

A View from the Trenches Toronto, Friday, January 22nd, 2010

Good morning,

What was President Obama thinking? I know I told you yesterday that of the two forces I saw, I expected the non-neutrality of money to prevail. Well, I think 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 trust I am clear.

Please, do not lose perspective here. Earnings do not matter. Fundamentals do not matter. This was and continues to be a liquidity crisis. When leverage increases, prices increase. When leverage decreases, prices decrease. The latest political action in the USA and the decision to prohibit banks from running proprietary trading operations, from sponsoring hedge and private equity funds, and to cap at 10 percent the market-share on deposits is first nothing else than idiocy of the first order and secondly, a hit to the relevering game that was taking place since last March.

It is true, the concerns on the sustainability of Greece's fiscal path added to the fire yesterday morning. There was a rumor circulating early yesterday that the European Central Bank would consider a loan for Greece. It was immediately dismissed. But folks, let me say this: Whatever assistance Greece may get from Europe will not be explicit. Nobody will face the scrutiny of public opinion or the moral hazard of such a move. As I wrote earlier, I believe Greece still has a lot of tricks at hand that can use to its benefit, to keep financing its current deficit. One of them is with the private placement market. If Greece continues to use it, selling its debt to local banks (which take deposits in Euros), then Greece will have infected the Euro zone with its disease, forcing the European Central Bank to provide liquidity lines to its financial system. This would be a hidden way to support the deficit and I would be surprised if it is not explored. Therefore, to me, Greece is only noise in the market. Loud noise, but still noise...

The situation in China is different. A lot, really a lot of different outcomes can play out when we think of how the People's Bank will manage to rein in inflation and its currency appreciation. On top of this, we must also not forget India's latest developments, but these are the subject of another letter.

Thus so far, only by the idiocy of politicians that don't get Keynes' right, we witnessed a huge technical damage to all the key macro prices yesterday. And I find it very hard to repair this damage. What did Keynes write? We quoted him endless times and we quote him again: "...when output has increased and prices have risen, the effect of this on liquidity-preference will be to increase the quantity of money necessary to maintain a given rate of interest..." (General Theory, Chapter 13) That's right! Folks in Washington, London, Frankfurt, Beijing and Tokyo: Please, be consistent. If you are going to print our way out of this one, the world will need an increased quantity of money, to maintain the rate of interest (or marginal efficiency of capital). There is no other way!

Finally, a few comments on the Canadian dollar. As you can see in the charts below (source: Bloomberg), which show the CAD vs. the USD and EUR, it seems that the appreciating trend of the Canadian dollar remains in place. It is being seriously challenged as we write, but it looks like it is still in place.



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