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REMEMBERING THE FUTURE

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"Roses Among the Thorns: The Financial Road to the New Economic Regime"

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Introduction

Over the course of the last few weeks, we have witnessed the continuation of an equities market going sideways, rising concerns about the viability of the EU rescue package for the weak EU nations, concerns about Hungary, financial tremors in Spain (our website has briefs on the latest market developments), rising borrowing costs (Libor) in short-term EU markets, a contained flexibility-appreciation of the Chinese currency (RMB), calls by the Russian President for a new international currency regime, weak housing data, deflationary pressures, austerity measures in Germany, France, U.K., gold reaching all-time highs, and an overall environment of mistrust and risk-aversion. To that list of course, we could add the questions about the viability of the economic recovery based on manufacturing and employment reports, the rising credit risk of BP and the assets it holds, the additional expected bank write-downs in both EU and the US, as well as the comeback of some sovereign wealth funds and the cash they hold, some of which they desire to place in hard assets such as gold. The list is long and could be expanded. The focus should be on the rising uncertainty that seems to pre-occupy the hearts and minds of visible and invisible forces.

It seems that the investment community is looking for asset classes that have one basic characteristic: The investment itself will not be the liability of any counter-party. Such an investment class eliminates all counter-party risks. Guess what: Holding hard assets fulfills that basic attribute. No one can question the viability of such an investment, while they can easily question the viability of bonds, equities, let alone of toxic assets that fill the balance sheets of banks and other institutions such as pension funds.

In this issue we would like to continue the theme of international diversification we started in June (where our focus was on Canadian and African prospects), by stating few facts on two other places that may hold lower risks and better prospects in terms of return. Specifically, we will be exploring investments in Australian and Russian markets (always keeping in mind that in the medium term we expect both of the respective currencies to appreciate against the US dollar). However, before we explore those options, allow us to say a few things about the Spanish tremors and also explore investment options in silver which we estimate will enjoy collateral benefits from the rising prospects of gold. Silver, is mostly used in industrial applications while gold is mostly viewed as an investment class by itself. As we have explained in previous issues, we believe that a new bull phase is at work for gold. We believe that this new phase will show its bright face at the latter part of this year and in 2011 we will see significant gains in gold while other major asset classes suffer significant losses (especially if China collapses). The collateral benefit of such gold-rush will be that silver might lose its prospects as its demand for industrial purposes declines (double dip scenario), while due to its price and nature will develop its prospects as an asset/investment class by itself.

Let us start then…

On Silver

Throughout history and across civilizations silver has possessed an intrinsic value as a metal that can play the role of wealth preservation. Silver's prospective future is strong due to a mix of both fundamental as well as technical analysis and reasoning.

Silver could be considered as part of the metals asset class (along with gold and platinum) which finds its greatest value when the reliability of fiat currencies is questioned. As Figure 1 indicates, the crisis of 2008 served silver much better off, enjoying gains of over 400% since the beginning of the new century. The amount of silver that has been bought for investment and not industrial purposes is the highest over the course of the last forty years. In fact, the P/E ratio for SLV (common silver ETF and the largest global holder of bullion silver) is higher than GLD, its gold counterpart.

For investment purposes, we primarily recommend hard, bullion silver as its limited supply gives it a premium in value and experiences the best returns.

Figure1: Price of Silver

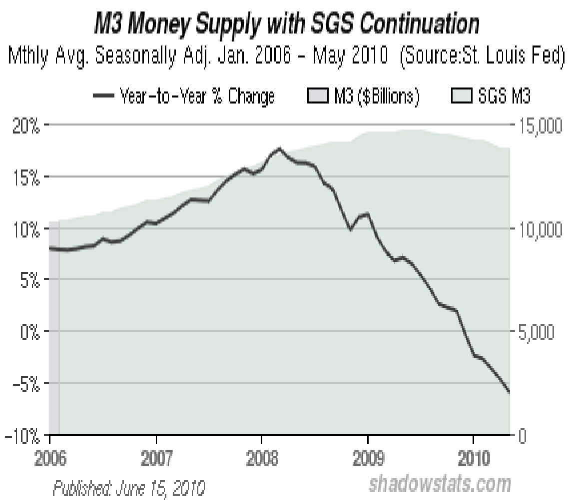
By now, our position and reasoning on gold has been articulated, emphasized and redeemed, with its outlook also promising as the World Gold Council's figures demonstrate that sovereign nations continue to accumulate gold and that other assets denominated in USD are being dumped, as the Wall Street Journal reported of the BRIC countries (Brazil, Russia, India and China) for the month of April. Silver and platinum are the other precious metals that are regarded as safe havens in the midst of crisis, but silver is mined at much higher rates, which is one reason for its much lower price.

However, while we advocate gold as a promising destination for investment, we believe silver is undervalued and boasts significant investment opportunities. For one, silver hasn't even approached half the level of its all time high of $50 in 1980, despite the tumultuous damage caused by this the worst crisis since the Great Depression. This discrepancy calls for a corrective action.

Gold is preferred by investors (especially sovereign nations and their central banks who have significant holdings of dollar and Euro paper-assets) compared to silver. The accumulation of gold for investment purposes is driving the price of gold up significantly. This preference and extensive buying on behalf of the globe's largest and most influential institutions has grossly exaggerated the gold-to-silver ratio, the number of ounces of silver that need to be bought for one ounce of gold. The historical average, and benchmark, for this ratio is 16:1; however, since 2006, the ratio has not been below 45 and is currently at 65. This price discrepancy – taking of course into account the relative production levels of silver and gold – points to an expected silver appreciation. If the above facts are combined with some indicators of silver shortage and a possible stoppage of an alleged silver-price manipulation, then we could say that silver has the fundamentals – and after passage of the financial regulatory bill even the technical characteristics – of a historic rally.

The anticipated hard-asset rally that will uplift the prospects of gold and silver can be foreseen in the money supply figures. The latter – as seen from its broadest M3 perspective – has been tumbling and points to the upcoming double dip recession and major crisis, which cannot be forestalled due to austerity programs, debt issues, central banks suspension of their toxic-asset acquisition programs, the anorexia for more debt, as well as the inability of banks to identify credit-worthy customers.

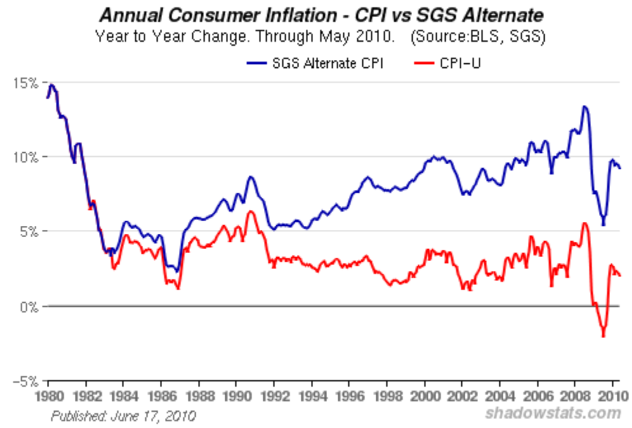
Figure 2: Money Supply Growth rate



The contraction of the money supply resembles the one that took place between 1929 to 1933, and is anticipated to have deflationary effects in the beginning due to global slowdown – as we have explained as recently as this past March in our newsletter – but eventually will lead to substantial inflation. The latter will be one of the main factors for hard assets' appreciation.

Actually, if we used the same methodologies used in 1980 to calculate the cost of living (CPI), then the following figure may be eye-opening, since it shows that the shifting of the methodology used, has covered up true inflationary pressures. The latter will be unleashed as the fiat currency starts its wild circulation in order to fight a global relapse into recession.

Figure 3: Actual Inflation vs. Reported Inflation



Silver's low price will be a factor investors cannot ignore for much longer, especially as individual investors looking for both an inflation hedge as well as solid return prospects in a climate of uncertainty. "Gold's little brother" (as deemed by Commerzbank) could potentially perform better than gold, in percentage terms, as it has been forsaken to an extreme when compared to gold. If gold were to rise to $1600 and the gold to silver ratio to be cut to 50 (if e.g. shorts cover their positions and investors flee to silver due to its low price) from 65 nowadays, then we would be looking at a $32 price for silver, implying that gold prices would have risen by about 30% while the price of silver would rise by 68%.

Despite the asymmetries in price and circulation of silver, the metal has still appreciated substantially and holds a very bright future as the U.S. Mint sold record levels of silver coins last year. We are of the opinion that this ratio is just one indicator which demonstrates silver's enormous potential in the midst of economic turmoil. A correction in the gold-to-silver ratio will eventually come around in the long term and we believe this correction means an appreciation in the value of silver to a large degree. However, silver is inherently more volatile than gold given that it possesses more industrial and consumptive purposes compared to gold. Yet its role as a precious metal will outperform any losses suffered from a decline in industrial demand, as silver is versatile in nature. One threshold to watch is the $25 mark; once silver crosses that point its value could rise sharply. The chaos in the Eurozone and the currency's deteriorating position will increasingly raise the demand for precious metals and hard assets in general and silver is poised to enjoy the ride as an inflation hedge. The Chinese potentially could play a significant role in the upward trend - especially if they recall their history when the yuan was tied to silver - as they are looking to diversify their vast US paper-holdings.

One further factor to consider regarding silver's future resides with the role of the Commodity Futures Trade Commission. Just a few months ago, Chairman Gary Gensler announced that his Commission, as well as the Department of Justice, would investigate possible price manipulation in the precious metal industry, specifically silver. Some major institutional investors, and some of the largest holders to bullion silver and its operational infrastructure, have been shorting the silver market and artificially depressing the price. Mr. Gensler and the CFTC are expected to announce position limits for institutions at some point in the future which will prevent such manipulation from disturbing market prices as based on fundamentals. Given silver's quality as an inflationary hedge, its discrepancy in both price and tonnage in circulation, the new CFTC policies could dramatically change the face of the commodities industry, allowing for market forces to reign supreme, which should add up to a substantial appreciation in the value of silver. To that we should add that the US reserves of silver are gone, and the Fed itself as well as other central banks may start compiling silver as part of their reserves, let alone that the US government is one of the world's largest buyers of silver for their coin programs.

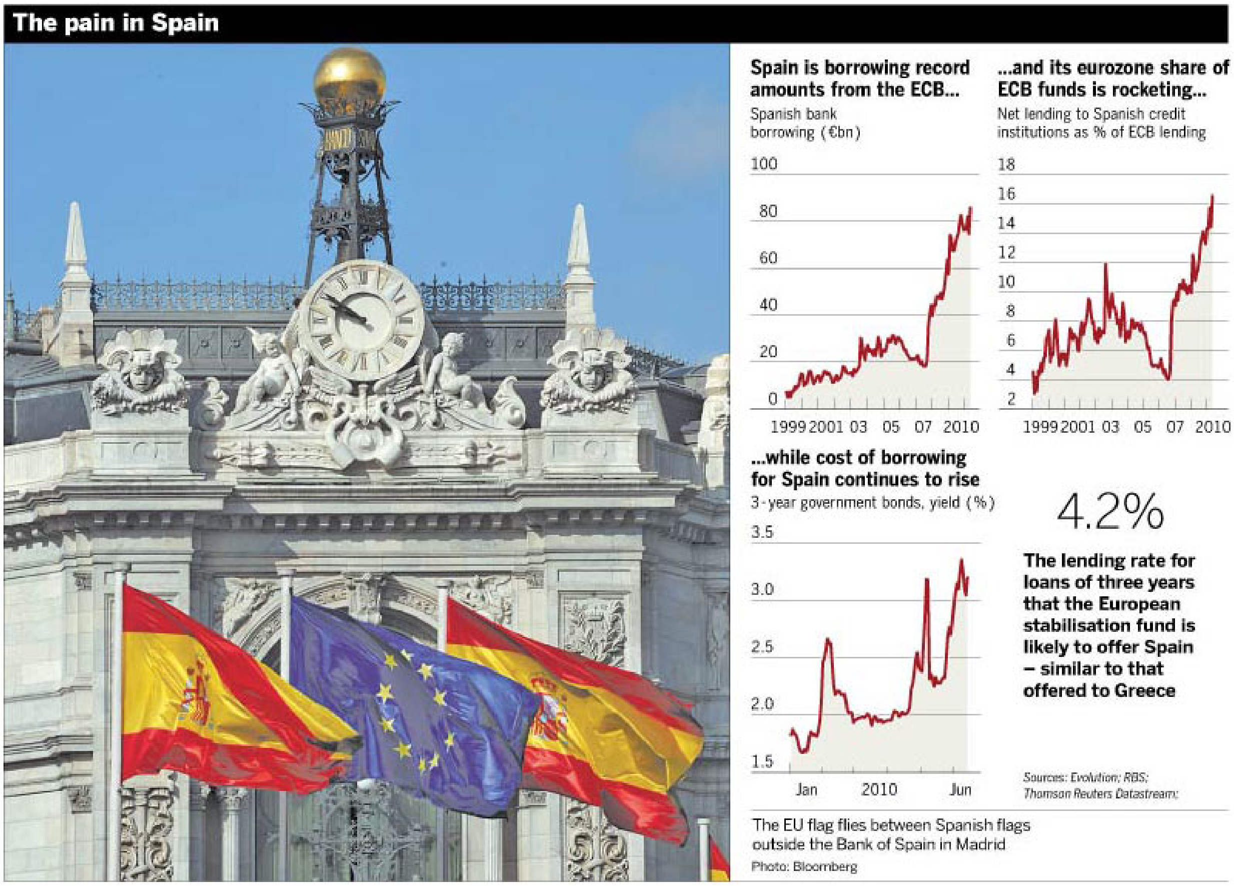
In recent commentaries we have posted on our website, we have been warning about an impeding crisis, especially in 2011. As financial panic spreads, a stampede may be created where institutional and individual investors will seek refuge to metals and other hard assets.

A few comments on Spanish Upcoming Tremors and its European Implications

We are hearing that the Spanish auction of 10-year notes went well. We choose to differ on the situation in Spain. Spanish banks have significant problems; just these past weeks they borrowed from the European Central Bank (ECB) at record levels. Specifically, they borrowed over $100 billion US dollars. Not even in the days of the Lehman Brothers collapse did they not borrow that much! They have been absorbing more than 16% of all ECB loans. This percentage is disproportional to the size of the Spanish banking sector and points to the fact that tremors are coming and that the international capital markets are not lending to Spanish banks. The auction on June 17th, was not absorbed by the international markets, but rather by domestic customers.

The tensions in the Spanish banks will keep absorbing ECB's liquidity from the rescue package (close to $1 trillion) that the EU and the ECB along with their new guardian a.k.a. IMF, put together. The problem is that once they start tapping that fund, they can no longer contribute to the fund (per regulatory framework), which will make the EU problems worse. Short and long-term yields are rising in Spain. As the following graphs show, the short term spreads and cost of borrowing has almost doubled since January.

Figure 4: Spain's Financial Troubles



The EU flag flies between Spanish flags outside the Bank of Spain in Madrid
Photo: Bloomberg

The potential Spanish banks' crisis would shake European and global markets. When banks cannot find access to funding, the corporate structure in the country is shaken. That could create waves of business failures, which in turn will raise the already high unemployment rate (the official rate is over 20%), and will reduce spending, making a double dip almost certain. However, the problem would not stop there. The waves and tremors will transfer to other EU countries, and we suspect that the next stop will be Italy, with its already high debt level that is close to 120% of GDP.

Weak banks and weak government finances make a lethal combination. The Spanish and Italian banks have big exposures to the real estate sector. Once the tremors start, the cost of borrowing for the country will increase, the cost of insuring the country's debt (credit default swap, CDS) will also increase substantially. We agree with the Chairman of the Eurozone Jean-Claude Junker that "Spain is not Greece". We would only differ and say that Spain's problems would be much more serious than Greek problems.

According to the latest estimates by RBS officials, the total amount of Spanish liabilities that is held by investors outside the country exceeds $1.8 trillion. Such a huge amount represents a multiple of Spain's GDP. Reports in the Spanish press on June 16th stated that the IMF, the ECB and the US Treasury are preparing an emergency plan. What is the next stop for the Euro? Your guess…

The continuing tremors in Spain force investors to look elsewhere for their investments. One such place is Australia.

The Australian Prospects

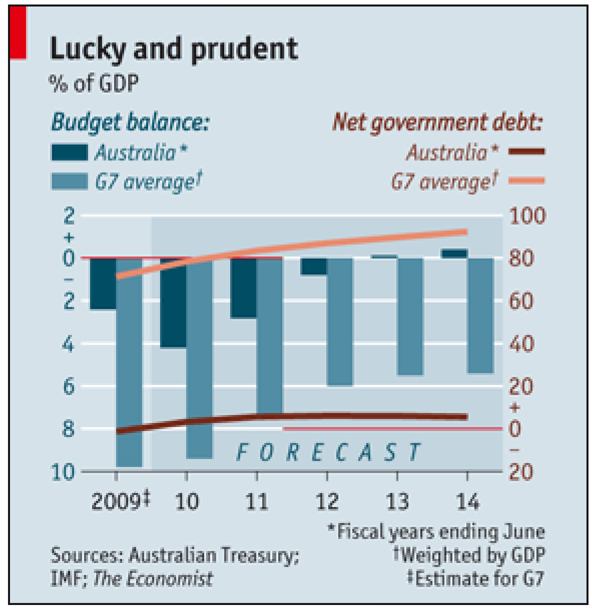
Like Canada, Australia's financial system rebounded quicker than most developed economies from the credit crisis of 2008, evident in the Central Bank's interest rate policy since last year. Australia was able to rely upon its rich endowment of commodities to sustain growth in the aftermath of the global financial crisis as its minerals gained in value and its energy exports fueled China's fiscal stimulus measures. While larger and more sophisticated economies contracted in 2009, Australia was able to squeeze out a 1% growth rate and by the end of 2009, began winding down its loose monetary policies.

We mentioned in a previous issue of how Canada's interest rate hike was emblematic of the economy's emergence from a rough 2009 and its avoidance to toxic asset/securitization exposure that terrified the economies of Europe as well as the United States. Similar things need to be noted for Australia's financial system. Standard and Poor's rates Australia as the soundest banking system in Asia/Pacific. To avoid the expansion of asset bubbles Australia has raised interest rates six times since October.

The reaction of markets was a fear that higher financing costs could stifle growth and the business climate. As a result, Australia's currency saw sharp declines, especially since the beginning of May and in our opinion was vastly oversold because Australia still possessed solid fundamentals. For starters, the IMF has forecasted growth for Australia to reach 3.3% in 2010. Its first quarter GDP growth this year was the fastest in over two years according to the Financial Times. Add in Australia's hard assets, its high capacity utilization (a measure of efficiency), and its low inflation demonstrates the country's favorable investment climate.

While the approval rating of the former Australian prime Minister Kevin Rudd forced him to reassign his position, the policies of the Australian government seem to have strengthen their economic fundamentals. Specifically, the very low defcit of $27 billion, is expected to turn into a surplus in 2012. Their debt to GDP ratio is so low (6.1%) that is considered negligible. The above figures can be seen below.

Figure 5: The Australian Prudent Record



Moreover, Australian unemployment is falling steadily, since it peaked at 5.8% last year. Even opinion polls show that 86% of Australians are optimistic about their economic future. Australia's possession of energy and mineral assets, along with its close trade ties to China, spell a formula of positive expectations for the rest of 2010 (they just signed multibillion dollar worth of trade deals with China and stand to benefit substantially with a yuan appreciation) but offers even greater opportunities further down the road.

It is important to remember that the global financial crisis that shook the world has led world economics and politics into a watershed moment. The future economic system and its foundation, in an attempt to ensure stability through minimizing dependency, appears that it will use multiple currencies and assets as an anchor and weight. While we are currently early on in the process, the preliminary rumblings are that Australia and its dollar will play a more influential role in a new system, as a reserve currency, due to its endowment of hard assets and its positive ties to the emerging powers who will command a greater role in global affairs. Until a new system is in place Australia and its respective hard assets will experience in volatility. Thus, patience will certainly be a required virtue but if exercised could prove to yield good dividends.

Conclusion: A Note on Russia

For those investors who are willing to take risks and also exploit a scenario where Russian sweep away Chinese assets – if China collapses – then, a Russian fund might be the way to diversify risks while enjoying higher returns. Moreover, even for an investor who has long-term perspectives, Russian assets could pose a viable destination of investment. While we believe the Australian Dollar (AUD) will possess a greater role in a new economic system, its influence will still be minor. Russia on the other hand may be part of the emerging powers that will have a strong hand at the grand table of global affairs in the coming years.

Opinions differ greatly over the prospects of the Russian economy. At the beginning of the century, the Russian economy was grouped, by Jim O'Neil of Goldman Sachs, with the rising giants of China, India, and Brazil to form the BRIC economies whose soaring growth was elevating their place in the global system and attracting foreign investment from all over. With regards to Russia, the institution of a tax system, stronger property rights (although concerns in this area are still strong), and a reorganized energy system brought the country wealth and a higher standard of living that millions had never experienced.

Other economists, such as Arthur Aslund, are more pessimistic on Russian investment prospects. Citing state intervention, energy dependency, wasteful investments, and a banking system in poor condition, Mr. Aslund believes Russia doesn't belong with the rest of the "BRICs". He also points to Russia's enormous contraction in 2009 (mainly due to the collapse of oil) as signs that Russia's economic system is behind in its development when measured up against its comparable partners.

Yet as stated earlier, this is a watershed moment in the landscape of the global financial and economic system and when all the cards are laid down Russia could greatly accrue more wealth and influence because of its huge reserves of assets. Minerals, oil, and gas make Russia a global player and a dynamic force in any new economic system. Moreover, Russia has extensive diplomatic and commercial relations with numerous Central Asian nations, putting them in control of additional energy and mineral deposits in the region. In addition, Russia's importance and relationships with Europe, China, and Turkey compound its economic vitality and significance.

Thus, the downturn of 2009 in Russia provides investors with a prime time for entrance. Industrial output grew nearly 6% year-on-year in March of 2010, adding credence to the belief that 2009 is in the past for Russia and that 3.5% growth could indeed be attained in 2010. Further proof is that retail consumption rose for the fourth month in a row as of May, assisted by a rise in the ruble over the same period of time and an increase in fiscal expenditures in the wake of the crisis. Despite a surge in government spending, Russia still possesses a low debt to GDP ratio.

Near term gains in Russia are indeed possible with these positive indications of output, growth forecasts, and low debt, but it's the long term for which Russian investments should be pursued. President Medvedev announced bold aspirations earlier this week for the development of sophisticated capital and financial markets, which Russia is in dire need of. The ruble is almost certain to take off in importance with the installation of any new currency regime. Given the wealth of assets Russia possesses, its ties to current and rising powers, and large holdings of foreign exchange, Russia is destined to become an even bigger player within the next few years. Russia's long-term prospects are bright as we see a return to an asset-dominated financial system on the rise; if investors are willing to post long-term patience and experience volatility on the ride to the future, Russia offers large gains and returns.

It seems that we may be approaching the beginning of a volatile period in world economic history, and the ride might be painful, adventurous, and full of suspense.

Please enjoy the ride!

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