A View from the Trenches

Toronto, Thursday, April 29th , 2010

Good morning,

What a week! It's amazing how a few days make a difference these days. We will force ourselves to summarize into a few main points our views:

In our previous letter, we wrote: "*The ECB has its hands tied and hikes in policy rates cannot happen any time soon. The Euro will continue to be tossed off the proverbial cliff. But the question here is: What will the Euro fall more against, in relative terms? The USD? The CAD? Gold?*

In our view, speed here is of the essence. If the Euro devaluation is not carried out in order, global liquidity will be affected. If it is orderly carried out, then the quiet and underlying shift of other central banks' reserves (i.e. Russia , China) out of the Euro and into the CAD, the AUD or gold will be more relevant, in relative terms. Hence, it is critical to understand what can cause a "disorderly" devaluation of the Euro and what its corresponding likelihood is. We think that anything that hints towards the dissolution of the monetary union, institutionally, will generate confusion and disorder. Under this scenario, Euros, gold, CAD, AUD and commodities will be sold, while USD and US Treasuries will be bought. Anything else that hints towards a slow and steady debasement of the Euro, will favor gold, CAD, AUD and commodities, at the expense of USD and US Treasuries demand..."

And now, post Greece/Portugal/Spain downgrades, we realize we were half right, or half wrong. The downgrades put the Union in a really tough spot. Commodities, stocks were sold and the USD strengthened. But gold....gold rallied. What happened?

In general, money serves three main purposes: It's a unit of account, a medium of indirect exchange and a reserve asset. These uses are deeply interconnected. The demand for money is therefore usually conceived as the sum of the demand for liquidity purposes and for saving purposes: Md = Ld + Sd.

What we saw on Tuesday is proof to us that Md (=demand for money) is now STARTING TO BE (the operative word here is "Starting") at a global level: Md = L (in USD) + S (in Gold). That is, the world may now be starting to use USD for liquidity/funding purposes and gold as a reserve asset. "Starting" again is the operative word. Some people may call this Gresham 's law. Gresham 's law would be currently at work on the Euro. People toss the Euro for USD and whatever else that is not needed for liquidity, is exchanged for gold.

Since Tuesday, it is evident to us that Europe has only two choices: Either Germany/France guarantee Greece's debt (and soon Portugal's) or the European Central Bank lifts the veil and accepts junk sovereign debt as collateral to fund PIGS banks. Which one do you think is politically easier to implement? In our view, it is the latter, which means the Euro will be devalued big time.

Until Tuesday, we considered gold as just another asset. Now, we've changed our view, which forces us to pay attention to this detail: Every time a risk position is unwound and a certain percentage is recycled back to USD for liquidity purposes, while another percentage goes to gold, we think that the capital that moves to gold is capital OUT of the system. Who will fill the gap? Will the ECB (i.e. central banks) fill the gap? Has that gap to be filled anyway? Why?

When a central bank tries to fill the gap, we have low inflation morphing into dynamic inflation which, if allowed to blossom, later becomes hyperinflation. At that point, and perhaps we are closer to that point than many of us want to believe, gold becomes "THE" reserve asset. What has to happen for this to materialize? It has to be a global shift in nature. Contagion out of Europe has to spread, it is a necessary condition, in our view.

Under such scenario, would commodities drop in price because Europeans wouldn't be able to afford them? This is the key question for us in Canada and we think the answer is positive. Therefore, perhaps and only perhaps, we will not see any exit strategies after all. How do we position against this scenario? We want to start buying weakness in gold.

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