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Nessun Dorma: "None Shall Sleep" 2011

“The client is not always right.”

Enzo Ferrari

“It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only those individuals know.”

“Perhaps the fact that we have seen millions voting themselves into complete dependence on a tyrant has made our generation understand that to choose one's government is not necessarily to secure freedom.”

“With the exception only of the period of the gold standard, practically all governments of history have used their exclusive power to issue money to defraud and plunder the people.”

Frederich August von Hayek

Fear – it is an innate emotion – it is a basic survival mechanism. It is a required response to a specific stimulus to avert danger and or more pain. It is our ability to recognise danger and run like hell from it and, failing an escape route, fear adrenalises us to stand and fight. Now fear can flip into an irrational reaction to a set of negative stimuli. An overreaction. Sometimes this can become entrenched – a phobia.

Fear has undoubtedly driven some attitudes in the last few years of financial and economic mayhem. A lack of comprehension of events outside of our control arguably engenders most fear, but is this not an anxiety? Anxiety is usually considered an emotional state which typically occurs without an external threat, so no it isn't. So based on this definition, we as a Management firm feel fear, based on the definition that we are reacting to a known external threat.

We in Hinde Capital would like to share our "fears" about social, economic and financial eventualities. How predictable for a gold focused firm to dwell on such negativities we hear you say. We like to think our fears are not born of pessimism but realism. We have a positive expectation of this misery.

Most will be familiar with Giacomo Puccini's famous tenor aria, *Nessun Dorma*, from his Opera *Turandot*, as it has been popularised by the late Pavarotti who helped bring Opera to the masses. Think World Cup Football Italy 1990 signature music. Literally translated – "None Shall Sleep" encapsulates our view for 2011. But like this popular aria was the final act of an enchanting Opera, will this be a notable last act for the crises that have so engulfed the world socio-economic order and/or as pertinently for us the last act for gold? After all as people do not tire of mentioning, it has climbed relentlessly for ten years. But then so has their currency descended in to the flames of Hades.

We wish to highlight not all but some of the "fears" that keep us awake at night, and illustrate why right now is not the final act for gold. 2011 could be an explosive year for this most illustrious of metals. We do not wish this, as we prefer the orderly ascent of gold to protect our investor base. We would not wish gold to become the final bubble of so many that have marred the last two decades and thereby undo its unique monetary properties, as it is once again cast aside. We believe that not withstanding a lack of gold standardisation, gold has a firm place in modern portfolio management and in accounting procedures.

We want to address our generic fears and then consider what this could entail for financial markets within the context of our rapidly evolving socio-economic and financial order (macro).

2011: As we start each New Year Investment participants are all challenged to outline or even forecast markets. Each year we all protest about how we loath to prognosticate on the world economy and markets. Personally I think it is as good a time as any to have a period of reflection and so we will probably make forecasts and even make a subjective analysis of when our forecasts will manifest, (even if they do not). For us what is most important is that we have a framework of portfolio management so that even if we make the wrong allocation mix based on our predictions, our risk management will be so robust that we will outperform our chosen asset classes and sectors. Specifically for our Gold Fund, if gold was to fall in value relative to our USD benchmark we will endeavour to outperform. Shortly we will be illustrating in another article our reasoning behind portfolio construction in the context of real returns during the past 40 years.

Our framework for viewing the world is based on a belief that there is an abundance of credit and money, but no capital, ie no savings just credit and consumption has manifest to such unserviceable heights that production does not exist in the sense of providing sustainable wealth. All assets have a subjective value that is not quantifiable in a meaningful media of exchange. These past years have perpetuated an era of dishonest money whereby credit/debt (they are flip sides of the same coin) have subjugated morality by encouraging conspicuous consumption and personal vanity at the expense of better sustainable living standards for all. We are not taking the moral high ground, we like 'nice' things too. Just we want sustainable items.

Morality of Value

Illusionary as wealth may be, the rich poor divide has grown wider even as technology advances have allowed us to witness real-time the misery of most. Undoubtedly a particular palliative of all governments, both in the Occident and the Orient, has been to assuage the disgruntled poor by encouraging enrichment via the seemingly never ending tap of credit. This system of debt and credit cannot survive indefinitely. It will fail. When or how remains to be seen. It is this failure of credit that preoccupies the majority of our waking moments. How will the macro unfold? For those interested in pursuing the relationship between money and morality, a friend of ours, incidentally based in Ireland, recommended this book a few years back. The Ethics of Money Production by Jorg Guido Hulsmann is available at www.mises.org.

Right now Hinde's function as an Investment manager is first and foremost to protect wealth. This doesn't preclude capital appreciation. By looking to protect our wealth, we are seeking to protect our purchasing power. We define this by reference to ounces of gold. What will an ounce of gold provide? Appropriate asset allocation decisions should help us all to enhance our purchasing power.

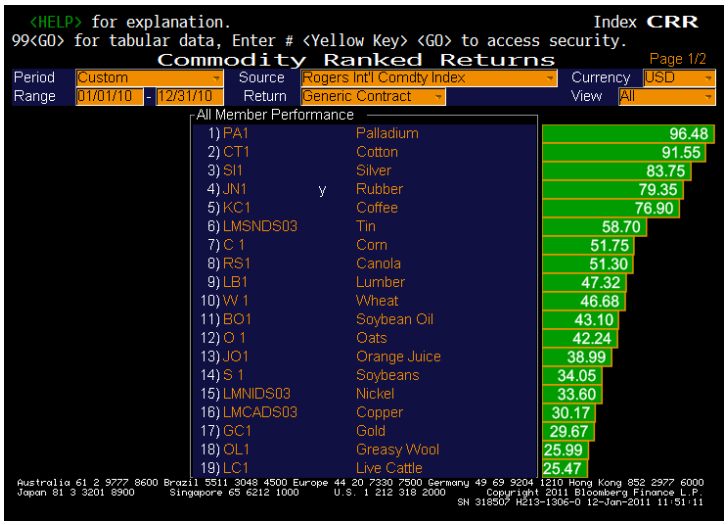
Our premise for evaluating markets is primarily based on assessing value. But what is value. Never has calculating value become so subjective when observed through the prism of collapsing fiat currencies. Our media of exchange, our legal tender seems to have grown and morphed so grotesquely in recent years that pricing goods and services needs real time application. We have to concentrate on 'real' prices adjusted for a basket of goods and services (inflation indices) and/or money supply adjusted for growth (GDP).

Lord of the Flies

The world is witnessing a powerful confluence of increased monetary bases and supply constraints. So we have a big pie of intangible and tangible resources that needs to be divided. However excessive money and credit, and disparity in the distribution of resources have led to more consistent and sustained tension for these resources. We know this because prices for a basket of commodities have risen even in the face of supposed large output gaps.

In the years to come we believe we will witness the moral fallout of nations competing for finite resources, in a real life drama that William Golding's Lord of the Flies depicts. The book was an allegory of man's conflict between innate and learned behaviour. It provides a fictional account of how marooned civilised children become intoxicated by power and the need to survive. It exposed man's raw animalistic behaviour when survival was at stake.

Rogers International Index: Best Performing Constituents 2010



Source: Bloomberg

If one Googles the term ‘supply constraints’ there are an alarming number across tangible commodities and human supply chains. Supply constraints are evident because the BRIC phenomenon, the acronym for Emerging growth, has seen increased industrial demand from approximately 3 billion people, which is now competing with the developed world needs.

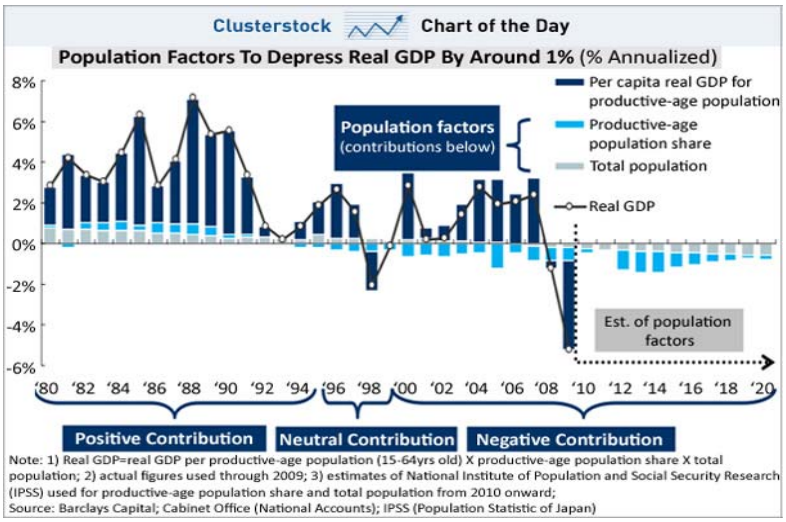
Bloomberg: Coffee Price Rises to 13-Year High; Cocoa, Orange Juice Gain
Coffee futures extended a rally to a 13-year high on speculation that supplies may be reduced because of adverse weather in Brazil and India. Cocoa and orange-juice prices climbed.

Bloomberg: Sugar Extends Rally to 29-Year High on Brazilian Supply Concern
Sugar futures rose in New York, extending a rally to a 29- year high, on speculation that supplies will start running low from Brazil, the world’s largest producer.

Bloomberg: Rubber Climbs to Record on Tire Demand, Production Disruptions
Rubber futures climbed to a record on speculation that a global shortage will worsen as tire demand increases and wet weather hurts supplies from producers including Thailand, the biggest grower. The cash price also surged to an all-time high.

Perversely even though we are witnessing aging demographics primarily in developed countries, most notably Japan and even in Emergent nations such as China (due to one child policy) one would think that the strain on resources would dissipate. Possibly, but the consequences of aging demographics is for an increased fiscal burden on these countries, as they have less eligible ‘productive’ workers. This has exacerbated the needs of these countries to meet the shortfall of both cyclical and structural deficits.

Japan's Aging Population to depress GDP output



Source: Cluster Stock

ENZO Farmers

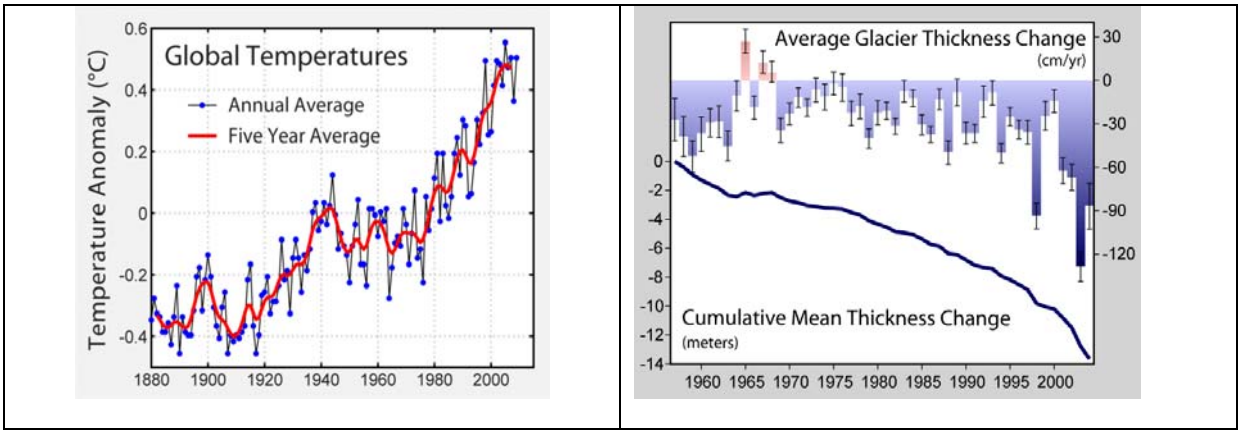
Like the Enzo Ferrari V12s that have become progressively more turbocharged, weather patterns appear to have become more unstable. No more so is this evidenced than by the heightened intensity and irregularity of ENSO (*El Niño* / *La Niña* -Southern Oscillation).

ENSO is a quasi-periodic climate pattern that occurs across the tropical Pacific Ocean with on average five year intervals. It is characterized by variations in the temperature of the surface of the tropical eastern Pacific Ocean - warming or cooling known as ***El Niño*** and ***La Niña*** respectively - and air surface pressure in the tropical western Pacific - the *Southern Oscillation*. The two variations are coupled: the warm oceanic phase, El Niño, accompanies high air surface pressure in the western Pacific, while the cold phase, La Niña, accompanies low air surface pressure in the western Pacific.

We are not climatologists and although our natural scepticism leans towards dismissing the climate anthropogenic thesis, ie warming as a consequence of human interaction with the environment; it is clear whether you are a believer or not that man's present infrastructure does not leave room for adaptation to our present angry Iberian child prodigy of the inclement kind. El Niño, even to non-linguists means Spanish for boy and La Niña for girl. El Niño was originally recognized by fisherman off the coast of South America as the appearance of unusually warm water in the Pacific Ocean, occurring near the beginning of the year. El Niño also means Christ child in Spanish. This name was used for the tendency of the phenomenon to arrive around Christmas.

A paper by the appropriately biblical sounding NOAA – National Oceanic and Atmospheric Administration acknowledges the contentious debate on climate warming versus cooling. The question remains how easily can we model climate change ENSO. We can't help but think of Heisenberg's Uncertainty principle and so for now think it is highly improbable that we can forecast weather systems sufficiently to protect human resources. For there is no doubt that ENSO has led to extreme weather conditions such as floods, and droughts. Have they become more regular or are we mapping out cyclical patterns associated historically with the past two centuries?

http://www.esrl.noaa.gov/psd/csi/images/GRL2009_ClimateWarming.pdf



Source: NOAA

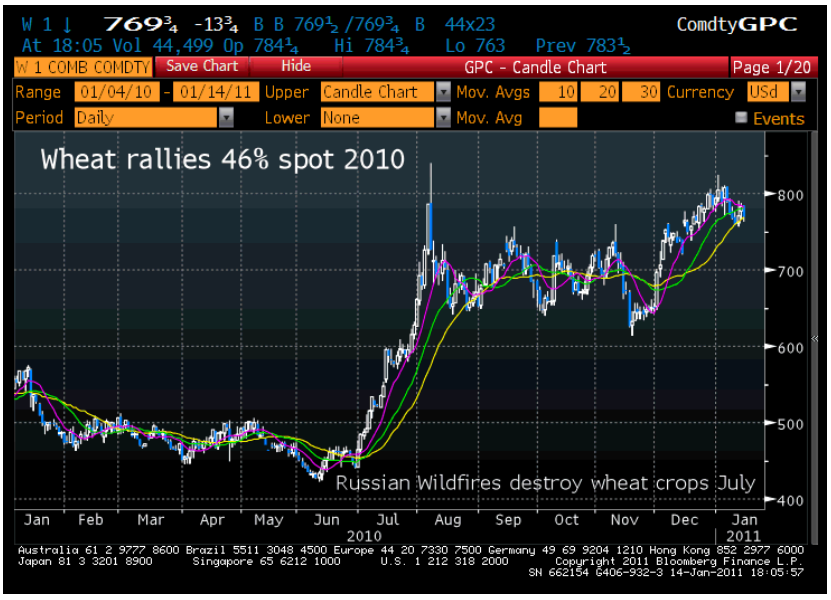
One can cite a myriad of natural disasters that have occurred over the last few years - tsunamis, hurricanes, droughts and floods, that have all inflicted untold misery, loss of life and strains on food supply chains.

http://www.bloomberg.com/news/2010-08-04/wheat-surges-to-22-month-high-on-russian-drought-corn-soybeans-advance.html

Bloomberg: Wheat headed for the biggest weekly gain in half a century on concern other countries may follow an export ban by Russia, and may reach $10 a bushel, a price not seen since the global food crisis in 2008.

Russian Prime Minister Vladimir Putin said Kazakhstan and Belarus should also suspend shipments as Russia announced a ban on grain exports from Aug. 15 to yearend. "It's got $10 written all over it," said Peter McGuire, managing director at CWA Global Markets Pty, who on Aug. 3 correctly forecast the surge to $8.50. Wheat was last at $10 in March 2008, and a gain to that price would be up 23 percent from yesterday's close.

Wheat Spot Futures rally over 46% 2010

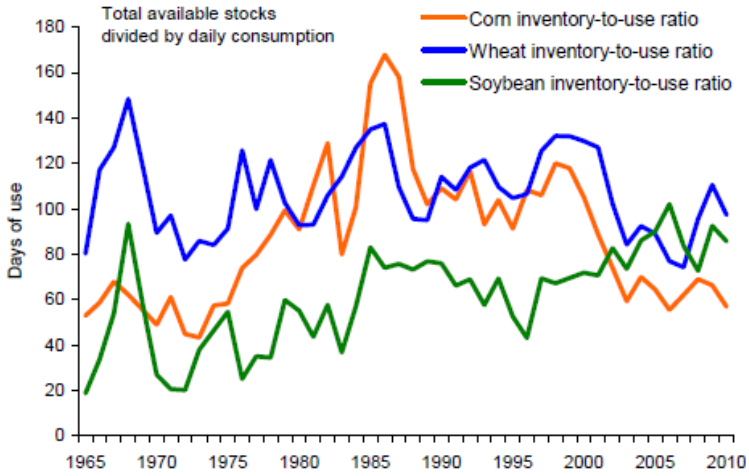


Source: Bloomberg

Feast or Famine

At the time we clearly remember seasoned analysts commenting that there *should* be sufficient global supplies of wheat. We all turned our attention to Australia and Argentina for their status on wheat supplies. Now these countries are experiencing weather related crop issues.

Stock-to-use ratios: Grains & Soybean



Source: CSFB, Bloomberg

So do farmers love ENSO? Depending on their geographic location one man's misfortune is but another man's fortune. Farmers in the corn and wheat belts of the Mid-West will soon be swapping their V8 John Deere's for V12 ENZOs as they benefit from skyrocketing grain prices. Move over 'ungrateful' bankers.

The United Nations rated the floods in Pakistan last year in July as the greatest humanitarian crisis in recent history with more people affected than the South-East Asian tsunami and the recent earthquakes in Kashmir and Haiti combined. A staggering one fifth of Pakistan's total land area was underwater, affecting 20 million people (out of potential 174 million). The regular monsoon turned into a deluge after above average rainfall in prior months due to ***La Niña.***

Cotton spot price rallies 104% July to Nov 2010

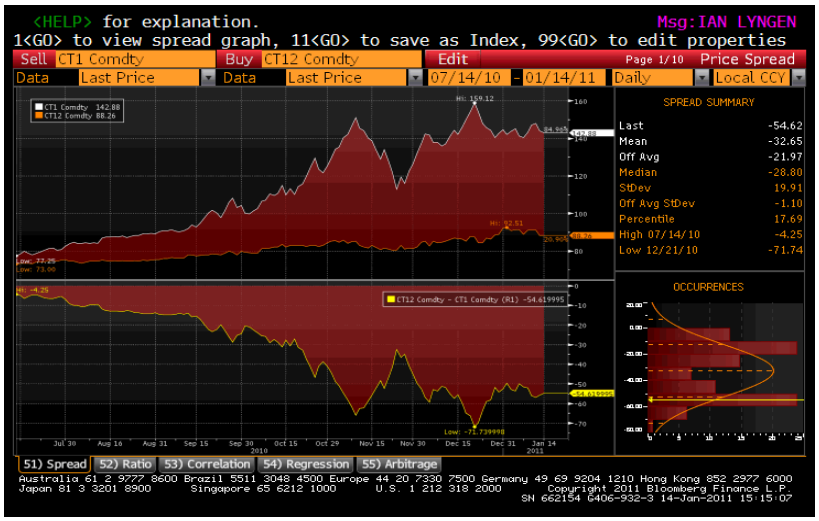


Source: Bloomberg

The proximate trigger for cotton futures was clearly the destruction in Pakistan, which is the fourth largest producer in the world. A third of its crop production was destroyed, with the targeted 14 million bales falling short.

The point to grasp here was that in the end a shortfall of 1million bales had a disproportionate impact on prices. This is because the commodity supply demand balance was already experiencing tightness due to surging Chinese demand, (China is the largest producer incidentally), and Indian restrictions on exports. The impact on near term was acute as evidenced by the rise in backwardation.

Cotton March 2011 Futures spread to Cotton March 2012: Backwardation



Source: Bloomberg

The fall out of such price moves is only too evident for the garment and textile industry. Without immediate fibre substitutes, prices have been passed on to some extent, as margins have squeezed to unprofitable levels. We note that cotton is susceptible to general crop price surges particularly as land suitable for the crop is relatively scarce.

http://www.telegraph.co.uk/news/worldnews/asia/pakistan/7935485/Pakistan-floods-disaster-is-the-worst-in-the-UNs-history.html

So much has happened in 2010 we were remiss in remembering the Spring (March 2010) drought and accompanying dust storms in China and across the ASEAN region. This brought widespread misery and price rises particularly in domestic produce. It was considered the worst in a century for Southern China. This was on the heels of severe droughts in Northern China in 2009, which saw food production drop by over 50%. Shortages of water severely impacted commodities including sugar cane, flowers, tea, fruit, potatoes, rapeseed, medicinal ingredients, tobacco, wheat, rubber and coffee with output again reduced by as much as 50%. It would be remiss of us not to point out that many non-exchange traded commodities have risen substantially. This isn't just a speculative issue, as governments would have one believe. Even if it was, it is a natural reaction by investors to this debasement and the inducement of inflation by government.

Even into this year end Uruguay and Argentina have experienced the severest droughts in 100 years, which helped underpin cattle prices.

http://en.mercopress.com/2010/12/27/drought-stricken-uruguay-praises-argentina-s-formidable-gesture

Such excessive weather patterns are disrupting social cohesion particularly in countries living at a subsistent level or certainly a standard of living still far below the OECD. This is in addition to the human toll of immediate loss of life from the acute disasters themselves.

Undoubtedly agricultural cycles tend to be shorter from trough to peak. Average duration is 21 months and price rises are typically of the magnitude of 130 to 150%. This makes sense intuitively as there is a quick new supply response.

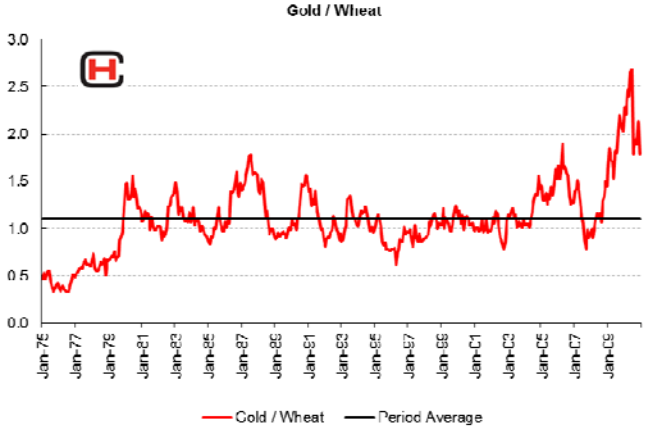
Farming is not capital intensive when compared with the mining or energy sectors, which takes up to an average of 5 years to accelerate supply. Agricultural production can be accelerated in a year if there are no land, machinery or chemical constraints. Not withstanding this, wheat, a reasonable proxy for the agricultural sector is still historically undervalued even accounting for its recent rally in 2010. Let's not forget this was from all time lows (both real and nominal). The gold/wheat ratio at 2.5 last year signals this extreme wheat undervaluation.

Agricultural Price Rallies Since 1972

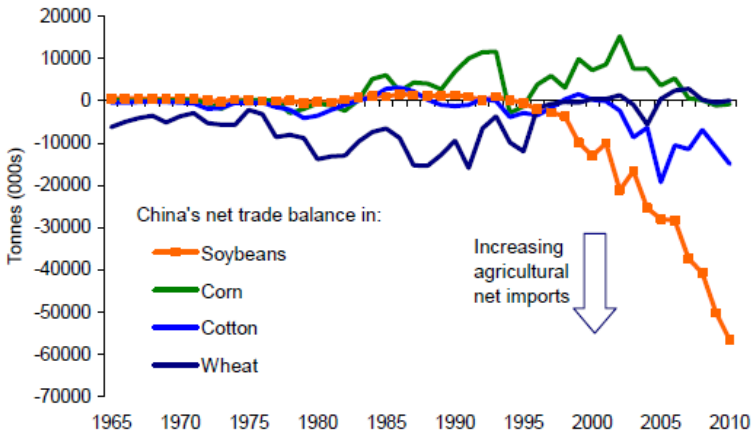
		Change (USD)	Change (%)	Duration (months)
Corn	Average	2.46	129%	17
	Current	*3.04*	*94%*	*7*
Wheat	Average	3.77	165%	26
	Current	*3.78*	*88%*	*7*
Soybeans	Average	5.72	127%	15
	Current	*4.33*	*47%*	*7*
Sugar	Average	13.7	219%	22
	Current	*20.7*	*152%*	*7*
Coffee	Average	1.34	218%	16
	Current	*1.39*	*137%*	*24*
Cocoa	Average	16.68	171%	26
	Current	-	-	-
Cotton	Average	0.45	111%	22
	Current	*1.19*	*298%*	*21*

Source: Deutsche Bank

Gold/Wheat Ratio 1975 to present



China Net Trade Balance Grains/Soybean/Cotton (1965 to 2010)



Source: Bloomberg

China's agricultural trade balance has deteriorated significantly. Soybean and cotton are large requirements and they appear to have turned net importer of corn. Now although demand for corn vis-à-vis feedstock for ethanol has risen dramatically according to the USDA, new acreage has been planted, but most likely at expense of soybeans. So couple this with 'naughty' La Nina (which means a colder winter for US and droughts in the growing season in South America) then soybean could be one to watch.

Soybean rallied 55% approx. July to Dec 2010

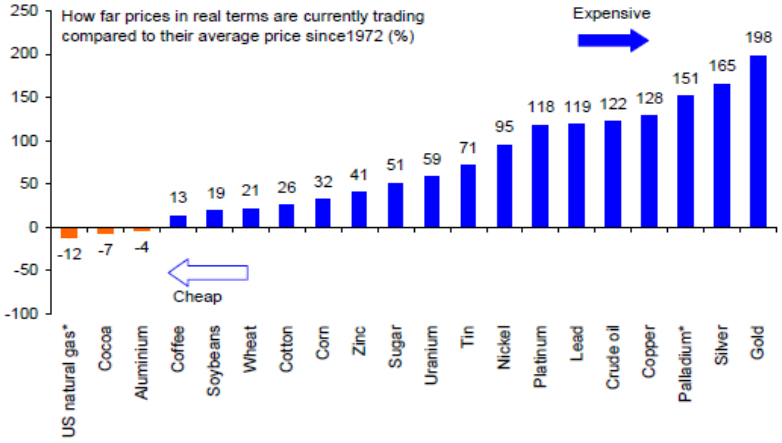


Source: Bloomberg

A ‘paltry return’ of circa 35% for soybean in 2010 makes it look a veritable bargain. We are not trying to make a strategic play on any one commodity, as our expertise is no better or worse than the average macro observer. **We are suggesting that allowing for rotation between sectors there is growing demand supply friction in many commodities which may or may not be a cyclical or structural occurrence.**

Is this all in the price - is the perennial question. During the last 40 years we do not believe .average ‘real’ price levels for agriculturals in particular have been met, nor for many metals, notably zinc. :

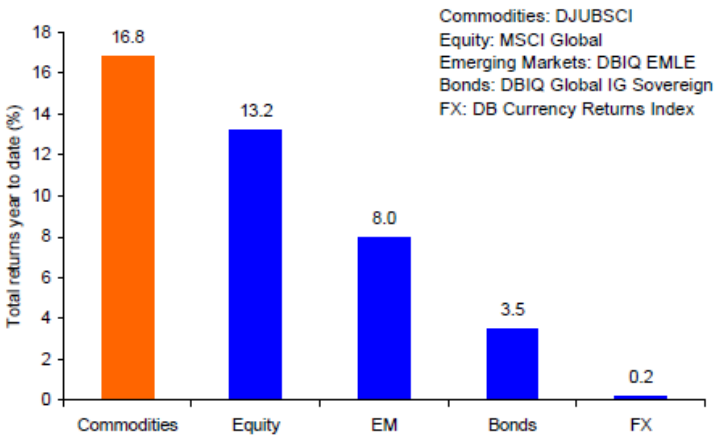
Commodities in Real Terms 1972 to Present



Source: Deutsche, Bloomberg

It is highly likely we will see some mean reverting that will underpin agricultural prices and support commodity indices. The chart on the previous page is misleading as it takes ‘real’ levels from government cpi statistics which understate true inflation. Also these ‘real’ prices do not reflect the growth in monetary bases and when viewed in this context resources still look *extremely* undervalued. Most notably gold and silver should not be considered commodities but really money proxies.

Total returns by Asset Class 2010



Source: Deutsche, Bloomberg

The chart on the previous page suggests that typical commodity indices were up 16%, in reality this understates the real price increases of a basket of goods. As the Rogers Index showed the average is substantially above 30% last year. Weightings in this index are based on % consumption.

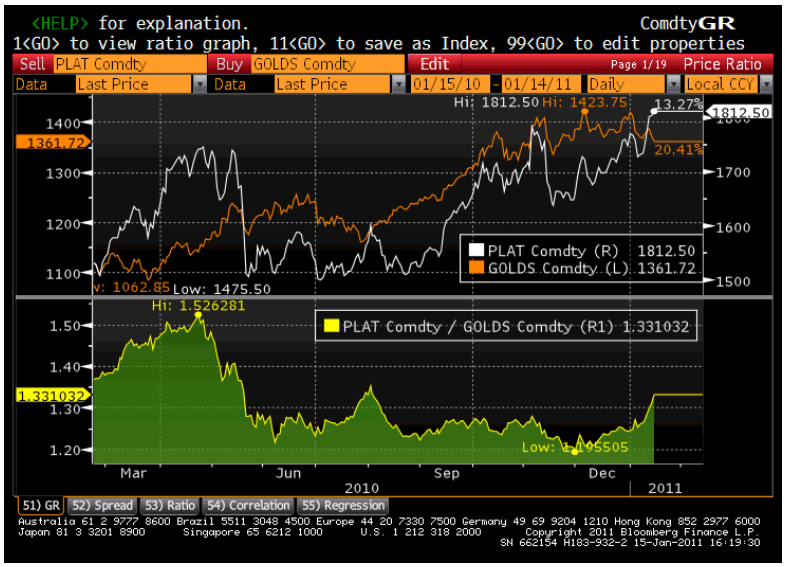
RICI Handbook: A commodity will be considered fit to be included in the index if it plays a significant role in worldwide (developed and developing economies) consumption. "Worldwide consumption" is measured by tracking international import/export patterns, and domestic consumption environments of the world's prime commodity consumers.

http://www.beelandinterests.com/PDF/RICIHandbookJan26.2010.pdf

The CRB index does not reflect a fair snapshot of price behaviour due to indexing by exchange, which is the 16% return cited for 2010 performance.

We don't have the space to address the metals and energy sector here. Suffice to say oil sentiment is bullish, but we don't see any restraining factors on oil prices to challenge this status quo, especially as we see rising input prices in general. A structural deficit seems to be brewing in some of the PGMs. This make us particularly bullish on Platinum (less so Palladium now), plus mean reversion suggests Platinum will play catch up with gold and silver, as it has already begun to.

Platinum/Gold ratio, bullish for Platinum 2011



Source: Bloomberg

Ex-Dorma Cogitatio

Okay so what *specifically* keeps us awake at night? Too be honest all the issues we discussed last year and more.

We would like to reiterate that policy prescription has not solved the problems that were exposed by the 2008 crisis. They have if anything exacerbated the problem and 2011 could be a year when such problems re-emerge with a vengeance. If debt and credit is the problem what is the solution:

Deleveraging. This has not happened in the private or public sector. At the private level, banks have adopted fair value accounting and capital adjustments have been deferred until 2013 to 2015. Basel III. Bank and sovereign contingent liabilities are synonymous. If you are a bank you own sovereign debt and if you are a sovereign you own banks. This is ponzi scheme in the last act. We need remission.

"Capitalism without failure is like religion without sin" (Kindleberger, Manias Panics and Crashes)

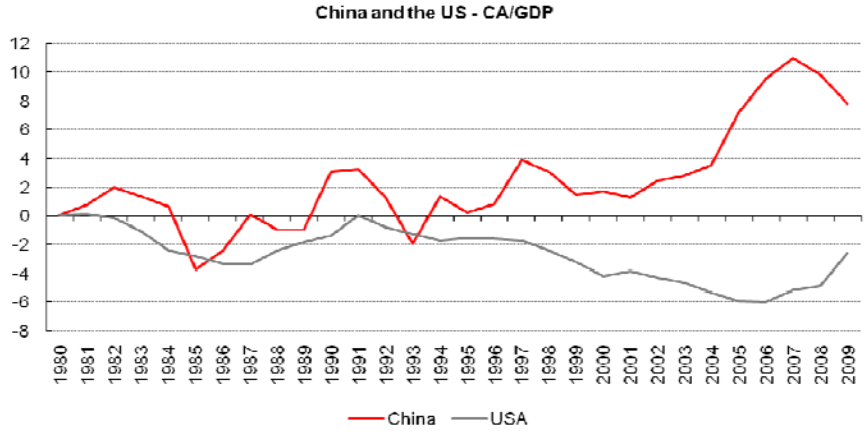
Methodology for deleveraging = Growth, Austerity, Currency Devaluation, Explicit Default.
http://www.hindecapital.com/docs/hil_reports/Debt_No%20Jubilee7.pdf

We believe growth will not be sufficient in the developed world to address debt problems. Revenue from tax receipts will never be enough. Reflationary tactics will continue to be employed. Currency devaluation will be encouraged. 'Quantitative easing' will be pursued further to fund deficits as global sovereign and private debt have grown to such levels that countries will have to focus on funding themselves not others. This will lead to implicit and explicit defaults.

Most notably last year we spoke about how central to our framework is the BW2 yuan/dollar exchange rate mechanism. We believe adjustment of the imbalances of current and capital accounts in the world via a normalising of this peg, ie the ultimate liberalisation of the yuan away from this peg, will be highly destabilising. The reflationary behaviour of the developed world is reflected via this peg into Asia, primarily China. This is very stimulatory for the Emergent countries.

Throughout this letter we have interspersed work by Variant Perception, which was spun out of Hinde Capital as an independent research house, VP remains integral to the analysis of our macro framework. VP comments are in 'grey'.

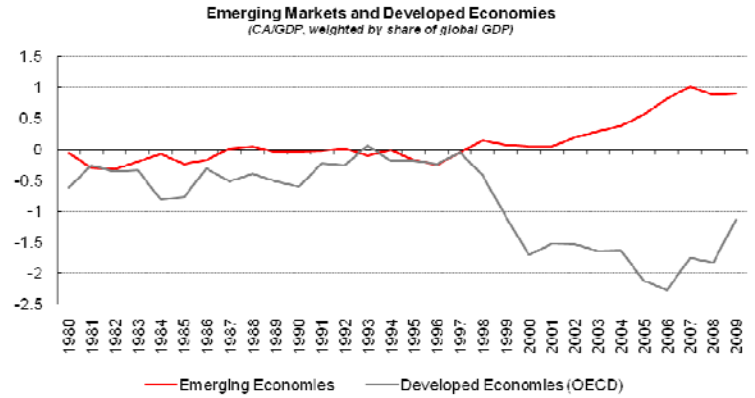
Surplus vs Deficit countries conflict



Source: Variant Perception

Much of the political squabbling is down to the continuing trade imbalance between the US and China. US Treasury Secretary Timothy Geithner put forward a proposal to make it official G20 policy that no economy's current account surplus should exceed 4%. Not unsurprisingly, the big surplus economies (Japan, Germany and China) put their thumbs down and instead responded with a critique of what they see as US devaluation by stealth through the Fed's re-launching of quantitative easing.

A closer look at the data suggests that there are many ways to skin the same cat. In the chart below, emerging economies are represented by Korea, China, Brazil, India, Indonesia and Chile while the developed economies are represented by the major economies in the OECD; Germany, Japan Greece, New Zealand, Spain, Australia, the UK the US, France and Italy.

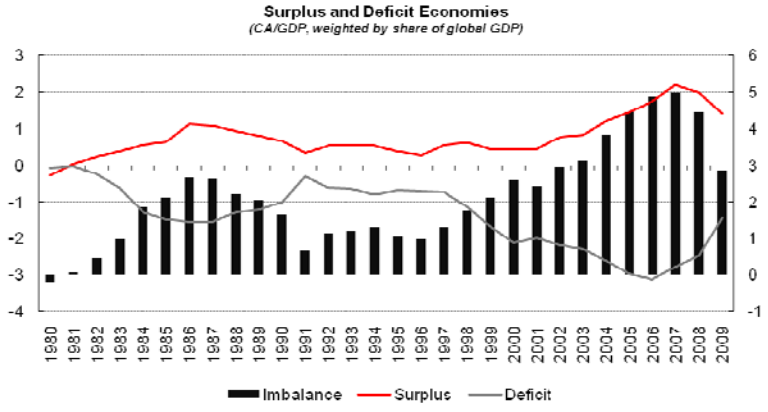


Source: Variant Perception

The presence of this situation is essentially a story about the fallout from the Asian currency crisis in 1997 after which many emerging economies assumed a once bitten twice shy mantle and started to accumulate foreign exchange reserves in order to be able to withstand sudden volatility in international capital flows.

A puzzling aspect of the global imbalances is that the economies with the highest potential future growth rate are financing those with the lowest growth rate. As we have highlighted on several occasions, we believe this will slowly but steadily change to reflect evolving global demographics. Thus we should eventually return to a "normal" situation in which the old finance the young.

But the focus on a strict demarcation between emerging economies and developed economies is not exactly accurate either as this distinction does not catch the real divergences between the biggest surplus and deficit economies.



Source: Variant Perception

Here, the surplus economies constitute, in particular, China, Germany and Japan whereas the deficit economies constitute the Anglo-Saxon and Spain. Not unexpectedly, the difference between the surplus and deficit economies peaked just before the financial crisis at about 5% of global GDP and has since declined to about 3% of global GDP as a result of the overall contraction in global trade.

China is exporting inflation to rest of the world. China is pushing the horns of the 'Impossible Trinity' right up the proverbial backside of the Japanese. Passing dollars to their trading partners causes these countries to intervene in their FX markets or pursue inflationary monetary policy at a more rapid rate than already prevails in the endogenous fiat system.

The original Bretton Woods was at least an attempt to rebalance the world order, but today - dare we say - it capital mobility is helping to support current account deficits which mask the long term sustainability of revenues in those countries. We expect to see more capital and credit controls. Also, sadly with rising commodity prices we suspect price controls and protectionism will intensify. This invariably leads to military conflict, in extremis. We are already witnessing extreme weather and price volatility so this is likely.

Here are two images form 2008 food riots and now 2011. Cyclical price rises seem to be narrowing in duration.



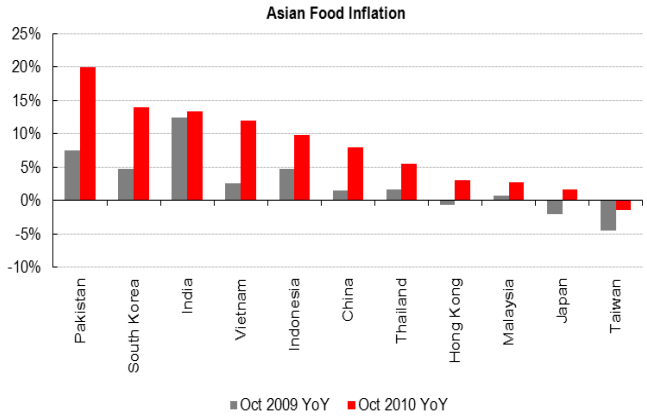
Source: *AP, 2008: Rising food inflation sparks violence*



Source: *AP, 2011 Indian experiences protests at rising food prices*

Food Frenzy

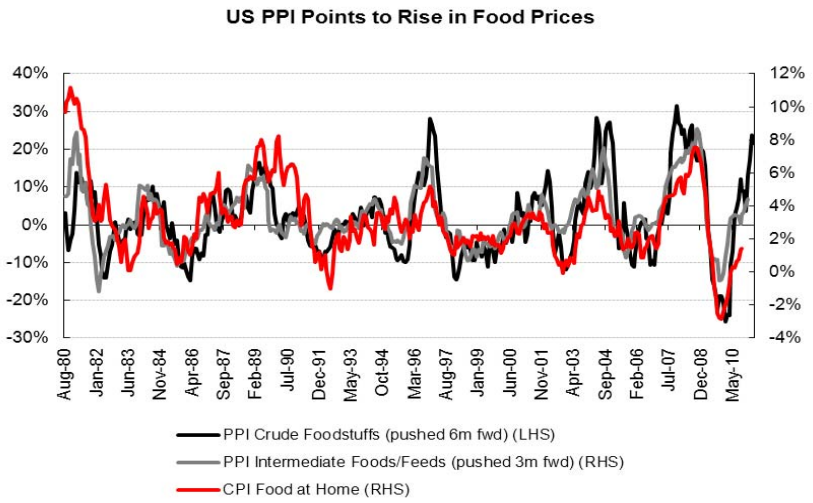
The impact of QE and supply constraints exacerbated by unstable weather conditions is all too evident in Asia, which places pressure on ASEAN and China to curb it. The CRB Food Index was up 25% YoY in December and this translates into an almost immediate price-rise in those economies where food is a large component of the CPI basket. In addition, in many countries food inflation may also, if kept unchecked, lead to supply disruptions and social unrest. For that reason, we can expect national authorities in emerging markets to be vigilant when it comes to taming food inflation.



Source: Variant Perception

In theory, food inflation should accelerate the steepening of Asian yield curves as the transmission mechanism from rising food prices to inflation in Asia is very high. Yet, policy makers may opt to use other tools than interest rate increases to restrain food inflation, not least in order to avoid raising interest rates too quickly which could attract excessive hot money inflows.

It is worth highlighting that in the developed world, rising food prices also have an effect. The US PPI for crude foodstuffs and intermediate food tend to lead the retail food CPI well. It points to higher prices going into 2011.



Source: Variant Perception

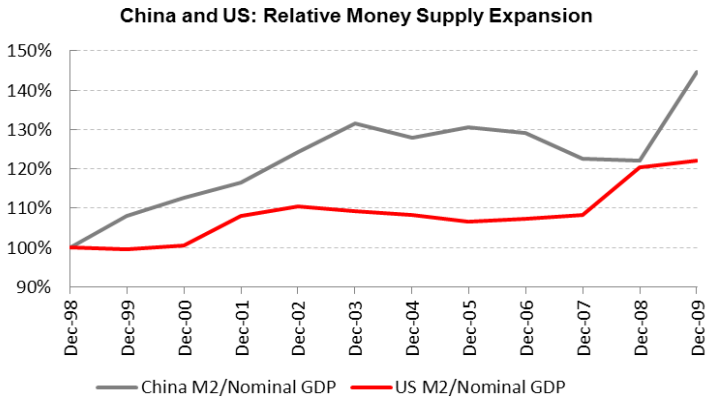
Emerging Market Madness?

The macro growth consensus appears to be along the lines that Emerging Country (EM) growth will continue as private debt is lower, fiscal conditions are healthy, but that the developed nation growth will languish as fiscal austerity and/or over indebtedness of both private and public sector remains high.

Inflation expectations are definitely considered to be muted in developed nations, whilst inflation is considered a threat in Asia in particular. The question remains is China overheating and will their tightening antics, through macroprudential methods, capital controls, and monetary tightening cause a debt deflation crisis? The knock on effects are self-evident, slower commodity demand could severely impede world growth.

At this stage its not evident whether a cyclical or structural adjustment is underway in China. But we maintain that the once disinflationary impact of China's urban migration has dissipated and that now wage harmonization across China has seen wages start to rise dramatically. Couple this with strong yuan versus dollar (the REER for China is not strengthening) and production in China is not the "cheapy" it used to be.

Nonetheless in 2008 the Chinese pursued extreme fiscal and monetary largesse spending nigh on $2 trillion dollars to try and maintain the status quo. Couple this with US QE landing on their doorstep and they have experienced property price rises and growing inflation that contacts on the ground say is already into double digits.

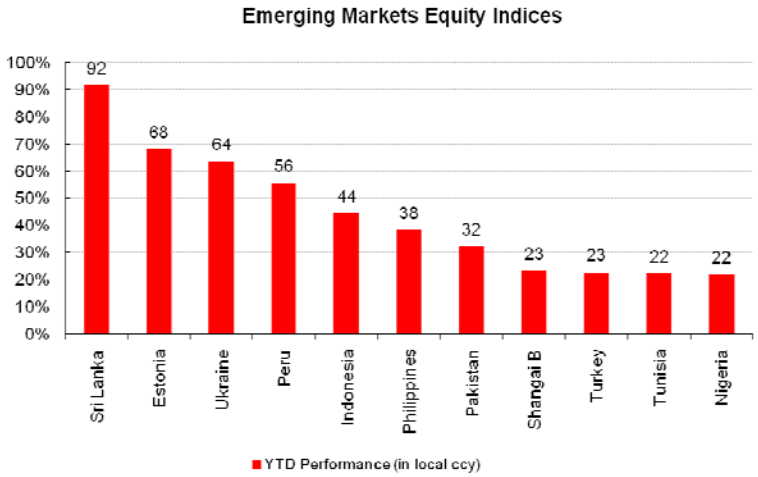


Source: Variant Perception

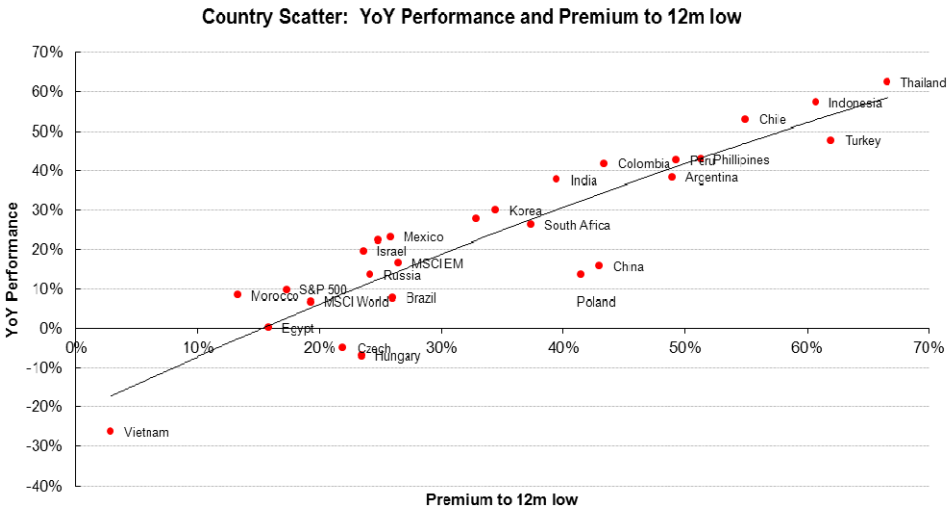
Oh yes the Chinese can play the old stats game too. (Remember the economic trilemma for China is they cannot control their monetary policy independently as their currency is pegged to the US dollar.)

It would be short-sighted of us not to monitor or contemplate the fall out of the removal of such credit. Needless to say, with Germany potentially on the hook for the European periphery, a collapse in these two creditor nations could be stupendously deleterious for world growth. The collective response could unleash brazen monetization around the world. We see no signs to suggest that this is not still the path policymakers would pursue.

The pace of EM equity performance has been remarkable and with forward P/Es of around 13 excl. Japan, traditional value metrics look very reasonable. However we believe that investors will need to be a bit more discerning about country fundamentals rather than relying solely on 'Mr. Liquidity' for a uniform rise in EM. Although as we have already debated, maybe the hyperinflationary melt-up is coming - see our Aurophobia piece of 2008 on our reports page.



Source: Variant perception



Source: Morgan Stanley

USDZAR spies VIX Index

South Africa is a good example of an emerging market to avoid. There has been 3% growth – a product in part due to the World Cup. They have a strong rand coupled with a rising current account deficit. This is not America, the rand will devalue. The stock market went out on the highs of the year matching the 2007 highs. Something is not right.

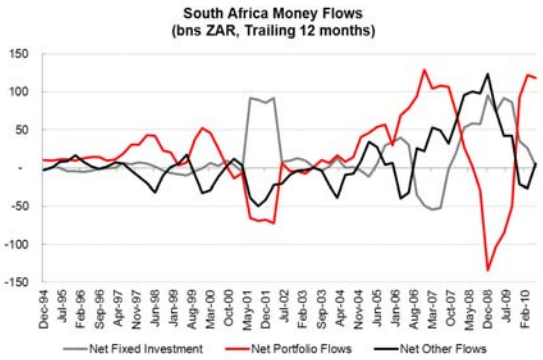
SAfrica: FTSE/JSE Africa All Share hits 2007 highs?!

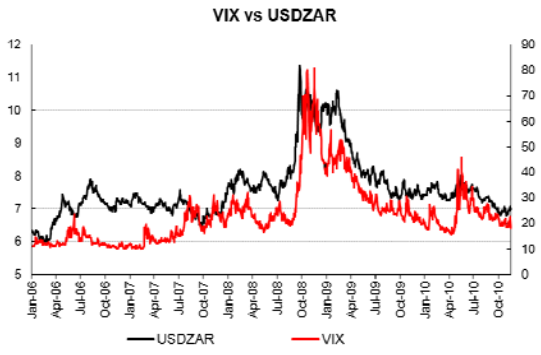


Source: Bloomberg

We have argued before that when there are international liquidity crises, the places that get hit worst and where correlations to volatility are highest are emerging markets that finance themselves via portfolio flows. (The stickiest kind of financing is Foreign Direct Investment, followed by bank loans, and then by portfolio flows.)

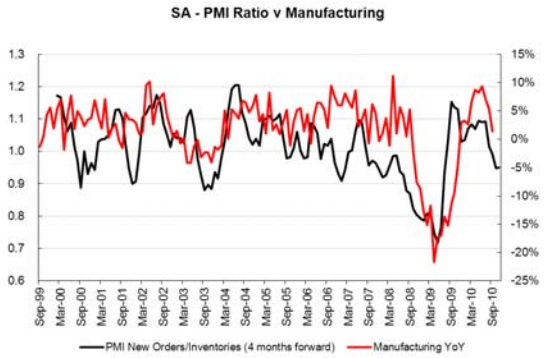
We generally like emerging market currencies, but the South African rand is among our least favourite in times of crises. South Africa finances itself primarily via portfolio flows, and the level of portfolio flows today is as high as it was at its peak in 2007 before foreigners became net sellers in 2008. At the peak of the Lehman crisis, over 150 billion ZAR were withdrawn from South Africa. Also, USDZAR spiked before the VIX spiked and stayed high longer. Shorting the ZAR remains one of our favourite risk aversion trades.

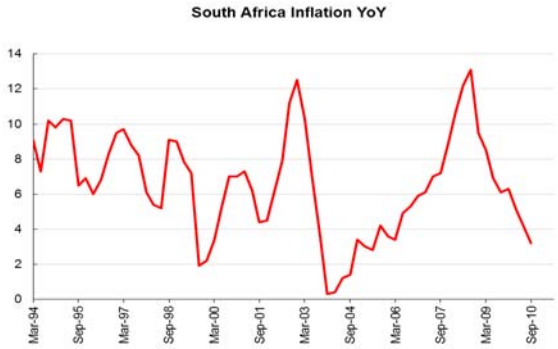




Source: Variant Perception

Beyond the asymmetry of selling off massively in the face of risk, shorting the ZAR makes more sense given falling official inflation figures and a decline in leading indices. The SARB has cut rates given lower inflation rates, and the carry differential of shorting the ZAR against other emerging market currencies and the dollar is less costly.





Source: Variant Perception

Equities Weimarization?

We have consistently discussed that world Central bank's are targeting real assets. We concluded this in 2008 based on weight of history and Ben B's interpretation of it. We illustrate our thoughts again using an insert from a blog piece for King World News.

http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2010/9/15_Ben_Davies_-_Gold_Will_Outperform_Many_Fold.html

September 15 (King World News) - At face value it would appear that money velocity is falling and central bank balance sheets have expanded dramatically in the last few years. The reality is a surfeit of credit money has found its way into financial assets. What we are really experiencing is the invisible signs of inflation as fundamentally public sector financing is merely propping up an ailing global economy. It is creating an illusion that all is ok.

Stock markets are having a hard time declining from these levels because of this surfeit of money. During the Mexican Peso Crisis of 1994, the stagflation of the 1970s or more recently the hyperinflation of Zimbabwe, we witnessed similar behaviour. Far from stock markets collapsing they rose dramatically even in the face of extraordinarily poor economic output. This was in nominal terms, but in real terms i.e. adjusted for inflation they collapsed in value. So I repeat, these are the classic signs of invisible inflation. We expect real assets such as gold and silver to lead stock markets higher, as global currency creation continues to debase the indices of leading asset classes.

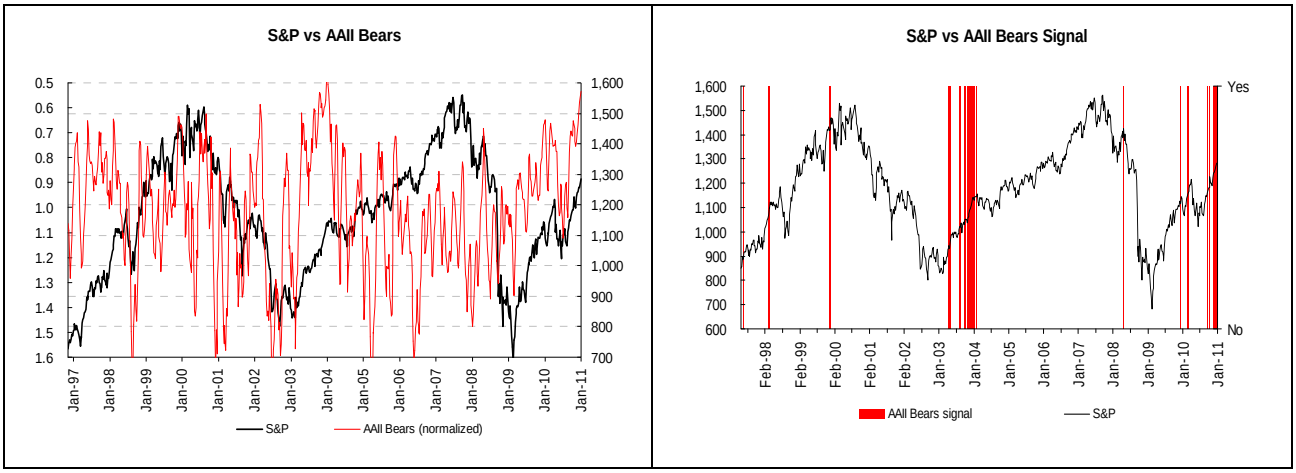
A recent CNBC interview of Ben Bernanke should dissuade anyone who had any doubt about how misguided current fiscal and monetary policy is, watch this clip.

http://www.cnbc.com/id/15840232/?video=1742165849&play=1

Go to minute 1. QE2 succeeded because it has made the stock market go up. There you have it. That is what the Fed is targeting now. Not inflation, not economic growth. It is targeting S&P going up. Who will wager this will turn out well? Perhaps the Fed should target a given level of S&P growth. Say 20% a year.

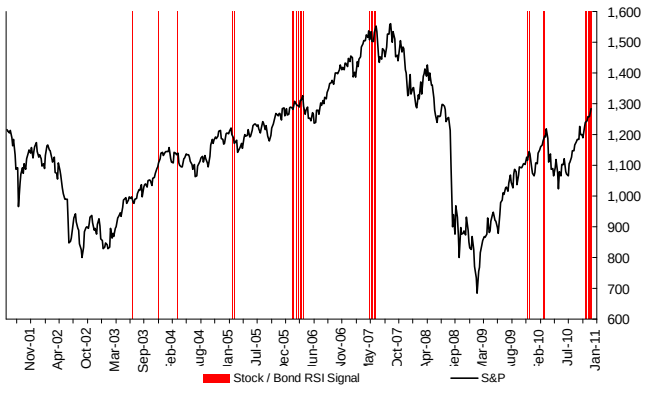
The relentless drive higher in US equities defies any sentiment indicators or forecasting models that we have developed and that have served us exceedingly well these past 25 years. We have been long equities, primarily vis-à-vis Emerging markets and Japan of late, and we recognised we did not want to short the S&P500 against these.But we are increasingly concerned that there will be volatility to come, primarily to the downside. We haven't experienced a 0.3% drawdown for 90 odd days. We are not sure if this is a record but it is quite staggering price "support". With Rydex Mutual Funds reflecting fully committed monies, it begs the question who or what is driving this? Mr Bernanke must think he is a Fund Manager.

American Association of Individual Investors Bear Sentiment vs S&P 500: BEARISH

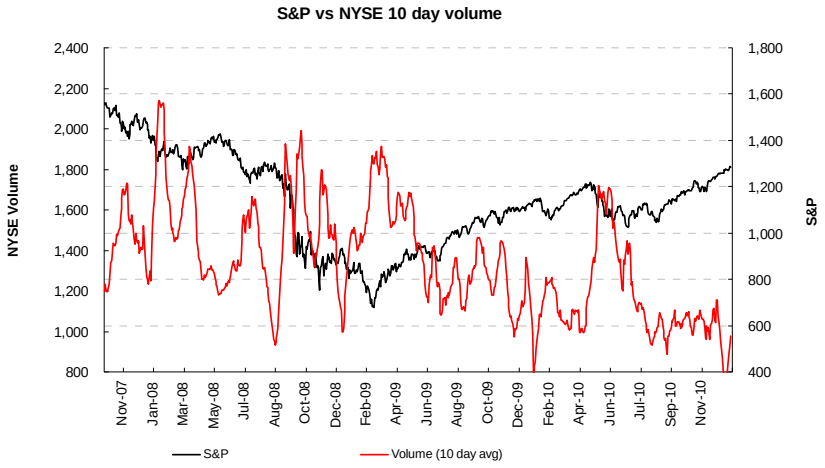


Stock/ Bond RSI signal acutely in favour of US bonds vs S&P500. Although buying bonds on an outright basis would be purely tactical, we are bears of all debt. We have been tactically long US bonds since the start of year. As the USDZAR chart indicates VIX could spike so we have been buying S&P500 put protection vs long NKY (Nikkei/ Small Cap Japan). Japan longs were initiated in October 2010 post the BOJ meeting. More on this shortly.

S&P vs Stock / Bond RSI Signal



Breadth indicators are seemingly ominous too.



Source: Variant Perception

NYSE Advance Decline, New Lows and New Highs are all exhibiting very negative breadth credentials for the market. Can it give? Even in hyperinflating indices one gets volatility but the trend is higher and as yet our Hinde system model which we use for our gold fund has not had one trigger to go short or underinvested in weeks. An unusual occurrence as it picks up reversals on this level of overboughtness on a very sensitive time duration, capturing hours rather than days or weeks.

TRAM 28 (No more Euro 2011?)

This is an excerpt from our HindeSight Investor Letter Dec 2010; The Euro Brady Bunch

2011 will be the moment of truth for the eurosystem, judging by the rapid pace of events. *Either the core countries will find a way to pay for the mess the common currency experiment has created, or contagion will spread beyond individual countries and straight to the heart of the euro itself.*

The most obvious solutions are the issuing of EU bonds to guarantee ***full*** *periphery issuance (fiscal centralization) and increased purchases of periphery debt in the primary markets (debt monetization). Further bending of Treaties will be needed but will lead to further claims of unconstitutional behaviour by member country civilians.* ***If proper fiscal centralization or debt monetization cannot be achieved, the continuing viability of the common currency will be a growing focus for market concern and we will see a series of debt restructurings.***

We will not deliberate too much here as we have written and spoken extensively on this subject both on CNBC and King World News (Hinde and Variant Perception). The EFSM is a self-perpetuating mechanism of debt contagion and intolerance. If Portugal is bailed out, and it will be, then funding pressure will escalate for Spain and then Italy. The recent Portuguese 10yr auction was a great example of financial oppression. The dealers took the bonds down onto their bank balance sheets and the ECB stood firmly in the market on the bid in the prior week.

BBC Radio 4 broadcast from *Tram number 28*, which was full of commuting Lisbon workers discussing the outcome of their auction. That was a very bullish signal for the auction. If ever the market was ripe for a short squeeze well this was as good as it got. It reminded us of when the US SEC banned naked short selling in 2008 or was it any kind of selling of matters naked…porn anyone? Back then shorts on bank stocks screamed COVER.

Speaking of cover, the bid to cover ratio for the Portuguese auction was impressively *'rigged'* with bids coming in very *'artificially'* strong at 3.2 x vs a comparison of 2.1 for the Nov. auction last year. Ten year Portugal bonds were trading at 6.85 give or take prior to auction and came through the market by 10 bps yielding 6.716bps for the 599mm euro issue of 2020 debt. What's Portuguese for 'Cover'?

XLF (US Financials ETF) SEC induced Short Squeeze Sept 2008



Source: Bloomberg

We can never underestimate the powers that be. I have heard rumours of coordinated central bank purchases of European debt from even the likes of Canada and Australia. Certainly it struck us as surprising that the Japanese were buying and making such a public declaration. It's a rumour they wanted the market to hear, because funding needs are almost 1 trillion euros for this year. This will be very hard to digest.

Figure 25. Selected Countries – Gross Financing Needs 2010 – 2015

Country	2011	2012	2013	2014	2015	2011-2013
Belgium	89	53	50	48	51	192
Greece	56	46	39	38	25	141
Ireland	29	20	19	23	10	68
Italy	372	257	190	148	183	818
Spain	205	133	129	103	93	467
Portugal	37	19	17	24	23	72

Gross Financing Needs are calculated as the sum of maturing debt and budget deficits. Debt redemptions are maturing debt from national and regional governments provided by Bloomberg. Budget Deficits are IMF estimates.
Sources: Bloomberg, IMF WEO November 2010 and Citi Investment Research and Analysis

Source: Citigroup Global Markets

Conversely there is also persistent talk of Germany exiting centre stage and returning to the 'Mark'. Just before the auctions and ECB this week – we had flippantly remarked could Trichet raise or even intimate raising rates to try and attract capital. After all Turkey is trying the reverse tactic of lowering rates to try and temper capital inflows that are helping to inflate their economy and stock market. Well 'tie me down kangaroo' if he didn't infer they were inflation vigilant. He was hawkish. The euro exploded higher on short covering, again.

As hard money advocates we find ourselves in an unusual situation, a real mind melt. The euro cannot survive a hike with their level of indebtedness and fragility of their bank balance sheets. But how can we condone a zero rate environment below market rates? We can't. As Hayek intimated and we cannot recall his complete words, but he suggested 6 months of 20 per cent unemployment was instantly preferable to 20 years of 10 per cent unemployment. So let's have it. An acute swift pain of deleveraging instead of the drawn out 'kick the can' down road mentality that we are witnessing.

Celtic Clawback Coming?

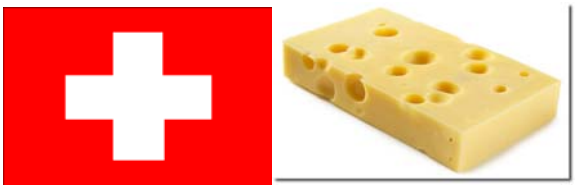
We would use this opportunity in euro strength to exit euro holdings and construct bearish euro currency and bond trades. This mess is far from over. The bailout mechanism is insufficient. Both outcomes – default or increased ECB intervention and further bailout funds are all constructive for gold, as the tide of debasement will merely continue.

We must be very vigilant running into the Irish general election for the 31st Dáil and election of a new Taoiseach (Prime Minister) shortly after. The Green party leader, John Gormley had called for an election in second half of January. There is a stung possibility that this election could spark a revolt and request to not undertake the onerous terms laid out by the bailout package which has firmly placed the good of the Europe Union at the feet of Irish taxpayers.



Swiss: 'Hard' Cheese

Beginning the year fearing a euro squeeze due to positioning and the power of government to surprise, we initiated conditional and actual trades on CHF weakness versus the dollar. We have our innate suspicions that the CHF is full of holes like its cheese. We are very distrusting of the Swiss National Balance sheet and primarily believe social dynamics have changed with regard to the CHF maintaining a safe haven legacy. Euro participants exited to the CHF very much based on years of 'because it just is'. (A topic for further discussion in other letters.) The Swiss Franc is 15 to 20% overvalued and with EURCHF flows conducive to CHF weakness as the Swiss run a trade gap with Europe, we see the next 23 months as particularly negative for the Swissie.



Swiss National Bank President Philipp Hildebrand Friday said the bank's purchases of foreign currencies led to a large book loss for 2010, and said further losses are possible in coming years.

The SNB must expect strong swings in profit due to the volatile movements in the financial markets, Hildebrand said at a press briefing in Bern after the release of its provisional 2010 earnings.

From March 2009 to June 2010, the bank spent billions of francs to curb the currency's relentless surge as nervous investors sought a safe harbor amid the turbulent global economy. The soaring franc resulted in a loss of about CHF26 billion on its foreign currency positions, according to the SNB. Overall, the bank swung to a book loss of CHF21 billion from a profit of CHF10 billion in 2009.

WSJ, 2011; http://online.wsj.com/article/BT-CO-20110114-711104.html

Swiss investors, who largely have a huge affinity for gold have been lamenting the performance of gold in Swiss Francs. It would be unkind to say 'hard' cheese as the vernacular saying goes, but we would suggest this is a good opportunity for investment, not that the outcome is really a positive event socially speaking.

Gold in CHF 2010 Approx +18% vs USD +29%



Source: Bloomberg

If we assume overall dollar sponsorship in the next three months we do believe that as these problems cannot go away, ultimately a credit shock in some shape or form will spur the Federal Reserve to provide even more liquidity vis-à-vis liquidity swaps. We note that most global balance sheets are primarily dollar based due to the predominance of actual USD debt issuance via the private and public sector; much of it swapped up with the domestic currency.

House of Horrors

Moving our attention to the other side of the pond, foreclosure gate is preventing a recovery in the housing market in the USA, at a time the country and its constituent federal states can ill afford their population not to be imbibing in their usual conspicuous consumption. The risks to the Banks are palpable although we can see the recent BofA provisions probably mean that all this will be swept neatly under the carpet in keeping with 'fair' value accounting. Both mask the true reality that these assets are severely depreciated. That's not even accounting for who the hell actually owns the underlying mortgage and or title.



Source: Hammer House Film Productions

Over 10 million houses now have negative equity, over 8 million are on LTV ratios of 100%. Defaults will continue to rise. This is estimated to be $1.5 trillion worth of potential losses. This is likely, as state finances and pension are in severe peril, so servicing mortgages will be an issue for many public sector workers who comprise the negative equity demographic.

Ben we doubt will do a Trichet. Rates and reduction of balance sheet and Fed is not an option. His Testimony was very dovish. He is acutely aware that with a true unemployment rate of 17% with individuals now dropping out of the labour pool that to get the unemployment headline rate of 9.4% down to 5% will require GDP growth at 4% annualised for the next five years.

http://www.federalreserve.gov/newsevents/testimony/bernanke20110107a.htm

Chairman Ben S. Bernanke
The Economic Outlook and Monetary and Fiscal Policy
Before the Committee on the Budget, U.S. Senate, Washington, D.C. January 7, 2011

As we are discussing housing we would also like to point out that we have observed lax lending criteria in Australia. This is helping to fuel a housing bubble in Australia, where income to value ratios outstrip any seen elsewhere in the world this past few decades. Also a proxy for a China slowdown is to look for bearish financial and currency trades in Australia as this could prick the housing bubble.

BABs or just plain BAD: The Muni Monster Crunch

Municipalities have borrowed only $620 million in the first week of the year down from the $7.4 billion at the start of 2010. That is a precipitous fall of over 90% at a time we know State coffers are empty. The reason cited is that issuance ramped up into year end due to the cessation of the BABs (Build America Bonds Program).

Under this program the Federal government paid 35% of the interest servicing costs of all munis. This has not been extended, and instantly funding has collapsed. (A note of thank you to The Privateer for pointing this out). It just illustrates our point that this whole edifice is a ponzi scheme splitting at the seams. BABs or just bonds that are plain BAD. They seem BAD to us.



Source: Walkers

We quote a blog piece https://macromon.wordpress.com/ which exemplifies the chicanery that is likely to transpire this year:

Principal author of the Public Employee Pension Transparency Act is Rep. Devin Nunes, a Republican from California, where about 80 cents of every government dollar goes for government employees' pay and benefits. His bill would define the scale of the problem of underfunded state and local government pensions and would notify states not to approach Congress like Oliver Twists, holding out porridge bowls and asking for more…

There are legal provisions for municipalities to declare bankruptcy. Some have done so. As many as 200 are expected to default on debt next year. There are, however, no bankruptcy provisions for states. Some who favor providing such provisions say states are "too big to fail," and under bankruptcy, judges could rewrite union contracts or give states powers to do so, thereby reducing existing pension obligations. Unfortunately, government-administered bankruptcy of governments might be even more unseemly than Washington's political twisting of the bankruptcy process on behalf of General Motors and Chrysler, including the use of TARP funds supposedly restricted for "financial institutions."…People seeking backdoor bailouts hope that the fourth branch of government, a.k.a. Ben Bernanke, will declare an emergency power for the Federal Reserve to buy municipal bonds to lower localities' borrowing costs. This political act might mitigate one crisis by creating a larger one – the Fed's forfeiture of its independence.

We cannot believe how little focus globally there has been on the Muni situation. State finances, most notably California, New Jersey and Illinois account for a debt of 20% of US GDP. This is some $3 trillion, which is reinforced with another $3 trillion of State Employee Pension Fund liabilities. Just to illustrate how significant this is, Greece was 3% of eurozone output, whilst California contributes 15% of US GDP. Greece has caused widespread contagion in Europe. "LA we have a problem!" So a highly indebted state contributes significantly to a highly indebted nation – does that sound sustainable and highly productive to you?

Pay-As-You Go: 'Mobile' Debt Ceilings

This leads to the other issue of the moment and in the words of Austan Goolsbee the Chairman of the White House Council of Economic advisors "The debt ceiling is not something to toy with"….really…so please explain to us why the debt ceiling was elevated by over $2 trillion in the space of six weeks at the end of 2009 and the start of the 2010. Don't write to answer that we all know why, but it's like your teenage children asking for another raise in their allowance because they had already spent it. Does anyone care? I think they would if they really understood, which is why we will keep banging on about this insanity.



By April 2011, at latest, the debt ceiling will once again be raised for the 'good' of the country from $14.3 trillion to $16 trillion give or take a few billion. Three key points to make here:

1. Despite Europe ailing it so far has pursued a cutting of budgets whilst the USA seems hell bent the other way, even allowing for Tea Party concessions that if ceiling is raised, spending cuts have to be enforced.

2. Demand for US debt is not falling out of Asia, because the amount of QE the US has undertaken has been matched by creation of YUAN deposits to maintain their peg, so currency reserves in China have reason.

3. However debt issuance is rising at greater rate than demand. The Fed bought over 45 per cent of all Treasury offerings up 10 per cent from December. **This dynamic will only ratchet up and continued monetisation is going to lead to, dare we say it, hyperinflated prices. Participants could misconstrue this nominal rise in all facets of the economy as a signal of economic recovery. It will not be.**

Mrs Watanabe: You Want To Buy My Gold?

On the subject of debt ceilings in the autumn of last year the BoJ lifted the lid on its monetisation potential. We had originally stated we thought this was highly likely in the months prior to the meeting in our piece 'The World Monetary Earthquake'. (Please see report section on our website). In this we highlighted how precarious Japan's debt predicament is, within the context of an aging demographic.

On the announcement, Ben Davies discussed how the market had initially misinterpreted the BoJ's intentions.

http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2010/10/5_Ben_Davies_-_Lets_Say_Gold_Went_to_$13,000.html



Source: Nippon Helicopters (ANA)

The BoJ has indicated it will purchase all manner of assets: government and corporate bonds, ETFs, (yes ETFs!), real estate (J-REITS), as well to conduct the fixed-rate funds-supplying operation against the pooled collateral (i.e. monetise tangibles and unsecuritized business receivables). Offer them some nuts and bolts - they may well just buy those too. ***The market has all but missed that this asset program allows them to circumvent the ceiling of debt that can be issued against bank notes in circulation. The BoJ can exceed existing limits by as much as they like.***

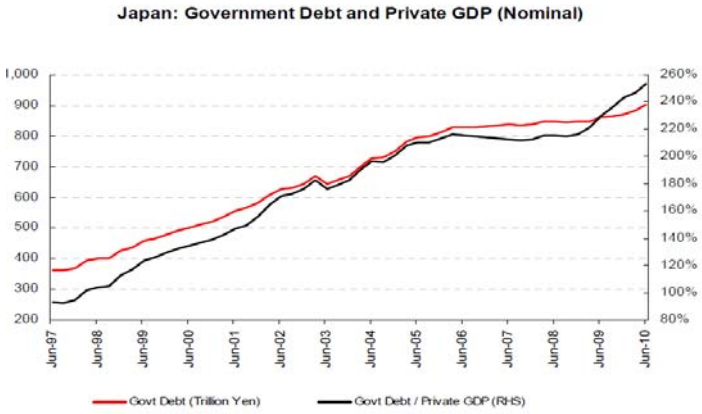
BoJ Statement Oct 5th 2010 "Comprehensive Monetary Easing" states: Therefore, the Bank's holdings of long-term government bonds purchased through the program will be treated differently from the long-term government bonds purchased within the ceiling of the amount of banknotes in circulation.

The response as yet has been muted. The market has not fully digested the ramifications of this last line in point 3 of the BoJ statement. *Blackhawk Ben has some competition from Nippon helicopter. If you refer to the chart (in the blog) it is evident Japan has some room to move to catch up with the QE efforts of other members of the G7. Japan hasn't even begun.*

Since this time the Nikkei has rallied approx. 14% outstripping the rate of acceleration in the S&P500 for that period, clearly BoJ Governor Shirakawa is a better trader than Ben-san.

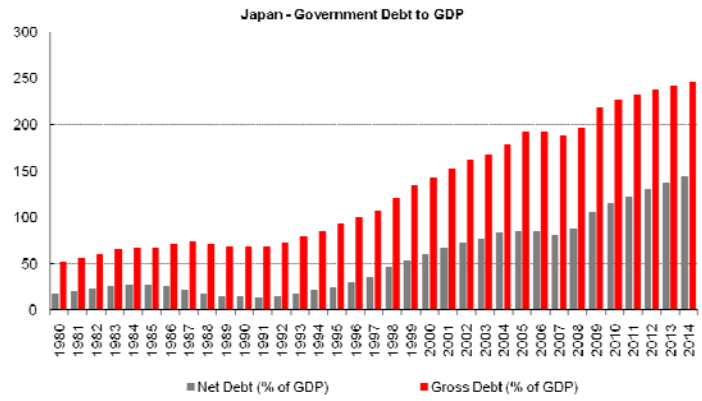
Japan is the poster child for anaemic growth. Gross debt is over 220% of GDP and net debt of half this is not comforting as a great portion of the asset side of Japan is the JGBs which the private sector (insurance companies) own on their balance sheets. As for the rest, it is currency reserves and overseas investments both intangible and tangible, again owned primarily by the private sector. So if you think the asset side is a source of solvency, think again. Good luck expropriating those assets without causing widespread civil unrest and a collapse in private sector revenues.

Japan's government debt to private GDP is now over 253%. Remember it is the private sector that will need to generate revenue for taxes to pay down the public debt.



Source: Japan MOF, Variant Perception

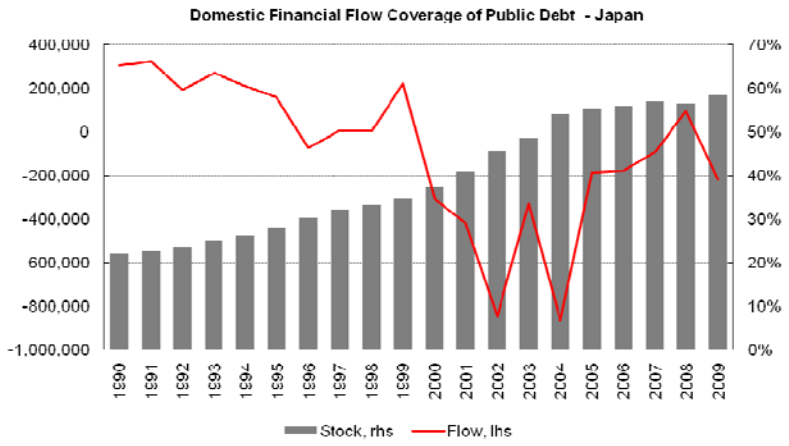
To understand more how Japan is at the debt servicing limit and its ramifications, please see the report cited - The World Monetary Earthquake as well as the following excerpts from our VP research:



Source: Variant Perception

Apart from being unsustainably big, one notable characteristic of the stock of Japanese government debt is that it is almost entirely held by domestic investors. Coupled with a structural surplus on the external balance this essentially insulates Japan from the reliance on foreign investors and thus foreign demands for yield.

However, with Japan's rapidly ageing population there is likely to be an inflection point where the flow of domestic savings cannot keep up with the ongoing financing need of the central government to finance deficit spending.

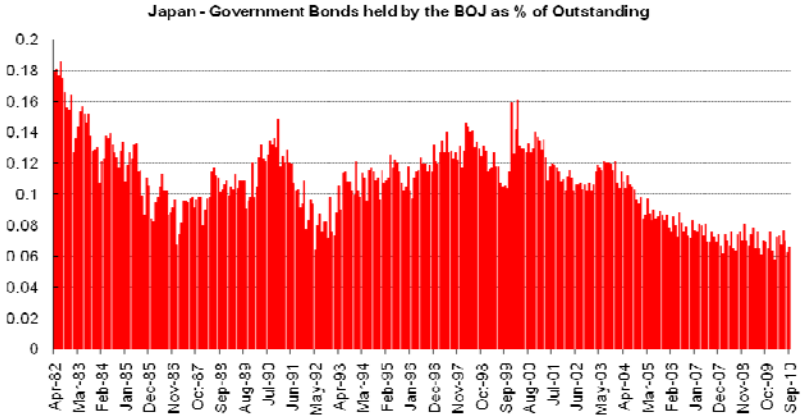


Source: Variant Perception

The chart above shows how much of the flow of government issuance (ie the yearly change in the value of government bonds outstanding) that is covered by the *flow* of domestic savings (deposits, currency, pension and insurance reserves). The *stock* measure shows that about 60% of Japanese deposits and liquid reserves are parked in government securities. The flow measure shows the difference between the annual flow of government bonds and the flow of domestic savings.

Between 2000 and 2009 the stock of government bonds rose by 3.7trn yen while the stock of domestic savings fell by 3trn yen. This leaves a shortfall of 6.7trn yen of domestic financing "unaccounted" for. Such a shortfall in the flow of savings versus flow of government liabilities can be offset in three ways.

The first is to run a current account deficit and let foreign capital enter to finance government borrowing. Clearly, this has not been the case in Japan as the current account surplus has improved between 2000 and 2009. The second option is for the BoJ to engage in outright monetization of government debt. However, the pace of government bond accumulation by the BoJ has not kept pace with the issuance by the MoF, as the following chart shows.



Source: Variant Perception

This only leaves one possibility as the source of funding for the ongoing issuance of government liabilities: a structural shift in the stock of savings in Japan towards financing government bonds.

Crucially, the annual flow of savings in Japan is now negative on a structural basis. This means that there is no incremental financing for the positive flow of government bonds. Increased debt issuance must be financed by the share of government liabilities, accounting for an ever larger share of the *already existing* stock of savings.

This is exactly what is happening in Japan now. Between 2000 and 2009 the share of outstanding government debt as a percentage of the total stock of liquid savings in Japan (deposits, currency, pension and insurance reserves) rose from 22.6% to 48.6%. The continuing issuance of government bonds in excess of flow of savings is essentially crowding out the investment in other assets.

For those investors interested in the big short on Japanese government bonds, they need to watch the quarterly flow of government bonds and the corresponding shortfall from the negative flow of domestic savings. As the share of government bonds to the total stock of savings can only reach 100% (in theory), this puts a natural limit to the ability of Japan to keep its bonds inside the country.

In this context, we would emphasize two things.

- The BoJ is likely to be a much larger buyer of government bonds going forward and its potential purchase is unlimited.
- If Japan were forced to go to foreign creditors to finance its government spending, this would imply a drastic increase in yields. Much more likely is that the BoJ would accommodate by offering an ultra-loose monetary policy to offset the rise in yields.

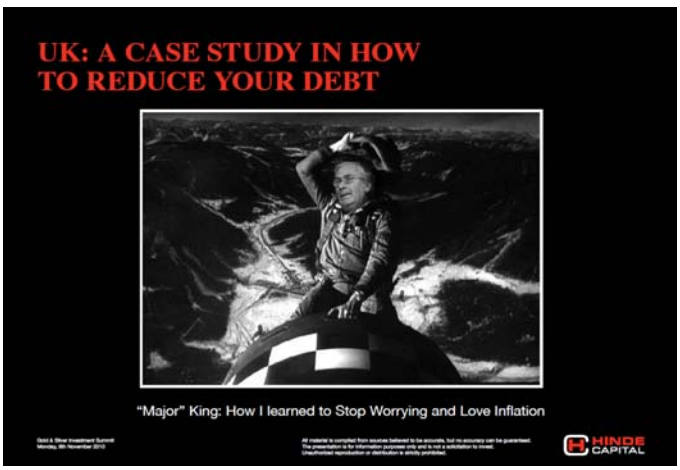
Both point towards a weaker yen and a higher nominal Nikkei index as the BOJ loosens monetary policy.

Our one caveat is that a slowdown in China will impact Japan's export market and with growth and deflation expectations rising the yen could rally to match the REER from when the yen last was at 85 under 'Mr Yen'. But we absolutely believe the policy response of reflation would be monstrous and even allowing for undercapitalised bank balance sheets, something Hugh Hendry makes a very good reference to, the BoJ will go ballistic in its monetisation efforts.

We reiterate, most countries have bad choices and worse choices. Japan has only worse choices.

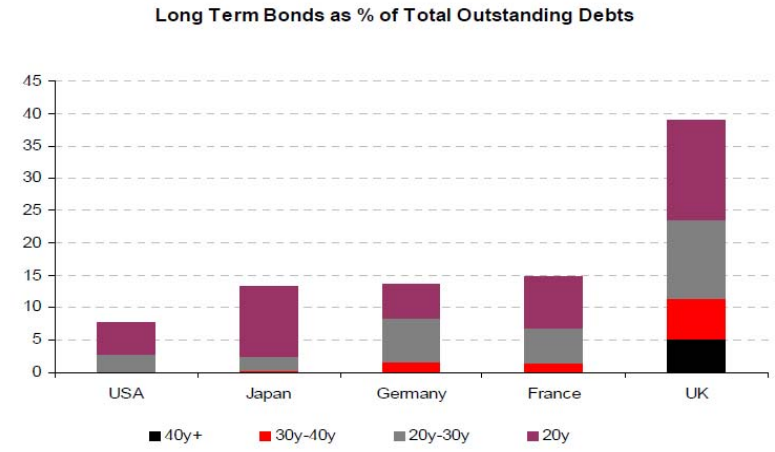
UK: Learn to Love Inflation

Last year we put together a piece called the Debt: There is No Jubilee, primarily in reference to the UK fiscal and monetary position. Please find it under reports section, along with others mentioned.

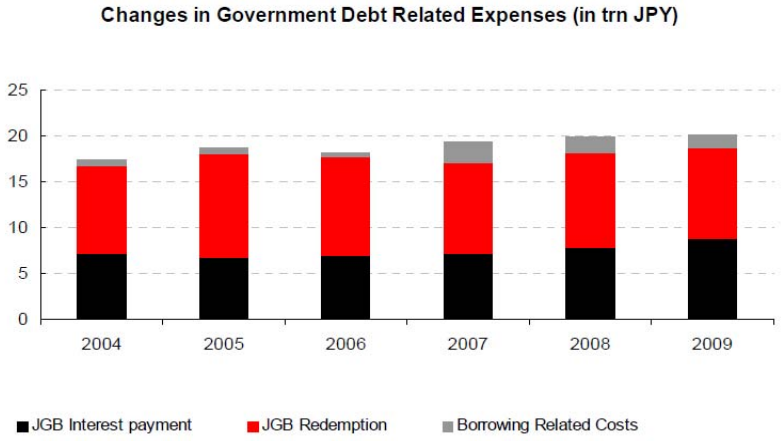


Japan has a debt rollover problem, a negative, the UK doesn't, a positive. Japan has relied on domestic funding so that would seem more positive, the UK relies on overseas investors and the BoE, this is a real negative.

In Japan almost all the debt is funded with short term maturities, so rollover risk and higher interest rates are a very acute danger, as they are potentially more sensitive to changes in bank base rates than long end rates.



Source: Variant Perception



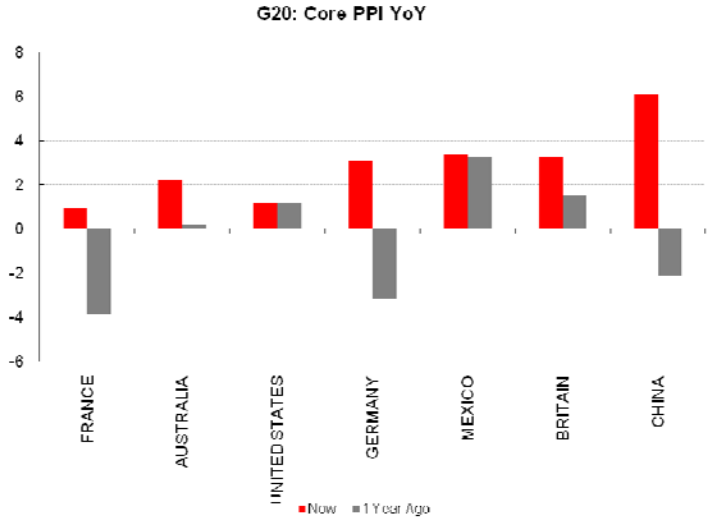
Source: MOF, Variant Perception

The UK combines a terrible set of characteristics, which makes gilts one of the worst investments possible for 2011. We do not rule out a disorderly unwind of the gilt market.

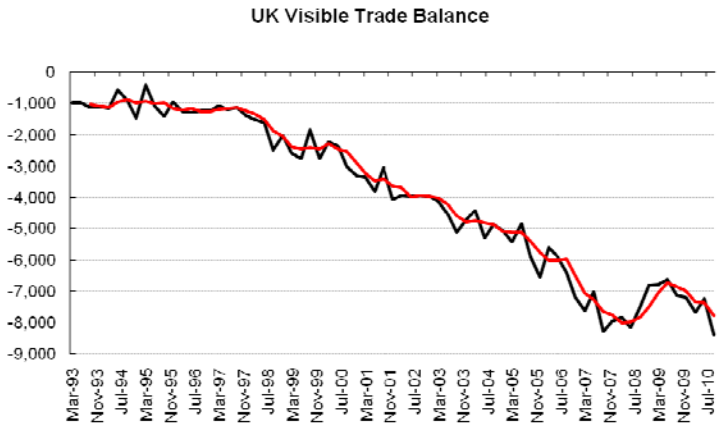
The UK has a toxic combination of characteristics:

- High inflation and negative real interest rates. This is true whether you look at CPI swap rates or reported CPI.
- Rising inflation expectations. Inflation expectations are near previous peaks. Previously inflation was high but inflation expectations were contained. This is no longer true.
- Government borrowing that continues to surpass estimates. Recent months have surpassed all previous records for government borrowing.
- A growing trade deficit. The trade deficit is now at the same level it was in 2007 and 2008.

The Bank of England is an emperor with no clothes. As recent UK inflation numbers and inflation expectation numbers make clear, the BoE has lost what little credibility it had left. Over the past six years CPI has exceeded the 2% target in all but 9 months. In what should have been the biggest deflationary bust since the Great Depression, British CPI is running at 3% and RPI is running at 5%. These numbers are all set to go higher, and CPI will spend much of 2011 above 4%. As the following chart shows, core CPI of 3% is the highest among western industrialized countries, and the trend is rising.

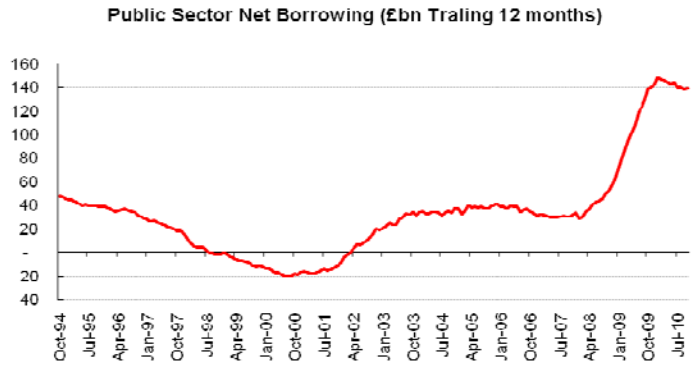


Source: Variant Perception



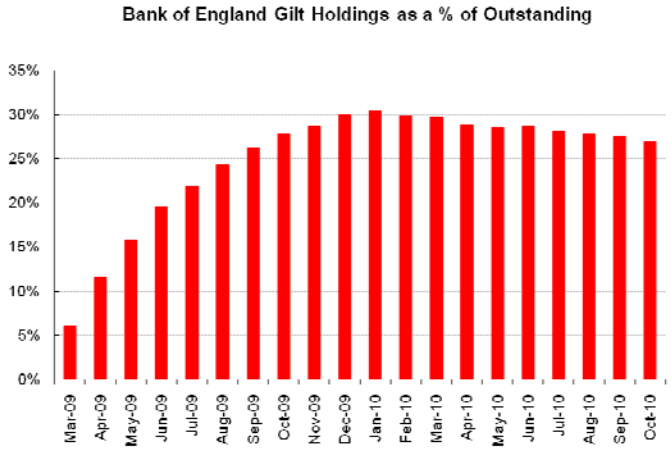
Source: Variant Perception

Public sector net borrowing in November hit an all time record of £23 billion pounds. The cyclical recovery improved tax receipts by 3% year over year, but government spending rose by almost 11%. The November data point confirms the recent trend. The rolling three, six and twelve month averages show that borrowing remains at historic peaks no matter how you look at it.



Source: Variant Perception

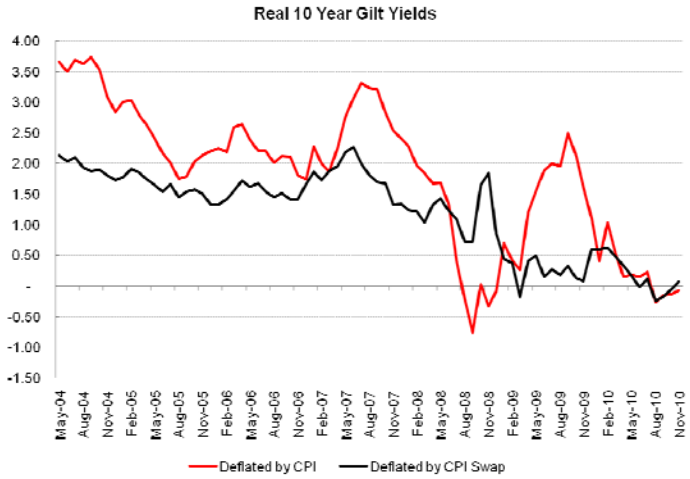
As we have pointed out before, the Bank of England is the primary reason we did not see a collapse in the gilt market in 2009 and 2010 when issuance of gilts went stratospheric. The BoE currently holds over a quarter of conventional gilts.



Source: Variant Perception

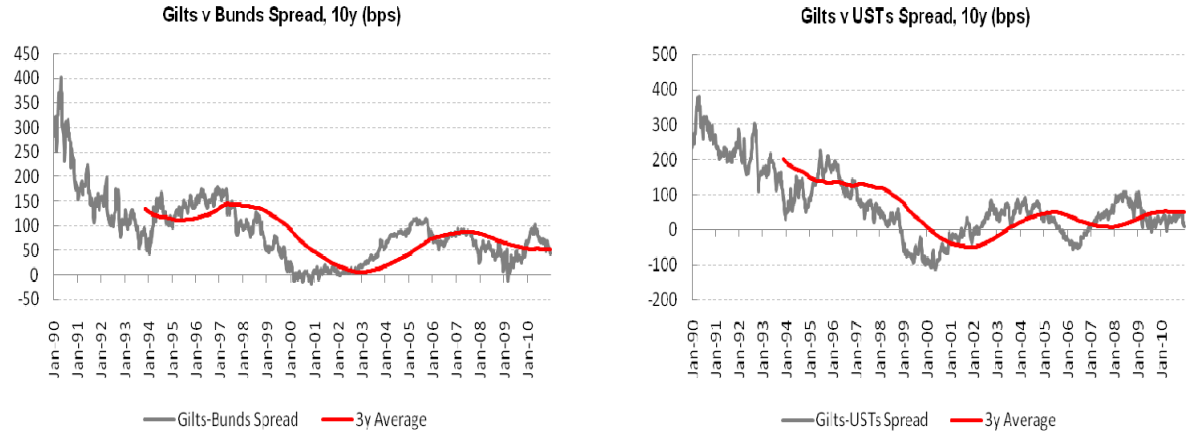
Moreover, the BoE could end up owning a much higher proportion of gilts. **QE2 in the UK is looking more likely than not.** VP's base case is for monetary easing to accompany fiscal tightening. The fiscal tightening announced last year will start to bite in 2011. Continued loose monetary policy will be required to support the likely at best sluggish growth that we will see in the UK this year. The ever present spectre of inflation leading to a bond rout will further support the argument for another round of quantitative easing. Whether this will be successful or not is another matter.

Indeed, there is little other reason for such low real yields on UK gilts besides massive government support for the gilt market and "financial oppression", eg mandating that banks increase capital requirements via purchases of government securities. As the following chart shows, gilts offer no real yield on the basis of official CPI or of CPI swaps.



Source: Variant Perception

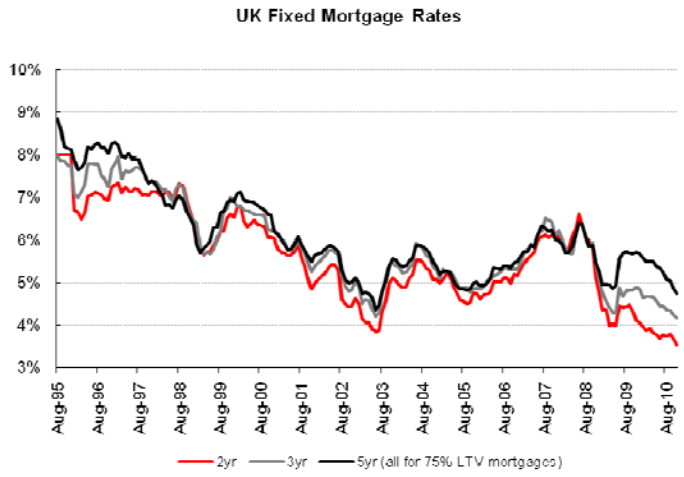
Gilts also look rich when compared to bund yields in Germany. The spread is currently below its 3 year average, and considerably lower than the levels it saw in the early 1990s. This is similarly true for gilts vs US Treasuries.



Source: Variant Perception

Our base case is that the Bank of England is intent on pursuing an inflationary line while publically stating that their greatest fear is deflation. *The goal was to raise inflation without raising inflation expectations.* However, given the steep rise in inflation expectations, BoE members are having second thoughts. In an interview this past month, Paul Fisher, the Bank's executive director of markets, said base rate will soon rise from almost zero to the more normal historical 5%.

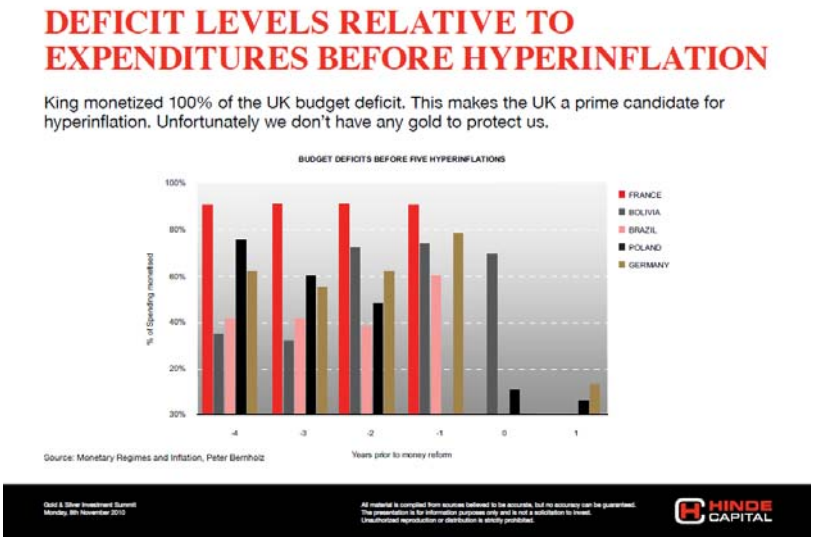
Raising rates will be difficult for the BoE. Any increase in the base rate will immediately pass through and raise mortgage rates. In the UK there is over £1.2 trillion pounds of mortgage debt. A rise in the base rate would lead towards increasing falls in property prices and more delinquencies and defaults.



Source: Variant Perception

If the Bank of England does not raise rates, the combination of loose monetary policy and tight fiscal policy will likely be beneficial for equity markets, but negative for the currency (which is itself generally positive for the FTSE100 as companies in the index derive most of their earnings from overseas).

Or alternatively you can think of this as another form of Zimbabwefication/Weimarization, but sterilization it isn't!



UK like Japan is a prime candidate for both implicit and explicit default. If Europe tips over be sure to sell sterling due to the contingent liabilities of UK banks, the FED will supply both the UK and Europe with ample dollar liquidity, which will fuel an inflationary dynamic in the UK particularly, as it has a free floating exchange rate mechanism.

A fellow Austrian pointed this website out to us – we probably should have saved our words – this says it all.



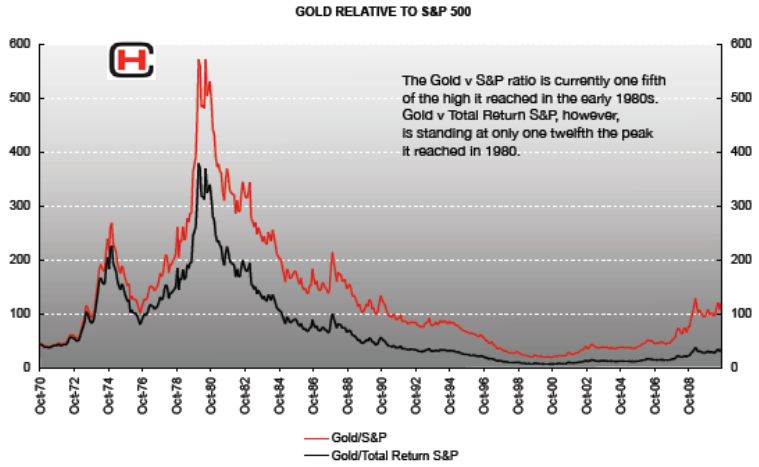
Source: www.debtbombshell.com

Gold is the currency of *first* resort

We have received many calls, mostly positive, one nasty. In the main they have complimented us on our work and views on the market including our performance. We are genuinely appreciative, it spurs us on to extract the truth out of our data sets and subjective analysis of the world. **Since moving to a benchmark of USD gold bullion as opposed to a 50% gold equity/ 50% gold bullion weighted benchmark in Nov. 2008 we have returned 157% net of fees versus a gross return for USD gold bullion of 97%.** We say gross, because for retail investors they will then have to pay 4 to 5% for bars plus storage of 1% for duration held. This has been achieved whilst maintaining an annualised volatility in line with bullion.

Let's be sure we never do the following – confuse talent with being bullish. Bull markets make geniuses out of idiots. We aim to be one less an idiot. All this aside we would like to emphasise that we are outperforming substantially our benchmark at over 16% annualised. That you can confuse with talent, or at least hard work! We sincerely hope to maintain what our Gold Fund says on the tin – providing upside returns whilst smoothing the downside volatility within the context of a long bias.

Continuing the theme from our KWN excerpt earlier on Equity Weimerization we note if one perceives the equity market to be rallying as a consequence of the growth in the monetary base it follows that gold looks extremely undervalued:



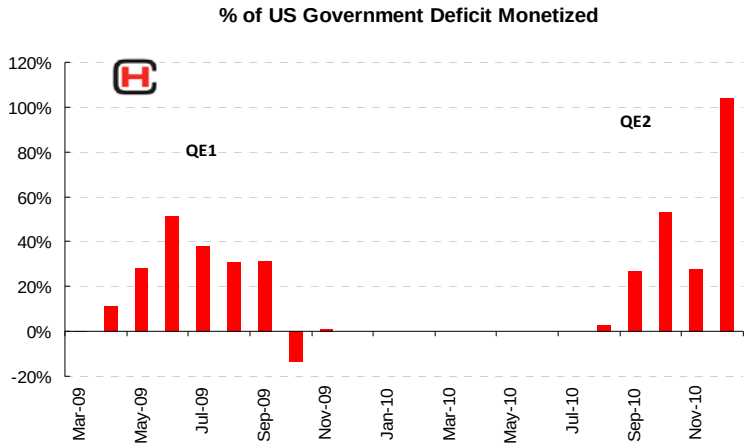
Looking at the chart above, we can see that gold is extremely undervalued relative to the S&P 500 adjusted for total returns (dividends reinvested).

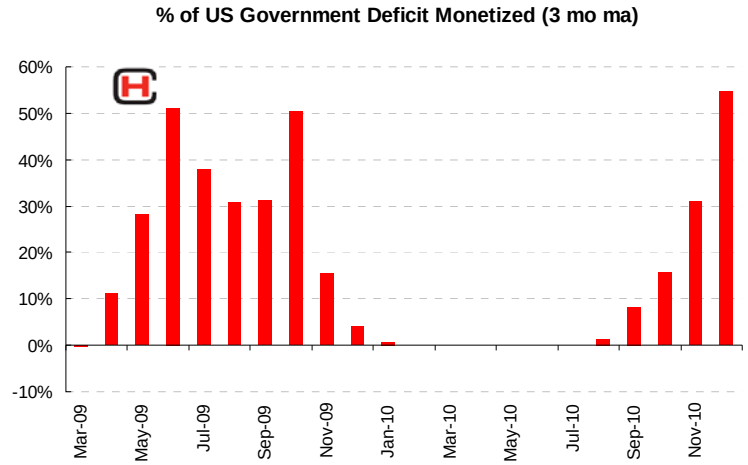
We believe gold will readjust versus the S&P 500 with both ultimately rising to higher levels. The fact is that gold will outperform the equity markets around the world many times. The recent interventions in currency markets by leading G7 central banks, namely the Swiss National Bank and now the Bank of Japan has produced yet more unsterilized amounts of currency to chase an unchanged supply of assets. More money chasing less assets equals only one thing: higher nominal prices.

We are at an inflection point for world markets as the issuance of sovereign debt and the consequential proliferation of currency has left gold as the only viable store of value.

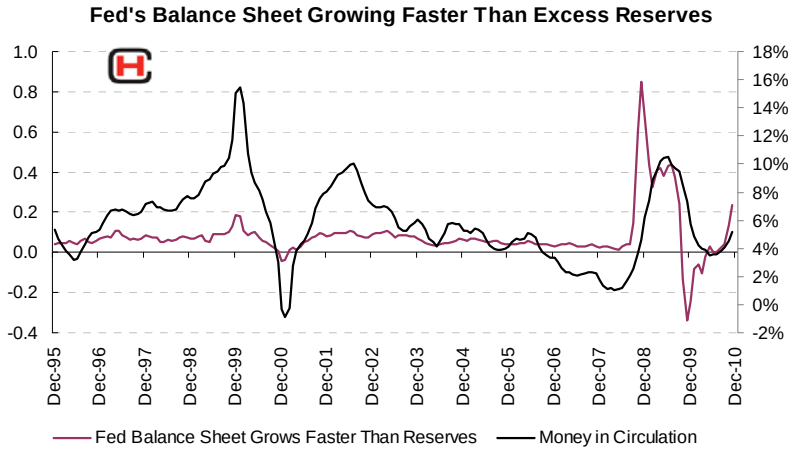
CEO Ben Davies (King World News)

These next two graphs should *not* leave you under any illusion that the FED is fully monetising recent bond issuance. QE2 on monthly data exceeds 100% on a monthly basis. Even on the 3 month average this is over 50% and worryingly it will only continue rising as QE2 gets underway.





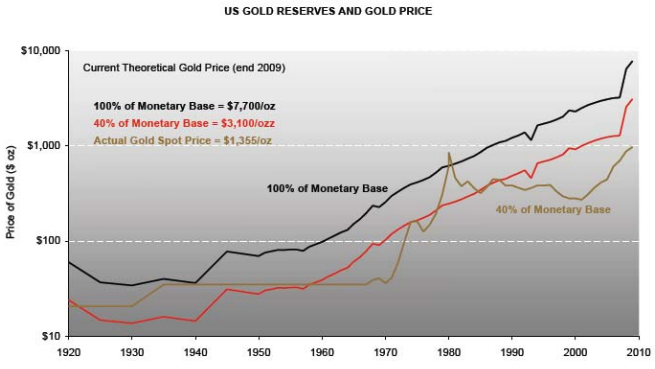
The Fed's balance sheet is now growing faster than excess reserves, whilst money in circulation is beginning to rise. Variant Perception will try to analyse real-time the implications for monetary velocity. In the 70s inflation appeared very quickly, nobody is really considering it a true possibility. It is here and looming. Do not be fooled by the stats, if you look around you its everywhere. Our standard of living is collapsing and no one is protesting, worse inflation expectations are becoming embedded. In the UK truckers went on strike because of £1 / litre fuel prices now with £1.40 on the horizon due to fuel duties and VAT rises the masses are silent. Fuel Stabilizers are not the answer, it is like inhaling Vicks, it soothes but doesn't remedy. We need sound finance. This means ending the global ponzi scheme. **The world is now truly FUBAR.**



In the context of money, gold is extremely undervalued. It is the currency of *first* resort.

GOLD: THE CURRENCY OF *FIRST* RESORT

Solving our equation for additional monetary base of $600bn by June 2011, using 40% rule implies a fair value gold price of U$4,000 / oz.



Source: Thanks to EIV Investments, LLC : Dr. F. Conrad Engelhardt IV

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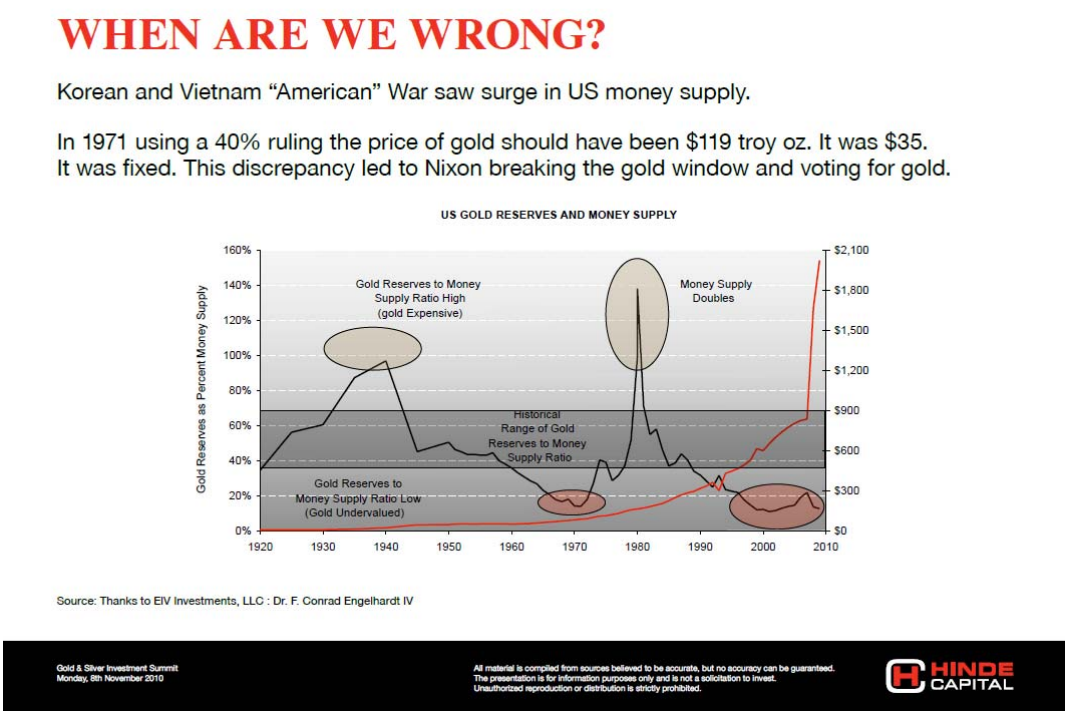
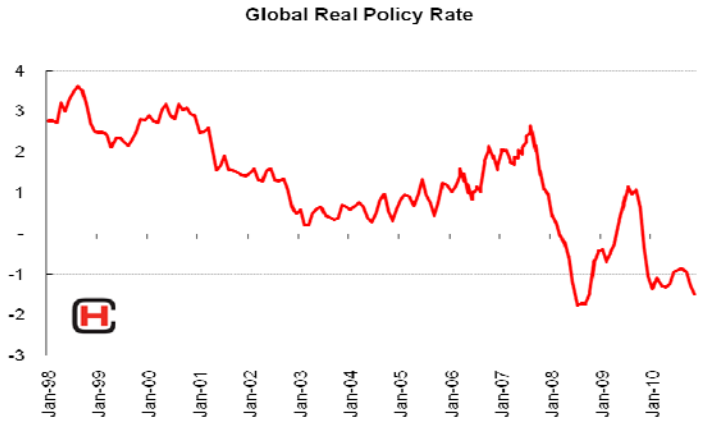
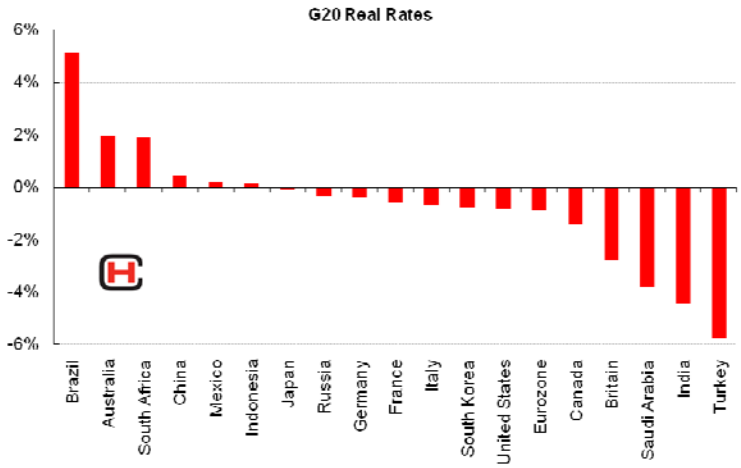
When Are We Wrong?



Also while global interest rates are negative gold will be the store of value, *par excellence.*





GATA 'In *the* Camera'

It would be remiss of us not to make comment on GATA's superlative quest for truth and pursuit of free markets.

"Judge Orders Fed to deliver gold records for her review": http://www.gata.org/node/9496

GATA today scored a small but perhaps auspicious victory over the Federal Reserve in our lawsuit seeking access to the Fed's secret gold files. The judge presiding over GATA's federal freedom-of-information lawsuit in U.S. District Court for the District of Columbia, Ellen Segal Huvelle, granted GATA's motion to order the Fed to produce in complete form for the judge's private review 20 gold-related documents the Fed has sought to keep secret. The judge ordered the Fed to deliver the documents by Friday.

Through its lawyers, William J. Olson P.C. of Vienna, Virginia -- www.LawAndFreedom.com -- GATA has argued that the Fed's production of gold-related documents has been so inadequate and the Fed's arguments for keeping them secret so weak that the court should review the documents acknowledged by the Fed and order the Fed to answer 25 questions from GATA about the Fed's search for relevant information.

The documents will be viewed 'in camera' ie in private by the Judge and if she deems them worthy of public attention she will rule the Federal Reserve to disclose them.

GATA has campaigned tirelessly for the truth, that the US government in conjunction with other governments has systematically sought to suppress gold prices. It is clear from the weight of evidence that they have provided and that which the likes of the late Ferdinand Lips uncovered that it is beyond all reasonable doubt that not only has the US pursued this policy for the past 50 years but that they worked in coordination with International counterparts.

The suppression scheme is unravelling in front of their eyes; GATA is quite incredibly beginning to win this battle. It may even be the final Gold War. (Please see our Gold Wars speech and presentation for a synopsis). Now even academics and policymakers from within the ranks of those that have tried to hold back the progress of mankind by systematically robbing individuals of their day's hard labour are voicing a return to a classic gold standard. We will write more on this in coming months.

Earlier this week Thomas Hoenig, president of the Kansas City Federal Reserve, went out of his way to call the gold standard a "very legitimate monetary system." In November, World Bank President Robert Zoellick and Indiana Republican U.S. Rep. Mike Pence both called for a serious look at using gold as the centerpiece of international monetary reform.

The fact that a Fed leader, the highest-ranking American official in international economics, and a potential presidential candidate are talking up the gold standard indicates that floating money is running out of political cover, and that the obstacles to gold replacing it are narrowing.

The first confirmation of this was the reaction of certain economic elites who, instead of responding with a straightforward defense of the status quo, lobbed ad hominem attacks on those who dared to mention gold. "I think [Zoellick] is living in the past," Edwin Truman of the Peterson Institute for International Economics told the Financial Times. Gold is "minor and really irrelevant," echoed Peterson Institute Director Fred Bergsten in the same article.

http://www.forbes.com/2011/01/10/gold-dollar-world-bank-opinions-contributors-jeffrey-bell-rich-danker.html

Sean Fieler, Frank Cannon, Andersen Blom, Jeffrey Bell, Rich Danker and Ralph Benko are one step nearer to Gold Standard 2012. http://goldstandard2012.com/about/

We cannot overemphasise how important it is for people to comprehend the tireless work of groups such as GATA, the Committee for Monetary Research and Education, the GoldMoney Foundation and now Gold Standard 2012 (American Principles Project) in attempting to wake up individuals to the consequences of government fiscal and monetary behaviour. There are other groups and individuals involved who have contributed ,but with whom we are not personally familiar .

Unfortunately in spite of their work and now our own in helping to carry the baton in this seemingly perpetual relay we believe that monetary ruin happen before the masses can begin to comprehend just how they have been duped.

'Q.E.'D.

The current monetary order is highly unstable and deflationary episodes mask the true inflationary implications that lie at its foundations. We are not entirely sure what event will trigger an unravelling of this flawed system, but we believe the 2008 crisis began the descent to the ultimate conclusion – a reserve currency collapse and the reinstatement of a better financial order.

We leave you with these thoughts:

Japan has $30 trillion of gross debt, some 60% of global GDP. One must not underestimate the impact of a default by this country. It will be devastating. If the default bypasses implicit default and Japan experiences an explicit default then the deflationary ramifications will be substantial, but do not think for a second the world central banks will not act to reflate. It will be their mandatory course of action, for they do not know any other way.

Outstanding debt is exceeding servicing capacity. The global debt ponzi financing scheme merely permits more refinancing and the false appearance of solvency. The US dollar may look a better bet than sterling or the euro or the yen, but it is the world reserve currency that underpins all world debt. It is fallible. It too will come to pass.

Gold is the vital barometer of the health of a nation's currency. We must never forget this lesson of history. We must reinstate its worth.

DISCLAIMER

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