

A View from the Trenches

Toronto, Monday, November 21st, 2011

Good morning,

At this point, we would like to take the time to summarize a few ideas and to provide more clarity on where we have stood and continue to stand. Revisiting what we wrote on May 2010, at the time when the first bailout package for Greece was put in place, we see that almost everything we forecast then is unfolding now before our eyes. The reader only needs to click [here](#) (refer to scenario 2: “ECB sterilizes PIGS debt purchases issuing short-term debt”) verify. The main points were:

“...there cannot be an exit strategy. The ECB has its hands tied and eventually depends on the PIGS sovereign to generate a consolidated fiscal surplus to buyback their debt. Therefore, a reputational issue threatens the European financial system:

a) What if the so-called “short-term” ECB debt backing deposits is indefinitely rolled over and depositors see the risk and decide not to renew deposits?

b) If the ECB becomes a riskier bank, its currency will (actually is) no longer be considered an alternative reserve asset and the propensity to exchange it for gold or USDs will increase exponentially. If so, what was the wisdom behind Sunday’s decision by the central banks of the USA , Canada , UK , Switzerland and Japan to provide currency swaps to the ECB? Are currency swaps all of a sudden a “free lunch”? What for were the balance sheets of these institutions compromised? Who pays for it? Should the senior management of those central banks not be audited for decisions of this sort? Who is accountable?

This analysis suggests there could be a generalized run against the Euro as a currency...(...)

Another aspect here is that as this process takes place, the credit quality of the loans held in the Euro-zone banks would quickly deteriorate, further weakening the ECB position.

Would this lead the world to the end of paper money?

We have written many times before, that we were amazed by the fact that regulators did not understand the systemic nature of sovereign credit default swaps. These swaps, which in the case of Euro-zone sovereigns are denominated in US dollars would be the link here, connecting US financial institutions with Euro liquidity problems.

The Fed last Sunday already extended currency swaps to the ECB in a very murky way, which even caused a heated debate in the US Senate. What do you think would happen under a terminal situation, where the European banks’ risk as counterparties would jump exponentially?

And then, friends, would you hold US dollars as a reserve asset, knowing that they are thrown into a hole to fight the last battle? Doesn’t this actually make gold look like a bargain at \$1,240/oz?...”

All of these concerns/predictions have materialized the way we imagined them. The last act here is to see the systemic implosion of the sovereign credit default swaps. When we finally see the respective defaults, we will realize the severity of it.

There is however one side to this story that we have overestimated. We thought that with the USD swaps extended by the Fed to the ECB, the pain, the cost of USD liquidity would be contained. What we see today, a EURUSD swap basis of more than 125bps and comparable to 2008, is not what we had in mind. But if so, can’t we say that gold at \$1,724/oz is resilient?

To summarize, since May 2010:

-Our predictions on the dynamics in the Eurozone have proved correct

-We have not yet seen the unfolding of the systemic risk hidden behind sovereign credit default swaps

-We wrote that eventually the Fed would step in to provide USD liquidity, but we overestimated its impact. So far, the markets are shrugging it off.

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This last point is connected to our last two letters, which put us on the contrarian side. Why? We clarify below:

-What the market collectively believes:

The market at this point seems to believe that the ECB still has time to step in, buy unlimited amounts of peripheral sovereign debt and, in so doing, avoid the collapse of the Euro zone.

-What we believe:

We believe that even if the ECB stepped in, the collapse at this point is unavoidable. And as we wrote on November 7th, ten days before the controversy between France and Germany would become public (see: <http://www.bloomberg.com/news/2011-11-17/france-renews-pressure-for-ecb-to-finance-euro-bailout-fund-as-yields-rise.html#>), we think the break up is most likely to be triggered by France leaving the Euro zone. On November 7th, we wrote:

*“...the increase in Italian sovereign risk will affect French banks more than German banks. **The endgame here is France leaving the Eurozone**, as it becomes evident that the German lobby on the ECB forces France to recapitalize its financial system at a prohibitively high cost. France would be better off recapitalizing/nationalizing its system in French Francs. But if France leaves, there is no Eurozone...”*

Now, our pessimism on this issue has increased over the past week. Why? Because of two things:

-Thing 1:

We were reading Murray Rothbard’s “*America’s Great Depression*” (www.mises.org/rothbard/agd.pdf), which according to the famous British historian Paul Johnson, “...brings the world of economic history (...) vividly to life, and which contain so many cogent lessons, still valid in our own day...”. In his chapter 12, under the title “The Attack on property rights: The final currency failure”, we have a vivid description of the year 1933, when American depositors ran for liquidity in different states. The Fed provided all the liquidity necessary, just like politicians outside Germany are demanding that the ECB do, but even then, Mr. Rothbard tells us that: “...despite the gigantic efforts of the Fed, during early 1933, to inflate the money supply, the people took matters into their own hands, and insisted upon a rigorous deflation (gauged by the increase of money in circulation)—and a rigorous testing of the country’s banking system in which they had placed their trust. The reaction to this growing insistence of the people on claiming their rightful, legally-owned property, was a series of vigorous attacks on property right by state after state. One by one, states imposed “bank holidays” by fiat, thus permitting the banks to stay in business while refusing to pay virtually all of the just claims of their depositors...”

Unfortunately, we think this is the most likely scenario in the coming weeks/months: People will take matters into their own hands! This scenario is consistent with the indifference we see today in the USD liquidity market, vis-à-vis the swaps extended by the Fed. The market doesn’t care! Policymakers, take notice: A rigorous testing of the global banking system is underway!

-Thing 2:

Thinking on the necessary conditions to break the Euro zone in an orderly fashion, we concluded that it is an unfeasible task. If it breaks up, it will be amidst chaos. Given its complexity, we will not address this now, but can say this: An orderly break up of the Euro zone would require a SIMULTANEOUS Euro-wide bank holiday (a week-long), after which the following would have to emerge: a) new national banks backing their respective currencies with a common denominator: gold and a basket of foreign exchange reserves, b) credits from different former EMU nations against the equity of EMU-wide recapitalized banks would have to be cleared, and c) the value of the local currencies against gold and the foreign exchange would have to be flexible, allowing capital flows and the testing (by the market) of the new national banks’ solvency.

Under the existing political conditions in Europe, we are not even close to seeing this. We fear chaos of the worst order awaits (and we haven’t even begun to analyze the US deficit dealings by the Super Committee).

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