A View from the Trenches Toronto, Friday, December 18th , 2009

"*…And when output has increased and prices have risen, the effect of this on liquidity-preference will be to increase the quantity of money necessary to maintain a given rate of interest…"* (J. M. Keynes, "The General Theory of Employment, Interest and Money", Chapter 13, Section III, 1936).

Good morning,

The world seems to have radically changed in the past sessions and it is important not to lose track of the fundamental logic that was behind the action in 2009 and will possibly be in 2010. Briefly, in 2007/8 we had "liquidity issues" in an overleveraged world that had misallocated resources into real estate. The issues were eventually "taken care of" by the intervention of central banks. Damage was nevertheless caused, in my view, due to a delayed the intervention, with the political transition from the Bush Administration to the Obama Administration (or more precisely from H. Paulson to T. Geithner). After that delay, the quantitative easing programs gained full speed and we won the rally of 2009.

In the face of Greece's downgrade and the surprise of the US labor market stats yesterday (jobless claims at 480k vs. consensus of 465k), why will liquidity be an issue again? What makes you think that this time the situation will be different? Political struggles within the Euro zone?

The Fed reiterated only a day ago (and for the 100th time) that it intends to leave the Fed funds rate at a low level for an extended period. Perhaps that clarity was lacking with respect to the European Central Bank but now, after the mess in the so-called peripherals (Ireland, Portgual, Spain, Italy, Greece), we may have clarity sooner rather than later.
Therefore, it is starting to be evident (at least to me) the Fed and the European Central Bank would (or should) maintain an accommodative approach, also in 2011. However, according to our Thesis No. 2 on gold, under such coordination, gold should underperform (see: www.sibileau.com/martin/2009/04/21). On December 7th (see: www.sibileau.com/martin/2009/12/07 , "Gold is put to the test") I wrote about this and so far, the market is telling me I am right. However, I want to wait until January to reach a conclusion and I sincerely hope I am wrong on this one…

On the other hand, if the monetary accommodation takes place, risky assets should continue rallying, which would suggest that December 2009 might, in hindsight, look like a buying opportunity months from now. But the move in the USD was very violent and very strong, and it certainly takes a leap of faith to focus on the big picture for 2010 and to stick to the logics of liquidity (low rates) and non-neutrality of monetary and credit expansions.

I want to be constructive. Following the scientific method of empirical falsification (http://en.wikipedia.org/wiki/Falsifiability), I will stick to what has worked. I will not be bearish until I see that demand for liquidity is not met by supply. So far, it has been met. With all the turmoil, all the noise of the last days (I call it noise because except for the labor stats, everything else was not surprising), the 3-mo Libor – Overnight Index Swap spread is still at record lows, below 10bps. In addition, the trend in corporate credit is still that of spreads compression.

Lastly, with all the activity in sovereign risk, an interesting "convergence" in sovereign spreads may occur within the European Union. Given that the base hypothesis here is that the Union will not break, its main contributors (France, Germany, Netherlands et al) should end up bailing out the peripherals. Under that scenario, the credit default swap of the big brothers should widen, while that of the peripherals would tighten (in the long term), converging towards a new equilibrium, consistent with a new NOMINAL rate of interest for the Euro. The quote from Keynes above continues to be prophetic and eternal.

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