# Focal Points

*Investment & Trading Ideas*

**June 8, 2010**
Research Comment
Quantitative/Technical Research

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## Go to Cash – In Plain English

### Summary
We advocate switching out of equity positions and going to cash. The European sovereign debt crisis appears to be nowhere near over. The global credit environment is worsening. Cost of capital is going up and availability is going down. There are large gaps between where the credit market prices risk and where the equity market is priced. Equity is lagging the deterioration in credit conditions. Moves in currency, equity and commodity markets are mirroring the moves in the credit market. Global growth, in a credit-constrained environment, will slow. Profits will be squeezed by the higher cost of capital.

### Preface

In my youth, my parents were my biggest supporters. They came to every football and rugby game that they could get to and cheered from the sidelines. They were interested and engaged.

After eight years of university, I showed my parents my Ph.D. thesis. They flipped through the coloured graphics, smiled and gave the book back to me. They did not read my thesis. They were not engaged.

This lack of engagement was not a lack of support. There was simply a gap that was too difficult to pass, and even if it were, what purpose would it serve? My parents did not need to know anything about the Properties of Semiconductor Nanoclusters in a Zeolite host. Few do.

Our "Focal Points. – Go to cash: Facts and Fiction" is a very technical document. I did not show it to my parents, but I did convey the message. There is a need to bridge the gap and explain our financial thesis. This document is meant to support the non-technical reader.

Like our technical focal points publications, this comment is a blend of fact (what was and what is) and prediction (fantasy, or what may be). The key is to understand the facts, or the state of the market. The tricky point is always the future, or the fantasy. Do not expect any analyst to tell you what the future will bring. They cannot do it, repeatedly, that is. They can only give you their best prognosis for the future, based on the limited facts that they see. This document details how we view markets, based on the limited facts we see.

The electronic version of this document contains many hyperlinks to news articles and some excellent technical, though very readable, papers. Our goal, however, is to provide enough detail that this comment should stand on its own. Readers can follow the links if they want to explore topics in more detail. My parents, incidentally, do not own a computer.

### State of the Market: Credit vs. Commodities & Jobs

- The frail state of the markets is now becoming more obvious and as such the audience for our call to cash is growing. The difficulty in getting our message out is that in its raw form (how we normally write), the argument is quite technical:
  - **Client**: Why go to cash?
  - **Quant/Technical**: Look at the euro-dollar basis swap pricing!
  - **Client**: Say what??
- Now, however, the market is showing signs that everyone can easily recognize as indicative of economic weakness:
  - job growth has stagnated, and
  - commodities and inflation expectations are falling.
- These new signs are not new information on why things are bad. Rather, they are symptoms, or outward displays of how weak the credit market has become.
  - Weakening credit conditions are the cause.
  - Economic fallout is the effect.

### Our Job: How Do We Operate? What Do We Know? What Don't We Know?

- You will notice that the vast majority of our work includes charts. Charts are factual observations that convey the current and historical state of the market.
- In these charts, we detail the evidence of how the markets behave, or, more importantly, how they are priced. This is what we care about; how the market prices, and how this may change day by day, hour by hour, and tick by tick.
- We observe markets as a scientist observes an experiment. In this case, it is a social experiment, entitled "capital markets."
- What we find intriguing is seeing relationships change. When markets start to price things differently, our hunt is on for why pricing is changing, what it means, and where it might take markets.
  - What we find now in the market pricing is disturbing, which is why you are reading this.
- The nature of our work stems from observation of the markets, as opposed to the collection of economic data.

### Western European Sovereign Debt Crisis = Asian Growth Problem

- We observed that the sovereign default risk of Europe was very well connected to the sovereign default risk of Asia.
  - Then we tracked down the tidbit that European financials have funded Asia to the tune of more than half a trillion dollars.
- By observation, we know there is a link and now we have part of the economic rationale for what we are seeing.
- We have what we need for our call for extreme caution:
  - The funding of Asian growth is closely tied to the health of the European financial system.
  - **Further, we know that the North American equity market is fixated on Asian growth**.
  - **Our equity market correction starting gun** went off **the moment Asian currencies, and thus optimism toward Asian growth, started falling**.
- The close ties between European and Asian credit are showing up in the tick charts only in times of stress, which is why we started picking up the relationship quite recently.
- Growing Asian risk is equal to, outward capital flows, and ultimately a slowdown in Asian growth. An Asian economic slowdown in a capital-constrained world will bring forth lower global growth, and lower commodity prices.

## European Sovereign Debt: Hard & Soft Asset Bubbles

- The bond market weighs in on whether it wants to fund an entity, and, if so, at what price, each and every day.
- The market has decided not to fund the Greek state, so the ECB, IMF and other European governments have stepped in to rescue Greece, or more realistically, to defer a Greek default.
  - We see the Greek problem as a "soft asset" bubble. Greece received Bundesbank priced (cheap) euro credit, yet maintained a Greek level of corruption.
  - The bond market has decided to no longer fund the social network of Greece and the social network is now being changed. This is called austerity. Soft asset bubbles are not changed through simple recapitalization; they are solved via a change in lifestyle, which is not popular.
  - The Greek tourism industry is set to strike on June 16 and 30, meanwhile Greek tourism cancellations soar.
  - Greece has started the process to sell private assets to raise capital. Publicly traded Greek stocks in which the government has a stake are falling fast, as investors fear large government sales.
    - We created a Bloomberg ticker for these companies: ".GreekAssets."
  - The market is concerned that the German taxpayer will have to fund a Greek debt default spiral. Alternatively, euro holders worry that the German taxpayer will not fund Greece, leading to euro disintegration.
- The **market is now giving Spain a hard time**, with Spanish government 10-year yields now higher than when the bailout package for Greece was announced.
  - The Spanish problem is also one of easy euro credit, which fed a construction, or hard asset bubble, that has now burst.
  - At the leading edge of the credit crisis in this case are Spanish regional banks, or cajas.
  - As the FT described succinctly; "*the unlisted cajas – many of them politicised, linked to regional governments and with an opaque ownership structure – seized market share from the banks at the peak of the recent housing boom and now account for about half of outstanding loans in Spain. Several are heavily exposed to bankrupt property developers and homeowners unable to meet mortgage payments.*"
- What the bond market does not like about Spain is a combination of
  - the "dire state" of the property market;
  - the fragility of political support for austerity measures;
  - the collapse of support for the Spanish Prime Minister Jose Zapatero;
  - the potential for a deflationary debt spiral;
  - that Spanish government debt auctions would fail without Spanish banks; and
  - that Spanish banks are maneuvering to delay, as opposed to tackling losses.

## Connecting Crisis I and Crisis II: Dollar Imbalances

- European financials, still hobbled by dollar-based bad U.S. mortgage assets (credit crisis I), have been dealt a second blow: bad sovereign debt assets (credit crisis II).
  - This combination is proving toxic.
  - Funding for European banks is being strained.

## A Step Back: Imbalances by Design

- The financial system was created to allow imbalances.
    - *A person wants to own a home but does not have the money to buy it outright, so borrows it from a bank.*
    - *There is money borrowed and lent from very disparate parties. An imbalance is born.*
    - *The interest rate paid for that mortgage is the cost to the home buyer / compensation to the lender for the imbalance that was set up.*
    - *As long as conditions for both the borrower and lender do not change dramatically over the course of the mortgage contract, both parties will be satisfied, and eventually the imbalance will likely be unwound by the homeowner paying off the debt obligation.*
    - *The imbalance created benefits both parties.*
    - *This is when things go right.*

## Dialing for Dollar Imbalances

- Dollar-denominated assets:
    - A German financial institution needs to secure dollar funds to support U.S. conduits that own U.S. mortgage assets. Dollars are sought.
    - A French financial institution wants to trade U.S. dollar-denominated assets. Dollars are sought.
- Assets demanding dollars:
    - A Chinese exporter is selling goods to Europe. He wants to be paid in dollars, as he distrusts the future of the euro. Who has these dollars? The last time the European importer looked at his paycheck, it was denominated in euros. Surely, a financial institution can convert the European importers euros to dollars, to satisfy the demand of the Chinese exporter. Indeed this can be done, at a price, which is set each and every day. Dollars are sought.
- Where do these dollars come from?
- European institutions do not typically have a natural source of dollar deposits as a U.S. bank does, with a base of customers having dollar-denominated checking and savings accounts. They have to go to the markets for this funding. Which market do they go to?

## Commercial Paper Market

- Large respected institutions can use their prominent standing in the market to borrow dollars over the short term from the commercial paper market.
- Commercial paper is an IOU, unsecured against any asset (unlike a bond).
    - If the financial institution that issues the commercial paper goes bankrupt, the IOU will not be paid back in full.
    - A failure like this caused the $62B Reserve Primary Fund to “break the buck” upon the demise of Lehman Brothers.
        - Due to this failure, the SEC has introduced more stringent rules to enhance the safety of money market funds.
        - Acceptance of risky (non-T-bill) paper has been curtailed.
- Commercial paper comes at a cost (interest rate) and duration (lending period).
    - The cost and time frame of the new loans are determined in the market each day, by the supply/demand dynamics of the market.
    - The commercial paper market adjusts depending on the appetite of the lender, which relates to the perceived creditworthiness of the borrower.
- European financials, with balance sheets weakened by both dollar-based mortgage assets and now euro-based southern European sovereign debt (generally termed PIIGS: Portugal, Italy, Ireland, Greece, Spain) are now seeing appetite erode for their commercial paper.
    - Dollar funding via commercial paper is becoming less accessible. One can watch the falling outstanding commercial paper funding to foreign banks each week @ Thursday from the Fed statistics.
    - If commercial paper is accessible, it is coming at a higher cost. We can observe these funding costs aggregated by the Fed in its daily report. If the issuer is large enough (like Société Générale, or SocGen), we can observe the pricing daily on a Bloomberg terminal.

## Currency Swap Market

- The origins of the currency swap market go far back. We will go back only to the 1930s. The esteemed J. Wellington Wimpy, acquaintance to Popeye, would use the swap market to exchange goods for currency.
    - The time frame of the swap agreement was short: in fact, the upcoming Tuesday.
    - The contract was not even written; it was verbal.
    - The assets swapped were dollars for food.
    - In 1932, the verbal contract became standardized to the form still quoted today:
        - **"I'll gladly pay you Tuesday for a hamburger today."**
- We care about swapping euros for dollars (as opposed to Wimpy caring about swapping dollars for hamburgers).
- The cost for a financial institution to swap euros (which European financials have) for dollars (which European financials need) is called the euro-dollar basis currency swap. It is quoted in basis points (bps).
- A euro-dollar swap quoted at a negative 50 basis points mean that the euro owner/dollar borrower will pay the dollar owner/euro borrower 50 basis points, or one-half of one percentage point, to borrow those dollars on a quarterly basis, for the lifetime of the contract.
- Currency swap agreements are typically for years, as opposed to the days or months by which the commercial paper market operates.
    - Currency swaps, or the cost to swap one currency for another, may be monitored tick by tick in real time.
- The degree to which the pricing moves shows the degree to which dollars are demanded over euros in the case of a euro-dollar currency swap.
- Euro-dollar swaps offer a real-time indication of dollar funding costs.
- We considered that this esoteric, yet very indicative financial market instrument was so key to our analysis of market conditions that we blended three euro-dollar swap contract prices together and gave it a name: EuroDoom.
- EuroDoom is easier to remember than euro-dollar basis swap.
- The keystroke ".Eurodoom" is easier to remember than the tickers for euro-dollar swap contracts.
- We have made this market barometer accessible via Bloomberg to our clients.

## Dollar Squeeze

- The European banking system dollar funding gap, or market-funded dollar demand, in 2007, was measured in trillions of dollars. The extent to which financial institutions cannot roll over their dollar funding contracts is the extent to which dollar-denominated assets would be dumped on the market in a disorderly fashion (credit crisis I).
- European financials are being squeezed out of the commercial paper market, and as such they are looking for alternative places to get their dollar funding. EuroDoom measures the pricing for getting this funding in the currency swap market.
- As information on the outstanding amount of commercial paper is observed only weekly, and the dollar squeeze started just five weeks ago, we are only now able to show the relationship between the two sources of dollar funding.
    - See our June 4 "Focal Points – For Better or Worse: EuroDoom, PIS, Gold."

## Emergency Dollar Funding: Central Banks

- A central bank is meant to be the ultimate backstop to the financial institutions that it supports.
- This central bank backstop is a fundamental solid rock of support upon which the banks build their houses of money.
- If a local bank needs emergency support, the central bank needs to be there to provide such support.

### The Central Bank of Iceland

- Starting in September 2008, Iceland nationalized the first of its major banks: Glitnir.
- The central bank did not have the resources to satisfy the obligations of its banking system.
- The banks outgrew the support of their central bank, and when the banks got into trouble, they failed and became nationalized.
- The ultimate cost of the damage is still being determined.
  - The Iceland debacle disclosed that the **ECB was ensnared in dodgy behavior, which was uncovered only far after the fact**. The ECB has been shown to lack transparency, when the world needs more central bank transparency, accountability (and independence).

### The European Central Bank (ECB) Is Lacking Support

- The ECB does not have a trillion U.S. dollars to support the rollover risk of European financial companies during a major crisis. In other words, the ECB cannot on its own backstop European financial institutions in a dollar crisis.
- The ECB started buying toxic Greek bonds in May in a startling reversal of policy, as it was a blatant violation of its own rules. Leading candidates to replace ECB president Trichet next year, Axel Weber and Mario Draghi, want these bond purchases stopped.
- There are no buyers for Greek debt at the ECB's zombie price. The ECB's balance sheet has been weakened by that move.
- The ECB has not restored confidence to bond markets in the southern European countries.
  - Rather, bond yields in these countries are reaching, or exceeding, levels reached during the peak in panic (prices, which move inversely to yields, are reaching lows).
  - Popular stories in European papers relay the motive of the ECB, to relieve banks of the toxic sovereign debt they own. The German press says it's to help the French banks. The French press say their commitment to Greece is greater than the Germans. Tit for tat. ECB buying Greek debt is a direct help to the European banks that are dumping it. The flipside of the coin is that the ECB's balance sheet is deteriorating in the transaction.

### U.S. Fed Backstop to European Central Bank Dollar Deficiency

- On May 10 the U.S. Federal Reserve reopened emergency swap lines (U.S. dollar loans) with the ECB and other central banks to be the ultimate dollar funding lender of last resort.
- This Fed funding comes at a penalty rate. The Fed does not want to be a source of dollar funding; it wants to act as a lender of last resort, for as little time as possible.
- There is also a moral/political lower limit to the penalty rate that the Fed charges for its dollar swap facility. If the Fed cuts the rate too low, it will ultimately be satisfying European financials at a discount to the rate it funds U.S. financial institutions via the discount window. This is hardly palatable for U.S. politicians, or the U.S. taxpayer.
- The upper limit on the size of the swap lines ultimately can be extended to the limit of which the Fed sees the ECB as a creditworthy counterparty (customer) to its swap agreement. After the Lehman failure, nearly $600B was provided under these swap lines. As of last Thursday, just $6.6B of Fed swap lines were tapped.
- In our view, credit crisis II is just getting started.

### Cost of Credit Rising, Availability Falling

- The sovereign debt sell-off is affecting the funding cost of corporations.
- In the most basic example, we noted in our first "correction watch piece" ("Focal Points: 5-10% Correction Potential For Equity Markets") that moves in Western European sovereign default risk insurance contracts were being mirrored by moves in European senior financial default risk insurance contracts.
  - This relationship speaks to the balance sheets of European banks, which hold European sovereign bonds.
- High yields, or high cost of capital are also feeding into mainstream U.S.A. Corporate debt spreads are rising. Capital is becoming more expensive. As debt costs rise, profits will be squeezed.
- Corporate debt sales are slowing. Debt managers are weighing between new issues and opportunities in the secondary market as weak holders of debt sell.

## European Problems on U.S. Soil

- Because capital markets are interconnected, they can become very contagious in this time of stress.
    - Our contagion smell test, entitled "The Destructive Power of ONE," is an overlay intraday of charts of equities, commodities, currencies and government bond markets.
    - If they are all swimming together, as is currently the case, then the macro environment is in a contagious state (correlations tend toward perfection, or R goes to 1, ONE). Markets are on high alert to see who may end up swimming with the fishes. Rumours abound.
    - Why own asset A rather than asset B if they are both priced the same way? Portfolios once offering diversification become less diversified. Portfolio risk balloons.
- The day-to-day pricing of bond risk insurance contracts, or credit default swaps, of major U.S. banks, notably Bank of America and JP Morgan Chase, looks too much like the day-to-day pricing of similar contracts on European banks, notably SocGen and Banco Santander. These disparate banks are showing very similar risk profiles.
- This interconnectedness of the banking system is the reason the Fed opens dollar swap lines to foreign central banks. It is not a U.S. handout. Rather, it is a mechanism ultimately meant to retain the integrity of the U.S. banking system. Move over "too big to fail," "too interconnected to fail" is the key phrase.
- U.S. banks, for themselves, are hoarding safe-haven treasuries.
- About one-third of U.S. exports go to Europe, land of the falling euro, and rising austerity measures.

## European Problems on Canadian Soil

- The key transmission of European financial stress to the Canadian equity market is via lowered global growth expectations.
    - Growth needs to be funded, and funding markets are seizing up.
- Thirty-four percent of the capital in the Canadian equity market is invested in non-gold resources, which thrive in a buoyant emerging market (resource hungry) led global growth environment. Less growth equals less buoyancy.
- A month ago we noted a "fresh" fit between European and Asian sovereign creditworthiness. This relationship has been maintained, meaning that Asian risk, which is primarily a growth phenomenon, is tied to European sovereign and thus European corporate financial default risk. We are now picking up good fit between moves in Asian creditworthiness and moves in crude oil.
    - The Canadian equity market has a 26% weighting toward energy. This energy exposure and the connectedness of oil to global growth probably overstates the risk somewhat. Gas-related equities have already been pre-disastered due to technological advances in unconventional natural gas production, which have dampened prices.
- Base metal prices are also falling, trailing behind the falling creditworthiness of base metal producers.
- If we are picking up on the good fit of credit (the reason for our concern) and commodity pricing now, then the host of strategists who use commodity prices to determine the "double dippyness" of the global economy will soon follow suit.
- Commodity prices are not an early warning sign of economic weakness; they are a result of weakness in credit markets.
    - In a levered market, credit leads.
- We expect that commodities will lend a hand in finding the bottom, rather than the top. This was certainly the case in 2009, and the reason for our bullishness a little over a year ago. See *Red Book* March 17, 2009, "In Future Growth We Trust."
- A key difference between now and 2008, is that back then we did not have a property bubble bursting in China. This is an important piece of information (don't you think?).

## Conclusions

- We see credit crisis II as just beginning. Few markets are untouched. Few signs of optimism can be seen. We are now at the tipping point when the crisis becomes more obvious. Markets will get more dangerous during this phase.
- We advocate a zero weight toward equity, and that investors convert their equity positions to cash.
- We will continue to provide updates in our daily *Market Elements*, *Relative Strength Filter*, and our topical *Focal Points* publications.

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