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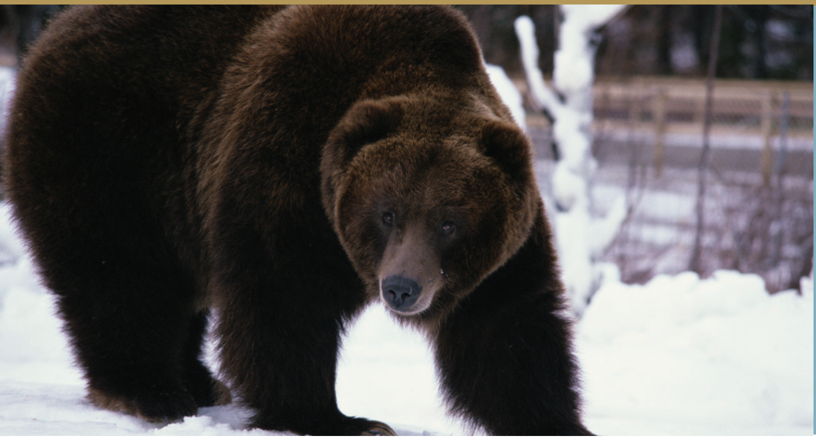
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



The End of Paper Money

"Over the millennia, dating back to the time of ancient Egypt in 3150 B.C., gold has always been highly prized by mankind. Indeed, whether used for ornamentation, or as a medium of exchange, gold has a long history as a store of value.

Gold has withstood the test of time in terms of its density, malleability and lustre. The price of gold was first standardized in 1717 by Sir Isaac Newton, then Britain's Warden of the Royal Mint. In coinage as a backing for paper (fiat) money, gold's value has fluctuated with world crises and market forces. When no longer pegged at $35 (U.S.) per troy ounce after 1971, gold became a freely traded commodity. GOLD IS MONEY. GOLD REPRESENTS WEALTH AND FOR MANY REASONS, THIS HAS NEVER BEEN TRUER THAN AT THE PRESENT TIME." (Winter Warning, October 19, 2009 – All That Glitters Is Gold by Ian Gordon and Christopher Funston)

Since August 1971, when U.S. President Nixon repudiated the gold-exchange standard, the world's financial system has operated on a pure fiat monetary system with the American greenback as the sole global reserve currency. To a great extent, the success and viability of any global fiat monetary system is directly dependent upon, not only the soundness of the reserve currency, but also, the financial health of the issuing nation. In other words, the global community expects the United States of America to behave as a responsible and conservative creditor nation; with its central bank, the Federal Reserve, safeguarding the purchasing power of its currency and its elected representatives, the U.S. Congress protecting the status of its 'AAA' sovereign credit rating in the global fixed income markets. Fundamentally, the global financial system of the industrialized world operates on the basis of credit and interest rates represent the cost of credit. As is often mischaracterized by the media, interest rates do not represent the cost of money! The value of money is determined by its purchasing power, i.e. what it will buy in terms of goods and services.

"Although it was the firm intention to return to the pre-World War I gold standard, the major nations, with the exception of the United States, decided in favour of introducing a dangerous surrogate. At the Genoa Conference in 1922, the Gold Exchange Standard was introduced under which the U.S. dollar and British pound were as good as gold and could be held as reserve currencies. Unfortunately, the world did not return to the classical gold standard. What everybody should have known is that these currencies had lost purchasing power and could be expected to lose even more in the future. They could, therefore, not be as good as gold." (Gold Wars – The Battle Against Sound Money as Seen From a Swiss Perspective by Ferdinand Lips – 2002)

"After the Wall Street crash of October 1929, the world financial system began to unravel. It all started with the collapse of the over extended Kredit Anstalt Bank in Austria in the spring of 1931, which forced Austria off the Gold Standard. Following the collapse of the Kredit-Anstalt Bank, panic spread to Germany, whose banks had borrowed over the short-term and loaned over the long-term. By July 1931, Germany too, had abandoned the Gold Standard. It is interesting to ponder which bank, in which country, might collapse under the weight of derivatives exposure, or whatever, in the current Long Wave, and thereby act as the catalyst to the collapse of the present financial system." (The Long Wave Analyst – The War on Gold by Ian Gordon – September 1999).

While the collapse of Austria's Kredit Anstalt Bank in May 1931 forced Austria off the gold-exchange standard; as well as Britain in September 1931, accordingly, we can draw a parallel to recent U.S. banking events in the current Kondratieff winter. In early March 2008, the monetary fabric of Bear Stearns, one of America's oldest and largest investment banks, began unraveling. Within the next two weeks, the investment bank no longer existed; its assets sold under duress to rival JP Morgan Chase. Or, perhaps you will recall the collapse and demise of another U.S. investment bank, Lehman Brothers, in September of that same year. "The cost of insuring the short-term obligations – known in Wall Street jargon as "credit default swaps" – of both Lehman and Bear Stearns had increased steadily since the summer of 2007, then, more rapidly in February 2008. Lehman had gone from twenty-five to thirty-five times leverage within a year. As Lehman's financial condition continued to worsen, a likely takeover by Barclay's Americas surfaced as a possibility. The Financial Services Authority, Britain's equivalent to the U.S. Securities and Exchange Commission (SEC) then concluded, based upon the amount of (due) diligence, the risk profile, and the lack of any assistance from the U.S. that they were not going to let it proceed." (House of Cards by William Cohan – 2009).

During the past several decades, the United States has accumulated an unsustainable national debt of $13.6 trillion. Indeed, for the 2010 fiscal year just ended September 30th., we can expect the U.S. Treasury Department to report a fiscal deficit of at least $1.3 trillion in about a month's time. As such, the U.S. has become the world's largest debtor nation by a gigantic amount. An even bigger dilemma lies in America's off-balance sheet future entitlement and benefit programs for its citizens. If we add the government promises for Social Security, Medicare, Medicaid and include the military budget in the list, the projected national debt total soars in excess of $60 trillion. It would take double-digit growth in America's gross domestic product (GDP) over several decades to eradicate such a mountain of debt, i.e. impossible. Today, the only collateral behind U.S. Treasury bonds is America's good faith to remain solvent long enough to repay creditors in viable dollars. There has never been a time in history when a reserve currency nation has been transformed from the world's largest creditor nation into the world's largest debtor nation. And there has never been a time in history when a large debtor nation, let alone the largest debtor nation, has retained world reserve currency status. That distinction has always gone to the largest creditor nation. This is China today.

There is another danger which lurks in the shadows of the global currency and bond markets. A huge number of domestic and international investors still deem the U.S. dollar as a "safe haven" in these uncertain economic times. However, as time passes and the U.S. gross domestic product (GDP) and unemployment numbers worsen, together with a burgeoning national debt, more investors will be viewing America as an impending currency and credit risk, rather than a "safe haven" and whose 'AAA' sovereign credit rating may be in jeopardy.

The above chart illustrates the volatility of the U.S. Dollar Index Future – Spot Price over the past 12 months, wherein a classic "head and shoulders" pattern has developed; indicating greater downside potential for the American greenback versus a trade-weighted geometric average of the following six currencies: the European Union euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc. The "head and shoulders" pattern is considered one of the most reliable trend-reversal chart patterns in technical analysis. (A break below 74 on the Dollar Index would imply a move down to 60.)

Also, looming on the near-term horizon is the prospect of several American state and municipal bankruptcy filings. In a newly published 600-page report entitled "Tragedy of the Commons", U.S. banking analyst Meredith Whitney documents the fiscal challenges facing the 15-largest American states, asserting these budgetary problems are "without doubt" the next systemic risk for the U.S. "I see a lack of transparency and an abundance of complacency on behalf of investors and politicians, just as we saw before the banks imploded." Ms. Whitney rates California in the worst financial shape, followed by a tie among Ohio, New Jersey and Illinois for the second-worst position.

The Fading Options for U.S. Monetary Policy

The budgetary deficit problems of several European Union countries, namely Spain, Portugal, Ireland, Greece and Italy, notwithstanding, the greatest threat to global economic stability and prosperity remains the U.S. position of being the world's largest debtor nation. As such, the U.S. now finds itself in an increasingly deteriorating fiscal position and in an untenable national debt situation. This represents a growing dilemma for the issuer and guardian of the world's reserve currency, notably, the U.S. dollar. The Federal Open Market Committee (FOMC) is now conducting monetary policy like a king-in-check on a chessboard, whose future moves are rapidly fading.

It would appear that following the mid-term elections the Federal Reserve will resort to another round of quantitative easing (money printing). Since the first round of quantitative easing failed so dismally, we believe another round would fare no better. The only beneficiaries of quantitative easing are the large banks, who incidentally own the Federal Reserve. At times, the central bank prints dollars to buy government debt from the banks; and on auction dates, the Fed buys government notes and bonds directly from the U.S. Treasury. This quantitive easing is viewed around the world as a means to devaluing the American dollar for international trade advantages.

Uncertainties abound surrounding the outcome of the mid-term elections; as well as the forthcoming December report from the President's National Commission on Fiscal Responsibility. The Commission will make recommendations to the U.S. Congress regarding deficit reduction measures, but they will be non-binding in nature. Of macro concern is a possible upturn in Treasury yields at some point, if foreign lenders begin demanding higher yields at new Treasury auctions, while the U.S. economy remains depressed and the unemployment rate stays high.

The Homegrown American Financial Mess

From the U.S. credit rating agencies knowingly granting preposterous ratings to sub-prime mortgage-backed issues (MBS), to over-leveraged American banks with investment portfolios stuffed with collateralized debt obligations (CDOs); and from the lax supervision of many regulators including the Securities and Exchange Commission (SEC) to the "bubble economics" monetary policies of former Federal Reserve Chairman Alan Greenspan; there is no foreign investor or entity the U.S. can blame for the financial mess in which it finds itself. Obviously, given America's propensity to add to her debt there is no desire to tackle her debt problem as there is in, many European countries including Greece, Ireland and Great Britain. Indeed, American Government officials have recently chastised the British Government for reducing military spending in an effort to reduce government debt, and have threatened that such efforts might cause a rift in the so- called 'special relationship' between the two countries. America doesn't seem to care a toss about reducing her debt; indeed she appears hell bent on growing it substantially, currently at the rate of about $200 million per hour, to the obvious discomfort of all her creditors. It is they that will likely force the issue.

The Gold Standard

"Gold's monetary function, lasting more than 6,000 years, has not always pleased governments. Since the eighteenth century, the linking of valueless paper to a fixed quantity of gold gave a hard to resist attractiveness to monetary units, as long as the governments were ready to exchange them for the yellow metal. But since rulers, and later republics, have been unable to manage their finances and thus their currency without spending more than they take in, they have had to default in various ways on their promises or contracts and have simply cheated those who have been gullible enough to believe monetary authorities. During its heyday in the nineteenth century, the pure gold standard formed a basis for the western world's most successful period of industrial and financial development. It lasted until 1914." (The U.S. Dollar – An Advance Obituary by Dr. Franz Pick – 1981)

The gold standard has long been a subject of interest to economic historians. Attention has focused on three main aspects of the gold standard's performance: as an international exchange rate arrangement; as a provider of macroeconomic stability and as a constraint on government policy actions – as a form of monetary rule. Historically, gold was accepted as money because of its intrinsic value and desirable properties such as durability, storability, divisibility, portability and uniformity. Paper claims, developed to economize on the scarce resources bound up in commodity, became acceptable only because they were convertible into gold. In the U.S. during the mid 1800s, paper money was deemed to have no intrinsic value, therefore, was not considered a standard of value. Rather, paper money was invariably labeled as an evidence of debt. Gold, however, due to its scarcity and great adaptability for coinage, was recognized as a standard of value.

"Money is a common denominator against which all other economic values are reckoned. The key feature of a standard of value is that it remains fixed. Thus, the primary value of a yardstick is that it remains forever equal to three feet. The supply and demand for yardsticks as such do not alter the identity that yardsticks represent: a yard is three feet. So with money. Fluctuations in any standard of value only nullify its raison d'être. In fact, it is the integrity of the standard of value itself that determines the supply and demand for it. Reliable yardsticks are more readily supplied and demanded than unreliable ones. Throughout history, gold has been the most reliable monetary yardstick known. A gold standard means that economic goods and services are valued in relation to specific weights of gold, weights that comprise the various units of account that evolved over time, such as the dollar, the pound, the yen, or the franc. Paper claims on gold, denominated in dollars, or other units of account, retain their value in the marketplace only to the extent they are freely convertible into fixed weights of gold." (Gold and Liberty by Richard Salsman – 1995)

A major reason why the gold standard was embraced in some countries for long periods of time was the fiscal discipline it demanded over government debt policy. "With the exception only of the period of the gold standard, practically all governments of history have used their exclusive power to issue money to defraud and plunder the people. What is dangerous and ought to be eliminated is not the government's right to issue money, but its exclusive right to do so and its power to force people to accept that money at a particular rate." (Reported from a speech by F.A. von Hayek in Lausanne by Gold Newsletter – December, 1975)

"This is the shabby secret of the welfare statists' tirades against gold. Deficit spending is simply a scheme for the 'hidden' confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard" Alan Greenspan in Gold and Economic Freedom, 1962, before he was co-opted by the very statists he denounces so capably in this essay.

"Looking back over monetary history, we see that gold has always been prominent as a protector of individual sovereignty. Private gold ownership is inconsistent with the aims of dictatorship; a war on gold is a necessary concomitant to centralized political power. Wars and fiat currencies have always gone hand in hand. From the 800-year old Byzantine Empire, which traded from one end of the known world to the other, to the industrialization of nineteenth century Europe and the United States, we see that economic prosperity was based on gold-stabilized monetary systems. Significantly, throughout history those eras of gold-backed currency stability became platforms for sustained economic advances." (The War on Gold by Anthony Sutton – 1977)

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The Peril of Paper

"We have come full circle to the concept of financial fragility in economies with massive indebtedness. All too often, periods of heavy borrowing can take place in a bubble and last for a surprisingly long time. But highly leveraged economies , particularly those in which continual rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever, particularly if leverage continues to grow unchecked. This time may seem different, but all too often a deeper look shows it is not. Encouragingly, history does point to warning signs that policy makers can look at to assess risk – if only they do not become too drunk with their credit bubble-fueled success and say, as their predecessors have for centuries, "This Time Is Different." – from their new book of the same title encompassing 'Eight Centuries of Financial Folly' by Carmen Reinhart and Kenneth Rogoff – 2009.

The 1999 – 2001 Gold Bullion Bottom (Privateer Market Letter)

"As long as gold is an alternative money, it will have a price. That will end once it re-assumes its age-old role as money itself. The only form of money which has ever been found to maintain and increase its purchasing power is the precious metals. The only form of money which has always been found to lose purchasing power to the end point of extinction is paper. Sound money need nothing behind it to perform perfectly all the functions of money. Unsound money, especially paper money backed by nothing but debt to be paid by future generations, is totally dependent upon the prices of the collateral being held against the debt which backs it. For forty years, the world has operated on a debt-based monetary system which is fueled by means of credit creation. It stands or falls on the assumption that the debt upon which it is based will, someday be repaid. The U.S. central bank, the Fed, prints the reserve currency behind the U.S. Dollar. That being so, the global demand for treasury debt greatly exceeds the demand for any other type of collateral. That has allowed the U.S. to go on living beyond its means for far longer than it otherwise would have found possible. The limits to this situation were revealed in March 2009, when the Fed began monetizing Treasury debt and were underlined in August 2010, when the Fed resumed its task. No matter what, the collateral value must be maintained." (The Privateer Market Letter – September, 2010)

U.S. Political Gridlock and Lack of Leadership

"Merely to maintain stability during the period in which the world is struggling back to sound finance will require strong leadership in America, scarcely less than in others. If it should come to a point where the integrity of the gold reserve or the genuine solvency of the Federal Government were immediately threatened, authoritative action of the swiftest and most vigorous kind would be required. Moreover, it is to be borne in mind that not yet, despite the administration's defensive measures, have those fundamental values underlying our credit structure been placed upon a solid basis. That the spread of want and unrest threatens to force the Government to assume responsibilities for outlays beyond its taxing or borrowing power (the limit of which can already be discerned). It is also to be recalled, with a sense of misgiving, that the American system of government renders the prompt emergence of decisive leadership in time of need, uncertain. All this means simply that the United States faces yet a very difficult period." (The Great Depression and Beyond, by Lloyd Graves – 1932).

Mercifully, the U.S. mid-term elections are less than one month away. However, the immediate downside to this franchise exercise is likely to be political gridlock. Even if the Republican Party were to gain control of both the House of Representatives and the Senate, immediate and major national issues, such as the extension of the Bush tax cuts, or a repeal of the Health Reform Bill, are unlikely to be resolved. If you're expecting some Churchillian, or other statesmanlike leadership to emerge at a high level south of the 49th. parallel post the elections, look no more – for none exists!

The Return of "Beggar Thy Neighbour"

At the onset of the Great Depression and third Kondratieff Winter Cycle in the early 1930s, currency debasement usually meant an abandonment of the gold standard by countries seeking to gain an international trade advantage, in order to boost their exports. In the case of the United States, however, it devalued the dollar in January 1934, by raising the price of gold from $20.67 (U.S.) per troy ounce to $35.00 (U.S.) per troy ounce; a devaluation of almost 70%. Today, at the onset of the current fourth Kondratieff Winter Cycle, countries who are trying to expand their export programs, fend off deflation and get their economies "growing again" are actively intervening in the currency markets by selling their domestic currencies against the U.S. dollar, the world's reserve currency – mirroring the debasement activity prevalent in the 1930s. Meanwhile the US resorts to quantitative easing in an effort to debase its currency. Moreover, we now witness the Thai cabinet imposing a 15% withholding tax on capital gains and interest payments for Thai government and state-owned company bonds, citing it will take strong measures to discourage inflows of money into the baht, which has recently soared to its highest level against the U.S. dollar since just prior to the Asian crisis of 1997-1998.

In recent weeks, concerned about potential loss of global market share to competitors in China, Taiwan and Thailand, the Bank of Japan has sold the yen against the U.S. dollar; as well as announced it will purchase the equivalent of $60 billion (U.S.) of government bonds; short-term IOUs from banks and corporations; and packages of securitized real estate loans (quantitative easing). Likewise, during the past 16 months, the United States Federal Reserve has also embarked on a $1.7 trillion (U.S.) program of quantitative easing by purchasing U.S. Treasury securities, collaterialized debt obligations and securitized debt products, mostly from the banks. Indeed, The Federal Reserve is signaling it will initiate another round of quantitative easing soon after the mid-term elections, which is rumoured to total $1 billion (U.S.) a month for as long as a year; ballooning the Fed's balance sheet to $3 trillion (U.S.). As we have previously stated, additional quantitative easing will only serve to maintain the prevailing level of interest rates at historically low levels and narrow yield spreads all along the yield curve; while simultaneously, doing nothing to stimulate aggregate consumer demand within the U.S. economy; but likely further weaken the U.S. greenback. South Korea and Brazil have also taken steps recently to offset the domestic impact of a rising won and real, while China, despite American demands, continues to insist there is no need to allow the renminbi to appreciate significantly against the U.S. dollar. The currency markets fear that many countries will embark on a series of competitive devaluations that will lead to trade wars and outright protectionism, destabilizing the global financial system, just as in the early 1930s.

In a U.K. Telegraph op-ed, economics reporter Ambrose Evans-Pritchard warns: “The overwhelming fact of the global currency system is that America needs a much weaker dollar to bring its economy back into kilter and avoid a slow ruin; yet the rest of the world cannot easily handle the consequences of such a wrenching adjustment. There is not enough demand to go around…This an intolerable situation for the United States. It should be no surprise that Washington has begun to retaliate in earnest, and not just by passing the Reform for Fair Trade Act in the House of representatives (not yet the Senate), clearing the way for punitive tariffs against currency manipulators…This is a dangerous moment for the world, and may backfire against the U.S. itself. We are already starting to see the same sort of rush into oil and resources that played such havoc in mid-2008 and may have been a key trigger for the Great Recession. There is a risk that this commodity shock will hit before (any additional U.S.) quantitative easing stimulus filters through. While the French deny that they are in talks with China over the creation of a new currency regime, I heard French Finance Minister Christine Lagarde say in person at a meeting in Italy, that France would use its G20 presidency to push for an alternative (reserve currency) to the dollar. She specifically cited the “Bancor,” the idea floated by Keynes in the 1940s for a commodity currency priced off a basket of metals. The U.S. risks gambling away the ‘exorbitant privilege’ it has enjoyed for two thirds of a century as currency hegemony.”

At last weekend’s annual meetings of the International Monetary Fund (IMF) and World Bank, finance ministers and central bank governors enlisted the IMF to help them contain a growing number of emerging market countries seeking to control the rise in their currencies; inflaming the mood for retaliatory measures in countries which continue to struggle with high unemployment, especially the United States. Canadian Finance Minister Jim Flaherty commented: “We all agreed that we needed to move toward co-operation on exchange rates… The drift of talks over the weekend was to establish guidelines for when government intervention in foreign exchange markets were proper and not just a subsidy for exporters.” On Saturday, the IMF’s 24-country steering committee directed the Fund’s management to “deepen” its analysis of the economic forces driving currency markets, including the accumulation of record foreign exchange reserves and the long-term dangers of China, Japan and Germany ramping up exports rather than generating more internal demand.

As in the early 1930s virtually all countries are seeking competitive trade advantage by debasing the value of their respective currencies, but as the IMF noted, “Not all countries can reduce the value of their currency and increase net exports at the same time.”

Summation

As we have seen from past events chronicled above, history does repeat itself. When the British pound was forced off the gold standard in 1931, it marked the beginning of the end of the world’s monetary system. Despite the U.K. Pound and the U.S. Dollar being considered equal at that time, no reserve system emerged after 1933 until the Bretton Woods agreement following the end of World War II. With this collapse world trade all but ceased to function. Countries retreated into small enclaves to trade with each other; Great Britain with the Empire, the European countries for the most part stuck together and self sufficient America retreated into isolation. Japan, cut-off by America for her oil supplies resorted to military conquest to satisfy her requirements for raw materials.

Over months and recent weeks, we have witnessed the price of gold continue its exponential rise and its steady ascension as the money of trust. We are now in the fourth Kondratieff winter deflationary depression when fiat, or, paper money will become mistrusted and discredited. The endless erosion of the U.S. dollar’s purchasing power by the Federal Reserve and U.S. Treasury bodes ill for the future of the world’s reserve currency. “America has thoroughly mismanaged her monetary stewardship. That responsibility is about to be taken away from her.” The Long Wave Analyst, May 2001. Several nations, led by China and France, are already exploring alternatives to the current global monetary system. As the U.S. Dollar continues its downhill demise, we believe gold will be a factor in any new, or revamped global monetary reserve system within the next decade.

Written By: Christopher Funston