

Good morning,

With a shortened week in Toronto, courtesy of the G-8 & G-20 summits, we have lost the pulse on the day-to-day developments, to gain perspective in what is to come. Perhaps the biggest headline these days is the upcoming regulations affecting financial institutions in the US and Europe, and on this, we will focus our comments today. In both currency areas, efforts are wasted on the issue of the capitalization of banks. In the US, the goal is to avert future systemic crisis, while in Europe it is to provide more certainty to investors worried about the implications of the rising sovereign crisis.

The underlying belief here is that even though banks have (by definition under fiat currencies) a portfolio of leveraged loans, there is an optimal level of capital that can stop a run against a financial institution from becoming a widespread financial crisis. This is completely absurd, but acknowledging the absurdity would lead to review the usefulness of central banking, which is blasphemy. Why is increasing banks' capital levels absurd?

*"...If the fiduciary media are issued only on good security and if a guarantee fund is created out of the bank's share-capital for the purpose of covering losses, for even under prudent management losses cannot always be avoided, then the bank can put itself in a position to redeem in full the fiduciary media that it issues, **although not within the term specified in its promises to pay**...(...)... even if the fiduciary media are completely covered by the assets of the issuer, so that only the time of their redemption and not its ultimate occurrence is open to question, this cannot have any sort of influence whatever in support of their capacity for circulation; for this depends exclusively upon the expectation that the issuer will redeem them **promptly**. To have overlooked this is the error underlying all those proposals and experiments which have aimed at guaranteeing the issue of fiduciary media by means of funds consisting of non-liquid assets, such as mortgages...." Chapter IV "The Redemption of Fiduciary Media", The Theory of Money and Credit, L. Von Mises, Yale, 1953.*

If Basel III or the upcoming Financial Bill in the USA is not one more of those "**proposals and experiments which have aimed at guaranteeing the issue of fiduciary media**", then we should not be writing nor should you be wasting your time reading us...

The other experiment we are witnessing these days is the establishment of stress tests for the Euro-zone banks. The assumption here is that because bank tests "worked" in the US providing certainty to investors, they will also work in Europe. We find that assumption totally flawed. As we wrote already many, many times here, the cases of US in 2008/09 and Europe in 2010 are radically different.

What triggered the crisis in the US was a revision on the value of assets held in the banks' portfolios, i.e. mortgages or their respective derivatives. In economic terms, these are stocks. And once that revision was triggered, the creation of these assets stopped. The market for mortgages and their derivatives collapsed. It made sense therefore, to carry out a one-time inventory account of these assets held in the banks' portfolios, with the stress tests.

What triggered the crisis in Europe was a revision on the sustainability of fiscal deficits and their impact on an institution called the European Monetary Union. In economic terms, deficits are flows, not stocks. And once the revision was triggered, the generation of these deficits did not stop and will not stop in the foreseeable future. The market for the corresponding government issues did not collapse and they are being monetized by the European Central Bank and now the Swiss National Bank. It makes no sense therefore, to carry out a one-time inventory account of the sovereign debt held by banks, which ends up anyway in the balance sheet of the European Central Bank. Nobody will be any more certain about the soundness of a Euro-zone bank today than he or she will be tomorrow or was yesterday. The mere suggestion that such tests be enforced shows the ignorance of policy makers on economic matters and makes good a much clearer investment thesis.

On a final note, Professor Joseph Stiglitz, Nobel prizewinner who was senior economic adviser under President Clinton and is currently professor of economics and finance at Columbia Business School, was interviewed by The Independent this Sunday (<http://www.independent.co.uk/news/uk/politics/osbornes-first-budget-its-wrong-wrong-wrong-2011501.html>), and among other things, he had this to say: "*The problem was that, in the US, the stimulus wasn't big enough*" ... "*Too much of it was in tax cuts. And when they gave money to the banks they gave it to the wrong banks and, as a result, credit has not been restored* – we

A View from the Trenches

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can expect a couple of million or more homes to be repossessed this year than last year – and the economy has not been restarted...(...)....Governments should set up their own banks to restart lending to businesses and save struggling homeowners from repossession. If the banks aren't lending, let's create a new lending facility to do that job. In the US, we gave \$700bn to the banks; if we had used a fraction of that to create a new bank, we could have financed all the lending that was needed..."

At "A View from the Trenches", we were not surprised to read this. Last April 19th, we warned about the ominous consequences that the case against Goldman Sachs was anticipating in our mind:

*"...The upcoming financial regulatory framework will be supportive of monetization. Hence, the need to press institutions, as we first glimpsed on Friday. As the issuance of Treasuries and rise in policy rates eventually increase the cost of capital, it will be evident that the sustainability of the recovery/valuations will be more fragile. **The government will continue to blame Wall Street for not lending enough to Main Street, while it simultaneously generates a crowding-out effect on corporate credit with the implementation of Basel 3.** Under Basel 3, regardless of its final shape, banks will be forced to hold government debt as liquid assets (vs. other corporates) and to issue more equity to raise capital. **In countries like Argentina, we have seen this coercion take place already. How was the liquidity shortage circumvented? The government itself became the major lender** (i.e. Banco Nación). Would the US not do the same through its Agencies? In our opinion, US financial institutions will be the losers in this game, while gold starts to look like the real winner..."* (refer: www.sibileau.com/martin/2010/04/19).

When a government actually starts lending under increasing sovereign spreads, why would investors own sovereign risk, when they can get a higher yield from financials, with the same underlying risk?