

# A View from the Trenches Toronto, Thursday, February 4<sup>th</sup>, 2010

Good morning,

In the previous letter, I framed my review of 2010 in three stages. The bottom line is that I am bearish, and expect the bearishness to progress. The progress will be marked by the lack of credit expansion, caused by central banks unwinding quantitative easing policies or by governments limiting the credit expansion, through regulation. Without this lifeline, the onus is on fundamentals. So far, they don't seem to surprise nor disappoint. I think there is merit in my intuition, proved perhaps by the fact that both the Reserve Bank of Australia and the Norges Bank took a break from rising policy rates this week.

In this context of stagnation, monetary authorities will be increasingly pressed to leave the status quo unchanged. However, in the case of Europe, the situation may be different. As the fiscal situation deteriorates seemingly faster than previously thought, the European Central Bank will have to take an holistic approach to the problem. As I mentioned on December 17th ([www.sibileau.com/martin/2009/12/17](http://www.sibileau.com/martin/2009/12/17)), I expect the path of least resistance to be the abuse of the private placement market (bank debt) to finance peripherals' deficits (i.e. Greece, Portugal, Spain, Italy, Ireland). This will guarantee that the European Central Bank will be forced to extend liquidity to the affected financial institutions, providing a hidden subsidy. This is clearly bearish of the Euro. The chart below is very ominous in this respect. It shows the IBEX (Spain) stock index, which is approx. 11% off its January peak (Source: Bloomberg). Yesterday, the weakness was noticeable, driven by financials (bank stocks). This is the worst kind of weakness you can see and a bull market will never rise from it.

Yesterday, the markets surprised me. Stocks and fixed income sold off, while credit remained flat. Credit, it is true, is undergoing a lot of technicals, which make the picture blurry. However, on average, the market sought liquidity, for the sake of liquidity given the steepening of the US yield curve (2y10y by 3.8 bps, to 282.2 bps). The USD strengthened, while I believe the strength in oil was merely a bounce within a bearish trend. If I am correct, not even the upcoming G7 meeting (where neither China, India or Russia will be present) will be able to coordinate the required global exit strategy. On this basis, I see an increasingly bigger role for gold as a reserve asset (not currency). But we will still have to see a lot more water running under the bridge, before gold shows us the way. All along, the social backdrop will grow uglier, as unemployment will remain high.

How to trade with this outlook? Keep it liquid, and keep it simple, when you short the stock market or play the curve in European sovereign credit. As I previously said, I don't see volatility waning in 2010, given the global fiscal front, which means that complex trades can get killed by tail risk, courtesy of liquidity preference behavior.



Martin Sibileau

[martin@sibileau.com](mailto: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.