

# A View from the Trenches

Toronto, Tuesday, June 22<sup>nd</sup>, 2010

Good morning,

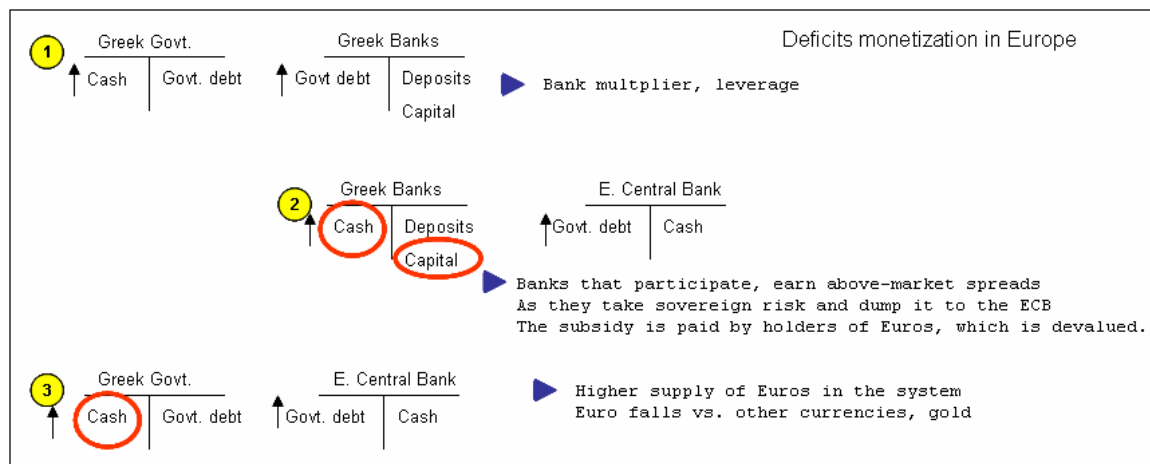
We've started the week with a weekend announcement, by the People's Bank of China, which has been already widely analyzed in itself and in terms of its implications. (refer: <http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1488> ).

Our initial reaction was caution. We don't really believe, as the Bank of China does, in equilibrium values for the Balance of Payments or even the virtue of having a Balance of Payments equilibrated, let alone in the "management" of foreign exchange for that matter. Those conceptions belong to 17th century mercantilism, which David Ricardo so much fought, for the final and large benefit of Great Britain. Essentially, this move was political in nature, to appease the critics expected at the G-20 meeting this upcoming weekend in Toronto. Nobody really thinks the Yuan will appreciate significantly and nobody really paid much attention to the fact that the text mentioned a basket of currencies backing the Yuan, rather than the USD or USD assets.

In the long term, all things equal, this "flexibility" should increase the purchasing power of the Chinese people and therefore, global consumption as well. It was along this line of reasoning that the markets reacted initially, taking the EUR above 1.2450 USD. We, like everyone else, expected oil stocks to rally, but perhaps unlike most, we thought the news would be neutral to non-energy stocks and gold. We were half right or half wrong, but not because of the forecast, but because of subsequent intraday political news.

If we had to answer what triggered the late sell-off in risk yesterday, we would point to the declarations coming out of the European Central Bank, which would impose new fiscal rules, where deficit offenders may lose voting rights, as well as the ratings downgrade BNP by of Fitch Ratings (long-term issuer to AA- from AA). The declarations from Europe signaled everything but cohesion. If we had to answer what triggered the sell-off in gold, we would plainly answer that is was profit taking. Sometimes, explanations can be that easy.

Finally, there are two "things" that we think may become more relevant in the near future. The first one is related to the analysis Barclays Capital's Credit Research team published last Friday (June 18<sup>th</sup>) about the liquidity position of Spanish banks (refer: European Credit Alpha: "*Spanish banks: Long-term headwinds but no acute crisis*"). Basically, the report concludes that "...there is no funding crisis for large Spanish banks, although cajas (i.e. savings banks) are in a more precarious situation...". This in itself did not catch our attention. What caught our attention was the conclusion that the misunderstanding over Spanish banks, which has taken their credit spreads wider, was simply caused by the fact that the large banks were reducing their reliance on covered bonds for funding, "...in favor of cheaper ECB repo funding...". The note concluded suggesting that: "...The issue is therefore one of cost of funding (a profitability issue) rather than access to funding (...) outside the caja sector...". Having read this, I invite the reader to go back to our letter of April 19<sup>th</sup>, where we explained fiscal deficit monetization in Europe. We reproduce the chart below:



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As you can see, we had published the chart in reference to Greek banks. Now, it seems the chart fits Spanish banks too... As we wrote two months ago:

*"...in step 1, governments place debt at banks. Among other sources of funding, Banks use deposits (in Euro) to leverage their capital in this transaction. In step 2, banks may turn to the ECB to exchange the government debt for liquidity, at face value (at par). The final outcome is shown in step 3: Basically, the ECB has bought government bonds, in exchange of fresh money. This is an indirect monetization, which transfers wealth from all the holders of Euro notes to the taxpayers who enjoy the fiscal spending of governments that use the ECB. The size of this transfer equals the fall in purchasing power of the Euro vs. other currencies/commodities, multiplied by the amount of Euros in circulation. It is easy to see that soon, every government will compete to place its debt at the ECB, to win this game..."*, and competing they are, really, which is why we are increasingly reading all sorts of rumors about the future of the Euro. For instance, the Daily Telegraph this weekend reported that there are ongoing discussions for the creation of a "super euro", which would include France, Germany, Holland, Austria, Denmark and Finland only (refer: <http://www.telegraph.co.uk/news/worldnews/europe/7837874/Germany-and-France-examine-two-tier-euro.html>)

Is there any doubts that with news like these, the markets would take a more cautious view? If there are, please, continue to read below.

The second "thing" that concerns us is another research note about the impact on USD liquidity at expiration, on July 1<sup>st</sup>, of the ECB's 1-year 1% long-term refinancing operation (refer: Barclays Capital Interest Research: "Libor: Buckle Up?", June 21, 2010). What are we talking here? No less than EUR442BN. We understand that the ECB will not refinance this for an additional year. Instead, the ECB will offer a 3-month operation, for an unlimited amount. The street is watching therefore what remains with the ECB and what goes out. However, most banks have liquidity and it is estimated that currently there is about EUR300BN surplus liquidity in the Euro area market.

How is it that a Euro refinancing operation may impact USD liquidity? The bigger the size of this refinancing on July 1<sup>st</sup>, the higher the likelihood that the quality of the assets of participating banks be lower than it had been expected. Therefore, this could provoke a reassessment of counterparty credit risk in the Eurodollar market. Would this put pressure on gold, as analysts estimate Libor may rise to 75bps? Was yesterday's action the omen?

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