

# A View from the Trenches

Toronto, Thursday, January 28<sup>th</sup>, 2010

Good morning,

The bearish trend in all markets remains in place. “A View from the Trenches” has a neutral view since Friday, January 22<sup>nd</sup>, but we are increasingly nervous on “headline” risk, given the inconsistencies we hear and read on a daily basis from the world’s most influential policy makers. If this situation continues, and we fail to see why not, we will have no choice but to turn bearish sooner than later (For those interested in these inconsistencies, please, refer to: “*The trade cycle and money expansion: The economic consequences of cheap money*” L. Von Mises, 1946, <http://mises.org/books/causes.pdf>, pages 197-8 of pdf doc.)

Since our last letter on Tuesday, perhaps the main policy update we’ve had is the confirmation (as it had been widely expected) of the Fed’s intention to pay interest on reserves. These reserves surpass the \$1 trillion mark and this interest payment will be charged to US taxpayers. Such is the social efficiency of central banking... This measure will increase the cost of credit, by establishing a floor on the price of “savings”. This is certainly not bullish. It will be effective, no doubt, and it will have an impact on Libor (increase) and the overnight rate. Essentially, the Fed will gain control of the cost of liquidity, as it embarks on its experiment to unwind the quantitative easing undertaken last year. We wish them well, but we cannot help expressing our distaste for price distortions created by governments, and manipulating interest rates is one of such distortions. We always prefer central banks that manage their balance sheets (leaving markets to determine prices) over those that manage prices (leaving markets to determine volumes).

On another note, Greece has received an abysmal amount of attention in the last days. The market is not pricing a near term default so far and numerous analysts have rehearsed a multitude of scenarios. At “A View from the Trenches”, we were ahead of the curve, when *more than a month ago* we went on record saying that we don’t believe Greece will default in the near term (12 months) and that instead, the country’s government will seek to get the indirect and hidden subsidy of the European Central Bank, by placing its debt in the private markets (Greek banks):

*“...in our letter from yesterday, I incorrectly compared the situation in Greece with that of Argentina. Although it is true that in both countries the governments “stuffed” local banks with their own debt, the comparison is not correct. In Argentina, the financial system was totally compromised, because the peso was under a convertible (with the USD) system, where the Banco Central had given up the ability to act as a lender of last resort. In Greece, the situation is radically different. The EUR2BN private placement that was announced yesterday is nothing else but an undisclosed tax on Euro zone taxpayers, to subsidize Greece’s fiscal deficit. Greece cannot get a direct subsidy, but the banks that took on the government debt have access to liquidity facilities from the European Central Bank. Thus, the 250bps spread on Euribor charged for the issuance was an arbitrage on taxing jurisdictions, earned by the shareholders of the respective lenders and in a more diluted way, by Greece citizens too...”* (refer: [www.sibileau.com/martin/2009/12/17](http://www.sibileau.com/martin/2009/12/17)).

Since last week, every analyst places this scenario (Greece’s government using the private placement/syndication market) as a likely option. We proposed it more than a month ago, and believe that the current inversion in Greece’s sovereign credit curve presents an interesting trading opportunity. It also makes me think that Latin America’s sovereign space is very rich in light of the new tightening environment in China.

Finally, I cannot help noticing that the Canadian dollar is under real stress lately, with the bullish trend seriously challenged, as shown in the chart below (source: Bloomberg). In the next letters I will write more on this as well as thoughts on gold.



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