is anything interesting about this leverage crisis is that the world is trying to get out of it via more leverage. Therefore, any minimal suggestion that signals a hike in interest rates, or the need for higher capitalization of financial institutions, or tougher regulations that destroys flexibility in the financial markets is going to derail the healing process started last March. It will not be weaker fundamentals, animal spirits or educated fear. It will be politicians not doing the smart thing that will lead us from an overdue correction to a new crisis.

Personally, I don't give a lot of probability to a catastrophic scenario, because it is hard for me to believe that so much political reputation will have been put on the line to arrive to November and make a false move that brings down the house of cards. But I always hope for the best fearing the worst...



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