A View from the Trenches

Toronto, Tuesday, November 3rd, 2009

Good morning,

As we write, the correction continues, relentless. It does not matter that macroeconomic data releases like yesterday's (ISM Manufacturing Index, ISM Prices, Construction spending and pending home sales) are positive. Profits are taken and money is put aside. Although in equities we finished slightly higher (S&P500 at 1042.88pts or +0.65%), the intraday weakness was there and the trend is clearly to the downside.

Thus, further to yesterday's letter, I tried to think along two lines: Historical context and logical thread. I do not think I was too successful at it but here is where I got:

-Historical context

The following comparison will seem a bit stretched, but I still believe it has merit. By 1995, when the Tequila crisis took place, Argentina had been under a convertible system (1 peso = 1 USD) for four years already. During the crisis, market participants got very nervous. The convertibility system was being put to the test. Being an emerging market, money started to flow out from Argentina, in association with the Mexican crisis. The Argentine monetary authorities at the time did nothing but honor the promise they had made: For each peso returned, they refunded investors with a USD, and each returned peso was taken out of circulation. Interest rates of course shot up and the political pressure to abandon the convertibility was very strong. Yet the neither the central bank nor the government show any reaction at all. In the end, those who bet against the central bank lost the opportunity to earn a great yield in convertible pesos. Convertibility was to last another six years.

Why do I bring this up? Because this profit taking exercise reminds me a lot of Argentina under the Tequila effect. Macroeconomic data seem to show that so far, there is a mild virtuous cycle triggered by the stimulus policies. All we need is productivity (the "physical supply functions" Keynes wrote about) and growth to validate the asset prices we have reached. All we need is governments to remain quiet and with a low profile, for those unconvinced investors to realize that there may be more to lose by leaving to the sidelines than by keeping their chips on the table. However, there are many differences with 1995. We have many governments, not just one, playing their cards. We also do not have a polarized situation, where we know with certainty which policies do work (i.e. convertibility) and which ones do not. We are not even sure the Treasury purchase program was a good thing. Thus, it is even more critical that governments abstain from generating volatility in these times.

-Logical thread

The logical thread that would take us from profit taking to a new, dramatic sell-off would necessarily have to be based on: (a) Negative or poor macro data (high unemployment does not qualify here, because it should surprise nobody), (b) the unanticipated sudden increase in USD interest rates and/or (c) an unanticipated deterioration in balance sheets (higher defaults, lower recoveries) (Feedback here is as usual welcome here).

So far, macroeconomic data does not seem to have been disappointing to me and balance sheets have been able to get refinanced, pushing the problem years ahead. Recoveries seem to have increased and realized defaults to have been lower than forecasted. The big question is on interest rates, it is political in nature. Therefore, my question to you is: "What makes you think monetary authorities will either pull the plug (=let interest rates increase) or recklessly accelerate the monetization of fiscal deficits (=let the USD or GBP plunge)?"

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