A View from the Trenches Toronto, Friday, November 20th, 2009

Good morning,

In the chart below (source: Bloomberg), I show the intraday spread between the 30-yr US Treasury and the S&P500 Index. As you can see, this spread widened significantly until 11am yesterday.

Macroeconomic data released yesterday morning by 10am were mixed. On one hand, the initial jobless claims and Philadelphia Fed Manufacturing Index were positive. Jobless claims are approaching the 500k level and should they break through to the downside, an important milestone will have been achieved. On the other hand, the Leading Indicators index and Mortgage delinquencies data disappointed (0.3% vs. 1% expected and 9.64% vs. 9.24% expected, respectively). However, as the chart above shows, before the releases (i.e. overnight) the fixed income market was already selling off overseas (white line shows price of 30-yr Treasuries going up until 11am). Afterwards, the market did not react either, until 11am.

What made markets react at 11am? The only news I found at 11am was the US Treasury bills and coupon auctions announcements. But there was nothing to be surprised. Analysts were fully expecting $118BN of coupon issuance in total, composed of different maturities. Not only were the full $118BN announced, but their composition was also announced in the exact maturity buckets the market had been expecting. Why did markets react?

I think investors are starting to acknowledge that the burden of the fiscal deficits worldwide will be significant. The sell off was triggered in Europe, where Greece's central bank expressed concern over the usage of Euro liquidity facilities by Greek banks. Greek bank stocks sold off on the news and the contagion effect spread further sovereign credit default swaps. Sovereign credit default swaps saw a steady and solid bid yesterday. Yes, the problems are macroeconomic and those who have been suggesting otherwise may be proven wrong. The proof is, in my view, in the price of gold, which tracked the movements in US Treasuries simultaneously. It was exactly after 11am that the price of the ounce began to regain what had lost, to finish almost flat. This meant, I think, that once there were no surprises on the auction announcements (=the party can continue) the bid for risky assets could keep going on.

Was someone out there expecting a different auctions announcement? At the end of the session, almost most key variables remained flat; the sovereign credit default swap market was left with wounds. Maybe they heal, maybe they don't.

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