A View from the Trenches

Toronto, Thursday, April 8th , 2010

Good morning,

We're back from Chicago, where we spent the Easter weekend, a holiday in Canada. Since last week, we have the feeling that some changes of consequence have taken place at the macro level, globally. We will try to summarize what we believe is the most relevant:

-Sovereign risk: Europe/Greece
On Tuesday, we heard/read rumors that depositors in Greek banks are withdrawing/not renewing their deposits. Only rumors… What was not a rumor was the European Central Bank's (ECB) decision to introduce a "graded haircut schedule" on government debt (i.e. Greek debt) in January 2011. The details of this decision will be released today, but we think this would be inconsistent with the role of a lender of last resort. Think about this for a moment…To accept junk collateral at a discount sends two signals: a) the recognition of a junk paper, with the establishment of a cap price for that paper, and b) the explicit monetization of a fiscal deficit, at a specific rate (the rate of issuance of the government that places the debt as collateral)! Besides, it will inevitably create frictions between the issuing governments and the ECB. The difference between inflation and hyperinflation is nothing else but the incorporation of inflation expectations to prices by investors. If a central bank facilitates the job, then we are entering dangerous waters. We, at "*A View from the Trenches*" had anticipated this back on December 17th (www.sibileau.com/martin/2009/12/17) and later laid out the scenario, on January 7th (www.sibileau.com/martin/2010/01/07). We were clear, we wrote we would be sellers of Euro. These events remind us of our years at the Univ. of Buenos Aires, when a professor that shall remain anonymous compared inflation with pregnancy: "Nobody can indefinitely be just a "little" pregnant", which brings us to our next point:

-Gold:
Almost a year ago (refer: www.sibileau.com/martin/2009/04/21 , "*Two main market theses*"), we put forward a simple thesis on gold: *"…when there is global coordination of inflationary monetary policies, gold cannot be a safe and lucrative asset. When inflationary monetary policies are not globally coordinated, gold is a safe and lucrative asset…*". This thesis was very useful and has never proved us wrong so far… On Tuesday, we turned bullish on gold. With the ECB' decision to monetize peripherals' sovereign debt, China's recent signal that the Yuan will gain flexibility while still manipulating interest rates (the government announced yesterday its intention to begin issuance of 3-yr debt), the upcoming election in the UK and fiscal crisis in the US (see further below), global monetary coordination is taking a pause (the Fed concluded last week its unprecedented purchase of mortgages). Since the Dubai event, we had been neutral-to-bearish of gold (refer: www.sibileau.com/martin/2009/11/30), preferring Canadian equities, to ride the safe-haven bid theme on the Canadian dollar. We had showed the spread between the ETFs XIU.TO (TSX 60) and IGT.TO (gold, in CAD), to make our case. As the chart below shows (source: Bloomberg), the spread tightened this week. We were waiting for IGT.TO to touch the C$112 level for confirmation of the trend and that happened yesterday. The trigger however was, in our view, the ratings downgrade of Greek banks (National Bank of Greece, EFG Eurobank Ergasias, Alpha Bank, Piraeus Bank, Emporiki Bank of Greece, Agricultural Bank of Greece and General Bank of Greece) on March 31, at 8:31am ET.

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-Sovereign risk: US (the next big thing)
While we have seen an impressive increase in the volume of public issuance lately driving swaps into negative territory, since last week, a series of news has muddied the waters: Harrisburg, PA, announced it will miss a loan payment, Fitch cut Illinois' rating on $23.4BN of municipal bonds one notch to A-, citing a rising budget deficit for 2011, and New York state announced a delay in $2.1BN of school aid, given its $9BN deficit for 2010. The news yesterday of an 11.5BN (vs. +5BN) fall in consumer credit and the Healthcare bill don't help at all in the face of the massive state/municipal deficits. Yes, other central banks are reallocating what they can from what they had in the form of Euro to US Treasuries, but the yield curve is still steeper vs. last month (with yesterday's news, the 2y10y spread flattened by -3.2 bps to 279.4 bps). How is this going to work out within an increasing interest rates environment? Exactly! There will be no increases in the near term, or at least, not as quickly as most expected, according to Tuesday's Federal Open Markets Committee's statement, which brings us back to our point on gold…

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