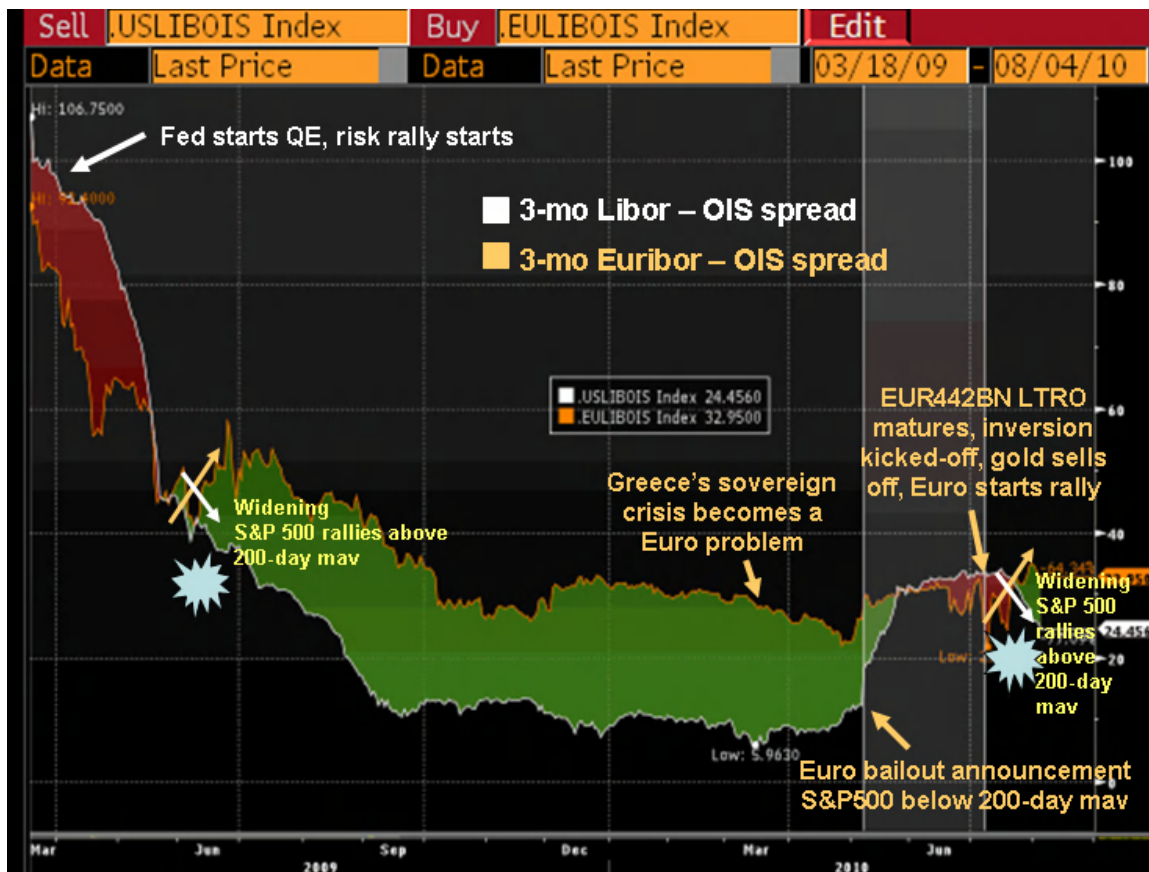


# A View from the Trenches Toronto, Thursday, August 5<sup>th</sup>, 2010

Good morning,

Liquidity won, fundamentals lost. This should summarize the action this week. The question now is how much longer this picture is going to last. If we take the demand side of liquidity off the picture for a moment, assuming it remains relatively constant, and focus on the supply side, we can think in terms of two main suppliers, namely the Fed and the European Central Bank. We thought the chart below would be very illustrative (source: Bloomberg). It compares the 3-mo Euribor-OIS (or Euribor-EONIA) spread vs. the 3-mo Libor-OIS spread. In other words, we can see **the relative cost of liquidity in USD vs. Euro** (for a discussion of 3-mo Libor-OIS, refer our letter of Dec 1<sup>st</sup>, 2009: [www.sibileau.com/martin/2009/12/01](http://www.sibileau.com/martin/2009/12/01)):



As we can see, at the top left, the cost of liquidity in USDs dropped dramatically in March 2009, when the Fed put its quantitative easing program in place. By mid-May 2009, this cost was below that of Euro liquidity and with this interest rate differential, the 2009 rally sustained itself at the expense of the USD value. As long as that spread differential was wide, stocks, credit and commodities rallied, and volatility declined.

This rate differential began its narrowing trend in the wake of the Euro zone institutional crisis and it inverted at its worst point, the week after the European Monetary Union announced the EUR750BN bailout. The fall of the S&P500 below its 200-day moving average coincides with this point in time. It took place precisely in that infamous week of May. The price of gold also tracks the evolution of the rate differential (not shown in chart).

Now, at the far right, we can see that the differential is expanding again, with 3-mo Euribor-OIS currently at 32.95bps vs. 3-mo Libor-OIS at 24.45bps.

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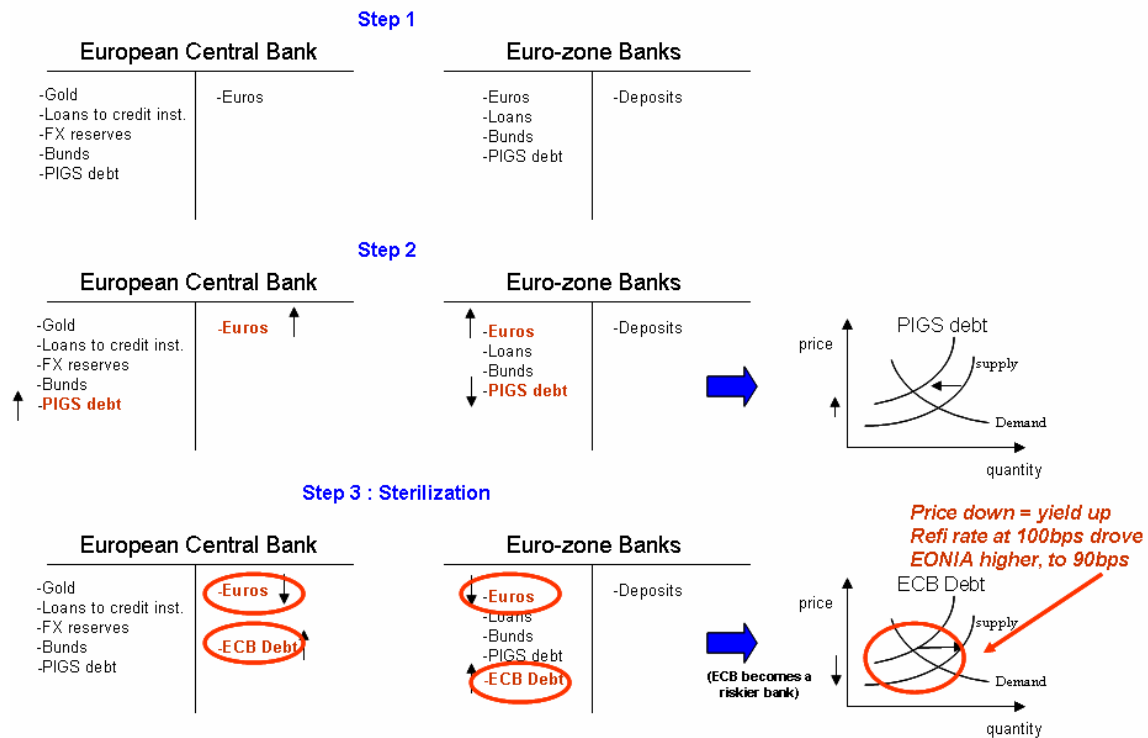
# A View from the Trenches Toronto, Thursday, August 5<sup>th</sup>, 2010

**Is the widening sustainable? Please, note that I am not asking if the spread is sustainable, but if the *widening* in spreads is sustainable.** If it is, we think the Euro rally should continue, along with higher stocks and tighter credit. Gold should not outperform stocks, but the trend from the bottom left to the top right would of course remain intact.

In 2009 the widening was sustainable because the Fed could trigger its quantitative easing program, while the European Central Bank (ECB) maintained its anti-inflationary stance. In 2009, there was a reason for the Fed to undertake quantitative easing. The assets that the Fed purchased directly or indirectly (i.e. funding the Treasury) were assets that the market despised, namely mortgages. That made sense. What may not make sense now is to think that the Fed would keep buying them, as many analysts suggest, after Fed's Bullard's speech on this point. Are Treasuries not at record low yields? Are mortgage spreads not at record lows? Is credit not tightening? **Why therefore would the Fed rush to buy that which everyone else is buying? Where is the need?**

If we look closer to chart above, you will notice that the reversion in the interest rates differential started right after the July 1st refinancing of the EUR442BN 1-yr Long Term Repo Operation (LTRO) by the ECB. This transaction was a success, as it withdrew liquidity from the Euro zone. The volatility that followed was marked by subsequent refinancing transactions (which resulted in liquidity reductions) done by the ECB, as well as the direct purchases of sovereign bonds, which so far have amounted to approximately EUR60BN, sterilized. The cost of liquidity in Euro has been driven by the ECB refinancing operations, as we anticipated on May 13th, when we described the sterilization process. We reproduce the chart below:

## Scenario 2: ECB debt



# **A View from the Trenches** Toronto, Thursday, August 5<sup>th</sup>, 2010

Back to the most important question (i.e. **is the widening sustainable?**), we think the market may be misled by looking at the 3-mo Libor-OIS spread, as the driver here:

$$\text{Spread} = (3\text{-mo Euribor} - \text{OIS}) - (3\text{-mo Libor} - \text{OIS})$$

Spread widens if  $(3\text{-mo Euribor} - \text{OIS}) > (3\text{-mo Libor} - \text{OIS})$  over time

As you can see, the spread is not only driven by movements in the Libor – OIS spread. This is what we think is occurring lately. We think that so far, the USD has been on the passenger seat. The widening of the spread has been mostly driven by the European Central Bank's refinancing transactions, which brings us to an important conclusion: **If the ECB does not have relevant refinancing transactions in the near future, the spread between the Euro and USD liquidity cost should stabilize.** So far, we understand that the ECB will not have any relevant refi operations until September 30<sup>th</sup>, and we don't see the Fed making any changes prior to that date. **Change therefore should be born out of exogenous factors. There are no such factors on the sovereign risk horizon in the next month, coming from the Euro zone and we doubt we will see municipal/state debt stress arising in the US during the same period.** Yesterday, China announced a stress test to its banking system against a 60% drop in the value of their real estate holdings (vs. prior 30%). It did not affect the picture.

**In conclusion, in the absence of any catalyst for a further widening of the 3-mo Euribor-OIS spread vs. 3-mo Libor – OIS spread, the risk rally (i.e. gold, stocks, oil, credit, Euro) that we have witnessed in the last weeks should remain range bound.**

**Approaching October, should the recovery in the US become stronger, in the absence of further quantitative easing, (= 3-mo Libor – OIS rises), ceteris paribus (=things in Europe remain flat), the rally will weaken. The debate on monetary policy is therefore delayed a few months. The problem here is that by October, things in Europe will not have remained flat (sovereign debt refinancings will take place) and the US will be facing an election.**