

A View from the Trenches

Toronto, Thursday, October 29th, 2009

Good morning,

Yes, we are experiencing a correction. No news here. Yesterday too, the Norges Bank raised its benchmark rate by 25bps, signaling the beginning of the end in accommodative policies.

From wherever one sees the markets, profit taking is at the order of the day. The minimal hint that the recovery process will take longer than expected launches a new selling wave in risky assets and strengthens the USD. Has anything material occurred during the last week? No. Has the outlook on the recovery (slow) materially changed? No. Has the Fed signaled that they are willing to err on the side of caution and increase rates early? No. Has liquidity become more expensive (3-mo Libor – OIS spread)? No. Have emerging markets engaged in dangerous accommodative policies? No. Do we have political tensions in the world? The answer again is “No”!

What then is driving the correction? The law of marginal returns, mixed with constant risks. At the levels we had reached in equities and credit, the risks outweighed the feasible short-term marginal returns. And there is really not much more one can add here. Will central banks find it harder to quit the monetary easing under a correction? Yes, they will. Will governments see in the general weakness an excuse to remain under deficit? Yes, they will.

Can a correction spiral into a more serious sell off? With the information at hand, it is very difficult to see this happening. Something more material should be here, interrupting the liquidity normalization process. Could it be the idiocy of asking banks to be better capitalized? When the 2001 crisis unfolded in Argentina, banks had fractionary reserves of the order of 30% of assets, and of course, that was not enough.

In general, if this correction continues, it may present us with an opportunity to step in. For now, the general economic backdrop remains constructive in my view, and although the new home sales figures or oil inventories disappointed today, I see these issues anecdotic and it would be naïve to expect a recovery process to go unidirectional, from the lower left to the upper right.

Lastly, I thought I would quote here a paragraph found on Chapter XXXI “Currency and Credit manipulation”, of Ludwig Von Mises’ “Human Action”, published in 1949 (can be found at <http://mises.org/humanaction/chap31sec5.asp>). These comments remain sooo relevant...:

“...The idea which generated what is called qualitative credit control [p. 796] is to channel the additional credit in such a way as to concentrate the alleged blessings of credit expansion upon certain groups and to withhold them from other groups. The credits should not go to the stock exchange, it is argued, and should not make stock prices soar. They should rather benefit the "legitimate productive activity" of the processing industries, of mining, of "legitimate commerce," and, first of all, of farming. Other advocates of qualitative credit control want to prevent the additional credits from being used for investment in fixed capital and thus immobilized. They are to be used, instead, for the production of liquid goods. According to these plans, the authorities give the banks concrete directions concerning the types of loans they should grant or are forbidden to grant.

However, all such schemes are vain. Discrimination in lending is no substitute for checks placed on credit expansion, the only means that could really prevent a rise in stock exchange quotations and an expansion of investment in fixed capital. The mode in which the additional amount of credit finds its way into the loan market is only of secondary importance. What matters is that there is an inflow of newly created credit. If the banks grant more credits to the farmers, the farmers are in a position to repay loans received from other sources and to pay cash for their purchases. If they grant more credits to business as circulating capital, they free funds, which were previously tied up for this use. In any case, they create an abundance of disposable money for which its owners try to find the most profitable investment. Very promptly, these funds find outlets in the stock exchange or in fixed investment. The notion that it is possible to pursue a credit expansion without making stock prices rise and fixed investment expand is absurd...”

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