A View from the Trenches

Toronto, Tuesday, December 21st, 2010

Good morning,

This is our last letter of the year. Briefly, we want to go over the main themes that we leave with, to touch upon a subject that we have already expressed our concerns on. Let's see…

To give structure to our first point (i.e. main themes), we will classify the themes according to their respective currency zones. Starting with the US, we must say we're impressed by the level of optimism expressed in the many research notes we've read in the past week. The outlook for 2011 is too good and shared by too many, which is a recipe for deception. Most of it is based on the fact that from a fundamental perspective, 2011 will "suffer" from a negative net issuance in almost every credit/fixed income class, exacerbated by the Fed's announced purchase of $600BN in Treasuries. This shortage in net issuance is to us the main theme, the basis of an expected asset reflation trade. Do we agree with this view? No! This view is not dynamic. This view assumes market participants will be comfortable once the negative net issuance is over and we enter 2012. This could never occur, because once the force behind the reflation weakens, the pain will be even less tolerable and a new source of price inflation will be sought.

For the European Monetary Union, next year will be quite the test. We differ with those who see indecision in European politicians to take the next step towards a fiscal union. But we fear more the idiocy or lack of understanding by politicians, of certain economic fundamentals. To tell sovereign debt investors they will be subordinated to supranational debt (i.e. European Financial Stability Facility), to threaten those they call speculators but provide liquidity to the market, will only take the pricing of future badly needed issuances to unsustainable levels, seriously jeopardizing any chance of survival.

In the meantime, in 2011, we think the UK will keep playing its Keynesian game of debasing real wages (i.e. inflation) and cutting fiscal spending, as long as investors allow it. The UK has an enviable sovereign debt maturity profile (i.e. long-term skewed), where the benefits of a small inflation surpass the political costs of frugality….for now…

We see China's oligarchy further condemning the masses to coerced saving, by increasing the segmentation of its capital markets. Hong Kong will profit, while mainland Chinese labour will foot the bill, continuing to work at suppressed wages for the party to continue in the West. How do you segment capital markets? You disrupt the credit multiplier raising the reserve requirement ratios, forcing exporters to clear payments in Hong Kong, taxing capital inflows, raising the exit costs for foreign capital. All in the name of a pegged Yuan. Can this last another year? We think it can.

Finally, Emerging markets and the "other dollars" will walk the tight rope, as they try to keep their economies open and at the same time, seek to prevent the import of inflation from Helicopter Ben. This, as David Hume back in 1752 wrote, is futile. It's a losing proposition. In the case of Canada, we would not be surprised if the Bank of Canada abuses its repurchase agreements or the if Canadian Home Mortgage Corp., on behalf of the export lobby, injects liquidity in the market by repurchasing mortgages. All this to keep the Canadian dollar from going beyond parity. It will be sad, but it will happen.

Now, to our second point. We have followed and continue to follow with utmost interest the political career of US Congressman Ron Paul. We sympathize with Mr. Paul's cause for sound money, but he and his political life reminds us of Cicero in the face of Rome's final days as a Republic. Mr. Paul may be remembered by historians of the United States, just as Cicero is remembered by historians of Rome. There is however a small but relevant difference between Cicero and Congressman Paul: Cicero took sides. Cicero, in the end, sided with Octavivs. Yes, Octavivs betrayed Cicero, but Cicero, also saw that neutrality was a sterile path.

Congressman Paul is not taking sides. Having been repeatedly asked lately what his plan is as the new chairman of the Financial Services Subcommittee on Domestic Monetary Policy, with Congressional oversight of the Federal Reserve, Mr. Paul replied that he would simply seek to allow gold or any other asset to compete as legal tender with the US dollar (in addition to audit the Fed, that is). We understand the noble intention behind this, but we can't support it. We have no idea as to what the real chance is for this innocent proposition to be enacted. But we can say that this plan will only have the unintended

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consequence of creating unnecessary discredit to the Austrian economics tradition. Why? Because it is no plan! No, we are not advocating to plan monetary policy. That is also very un-Austrian. We are simply noting that to "end the Fed", a plan is required.

A simple example (among many others that this short space doesn't allow us to elaborate on) should help visualize our point. If gold has a chance as an alternative asset, ***in simultaneous competition*** with the US dollar, it will only be natural that we witness once more Gresham's law at play. Gresham's law, simply put, states that bad money displaces good money out of circulation. In a leveraged system like the one we live in, this means that market participants would arbitrage the system. They would simply borrow in US dollars and save in gold . To some degree, this is starting to slowly occur, but today the speed of this change is driven by the deterioration of the paper money, not by the quality of gold as legal tender. However, if gold was allowed to compete, this process would take place faster. This would quickly lead to the bankruptcy of the entire financial system, ***as we know it*** , for the cost of borrowing would increase exponentially, in real terms (i.e. in gold). But, if Mr. Paul does not end the Fed, as long as this institution survives, it will be forced to provide liquidity to the financial institutions, creating hyperinflation along the way.

What is the problem with hyperinflation? That those who still earned wages in paper money would see their income (and possibly their wealth too) destroyed. Please, note the following:

1.-Fiscal deficits, as long as the government does not bail out banks, would have NOTHING to do with ***this*** hyperinflation Mr. Paul's plan would bring.

2.-The Fed would create hyperinflation by providing liquidity, not bailing out banks as in 2008, when it bought defaulted liabilities. In fact, as inflation spikes, it would be extraordinary to see defaults in paper money (i.e. bad loans), for the cost of paying off US denominated debts would decrease along with the higher rate of inflation

The only way to prevent hyperinflation would be to create fiscal surpluses and use them to buy gold to back the US dollar, for the Fed to be able to compete against gold-backed notes. Now, if you think the public and the financial lobby would allow monetary developments to get to this stage, you really are an optimistic in life. In the process, Mr. Paul and the rest of the Austrian movement would be blamed for creating inflation and making the poor poorer.

Given the impossibility to save the Fed, the next stage, which would see the Tea Party ousted from Congress for decades, would be to unwind the Fed. And the United States would have a multitude of unregulated banks issuing gold-backed notes, lending more than they have in deposit. It would only be a matter of time, until the next Ponzi scheme is uncovered and by then, given the absence of a lender of last resort, the public would seek to solve the problem with regulation. Someone would remind Americans of the good old times when there was a lender of last resort and the United States was the global power, and we would see central banking back in place.

We can't let that happen, Mr. Paul. We need a plan to unwind the Fed without creating hyperinflation. The good news is that it is technically possible.

We want to thank everyone for accompanying us on our second year and wish you all a great 2011!

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