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Mar 11

Freedom Fighters: The Facebook Revolution

In the name of this flag I appeal to lovers of freedom all over the world to cooperate with this flag.

Bhikaiji Rustom Cama

Freedom is never dear at any price. It is the breath of life. What would a man not pay for living?

Mohandas Gandhi

All the great things are simple, and many can be expressed in a single word: freedom - justice, honour, duty, mercy, hope.

Winston Churchill

Money won't create success, the freedom to make it will.

Nelson Mandela

The desire of gold is not for gold. It is for the means of freedom and benefit.

Ralph Waldo Emerson

'Freedom Fighters'- the phrase invariably conjures romantic notions of charismatic individuals mobilising oppressed populations against tyrannical regimes. Iconic images of Che Guevara, as immortalised in Andy Warhol inspired T-shirts, have become the ubiquitous countercultural symbol of the modern day freedom fighter, most notably amongst today's young. His image is a popular insignia for any rebellion, from the classroom to the streets of Bangkok.

The recent risings in the Maghreb do not conform to this stereotype. They are led ironically by a leadership of many faces - a morphing of the masses to the rally cry of social media sites such as twitter or Facebook. It seems totally apt to name this the 'Facebook Revolution'. This is not about one stand-out person but the many.

Hopefully there is a strong democratic leader amongst them, but we are not giddy with naive hope. It is evident there is a growing power vacuum. The growing turmoil in the Middle East will not be lived out in a matter of weeks, as the Tunisia revolt perhaps mistakenly led us to believe. Democracy, if at all, will take years, even decades.

The protests and uprisings have their roots in a common thread - high youth unemployment, a lack of political representation, repressive and corrupt governments, coupled with brutal state police, as well as rising poverty exacerbated by rapidly climbing commodity prices. Although we will touch on some of the specific political nuances of this part of the world (we are not resident experts), we have tried to assimilate as much information of the geopolitical scene, as market practitioners, so as to make educated but nonetheless *subjective* assessments of the impact on asset classes going forward.

To paraphrase Deng Xiaoping, "One should not talk of methodology every day. In real life, not everything is methodology." Clearly this will all have a profound impact not only on energy and commodity prices, but both regional and international financial markets. For us the tipping point was rising commodity prices (food namely), which we believe are a **symptom of the heavy mix of price controls, subsidies and abuse of the US numeraire, by the ultimate price fixers - central banks.** After all they have a monopoly on money creation.

We will examine why price controls are ineffectual and concomitant with excessive monetary largesse, are highly inflationary. We will look specifically at the rising issues of the OPEC cartel, the central bank cartel, Japan price controls and discuss potential commodity shortages. **The events in the MENA, and the awful events in Japan will serve to expedite the acceleration in the demise of the *fiat* currency system.**

Facebook Revolution

The spreading discord emanating from Tunisia to the rest of MENA has also been dubbed by media outlets as the Jasmine Revolt, or the Arab Spring. Wander amongst the sweet smelling jasmine and bourgainvillea enshrined residents of Tunis and you begin to understand why. The scent of Jasmine that evokes the exhilarating promise of freedom of expression and democracy is however particular to Tunisia.

Tunisia was a truly organic rising, inspired by the self-immolation of a desperate young man, Mohamed Bouazizi. Unable to find work after his graduation he took out a loan to fund a cart so he could be a humble fruit and vegetable market seller; persistent persecution by state police led him to set himself on fire. Social media spread the word, igniting the simmering disquiet of a repressed people, and within weeks an ousted President Ben Ali, after 23 years of rule, fled to Saudi Arabia.

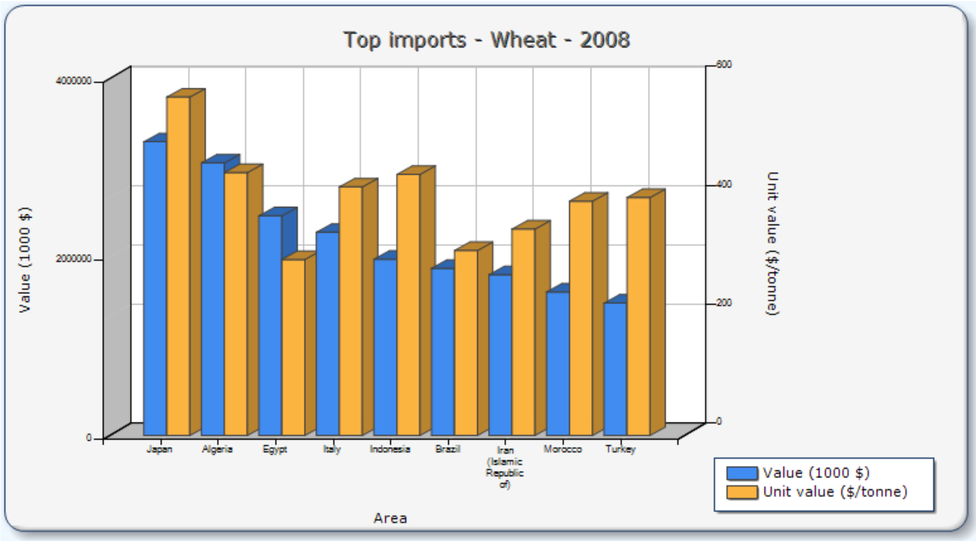
Egypt, January 25th, saw tens of thousands descend on Cairo mobilised via the net seeking democracy, social justice and an end to corruption, torture and police brutality. This was not an Islamic revolution either, but nor was it truly organic. Military encouragement of protest has led to the cession of power of the former President Mubarak to the military. We wonder how long before pro-democracy activists and the military elite's interests divide.

Tunisia, like Egypt, though finds itself largely dominated by members of the former regime who, although denouncing Ben Ali, and donning the face of democracy, clearly do not represent the needs of the people. Interestingly, the mainstream media refers to the anti-Gaddafi forces in Libya as rebels. It may not be meant pejoratively but these people are not rebels as they are so thoughtlessly referred to, but desperate people fighting for their lives and a better way of life. They are Freedom Fighters. We will glamorise them as such, as they need all the inspiration they can get.

In addition to Egypt, the people have taken to the streets to varying degrees in Algeria, Jordan, Libya, Morocco and Yemen. Local food riots have even broken out in rural China and other Asian locales as individuals watch events through the web. Subsidies are a notable contributor to food problems both domestically and abroad. According to The Wall Street Journal, in 2001, only 7 percent of U.S. corn went to ethanol. By 2010, the ethanol share was 39 percent. So instead of growing wheat, MENA farmers are growing corn in order to cash in on ethanol subsidies. Wheat has grown scarce in the region.

Egypt is one of the largest wheat importers in the world, but this was not always the case. She had been the 'breadbasket' (major wheat producer) in the world in the 1960s but in the late 80s and 90s the US and US centric institutions (World Bank/IMF) encouraged developing countries to import grain produced cheaply in the US. Coupled with poor land reform laws and generally woeful governance in Egypt, corruption has flourished. Nonetheless, food production has been reliant on foreign supplies and not kept a pace with population growth. Subsidising food prices to placate the masses has failed.

World Imports - Wheat - 2008



Source: FAO

A country cannot control prices in isolation forever. There are other open markets in the world. Productivity gains in agriculture these past decades have dampened prices, even allowing for subsidies. The impact of those subsidies and lower prices have helped reduce domestic production. You have no incentives to produce for profit in such a situation. So when prices rose on international markets, wheat and corn are up over 100 per cent this past year, subsidies were too costly. Sadly, corrupt regimes have not redirected funds (mostly US funding) to help their people, but then why would they, they are corrupt.

The events that sparked this turmoil in MENA are in the main based on an 'inflationary crisis', so unfortunately the on-going power shift will not alleviate these price pressures on income and will prolong the agony of these nations. They are not alone. These troubles in the developing countries are not particular to them. They are also occurring more and more frequently in the West.

The UK, Germany and France are all seeing rallies against the government, mostly peaceful, but with growing bouts of violence. We suspect the existence of a an overly generous welfare system has nullified any hugely radical behaviour. This is changing.

The unproductive efforts of too much public sector employment and an unfunded welfare system, is never sustainable without causing instability. Instability will arise either due to spending cut backs or because of debt monetisation. It is clear that spending cuts will enforce a lower standard of living. Monetisation will ameliorate the funding gap, but it always leads to inflation of prices and the loss of peoples’ purchasing power.

We are witnessing all of this and the 'firming fist' of rage is being levelled at developed nation governments. Rising prices are often met with price controls when subsidies are not affordable. No nation is truly autarchic with regard to resources - this will cause tensions in trade as either price controls are put in place on imports, or producers are subsidised.

Price Controls

To steal a thought from Milton Friedman, *economists may not know much, but they do know how to produce a shortage or surplus.* Replace the word economists for governments in this quote and Milton would be spot on.

According to George Reisman's outstanding treatise of economics, *Capitalism*, price controls are implemented as a method of controlling inflation. It is assumed that inflation means rising prices and exists only because businesses raise their prices. Therefore it follows that if price increases were simply prohibited by price controls then inflation would cease.

We will examine in the section *Economic Amnesia*, that rising prices are in fact a symptom of inflation, not the phenomenon itself. **Inflation can exist, and, indeed, accelerate, even though this particular symptom is prevented from appearing.** Inflation is simply an increase in the quantity of money caused by the government and central bank.

Price controls are largely the preserve of governments. **They are used to fix prices for both commodities and services at a different level than would ordinarily have been determined by the *unhampered* (free) market[1]**. They invariably fail with disastrous consequences, although these may not be felt initially or even for years. The case against price controls, fortunately is not an academic concept. Over 4,000 years of economic catastrophes have been illuminated by a book well known to followers of the Austrian School - www.mises.org. - *Forty Centuries of Wage and Price Controls* by Robert Schuettinger and Eamon Butler.

One section of the book depicts how Ancient Egypt suffered at the hand of price controls. The echo of its past resonates today. For centuries the Egyptian government strived to control the grain crop, understanding that control of the foodstuffs was control over the lives of their people. Using the pretext of preventing famine, the Egyptian government gradually regulated more and more of the granaries. This regulation led eventually to direct ownership; land became the property of the rulers and was rented to the agricultural class. Egyptian farmers eventually gave up farming. Persecuted by price inspectors, they hardly had the incentive of high margins to offset this state intervention. The threat of starvation, that originally led to government control, actually came to pass as production levels failed. Ultimately the Egyptian economy collapsed, along with her political stability.

Price controls do have an intuitive feel to the uninitiated. They can protect socio-economic groups in an economy who are unlikely to be able to afford price increases. Maximum price levels for bread are supposed to protect the poor, who depend on it as a subsistence living. Likewise rent controls are supposed to protect those who are renting when the demand for flats exceeds supply and landlords "price-gouge" (higher rents) their tenants. In time the introduction of a few price controls can lead to blanket control of services and the production process. This is tantamount to 'confiscation' of property rights - a defining tenet of a free society.

[1] Ludwig von Mises. "1. The Government and the Autonomy of the Market", Chapter XXX, Interference with the structure of prices, *Human Action* online edition, referenced 2009-09-11.

Reisman put it succinctly -"a government which imposes price controls is in the process of destroying the economic system of its own country."

Effects of price controls are best illustrated from our summary of several chapters out of the two books mentioned previously, *Forty Centuries of Wage and Price Controls*, and *Capitalism*:

1. Controls lead to distortion in the market system. Price ceilings, which prevent prices exceeding a certain maximum, cause shortages. Prices in a free market inform buyers and sellers of the relative availability of all goods and services and encourage them to restore supply and demand so as to facilitate equilibrium prices. If demand exceeds supply, prices are bid up. Sellers are drawn in at these higher prices due to the higher profit (margins) and supply increases, restoring supply and demand to equilibrium.

Controlled or *manipulated* prices distort these 'signals' and create shortages. **Price controls cause shortages.** It is impossible to distinguish real signals from these artificial ones. Shortages become common because firms are not induced by higher profits to expand their supply. This opens up the way for a **'black market'** where the demands of individuals would be met sooner rather than later because of these shortages. This comes at a price - a higher one. The controlled firms become unprofitable as production falls as they have no inducement to produce. Bankruptcy is often common. Meanwhile investment is redirected to other areas of production not under control that would not necessarily be profitable but for a time have the illusion of a sustainable business. A clear misallocation of capital which eventually leads to a malinvestment.

2. Controls negate 'capital' motivation for profits. A government introduces controls when they see that the prices are 'too high'. It often suggests governments believe profits are too high for a particular industry, eg energy companies and utilities. This stymies investment to worthwhile industries as profits are the motivation. Clearly such manipulation also leads to dislocation in capital formation and investment.

3. Controls create 'complacent' attitudes. If wage and price behaviour is predictable, (wage controls are a form of price control), they are not taken account of in the economic decision making of a firm. In free markets there is no such safety net for businesses on price and wage levels. Suppress their level for long enough and companies maintain inefficient businesses, which as soon as the controls fail will lead to instant bankruptcy. Likewise governments will become inactive to risks of inflation as fixed lower prices put an initial dampener on inflation and do not restrain aggregate demand or increase unemployment. Re-election prospects rise in such time periods.

4. The controller or regulatory body becomes bigger than the market. This leads to bureaucracy that impairs productivity and profits. In any country where there is too much wage regulation the unions are emboldened as government spends too much time consulting them. Likewise employers spend time placating or not the unions as well as the regulatory body, instead of driving productivity. Bureaucracy equals inefficiency and falling returns on investment.

5. Controls mask the real causes of inflation. C. Jackson Grayson, Jr. who was Chairman of the Price Commission under Nixon's Economic Stabilization policy knew only too well the true damage of price controls, which he said **"drew attention away from the fundamental**

factors of inflation - fiscal and monetary policies, tax rates, import-export policies, productivity, competitive restrictions and the like."

6. Price controls potentially inhibit recovery after disasters and hurt precisely the people they are intended to help. If you put in measures to prevent price gouging, ie 'unscrupulous individuals' raising the prices of necessary supplies like water, fuel, ice etc, higher prices for those services in a uncontrolled markets would signal shortages are evident. Price equilibrium would be restored quicker in time.

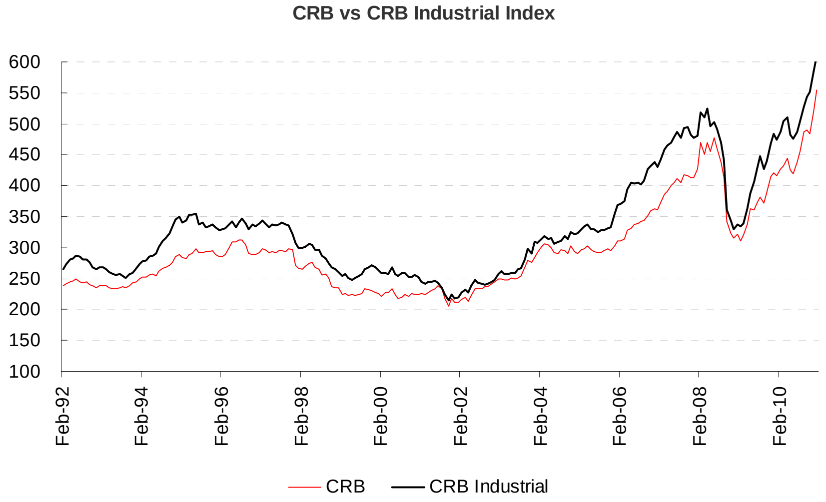
Other effects could be quality deterioration in products to maintain margins; in foodstuffs this can cause health risks eg more fat and cheaper meat is put in the hamburgers. During periods of inflation, prices are rising and workers are claiming higher wages - at the same time, sellers are raising their prices to keep up with the costs. There is no right moment, when the prices can be frozen, without causing problems to both businesses and workers. Finally, when the controls fail and are removed, any prices that did not catch up with the real inflation will rapidly rise, creating further economical problems. This is by no means an exhaustive list but it provides a good idea of the negative impact these controls have on an micro and macro economy.

In our globalised world a single country cannot maintain price controls without limiting exports, which damages foreign markets and trade agreements, otherwise, the underpriced goods will be exported. This leads to retaliatory behaviour in other countries. In a debt-laden world, export growth is the panacea - it is inevitable we will see more domestic subsidies and tariffs put in place.

Ultimately price controls shift power entirely to centralised planning, usurping free market decision making away from the private producers and consumers to government, regulatory bodies and labour bodies. Human nature being what it is, every other decade or so we forget the previous mistakes of such supply side economics and try them all over again.

We will illustrate how amnesia of these issues has set in because we have had long held cartels in place which for years masked the deleterious ramifications of price controls. We would argue the events today where we are experiencing extreme and universal price rises are a manifestation of the struggle between free market action and those of unadulterated coercion of markets by price controls.

Exchange Traded Commodities & Non-exchange traded Commodities



Source: Bloomberg, Variant Perception

An almost three-fold rise in both exchange traded commodities and non-exchange traded commodities, eg leather, tallow etc, is clear sign it is not speculation as government would have you believe. This price appreciation in raw materials is not the sign of a sound financial monetary system.

Economic Amnesia

Ask most individuals their greatest fear about growing old and chances are most won't speak of wrinkles, or grey and thinning hair. We suspect most worry about the loss of their mental faculties. We know we do. Alzheimer's is an aging disease that promotes the loss of such cognitive ability. A form of dementia - it is an incurable, degenerative and terminal disease.

By 2050, researchers suggest 1 in 85 of the world population will suffer from this cruel affliction. Sadly these past few decades the world populace has been suffering from another form of mental incapacity – 'economic amnesia'. Individuals have forgotten the rudiments of monetary supply and demand. Too much money creates a rise in the price of a stable supply of goods and services. They forget this is also concomitant with a loss in the value of their day's earnings.

Egyptian man holds all the 'Bread' (moolah)

Source: AP

The introduction of an overbearing welfare system in most developed countries has robbed the masses of independent thought. Government has induced a powerful amnesia in us. But there is good news: fish oils may ameliorate the decline of impaired thought, but the internet could likely prevent it entirely. The internet never sleeps, but more importantly it will never allow us to forget. Never before has so much information been so readily accessible, and to so many - information that extols the truth, free of government propaganda. The seminal events in the Maghreb are a testimony to the power of the internet. Fortunately the internet is creating awareness of other groups pursuing democracy.

The financial world should be fortunate for their very own breed of freedom fighters: liberal economists. Their philosophy encompasses *laissez-faire* - a society in which private transactions are free from state intervention, including restrictive regulations, tariffs, state monopolies and taxes. The pursuit of democracy, political and social freedom are inseparable with economic freedom in the eyes of such economists. This is why they (and we) salute democracy and its pursuit, as a state devoid of constant intervention can pursue free markets, where market transactions are facilitated by the unadulterated price signals of supply and demand.

Human life and wellbeing depend on the production of wealth. The production of wealth vitally depends on the division of labour, that is, a system of production in which the labour required to support human life and wellbeing is broken down into separate, distinct occupations. Under a system of division of labour, the individual lives by producing, or helping to produce, just one thing or at most a few things, and is supplied by the labour of others for the far greater part of his needs. In short, division of labour increases/raises the productivity of labour.

Division of labour allows specialisation, whereby production and (knowledge of this production) of goods and services benefits the rest of society. A wheat grower benefits from an oil producer, and a steel producer benefits from another resource producer. Self-interest of the individual to make money for himself by production has benefited most. Marx and

Engels deplored this Smithsonian free market concept, but we only have to observe the 'collective' bureaucracy in any modern day public sector to see that their socialist construct fails. They are grossly inefficient and costly.

Unfortunately the criticism levelled at capitalism's supposed failings are not a function of failed free markets but are a function of state intervention in the supply of money. The failing of the banking system is because of meddling in the true or real rate of interest which has distorted all pricing mechanisms in the production of both credit, resource extraction, manufactured goods and services. This has been a global phenomenon

MENA freedom fighters and liberal economists alike desire less intervention by an oppressive state. Monetary policy under a fiat currency system is the ultimate pursuit of price control, as it both tries to fix a maximum and minimum price limit, a ceiling and floor.

Central Bank Cartel

The ultimate form of price control is the setting of interest rates by central banks.

In 284 A.D. the Roman Emperor Diocletian created inflation by placing too much money in circulation, and then "fixed the maximum prices at which beef, grain, eggs, clothing and other articles could be sold, and prescribed the penalty of death for anyone who disposed of his wares at a higher figure." The consequences according to Schuettinger and Butler were that " the people brought provisions no more to markets, since they could not get a reasonable price for them and this increased the dearth so much, that at last after many had died by it, the law itself was set aside."

For those interested in Ancient Rome and Diocletian's Price Edict should read this paper by Robert C Allen: http://www.economics.ox.ac.uk/Research/wp/pdf/paper363.pdf.

Diocletian intuitively understood that by creating too much money, prices would rise and he thought he could control these with fixed lower prices. Today central banks have set interest rates in the same vein of preventing prices falling, but this is to distort entirely where the market perceives value. It may well be those lower prices are it. People will borrow if they require a product because the market place has signalled fair price by true supply and demand.

Liberal economists, more specifically Austrian Economists, show that interest rates reflect a particular preference of human beings, namely *time preference*. Humans prefer to have things now than in the future, and are prepared to borrow money at interest to get them. When we lend something, we demand to be paid interest. This forms the basis of the theory of investment, production and use of capital.

The Austrian school of thought enables one to understand that economic decisions are inherently personal. Value does not exist in things, but in the minds of the individuals who value them. Trade occurs and prices emerge precisely because people value things differently. Markets steer goods to their most valued uses. Private ownership is essential to achieving the best results. Government / central bank intervention, will disrupt this highly complex market process and invariably produce perverse results. Inflation is such a policy mistake brought about by trying to set interest rates too low.

Setting of interest rates at face value may appear to be an indirect manipulation of prices but in reality it is a price control extraordinaire. Like other economic goods, there is a *supply* of money and a *demand* for it, and money has its *price* (interest rate). The price of money is expressed a little oddly – not in terms of the value of goods that will exchange for one unit of it (how many loaves of bread for a dollar), but the number of units of money that exchange for the other goods (how many dollars for a loaf); and we talk about its *purchasing* power rather than its price. Yet the purchasing power of money is a price like any other, decided by how people value it, through the pressures of supply and demand.

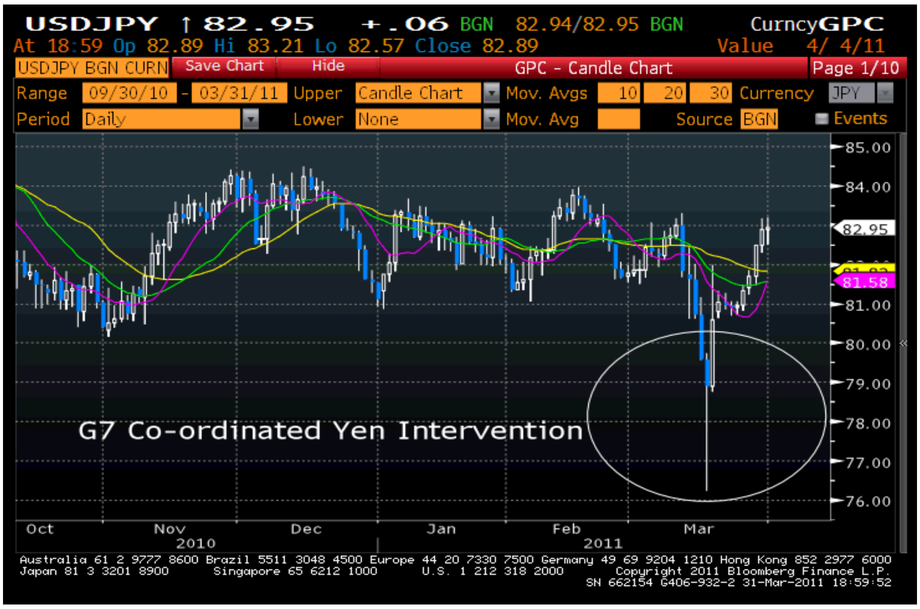
If you set the price of money too low, you are encouraging individuals and corporations to borrow as there is no perceived cost to them - the interest rate is so low right now it feels like free money to people and it is, until it is used elsewhere. A parallel universe of overinvestment and overconsumption occurs simultaneously, until such time as the rate of savings cannot support it. Simply put one runs out of potential capital.

This is exactly what central banks have achieved. They have lowered rates around the world below the market interest rate which would normally reflect consumer preferences. Public and private sector borrowing has been so egregious that they have run out of true savings and are reliant on creating infinite amounts of money (out of thin air) to replace this hard earned savings. If the economy could thrive on such money life would be very simple. In fact if it was that simple why would any of us ever work. It would all be play time.

This increase in the supply of money has set off an avalanche of price changes which has torn through markets, drawing resources first to one place, then another, creating real and destructive changes. Money is not *neutral*.

Central Banks are a cartel. The US may own the reserve currency status but the fiat monetary order under Bretton Woods II has encouraged a collaboration on the fixing of money prices. This is an example of a public cartel. The recent price intervention in the yen is an example of *a crisis cartel*. The acute shortage of yen, or rather perceived shortage of yen that would have transpired from repatriation of insurance monies, led to an infusion of yen by the G7 central banks. They ultimately fixed the price of yen at 79 – 80, for the time being at least.

G7 Co-ordinated Yen Intervention March 2011



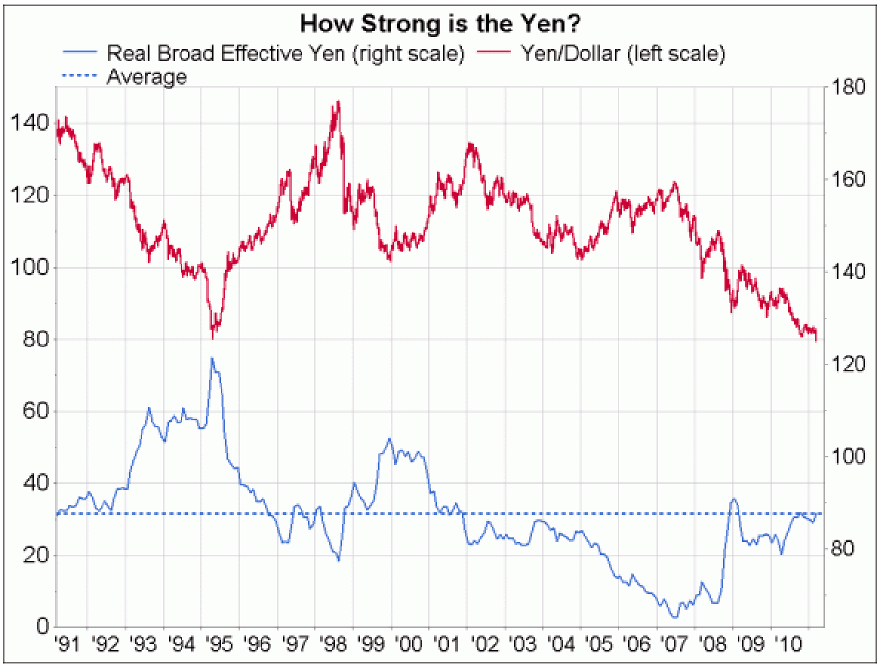
Source: Bloomberg

The Ministry of Finance announced this past week that Japan conducted a total of 692.5bn yen (U$8.4 bn) in foreign exchange intervention. This was a joint intervention along with the other members of the G7, the first in over a decade. On March 18th as the yen traded close to 76 yen selling by G7 began in earnest. **This number does not reflect the true extent of yen intervention as this likely only captures Japan's efforts. Let's not forget that it was only last September that the BoJ/MoF sold 2.12 trillion yen to combat the 'Chinese push of dollars' onto them.** This suggests that the yen sales were extensive.

In 1995, after the Kobe earthquake, the yen surged over 20 per cent, but this was more a function of the Plaza Accord and dollar weakness than repatriation needs of Japanese industry for reconstruction. If we observe the real effective exchange rate (REER) of the yen we can observe that relative to 1995 when we were last at the 80 level in nominal terms the yen is weaker. Hence why Mr Yen, Eisuke Sakakibara, once the *enfant terrible* of the yen market, says the country can cope with a stronger yen at this stage.

The MOF, like all government bodies blamed speculative activity. In truth it was most likely the unwind of yen shorts (perversely) and structural positions which benefit from borrowing in yen and investing overseas - the yen carry trade. Clearly coordinated yen intervention has proven momentarily more successful than unilateral actions. Fear over a collapse of revenue for Japan's export economy appears to be the rationale. Like all economies that run a large current account surplus, Japan has tremendous holdings outside the country. Indeed the Japan fiscal year end on 31 March we would typically see some yen sent home to balance corporate books. As free market exponents, we say again crisis controls can have catastrophic ramifications. Once the state pursues a policy of intervention they find it all too easy to continue down the same old route.

Yen Nominal Price vs Yen REER



Source: Bloomberg

YEN Money Supply. Excess reserves.

It's well documented that psychopaths who commit murder say the first one was the hardest and then it just gets easier and easier as one becomes inured to the thought. Next thing they know they are facing the "fryer" themselves. Actions have consequences, but by then the damage has been done. The 'psychopathic' mentality of the CBs who intervened to stem the 2008 Financial Crisis is a another case in point. They are finding it very hard to stop. Further rounds of liquidity swaps and QE 2, 3 have been pursued or considered. Where do they stop?

Japan has become obsessed with 'managing' its economy. Instead of addressing the structural issues of their economy, ie reliance on export market (exaggerated), bureaucracy and fiscal spending they fight a rear-guard action on the yen from 'beggar thy neighbour' policies of their mercantile neighbours. If they let events run their course corporations would adapt their business model to survive; instead they are guilty of inactivity as they know the state will bail them out.

Policymakers have neglected one reality: restocking. Right now Japan would most likely benefit from a stronger yen so as to restock their country with more affordable imports, and as a bonus their domestic market would quite possibly get 'real' and more efficient in order to compete with the world.

The extent of intervention suggests the G7's real fears were that of the potential deleveraging of $30 trillion worth of Japan total debt, which would have transported the world back to a 'ground zero' scenario - total destruction of the financial structure. Certainly the US do not need the Japanese selling their $800bn odd US Treasury bonds to fund the rebuild.

Saudi Food Market

Source: AP

The behaviour of central banks and governments this past decade, and policy prescriptions of 'more of the same' - that of debt infusions to maintain output - only works with diminishing effects. More has to be spent (monetised) to maintain the status quo. But perhaps more worryingly such policy actions leave the world vulnerable to any natural or financial shocks. Japan serves as a reminder of this. We are now witnessing a clear feedback link - a severe one.

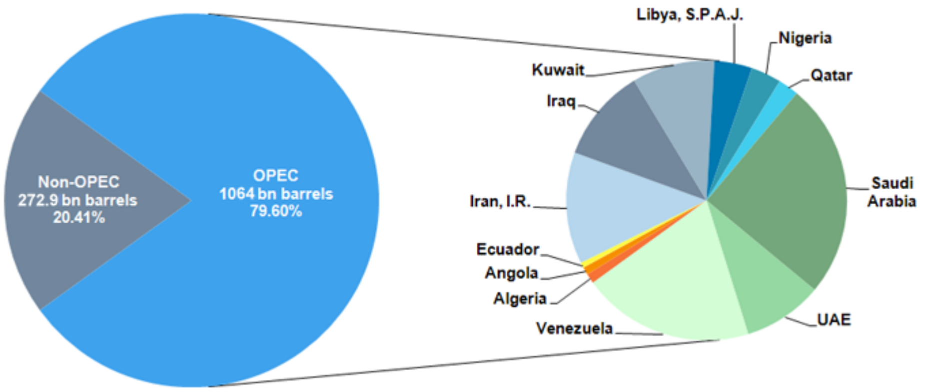
Higher debt levels are constantly monetised as private sector losses have been assumed by the public sector. Banks have been encouraged to recapitalise with sovereign debt. A win-win until you realise both are insolvent. The PIGS are out in the open now, but the issue remains. Deficit financing spawns rising prices, that we do know (even if Ben Bernanke does not), rising oil prices begets rising food prices, which begets falling disposable income, which begets recession. The central bank steps in and supplies more money. Cartels last a long time but this time we believe they cannot maintain a fixed price. Another famous cartel we turn our attention to is OPEC. Both cartels are clearly inextricably linked, because as we will show oil prices are the economy, and central banks love to control the economy as the economy is money.

OPEC Betrayal

Let's turn our attention to an example of private cartels. OPEC or the Organisation for Petroleum Exporting Countries (OPEC), is a group of twelve states made up of Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the UAE and Venezuela.

Just last year OPEC celebrated its 50th birthday. The organisation was founded in 1960 with essentially the purpose of regulating world oil prices and controlling the supply of oil. OPEC members collectively hold 80% of world crude oil reserves and account for 44% of the world's crude oil production, affording them considerable control over the global market.

OPEC Share of World Crude Oil Reserves 2009



OPEC proven crude oil reserves , end 2009
(billion barrels)

Saudi Arabia	264.59	24.9%	Iraq	115.00	10.8%	Libya, S.P.A.J	46.42	4.4%	Algeria	12.20	1.1%
Venezuela	211.17	19.8%	Kuwait	101.50	9.5%	Nigeria	37.20	3.5%	Angola	9.50	0.9%
Iran, I.R.	137.01	12.9%	UAE	97.80	9.2%	Qatar	25.38	2.4%	Ecuador	6.51	0.6%

Source: OPEC Annual Statistical Bulletin 2009

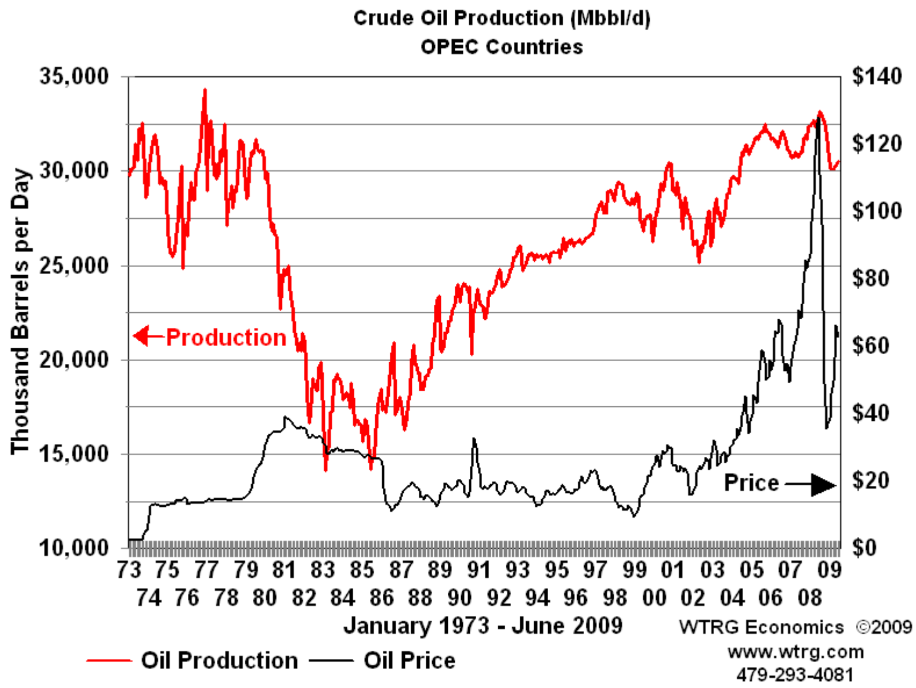
According to its statutes, one of the principal goals is the determination of the best means for safeguarding the organization's interests, individually and collectively. It also pursues ways and means of ensuring the stabilization of prices in international oil markets with a view to eliminating harmful and unnecessary fluctuations. It aims to give due regard at all times to the interests of the producing nations and to the necessity of securing a steady income to the producing countries; to be an efficient and regular supplier of petroleum to consuming nations; and to ensure a fair return on their capital to those investing in the petroleum industry.

It is apparent that a cartel such as OPEC tends to promote higher prices with lower production. A higher price would generally create conditions where there is the potential for inflation and economic recession, as happened in the early 1980s. As a consequence of reduced demand and oversupply, the oil price would then drop. Also, a very low price elasticity sprouts a substantial price hike. Such roller-coaster behaviour in the oil price does not fare well with OPEC members.

In 1972, the price of crude oil was about $3 per barrel. By the end of 1974, the price of oil had quadrupled to over $12. The Yom Kippur War started with an attack on Israel by Syria and Egypt on October 5, 1973. The United States, and many countries in the western world, showed support for Israel. Because of this support, several Arab exporting nations and Iran imposed an embargo on the countries supporting Israel. While these nations curtailed production by 5 million barrels per day, other countries were able to increase production by a million barrels. The net loss of 4 million barrels per day extended through March of 1974 and represented 7 percent of the free world production. Any doubt the ability to control crude oil prices had passed from the United States to OPEC was removed during the Arab Oil Embargo. The extreme sensitivity of prices to supply shortages became all too apparent when prices increased 400 percent in six short months.

From 1974 to 1978, the crude oil price was relatively flat ranging from $12.21 per barrel to $13.55 per barrel. When adjusted for inflation world oil prices were in a period of moderate decline.

OPEC Oil Production: Yom Kippur War 1973



Source: WRTG economics

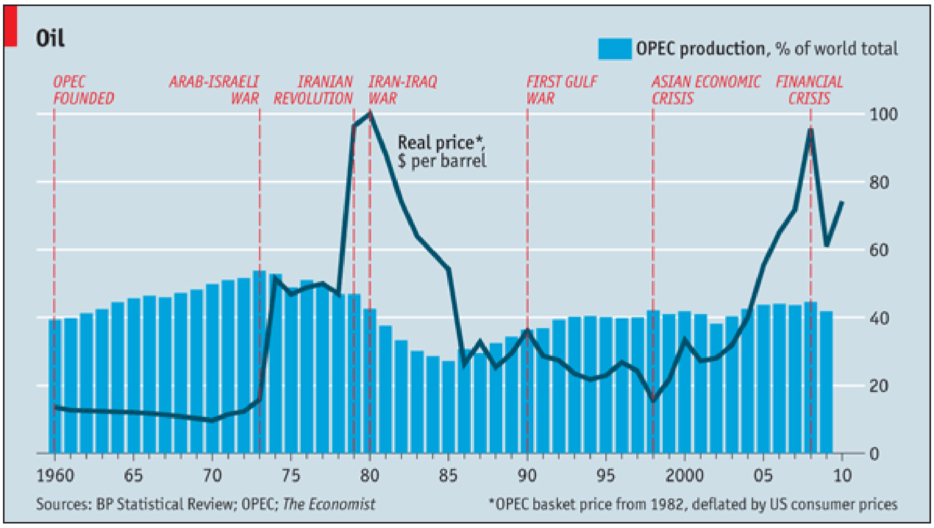
The rapid increase in crude prices from 1973 to 1981 would have been much less were it not for United States' energy policy during the post-Embargo period. The US imposed price controls on domestically produced oil. The case of the government's regulatory control over crude oil prices during this period provides an excellent example of how such activities disrupt the market. By attempting to soften the initial rise in oil prices caused by the Arab Oil Embargo, regulators actually compounded the problem. Worse yet, the continuation of regulation during the 70s led to numerous private decisions which would otherwise not have been made. Many of the resource movements prompted by governmental policy would have to be reversed at a later date when the true conditions of the market became known. To the extent that some decisions proved unwise and yet irreversible, is the extent to which the government's actions led to a real loss in economic well-being in the United States.

The obvious result of the price controls was that US consumers of crude oil paid about 50 percent more for imports than domestic production, and US producers received less than world market price. In effect, the domestic petroleum industry was subsidizing the U.S. consumer.

In the absence of price controls, U.S. exploration and production would certainly have been significantly greater. Higher petroleum prices faced by consumers would have resulted in lower rates of consumption; automobiles would have achieved higher miles per gallon sooner, homes and commercial buildings would have been better insulated (by alternative products), and improvements in industrial energy efficiency would have been greater than they were during this period.

The ramifications of this disastrous policy move was that the United States would have been less dependent on imports in 1979-1980, and the price increase in response to Iranian and Iraqi supply interruptions would have been significantly less. The free market would have ensured supply was available this second time around.

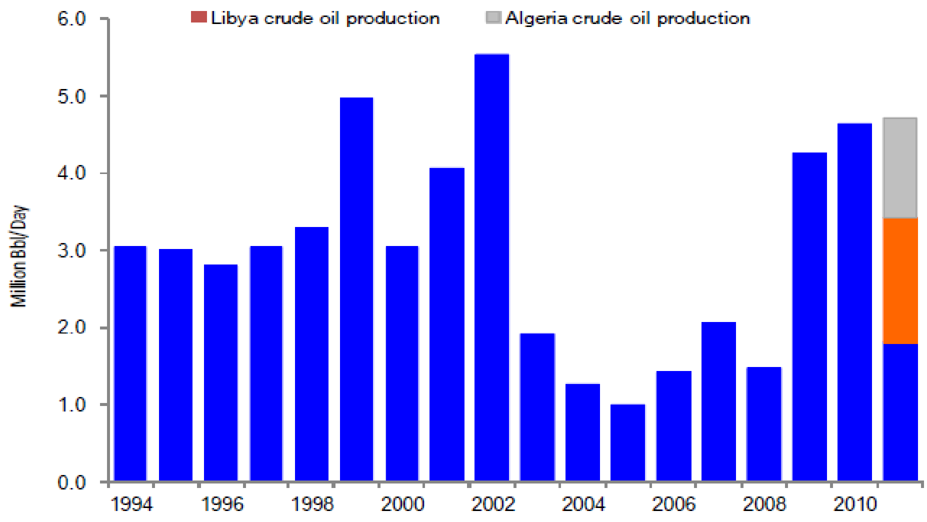
OPEC Production as % of Total World Production



Source: The Economist

As prices spike, the OPEC cartel or 'natural stabiliser', as some have termed it, will supply oil from their strategic petroleum reserves. For the OECD as a whole, strategic oil reserves amount to 1.6 billion barrels. There is plenty of medium sour crude but much less gasoline-light sweet barrels. Natural stabiliser is a euphemism for state price control. It is 'unnatural', there is no need for any price limitation. For as we have demonstrated, if you hold prices down artificially when those controls are released prices will only rebound higher.

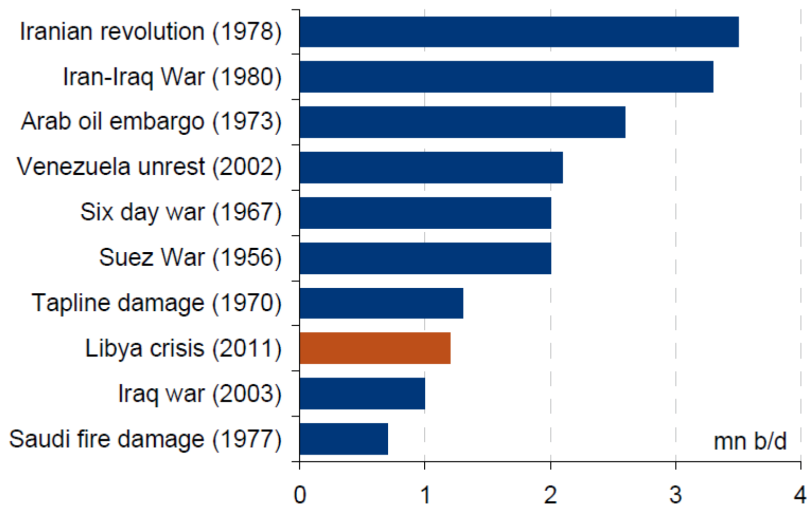
OPEC Spare Capacity outlook



Source: US DOE/EIA

The graph below graphically demonstrates previous supply losses from geopolitical events since the 1950s.

Global Oil Supply Disruptions (by average gross supply losses)



Source: EIA, ML GCR

In truth, through a system of quotas employed by the cartel - for this is the mechanism of price control - should in theory negate OPEC drawing on either spare capacity or strategic reserves. Higher prices in recent years have seen a surge in non-OPEC production, notably in Russia. This led some disparate members to deviate from their quotas - most notably Angola, Venezuela, Iran, Nigeria and Ecuador. So OPEC has already been increasing its production, which leads it to be less able to respond to higher prices.

Cartels rely on one of the most interesting theories on human behaviour - game theory. One such scenario thrown up by game theory is the *Nash Equilibrium.* Assume that there are competing players in a situation (a game). Each player has to choose which strategy to adopt. The outcome of that strategy is going to depend on what other people choose. In such a situation, a Nash equilibrium is formed when each player knows what strategies the other player is going to adopt and thus will gain nothing by changing their choice.

In the OPEC cartel, the 'players' agree to limit production (quotas) to enable not necessarily high prices of oil, but an optimal level that does not create demand destruction, while also ensuring prices do not fall too low. Non-OPEC production threatens the viability of the cartel. It introduces another player who is not bound by the same risk-reward profile. The mere presence of this other player encourages betrayal by OPEC members to increase production at lower prices so as to ensure they get money first before too much supply hits the market and prices fall, endangering their high margins. OPEC has survived a long time but as it is threatened, the ability to control prices will become harder.

This process has been underway for some time and so actually reserves and capacity are not readily available, especially for the more economically desirable sweet oil blends. We envisage higher prices. Space precludes us from discussing peak-oil theory and conventional versus unconventional oil. Suffice to say, irrespective of this debate, price control for so many years has left oil subject to sustainably higher prices. Again, coupled with the central bank/fiat currency mix, this creates an inherently volatile commodity which will be subject to accelerating prices followed by precipitous falls, only to once again resume higher. This is not a sustainable proposition for stable wealth production.

We mentioned earlier that the OEPC cartel and central bank cartel are inextricably linked. To examine this we should observe the relationship of energy and the economy.

The price elasticity of global oil demand is very low. We are experiencing a supply shock following a demand shock. As prices rise again the rough assessment is that for every 10% increase in oil prices, global oil demand will fall by approx. 0.5%.

The ramifications for growth are palpable. A study by James D. Hamilton, Professor of Economics at the University of California, on Historical Oil Shocks, highlights how such shocks contribute if not cause economic recessions.

http://dss.ucsd.edu/~jhamilto/oil_history.pdf

The question is which oil price should we be observing as having the greatest impact of global output?

There are many oil contracts in the world but the most influential on policy making, both empirically and subjectively are Brent and WTI oil. Dubai crude oil or the OPEC basket might well be more representative of the average global crude oil price, but neither offers a forward curve. This is important as there has been a remarkable divergence of prompt and deferred prices of West Texas Intermediate crude oil (WTI), traded on the CME/NYMEX and Brent, traded on the ICE.

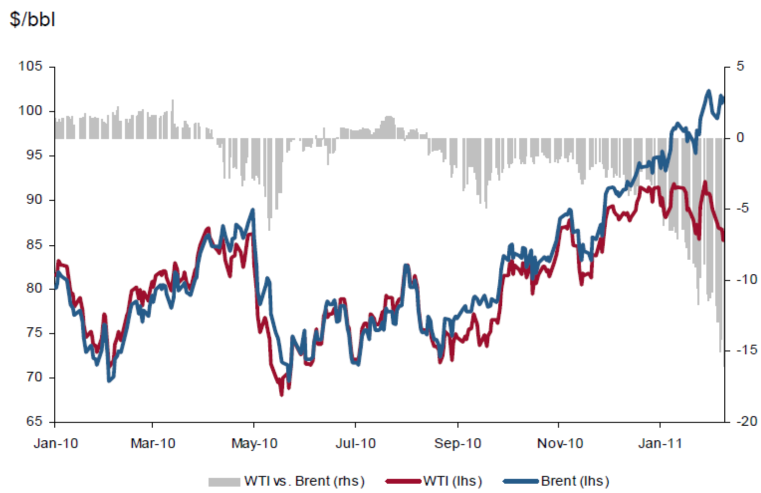
WTI has played as the world’s notional benchmark of the price of oil. As an abundant crude oil stream in the mid-continent of the US, WTI became the physical crude oil backing the successful futures contract established by the New York Mercantile Exchange in 1983. The success of the contract both propelled WTI into the lexicon of the oil industry and the global understanding of the price of oil, and helped consolidate the NYMEX as the world's largest commodity exchange with physical settlement. It is no exaggeration to say that the most commonly understood price of oil is the WTI daily settlement price on the CME/NYMEX. Open interest in WTI grew rapidly in the 1980s and 1990s and even faster during the last decade. WTI has been the favourite instrument through which long-term investors have gained exposure to the price of oil.

Later on, a Brent contract was established on the International Petroleum Exchange in London, based on Brent crude oil. The ICE bought the IPE and changed the contract in a number of ways. But the relationship between Brent and WTI prices was more or less fixed, with Brent trading at a premium to WTI with the difference between the two crude oil prices based largely on the costs of transportation between Northwest Europe (Brent) and Cushing Oklahoma (WTI), a one-way transport from east to west.

WTI has typically always traded at a premium to Brent because the two "lookalike" crude oil streams were trading in different locale, one in the North Sea (Brent) the other North America (mid-continent). The premium was required to pull North Sea crude to North American crude.

This premium disappeared in 2006 and now WTI trades at a discount to Brent.

Brent vs WTI Prices, WTI-Brent Spread



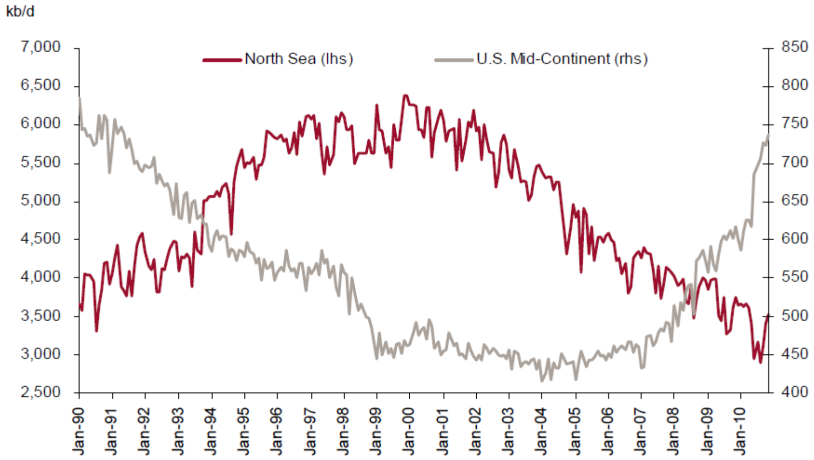
Source: Bloomberg, Credit Suisse

So why does Brent now trade at a premium to WTI?

1. North Sea production out of UK, Norway primarily has begun to decline. The North Sea's oil production fell from 6m plus barrels per day in early 2000s to less than 3.5m barrels today. The area is now a net importer.

2. US mid-continent the reverse was happening. Imports from Canada and a reduction in refining capacity at PADD2 of the US. So crude oil refining was falling as Canadian Tar sands was rising (3.1mm barrels per day , Canada).

Crude Oil Production Brent and WTI



Source: Energy Intelligence

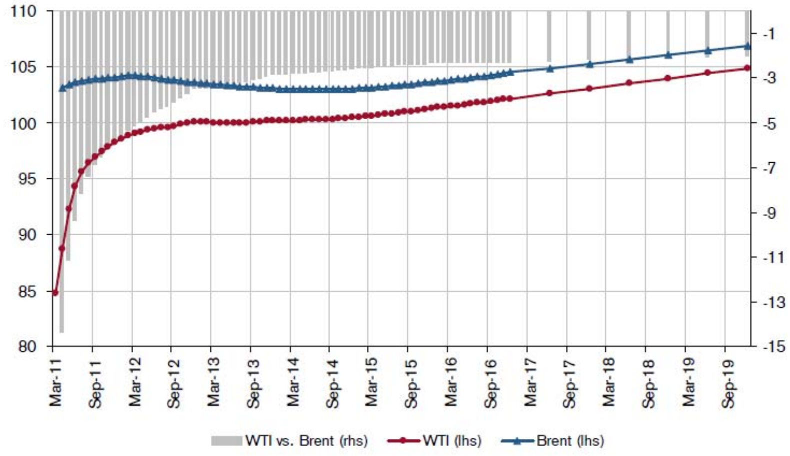
3. The Enbridge pipeline which was built from US to Canada, and the reversal of oil from Oklahoma (Cushing) to Chicago led to more storage at the better facilities at Cushing. But it is the Enbridge pipeline that was the game changer for WTI over supply.

Canadian & US Crude Oil Pipelines

Source: Enbridge, Kinder Morgan

These are not exhaustive reasons but they encapsulate the main reasoning. The recent issues in Libya specifically have exacerbated this premium of Brent over WTI.

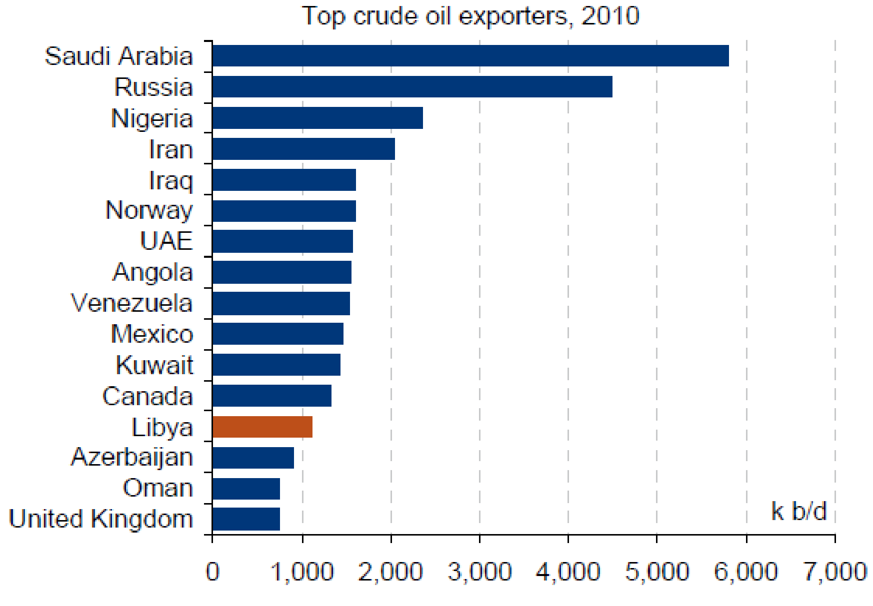
Brent vs WTI Forward Curves Today



Source: Bloomberg, Credit Suisse

Libya is one of the largest suppliers of light sweet blends, a quality of crude used in gasoline and diesel production. The Es-Sider Libyan blends so named after the refinery port have much lower sulphur contents and higher specific gravity than the Saudi medium sour crude, making refining much easier. The fighting in Libya is costing 1.2 mm barrels a day of sweet crude supply to the markets.

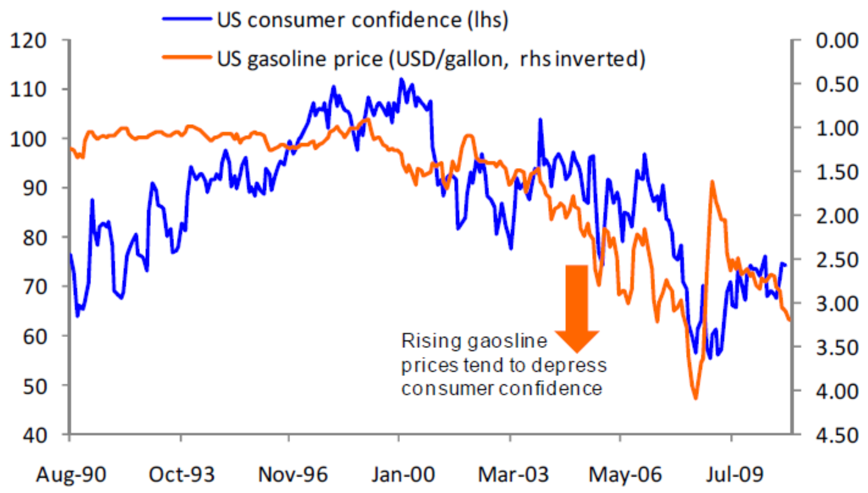
Libya Sweet Crude Exporter



Source: IEA, ML GCR

Only 40% of the US's SPR is sweet and 25% in the OECD as a whole. Supply is thus constrained. We can see the impact of gasoline prices, a distillate product of this blend. Brent is essentially distillate rich and demand has been high with the rebound of global growth expectations.

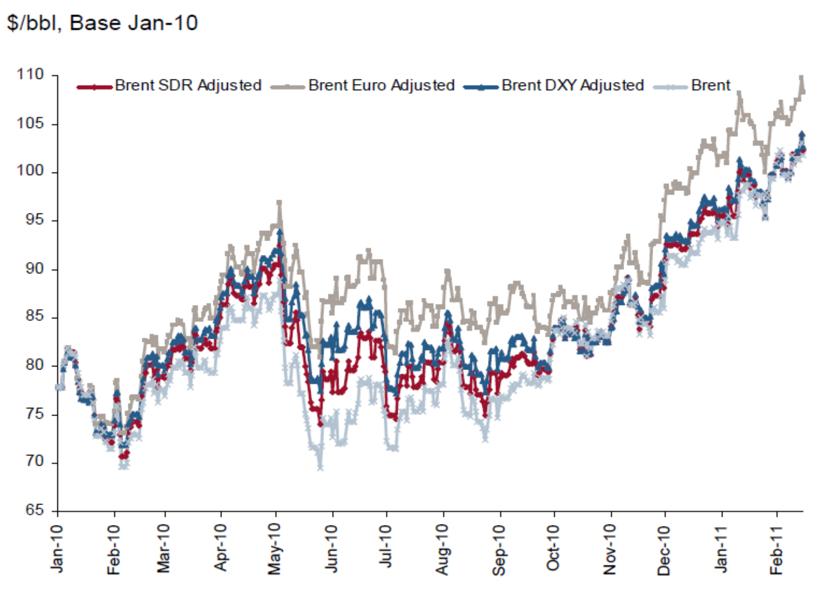
US Gasoline Prices vs US Consumer Confidence



Source: Bloomberg, Deutsche

Brent oil is trading at record highs in some currencies outside of the US dollar, in sterling for instance, and partially why George Osborne, the UK Chancellor, has increased taxes on UK oil producers.

Brent Price in GBP, EUR, SDR and Dollar Index (DXY)

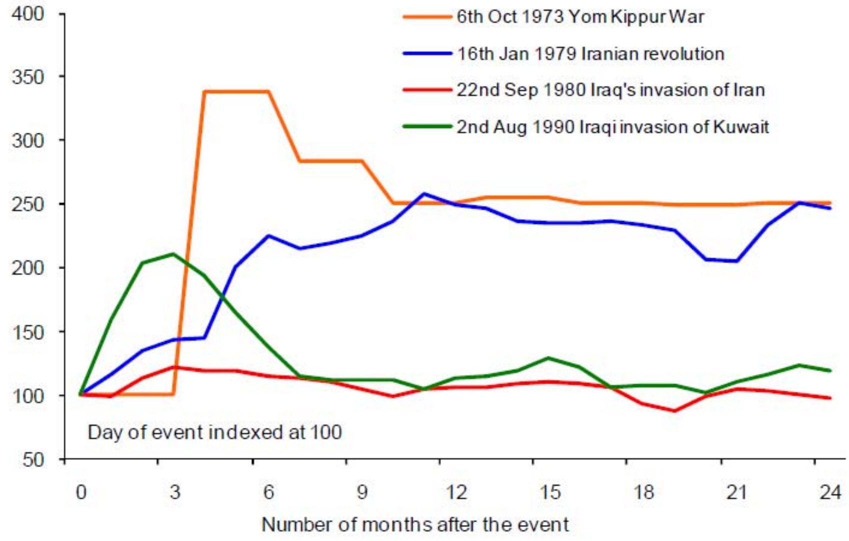


Source: Bloomberg, CS GCR

We think it less relevant which oil contract we observe as a barometer of economic health, but just be aware of their nuances. We are concerned that further Bahraini and Saudi unrest will cause WTI pressures to catch up with Brent's, as the risk is Saudi medium sour production may be reduced. As it is we think the spread will continue to narrow from the $20 peak of Brent to WTI premium seen in February (is currently around $10), as events continue to unfold and Saudi Arabia struggles to maintain production at heightened levels.

Oil shocks are of course nothing new. There have been four oil price shocks relating to supply disruptions since the start of the 1970s, as depicted in the chart below. After initial surges higher prices moderated over the next 6 months.

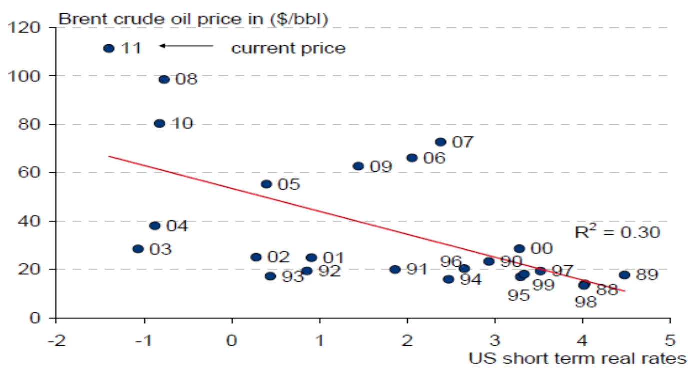
Oil Performance: 4 Major price shocks since 1970s



Source: Bloomberg, Deutsche

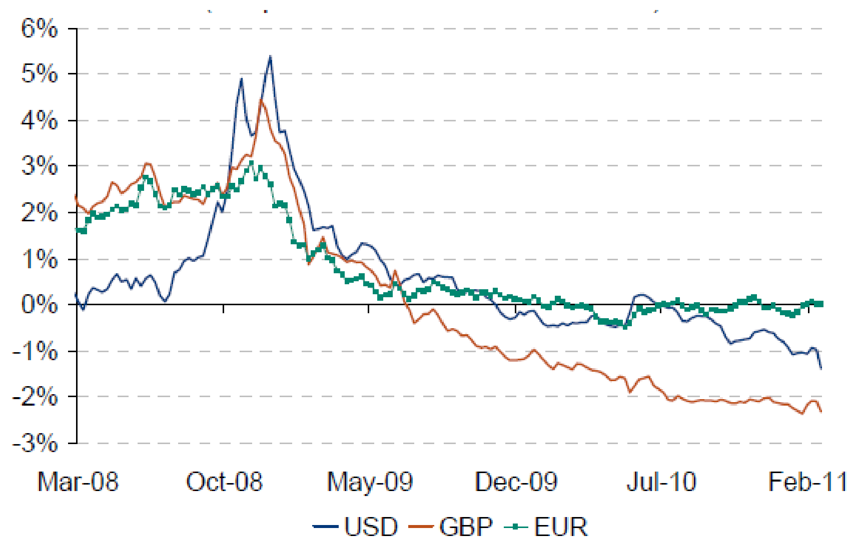
Higher oil prices correlate highly with lower real rates, as the risk of economic slowdown caused by the consumptive tax nature of higher energy prices, cause the Central Bank cartel to set artificially low rates to help encourage borrowing and more consumption of goods.

Higher Oil Prices vs Short Term Interest Rates



Source: Bloomberg

Negative Real Rates: 2yr Swap rate - Index Link Breakeven rates

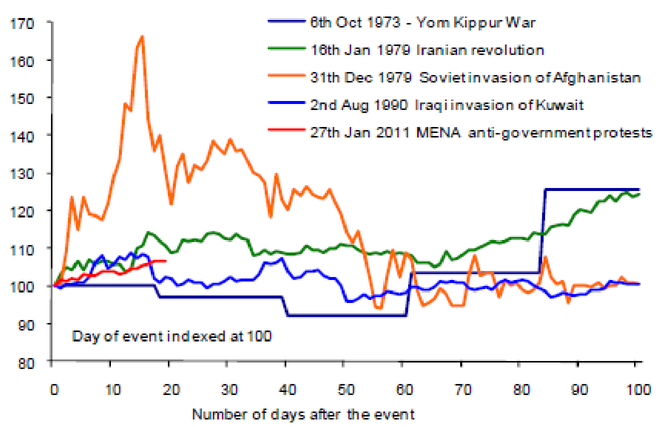


Source: Bloomberg

Despite recent speeches by various Federal Reserve Governors spelling out 'exit strategies' from QE and the shrinking of the Fed balance sheet, we suspect MENA and Japan-related events will severely test their resolve. Should global output begin to fall, 'psychopath' Ben Bernanke will likely resort to another dose of QE.

Historical evidence suggests that gold prices will remain firm. We believe that MENA issues will be with us for many years to come. The question to ask is: at what point will this be fully reflected in the gold market? As we believe gold is undervalued on many metrics, it is possibly a moot point. Nonetheless, one can see that the Iranian revolution sparked a concerted rise in the price of gold, and this was arguably after gold was firmly captured in the imagination of the world. Today awareness has only really begun, ownership will follow and MENA events will only reinforce the underpinning of physical bullion prices.

Gold Performance: Geopolitical shocks



Source: Bloomberg, Deutsche

Silver Shortage or Scarcity / Silver Oligopoly

The control of silver by two banks named in the hearings at the CFTC (Commodities Futures Trading Commission) is an acute example of another such private cartel. We mention this briefly here to illustrate how destructive cartels can be. Silver has been suppressed most likely for economic gain. Excessive paper sales, particularly around key events, expiry or even in moments of price instability have denigrated the natural supply and demand of physical silver. Silver was seen as a sideshow by miners, it has been considered useful as a metal to assign by-product credits when it's offloaded. The mere fact we have so few primary producers is testimony to the essential irrelevance of silver in their mindset, despite ever increasing uses in healthcare and more recently solar products.

We are witnessing the price discovery of a commodity that has been held back, it will move higher until such point as owners feel willing to realise their profit margins. But in an environment with fears about fiat currency they may not be so willing. The market is a \$30 - 35bn market capitalisation so although we believe this recent run will slow here or just above \$40 an oz, it clealy has room to grow.

Japan Fallout

Japan has \$30 trillion of gross debt, some 60% of global GDP. One must not underestimate the impact of a default by this country. It would be devastating. If the default bypasses *implicit* default and Japan experiences an *explicit* default then the deflationary ramifications will be substantial, but do not think for a second the world central banks will not act to reflate. It will be their mandatory course of action, for they do not know any other way.

As of Friday, Japan's central bank had thrown a reported \$475 billion into money markets. This is proportionately twice what the US Federal Reserve plans to inject over a year of its Quantitative Easing 2 program. The US economy is about 2.5 times as large as Japan's, so the equivalent amount would be nearly \$1.2 trillion.

Even though the four prefectures sustaining most of the earthquake and tsunami damage produce only 6 percent of Japan's gross domestic product, they have enough different plants that the disruption to final assembly plants downstream is considerable. And these plants generally don't have sufficient stocks of components to tide them over the supply interruptions.

BoJ Announcement: 5 trillion Yen added to its Asset Purchase Program = 40 trillion yen (\$486 billion):

(2) Asset Purchase Program

With a view to preempting a deterioration in business sentiment and an increase in risk aversion in financial markets from adversely affecting economic activity, the Policy Board decided to increase the amount of the Asset Purchase Program, mainly of the purchases of risk assets, by about 5 trillion yen to about 40 trillion yen in total.[3]

"The increase in asset purchases will be made in the following asset categories, and the Bank intends to complete the increased purchases by around the end of June 2012. It should be noted that the purchases of exchange traded funds (ETFs) and Japan real estate investment trusts (J-REITs) are conditional on obtaining authorization in accordance with the Bank of Japan Act.

Japanese government bonds: about 0.5 trillion yen

Treasury discount bills: about 1.0 trillion yen

CP: about 1.5 trillion yen

Corporate bonds: about 1.5 trillion yen

ETFs: about 0.45 trillion yen (conditional on obtaining authorization)

J-REITs: about 0.05 trillion yen (subject to the above condition)"

http://www.boj.or.jp/en/announcements/release_2011/k110314a.pdf

Our thoughts on the Japan fallout are beyond the remit of this piece. Suffice to say this level of monetisation will be very supportive of precious metal prices, and commodities in general as they rebuild their country.

Endgame

The "Facebook Revolution" in Egypt instigated the protests against an unjust regime. Government repression, corruption, unemployment and poverty are the likely catalysts for President Hosni Mubarak's forced removal from power. Such discontent reverberated across the internet to repressed citizens of all nations, particularly the Maghreb. It is arguably of more significance than the fall of Communism, as epitomised by the Berlin Wall collapse.

From the early inception of "organized" government, officialdom has attempted to control their economies. In Ancient times, in the land of the Nile, the state regulated all grain production and distribution.

All prices were fixed by "fiat" – by decree. Back then, he who controlled the "bread" was in the possession of the ultimate power. By controlling food prices, the Egyptian government thought it had ownership of the people. Today, government believes monopoly of the numeraire implies control of the masses.

The profligate behaviour of the state in fiscal and monetary policy has so distorted the true value of money that commodity and consumer prices have risen inexorably. We will see yet more unrest around the world in years to come. Monopoly of the media of exchange is the ultimate price control.

Price controls always distort the level of economic activity and cause disequilibria in prices and human behaviour. The irony is that MENA erupted on a wave of rising food prices. Modern Egypt, too, had lost the control of the "bread".

We have forgotten what true money is. Despite all the troubles, we are hopeful – the internet is curing our amnesia.

Each and every one of us should pursue individual rights, open markets, free trade, hard money, and freedom of movement. Unless Bretton Woods II is recanted we will likely see the growing use of capital and price controls as a means for the sovereign to alleviate price inflation.

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