

A View from the Trenches Toronto, Wednesday, December 22nd, 2011

Good morning,

In the absence of further meaningful events, this will probably be our last letter of the year. Reflecting on our main macro thesis, things have played out the way we thought they would. Not from the beginning of 2011, but from the beginning of 2010. That's right, already back in 2010 (refer for instance our letter from May 3rd 2010: www.sibileau.com/martin/2010/05/03) we envisaged a scenario exactly like the one we're facing today. Back then we wrote:

"...It has become clear and public that European sovereign debt is being and will continue to be bought by European banks backed by the ECB, making the sovereign risk contagion back to the financial system a done deal. Therefore, how safe are those who bought sovereign credit default swaps ("cds") from banks that are now exposed by the sovereigns?...We have mentioned this ignored side of sovereign cds in previous letters (for instance, refer: www.sibileau.com/martin/2010/03/01). How this issue is not discussed while every regulator in the world is still looking for ways to reduce systemic risk is beyond our understanding.

If sovereign jump-to-default risk increased, the ECB would most likely monetize sovereign debt (actually, the ECB is already doing it), further devaluing the Euro. But as long as no sovereign defaults, things will be under control. However, if a Eurozone sovereign ended in a credit event triggering the cds contract...How bad would the run for liquidity to the USD be? CDS contracts on European sovereigns trade in USD.

How much would counterparty risk (=risk between the banks that traded the cds) jump? Is the size of outstanding sovereign debt and that of the cds net notional useful to assess the impact? We think not and we guess that anyone downplaying this issue based on the size of Greece's cds net notional outstanding doesn't understand the leveraged nature of capital markets. Are Greece's funding needs in 2010 not minimal compared to the impact they are causing?

The next question is whether gold would rally or fall. To answer it, we have to speculate on whether the Fed would or not extend currency swaps to the ECB to avoid the collapse of the Euro. The Fed did so in Sep/Oct-08, upon the Lehman event, and we believe the Fed would so again, which brings us to the another point... What is riskier?:

a) To have the Fed extend currency swaps to the ECB to provide liquidity to the financial system for clearing purposes (as in post-Lehman) or.....

b) to have the Fed extend currency swaps to the ECB, as a ultimate back-up on liquidity on sovereign debt?

In the first scenario, should gold not sell? (It did). In the second, should gold not rally, as a sovereign default causes the collapse of the Euro (our base case assumption here)? Would American taxpayers ever get their monies back if the Fed extended those swaps to the ECB under the second scenario?..."

What we did not anticipate is that it was possible to start in scenario (a) above, and as we think will occur during 2012, transition to scenario (b). It may now be possible that these scenarios be not mutually exclusive, as we imagined then 19 months ago, but linked with one preceding the other.

Recapping the year, we should say we had a bit of cautious optimism, back in January, when we thought there would be agreement to use the EFSF to purchase sovereign debt in the secondary market. In perspective, we realize that the refusal to go this path by Germany in March, marked the death sentence of the Euro as we know it.

The debt ceiling negotiations in the US, including its sovereign risk downgrade by S&P, and the latest drop in reserve requirements in China are symbolic of what we will see in 2012.

The view from the rest of the world is also murky. In 2011, we witnessed the fall of dictatorships in the Arab world, without any clarity on what will follow. The same applies to North Korea. South America is divided into a right-leaning block (Chile,

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Perú, Colombia) and a left-leaning one (Venezuela, Ecuador, Bolivia, Argentina), with Brazil still trying to figure out which way it will go. We believe it will go left. It's the path of least resistance.

Overall, there has been disintegration in global trade, with the irony of a convergence in risk, between the developed and the emerging world. The first are being downgraded, while the second have been upgraded.

What next?

We think 2012 will see a rebellion of the people. On the economic front, they will likely repudiate the financial status quo, with an increasing run on deposits, perhaps even at a worldwide scale. On the political front, we will see a fight to retake democracy. In Europe, that may mean not just the fall of the Euro but also of the European Union. In the US, the rise of Ron Paul and if not him, his ideas, may create a serious schism in the Republican Party, in favour of Obama's re-election. In China, the rebellion should proceed at a slower pace, but steady nonetheless, as prices increase.

Back to a shorter term view, as the reader is already aware, yesterday the long term (3 year) refinancing operation resulted in almost Eur489 billion being borrowed by 523 banks. A lot has been said and written. All we want to add here today is this: We must keep in mind that all this does is to prevent the further sale of assets (sovereign) by Euro banks. Nothing else. If sovereign ratings are further downgraded, the respective losses will still have an impact. If fiscal deficits persist in the Eurozone, the value of the sovereign debt will fall and will still have an impact. If investors are further affected by the Greek situation, the value of sovereign debt will fall and will still have an impact. As you see, the substance of the problem remains alive. All eyes will be on the Fed, which will have no alternative but to remain financing the rest of the world via currency swaps.

This situation however leaves us with uncertainty and uncertainty breeds volatility. Gold and the rest of the risky assets will have a hard time.

We wish you all a prosperous 2012!

All the best,

Martin.

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