A View from the Trenches

Toronto, Thursday, March 18th , 2010

Good morning,

Since European leaders confirmed their support to Greece a few days ago and the Fed repeated that "*economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period*" in their last Federal Open Market Committee statement, the rally in stocks and credit, driven by a lower USD has continued, reaching new highs. What seemed to be the next and unavoidable hurdle for the market, the oversupply of Agency debt once the Fed stops it purchase program, is no longer a concern. This week a few market analysts have revised their demand expectations for this product and it appears the demand will be there (refer: "*Against All Odds*", US Fixed Income Situation, BofAML, March 12th and "*Where next for the Treasury Market?*", Fixed Income and FX Research, UBS, March 17th). Will the demand be there for mortgages because they are intrinsically a good product? No, they will be there because alternative investments in credit are already too tight and traditional mortgage investors are underweight this product.
If this sounds counterintuitive, then let us add that although most agree that credit is already too tight and can still become tighter, default expectations have not necessarily decreased, particularly in High Yield. Finally, fundamentals are signaling a stronger than expected recovery in the US, Canada and Europe.

Is this all the lagged consequence of the earlier quantitative easing policies? Certainly, but why should we care?
In our view, the latest action in the markets proves that they are dependent on a given rate of money supply. This is a difficult concept to grasp in the developed world, for it is the base upon which the dynamic theory of inflation was developed. A rate of money supply is a dynamic concept, and we are used to think in "comparative static" terms. The dynamic approach to inflation evolved during the '60s, mostly under the so-called "heterodox" line of economists. In Latin America, Dr. J.H. Olivera's contribution to the theory is widely acknowledged.
Basically, this line of analysis sustains that agents in the market "get used" to a rate of money supply, which they incorporate in their expectations. For instance, if you have the Fed buying, say, $10BN of mortgages/week, the respective market incorporates this liquidity metric and invests accordingly. It is a "sticky" expectation and the problem with it is that policy makers begin to interpret that the problem is with the markets, in that they expect "irrationally". More so, when an exit strategy like that of the Fed is being widely publicized. But this interpretation is incorrect, because it ignores the non-neutrality of the rate of money supply.

Regardless of expectations, the intervention of central banks in the rates markets has a real impact that distorts relative prices. In our present case, the intervention has been steady and consistent, and we have become too comfortable with it.
Think about it for a moment. Think about the message the markets are sending: "Don't worry about the upcoming supply of public debt, because there will be demand for it"…But, what is supporting that demand? Low-yield investment alternatives and a sea of liquidity. Where does that liquidity come from? From the Fed's purchases of public debt, which reminds me of chapter XII of "The Little Prince", by A. de Saint-Exupéry, reproduced below:

"*What are you doing there?" he [The Little Prince] said to the tippler, whom he found settled down in silence before a collection of empty bottles and also a collection of full bottles.*

I am drinking," replied the tippler, with a lugubrious air.

"Why are you drinking?" demanded the little prince.

"So that I may forget," replied the tippler.

"Forget what?" inquired the little prince, who already was sorry for him.

"Forget that I am ashamed," the tippler confessed, hanging his head.

"Ashamed of what?" insisted the little prince, who wanted to help him.

"Ashamed of drinking!" The tippler brought his speech to an end, and shut himself up in an impregnable silence.

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

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