A View from the Trenches

Toronto, Monday, November 7th , 2011

Good morning,

The events that took place last week will be consequential. In our last letter, we made the case that even without further details, the measures at the EU summit only showed an impressive lack of common sense.

Last week, EU leaders agreed on three fundamental measures: (a) To leverage the EFSF (European Financial Stability Facility), under a first-loss insurance scheme that would cover the initial losses on newly issued debt of EU sovereigns; (b) Greece's sovereign debt will be "voluntarily" restructured without triggering a credit event. The eventual haircut (i.e. discount) on Greek debt will be significant (approximately 50%), or at least higher than 20% for the purpose of our discussion; and (c) EU banks will have to raise more capital by 30 June 2012. As we explained, these three measures constitute an inconsistent system, which will leave the European Monetary Union in worse shape.

By now, the market seems to share our view. Italy's sovereign 10-yr yield broke the 6% mark from below and on Thursday, the EFSF decided to postpone a $3BN pre-funding issue, blaming market conditions. How could they do that? Is the EFSF not supposed to raise money for sovereigns in distress precisely when market conditions are not optimal?

The whole exercise of saving Greece is exposing one of the biggest Ponzi schemes ever (the record in Ponzi schemes is still proudly held by the US Treasury). Shamelessly, the goal of the G-20 meeting last week was disclosed as nothing else but one more layer in the game, where EU banks finance sovereigns, sovereigns and the ECB (i.e. European Central Bank) finance banks, the EFSF finances the sovereigns and now probably, the rest of the world would finance the EFSF. But it is too late. The crack is out there for everyone to see and Italy is screaming the word "contagion" so loud that even amid a severe volatility, gold managed to end the week higher, even in USDs (i.e. the case for higher Gold/Euro is obviously clear at this point).

But if it is that clear that all measures so far are not going to solve the problem, why is the Euro still so strong? Why have we not seen a major sell off? We think the answer lies in the interest rate cut the ECB offered on Thursday. The market knows that the only way out now, if any, is to monetize sovereign debt and wants to believe that Draghi's (i.e Mario Draghi, the current President of the European Central Bank) move last week was a signal of support in that direction. We think it is a bit too optimistic but acknowledge that monetization will arrive at the last hour.

What would that last hour look like? What would precipitate it? We have been discussing this point with an old friend and reader who shall remain anonymous. Here's our thoughts:

It is now clear that Greece is no longer the problem. Greece has already been discounted and the market, as always, is now looking into the future. It looks grim. Contagion is already spreading and cannot be denied. Portugal? Spain? Ireland? No, those countries had been accounted for. The problem now is Italy and the upcoming arbitrage of banking jurisdictions, in the face of the Eurozone breakup. As the last day approaches, deposits in the periphery of the EU will not be renewed and, if money is not held under the mattress, it will make its way into deposits at German/EU core banks.

This jurisdictional arbitrage within the Eurozone, will grow exponentially intolerable. Banks in the periphery will increasingly use the ECB liquidity lines, including USD loans facilitated by the Fed through cross-currency swaps, to meet the run for liquidity facing them. The ECB will have to accumulate collateral against these lines and the money redirected to core banks will sit as reserves, generating a credit contraction in the EU. Some will feel the pain more than others. None of the countries that face rising yields today will be in a position to address their ever growing deficits, as their tax revenue collapses.

Where it will be particularly felt, in our view, will be Italy. Until this point, we can either assume ***(a) that the ECB holds the line with sovereign bond purchases*** or (***b) on the contrary, it accelerates them***. If it holds it, then 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 and Germany is left without the benefit of its pan-European reserve currency. The negotiations leading to this result would be very interesting, full of volatility and we don't know what would happen to the value of gold here. Indeed, gold

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should find a strong bid, but at the same time, one has to believe that the Fed would find it very, very difficult to justify renewing USD swaps to a central bank (the ECB) in the process of being liquidated. This is true particularly in the following months, as a cornerstone of the Republican Party is the promise to closely audit the Fed. In this case, the cost of USD funding would shoot exponentially and margin calls would crush the price gold and the rest of the risky asset spectrum.

If, on the contrary, under Mr. Draghi, the ECB accelerates sovereign bond purchases, the Euro would embark on a devaluing road and gold would steadily rise against ALL currencies, as the Fed would extend a hand to the ECB, in the belief that the Eurozone can survive, albeit at the expense of losing purchasing power and perhaps too, the dream of ever challenging the US dollar as the world's reserve currency.

In this scenario, ***the devaluing game would continue as long as the German public tolerates the resulting inflation***. This scenario could easily include the separation of Greece and Portugal from the Eurozone, while Spain makes progress with its fiscal program and Italy wins time to restructure. This is the can-kicking option, with no guaranteed results. But it buys time and perhaps ends in some sort of federal tax structure. If inflation picked up significantly, this scenario could potentially end with Germany leaving the Eurozone, particularly if no advance is made towards a pan-European fiscal integration.

We think therefore that this last option (**ECB accelerates sovereign bond purchases**) is the most likely and see brighter days for gold.

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