

A View from the Trenches Toronto, Tuesday, September 28th, 2010

Good morning,

We spent a lot of time going through FX intervention mechanisms in the last two letters, and did not have the time to write about what is obviously moving markets lately: The Fed's decision to bring inflation to a level consistent with their target employment level and the ongoing fiscal crisis in Ireland (the sovereign credit default swap widened from 200bps, the low in July to 500bps last week). Honestly, there is not much more we can add here and we won't, except that we are surprised by the strength of the Euro and not only vs. the US dollar, but the Canadian dollar as well.

If we had to give a quick answer to this recent appreciation, we will point to actual weakness in the US dollar, post FOMC communiqué on September 21st, rather than intrinsic strength on the part of the European Monetary Union. As we wrote before, many analysts suggest the Euro should be strong because of the access the distressed members have to the European Financial Stability Facility. However, we think the opposite is true. If these countries ever need to access that facility, the whole monetary union will be in crisis, as a race will start among peripherals to use it before it's gone and Germany feels the real pain of honoring their guarantee to contribute funding, perhaps even alone. Yes, we think there is a chance that the approval the parliaments of the respective union members gave, might be denounced by some countries.

But today, perhaps we should bring collective attention to the Euro in relation to the Canadian dollar. Since the communiqué by the Fed, the Canadian dollar has been underperforming. It is as if suddenly, Canada's relative fiscal and financial situation were irrelevant. Gold has made new records and yet Canadian mining stocks are not (for instance, check gold vs. iShares S&P TSX Global Gold Index Fund, ticker: XGD.TO). Oil is showing strength, but the energy sector represented in the TSX is not (for instance, check crude oil vs. iShares S&P TSX Capped Energy Index Fund, ticker: XEG.TO).

There is increasing concern about the highly leveraged balance sheet of the average Canadian citizen and about the real estate market, particularly in the condo sector. The Bank of Canada is on a difficult position: If it raises its policy rate, to bring it to a more "neutral" level, it will face political pressure from the "export" lobby and the left, which of course sees the Bank as part of the official party. If it leaves it unchanged, the Canadian dollar will depreciate and inflation will be accelerated.

If Canadians don't want to see their purchasing power fall, the world will need to see evidence that something new is coming up: Lower taxes or privatizations or spending cuts (By the way, this also applies to any society). It doesn't matter which one or what combination thereof. Otherwise, in the absence of nice surprises, the trend will be for the Canadian dollar to fall on weakness and to underperform on strength. We don't often write about Canada but when we did, we said that "...*Canadian stocks are rising because foreign money is flowing in! And for foreign money to keep flowing in, Canada must show it can provide a stable currency. The world is starving for stability! All Canada needs to do is to remain quiet, while the rest of the world misbehaves and voices its anti capitalistic rhetoric...*" (refer: "Meanwhile in Canada", June 2nd, 2009: www.sibileau.com/martin/2009/06/02 and "The stars favor Canada", March 4th, 2010: www.sibileau.com/martin/2010/03/04)

September 21st marked the end of the good times for Canada. Canada is now linked to the fate of the US sovereign crisis. Stability is no longer enough. It can be found in gold, by those who seek a reserve asset, or in emerging markets, by those who look to profit from growth. The onus is on Canada to show the world that it can also outperform.

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