Why Market Interventions by Governments worsen Economic and Financial Conditions!

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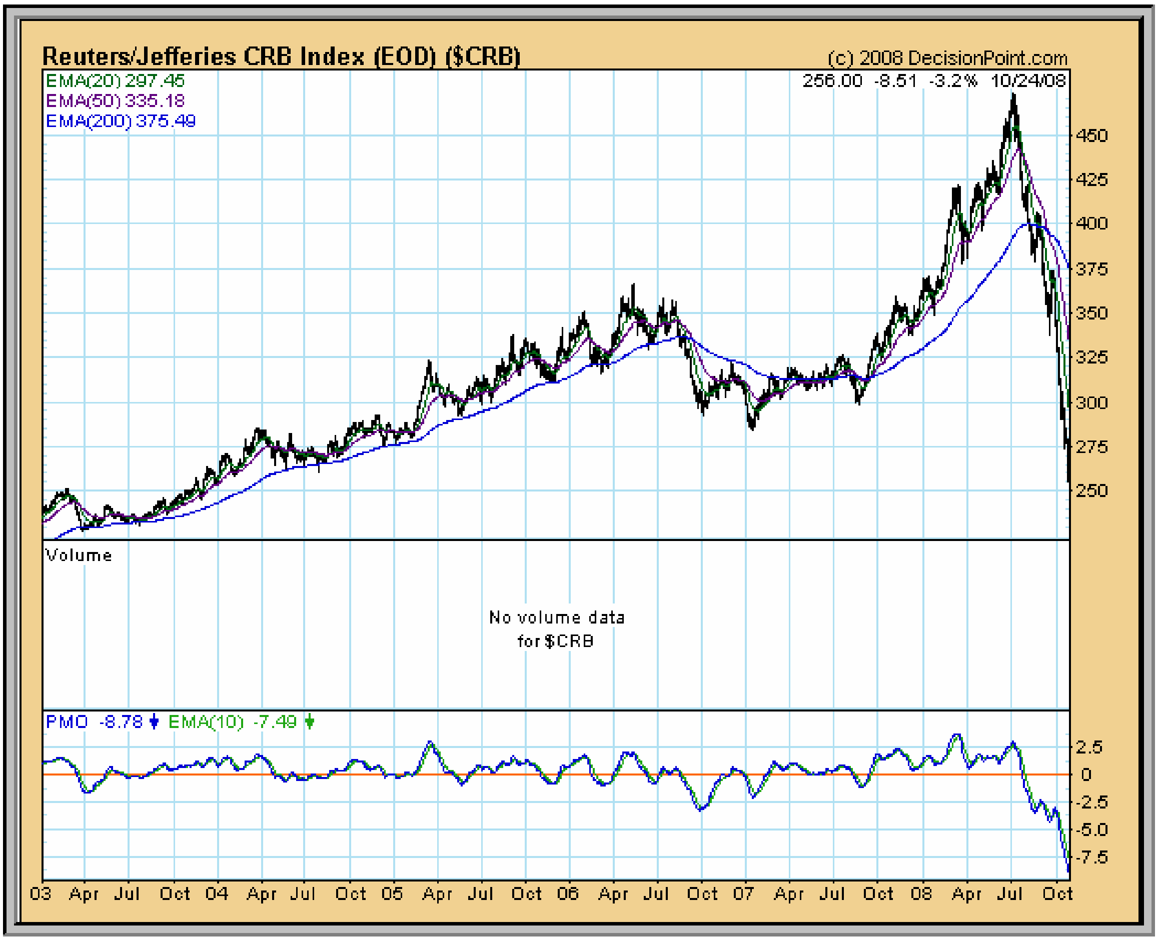
> **"When you look at the mistakes of the 1920s and 1930s, they were clearly amateurish. It is hard to imagine that happening again—we understand the business cycle much better."**
> (Greg Mankiw, Harvard economist and textbook author, Wall Street Journal, February 1, 2000)

A look at the CRB Index since 2003 reveals an interesting pattern (see Figure 1).

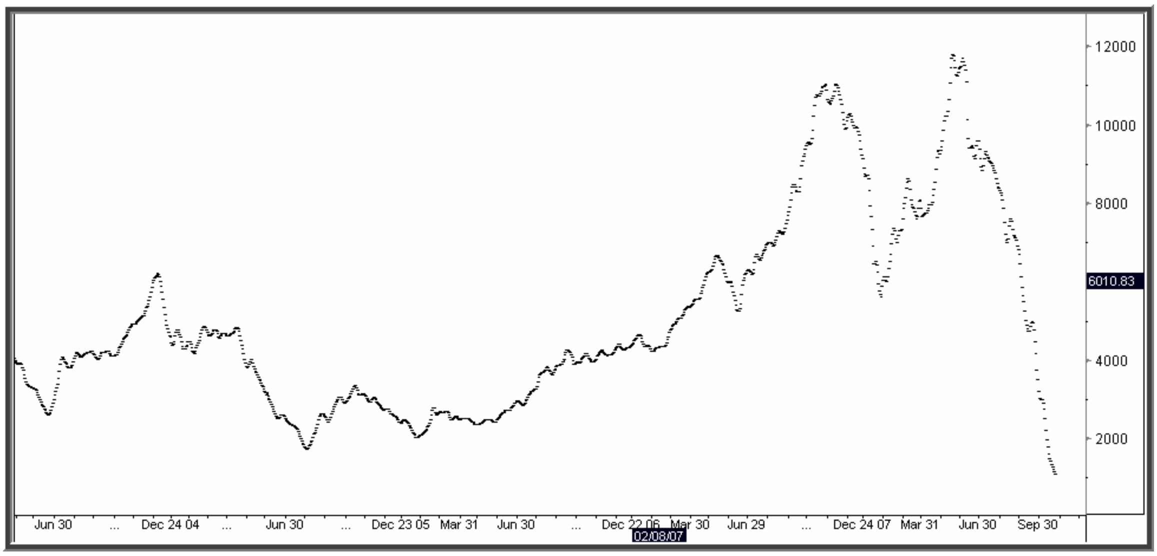
Figure 1: CRB Index, 2003 - 2008



Source: www.decisionpoint.com

From 2003, the CRB moved up at a measured pace until its peak in May 2006 at 365. Thereafter, a correction followed, which lasted until September 2007. But when the Fed embarked on its aggressive rate cuts from 5.25% to 2% in January 2008 (now 1.5%) the CRB went ballistic and soared from around 320 before the rate cuts to a high of 473 in July 2008. Let's call this September 2007 to July 2008 upward move the "Bernanke Rally." Thereafter, the inevitable collapse followed as it became increasingly evident that demand for industrial commodities would contract badly in the second half of 2008. The Baltic Dry Index (BDI), which correlates closely with commodity prices, was even more volatile (see Figure 2). Toward the end of 2007, the BDI had begun to correct. But when aggressive additional rate cuts occurred in December 2007 and January 2008 the Index managed to surge to new highs reaching almost 12,000 in May 2008. Since then the BDI is down more than 90% to less than 1000…..

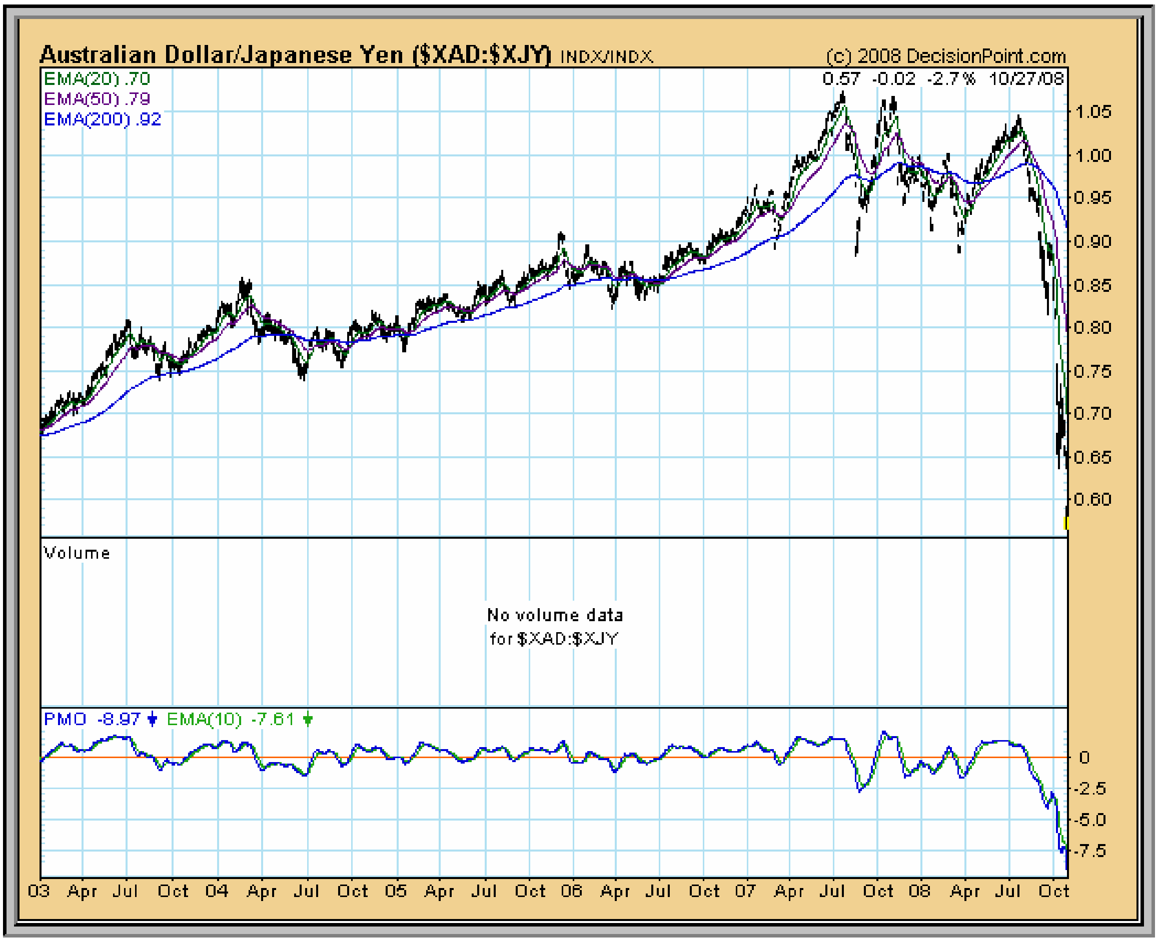
Figure 2: Baltic Dry Index, 2004 - 2008



Source: Bloomberg

What I want to make perfectly clear is that Mr. Bernanke's inept monetary policy actually increased volatility and led to greater losses compared to what would have occurred had rates not been prematurely cut in September 2007. Needless to say that the principal cause of the current financial crisis was the ultra expansionary monetary policy the Fed pursued since the late 1990s - beginning with the bailout of LTCM, thereafter the monetary injection ahead of Y2K and finally the 2001 rates cuts, which brought down the Fed fund rate to 1% and led to a huge increase in leverage! In fact, I would argue that had LTCM not been bailed out in 1998, the market's response would have been at the time to reduce leverage and not to embark on a huge expansion of credit in the belief that the Fed would always be there to bail out everyone who was "too big to fail" (the famous Greenspan put). But back to Mr. Bernanke's monetary tribulations! His aggressive rate cuts also produced US dollar weakness and along with rising commodity prices a spike in commodity related currencies such as the Canadian, New Zealand and Australian dollar (see Figure 3).

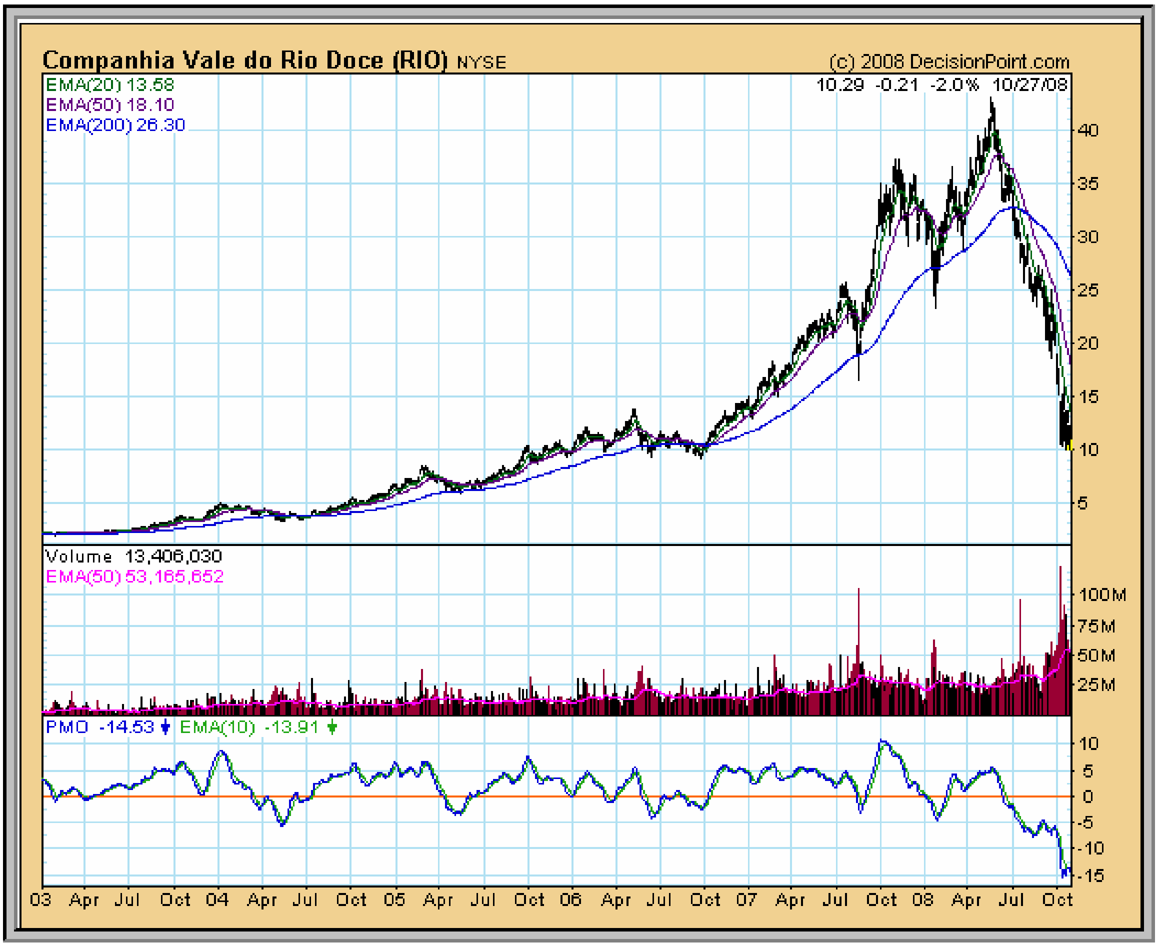
Figure 3: Australian Dollar versus Yen, 2003 - 2008



Source: www.decisionpoint.com

Alas, when commodity prices began to tumble in July 2008 and the process of de-leveraging gathered speed, the commodity related currencies and resource stocks also fell out of bed (see Figure 3 and Figure 4).

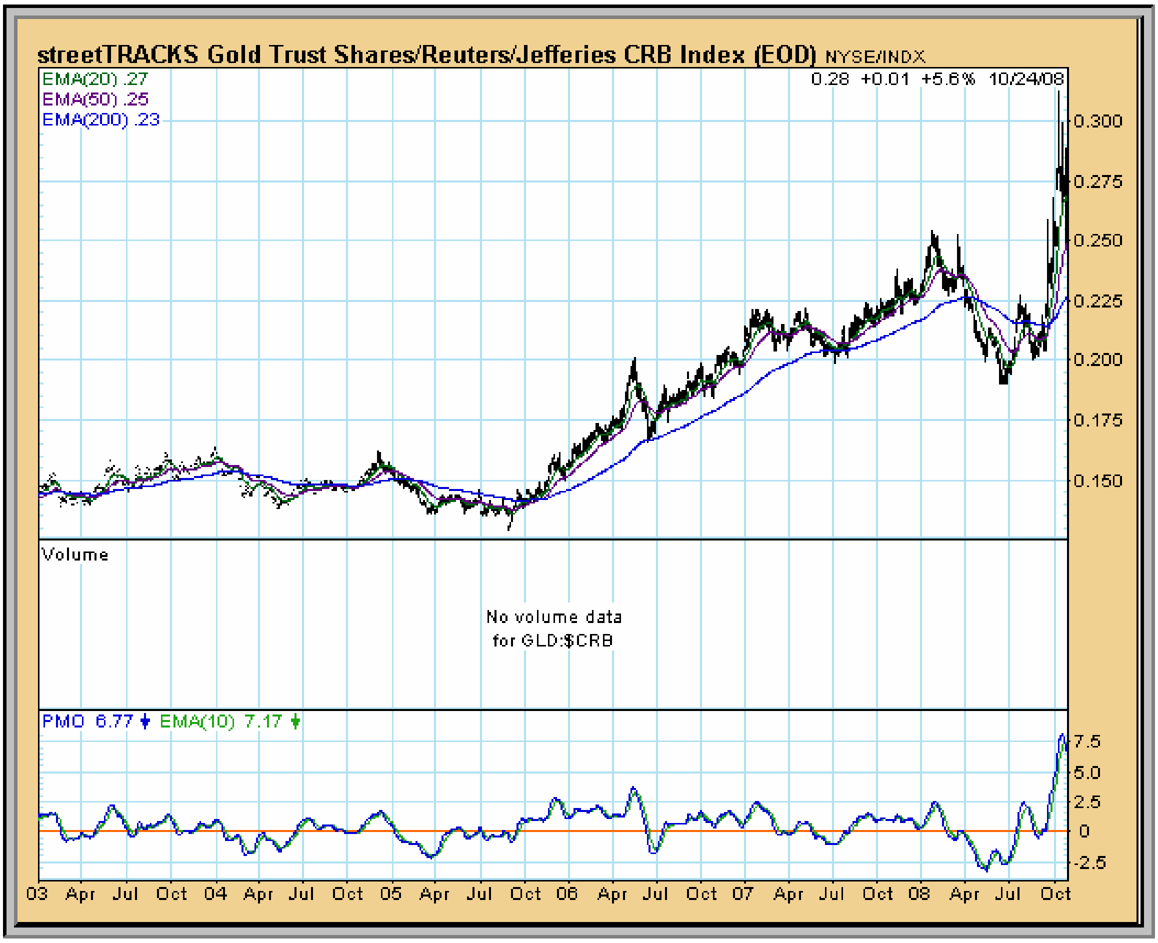
Figure 4: CVRD, 2003 – 2004



Source: www.decisionpoint.com

All I wish to point out is that market interventions (a better term is market manipulations) with fiscal and monetary measures bring about unintended consequences, increase volatility and make it more difficult for investors and businessmen to obtain information from the movement of markets. I may add that an unintended consequence of the ban on short selling of certain stocks (quite a large number) accelerated the unwinding of long positions because investors could no longer hedge their long positions. And when European governments began to guarantee bank deposits it brought about massive selling of assets in emerging markets because bank deposits suddenly became a safe haven. All I can say is that the history of market interventions has been a disaster (in an extreme case the planned economy, which was practiced under socialism and communism) and that they lead to huge economic and financial volatility, great uncertainty and low transparency and visibility. I am mentioning this because I am continuously assailed with emails asking me whether the world will move into deflation or inflation and how gold will perform under deflation. My view is this: We may have first some bout of deflation, which induces the chief money printer to print even more money and the Goldman Sachs clerk who was dispatched by his firm to the Treasury to inject even more capital into Wall Street and other financial companies (not without any self interest since his family is the beneficial owner of a large block of GS shares through a trust account). Eventually this could lead to very high inflation rates. In the meantime, gold should perform **relatively well** under any scenario (see Figure 5).

Figure 5: Gold compared to the CRB Index, 2003 - 2008



Source: www.decisionpoint.com

It should be noted that under deflation and in an environment of de-leveraging gold is likely to trade lower (as it has since its peak in March 2008 at $1032) but that relative to other asset classes it is likely to appreciate as it has done in the past (see Figure 5). For a more scientific explanation of the behavior of gold under inflation and deflation I am enclosing to this report a Gloom Boom & Doom report I wrote in 2005 in which my friend Fred Sheehan discusses the subject thoroughly. I concede that under deflation (a decline in the overall price level) cash and highest quality bonds are the asset class of choice. However, both cash and bonds represent the liability of someone else. Hence, there is a counterparty risk – even in the case of government bonds since governments can also default! Physical gold held in a safe deposit box outside the US (Canada, Switzerland, Luxemburg, Singapore, Dubai etc) does not have a counterparty risk.

I wish to emphasize that I am not a hard core gold bug and I have warned in previous reports that commodities including gold would come under pressure in the second half of 2008 as in an environment of deleveraging all assets are sold – one after the other. However, I maintain that, in time, the huge budget deficits, the gargantuan monetary injections and negative real interest rates will lead to a collapse in the value of paper currencies. I therefore regard it to be prudent to own some physical gold.

The other question I am constantly asked is why I have a preference of owning physical gold versus gold mining companies. We need to distinguish between gold producing companies such as Newmont Mining and gold exploration companies, which are largely cash flow negative. The gold producing companies frequently have declining reserves and are faced with rising costs. The gold exploration companies are suffering from enormous financing cost increases or no access to new funding at all. Moreover, all resource companies are under threat from resource nationalism, which means either higher taxes or royalties or in an extreme case expropriation altogether. Now, whereas these events are negative for mining companies – and this is important – they keep future supplies under pressure (I suppose that within a year 50% of exploration companies will be running out of money and will have to stop exploration). As a result, I feel that physical gold will be relatively scarce and in time lift prices but not necessarily the mining stocks – unless precious metal prices really soar. Still, I concede that as of today, gold mining stocks having totally imploded, a strong medium term recovery potential does exist (see Figure 6). Noteworthy is that whereas gold prices have almost doubled since 2003 (even after their recent sell-off) the Gold

Bugs Index (an index of mining companies) is no higher than it was in 2003.

Figure 6: The Gold Bugs Index: Strong Rebound Potential!

Source: www.decisionpoint.com

Another source of questions relate to silver compared to gold. The silver bugs seem to be offended that I prefer gold over silver. However, the reasons for this preference are that it is easier to store 100 kg of gold than 100 kg of silver in a safe deposit box. In addition, it is easier to carry USD 100,000 worth of gold than USD 100,000 worth of silver (I am no longer that strong). Lastly, silver is like platinum and palladium more of an industrial commodity than gold. In the coming economic slump I find, therefore, gold, which is the ultimate currency, to be more desirable than the other precious metals. Having said that, I concede that in a precious metal's bull market and in a rebound phase silver, platinum and palladium as well as mining stocks could outperform physical gold. Still, I should like to point out that the best investment strategy is to keep things as simple as possible. I am not concerned that if gold increases by 20% silver moves up by 40%. What I am, however, concerned about is that in time the entire global financial system implodes because of massive defaults by governments. For this eventuality I want to own physical gold as my own "reserve currency." Central banks, especially the Fed, can simply no longer be trusted!

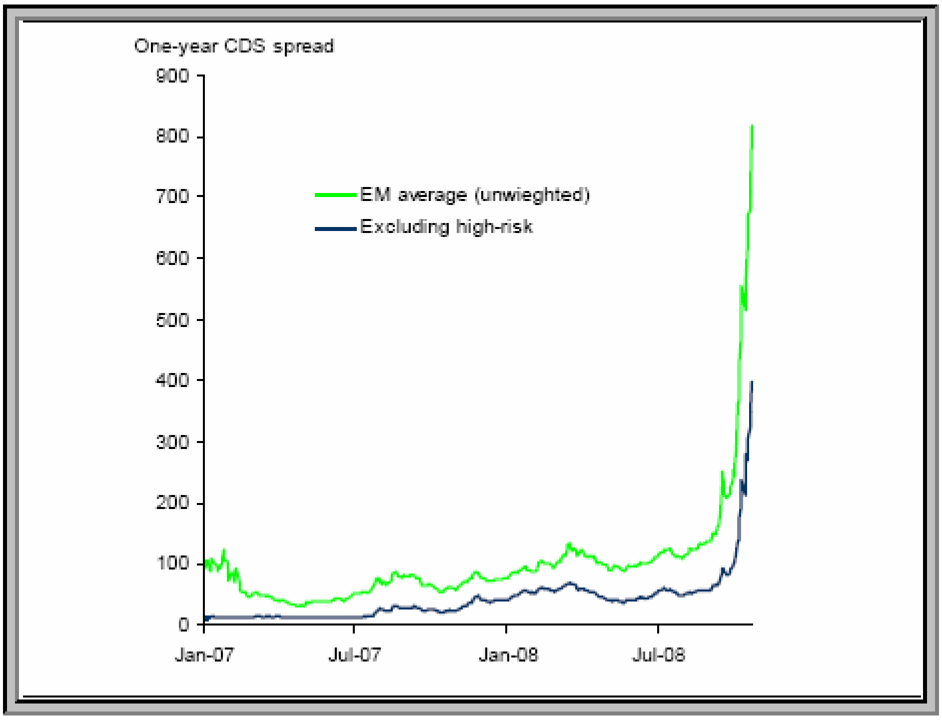
Many investors have been surprised by the strength of the US dollar and are now wondering for how long this strength will persist given the fact that fundamentally there appears to be little in favor of the USD. However, let me try to explain the dollar strength from a different angle (see Figure 7).

Figure 7: The Collapse of Chinese Shares as an Economic Indicator!

Source: www.decisionpoint.com

Grossly oversimplifying, let us think of the US as an economy that does not produce anything except services whereas China and other emerging economies are producers of goods (and oil) for the US. In an economic expansion (2001 – 2007) it is, therefore, logical for the producers to do particularly well, as increased consumption in the US stimulates production, employment and capital spending in China and other emerging economies. Best is to think of emerging economies (also the resource producers) to be some kind of a warrant on the US: more volatile than the underlying asset. However, this volatility also works on the downside. When the US slows down and goes into recession the following happens: Consumption declines in the US. US trade and current account deficit shrink. Exports from Asia diminish. Industrial production, employment, and especially capital spending are hit very hard. Demand for industrial commodities collapses. Resource producers (including oil producers) and their currencies get hit. Demand from the resource producers for consumer and capital goods contracts. Investment projects are canceled. Exports from Asia to emerging economies and Europe now also slump. International liquidity contracrs. CDS spreads of emerging economies soar (see Figure 8)

Figure 8: Credit Default Swap Spreads of Emerging Economies



Source: Jonathan Anderson, UBS

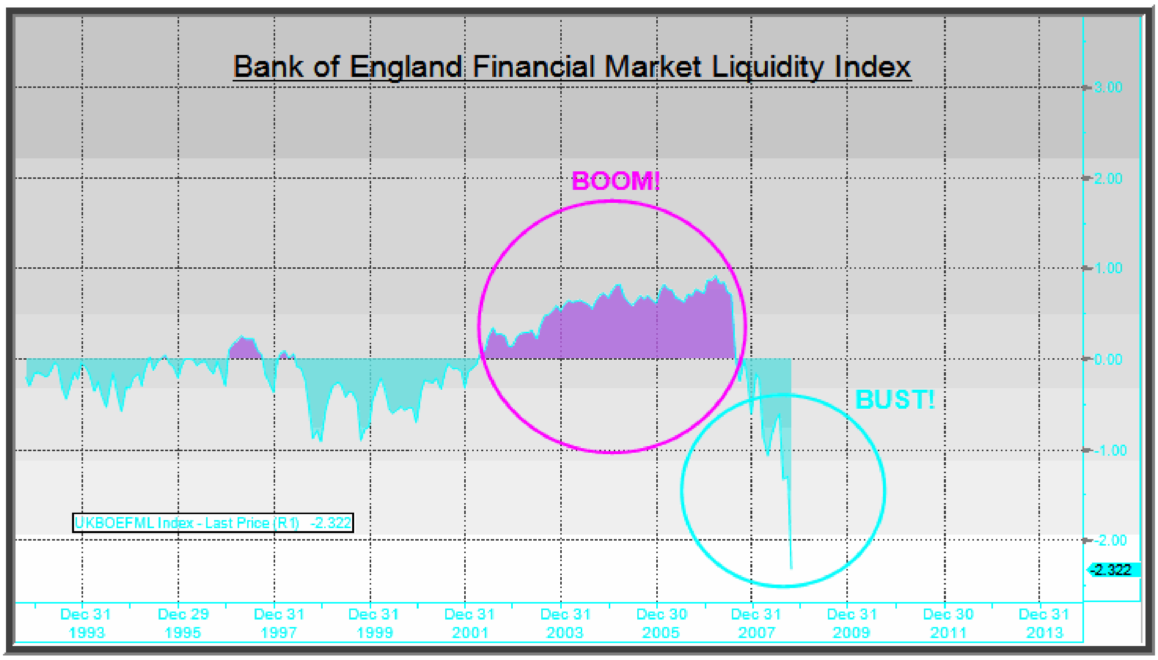
According to Jonathan Anderson, one of the most gifted Asian economists in my opinion, Figure 8 “shows the (un-weighted) path of 1-year credit default swap (CDS) spreads – i.e., the implicit cost of buying default insurance, which in turn is a measure of the implied default risk as priced by the market – across the emerging world. As you can see, everything was very, very quiet all through the recent global credit crunch … and over the course of the past few weeks the CDS market has simply gone ballistic.

This has been especially visible in countries like Argentina, Ecuador, Pakistan, Ukraine and Venezuela, where there is at least some objective risk of non-payment going forward – but as you can see from the blue line in the chart, even when we exclude these countries, the rest of the emerging world has still essentially seen a seven-fold increase in CDS spreads since the middle of September. And this is true for nearly every country individually in our EM sample as well. What’s going on? Has there really a seven-fold increase in aggregate EM default probabilities in the past few weeks?
From an economic point of view, of course, the answer is clearly ‘no’. **What is really happening, in our view, is a further tightening of the global liquidity screws as international deleveraging from emerging market positions continues**. You can see this in the continued sharp drop in emerging equity markets, as well as the ongoing dramatic spike in foreign-currency bond yields.”

I have to say that I have a more pessimistic view about the economic outlook of emerging economies than Jonathan, which leads me to China and back to Figure 7. I just don’t believe that a stock market drops by 70% without serious economic and financial causes. If the Chinese have learned anything form the US it is how to doctor economic statistics. From various indicators I follow and reports I read there is no way the Chinese economy was still expanding at over 8% annual rate in the third quarter. If the economy was growing at 5% the Chinese would be lucky (in my opinion a contraction is already underway). And if the Chinese economy is already in a mess just consider how much more badly less capital rich emerging countries must be doing! I am writing this report from Vietnam and along with all the other places I have recently visited business is down everywhere – not a little – but very considerably. The over-leveraged and imbalanced global economy is already in recession and it will get much worse as massive defaults and loan losses are likely to follow.

Having said that, we should also accept the fact that all asset markets, including - especially - equities and commodities, have become grossly oversold (see Figure 1, Figure 2, Figure 3, Figure 4, Figure 6 and Figure 7). In addition, whereas a year ago sentiment was very ebullient when stock markets peaked out, current sentiment could hardly be more negative. The exuberant sentiment of a year ago was reflected in the Bank of England's Financial Market Liquidity Index (FMLI), which was then at its highest in 17 years (see Figure 9). The FMLI gauges, according to Bloomberg, "how far a basket of nine indicators strays from its mean value. Those measures include gaps between bid-and-offer prices on bonds, currencies and stocks, the ratio of returns to trading volumes, and spreads in the credit markets." The Bank of England calculates the index twice a year, with the current level updated to Oct. 17. But whereas this Index was hitting all time highs last year, now it is at an extremely depressed level (as well as consumer sentiment).

Figure 9: Financial Market Liquidity Index, 1993 - 2007



Source: Bank of England, Bloomberg

Now, this does by no means imply that a new bull market is around the corner. But with all the fiscal and monetary measures, which are now flooding the financial system with liquidity, a temporary reversal of the present trends (down for equities and commodities and up for the dollar and Yen, and US government bonds) could occur at any time.

Still, there are in this respect a few observations I should like to make. The chart on the S&P 500 looks as of today ominous. Since late September the S&P 500 has been forming a "descending triangle" (see Figure 10). A break on the downside from this triangle would yield based on technical analysis a minimum target of around 700 for the S&P 500.

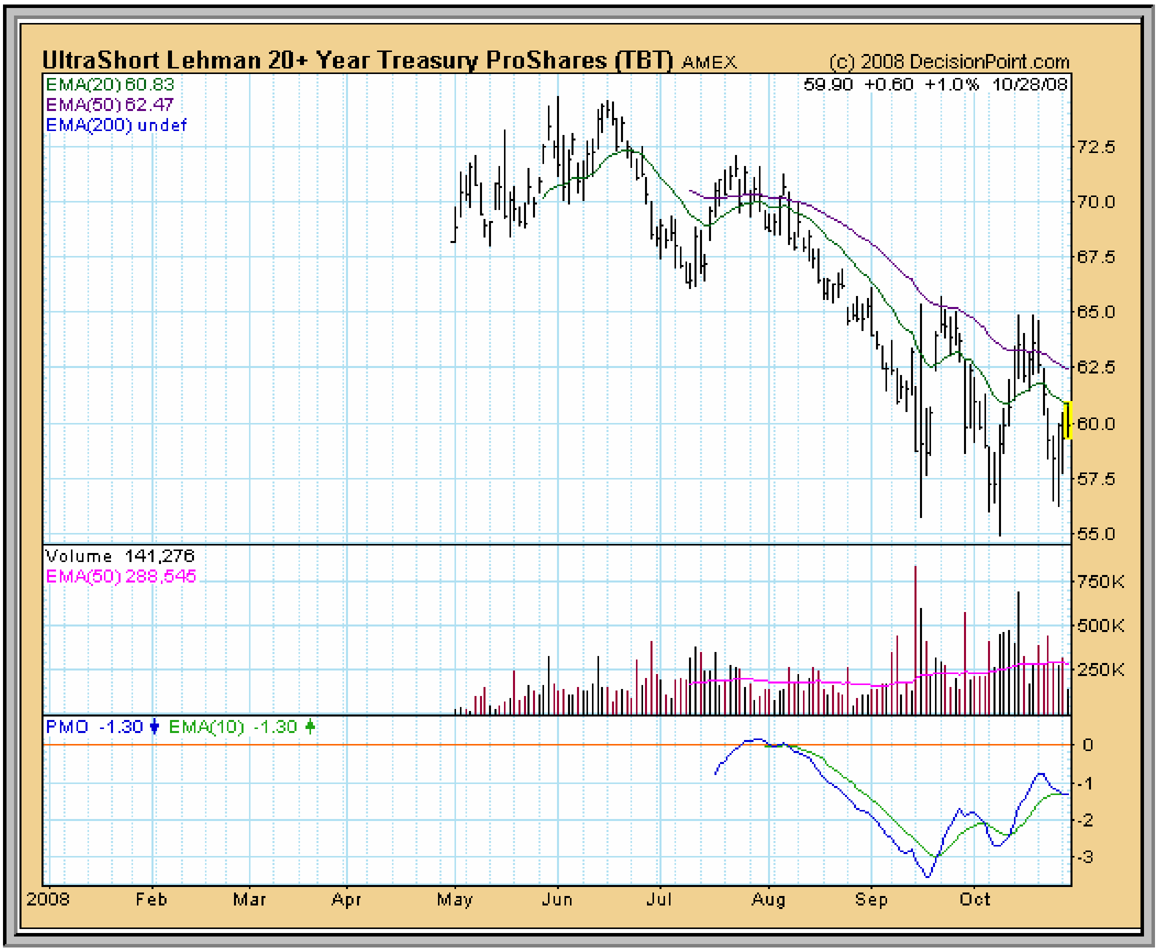
Figure 10: A Horrible Chart of the S&P 500, but….

Source: www.decisionpoint.com

However, if a breakout on the downside does not occur and the market reverses to the upside the countertrend move could surprise investors and really squeeze the shorts and lure back cash rich investors into the market. I would like to remind my readers that when based on some factors (technical and fundamental) a market is supposed to break out in one direction (up or down) and the breakout does not occur or fails, a very strong counter move usually gets underway. For what it's worth, I covered all my short positions before Tuesday's almost 900 points rally and increased my equity exposure to 10% of my assets. I would consider a move above 900 for the S&P to be a confirmation that a temporary low is in place.

Given the exploding government deficits the financing need will soar at a time of reduced international liquidity and declining current account surpluses in Asia. Hardly and environment for further sharp gains in long term US government bond prices (the last bubble, which has not yet been deflated – along with the ego of US economic policy makers who believe that they can control markets…). I would, therefore, look at establishing a short position in US Treasury bonds by buying the Ultra Short Lehman 20+ Year ProShares (see Figure 11).

Figure 11: Short US Treasury Bonds!



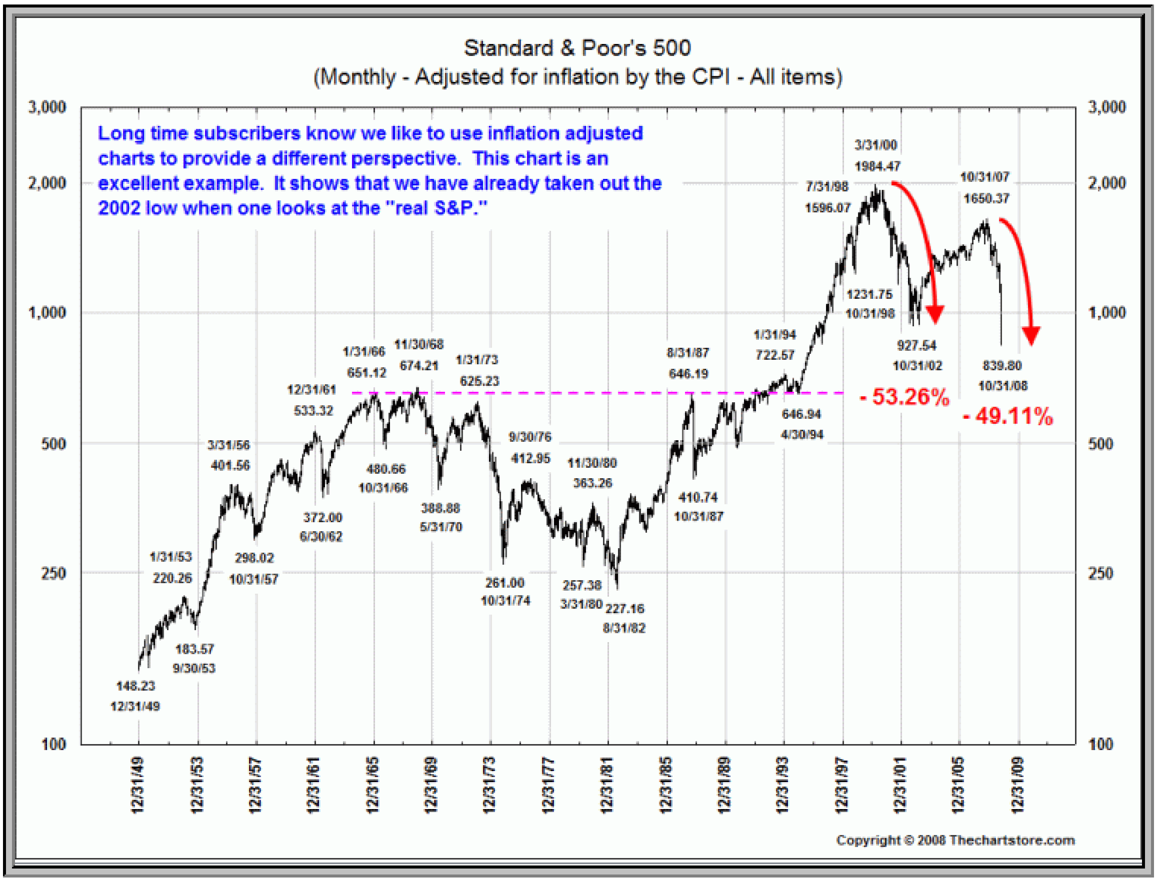
Source: www.decisionpoint.com

How would I play a temporary rebound in asset prices? I would buy any asset that has been slaughtered in the last three months. Commodities (see

Figure 1), commodity related stocks including oils (see Figure 4 and Figure 6), emerging markets (Figure 7), corporate bonds whose spreads have soared (see Figure 8) and the S&P500. I also suppose that when asset prices will recover US government bonds will decline.

Finally, I should like to make clear that the call for a temporary rebound (lasting three to six months and up by 20% or so) does not imply that we have seen the ultimate low – although I would not rule it out entirely in nominal terms. But it is unlikely that we are even close to a major low in real terms! In fact, in real terms (inflation - adjusted) the market would seem to have further considerable downside risk (see Figure 12).

Figure 12: S&P 500 Adjusted for Inflation



Source: Ron Griess, www.thechartstore.com

Above I have tried to explain that manipulated markets are even more difficult to forecast than "perfect markets," which tend to transmit information to the market participants most efficiently (but obviously not perfectly). As a result I prefer to refrain to make forecasts as to where the market will be in nominal terms in six months or one year's time. In real terms, my view is that we shall trend lower for quite some time.

On a separate note, email questions have almost become a plague and it will no longer be possible to answer all emails individually – although I always read them with great interest since my readers also provide me with all sorts of valuable information. But I simply cannot be the individual financial planner of all my readers. Moreover, I think that my stance toward investments in gold is now very clear. Further gold related questions will not be answered. I hope my readers will show some understanding for this.

Enclosed is a copy of the April 2005 Gloom Boom & Doom report entitled "The Performance of Gold during Inflation and Deflation." It is well worth a read.