

Good morning,

We are back after a relaxing and extended Canadian Thanksgiving weekend. We could have written earlier but we thought we would sound like a broken record. Everything we are currently seeing we anticipated long, long time ago. In fact, we anticipated it on our first letters, in April 2009, when we first wrote that

- a) Quantitative easing would only bring inflation, but not economic growth, and hence, we should be long stocks and commodities (refer our first letter: [www.sibileau.com/martin/2009/04/14](http://www.sibileau.com/martin/2009/04/14))
- b) Gold would outperform if central banks could not coordinate their policies (refer: [www.sibileau.com/martin/2009/04/21](http://www.sibileau.com/martin/2009/04/21))

We wrote about these issues extensively way before anybody else would explicitly think of them. However, all we did was to recite old texts that the world had forgotten or always ignored, from the Austrian school of Economics. The merit goes to all those Austrian thinkers who during the '30s came up with a good theory that can make strong predictions.

So far, we are enjoying a good run from the rally that started with the speculation of QE 2. But with yesterday's action, we have the feeling that the recent strength may have been overdone and that with the upcoming election in the US, profits may be taken sooner than later. Call it intuition...Accordingly, we have rigorous stop loss levels on our positions. The long term trend is however one of careless debasement of currencies worldwide, which at the extreme, can only be good for gold.

Having said this, we want to end this letter bringing collective attention to two concepts, ideas, that are being published these days, which we think are flawed. They are both related to monetary policy, but we will only deal with one today.

The first concept is about monetary policy coordination. Perhaps the best example of this is a research note published by the Foreign Exchange Research team of Barclays Capital on October 7<sup>th</sup> titled "*Be careful what you wish for*", although we have come across other analysts expressing the same concept on Bloomberg TV. We are referring to the idea that **a successful coordination has to be able to simultaneously address external and internal balances**. We think this is a wrong perspective in a global economy, because it ignores the role of prices in the resource allocation process. **The idea of equilibrium of external and internal balances is nothing short of mercantilist, but at the same time, it ignores the fact that today most products are made out of a diversity of inputs produced in different countries.** Foreign exchange crosses (i.e. CAD/EUR, CAD/MXP, CAD/RMB) are thus all relevant to every entrepreneur, and not just to those who export their produce. **Coordination, in our view, implies that there is an indeterminacy in the levels of foreign exchange crosses that allows the world to keep running without stress.**

This idea, first elaborated at a smaller scale by Don Patinkin in its famous paper titled "*The Indeterminacy of Absolute Prices in Classical Economic Theory*" and published in 1949 in *Econometrica*, tells us that for instance, the world is today as comfortable with a CAD/USD, EUR/USD, Yen/USD, GBP/USD, ...X/USD at (1.0049, 1.403, 1.6005, ...,X/USD) respectively as with a level that would be, say twice the current: (2.0098, 2.806, 3.201, ...,2x/USD).

To achieve this indeterminacy (i.e. flexibility), in our view, is more critical to address the rates (i.e. a dynamic problem) at which money is supplied by all the different central banks via their respective open market operations, rather than to focus on external vs. internal balances or policy goals. This concept is what first moved us to write on April 16<sup>th</sup>, 2009 that:

*"All currencies are being debased in calculated order. It is precisely this order that is denying gold the chance of playing a safe and lucrative asset. If the debasement had not been orderly, if it had been amid uncertainty and chaos, gold would have had a chance..."* ([www.sibileau.com/martin/2009/04/16](http://www.sibileau.com/martin/2009/04/16))

How did that coordination took place back in 2009? Essentially, it was supported by three pillars: 1) There was a genuine demand excess for liquidity by the private sector; 2) the quantitative easing was carried out by only one central bank on behalf of the rest, because US dollars were supplied via currency swaps to the other central banks, and 3) the quantitative easing

# A View from the Trenches

Toronto, Friday, October 16<sup>th</sup>, 2010

represented a transfer of assets (i.e. mortgage-backed securities), not fiscal deficits, which afforded other governments the possibility to remain quiet.

Today, there is no genuine demand for liquidity, which is evident by looking at prices in all the liquidity markets. Therefore, the mere expectation of quantitative easing fuels a flight physical assets, away from currencies. Today, central banks have different goals and quantitative easing is no longer about a transfer of assets from the private sector to the public sector, but the monetization of fiscal deficits, which are intrinsically uncertain in their final size. Thus, coordination is not feasible and expectations are slowly adjusting to this fact, as expressed in the steepening of the US yield curve.

In our next letters, we will also address the other flawed concept that is tightly connected to the idea that coordination is about focusing on balances, rather than the differentials in the rate of money supply by central banks. One of them is the idea that inflation expectations can be managed by central banks and hence, the notion of a “temporary” inflation above target is possible, with central banks later returning to the “normal” state.

Finally, we leave with what we wrote at the end of our letter on September 2<sup>nd</sup>, titled “Beware of coordination” ([www.sibileau.com/martin/2010/09/02](http://www.sibileau.com/martin/2010/09/02)):

*“...In summary, we are entering the final stakes of this game of musical chairs and with the coordination of central banks to keep the music going, **it will be difficult to invest following macro fundamentals.** In the US we are faced with technical insolvency at all levels of government (municipal, state and federal) and yet, with the Fed and other central banks buying Treasuries, we can see record low yields and tighter credit spreads.*

***In this environment, should gold not be able to rise and establish its price beyond \$1,250/oz?...”***