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# Working paper - 56

## *Overindulgence, Excess of complacency or … Is someone getting nervous?*

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# Do you know what means when borrowing is more expensive for the government than for banks?


*WM Reuters*

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## ... of course You do not. Neither do I. And you know Why?
## Because we never saw it throughout our lives


*Tullet Prebon*

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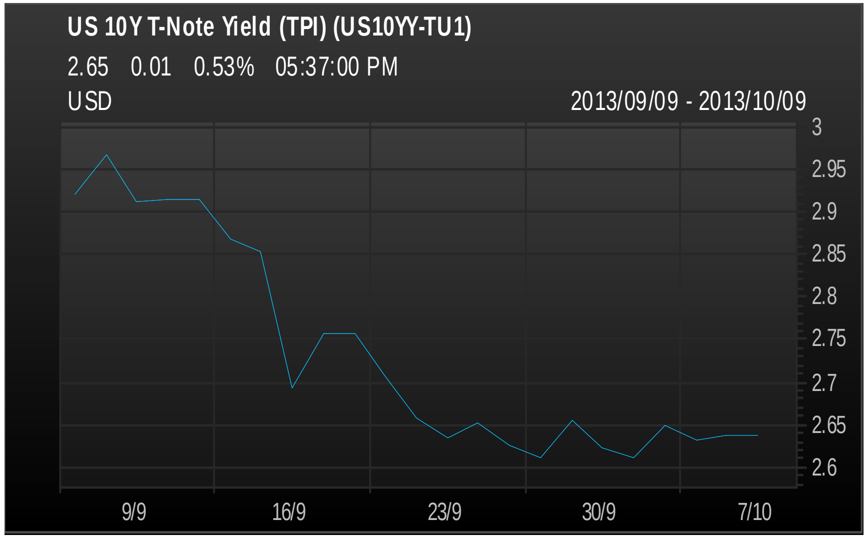
## Why is now happening something that never happened before? Because fears about the return OF capital are higher than hopes for Returns ON capital (nothing good at all)

- ✓ Imagine you are a cash manager in a company. You do not earn your salary because of your skills as a speculator, but to assure the cash is there as planned (to pay salaries, suppliers, electricity, etc).
- ✓ Now, with the odds rising of the Government blocking cash, it would be legitimate if our cash manager prefer to put "his cash" in a bank deposit yielding 0%, despite the fact that the 1month Treasury bill yields a higher 0.35%.
- ✓ This happens when you focus on "return OF capital" rather than "return ON Capital". And these are definitely not good news.
- ✓ As Mr Louis Gave mentioned, *"If you combine a raise in Short Term yields in Treasury bonds with the worst bid to cover at T-bill auction since March 2009, it seems that someone is getting nervous"*

# Is this nervousness affecting the entire market or only to a small part?

- ✓ Considering that the US equity market has experienced a correction of just 3.2% in the recent weeks …
- ✓ … and that the long end of the interest rate curve remains well supported …
- ✓ … the conclusion is that the overall market is not worried one bit (for now), except that cash manager mentioned in our tale

# Why market complacency is so high?
# Because of two reasons.

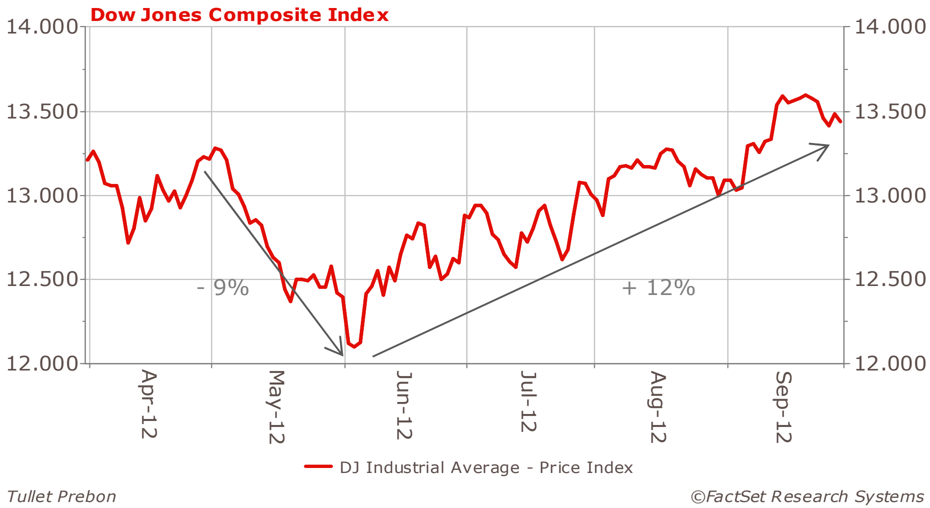
1. **The bulk of the market believes that ultimately there will not be a lock in payments of interests on US debt.** I have heard erroneous arguments of people advocating for this. Many are those thinking that as in previous occasions on which day limit was reached without an agreement, the Treasury department can reallocate resources by temporarily suspending contributions to the pension funds of federal officials in order to honor the debt. This argument is wrong because it refers just to a partial solution, being a mere question of time that pressure coming from debt payments intensifies again.

2. **… but one reason stands out above all and would explain the market complacency. It has to do with what happened in the last battle held in the US Congress about the increase of the debt limit (summer of 2012).**

   Some investors panicked and equities fell near 10% in just one month on fears of a shutdown. However, the market rallied once a deal was struck, leaving some investors looking like fools.

   Apparently, those same investors have learned the lesson and have decided to stay in the market today, despite the fact that this time a Shutdown has occurred and is lasting more than expected.

   **I'm afraid this could be like the game of Monopoly. The market (as "the house") always wins. Participants, lose, whatever their decision.**



# Should we be nervous?
# Our conclusions

1. According to our Payoff matrix for Obama and Republicans in this game of chicken, **the central scenario should be one where a deal is struck**. Thus, a scenario in which we would not see the U.S. in technical default.

2. Some are scared because they think that Republicans do a moral calculation (rather than a political one) based on the principle that "The debt is bad". Undoubtedly, if true, this could feed a decision with disastrous political and economic return. However, we have reasons to believe that Republicans will not embrace this "principle". First, because if they do, it will be very costly. And secondly because they voted on 5 occasions in favor of raising the debt ceiling in the age of Bush. Before 2002 the limit was US$5.9 T, but at the end of the legislature the limit was placed around the US$10T. Where is therefore the space for this sacred principle praying that "The debt is bad"?

3. As Mr Louis Gave reminds us, unwillingness to fund the government in the short term has not translated into either an unwillingness to fund the government in the long term, or fund the companies in the stock market (complacency). **Based on these three arguments, one should remain calm for now.**

4. **Said this, I would advocate today for abandoning complacency** for one simple reason. I keep my complacency high while investing in a familiar environment. However, when this same environment is changing and becomes unknown, the odds of a hostile atmosphere increases disproportionately and, then, it is a must to abandon all complacency. (Lesson number one in the theory of portfolio management).

5. And indeed we are now in a changing and unknown world.

   - ✓ In 2008 the Libor rocketed while the short-term USTs dipped as cash managers scared to keep their money into failing banks. Now, the flows of capital are going the other way (Libor is dipping while short-term USTs are rocketing). **For me, this is a change!**

   - ✓ In the same manner, the fact that for first time in history, borrowing is more expensive for the US government than for banks, puts us in an **unknown environment**.

   - ✓ Additionally , and considering that I do not appreciate a possible agreement on the debt limit as a positive driver for equities, but rather, every day that passes in the shutdown situation (which I anticipate will last until the 17th) is a negative driver, I see no sense in maintaining strong positions in Equity (specifically in U.S. Equities), specially when the stock market has not experienced any kind of correction.

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