

A View from the Trenches Toronto, Wednesday, December 2nd, 2009

Good morning,

Yesterday, the barbarians crossed the Rhine, compromising the status quo. With investors' realization that the news out of Dubai has done absolutely nothing to the general liquidity picture, they now know the vulnerability of the system, and they go for more. When barbarians crossed the Rhine in December 406 AC, their merit was underestimated, because their crossing was more a reflection of Rome's weakness than of their own strength. Like then, the rally in risky assets these days is underestimated, because its resilience is more a reflection of central banks' weakness (= flight out of debased currencies) than of its own strength. Yet barbarians finally reached Rome, and I am very tempted to say that they will also throw a significant challenge to central banks...

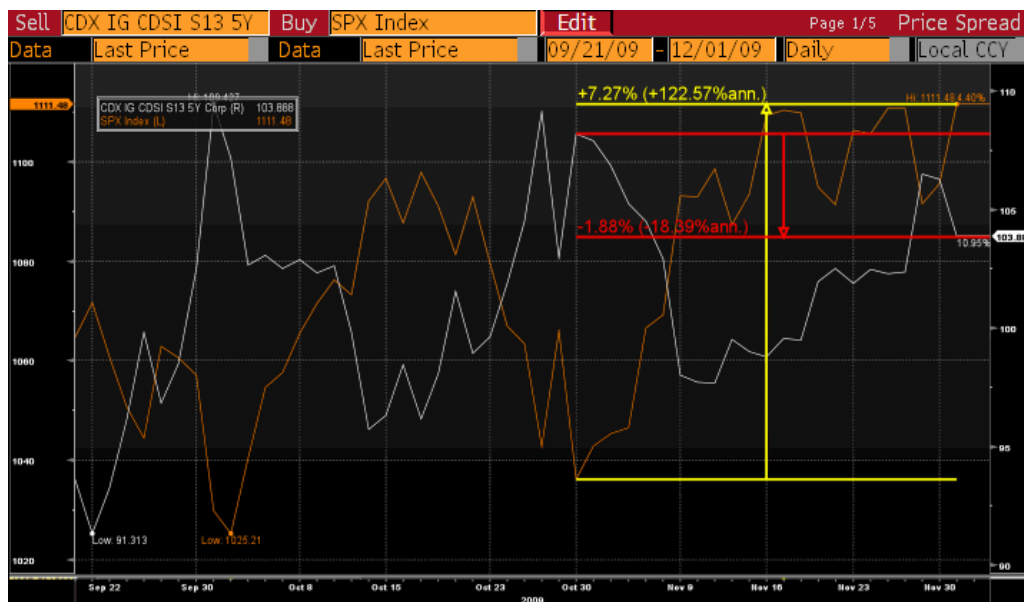
Who wins? The arm dealers. Who are the arm dealers? The gold mining companies.

Indeed, yesterday we learned that Dubai may restructure \$26BN in debt obligations and that there are liquidity lines ready for the local financial institutions. We also learned that the Bank of Japan is ready to inject more liquidity to the world, in the form of quantitative easing. There are countries like Australia (and perhaps Canada soon) that will not join the party and will keep raising rates (Australia did so by 25bps yesterday, to 3.75%). China, well...China still has to make up its mind...

On the other hand, there is widespread speculation on the financial stability of Greece, given what seems to be its unsustainable fiscal deficit. This is putting pressure on the Euro, which fell against the Canadian dollar (commodity currency). On Friday, one Euro bought 1.60 CADs. Today, it buys 1.575 CADs.

Emerging markets continue to capture capital flows. In Latin America, we have a new dictatorship in Honduras. In Venezuela, Chavez continues to buy arms and threatens regional peace. Ecuador has defaulted on its debt, like Argentina. Brazil goes as far as siding with Teheran on their nuclear aspirations, to divide the Caracas – Teheran axe. In Bolivia and Argentina (and perhaps soon Uruguay too), capital is fought with vehemence by their respective leaders. However, capital continues to flow in the region, discriminating and without fear, into Colombia, Peru and Chile at unseen speed and levels. For the first time in more than a year, even the Mexican Peso now trades below the \$13MXP/USD level.

This picture is only sustainable in the near term, and we should not be surprised to see gold trade above \$1,200/oz. This unprecedented monetary expansion, as we wrote too many times, cannot and will not bring economic growth. Therefore, at one point, equities will have to reflect this reality. It would seem as if the corporate credit market gets it. Since November, the compression in investment grade spreads has been more muted than the rally in the S&P500, as the chart below shows (CDX IG 5-yr Series 13 index (white line) vs. S&P500 Index (orange line); source: Bloomberg). The VIX index (benchmark of volatility in the S&P500) dropped dramatically yesterday, but even its descent has been bumpy.



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