A View from the Trenches Toronto, Monday, February 1st , 2010

Good morning,

We enter February and nothing is what used to be. Keep this in mind because you will hear, read and watch hundreds of market gurus tell you that this "correction" represents a buying (of stocks, risk) opportunity. We are deductive at "A View from the Trenches" and deduction demands that we rationalize our view. Here we go:

When at the end of 2009 I expressed some optimism for 2010 (refer: http://sibileau.com/martin/2009/12/16/, "Thinking about 2010) I did so with caveats (…*"I (…) ask myself what assumptions are behind this logical thread. The first one is the assumption of "stability" in benchmark, sovereign rates, with independent central banks"*…). As well, even though I was optimistic, I disagreed with the mainstream view that volatility would be muted in 2010 ("…*with the Euro zone falling into pieces, and with creditor countries in Asia exacerbating the USD peg. This is barely a picture of muted volatility and higher valuations…I am confident we will see effective policy action on all of these fronts. But, muted volatility? I don't think so"…)*. The chart at the bottom (source: Bloomberg) shows the VIX index. It is cruelly clear that volatility in 2010 is still relevant.

As 2010 commenced with a rally, I thought over and over how I could rationalize the market action. I structured my view in two letters, on Jan 20th and 21st (refer: "Two dimensions", Part I: http://sibileau.com/martin/2010/01/20/two-dimensions-part-i and Part II: http://sibileau.com/martin/2010/01/21/two-dimensions-part-ii/). Briefly, I think that in 2010 we see two juxtaposed forces: the non-neutrality of money and time or lack thereof, for the structural changes that different currency areas require.

But when on January 22nd I said : "*…the market proved me wrong. If by the close of today we see the S&P500 not at 1,120pts, then I hope that you are as liquid as possible entering the next week…",* I wrote purely on a technical basis (I appreciate the wisdom of one of Gartman's trading rules: "Think like a fundamentalist; trade like a technician"). I turned 100% liquid that same day and also made it clear that I was still not bearish, but neutral. I had to understand the new fundamentals…

To understand the new fundamentals, we can still use the two dimensional framework proposed earlier. Time has won over the non-neutrality of money, not based on its own merit, but because the non-neutrality of money was killed as China, the US and now India attacked the distribution chain (banks) of the credit expansion process, in the last two weeks. Time will also continue to win because the main assumption of stability mentioned above, relying on steady sovereign risk and independent central banks, is also dead. Europe is leading the destruction of stability in sovereign risk, while Argentina has already killed its central bank. Mexico follows, having announced its intention to repay a $47BN credit line to the IMF, with central bank's reserves. And although the European Central Bank still remains fairly independent, such independence will prove illusory. Greece, Portugal, Spain and Italy will deceive the North and make the posthumous case for Max Weber (http://en.wikipedia.org/wiki/Max_Weber). Our thoughts on Greece have been fairly laid out, and I stick to my initial script (refer: http://sibileau.com/martin/2009/12/17/).

With this backdrop, without monetary policy coordination, our Thesis No. 2 on gold, resurfaces. Gold has a chance. Tomorrow, I will write more on this chance, which requires further elaboration on how the macro picture has changed. But the bottom line is that now I am bearish. In the next letters, I will seek to provide structure to the bearish (and "beta") trade.

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