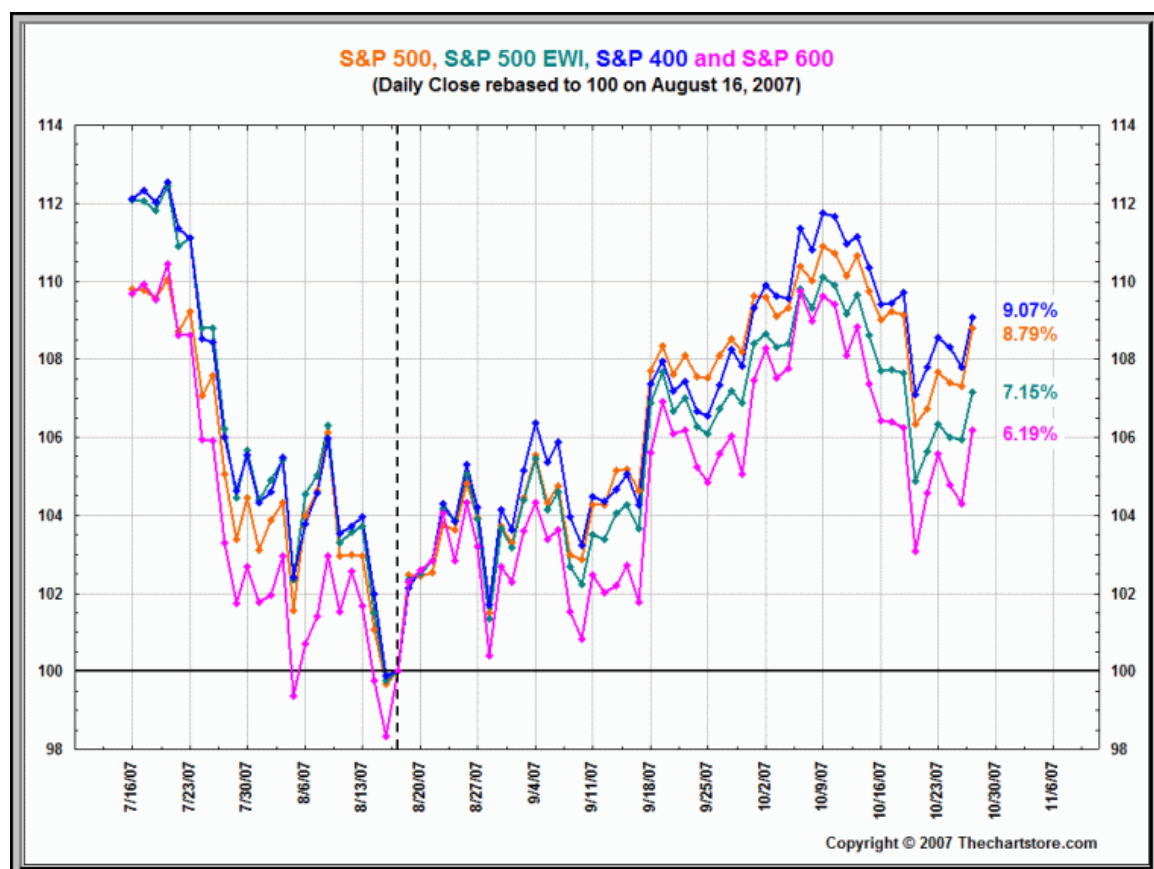


A New Monetary System

Marc Faber

I was about to write that in a “normal” economic system the least risky asset is cash parked in short term government paper or cash on deposit. Low risk and high liquidity also means that the return on cash tends to be lower than the returns on equities, bonds and real estate. However, since I am no longer sure what “normal” is, I decided to amend the above truism to “in a balanced and non-inflationary economic system” cash is the safest asset. Clearly, this does no longer seem to be the case. Cash is losing its purchasing power – it would seem – at an accelerating rate against other assets because of the Fed’s expansionary monetary policies (see Figure 1).

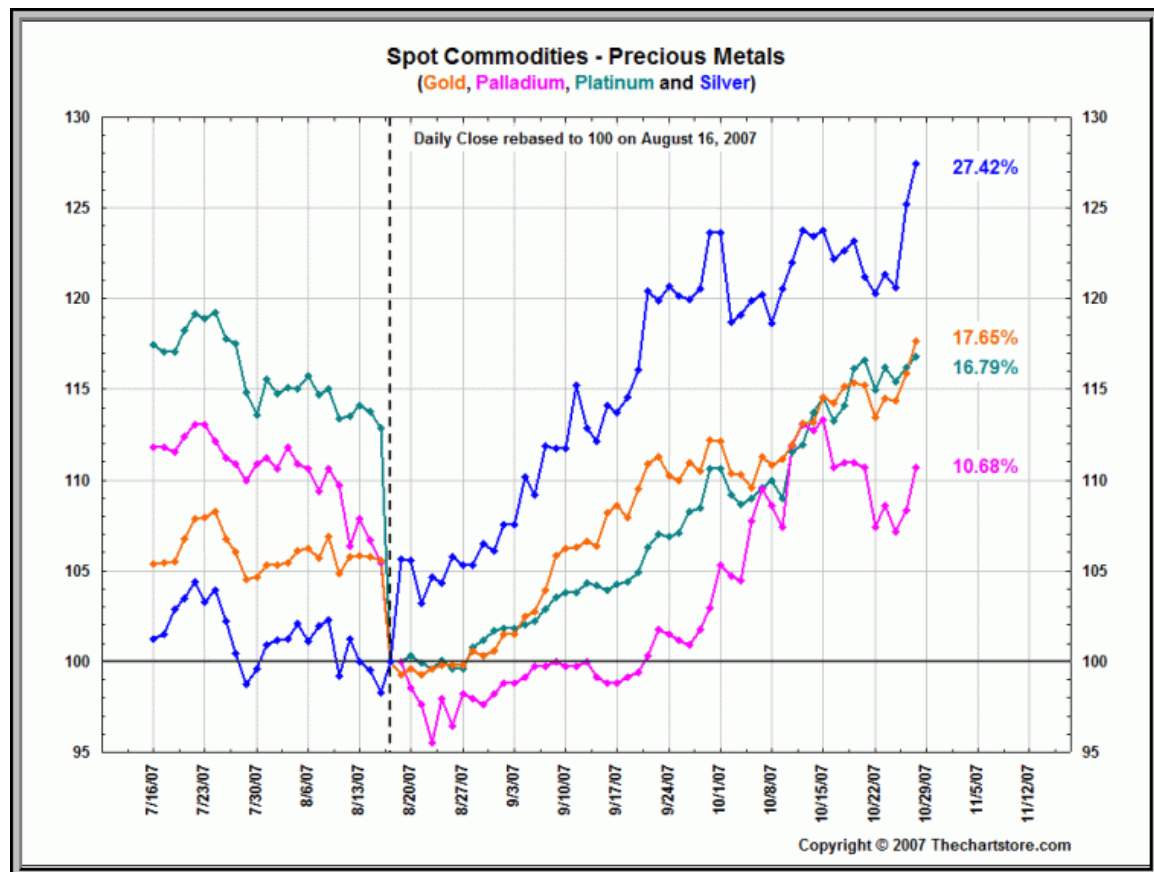
Figure1: Performance of S&P Indices, August 16 – October 26



Source: Ron Griess, www.Thechartstore.com

The goldilocks cult members will, however, see it differently. They will claim that stocks have performed so well since August 16 because of low valuations and favorable economic fundamentals. But that does not seem to be the case if we also look at the performance of precious metals since August 16 (see Figure 2).

Figure 2: Performance of Precious Metals, August 16 – October 26

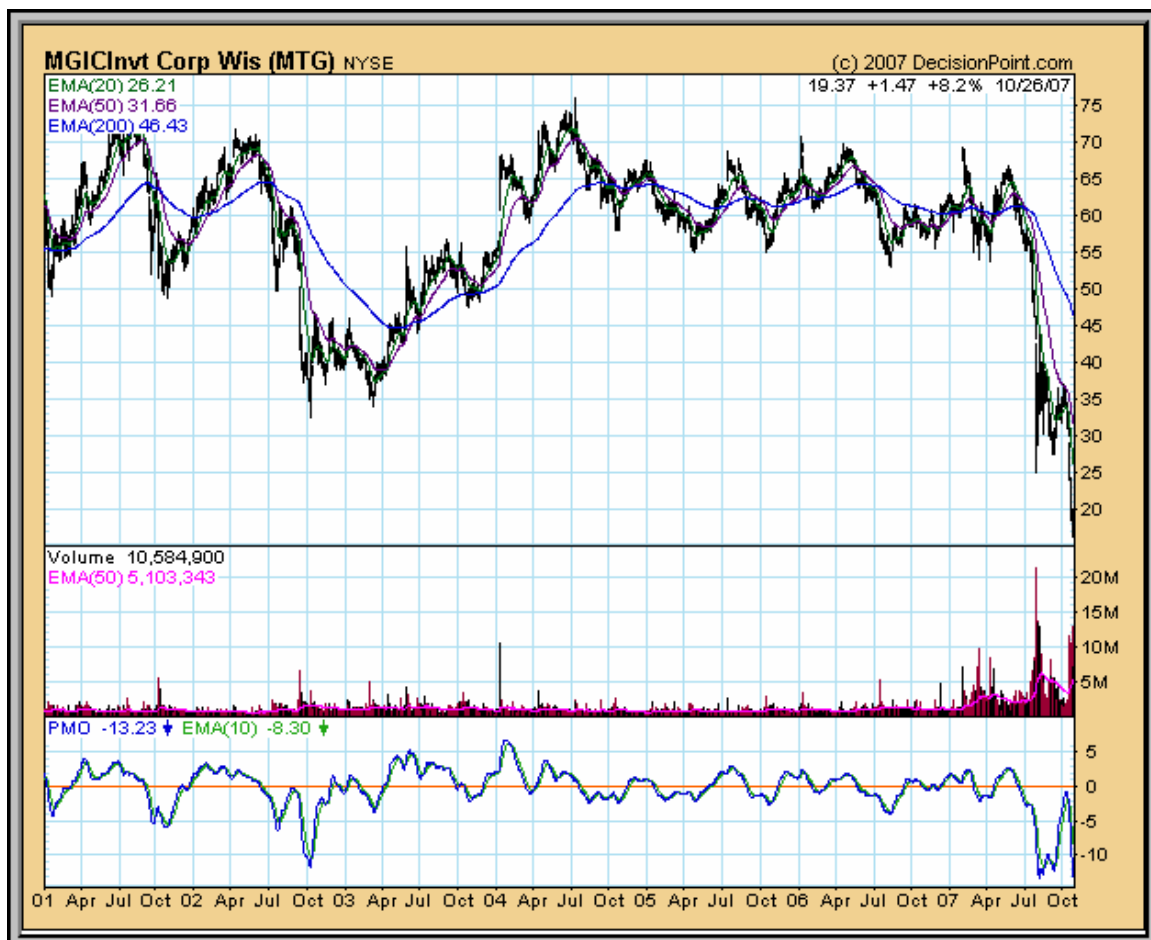


Source: Ron Griess, www.Thechartstore.com

As can be seen, precious metals have, as has been the case since 2000, significantly out-performed US financial assets. So, what we are faced with is the following: The worse the economic and financial conditions of the US become the more “cash” will lose its value against assets, which have now become the world’s monetary system’s “new money” courtesy of irresponsible central bankers under the leadership of the US Federal Reserve. The reason for this sad state of affairs is that the Fed, after having created a “monstrous” financial sector through expansionary monetary policies over the last 25 years or so, does not have the will to tackle the “causes” of the current financial mess it created, but is perfectly happy to treat the symptoms of the problem by printing paper money at

an accelerating rate (in the third quarter MZM grew at an annual rate of more than 18%). Mind you, the symptoms of the Fed's total incompetence became already evident with the NASDAQ bubble in 1999/2000, the fraudulent credit erected housing and sub-prime lending bubble from 1999 to 2006, and more recently with the "Structured Investment Vehicles" of financial institutions (which were - simply put - designed to by-pass reserve requirements) as well as with the collapse of Mortgage Insurance Companies' stock prices (see Figure 3).

Figure 3: MGIC Investment Corp, 2001 – 2007



Source: www.decisionpoint.com

But now, with additional fed funds rate cuts the Fed is adding to the symptoms of its incompetence symptoms of its "irresponsibility" and its well-deserved "mockery". How can a responsible central bank cut interest rates and pursue an expansionary monetary policy when the stock market is close to an all time high and when it is faced with a weak currency and soaring food and commodity prices??? "Only in America" one should say

because the US-infected IMF and World Bank would advise any country under these conditions to “tighten” monetary policies and to raise interest rates. But since the Fed’s only objective today is to “inflate” asset markets further at the expense of totally debasing the currency we need to look at a new currency as a “unit of account” and as a “store of value”. In my opinion, the world’s new currency with the qualities of being a “unit of account” and “store of value” will be gold and to a lesser extend other precious metals (see Figure 4).

Figure 4: Gold in Real Terms, 1969 - 2007

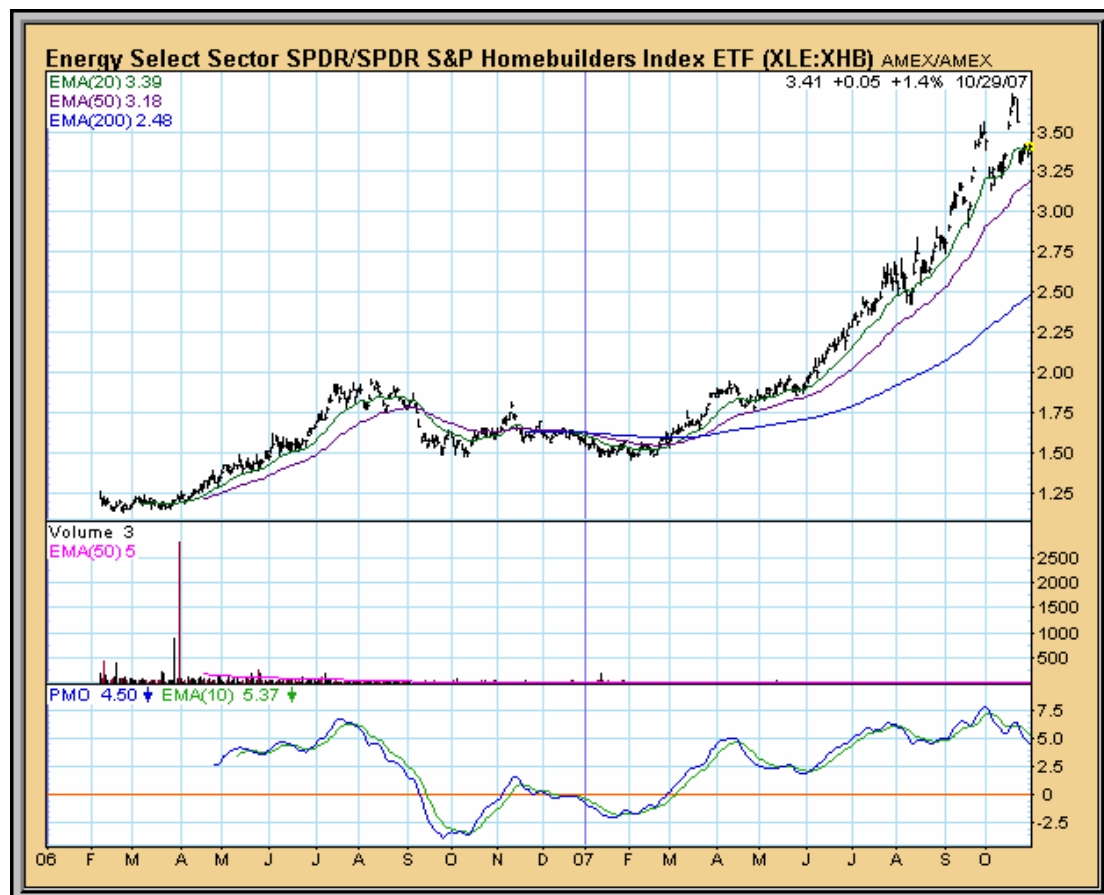


Source: Ron Griess, www.Thechartstore.com

Let me explain! In an environment of monetary debasement – that is when cash loses rapidly its purchasing power – all goods, services (R&D, patents, etc.), and assets become currencies as investors and savers realize that the only way to protect the purchasing power of their money is to move from liquid into “illiquid” assets. Consequently, money is no longer just dollars, Euros, Yen and Chinese RMB, and short dated bonds but also real estate, stocks, commodities, paintings, and even collectibles. Now, the same way as in a free market economy currencies fluctuate in

value against each other (so far the US dollar mostly down), the various asset classes, which have increasingly become “money”, will also fluctuate against each other. And the way sound currencies tend to strengthen and currencies with poor fundamentals tend to weaken, the various asset class monies will, depending on their fundamentals, either appreciate or decline against each other. Take as an example the energy sector compared to homebuilders (see Figure 5).

Figure 5: Energy Select Sector compared to S&P Homebuilders Index, 2006 – 2007



Source: www.decisionpoint.com

As can be seen from Figure 5, the “US homebuilding currency” and real estate in general has not only depreciated massively against the “energy currency” but also against “lousy” cash over the last three years by declining in absolute terms (see Figure 6).

Figure 6: US Homebuilders – A depreciating Currency in Relative and Absolute Terms. Toll Brothers, 2003 - 2007

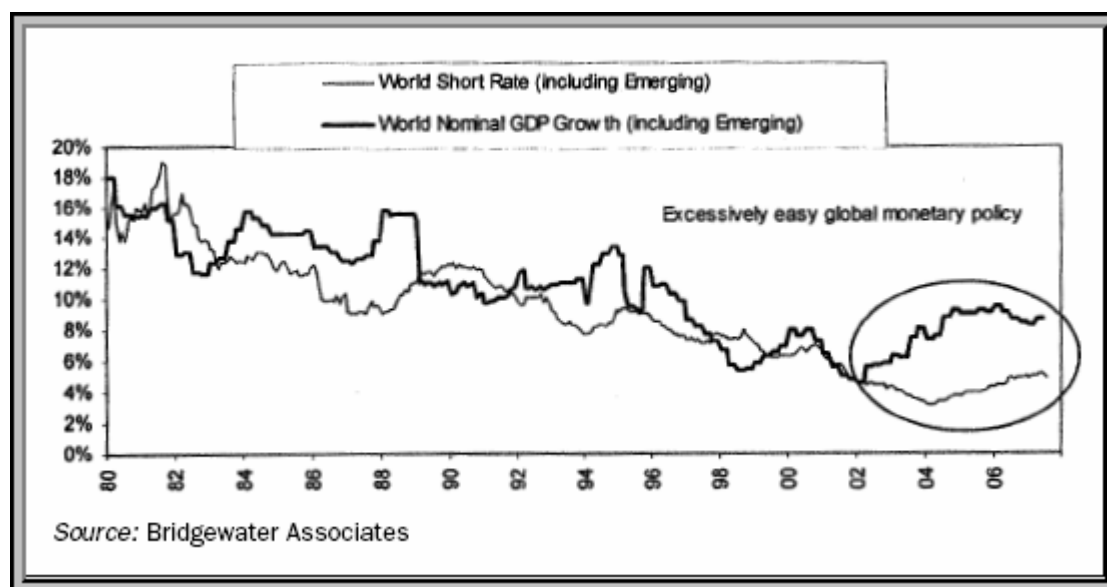


Source: www.decisionpoint.com

Now, while the above may sound extremely trivial because in the past some asset classes have always out-performed others, the problem for investors that comes along with is not trivial at all. The reason for this “new problem” is that in the past cash maintained more or less **over time** its purchasing power with compounded interest rates against a basket of goods and asset. So, whereas cash lost out against consumer price inflation and against oil and precious metals in the 1970s, it maintained its value against equities and home prices, which hardly appreciated during that decade. Also cash gained in value against bonds, which tumbled. Moreover, the loss of cash’s purchasing power (including interest) in the 1970s against consumer prices and precious metals was offset in the 1980s by cash appreciating strongly against consumer prices (disinflation) and commodities. But now, with the Fed and other central banks intent to keep asset prices up at all costs with artificially low

interest rates an era of continuous monetary depreciation has dawned upon all of us (see Figure 7).

Figure 7: World Short Term Interest Rates far Below World Nominal GDP Growth since 2002

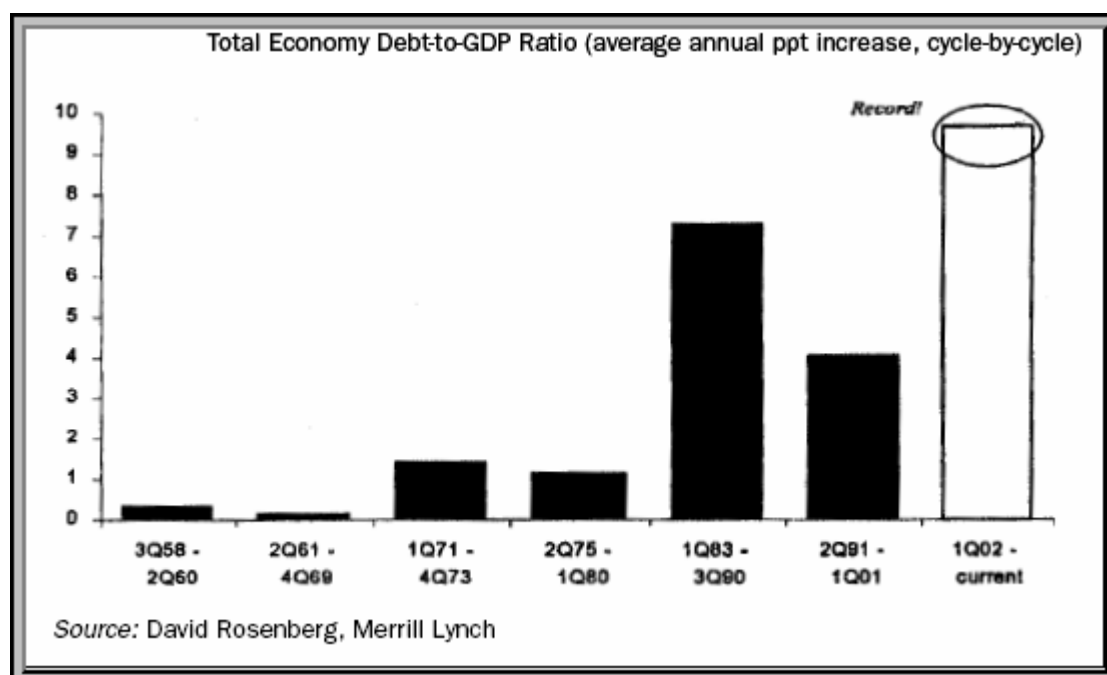


Source: Bridgewater Associates

Simply put, whereas in the past cash could be perceived as “reasonably” safe, today, cash may, courtesy of modern central banking under the auspices of the US Fed, actually have become quite a dangerous asset class due to its depreciation not only against asset prices but also against consumer prices, if these were measured properly by government agencies. In this respect it is interesting to note that, according to Bloomberg, Argentina’s President Kirchner who will be succeeded by his wife Cristina is thought to have grossly manipulated inflation data, which has transformed the “Argentine bond market into a financial bloodbath” in 2007. According to Bloomberg, “Argentina’s benchmark inflation-linked bonds have tumbled 24% this year, making the country’s debt market the worst performer in the world this year” (Merrill Lynch estimates that consumer prices in Argentina are currently rising at 17% annual rate – double the official rate). Now, I am not suggesting that consumer prices in the western world are rising at an annual rate of 17% but a reasonable assumption is that, at least in the US, prices (costs of living for the median household) are rising at more than twice core inflation figures – in my opinion at 5% to 6% per annum.

In short, the problem an investor is facing is the following: In the past, savers who wanted to avoid the problem of taking investment decisions and allocating their funds to different asset classes could keep their money in short term deposits. But in today's new monetary regime – characterized by massive monetary and debt growth and central banks that seem to be perfectly happy at “printing money”, which leads to a loss of money's purchasing power – savers are almost forced to invest into “something” in order not to end up as “penniless billionaires” (see Figure 8).

Figure 8: US: Fastest Debt Growth since the Second World War!



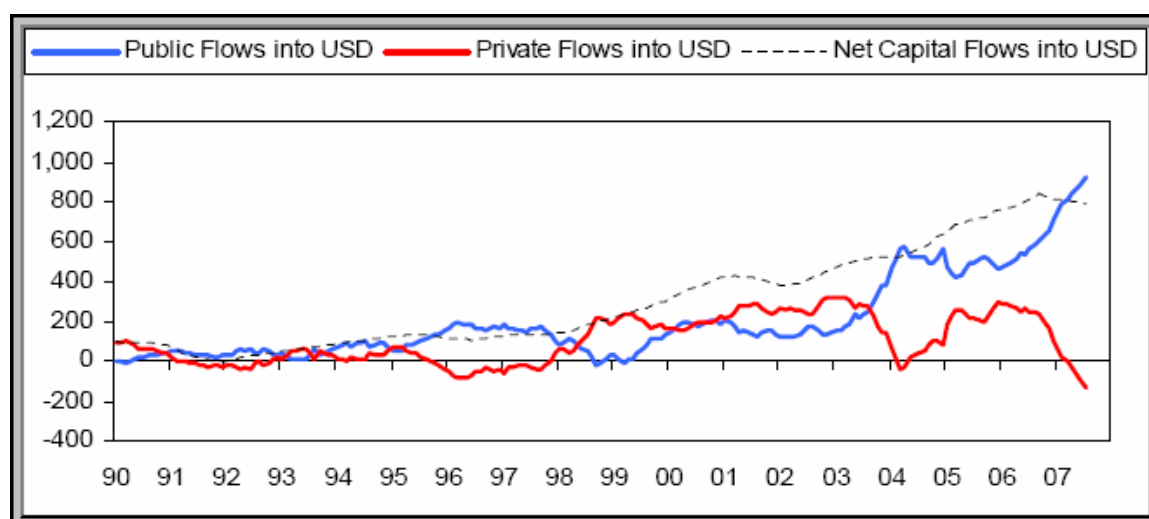
Source: Merrill Lynch

So what is the problem that assets appreciate faster than cash? This has always been the case over longer periods of time since less liquid assets tend to have a higher return than the most liquid assets. Correct, but in the present case, asset prices are not only increasing in value because of fundamental economic reasons but predominantly because of money and credit growth, and artificially low interest rates which lead to and encourage excessive speculation (see Figure 8). The problem, however, is that if the Fed is right in claiming that despite of all its economic tools it does not know how to identify bubbles, the individual investor is even less likely to be able to navigate the inflating investment environment

without getting from time to time badly caught by a popular asset class, which then deflates badly, such as is now the case for US, Spanish and Irish housing prices, and home building and financial stocks (see also Figure 6). I may add that - relative to the rest of the world – most US asset prices are deflating because of the dollar weakness. However, one thing becomes more and more obvious to me and this is that the prudent saver who holds his money in deposits is not going to retire well on his savings (given the artificially low interest rates) unless he shifts money from paper money to some class of asset money! The trick of course being that from time to time assets need to be reshuffled from an asset class that loses momentum to another one that is gaining traction. But who would be capable to perfectly time such moves from one to the other asset class?

Still, there are a few economic and financial conditions that might help us navigate this minefield. For one, it is clear that the US dollar is resting (sliding) on thin ice as private capital flows into the US are now negative (see Figure 9).

Figure 9: Capital Flows into US, 1990 - 2007

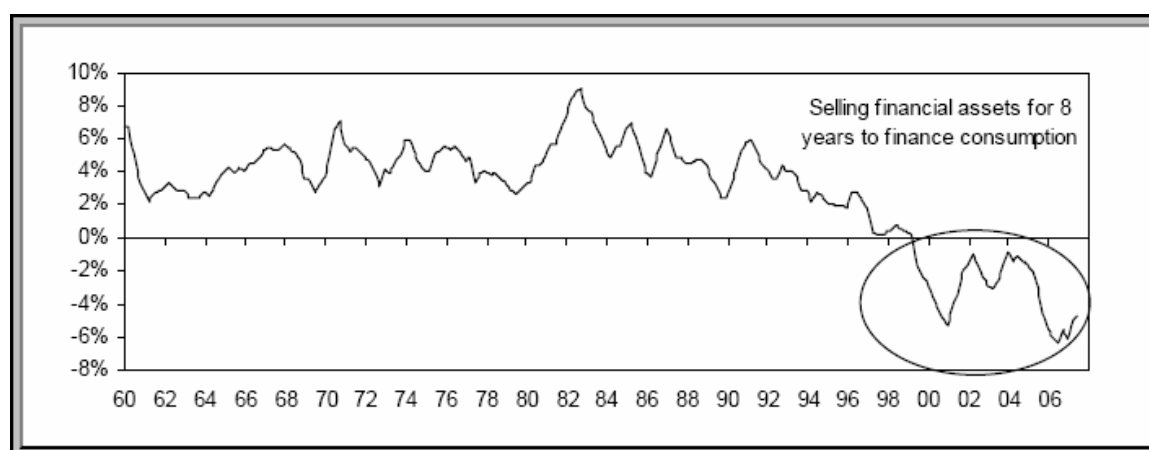


Source: Bridgewater Associates

As can be seen from Figure 9, the US dollar is now entirely supported by public flows into the US, which are largely purchased by foreign central banks. Private flows are negative. I suppose, however, that even central bankers will one day realize that to invest their reserves into US dollars is not the most desirable option and, therefore, longer term the dollar should continue to depreciate relative to assets, which are not “over-supplied” - as is the case for the US dollar.

Near term, shorting the dollar should be handled with care. Negative sentiment is at an extreme. Also, the US economy is no longer expanding, and the trade and current account deficit are no longer increasing. Moreover, what supported consumption in the US has been mortgage refinancing activity, which has already cooled off! In addition, the persistent selling of financial assets by households over the last few years has also allowed the household sector to keep up its consumption (see Figure 10).

US: Net Financial Investment as % of GDP, 1960 - 2007

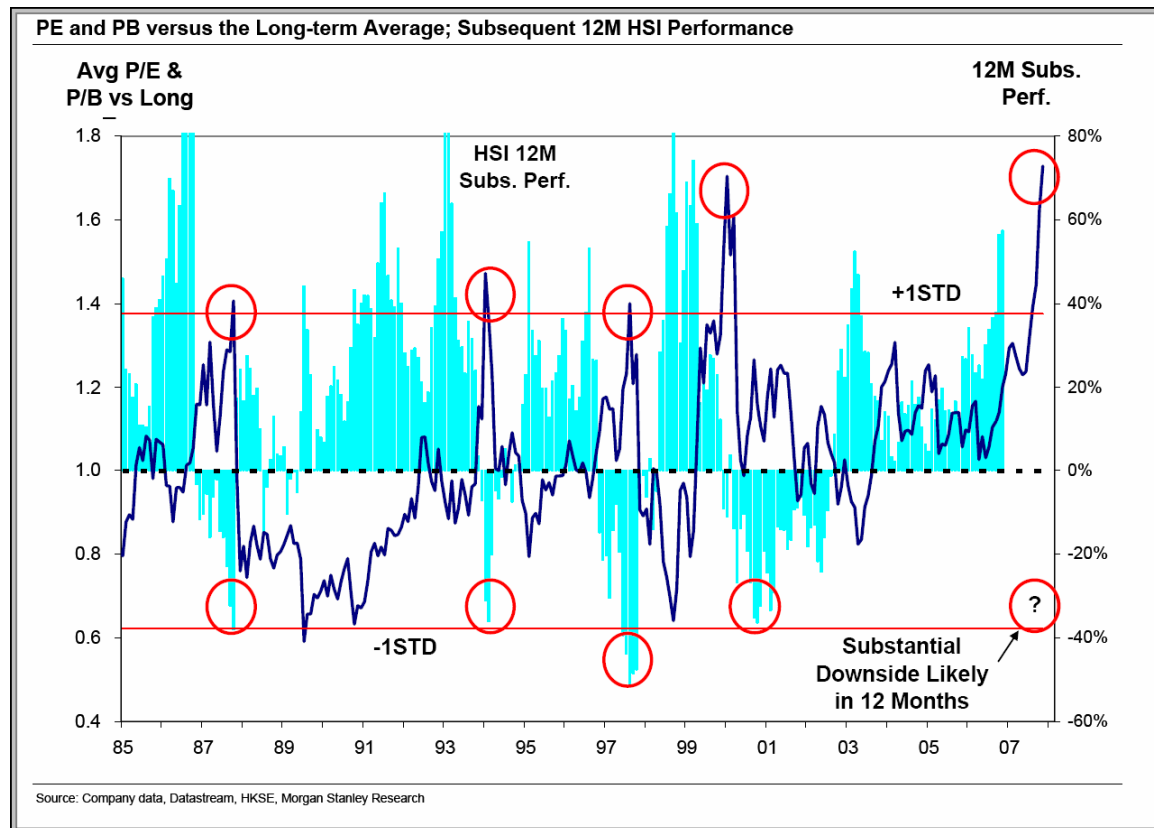


Source: Bridgewater Associates

It is safe to assume that at some point households will reduce their net liquidation of financial assets and boost their saving's rate. Obviously, this would cause a consumer led recession but would rapidly improve the trade and current account deficit and potentially create a dollar shortage (at least in relative terms). Moreover, once the Chinese and Indian stock manias come to an end, capital, which flowed recently overseas, is likely to head back to the US. So, whereas the long term fundamentals for the US dollar look poor – particularly in view of the Fed's propensity to print money in order to “solve” any problems (postpone in reality) – there are some potential favorable factors developing, which could support the dollar at least against other major paper currencies.

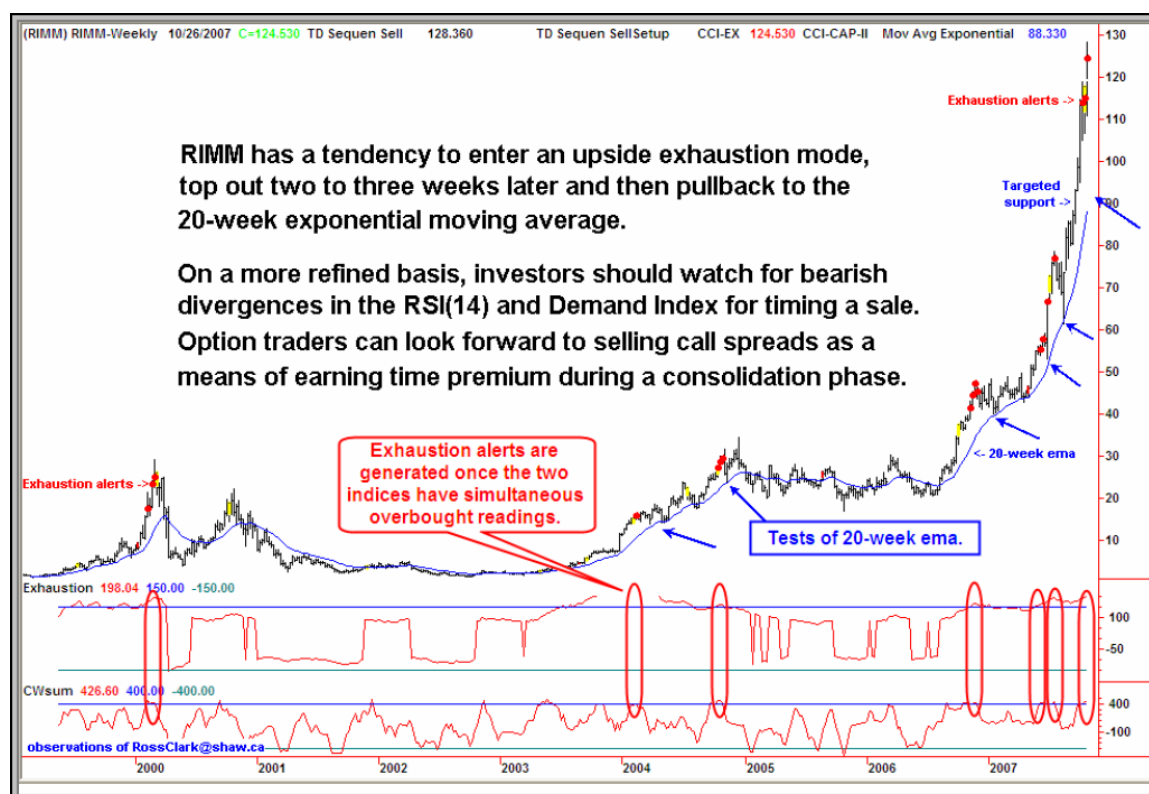
In a desperate attempt to capitalize on the Fed's easy monetary policies, investors have piled into momentum stocks and momentum markets. India, China and Hong Kong seem to be the prime beneficiary of the Fed's re-inflation effort (see Figure 11). However, as can be seen from Figure 11, the Hang Seng Index has become massively over-bought and is likely to correct soon meaningfully (between now and the spring of 2008).

Figure 11: Hang Seng Index Valuation and 12 Months Subsequent Performance, 1985 - 2007



Source: Morgan Stanley Research

According to Morgan Stanley the Hong Kong stock market has only hit similar valuations 4-times in the last 22 years, “and on all four occasions it fell over 30% in the following 12 months”. Similarly, momentum money in the US has boosted the prices of just a few NASDAQ stocks, which have driven the index higher. As at the end of last week, the NASDAQ was up by 448 points year-to-date (up 25.4%). Of those 448 points about 230 points came from just three stocks: Apple, Google and Research in Motion. According to Bob Hoye, Research in Motion is once again in an upside exhaustion mode (see Figure 12).

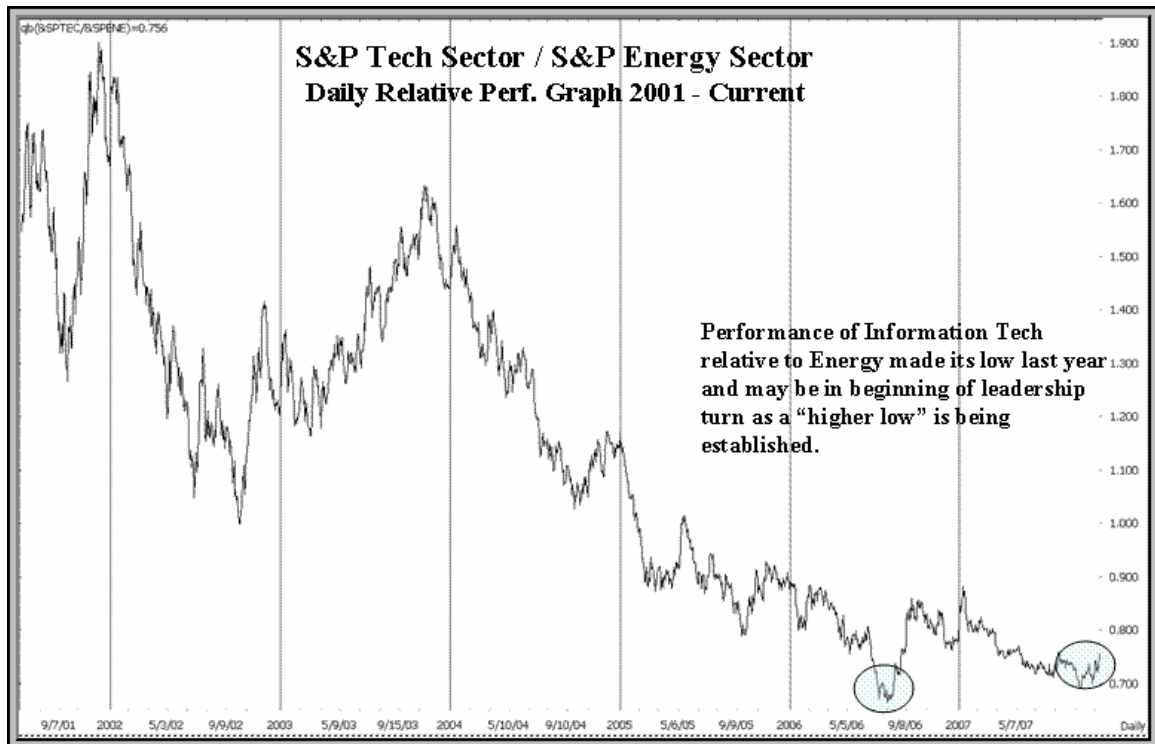
Figure 12: Research in Motion, 2000 - 2007

Source: Bob Hoyer

I started out by suggesting that cash had become a dangerous asset to hold because central banks were increasingly debasing its value. However, badly timed moves into “asset currencies” such as real estate, sub-prime lenders, mortgage insurance companies and homebuilding stocks in 2006 were also detrimental to an investors’ financial health. I would think that to currently move cash into Indian, Chinese and NASDAQ momentum stocks will in future also lead to widespread losses.

Moreover, as the global economy slows down and some countries like the US enter recessionary phases we should be careful about industrial commodities and material related equities. And whereas I am certainly not positive about the outlook for technology (with few exceptions such as Microsoft) tech stocks could begin to out-perform energy stocks (see Figure 13).

Figure 13: Tech Stocks to Out-perform Energy Stocks?



Source: Tony Dwyer, FTN Midwest

My preferred asset currency is still gold and other precious metals. Near term, however, sentiment is overly positive and additional positions should only be taken on a setback.

From the viewpoint of 2018, my hindsight sees that most 2007 viewers had no idea of how US capitalism would be abandoned to save the banks and our fiat currency!