A View from the Trenches

Toronto, Friday, November 27th, 2009

Good morning,

With US markets closed yesterday, the level of liquidity was not normal in the face of the events/news out of Dubai. Equity markets elsewhere got the message (finally!) and the sell-off, which to my surprise had been absent yesterday, took place.

As I write these comments there is speculation on the motive Dubai may have had to request the standstill (until at least May 2010) in financing payments by property developer Nakheel and other member companies of Dubai World, which is the company's state-owned parent. The markets' deception is due to Dubai's recent announcement of $5BN raised in a fully subscribed transaction with two Abu Dhabi-owned banks. I prefer not to comment on rumors. Apparently, this situation unfolded because of some tension between Abu Dhabi and Dubai. Later in the day, the market began to discriminate between Dubai's systemic risk and that of other Gulf nations.

At the big picture level, I think there are two interesting observations to make, related to two theses I have written about earlier. Back on September 2nd, I wrote that:

"*…emerging markets are the Achilles' tendon… We can perfectly see a G-8 central bank coordinate assistance with another G-8 member, but investors are wondering who is going to pay the bill, if a fiscal problem unfolds in an emerging market. The IMF? Maybe, but given that history suggests otherwise, the onus is on policy makers…*" (www.sibileau.com/2009/09/02).

This debt crisis seems to have certain unique characteristics, given the Emirates' political dynamic. However, given that local banks were involved in the financing of the real estate delusions with people's deposits, this is also another typical emerging market debt crisis. Therefore, policy makers in the developed world will be forced again to consider assistance mechanisms.

The second observation relates to our old thesis on gold. On September 3rd, I suggested that:

"*…A run against an emerging market's currency would* ***not necessarily be*** *supportive of the USD, if the same is triggered by a wave of defaults affecting the country's financial system. It could potentially be supportive of gold, if the big guys (G-8 countries) don't lend a timely hand..."* (www.sibileau.com/martin/2009/09/03)

Gold did not rally yesterday, but the USD did. Does this therefore mean that there will be a "timely hand"? (Our gold thesis reads as follows: *"…when there is global coordination of inflationary monetary policies, gold cannot be a safe and lucrative asset. When inflationary monetary policies are not globally coordinated, gold is a safe and lucrative asset…*")

One is tempted to induce an answer. However, we are not inductive at "A View from the Trenches". We follow the Austrian method, which is purely deductive. It is a fallacy to think that if A is true →B is true, therefore, when B is true →A is true.

Applied to this situation, it is wrong to conclude that: "If when there is global coordination (of central banks) gold doesn't rally (=is not lucrative), therefore, when we see like yesterday that gold did not rally (= was not lucrative), global coordination is on the way".

It is nevertheless a bit early to draw conclusions here because:

1. - Yesterday the US markets were closed (maybe this was precisely the reason behind the sudden announcement by Dubai),
2. - It is not yet clear what Dubai really intends to do.

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