

Good morning,

From our vantage point, the last 72 hours are confirming our long-term perspective that the recent strength in the stock markets is baseless.

There are currently two main arguments supporting the belief that the recent strength in asset prices may have longer legs. The first one refers to the positive surprises of earnings vs. expectations, which (for instance) the greater part of the S&P500 constituents are showing. In Europe, sovereign refinancings have been carried out without major problems and banks have “formally” passed the stress tests. The second argument refers to the asset shortage in the credit space. This means that there is more capital chasing yield than there is demanded. This applies not just to corporate credit, but to sovereign as well.

We think that these arguments are both misleading. Earnings are past information and should not be a decisive factor. Outlooks are more relevant to us and, in macroeconomic terms, the outlook is not too compelling. At “*A View from the Trenches*”, we tend to side with the Austrian school of thought and as R. W. Garrison properly put it, unlike mainstream economics, “...*Austrian macroeconomic theory is not a theory of real income determination. Ultimately, it is a theory of coordination of how the production process is coordinated with the tastes of individuals (their time and liquidity preferences), and how monetary disturbances affect this co-ordination. Because of its focus on the co-ordination problem, there is no sharp distinction between Austrian macroeconomics and Austrian microeconomics...*” (R. W. Garrison, “Austrian Macroeconomics: A Diagrammatical Exposition”, 1978: [http://mises.org/books/austrian\\_macro\\_economics\\_garrison.pdf](http://mises.org/books/austrian_macro_economics_garrison.pdf))

Therefore, we don't pay attention to indicators, price indices etc. Today, all we care about is that governments are raising and not lowering taxes. When governments cut spending, they don't do so by privatizing assets, which triggers resource allocations. Governments simply cut temporarily. This is quite the invitation to evade rather than to pay taxes.

Monetary aggregates are barely expanding (i.e. Europe) or not expanding at all and, given the destruction of global savings, armies of young people will remain unemployed for longer than most imagine. The incentive lies in saving and paying or refinancing debts, rather than investing. Regulations punish entrepreneurship and encourage companies to use or reduce the existing labor force, rather than to hire.

Interest rates are currently useless as the transmission mechanism that they are and which is needed to guide savings to productive endeavors. In summary, we have a hard time justifying the recent “asset inflation” most want to see in the last days rallies. Gold proved the case, we think. Other assets should follow.

The second argument is essentially an insult to intelligence. Indeed, asset shortage does support the current technical compression in credit spreads we are witnessing, but it should hardly be supportive of economic growth on its own. That would equal to argue that investors will keep investing just because they have the funds available to do so, regardless of the return/risk profile of the investment opportunities considered.

A final testimony of our two points above is the situation the Euro zone financial system is in. As we had anticipated in May, the European Central Bank has had to increase the refinancing as well as the short-term facility rates, in order to carry their liquidity and sterilization operations respectively. These operations are obviously affecting the inter-bank Euro rate, Euribor, which is slowly approaching the 100bps level. When we add this to the institutional and sovereign risk crisis the Euro zone is in, the result is a fragmented, two-tiered, financial system. With excess liquidity in the Euro system close to EUR150BN driven by the stronger banks, the weaker banks still survive at the expense of the central bank. Yesterday, for instance, at the 3-month Long-Term Refinancing Operation the ECB held, 70 banks were bidders, for more than EUR23BN. In this refinancing, EUR4.8BN were maturing and taken by 24 banks. In conclusion, the weak (banks) get rewarded by the central bank, while the strong (banks) cannot find investment opportunities. This is hardly a promising environment.