



Those who cannot remember the past are condemned to repeat it. Santayana

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WINTER WARNING



Winter Warning this week is entirely the work of Alf Field who has written a very good piece entitled "Chaos Chronicled"

Alf leads you through the history of the world financial crisis. He begins with an explanation of Goldsmiths, the original bankers, followed by the development into the Fractional Reserve Banking system. Alf then discusses the International Monetary System based on the dollar and the inherent weakness in such a system due to the ability of banks around the world to consistently add massively to loans. This is followed by an explanation of the OTC derivatives market and the crisis which has developed in this milieu. "Chaos Chronicled" is a coherent and chronological evolution into the crisis that has now enveloped the world.

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CHAOS CHRONICLED

By Alf Field

"Men haven't changed much in the last 2,000 years and, in consequence, we must still learn from history." – Kenneth Clark, "Civilisation"

"You shouldn't be worried. You should be angry. We've just come off a multiyear orgy of irresponsibility and recklessness that's unprecedented in the history of finance. Where was the government? Where were the regulators? How did this happen?" - Barry Ritholtz, CEO at Fusion IQ.

THE WORLD FINANCIAL CRISIS

Indeed, how did it happen? The onset of the world's worst financial crisis in many decades is one of the most important factors (if not **the** most important factor) currently influencing investment decisions.

The crisis has created chaos and confusion. Not many people understand how the world has arrived at this unfortunate situation. This report endeavours to identify the underlying causes of the crisis and explains why the USA current account deficit has been the main destabilising force in world finance.

To fully comprehend what has happened requires at least a rudimentary knowledge of a number of subjects, viz:

1. Money - its origins and the various forms into which it has evolved;
2. The Fractional Reserve Banking system;
3. The International Monetary System;
4. The development of derivatives, especially the Over The Counter (OTC) derivatives market;
5. How the various inputs melded into the difficult crisis that the world is now facing.

Some of what follows is very basic, but it is important to work through all the background in order to eventually reach the point where the reader will hopefully experience a moment when understanding dawns.

1. MONEY – ITS ORIGINS AND DEVELOPMENT INTO DIFFERENT FORMS.

Money evolved to facilitate the exchange of goods and services. In a barter economy in ancient societies one or two items became commonly used to facilitate exchanges. These items were useful and attractive to everyone. They were traded, not for themselves, but because they represented items that retained their value and could be traded later for other goods and services. These items represented the original forms of money.

These items that emerged as money had a number of basic characteristics. They facilitated the exchange of goods and services and could be divided into small units so that even the smallest items could be traded. This function is called the “medium of exchange”. Secondly, they provided a means of measurement of the relative values of different items, this is the “unit of measurement” function. Finally, the items used as money should not deteriorate so that they could be stored as savings for future purchases. This is the “store of value” function. All forms of successful money perform these three important and basic functions.

When the Bronze Age allowed men to produce metals, the metals soon became used as money, called “commodity” or “metallic” money. The metals were not perishable whereas early forms of money tended to be livestock and agricultural commodities which had limited life spans.

Many centuries of trial and error saw gold and silver selected as the primary forms of money, followed by copper and base metals. The use of precious metals as money really took off when coins were minted containing a guaranteed amount of metal, the guarantee being evidenced by the image of the King or Emperor stamped on the coin. In Roman times the Aureus and Denarius were the gold and silver coins in general use.

(See www.unrv.com/economy/romans-coins.php for a more detailed account of Roman coinage.)

These coins were widely accepted until the Romans started reducing the precious metal content of the coins, making up the weight with cheaper metals. This trend towards debasing the coinage eventually resulted in the demise of the Roman currency and also of the Roman Empire. The gold Bezant, produced in Constantinople, became a coin used successfully for over 800 years in international as well as national trade. It was the forerunner of other coins that were minted in European countries through the middle ages.

Gold and silver coins are heavy to carry around in quantity. Goldsmiths, who manufactured gold and silver jewellery, had secure vaults to protect their stocks. They extended their businesses to provide a safe-keeping service for wealthy individuals who owned large quantities of coins. The Goldsmiths issued receipts for the gold deposited with them. These paper receipts contained the following wording: “I promise to pay Bearer on demand at the above address xxx gold coins”.

These receipts were accepted by merchants and traders as being “as good as gold” and were the forerunners of modern bank notes. They were more convenient to transport and use than the heavy metallic coins. Thus the second form of money was “receipt” money, following after “commodity” or “metallic” money.

Goldsmiths spotted another opportunity to expand their businesses by making loans of gold coins. Initially the loans related to their own capital. The Goldsmiths simply issued a receipt against their own gold holdings to the borrower. Later, when the Goldsmiths noticed that only a small proportion of the gold coins held in storage were ever claimed by their owners, they started increasing their loan business by issuing receipts in excess of the gold that they had in storage. As long as they always had sufficient gold coins on hand to meet the quantity of receipts tendered for return of gold coins, everything was fine and the holders of the receipts were not aware of the shortfall in available gold coins.

In this way “receipt” money morphed into “fractional receipt” money, so called because the stock of gold coins in the Goldsmiths’ vaults was only a fraction of the gold receipts issued by the Goldsmith. If greed caused a Goldsmith to issue a vastly excessive number of receipts, it would cause concern amongst the receipt holders. This could lead to a sudden unexpectedly large surge of redemptions, absorbing the entire supply of gold coins in the Goldsmith’s vaults. In those circumstances the Goldsmith was bankrupt and would leave town in a hurry, just ahead of the lynching mob consisting of the remaining holders of unredeemed receipts which were now valueless pieces of paper. The threat of bankruptcy had the effect of imposing a discipline on the lending activities of the Goldsmiths.

Goldsmiths were the early bankers and the “fractional receipt” form of money eventually developed into the modern “fractional reserve banking system” which is in common use around the world. This system is discussed in more detail in the next section.

The final form of money that we need to discuss is the money in general use around the world today. It is money issued by Government edict and defined as “legal tender”. This simply means that all citizens are required to accept “legal tender” bank notes in trade and settlement of debts. It is commonly called “fiat money”. This is what we all work for and use for living expenses.

There were times when fiat money could be exchanged for gold at a country’s national reserve bank. When convertibility into gold was available, fiat money was “as good as gold” and generally accepted. The cost of the two World Wars necessitated a change because both the UK and the USA had to create far more of their local currencies to pay for the wars than the available gold stocks allowed.

The Bretton Woods agreement signed in June 1944 fixed gold convertibility of the US Dollar at \$35 per ounce, but convertibility was only available countries holding gold in their national foreign exchange reserves. Convertibility for individuals was cancelled. All other currencies were given a fixed relationship to the US Dollar. This system worked well until the late 1960’s when it came under pressure with many countries, led by France, exchanging their US Dollar foreign exchange holdings for gold.

In August 1971 President Nixon bowed to the pressure and abandoned the convertibility of the US Dollar into gold at \$35. This launched the world into a new and untried system of completely floating fiat currencies. All countries were put in a position where they could create unlimited amounts of their own local currencies without restriction. This is one of the important sources of trouble leading to the present crisis.

2. The Fractional Reserve Banking System.

Modern economies use fiat money systems where the local currency is designated by Government edict to be “legal tender” that must be accepted in all commercial transactions within the economy. Modern fiat money is not convertible into anything and is based simply on the “full faith and credit” of the Government concerned. This fiat money may only be created by the Government concerned, although most governments delegate this function to the country’s Central Bank (CB).

Modern banking systems allow Governments to “stimulate” their local economies by creating money and injecting it into the banking system. Assume that \$10m is injected in this way and it is received by Bank A which then uses this deposit to make \$10m of loans. These loans are used by borrowers and eventually deposited in other banks. This results in other banks receiving deposits totalling \$10m. This sequence could go on indefinitely until an infinite number of loans are created on the back of the original \$10m deposit.

To limit this multiplier effect of new money entering the system, banks are required to place a fraction of their new deposits with the country’s CB and it is only the remainder that may be loaned out. Typically the fraction of new deposits required to be placed with the CB is of the order of 10%. Thus in the example above, Bank A receiving a new deposit of \$10m would have to place \$1m on deposit with the CB and would be free to loan \$9m. The bank receiving deposits from the \$9m loaned by Bank A would have to place \$900,000 with the CB and would be free to lend \$8.1m. Banks receiving the \$8.1m would have to put \$810,000 with the CB and could lend \$7.29m, and so on. Eventually the original injection of \$10m is multiplied to \$100m in loans, a ten-fold increase of the original \$10m deposit.

The fraction of deposits that must be placed with the CB, which is called the “reserve ratio”, can be varied from time to time. It is one of the tools available to the CB to control the economy and banking system. A few years ago the reserve ratio in China was 7% which allowed Chinese banks to multiply new deposits into loans 14 times greater than the original deposit. With inflation increasing in China, the reserve ratio has been steadily increased to around 14%, allowing new loans to be “only” a 7 times multiple of new deposits.

In Australia the reserve ratio is 8% allowing a 12.5 times multiple of new deposits. Most Australian banks operate on a more conservative ratio. For most countries, the ratio is about 10% allowing a 10-fold multiplier of new deposits. This is the ratio that we will use in the following discussion.

A typical bank is a highly geared operation with reserves only 10% of assets. The majority of bank assets are loans. Major losses (generally bad debts) can cause pressure on the bank from several sources, pressure that has the capacity to bring the bank to its knees.

Each day a bank must regulate its reserve balance with the CB. After all trades are cleared at the end of a day, some banks will have surplus liquidity while others will have shortfalls. This gives rise to the overnight borrowing market where banks with surplus cash will lend to those with a shortfall so that they can top up their reserve deposits at the CB. If a bank with a shortfall cannot borrow sufficient funds in the overnight market, or if the other banks refuse to lend to that bank, the bank with the shortfall can borrow from the CB at penalty rates.

If a bank has to borrow excessively from the CB for a lengthy period of time, other banks and depositors will become suspicious of that bank's ability to carry on in business and will withdraw their deposits from that bank. This can happen via a line of individuals trying to withdraw their deposits (as in Northern Rock in the UK) or by electronic withdrawals (as in the Bear Stearns case). We will return to Bear Stearns in section 5.

This is a brief sketch of the Fractional Reserve Banking System, sufficient for the purposes of this discussion. A detailed review of this subject by Murray Rothbard can be found at:

www.lewrockwell.com/rothbard/frb.html

3. International Monetary System.

As previously mentioned, in August 1971 President Nixon decreed that the USA would cease exchanging gold at \$35 per ounce for dollars tendered by foreign central banks. This act completely changed the International Monetary system and removed the discipline that gold provided under the Gold Exchange Standard which was introduced at the Bretton Woods Conference in 1944.

Once gold was removed as the disciplining factor in the monetary system, a new reserve asset had to emerge. The US Dollar, presumably because of the size of the US economy, became the *de facto* international reserve asset. What evolved became known as the US Dollar Standard.

The principal flaw in the US Dollar Standard is that it has no mechanism to prevent or correct large and persistent trade imbalances between countries. Under the Gold Standard and its successor, the Gold Exchange Standard, countries that ran current account deficits had to curb their activities when they ran out of gold to settle their deficits. They had to devalue their currencies to stimulate exports and curb imports.

Under the US Dollar Standard, the USA can settle large trade deficits by exporting newly created US Dollars. Consequently, the deterioration in the US current account deficit has gone unchecked for decades. It recently reached the level of \$2 Billion **per day**. This is one of the major factors that has destabilised world economies, and is a major contributing factor to the current crisis.

When foreign companies sell goods in the USA they take their dollar earnings home and convert them into their own currencies. This puts upward pressure on those local currencies. The CB's of those countries intervene to prevent their currencies from appreciating in order to preserve their trade advantage. They intervene by creating local money and using this to buy US dollars. In this way, the exporters are able to keep their export earnings in their domestic currency, the local currency does not appreciate against the US dollar and the local CB's foreign exchange reserves reflect a large increase in their US Dollar component.

The US current account deficit of \$2 billion per day finds its way into banking systems around the world as new deposits. Enter the Fractional Reserve banking system multiplier of 10 times new deposits. This means that banks somewhere in the world have been given the capacity to increase their loans by \$20 billion per day, and that is **per day**, provided that they can find suitably qualified borrowers.

That is not the end of the story. The foreign CB's need to invest the US Dollar component of their foreign exchange reserves somewhere. They have tended to buy US Treasury Bonds, thus returning the \$2 billion per day US current account deficit back to the USA. These purchases result in new deposits into the US banking system of \$2 billion per day. Yes, that does mean that the US banks can also increase their lending by 10 times that amount, or \$20 billion per day, provided that they can find suitably qualified borrowers.

The magic of the Fractional Reserve banking system combined with the current unsound International Monetary system has, incredibly, provided banks around the world with the potential to increase their loans by \$40 billion per day! This is how massively the US current account deficit has destabilised the world financial system.

4. Development of the OTC Derivatives market.

The US trade deficit has been growing steadily for nearly 2 decades, providing vast new loan potential to banking systems around the world. This vast increase in world wide lending capacity is directly responsible for the various bubbles that have emerged in different places. Examples are Japan in the late 1980's (stock market and real estate), in other Asian countries in the 1990's and more recently in China. In the USA, the technology bubble and the recent real estate bubble were supported by this huge increase in liquidity flowing from the new lending capacity injected into the world's banking systems by the US current account deficit.

Not surprisingly, banks have had increasing difficulty finding suitable investments and credit-worthy borrowers for the vast amount of potential new lending capacity that they had available. Huge demand for new products or new investments emerged. Fertile minds on Wall Street and in other financial centres went to work to develop an array of new investment products with an alphabet soup of acronyms to satisfy this demand.

The search for new loans reached increasingly less credit-worthy borrowers. Ultimately standards degenerated to such an extent that people who should never have been allowed to borrow, called Ninjas, (no income, no job, no assets), were able to obtain 100% mortgage loans to purchase homes. The bottom of the borrowing barrel had been scraped bare. Thereafter it was only a matter of time before trouble in the form of losses emerged.

Bankers must have been aware of the risks being run in this highly charged situation of easily available excess liquidity. Over The Counter (OTC) derivatives were developed to provide insurance against specific risks and to distribute the general risks over a wider market. These OTC contracts are individually tailored instruments. A whole new lexicon or vocabulary has evolved around them. Words such as caps, collars, floors and swaptions emerged out of the Bear Stearns fiasco. What these words mean can only be ascertained by lawyers looking at the small print of each derivative contract.

There is no clearing house or market authority standing behind these contracts to ensure that they are fully discharged. In the event of some parties going bankrupt or simply refusing to meet their obligations, the counter parties to those contracts would have no alternative but to sue the defaulting party or stand in the line of creditors in the bankruptcy proceedings. .

The Bank for International Settlements (BIS) makes an attempt to quantify the growth in OTC derivative products. Growth has been phenomenal, recently reaching something of the order of more than \$500 trillion (with a T) in "notional" value. Notional value simply means the gross amount covered by the contract. For example an option or swap contract covering \$100m of bonds might cost say \$2m in premium. The \$100m is the notional value while \$2m is the initial underlying market value. Subsequently the market value of a particular contract could vary from zero to \$100m depending on the terms of the contract and how the underlying securities perform.

There is an element of double counting as many contracts have been arbitrated or sold to a range of different parties. The BIS only picks up OTC derivatives from banks and similar sources and makes no attempt to quantify OTC derivatives entered into by non-banking participants such as hedge funds, investment funds, stock brokers and others. The BIS believes that their figures cover about 85% of outstanding OTC derivative contracts but the truth is that they really don't know how much non-banking participants have generated in OTC derivative contracts.

The growth in OTC derivatives has been dramatic, particularly over the past decade. Credit Default Swaps (CDS) have been the fastest growing derivative category recently. They are a form of stop loss insurance on credit or financial instruments. CDS derivatives have grown from **\$10 Trillion to \$46 Trillion (notional value)** in the 2 years to June 2007. This included a massive gain of \$24 Trillion in just the 6 months to June 2007, a breathtaking 109% gain in half a year. A lot of people must have suspected what was coming and bought insurance against possible loss. It remains to be seen whether they will be able to collect on these contracts.

The numbers involved in OTC derivatives are so massive, even if calculated at supposed "gross market value" (assuming that it was possible to calculate that number), that they dwarf the rest of the numbers in the world economy and financial system. The risk inherent in OTC derivatives is that the entire edifice can only function provided all parties involved meet their obligations when they fall due. A collapse of a major counter-party could trigger a domino like collapse of banks around the world.

5. How it happened.

The crisis has reached the point where the US banking system has effectively exhausted its reserves that it should have with the Fed. The US banks are functioning only because the Federal Reserve is lending the banks what they need to meet their reserve requirements by taking on questionable assets at cost. It makes nonsense of the fractional reserve system of banking when the banks have virtually no reserves and are operating only courtesy of the Fed.

The desperate measures to save Bear Stearns (BS) were implemented because of the "inter-connectivity" of banks and investment houses involved in the OTC derivatives market. BS had an exposure to OTC derivatives of more than \$13 trillion notional value. If BS went bankrupt and could not meet its OTC derivatives obligations, it could possibly have triggered a domino like banking collapse.

JP Morgan Chase had the largest exposure to OTC derivatives of all the American banks at \$78 trillion prior to taking over the OTC derivative obligations of BS. When combined with BS, Morgan will have an exposure of over \$91 trillion to OTC derivatives at notional value. This is nearly 18% of the world's exposure to these instruments.

How did it all happen? Alan Greenspan is the top culprit being blamed by the media. There is an element of truth in this allegation but his part was a small one. The fact is that the world went along with the major problem, being the US trade deficit, and accepted US dollars in exchange for real goods and services. World wide fiat money and fractional reserve banking systems caused a much bigger flood of liquidity than Greenspan was ever responsible for.

Greenspan possibly did take interest rates too low for too long and allowed the Fed to be more accommodative than was strictly warranted during the early years of this decade. The cake had already been baked by then. Greenspan's free and easy attitude simply accelerated the eating of the cake. If Greenspan had taken a strongly decisive attitude, as Paul Volker took in the 1980's, Greenspan would have triggered a deflationary collapse. Nobody wanted that.

Call it benign neglect. Call it national introspection with individual countries only being concerned about their own interests. Nobody wanted to disturb the status quo. Call it lack of concern about what would eventually happen. It is summed up in the attitude: "it's our currency but it is your problem".

Sure the rating agencies and the regulators have questions to answer but the real reason it happened is that the world had to get to a point where totally irrational lending finally reached the last unworthy recipient of a loan. Then things could change. It required serious losses to refocus attention on conservatism and probity. It required losses large enough to get people to really examine what happened, to correctly identify the causes and to take action to ensure a better system in the future.

6. What happens now?

It does not take a genius to work out that the US Dollar Standard (with the US dollar as the reserve currency) has to go, but it will take a genius to work out what the new system should be. The new system will require sound money that cannot be manufactured at will by Governments, money that performs the 3 basic functions of medium of exchange, unit of measurement and store of value. A new international monetary system needs to be developed.

It seems that the eternal money, gold, will have to be returned to the monetary systems, both national and international, to provide the necessary discipline.

That is all for the future. Meanwhile there is a mess to clear up and how that occurs will have investment consequences and implications.

There was a crisis in the US banking system during the 1970's with major loans to South American Governments going sour. South American countries actually defaulted on their sovereign loans, leaving the American banks with large losses. If these losses were brought to account, the banking system would have wiped out its reserves. Special permission was granted to allow the loans to be carried at book value until the banks raised new capital and/or accumulated sufficient profits to write off their South American loan losses. The banks were allowed time to trade out of their losses.

The current situation is different. In the 1970's crisis it was possible to identify where the losses would fall and the individual banks could quantify their losses. In 2008 it is impossible to identify the quantum of losses or determine where they will fall. The US banking system has already recognised losses that have wiped out bank reserves to the extent that the banks can only continue operating with aid from the Fed. The losses written off to date are likely to be augmented by additional sub-prime and CDS losses of presently unknown magnitude. Moreover, it is unclear where those losses will finally appear. Every bank is suspect.

The mountain of OTC derivatives is one of the major problems facing the world's banking and financial systems. Unfortunately there is no easy way of getting rid of these derivatives. George Soros recently suggested that a clearing house system should be established for the OTC derivatives. This is an impractical suggestion as a brief example will quickly illustrate.

Assume that investor A buys \$100m of 5 year bonds in XYZ Company. He is unsure of the strength of XYZ Co. and buys a 5 year CDS from B to cover any loss in the event of XYZ Co defaulting on its bonds. The investor pays a premium of say \$2m per annum. Two years later it is desired to close down this transaction. If A and B were still the only parties to the transaction, they could sit around a table and discuss how to determine the current market value of the CDS. **IF** they could agree a market value for the CDS and **IF** both parties were willing to cancel the CDS, it could be cancelled by one party paying to the other the mutually agreed amount.

In reality B will probably have arbitrated its position to a number of other parties and the investor A may have sold his bonds to a number of other investors with the CDS protection attached. It is a practical impossibility to get all parties to this simple transaction together to discuss a possible settlement and cancellation of the deal. This is just one simple transaction without the complication of additional features such as collars, caps, swaptions, etc. It is also just one of zillions of OTC transactions that are in existence. To expect a clearing house to be able to settle these derivative contracts is just wishful thinking.

This mountain of OTC derivatives has the capacity to bring down the banking system in the event of the bankruptcy of one or more of the larger counter parties. Some way has to be found to eliminate this OTC derivative cancer which would otherwise be fatal to the present system.

History has shown that when debt becomes excessive, the lenders almost always lose. They lose either because their debtors go bankrupt or they lose because they are repaid in currency which has been debased by wholesale printing, making the currency worth very little in real terms. There is no doubt that the world has reached an extreme level of debt creation. The only question is whether the debt will be settled by bankruptcies or whether the debt will be repaid in largely worthless currency.

Fed chief Ben Bernanke has made it quite plain that his plan is NOT to allow debt to be repaid by bankruptcy and deflation. All his actions to date are in line with his proclaimed policy. There is no reason to think that he will change his thinking or *modus operandi*. Thus we have to believe that USA has embarked on a voyage that will allow debts to be repaid in debased, largely worthless currency.

Jim Sinclair has drawn an analogy comparing the Weimar Republic in 1919 with the present mountain of OTC derivatives. After World War I the Allies imposed excessively large reparation claims on the German Republic. The Germans objected to the magnitude of the claims and only agreed to the quantum when the Allies allowed the Germans to settle the reparation payments in Reichsmarks. The Germans then adopted the attitude that "if they want Reichsmarks, we will give them Reichsmarks". They then proceeded to print new Reichsmarks at an accelerating rate to settle the reparation debts, eventually causing hyperinflation that destroyed the German currency.

Jim Sinclair suggests that if one crosses out the words "reparation payments" and replaces them with the words "OTC derivative contracts" one would have a clearer picture of the current circumstances. The suggestion is that the OTC derivative problem can only be settled by creating sufficient new currency so as to inflate the currency to the point where it is largely worthless. That would allow all these derivative contracts to be settled in debased currency.

All the evidence to date suggests that a liquidation of debt via the deflationary bankruptcy route could only happen by accident. It is possible to have a temporary situation where debt is extinguished by bankruptcy in part of the economy whilst the currency is being aggressively debased.

Eventually, however, the odds strongly favouring the elimination of currently excessive debt via debasing the currency route should prevail.

This report commenced with two quotations and it finishes with 3 quotations. These come from above the massive arches of the triple doorways into the Milan Cathedral:

Above the first arch: ***"All that pleases is but for a moment."***

Above the second arch: ***"All that troubles is but for a moment."***

Above the third arch: ***"That only is important which is eternal."***

Gold has been the eternal money.

Alf Field
10 April 2008.

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