

# A View from the Trenches Toronto, Wednesday, January 6<sup>th</sup>, 2010

Good morning,

In my view, the main factor driving markets yesterday continued to be the concern on the housing sector. The release of the month-over-month Pending Home sales data at -16% vs. a -2% expected, confirmed investors' fear that the housing sector is lagging vs. other recovery stories. This is directly connected to my earlier comments this week on the Treasury's decision to support GSE debt indirectly, through the Preferred Stock Purchase Program (see [www.sibileau.com/martin/2010/01/04](http://www.sibileau.com/martin/2010/01/04) and [www.sibileau.com/martin/2010/01/05](http://www.sibileau.com/martin/2010/01/05)).

Having said this, you can see why range-bound trading in almost every major market took place yesterday. At the same time and consistent with the amount of speeches given by US monetary authorities this week, there is a lot of media attention on the timing and form of exit strategies. On the latter, I notice increased interest in the alternative of bond sales by the Fed. If you have been following these letters, you may remember that I went on record on November 24<sup>th</sup> and 26<sup>th</sup> with a new thesis precisely on this point (refer: "Introducing Thesis No. 3", [www.sibileau.com/martin/2009/11/24](http://www.sibileau.com/martin/2009/11/24); and [www.sibileau.com/martin/2009/11/26](http://www.sibileau.com/martin/2009/11/26)). At the time, I wrote it didn't make sense to target a level of reserves consistent with what we had pre-crisis, in disagreement with the mainstream opinion. It seems this view may be getting more support. Thus, there appears to be an increasing crowd favoring asset sales by the Fed. In an online forum, I made two points yesterday on the rationale for this, which I reproduce below:

- Historical:

Bond sales are consistent with what Keynes had in mind, on how to get out of a mess like the one we're in. He discussed this in Chapter 13, of his "General Theory ...". In 1936, Keynes wrote: "...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...". I am convinced that Bernanke has been following Keynes since this whole thing began. If I am right, Bernanke then should be seeking to manage the quantity of money, necessary to maintain the status quo... Keynes believed in managing a level of liquidity to determine rates, and not the opposite. How do you manage money, which is the liabilities of central banks? By managing the other side of the balance sheet: Its assets. Bond sales are therefore the way to go.

- Analytical

Quantitative easing policies are very disruptive to an economic system, because they distort relative prices. Therefore, if central banks want to reverse the distortions they produced in the markets (for instance the Agencies' debt basis), the simplest way is to unwind the initial trades that originally created these distortions. Bond sales, again, are the way to go. When the variable is "quantities", the model adjusts via prices. I always, always, always, prefer markets rather than governments to figure out prices (i.e. market clearing rate of interest).

Finally, there is also another big debate on how to prevent financial crisis going forward. This is a topic for another day. In the meantime, let me say that financial crisis will not be prevented as long as we have central banks. It's that simple.

Financial crisis can only be prevented under four necessary conditions: a) A free banking system (= no central banks and no legal tender); b) A central clearinghouse for the issuance of money (notes). A free banking system without a clearinghouse, where banks compete for the seigniorage (proposed by many authors within the Austrian school) is also a flawed system; c) a commodity-based unit of account (i.e. gold oz.); and d) free and flexible exchange rate system. Gold convertibility under a Conversion Agency (as proposed by Ludwig Von Mises on Part IV, Ch. III, p. 449 of his "The Theory of Money and Credit", Yale, 1953) is a quick and sure way to utter failure, in my view.

Like Fermat, I also have discovered a "truly marvelous" proof of this proposition, which this letter is too narrow to contain...

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