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REMEMBERING THE FUTURE
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The Pathology of an Impending Crisis: This Time is Truly Different!

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Introduction

In Business Schools they teach that they are two basic approaches to communication, namely the BIF (big idea first) and the BILL (big idea a little later) approach. Allow me please to use the BIF approach. A major crisis is brewing that may be like no other crisis we have experienced before. Even worse, this crisis, as we explain later has pretty good chances of hitting us within the next 8-10 months, and the only safe haven for individual and institutional investors would be hard assets.

The crisis of 2007-'09 started with minor trembles when two Bear Stearns hedge funds went bankrupt in June 2007. Within two months, the Fed announced some unprecedented measures related to the expansion of its balance sheet, the securities it would accept as collateral, to be followed by lower interest rates, quantitative easing, and re-assurances in late 2007 and early 2008 that the worst was behind us. The weekend of March 14, 2008 Bear Stearns went bankrupt, and we were told that the rescue package was sufficient to withhold a crisis. The people and the markets were re-assured and celebrated in the following months, only to be disappointed again with the collapse of Lehman Brothers, AIG, Citibank, Merrill Lynch, Wachovia, etc.

Over the course of the last year, we are observing a façade and a camouflage. Markets have recovered substantially with the assistance of measures (fiscal and monetary) that are truly unique and different. Financial holes have been covered up by passing the losses to the public sector or to the central banks. Most of the toxic assets are still around us, the zombies are out of the necropolis, and the markets feel that this time is truly different.

I believe that the tremors felt with the Greek debt crisis resembles the tremors felt when the two Bear Stearns hedge funds collapsed in June 2007. They may represent the beginning of pains to be felt in Europe, and North America. We have long advocated the view in previous issues that some form of Greek default is inevitable. The intervention of the IMF is just the beginning of that. The latest news from the Mediterranean front talks about a rescue package close to 150 billion US dollars. The IMF will finance a good chunk of that money. It was just in mid April when we were told that the rescue package of 45 billion US dollars was sufficient. The downgrades of Portugal and Spain in the latter part of April represent the beginning of new tremors to be felt in the months to come. Italy would not be far herself from experiencing financial quakes. Already the spreads above the Bunds (German 10-year bonds) are rising and the cost of insuring (CDS) the bonds is rising too. To some extent we may be experiencing the disintegration of the EU and its fiat currency. If that were to take place, we believe that the tremors could potentially create a tsunami that will reach this part of the Atlantic and will shake US markets and our own fiat currency.

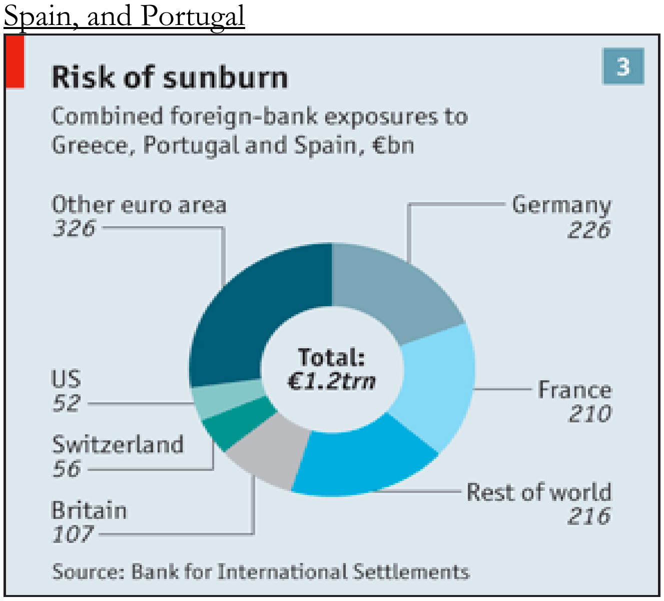
The Intricacies and Risks of Paper Assets

European and US banks, as well as financial institutions (such as pension funds), hold trillions of dollars in papers assets a.k.a. bonds. Figures from the

Bank of International Settlements (BIS, the central bank of the central banks) reveal some numbers that should make every investor weary of their implications. The Greek rescue package of more than $150 billion implies that if the contagion spreads to other EU countries, the $800 billion figure reported the week of April 26 as a rescue package for the Mediterranean region is a realistic number that will be infused into the markets for bailout purposes. We are afraid that we are seeing the same movie again, where in order to save the financial institutions that hold those paper assets, money is invented out of thin air. Two things could possibly play out in the short term. The banks' stocks (and the overall market in general) may need to be re-valued on more realistic terms given their exposure to sovereign-nations bonds, especially if they have off-balance sheet exposure. Institutional and individual investors are given opportunities to use their reserves to buy paper that pays high yields (Greek bonds pay as much as 12%) and which has implicit and explicit guarantees from prestigious institutions such as the Eurogroup (made up of the 16 countries that use the Euro), the European Central Bank (ECB), and the IMF (known as the troika). At the same time (please recall we are in the short term period) the Euro will experience a drop against the dollar.

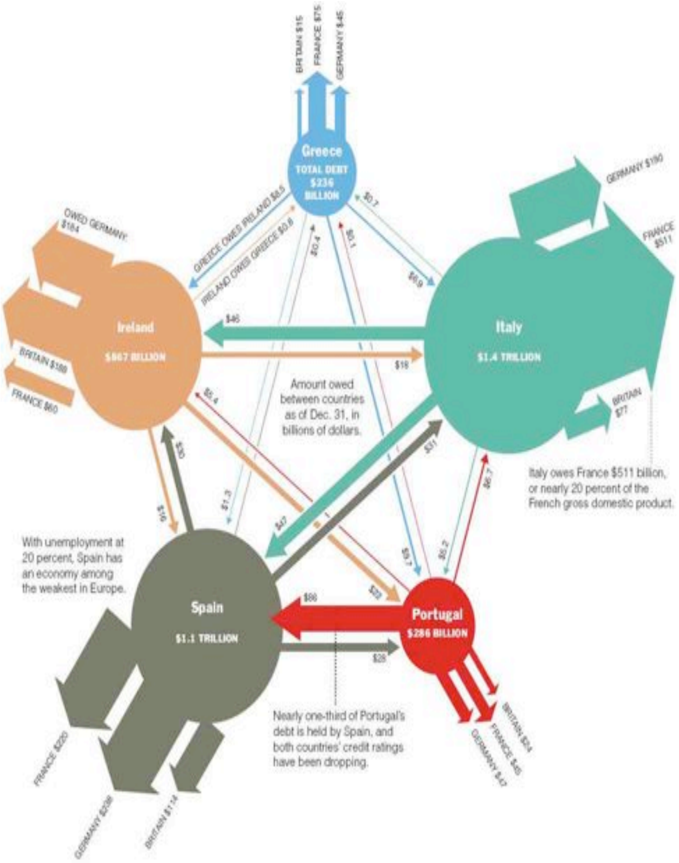
The following figure from the Economist (which calls it "The Risk of Sunburn") and BIS shows only the exposure of EU banks. Moreover, it only shows the on-the-balance sheet exposure i.e. the off-the-balance sheet exposure must be much higher.

Figure 1: EU Official Banks Exposure to Greece, Spain, and Portugal



When the EU countries commit billions of dollars to rescue Greece, they are actually rescuing the financial institutions that hold those bonds. The unfortunate thing is that there is a web of debt among the PIIGS (Portugal, Ireland, Italy, Greece, Spain), as the following figure shows.

Figure 2: The Web of Debt among PIIGS



BRITAIN $15
FRANCE $75
GERMANY $45
Greece
TOTAL DEBT $236 BILLION
GREECE OWES IRELAND $8.5
IRELAND OWES GREECE $0.8
$0.7
$0.4
$0.1
$6.9
OWED GERMANY $184
Ireland
$867 BILLION
BRITAIN $188
FRANCE $60
$46
$18
GERMANY $190
FRANCE $511
Italy
$1.4 TRILLION
BRITAIN $77
Amount owed between countries as of Dec. 31, in billions of dollars.
Italy owes France $511 billion, or nearly 20 percent of the French gross domestic product.
$5.4
$30
$16
$1.3
$47
$31
$9.7
$5.2
$6.7
$23
With unemployment at 20 percent, Spain has an economy among the weakest in Europe.
Spain
$1.1 TRILLION
$86
$28
Portugal
$286 BILLION
Nearly one-third of Portugal's debt is held by Spain, and both countries' credit ratings have been dropping.
FRANCE $220
GERMANY $238
BRITAIN $114
BRITAIN $24
FRANCE $45
GERMANY $47

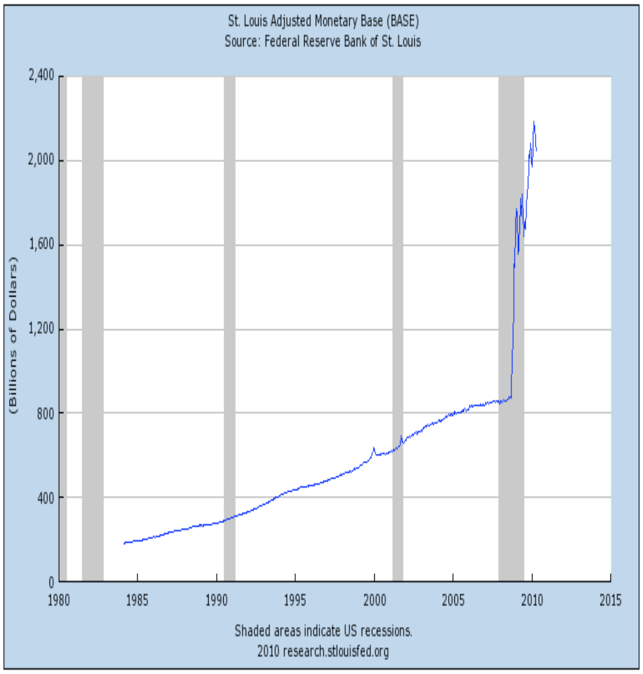
Source: Bank of International Settlements and New York Times

This web of debt implies that the risk of contagion is not only real and viable but most probable too. Let's summarize what we have said thus far: First, the Greek rescue package may need to be expanded to other countries. Second, the markets in the short term will experience tremors which may culminate during the summer months. Third, the Euro will fall and the US dollar may gain, temporarily. Fourth, new money is infused and leaked into the markets that temporarily may enjoy high yields.

The US Picture: From Medium to Long Term Views

With cross-border and cross-Atlantic banking and borrowing, and given the current exposure of US banks to the EU financial scenery, the US banks' reserves that earn almost zero return, may find their way/exit to the promising and "guaranteed" high yield returns of those paper assets. Let's not forget that those reserves need an exit strategy, since they are sitting idle, as the following figure shows.

Figure 3: Monetary Base in the US

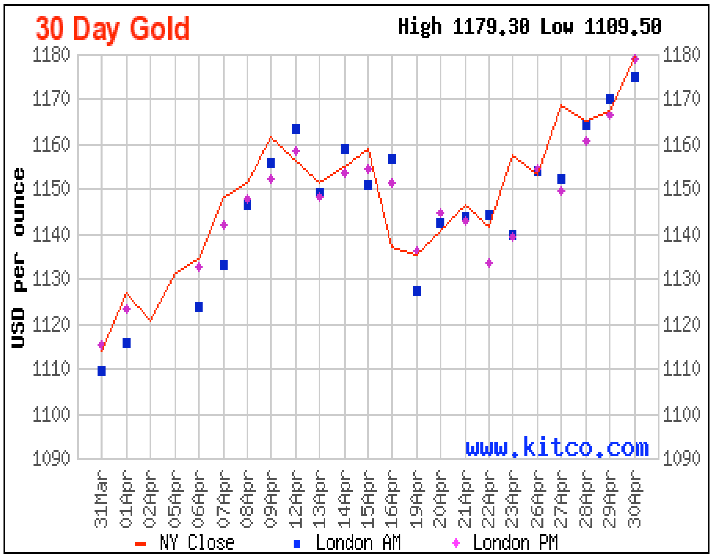


It seems that a new form of "swap" may take place, based solely on collateralization of paper assets that cannot be backed up by hard assets or production/trade figures. We are overloading the financial system with fiat money, and the system may not be able to afford such overloading. The effect would be that unless a mechanism is found to lighten up the debt burdens and defuse the monetary base from evolving into cash infusions via the acquisitions of "promising" paper assets, the economic system in the medium term (4-8 months) will be shaken, and in the long term may collapse.

The Euro will be traded at significant discounts when this "swap" is underway, because rational investors will start seeing that the situation is not sustainable. However, anything that can shake/question confidence in this house of cards may also shake the confidence in the US dollar and the paper assets denominated in the USD.

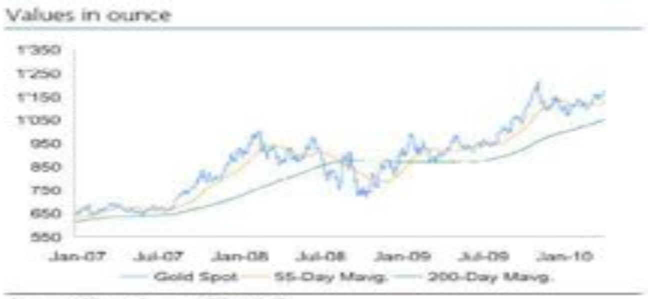
Under these developments, individual and institutional investors will start looking for a true safe haven, i.e. start moving away from the US bond market and the US dollar, and towards hard assets, such as metals. The market to some extent has already started doing so, otherwise gold would not have had the rally that it had in the last few weeks. The following figure shows the gold prices in the midst of the Mediterranean tremors while the USD has been proclaimed the safe haven.

Figure 4: Gold Prices, April 2010



Of course, if we wanted to take a longer view on gold, since the crisis started (and please remember that crisis have twins), then the following figure will show us that while the market has not recovered yet, gold is still pushing higher, and we may have not seen anything yet regarding this upward trend.

Figure 5: Gold Prices since 2007



Source: Bloomberg, UBS WMR

Effective Devaluations, Currencies' Intricacies, Banks' Balance Sheets, and Asset Allocation

The analysis presented above may resemble a financial tsunami that is building up and which will hit both parts of the Atlantic. We reiterate our belief that hard metals such as gold will prove to be one of the best options in terms of wealth preservation and growth. The average portfolio should have at least 25-30 percent in gold. We consider such percentage minimal and we would not hesitate to suggest a gradual movement into higher gold holdings. At the same time, we reiterate our belief that the energy sector (including alternative energy) or funds related to the energy sector (MLPs-Master Limited Partnerships that pay good dividends certainly qualify too) is a good place to park cash. Moreover, currency diversification (e.g. New Zealand's dollar) may also be considered a viable option that needs to be contemplated.

The emerging economic environment is one of risk aversion. We have written before that overextension of credit (especially one that is based on paper-assets) inevitably leads to financial and banking crisis, which in turn leads to sovereign debt tremors, and which will end with a new international currency regime. The contagion that is spreading in Europe signifies that debts are unsustainable, defaults are inevitable, and that a new economic/currency/political regime will emerge.

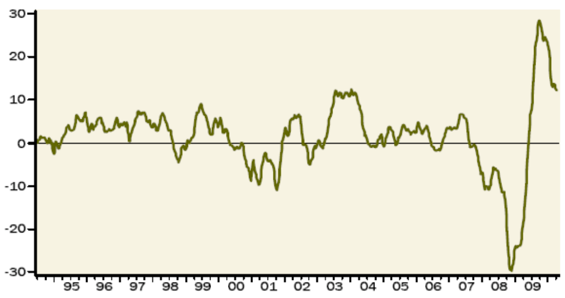
The web of debt as portrayed earlier makes the situation very complex since it is extended to numerous countries that have accumulated unsustainable debts (via overextension of credit and paper assets), and includes all of the EU, the US, and Japan. The banks of all those countries may have questionable balance sheets due to their exposure to such bonds. Moreover, those banks have issued their own paper/bonds that add to their liabilities and burdens. When a nation's bonds become of questionable value, along with the bonds issued by its local banks, it is a lethal combination. All these IOUs are on the balance sheets of institutions (sometimes pension funds besides banking institutions) outside the country.

Therefore, we are facing a domino effect, especially when we take into account the discounting that markets tend to do for even healthy economies and institutions. Moreover, when we take into account the fact that those countries are facing severe contractions (e.g. the Greek economy may contract as much as 4.6% in 2010), high refinancing rates, and higher unemployment (e.g. Spain's official unemployment rate exceeds 20%), then market pessimism may prevail that uplifts a sentiment of looking for real protection away from the printing machine.

Furthermore, even if rescue packages are implemented (some analysts question their viability), where is the money coming from when all developed nations have deficits? The money has to either be printed or the reserves credited from the previous bailout package of 2008-'09 are leaked into the system. Without even taking into account unfunded liabilities (see our April issue), the debt to GDP ratios are astronomically high. For example, based on World Bank figures the Debt/GDP ratio for U.K. is 342%; for Belgium 248%; for Austria 200%; and for the Netherlands 283%. These ratios are smaller than some of the PIIGS countries, such as Spain whose ratio is 159%, or Italy whose ratio is 113%.

If those economies were growing then the interest portion of the debt might have been sustainable. However, when the fundamentals are shaky and when even the US economy may be showing signs of lower growth expectations as the following figure demonstrates (especially when the stimulus money runs out), then the whole system (financial and economic) starts shaking. The uncertainties as to who is exposed to those risks creates the risk-aversion climate we talked before. To that climate we need to add the speculative forces, which through leverage and other tactics will try to take advantage of the amorphous environment.

Figure 6: Leading Economic Indicators (in percentage terms)



Source: Haver Analytics, Gluskin Sheff

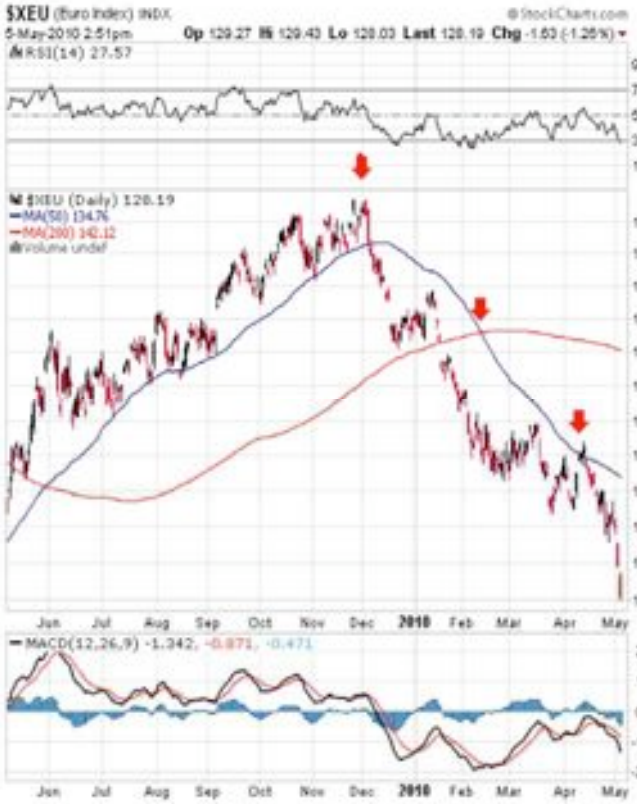
The figure above portrays the composite index of leading economic indicators, and signifies future direction. The picture speaks for itself. In the last few months the expectations for growth have declined significantly, which could only exacerbate the pain and uncertainty for institutions and individuals. We have warned about a double dip for quite some time. When we take into account that some of the banks that fell in 2008 were bigger than some of the countries at risk, then we could possibly comprehend that if banks are holding the debt of many insolvent or illiquid nations then another crisis might be knocking at our door.

It has been reported that the US will probably benefit out of the EU mess. We choose to differ on that estimate. Temporarily, funds may come to the "safety" of US bonds, advancing the dollar at the same time, while keeping interest rates low and thus the cost of refinancing the US debt. However, given that our own situation is not much better than the EU – primarily the fact that we also have a fiat currency whose partnership we sought after in support of a mini-dual fiat reserve currency regime - we could not but contemplate the scenario that sees US markets suffering significant losses and hard assets becoming the winners. The transmission mechanism in that process will be the banks' balance sheet.

Based on data from the Federal Financial Institutions Examination Council (FFIEC), major US banks (such as Bank of America, Goldman Sachs, Citigroup, JP Morgan Chase, and Morgan Stanley) have exposure of at least 2.5 trillion dollars in EU bonds. Moreover, based on their 10Ks reports they have major commitments to extend or guarantee credit to these troubled countries. When someone is looking at the FFIEC report they need to take into account that if a bank's exposure in a particular market is less than 0.75% of assets, that exposure is not provided. Now, if to the list of the five banks listed above one adds few more (such as HSBC Holdings, BNY Mellon, Wells Fargo, State Street Corporation, and Deutsche Bank), then the situation becomes much more serious, in terms of the trillions of dollars that are at risk.

When the ECB (European Central Bank) has degraded collateral standards, then, everything is on the table. In the next few months we may witness the decade-low for the Euro against other major currencies. Thus, while the next figure generates concerns in terms of how far the Euro has fallen, we may have not seen anything yet.

Figure 7: Euro Index



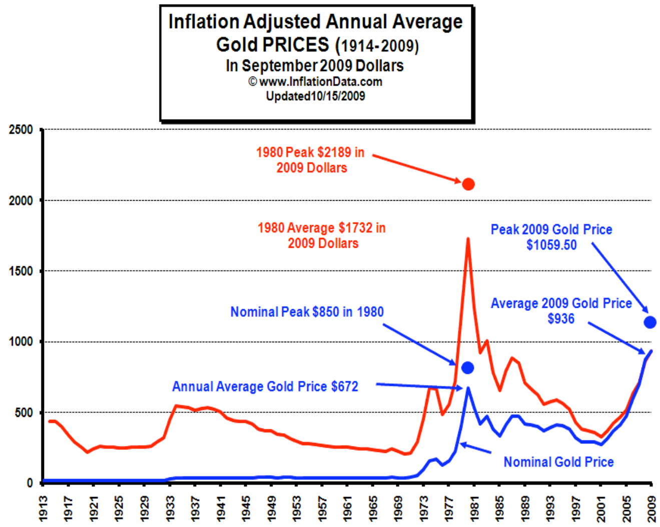
Source: StockCharts.com

The next stop for the ECB would be quantitative easing, and we are certain that there are good teachers around for that lesson too. Maybe tree-planting endeavors had a hidden agenda…Spain would need more than 250 billion dollars to refinance its debt within the next 12 months. Who will be the buyers? Who are the institutional investors who will pour money into those IOUs, when their balance sheets are already shaky?

Moreover, when we incorporate into our analysis private indebtedness (e.g. in Spain the figure exceeds 170% of GDP) then we realize that the postman is getting ready to ring the bell again. The Euro was created as a twin fiat currency to the dollar. Those twins perpetuated bubbles in the last 10-12 years. Keep feeding the turkey and the turkey keeps expecting food. But guess what, Thanksgiving is coming!

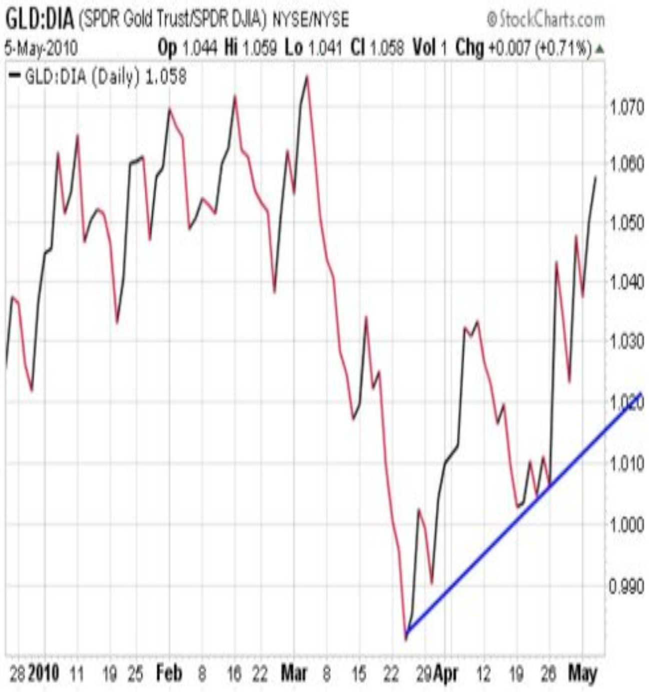
The depreciation of the Euro against other major currencies will open Pandora's Box for all major fiat currencies to be devalued against gold and other hard assets. The losses in paper assets and the tremors in institutional balance sheets will force everyone to look for a safe haven that historically has been attractive, has been used for preservation of wealth, is indestructible, cannot be easily reproduced, is finite, and which is not the liability of anyone (let's not forget that the fiat currencies represent liabilities of the issuers). Under this scenario, we should not be surprised if gold surpasses its inflation-adjusted price of $2,189 per ounce (see figure below).

Figure 8: Nominal and Inflation adjusted price for Gold



The legendary Richard Russell wrote recently in his commentary: "Fiat money is the greatest fraud ever inflicted on an innocent, passive, and ignorant population." We could not agree more! In the same commentary he rightly points out that Wall Street failed to assess risk, and that failure is opening now Pandora's Box. The number of stocks that trade above their 200-day moving average is steadily falling, indicating that sentiments of 2008 are coming back. The ratio of gold to the DJIA, has taken a sharp upward turn, as the following figure shows.

Figure 9: Gold over the DJIA



Conclusion: The Real vs. The Fiat Economy

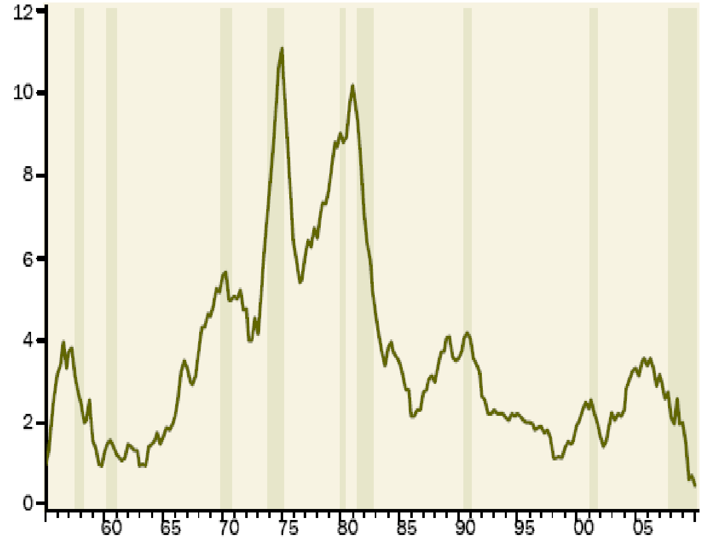
It seems that we have been accustomed to live in a surreal reality. This is post-modernity after all! Borrowing from our previous writings, we would like to call our readers' attention to the following facts:

First, the U.S. implicit GDP deflator (as figure 10 below shows) has been at its slowest pace over the last 60 years, signifies deflationary pressures, and the fact this recovery is shaky due to its temporary nature, namely stimulus funding and cost cutting measures accompanied by accounting shifts and maneuvering.

Second, the virtual reality of derivatives has grown disproportionably to the growth rate of GDP (see figure 11 below), while feeding the frenzy of overextension of credit, bubbles, leverage, paper assets, and corporate "profits".

Third, there is a financial feedback-loop mechanism, which based on the analysis of a research team I am privileged to be part of and submitted to the Congressional FCIC (Financial Crisis Inquiry Commission) for their hearings, is not only significant but might turn out to be the most important factor that creates bubbles and generates crisis where credit is extended without an anchor (a.k.a. the abandonment of the gold exchange standard). Figure 12 below, shows that financial feedback-loop mechanism and the relevant explanatory power in the pertinent statistical analysis performed.

Figure 10: GDP Deflator in the last 60 Years



Shaded region represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

Figure 11: Derivatives Growth vs. GDP Growth

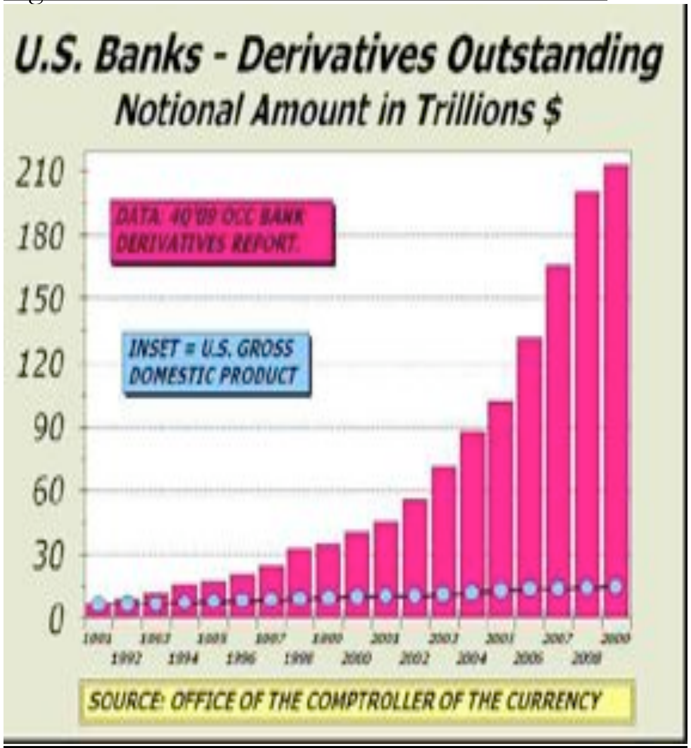
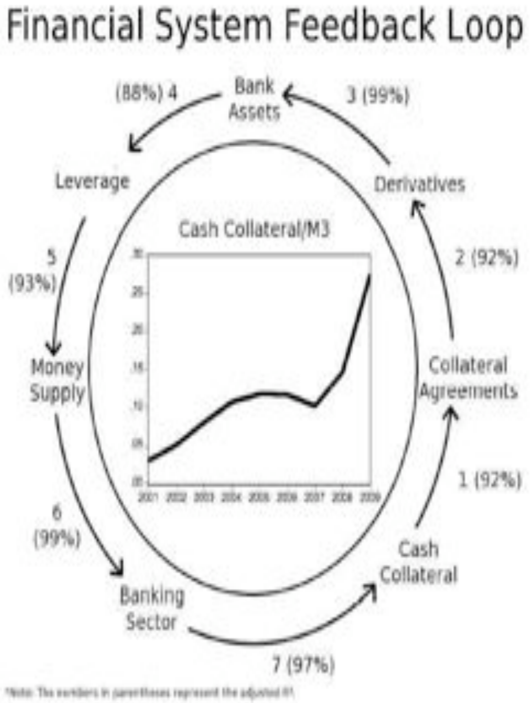


Figure 12: The Feedback-Loop Mechanism


Financial System Feedback Loop
Bank Assets
(88%) 4
3 (99%)
Leverage
Derivatives
Cash Collateral/M3
5 (93%)
2 (92%)
Money Supply
Collateral Agreements
1 (92%)
6 (99%)
Cash Collateral
Banking Sector
7 (97%)
2001
2002
2003
2004
2005
2006
2007
2008
2009
*Note: The numbers in parentheses represent the adjusted R²

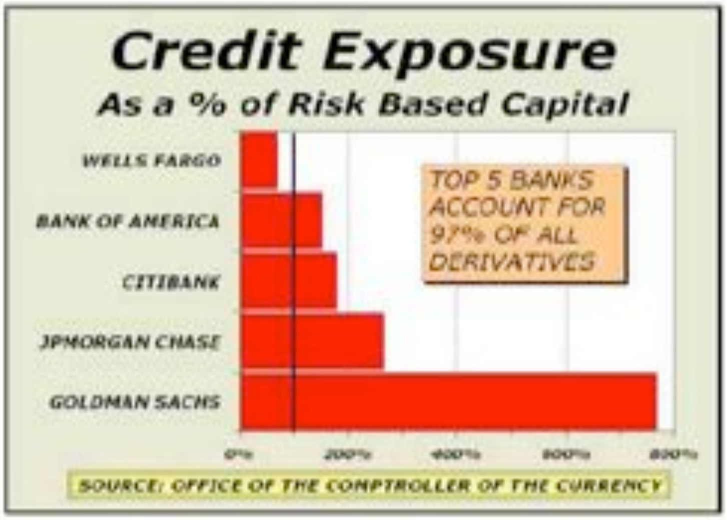
Source: Asbury University Research Report to the FCIC

When banks such as Goldman Sachs have net credit exposure as much as 766% of their risk-based capital, then they become the ultimate transmission mechanisms of collapse when nations' solvency and liquidity is put into questions. Our final figure below shows that the top five banks that are responsible for 97% of derivatives trading have on average a credit exposure that approaches 300% of their capital base.

When all the above figures are taken into account, one cannot but conclude that this time is truly different and as we have been saying for months now, it promises to be an interesting ride.

As always, please enjoy the ride and increase your exposure to hard assets!

Figure 13: Credit Exposure of the Top 5 Banks



Credit Exposure

As a % of Risk Based Capital

TOP 5 BANKS ACCOUNT FOR 97% OF ALL DERIVATIVES

SOURCE: OFFICE OF THE COMPTROLLER OF THE CURRENCY