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REMEMBERING THE FUTURE
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Stone-by-Stone Arriving at the Summit: Asset Allocation in 2011, and the Renaissance of Destructive Creation in the Midst of Financial Markets Hubris

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Introduction

In the next few weeks, we are making our transition to our new name, Blacksummit Financial Group Inc. Stone-by-stone, we are arriving at a summit where the financial world will understand the significance of hard assets, such as black gold and precious metals. The end of 2010 and the beginning of a New Year give us all an opportunity to review facts, contemplate presuppositions, and plan for the future. This past year the financial crisis unwrapped its next phase through the European debt and fiscal crises. Those crises –along with the financial crisis that started in the US in the summer of 2007 - reflect the simple reality that insolence financed through credit creation without proper productive capital resources and increases in productivity will always lead to hubris and an arrogant financial capital that unless it is restrained will ruin economic progress, rationality, and democracy.

The centralization of money creation that is delinked from proper anchors that hold value throughout time will inevitably lead to catastrophic chaos. The middle ages – which we unfortunately call the dark ages – were in reality the first age of Renaissance that planted the seeds for prosperity and growth. The middle ages did not produce the plague. Improper money creation brought in the plague that led to the death half of Europe's population. Unanchored money creation – without understanding the role of wealth creation – destabilized the economic, social, political, and cultural bases of the first Renaissance and with that destruction the hopes of millions died. The Eurozone, via its fiat money creation machine, centralized the money creation process in the EU without heeding the economic laws of prosperity. The result has been a currency that has no identity.

Of course, the situation in the US is not that much better. The Fed seems to react rather than lead. Its printing machine shoots pre-emptive strikes to feed the monster of private and public debts. In the grand scheme of things we could envision an asset allocation that focuses in hard assets, energy and good dividends of solid companies with a possibility of taking small position in the following: Shorting financials and possibly China – while hedging the latter with yuan positions - and slowly moving into selective funds related to real estate after the first quarter of 2011. There you have it then. Heavy emphasis on precious metals and other hard assets, energy investments, good dividend plays and sporadically two or three plays in other asset classes. However, we will devote this newsletter to precious metals, since we believe that they can make major breakthroughs in 2011.

Why More Exposure to Precious Metals in 2011?

We consider precious metals to be money that can preserve value. The printing machines of central banks debase paper money, and thus gold - which throughout history was considered money whose value cannot be eroded through the printing presses – should be considered as the ultimate place that can preserve wealth in times of financial turmoil. Moreover, precious metals in general and gold in particular provide a hedge against currency weakness. As we have written before, we anticipate that all currencies will lose significant value against precious metals. Thus, it might be irrational to try to speculate which currency will gain, when all of them are being debased against hard assets.

In traditional literature precious metals protect wealth against inflation. While the latter has

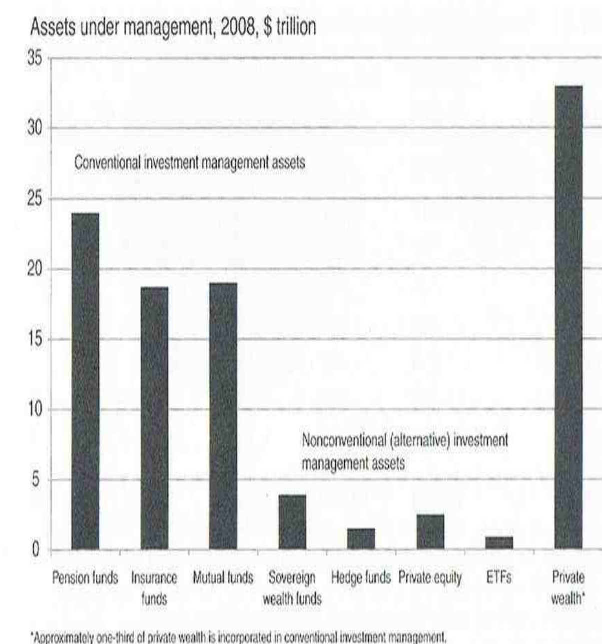
been tamed for the time being, we would not be surprised if inflation eventually picks up within two-three years. Taking a position against that possible threat, could only be considered a wise move. Moreover, it is not only the financial turmoil that we should be protected from. It is also the political instability that is been brewing around the globe. In a commentary to be posted soon on our website, we are of the opinion that in times like these we may need an aisimnitis (αἰσυμνήτης) who in the ancient Greek times was given the authority and the accountability to make things right. Precious metals always gain in times of political and economic upheaval.

However, the above do not represent the main reasons for which we consider that in 2011 positions in previous metals should be increased. The previous discussion of financial-economic and political instability (which may also feed social instability) serves as a prelude to the anticipated moves of fund managers. The instability will become the cornerstone of seeking refuge in safe heavens. Shayne McGuire published an excellent book this year titled Hard Money. We subscribe to his rationale and arguments and have adopted a good part of his analysis, which we found sound and well-articulated. We anticipate that in such an environment managers will start shifting funds from traditional asset classes such as equities and bonds into precious metals. Once this takes place, then demand and supply dynamics will come into play. In order to understand the consequences we first need to comprehend the value of all assets under management globally and more particularly into which instruments those assets are held.

In a nutshell, there are about ninety trillion dollars under management of which precious metals represent slightly more than half of one percent (see figure 3 below). The global flight to quality will push precious metal prices higher simply by the fact that they are of limited quantity and the central authorities cannot print them. In such a case and assuming that a very tiny fraction of a traditional portfolio will be invested in precious metals, the price movements of gold and silver primarily could rise at an exponential rate, and repeat the moves of the 1970s, when on average these precious metals experienced an increase of more than 250% per year. The historical precedent exists, and the circumstances are even more dire than in the 1970s, however we do not think that such geometric annual increases will take place. We are of the opinion that annual increases of 35-40% are warranted under the current global economic conditions, and therefore, we suggest that portfolio exposure to precious metals should be increased.

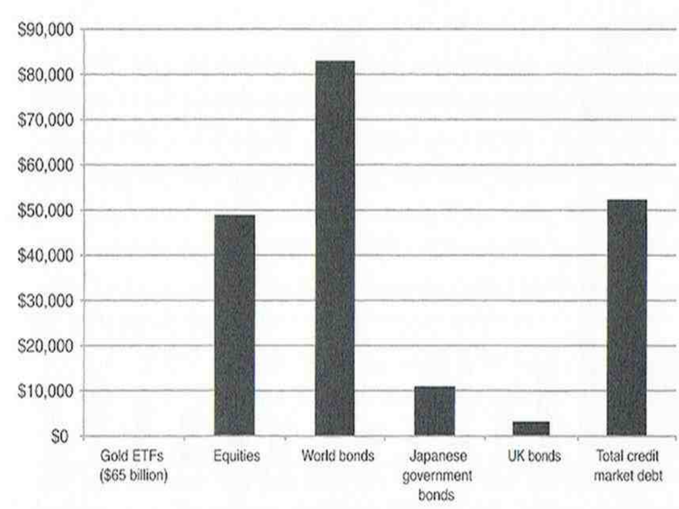
The following figures show the size of assets under management around the world, the size of major financial markets, and the relative position of gold as a percentage of global financial assets.

Figure 1



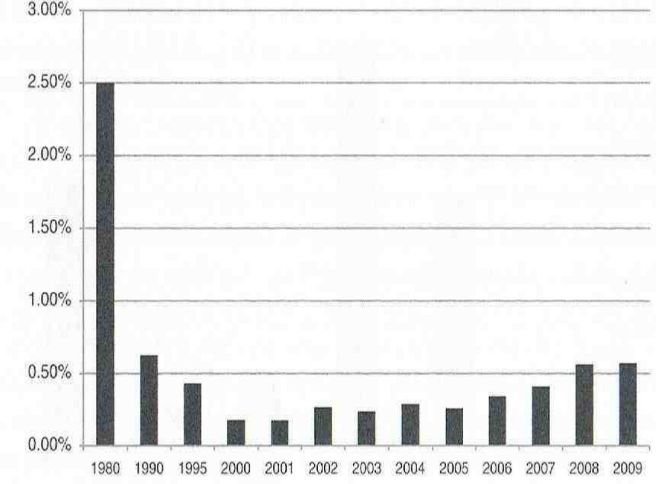
Source: International Fund Management Industry

Figure 2: Size of Financial Markets



Sources: International Fund Management Industry, Bloomberg

Figure 3: Gold as a Percentage of Global Assets



Source: CPM Group

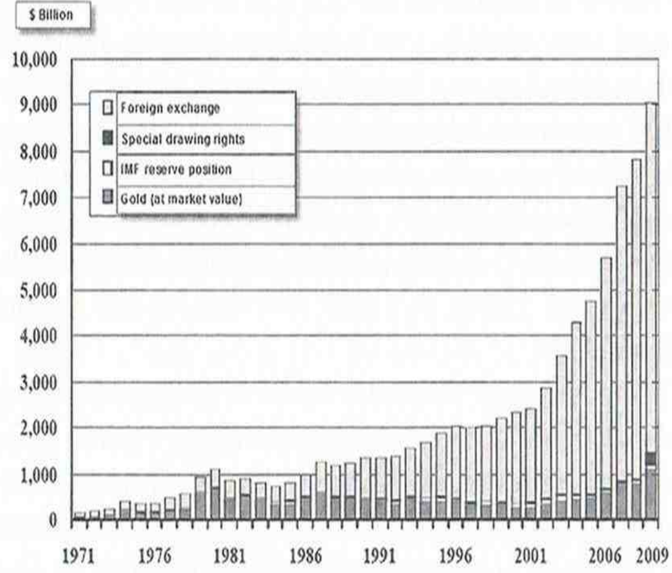
Under the distressed economic and financial scenarios, it would not be a surprise to us if managers shift to the allocation of the early 1980s, where as it is shown above close to 2.5% of assets were held in gold. Such a move happening over the period of two-three years could produce the rise in precious metals that we suggested earlier.

Our position is that the advertised and anticipated recovery is covered up by debt explosion, which makes it an illusion, forcing investors to amuse themselves to financial death. In figure 2 above, we observed that there are more than 80 trillion of bonds circulating around the world. This paper wealth may come into question in an environment where safety and wealth preservation is of primary importance. In the 1970s tremors that were far less significant than the ones that we are currently suffering from made investors and markets skeptical of fiat currencies and financial investments. Thus, they turned to tangible investments where an intrinsic value can be assigned.

We acknowledge the fact that traditional metric valuations such as discounted cash flows and P/E ratios are not applicable to precious metals investments. However we have a dual phenomenon for the first time in financial history: First we are going through financial instability; and second, for the first time precious metals have started to be considered an asset class. Historically, precious metals were considered money that can preserve its value and for which paper receipts were issued (i.e. currencies) which in turn could be redeemed for precious metals. Moreover, governments held steady the exchange rate at which currencies were exchanged for gold and silver, and thus such policies prevented precious metals from being an investment class.

The surfacing of precious metals as an asset class by themselves is also combined with the fact that the rising Asian nations have a culture that is fixated on gold and silver. Their fast rising savings rates are also translated into higher demand for precious metals (let's not forget that almost half of the annual 2,500 tons of gold production is taken up by the jewelry and the industrial sectors), while at the same time central banks are reversing their 1990s trends and have started accumulating gold reserves. We consider it a tragedy that the reserves of central banks are made up of fiat money, because in a case of global crisis where the markets reject fiat money, only catastrophic chaos could be seen. Therefore, we anticipate that the trend where central banks are changing the composition of their reserves in favor of more precious metals will continue and will contribute to the rising prices of precious metals.

Figure 4: Monetary Reserves since the 1970s



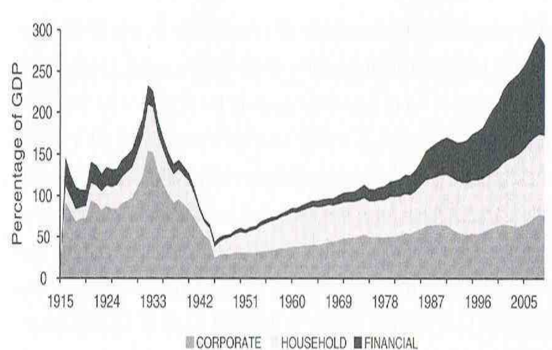
Source: CPM Group

The figure above shows us two fundamental things: First, central banks kept printing money, expanding the monetary base and allowing the over-extension of credit (with doubtful a.k.a. paper collateral); and second, this credit and money creation changed the makeup of the central banks' balance sheets, where the dominant form of reserves became fiat money without any intrinsic value and without any monetary anchor. The reversal of such a trend is

already underway and should contribute to the new landscape for precious assets.

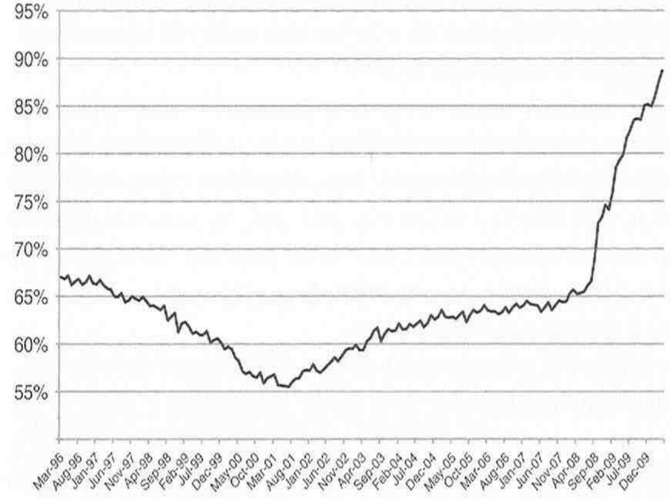
Such reversals as the ones described above, may prove to be cathartic in the sense of cleaning up balance sheets, destroying cancerous financial cells, and creating a sound basis for growth, prosperity, and investments. In a landscape dominated by debt and debt instruments, the markets need a surgery that will assist them revaluing assets on a more realistic basis where prosperity is earned and is not merely bought on credit. The explosion of the culture of debt as the following two figures show, require deleveraging in order for the foundation to become steady.

Figure 5: U.S. Debt as a Fraction of GDP



Source: Federal Reserve Bank

Figure 6: U.S. Public Debt as a Fraction of GDP



Source: Bloomberg

We may soon be witnessing a tragedy in the financial markets. The degradation of central banks' balance sheets (when toxic assets are taken in exchange for cash and credit) will be combined with the deterioration of public finances (where federal governments bailed out banks, insurance groups, and skyrocketed the deficits) which in turn may force the governments print their way out of this mess, creating inflation and effectively jointly debasing their currencies. If we now add to the above figures the unfunded liabilities (where on average an additional 200% of GDP is due) and the graying of populations from Japan and Europe, to the U.S., then we understand that we have in our hands a financial bomb that needs to be defused over the next 4-5 years. As long as the diffusion does not take place the dynamics exist for precious metals' appreciation, because precious metals cannot be produced at will, and the historical precedent is for precious metals to start climbing to the summit once uncertainty and instability become the modus operandi.

Financial Asset Valuations and the New Economic Landscape

In the landscape described above, investors (institutional and individual) will move away from debt instruments (bonds) and into more tangible assets. Such a move will raise interest rates, and assuming even the basic CAPM (Capital Asset Pricing Model), the higher risk-free rate of interest will increase the required returns, will reduce paper asset valuations and may create havoc in the markets. Given the very minimal size of the precious metal allocation relative to equities and bonds, even a very small change in the asset allocation has the potential of creating very large changes in the value of the precious metals (which is the essence of the catastrophe theory as we described it in our November newsletter).

The valuations that will be produced by such shifts have the potential of being unprecedented for precious assets given the size of the bond market as the following table and graph show.

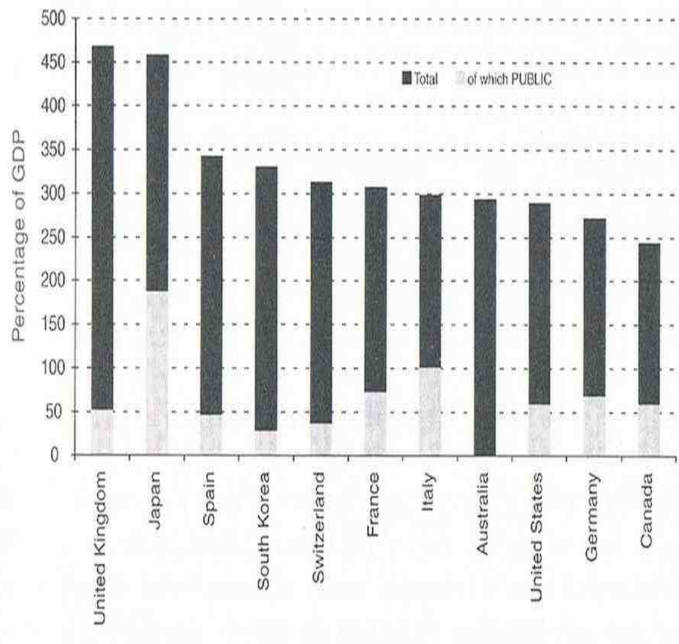
Figure 7: Size of Global Bond Market by Country of Issuance

	Total	Public	Financial	Corporate
United States	24,622	7,888	13,819	2,914
Japan	11,077	9,113	1,197	767
Italy	3,262	1,780	1,055	427
France	2,921	1,437	1,160	324
Germany	2,593	1,364	929	300
Spain	1,746	540	543	663
United Kingdom	1,223	827	378	19
Canada	1,035	670	254	110
Belgium	553	373	144	36
Others	10,634	5,795	3,795	1,045
World	**59,666**	**29,787**	**23,274**	**6,605**

Source: Bank of International Settlements

It is obvious from the table above (which excludes future unfunded liabilities for pensions and health care of an aging population) that just the U.S. and Japanese bond markets (which together make up almost half of the global debt portfolio) will be unsustainable in just a few years, especially when we take into account the fact that public funds were used for the bailout of private institutions. It is our opinion that the nations' credit cards have been maxed out, and the necessary rebalancing will be painful not just in terms of belt-tightening but also in terms of paper wealth destruction. The debt to GDP figures are simply unsustainable and the figure below is indicative of that fact.

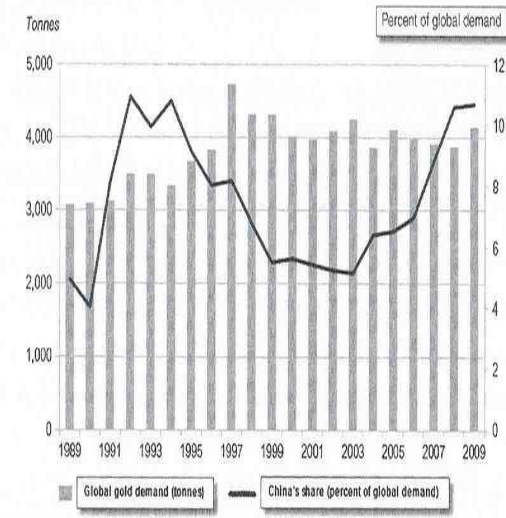
Figure 8: Debt-to-GDP Ratios



Source: Morgan Stanley

As demand for precious metals rise, and as Asian nations start playing a more vital role in the game of global growth and wealth creation, the necessity for an anchor as the basis of valuations will become even more dramatic. The following figure shows that the Chinese demand for gold as a percentage of global demand has more than doubled in less than seven years.

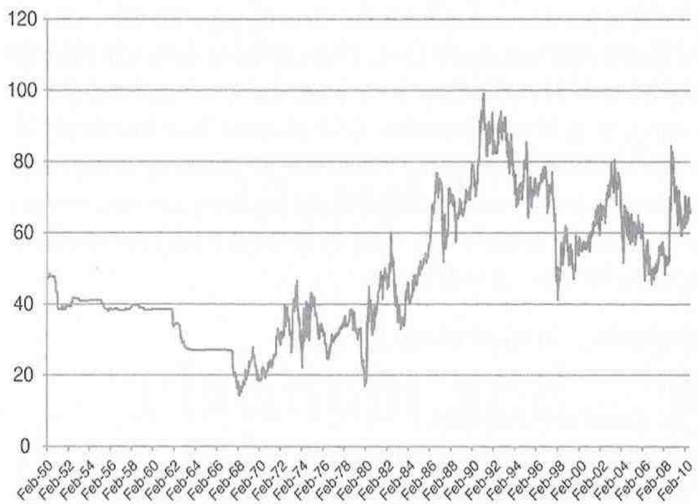
Figure 9: Chinese Demand for Gold as a Percentage of Global Demand



Source: World Gold Council

Given the expected volatility and reduced paper-asset valuations we anticipate that at least 1.75 trillion dollars will go into precious metals and other hard assets. Such a move will reduce the total capitalization of world markets and will cause the prices of the hard assets to increase dramatically since the tonnage (especially for gold) is not there to meet the higher demand. That may cause a shift in investors' interest into silver, platinum, palladium and other hard assets, and we are of the opinion – as we wrote last July in our newsletter – that silver has the potential of rising faster than gold, especially given the historical anomaly in their respective prices, where the gold-to-silver ratio is at historical very high levels, as the following figure demonstrates.

Figure 10: Gold to Silver Ratio



Source: Bloomberg

Conclusion

The precious metals are just starting their way up to the summit. While walking stone-by-stone in order to arrive at the valley where the summit may be seen from a distance investors should once again examine the particulars of their financial investments and ask the hard questions as to whether paper wealth is real wealth that is anchored on intrinsic values that cannot be manipulated and debased from the manipulations of the printing machine and of the realities that instability and uncertainty inflict to the markets.

Once again, ode to hard assets as we start our climb to the summit!