A View from the Trenches

Toronto, Thursday, December 2nd, 2010

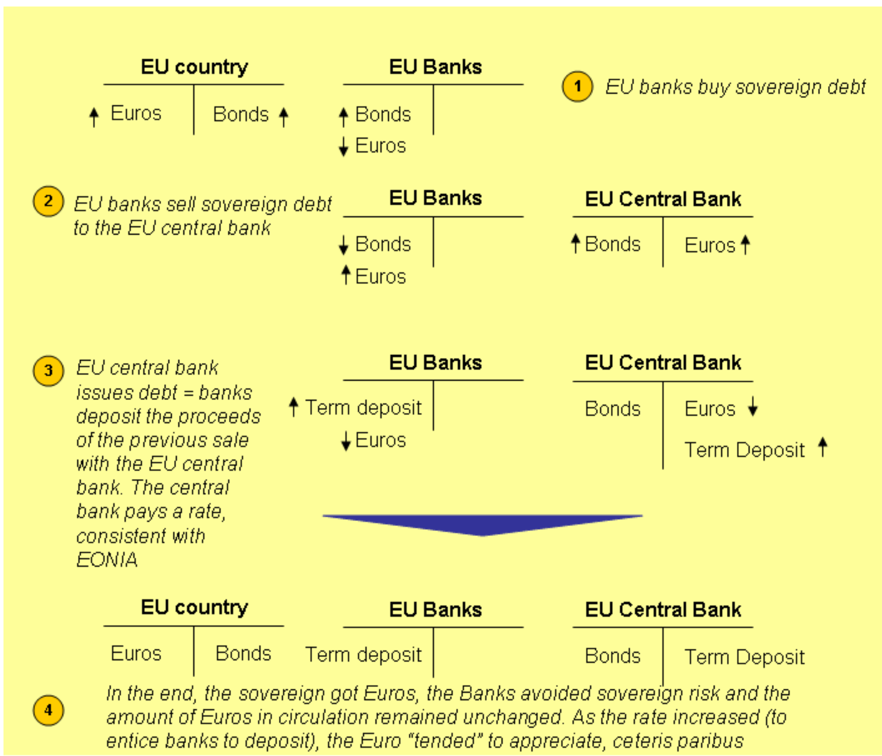
Good morning,

Again, most of the action this week has been driven by speculation on the future of the European Union. Let's begin today by repeating what we left with a week ago, when we changed our view, radically, on the survival of the Euro:

"…We think the EU is far more serious about the survival of the Euro than we had previously thought. The problem is nevertheless still institutional, the Euro will have to continue depreciating and fiscal austerity will remain in place…" (www.sibileau.com/martin/2010/11/24)

In the past days, we have been contacted by readers asking for our view on the situation in Europe. We answered, consistent with the writing above, that the key here is the European Central Bank. We said we agreed with Mr. Trichet's comment yesterday, in that we also thought the markets were underestimating the determination and capability of the Central Bank. A bit of this has been corrected yesterday, and some analysts have gone on record calling yesterday's action a typical dead bounce cat. We wouldn't be so sure about it…

If you think about it, the European Central Bank has not yet engaged into what we know as quantitative easing. Yes, it has bought sovereign debt directly or indirectly by purchasing bank debt guaranteed by the sovereign (i.e. Greece) but these purchases, unlike the case of Helicopter Ben, have been all sterilized through its Securities Market Program facility, which up to last week had the equivalent of EUR66BN in term deposits from the banks, as the chart below shows:



As you can see from the chart above, if the European Central Bank (ECB) simply let the term deposits expire, liquidity would be injected into the system, without the need to buy more government debt. If the problem is the government debt itself, because a sovereign refinancing is in the way, the ECB can always buy the issue, depreciating the Euro.

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Before we move on, please note that the mechanism shown above may or not, in the short term, trigger a depreciation in the Euro, ceteris paribus. It will depend on the resulting rates spread with the USD. However, the depreciation is inevitable in the long term.

Now, we must not lose perspective of the fact that the European crisis, although fiscal and institutional in nature, carries the leverage created by its weak financial system, which is weak because the EU lacks a unified bond market. This brews an arbitrage between peripheral banks and core banks whereby depositors in a peripheral bank shift their deposits to a core bank (i.e. Deutsche Bank), precipitating what we saw in Ireland.

This therefore begs the question of whether the European Central Bank did not stand up to its responsibility, as lender of last resort, in Ireland. Personally, had we been in government there, we would have asked ourselves what benefit would be derived from remaining within the EU monetary union, if the issuer of the currency (i.e. the ECB) does not act as lender of last resort and allows deposits to leave our jurisdiction. After all, if the country needs to put their pension funds and tax revenue on the line to support its financial system…why the hell would it need Mr. Trichet's authority over their monetary matters? But then again, what do we know? It's a done deal and the we all want to focus on the next in line…right?

So, what's next? As we hinted in our last letter, we are more concerned about the US fiscal situation than that of Europe. We think the ECB will this time use its ammunition to prevent a run against Portugal and Spain and that it will be difficult to fight it. Of course, one can never underestimate the idiocy of policymakers, as when they introduced the idea of making senior bondholders of bank debt…well, not so senior…You certainly want to avoid this sort of language in the midst of a currency/financial crisis.

But in the US, we understand a bipartisan revision of spending is underway. We ignore how far it can go but the fact that it is taking place is a sign to us of what may be coming next. Below, we mention other "interesting signs":

-Credit spreads of gold mining companies (i.e. Barrick Gold, Newmont Mining) are trading at lower levels than financials (excluding Canadian banks) and within the range of Germany's

-The Euribor-OIS spread, after all the stress of recent weeks, remains reasonably low

-The price of oil remains impressively above $80/bbl

-Activity and prices (not just asset prices) in the US are picking up, in line with the price of gold

-The curves of Euro sovereign spreads are pricing the issuance of AAA debt under the European Financial Stabilization Facility

And there is more…but for now, these are enough to tell us that a major proto-federal institutionalization is underway in Europe, while in the US it will be difficult if not impossible to revert an upcoming explicit inflation.

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