A View from the Trenches

Toronto, Tuesday, September 27th , 2011

Good morning,

Since our last letter, we have witnessed (and perhaps are still witnessing) once more, the typical run for liquidity, when all asset classes tell us that diversification is a myth and that there is no place to hide but in the US dollar. Those who were long of gold (including ourselves) got a good lesson (in our case, a reminder) in asset management under central banking and hopefully too, got to appreciate the value of stop losses, like we did, which saved our day.

Let's first begin by saying that from the perspective of the "real" economy, absolutely nothing has changed since September 12th. This sell off was indeed a déjà vu and we had, in previous letters, described a scenario like it. For instance, on February 2nd 2010, we proposed three phases in this downward cycle, shown in the chart below. Everything would seem to indicate that we are in what we called phase 2:

PHASE 1	PHASE 2	PHASE 3
Assumptions: -Unwinding of QE programs -Policy rates stable -Restricting measures on banking system (higher reserves, capital, regulation) -No clarity on sovereign risk dynamics in Euro zone -Earnings do not surprise	**Assumptions**: -Earnings disappoint -Sovereigns show no intention of cutting costs -Sovereign risk in Europe's peripherals deteriorates -No indication of change in policy by central banks -Central banks under political pressure	**Assumptions**: -Central banks cannot react, do not tighten -Inflation expectations surge -European Central Bank openly supports Euro's financial system
Consequences: -Credit, stocks stagnate -Commodities stagnate -Gold trades in a range -USD stronger	**Consequences**: -Credit, stocks sell off -Commodities sell -Gold sells -USD strengthens	**Consequences**: -Credit, stocks rally -Commodities rally -Gold rallies -USD weakens -Weak economic growth -High unemployment

When are we going to enter phase 3? Before we address the question, let's briefly comment on the announcement that triggered the recent sell off: the Fed's so-called Operation Twist. By now, everybody knows that the Fed announced it will shift the composition of its assets, basically selling short-term Treasuries and using the proceeds to buy longer term Treasuries (this is a very, very basic description). In doing so, three things will occur.

Firstly, the yield curve should flatten, affecting negatively the profitability of credit investors (banks, insurance companies) that fund cheap in the short term market to lend long term, at higher spreads. If providing credit will be less profitable, credit supply will contract, affecting borrowers.
Secondly, by shifting the tenor of its assets to a longer term, the Fed will suffer huge losses, when interest rates finally rise forced upon this central bank by a massive repudiation of the US dollar (its liabilities). By then, how will the Fed be recapitalized? This point however will take a lot to materialize. But we nevertheless mention it here for the record. Peter Schiff in his blog described these first two (watch: http://youtu.be/BCYGVKBOcCo) issues.

Thirdly, and to us this is perhaps the most important, Operation Twist contributes to confirm the stagflationary trend. For mainstream economists, this is difficult to see, because they ignore the role of the price system in the market process. Every mainstream analyst has told us in the past days that because the Fed is not expanding its liabilities, this move should not be inflationary. Let us tell you why, although this fact (i.e. no expansion of Fed's liabilities) is correct, the conclusion is not.

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Since the beginning of QE1, central banks and regulators have incrementally exercised financial repression on global markets. In doing so, they have deprived markets of the benefit of the price discovery mechanism through which they can efficiently allocate resources.

With the purchase of government bonds, whose yield are a benchmark rate, the benchmark rate has been manipulated to the point where, with rates practically at zero levels, markets no longer have a benchmark.
With the intervention in the banking system, markets no longer can easily price the solvency of banks and their capital needs.
With the intervention, during the waves of defaults, in the legal proceedings between creditors and borrowers, markets can no longer have a clear view on recovery values at default, or even seniority of credits. Will pension plans have priority over lenders? Will private investors in sovereign debt end up deeply subordinated?

Until last week, therefore, we had slowly lost our benchmark rates, the capacity to calculate losses/defaults, and understand the legal consequences of extending credit. Since last week, thanks to Operation Twist and a flatter yield curve, we will also lose a benchmark for the inter-temporal rate of exchange: The relative value of time will almost disappear. How can anyone make an educated investment decision in this context? He/she can't, which brings us sad memories of our life during the hyperinflation years in Argentina. During those extreme years, we remember having seen stores closed because "they lacked prices". Many stores would simply shut and leave a sign by the door that read: "*Cerrado por falta de precios*". Indeed, given the acute movement in prices, store owners could not decide whether their sales would leave them with a profit or a loss, and would not open to the public!

There and then, this happened with consumption goods. Here and now, it is starting to occur first with investment goods. All parameters relevant to an investment decision are absent: the value of a risk-free asset, probabilities of default and cost of capital, institutional certainty and soon, the value of time. In this context, investments, and subsequently productivity and employment can only collapse.

Going back to our point on the inflationary impact of Operation Twist, ***if we understand now that this measure contributes to destroying investment, if the produce of the USA drops, even if the size of the Fed's liabilities doesn't increase, the amount of money stock vs. output will have still grown and the value of the US dollar will have to drop!*** **This is why people call it stagflation!** (Money stock = monetary base + fiduciary media, refer Figure 2 in "*The causes of price inflation and Deflation: Fundamental Economic principles the deflationists have ignored*", by Laura F. Davidson at: http://libertarianpapers.org/articles/2011/lp-3-13.pdf)

Returning now to our previous question of "when are we going to enter phase 3?", the answer is: We are not sure. In summary, if the Euro crisis finds a fiscal way out in which the European Central Bank (ECB) does not have to capitulate (and this includes the ECB lending to a bigger European Financial Stability Facility (EFSF)) we will not have phase 3, and gold will continue to sell off, in our opinion, at the expense of equities. If the ECB is made to capitulate because no fiscal solution is reached and the only way out is a weaker Euro, we will enter phase 3, with gold and equities rallying.

Lost in the mess of these negotiations, there remains the issue of what will happen in China with its current imbalances. We are starting to lose sleep on this one…

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