Good morning,

In our last letter, we showed that our view from May 2010 is fully developing (We had stated that eventually money supply in the Eurozone would be determined by the growth in the zone's fiscal deficits). Also, the contagion from the Eurozone to the USD zone is also growing, thanks to the EUR/USD currency swaps extended by the Fed to the European Central Bank. This contagion, we wrote, is nothing new, but had been highly criticized already in the early 1930's by Jacques Rueff. We insist therefore that readers get a copy of Mr. Rueff 's "*The Monetary Sin of the West*", published in 1972. An online version can be found at: www.mises.org/books/monetarysin.pdf . Too old? Perhaps, but remember: There is nothing more practical than a good theory!

If you have been following us vs. other analysis, you will notice that only recently, other analysts are beginning to pay attention to these FX swaps. Mainstream analysts refer to it as the "Fed's USD backstop", which is also appropriate. Why is this for us so relevant? Because thanks to this backstop, the world ends up being impacted similarly ("similarly" being the operative word here) to what we would see, if the Fed bailed out Eurozone banks. Is the Fed bailing out foreign banks providing this backstop? We see it that way, although the Fed will always deny it. But think of this simple question: What would happen to the weakest Eurozone banks that need to roll over USD funding, if that backstop wasn't there? They would certainly be insolvent by now. However, the Fed doesn't see it that way. What the Fed sees is the underlying counterparty risk. The Fed turns around the question to tell us that if the backstop was not there, the US banks would have funding problems, competing with Eurozone banks for funding.

To his credit, Dr. Ron Paul, was the only politician to see this far in advance, last year, when he questioned Mr. Daniel Tarullo, member of the Board of Governors of the Fed, on this point on May 20th, at a joint hearing of the Subcommittee on International Monetary Policy and Trade (watch minutes 6:22 and 7:36 of this video: http://www.youtube.com/watch?v=hMo-V8HoNdc).

Had we been in that session with Mr. Tarullo, ***we would have asked him what would the Fed do, if the dollars lent to the European Central Bank, forwarded to Eurozone banks, cannot be paid back because the assets these dollars funded are in default or generating substantial losses to the originating banks?***

This is important because that is exactly what occurs during stagflation: Businesses go bankrupt. We know the answer: The Fed would do nothing, allowing these dollars, printed money, to remain overseas. This is why we say that the FX swap is effectively quantitative easing from the Fed on the Eurozone. We will go on record stating this: **AS LONG AS THESE FX SWAPS (USD BACKSTOP) REMAIN IN PLACE, WE WILL BE LONG GOLD. THE TOP FOR THE GOLD MARKET WILL BE REACHED THE DAY THIS BACKSTOP IS ELIMINATED EITHER VOLUNTARILY OR FORCED UPON THE FED BY THE MARKET AND NOT ONE MINUTE EARLIER.**

Turning now to the Eurozone, it is completely clear now what we have been predicating time and time again, since February 8th, 2010: The zone faces an institutional crisis. Back then, it was only an institutional problem. The disastrous handling of the crisis by Euro politicians have made it now a real economic one and we think there is no way out here but dissolution in chaos. This again, shall be very bullish of gold and bearish of risk (unlike mainstream view, we distinguish gold from "risk" because to us, gold is money). Enough said. We could go on but we think that over the past letters we have been very clear and unfortunately, times will now accelerate and we will witness this problem evolve exponentially.

In China, it seems the People's Bank has not been sterilizing its FX reserves purchases. However, to mitigate the corresponding inflationary impact, it has been relentlessly increasing the reserves requirement ratio of financial institutions, using the "credit multiplier" channel. According to Bank of America's Rates and FX Research team ("Global Rates and FX Weekly", August 26th, 2011), by September 2010 the level of USD reserves had reached \$3.4 trillion (CNY21.8 trillion) , while the People's Bank's debt had decreased from CNY4.4 trillion to CNY2.7 trillion. The gap between the FX reserves (i.e. assets) and the debt (liabilities) was covered by the increase in reserve requirements (i.e. liabilities too: Remember that the banks' reserves in a central bank are an asset to the banks and a liability to the central bank).

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Why did China's central bank choose to hike reserves rather than issue debt to mitigate the impact of its USD purchases? It was simply cheaper, apparently, which means that if the trend continues two things will become evident: 1) the profitability of China's banking system will be hurt, and 2) the US Treasury will find it harder to place its debt.

On the first point, the central bank may be forced to increase the interest rate on the reserves, dragging banks to depend on it, increasing the cost of eventually appreciating the Yuan (i.e. exit strategy). On the second point, the Fed will be forced to step in, should China merely stop accumulating reserves. We may add that as the first point becomes more relevant, the cost of eventual defaults will be way higher. Both issues are very bullish of gold and bearish of risk, too.

After all these considerations, we are really surprised to hear mainstream analysts say that another recession (as if the last one had ended) would be a so-called Black Swan event (i.e. a rare event). How so? We would argue that the opposite is true: In this context, avoiding a double dip is actually the Black Swan event!

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