A View from the Trenches Toronto, Tuesday, February 2nd , 2010

Good morning,

When Maynard Keynes wrote the already famous sentence: *"…And 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…"*, he was clearly considering "time" as a magnitude in his analysis.
It takes time to increase output and it takes time for prices to rise, reacting to such increase. The rise in prices and the speed of the output increase have to be matched by the nominal interest rate referred above. This is why Keynes also wrote, in the same paragraph: *"…prices will rise in a degree partly governed by the shapes of the physical supply functions, and partly by the liability of the wage-unit to rise in terms of money…"* (The General Theory of Employment, Interest and Money", Ch 13, S. III). Briefly, Keynes' idea was to coordinate monetary policy to debase a currency taking advantage of productivity slack (i.e. *the shapes of the physical supply functions*) and unemployment (i.e. *the liability of the wage-unit to rise in terms of money*).

Since the start of 2010, it seems that of all sudden, central bankers have forgotten this idea, while at the same time, governments attack banks with higher reserve requirements and capitalization ratios. Banks are not to blame for the shocks. Shocks are produced by central banks, which determine the money supply function, but I guess somebody has to be blamed.

With the above in mind, I thought of 3 phases that may unfold in 2010. In all of them, the challenge of matching monetary policy to productivity is omnipresent. This framework suggests a long-term bullish view of gold and commodity based currencies, and a definite path to inflation by 2011, when it is most likely that the real tightening will take place.
These phases are presented in the chart below, which I think is self-explanatory. In the next letter, I will nevertheless elaborate more on this framework. In terms of timing, the only certainty we may have is that we will need to wait another quarter to see earnings disappointing.

PHASE 1

Assumptions:

-Unwinding of QE programs
-Policy rates stable
-Restricting measures on banking system (higher reserves, capital, regulation)
-No clarity on sovereign risk dynamics in Euro zone
-Earnings do not surprise

Consequences:

-Credit, stocks stagnate
-Commodities stagnate
-Gold trades in a range
-USD stronger

PHASE 2

Assumptions:

-Earnings disappoint
-Sovereigns show no intention of cutting costs
-Sovereign risk in Europe's peripherals deteriorates
-No indication of change in policy by central banks
-Central banks under political pressure

Consequences:

-Credit, stocks sell off
-Commodities sell
-Gold sells
-USD strengthens

PHASE 3

Assumptions:

-Central banks cannot react, do not tighten
-Inflation expectations surge
-European Central Bank openly supports Euro's financial system

Consequences:

-Credit, stocks rally
-Commodities rally
-Gold rallies
-USD weakens
-Weak economic growth
-High unemployment

Martin Sibileau martin@sibileau.com **(647) 999-2055**

Disclaimer: The comments expressed in this publication are my own personal opinions only and do not necessarily reflect the positions or opinions of my employer. I prepared and distributed this publication as an independent activity, outside my regular salaried work. No part of the compensation I receive from my current employer was, is or will be directly or indirectly related to any comments or personal views expressed in this publication. All comments are based upon my current knowledge. You should conduct independent research to verify the validity of any statements made in this publication before basing any decisions upon those statements. The information contained herein is not necessarily complete and its accuracy is not guaranteed. If you are receiving this communication in error, please notify me immediately by electronic mail or telephone. The comments expressed in this publication provide general information only. Neither the information nor any opinion expressed constitutes a solicitation, an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments. The comments expressed in this publication are not intended to provide personal investment advice and they do not take into account the specific investment objectives, financial situation and the particular needs of any specific person. All rights reserved.