A View from the Trenches

Toronto, Tuesday, October 26th, 2010

Good morning,

The week started on a generalized sell off of the USD, as it is evident that the United States don't consider any way out, except through inflation. No privatizations, deregulation, more free trade or fiscal spending cuts. Inflation instead! The anecdote of the yesterday's session was that the US Treasury sold $10 billion of 5-yr Treasury Inflation Protected Securities at a negative yield. It was the first time ever! (see: http://noir.bloomberg.com/apps/news?pid=20601009&sid=aebshL_ncvQQ)

But the perspective in the rest of the world is no different. Nobody wants to suffer pain and creditor countries are exhibiting a diversity of tricks: From the classic purchase of US dollars by central banks, without sterilization, to taxes on capital inflows (i.e. Brazil) or the development of offshore parallel financial markets (i.e. Hong Kong), where exporters park their US dollars, which never reach the exporting country (i.e. China). All this does nothing else but ultimately delay the day of reckoning.

However, today we want to focus on one country in particular: Canada. Last week, as you may already know, the Bank of Canada decided to leave its target for the overnight rate at 1 per cent. In our view, this signaled capitulation by the Bank. From now on, assuming that quantitative easing continues in the US, we believe the Bank of Canada will not do anything that may appreciate its currency. It will seek to delay interest rate increases, provide liquidity via term repo operations and if this should not work, perhaps even decrease interest rates! Yes, we would not be surprised if well into 2011, we see interest rates decreasing to discourage capital inflows from the US.

The main problem with this is that Canada has not suffered yet a correction in its real estate market. Residential property prices have seen a steady rise and are now supported by record low mortgage rates, record leverage levels by the public and the upcoming decrease in transaction costs, if the settlement between the Canadian Real Estate Association and the Competition Bureau effectively allow sellers to directly sell their houses on the Mulitple Listing Service. These developments, under stable or lower interest rates have the potential to take the Canadian real estate market through the same path the US market took.

Canada, in our opinion, has dropped the ball. As the currency has appreciated, no efforts have been made to deregulate, privatize or strengthen our financial markets with sound money. Sound money is not money that is worth more than US dollars. Sound money is money that people can confidently save in, and hence must not underperform vs. gold. The Canadian dollar, like any other currency, has lost value, in terms of gold too. During 2010, it benefited from the reserve diversification moves carried by central banks, as well as the bid on the capital of Canadian based commodity producers. But since last week, when the Bank of Canada capitulated, the Canadian dollar risks losing ground. The purchasing power of Canadians is at risk.

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