

Good morning,

This short week is ending on a strange note. We've witnessed an escalation in geopolitical conflicts, from the Mediterranean to the Korean Sea. We've learned that the oil spill in the Gulf of Mexico will continue to exist for longer than expected. We've heard Mr. Buffet express concerns over the state of municipal finances in the US and the systemic significance of credit default swaps. We've seen the first G-7 central bank (i.e. Bank of Canada) start raising policy rates.

Finally, yesterday we realized again that the European Union can surprise us in new ways, with the news of Hungary's fiscal budget gap. We've decided to show below a chart (source: Bloomberg) that we think shows what triggered the action yesterday, and which perhaps will contribute to a sell-off today (Friday). In this chart, we see the EUR (in white) vs. the S&P500 (in orange) intraday. We can see how right before 10am ET, as UBS Strategist Manik Narain was making comments on an earlier press conference by Prime Minister Orban in Brussels, the Euro clearly resumed its downward trend.



The chart also shows the S&P500 Index, as a reminder of how global sovereign risk has become. During the rest of the session, the index tried to get back to its intraday high of 1,105.67pts on the back of a rising price of oil, after the announcement by US Minerals Management Service of the prohibition of drilling in the Gulf, regardless of water depth.

What concerned us a bit was what we see as a “relative” (the operative word here is relative) underperformance in gold, in the face of these news. We prefer to think profit-taking may have been involved, given how crowded the short EUR/long gold trade is. But the trend in gold, which is nothing else but the reflection of the steady erosion of fiat currencies, remains upward.

We also think that there continues to be confusion in the analysis of the EUR problem. The latest one consists in criticizing the ECB for lack of clarity in its bond purchases (refer: BankofAmerica's “*Global Rates Weekly: Europe's turn to act quickly and with clarity*” May 28th, 2010). We don't think this is a problem of “form” but of “content”.

While the Fed gave details about its unsterilized asset purchases, the ECB will not. But we explained why this is so: The Fed was financing what we call in Economics a “**stock**”, i.e. “...a variable that is measured at one specific time, and represents a quantity existing at that point in time, which may have accumulated in the past...” (http://en.wikipedia.org/wiki/Stock_and_flow). The ECB is financing “**flows**”, deficits, or “...a variable that is measured over an interval of time...” Therefore, by definition, we cannot know that variable until the interval of time ends... When will deficits end? Exactly!! Nobody knows! Thus, it is naïve to ask more clarity on this issue from the ECB. The only thing that is clear here is that the Euro, i.e. the liabilities of the ECB will necessarily have to depreciate as long as that interval of time exists, until a clear reduction in the deficits is seen.

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A View from the Trenches

Toronto, Friday, June 4th, 2010

At “A View from the Trenches” we were ahead of the curve, anticipating this “content problem” (refer: www.sibileau.com/martin/2010/05/10, “What to expect when you are expecting”), associated with secondary market purchases even before the announcement of the ECB’s plan. Back then we wrote:

“...the ECB would tend to behave like a convertibility board, where sovereign debt is converted to Euros. Therefore, under scenario B, the supply of money would be determined by the growth rate of the EU’s consolidated fiscal deficit! The ECB is not under control but is always “chasing the rabbit”...Governments puke debt and ECB comes after and cleans up buying in the secondary! Thus, what would be the exit strategy under scenario B? In the long run, the only way out for the ECB under scenario B is a consolidated fiscal surplus, which is totally out of ECB’s hands. De facto, the ECB is denied an exit strategy...”

There is also another criticism that we think is unwarranted, namely, the short term nature of the existing currency swap contracts between the ECB and the Fed. It is maintained that because these contracts are renewed on a weekly basis, instead of a longer-term (i.e. 84 days), USD funding conditions remain “uncertain”, which does not contribute to calm the markets. We believe the opposite is true. If the Fed validated the capital investments in the Euro-zone via currency swaps, which are nothing else but a hidden bailout of financial institutions, the Fed would be feeding the bullish trend in gold, at the expense of future higher USD inflation and of US taxpayers, and delaying an adjustment that would affect the ECB’s balance sheet more violently.

The term mismatch in the currency swaps (1-week) and the 3-mo Libor-OIS benchmark, as well as the uncertainty over its renewal sends a clear signal to those yet surviving that they need to unwind and take losses. In 1965, M. Jacques Rueff (http://en.wikipedia.org/wiki/Jacques_Rueff) described a very similar situation occurring in the ‘20s with “currency swaps” between Britain and France, in this way:

“There is a very interesting document from this period, a letter from Sir Austen Chamberlain, who was then Foreign Secretary in London, to M. Poincaré, who was Prime Minister and Finance Minister in France; it must be of 1928. Sir Austen said, “We know that you are entitled to ask gold for your sterling, but in the frame of the close friendship between Britain and France we ask you, so as to avoid trouble for the City of London, not to do that.” And we were, I must say, weak enough to comply with this request and not ask for gold. The fact that I had such important sterling deposits in London shows that we did not use this right to ask for gold. The adjustment, which would hardly have been felt if carried out on a day-to-day basis, was not made, and we had the fantastic boom of 1927, 1928, and 1929. This explains the depth of the collapse and of the depression, because the adjustment was so long delayed.” (J. Rueff, “The Monetary Sin of the West”, 1972)

Back in those days, as the Sterling and French Franc were backed by gold, the currency swap consisted in having Paris “lend” gold reserves to London, to address funding problems. The 2010 version of the same problem could read like this:

“There is a very interesting document from this period, a letter from M. Trichet, who was then the European Central Bank’s President, to Mr. Bernanke, who was the Chairman of the U.S. Federal Reserve; it must be of 2011. M. Trichet said, “We know that you are entitled to ask dollars for your dollars, but in the frame of the close friendship between the European Union and the United States we ask you, so as to avoid trouble for the European Union, not to do that, and receive Euros instead.” And we were, I must say, weak enough to comply with this request and not ask for dollars. The fact that I had such important U.S. dollar deposits in Frankfurt shows that we did not use this right to ask for U.S. dollars. The adjustment, which would hardly have been felt if carried out on a day-to-day basis, was not made, and we had the fantastic boom of 2009 and 2010. This explains the depth of the collapse and of the depression, because the adjustment was so long delayed.”