

Inflationists Or Deflationists?**Mighty Mishkin & Baldrick's Bollox****Abracadabra "ARDINBARA" Away You Go****Monolines Or Monoshoes****Business is Good At Danny's****ESKOM & Load Shedding****Global Gold Outlook****New Investment/SIPP****Inflationists Or Deflationists?**

Are you an Inflationist or a Deflationist? A number of comments and questions get levelled at us everyday concerning the outcome of today's macro events. Are we to experience deflationary or inflationary repercussions from this current downturn in the US, throughout the world? Can we experience both, have we stagflation and will we see hyperinflation?

First off we felt it was best to loosely define the meaning of these increasingly emotive words and phrases. *Inflation* is predominantly a monetary phenomenon. Whenever a Central Bank (e.g. the FED) puts more currency into circulation on net, there is monetary inflation. Some of the value of that existing currency gets eroded, even if the prices of assets or goods don't change. In a growing economy with a stable money supply, there would be no monetary inflation, but there would likely be goods *price deflation*, i.e. the same number of units of currency chasing more goods.

Let's narrow the focus and look at *price inflation* more closely. There are two types of price inflation, one for *assets*, and the other for *goods and services*. When monetary inflation takes place, each currency unit (e.g. dollars) can buy fewer goods or assets than in the absence of the inflation. Prices would not rise, if productivity had risen as much as, or more than, the amount of monetary inflation.

Now, the incremental dollars from monetary inflation can go to one of two places: goods or assets. Assets can be thought of as something that produces a bundle of goods in the future. Asset inflation is an increase in the prices of assets (or a subgroup of assets) without equivalent improvement in the ability to create more goods in the future. How newly printed incremental dollars get directed can make a huge difference in where inflation manifests itself later on. Let's cite a few examples:

1. In the 1970s in the U.S., the rate of household formation was relatively rapid, and there was a lot of demand for consumer products, but not savings. Money supply growth was rapid. The asset markets of the stock and bond markets floundered, but goods prices roared ahead. Likewise Commodities and housing also rose rapidly.
2. In the mid-1980s the G7 unit led Japan to inflate its money supply and due to an older demographic, most of the excess money went into savings that were invested in stocks that roared higher, creating the Japan bubble, but not creating any great amount of incremental new goods (productivity) for the future.
3. In 1998-1999, the Fed pumped the money supply to compensate for the Russian Default and LTCM fallout, and prepare for Y2K. The excess money made its way to tech and internet stocks, creating a bubble. On net, more money was invested than was created in terms of future goods and services. Thus, after the inflation, there came a disinflationary period, as the assets could not produce anything near like the value speculators had bid them up to.
4. In 2001-2003 the Fed cut rates aggressively in a weakening economy. The incremental dollars predominantly went to housing, producing yet another bubble. More houses were built than were needed in an attempt to respond to the demand from speculators. Now we are on the "deflation" side of the cycle, where prices adjust down, until enough people can afford the homes using normal financing.

Just for good form we note that Milton Friedman's widely repeated observation that inflation is always and everywhere a monetary phenomenon remains our point.



The caricatures of Bush, Paulson and Bernanke riding the monocycle (or should we say "monolines", but more of this later), along a path precipiced either side by Inflation and Deflation is verily an apt one.

Now, it's possible to have **goods deflation and asset inflation at the same time**; it is possible to save too much as a nation. The boom/bust cycles in the late 1800s showed some instances of that (see Baldrick section). It's also possible to have **goods inflation and asset deflation at the same time**; it's definitely possible to not save enough as a nation, or to have resources diverted by the government to fight a war.

The problem is this, then. It's difficult to make hard-and-fast statements about the effect of an increasing money supply. It will likely create inflation, but the question is where? A reiteration of the point we outlined earlier I know but one that is crucial to understanding money supply effects.

Many emerging economies have rapidly growing money supplies, and they are building up their productive capacity. The question is, will there be a market for that capacity? At what price level? Many of them have booming stock markets. Do the prices fairly reflect the future flow of goods and services? Emerging markets presently trade at a P/E premium to the developed markets. If capitalism sticks, the premium derived from faster growth may be warranted. But maybe not everywhere, like in China for example?

We typically refer to rising consumer prices as inflation, and falling consumer prices as deflation. In reality, inflation is an increase in the money supply via the extension of credit. The consequences of inflating the money supply are higher consumer prices and asset values (stocks, real estate, etc). Conversely, deflation is a contraction in the money supply which occurs when individuals and businesses no longer take on more debt. The consequences of a deflating money supply are falling asset and consumer prices. In simplified terms, when individuals and businesses take on more debt we have inflation, but when individuals and businesses stop taking on more debt, we have deflation.

Up until now we have believe we have experienced an inflationary environment where global asset prices have been rising, a function of both money supply and "real" demand. The question is now - are we going to see more inflation or does the current bursting of the global housing bubble signal a shift to widespread deflation?

If the banking system operated in a true free market economy, "the Invisible hand", it might be time to run for the exits. However, with Central Bank's namely the Federal Reserve and other numerous government fingers in the economic pie, we cannot accomplish much by simply analyzing the problems. We must understand the problems and decide what the most likely response will be from the Fed and policy makers. Finally, we must gain an understanding of the effect of the problems, in the context of policy responses, on economy and financial markets. So

1. The problem in our opinion is that we are undergoing a western world *asset deflation* as widespread credit contraction takes place, but that previous worldwide money supply increases have manifested themselves in "sticky" *price inflation of goods and services*.

2. What will be the stark reality of policy responses? *Our belief and raison d'être for the Hinde Gold Fund was that the reaction of Western policymakers would be to engender money supply increases, as well as stimulus via regulatory and fiscal policies. (Good for Gold as Money)*

3. The Impact of such policies could well be heightened price inflation and possibly an even greater emerging market bubble, even though deflationary headwinds are looming. Money, capital has to find a home somewhere...

Our conclusions for the recent policy behaviour came from analysis of widely available research papers and speeches. Essays on the Great Depression by Bernanke himself, and papers such as "Preventing Deflation: Lessons from Japan's Experience in the 1990's" by a Division of International Finance, the Board of Governors of the Federal Reserve system, all point to this course of action:



**Remarks by Governor Ben S. Bernanke
Before the National Economists Club, Washington, D.C.
November 21, 2002**

Deflation: Making Sure "It" Doesn't Happen Here

<http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>

Deflation is defined as a general decline in prices, with emphasis on the word "general." At any given time, especially in a low-inflation economy like that of our recent experience, prices of some goods and services will be falling. Price declines in a specific sector may occur because productivity is rising and costs are falling more quickly in that sector than elsewhere or because the demand for the output of that sector is weak relative to the demand for other goods and services.....

Deflation great enough to bring the nominal interest rate close to zero poses special problems for the economy and for policy. First, when the nominal interest rate has been reduced to zero, the real interest rate paid by borrowers equals the expected rate of deflation, however large that

may be.³ **To take what might seem like an extreme example (though in fact it occurred in the United States in the early 1930s), suppose that deflation is proceeding at a clip of 10 percent per year. Then someone who borrows for a year at a nominal interest rate of zero actually faces a 10 percent real cost of funds, as the loan must be repaid in dollars whose purchasing power is 10 percent greater than that of the dollars borrowed originally. In a period of sufficiently severe deflation, the real cost of borrowing becomes prohibitive. Capital investment, purchases of new homes, and other types of spending decline accordingly, worsening the economic downturn....**

The basic prescription for preventing deflation is therefore straightforward, at least in principle: Use monetary and fiscal policy as needed to support aggregate spending, in a manner as nearly consistent as possible with full utilization of economic resources and low and stable inflation. In other words, the best way to get out of trouble is not to get into it in the first place.

Bernanke spells out that in a violent financial crisis *the Fed should and does use its regulatory and supervisory powers to ensure that the financial system will remain resilient if financial conditions change rapidly. And at times of extreme threat to financial stability, the Federal Reserve stands ready to use the discount window and other tools to protect the financial system, as it did during the 1987 stock market crash and the September 11, 2001, terrorist attacks.* Irving Fisher (1933), was the first economist to emphasise the potential connections between violent financial crises (such as in the 1930's), which lead to "fire sales" of assets and falling asset prices, with general declines in aggregate demand and the price level.

Clearly today we stand on the edge of Deflation as we experience "fire sales" of assets such as credit, mortgage bonds and individual financial stocks, with ramifications for contagion selling of more assets as the overall economy is impacted.

The fact that Bernanke stated in 2002: **when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more preemptively and more aggressively than usual in cutting rates** (Orphanides and Wieland, 2000; Reifschneider and Williams, 2000; Ahearne et al., 2002). **By moving decisively and early, the Fed may be able to prevent the economy from slipping into deflation, with the special problems that entails...**left us in no doubt of his likely course action in the future. Note that he stated "when inflation is already low" he will act. As we have defined, there are many measures of inflation. We would contend he refers to price inflation in this context. If so, with price inflation rising sharply, and with Bernanke having slashed rates aggressively already, one should have no doubts about how serious he has taken the likelihood of a systemic banking crisis and its deflationary fall out. This is the **REAL DEAL**.

Central Banks enlist Government co-operation:

Each of the policy options I have discussed so far involves the Fed's acting on its own. In practice, the effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities. A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest

rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. Even if households decided not to increase consumption but instead re-balanced their portfolios by using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers. A money-financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money.¹⁸

Of course, in lieu of tax cuts or increases in transfers the government could increase spending on current goods and services or even acquire existing real or financial assets. If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets.

The U.S. Federal Reserve published a white paper in June of 2002 entitled Preventing Deflation: Lessons from Japan's Experience in the 1990s, which concluded deflation could have been avoided if both fiscal and monetary stimulus were applied aggressively.

International Finance Discussion Papers



Preventing Deflation: Lessons from Japan's Experience in the 1990s

Alan Ahearne; Joseph Gagnon; Jane Haltmaier; Steve Kamin 2002-729 (June 2002)

Abstract: *This paper examines Japan's experience in the first half of the 1990s to shed some light on several issues that arise as inflation declines toward zero. Is it possible to recognize when an economy is moving into a phase of sustained deflation? How quickly should monetary policy respond to sharp declines in inflation? Are there factors that inhibit the monetary transmission mechanism as interest rates approach zero? What is the role for fiscal policy in warding off a deflationary episode? We conclude that Japan's sustained deflationary slump was very much unanticipated by Japanese policymakers and observers alike, and that this was a key factor in the authorities' failure to provide sufficient stimulus to maintain growth and positive inflation. Once inflation turned negative and short-term interest rates approached the zero-lower-bound, it became much more difficult for monetary policy to reactivate the economy. We found little compelling evidence that in the lead up to deflation in the first half of the 1990s, the ability of either monetary or fiscal policy to help support the economy fell off significantly. Based on all these considerations, we draw the general lesson from Japan's experience that when inflation and interest rates have fallen close to zero, and the risk of deflation is high, stimulus—both monetary and fiscal—should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity.*

1930s Deflation and Japan 1990-2007, the Lessons Point toward More Inflation:

For those who argue long-term deflation is not a real possibility, you are right, as Bernanke does not want a repeat of 1930s Deflation. Just to quench a desire for facts we outline a quick review of recent events in Japan which may be helpful. Japan has experienced serious problems with deflation since December of 1989.

“The Nikkei remains 56 percent below its peak of 38,915.87 reached on the last trading day of the 1980s, making it the world's worst performing major stock market during the period. Valuations have come down as dramatically as share prices. The Nikkei is now valued at 23 times earnings, compared with about 70 times at the 1989 peak. The Bank of Japan lowered interest rates to near zero in the 1990s to help stimulate the economy and only started raising them for the first time in almost five years in July 2006. Government officials and many investors say that lower borrowing costs still were needed to fight deflation. In February 2007, on the day before the rate was raised to 0.5 percent, the lowest among major economies, the finance minister, Koji Omi, said that monetary policy should support economic growth.”

There are no typos above, Japan has been in a state economic difficulty for 17 years, from 1990-2007. Once a deflationary spiral starts it is very difficult to stop as the policy markers in Japan can attest. The quote above highlights falling prices of assets and a decreased incentive to invest.

Postponing the Onset of Deflation via More Credit:

History shows governments with large debts often favour inflationary policies to help reduce the burden of future payments. In the past large amounts of debt have been inflated away in China, Russia, Mexico, Brazil, Argentina, Poland, Greece, and Turkey.

Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), which allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Ben Bernanke, November 2002

When President Nixon closed the gold window in 1971, the U.S. dollar could no longer be redeemed for Gold. The dollar is simply backed by the "full faith and credit" of the U.S. government. Today, no major currency is on the gold standard. Any nation can create an endless supply of new electronic money via the fractional reserve banking system. So when we speak mostly of the US and Fed, it applies to all nations. The US is undoubtedly our main country of discussion as this past century the world has been dictated to economically by the US. Decades of poor risk management, profligate spending, irresponsible money supply expansion has made this superpower susceptible to a terminable loss of hegemony. With this there are obvious

ramifications for the World order. We have defined this simply as the **TRANSFERENCE OF WEALTH**.

Mighty Mishkin & Baldrick's Bollox

Frederic S. Mishkin took office on September 5, 2006, to fill an unexpired term ending January 31, 2014. He has long since served the FRB but previously as Director of Research at FRBNew York to name but one of his roles. He is a close friend of Bernanke and his academic research focuses on monetary policy and its impact on financial markets and the aggregate economy. As is evidenced by his increasing number of speeches and papers at the FED, Mighty Mishkin is a man to be followed closely as to clues on future monetary policy and behaviour. We outline some of the salient points from his recent speeches.



Source: Google Images: Mishkin or Baldrick?

Governor Frederic S. Mishkin
Financial Instability and Monetary Policy
At the Risk USA 2007 Conference, New York, New York
November 5, 2007

*By cutting interest rates to offset the negative effects of financial turmoil on aggregate economic activity, monetary policy can reduce the likelihood that a financial disruption might set off an adverse feedback loop....**However, because monetary policy makers can never be certain of the amount of policy easing that is needed to forestall the adverse effects of disruptions in financial markets, decisive policy actions may, from time to time, go too far and thus produce unwelcome inflationary pressures.** That's why I said that flexibility is also an important characteristic of monetary policy during a time of financial turmoil. **If, in their quest to reduce macroeconomic risk, policymakers overshoot and ease policy too much, they need to be willing to expeditiously remove at least part of that ease before inflationary pressures become a threat.***

<http://www.federalreserve.gov/newsevents/speech/mishkin20071105a.htm>

Governor Frederic S. Mishkin
Monetary Policy Flexibility, Risk Management, and Financial Disruptions
At the Federal Reserve Bank of New York, New York,
New York
January 11, 2008

*The monetary policy that is appropriate during an episode of financial market disruption is likely to be quite different than in times of normal market functioning...**Furthermore, a central bank may well be able to employ non-monetary tools--such as liquidity provision--to help***

alleviate the adverse impact from financial disruptions. All of these considerations must be taken into account in determining the most appropriate course of monetary policy.

<http://www.federalreserve.gov/newsevents/speech/mishkin20080111a.htm>

In highlighting in bold the text from Mishkins' speeches one can see that the Fed will undertake whatever it takes to prevent deflation using both conventional and UNCONVENTIONAL methods. INFLATE OR DIE

More Inflation Followed by Deflation?

What does it all mean? The odds favour more inflation. We may even see hyperinflation at some point in the next decade. When the vast majority of individuals and businesses no longer have any desire to take on more debt, the credit cycle will end and we may slip into long-term, widespread deflation. While some consumers and homeowners are currently overextended and on the brink of serious financial problems, the wealthy are still wealthy. Many banks and financial institutions are in serious trouble due to the current state of the residential real estate market, but the solvency of the vast majority of businesses is not threatened. Just as we saw deflation in stocks from 2000-2002, we will continue to see deflation in housing sector for some time to come. However, when stocks fell from 2000-2002, it did not result in long-term, widespread deflation. Similarly, deflation in the housing sector alone does not constitute Japan-like deflation. Widespread, Japan-like deflation means higher debt burdens, the loss of the wealth effect, economic hardship, and political change. With the "modern equivalent of the printing press" and published consumer inflation still low on a historical basis, we can expect the Federal Reserve and U.S. government to continue to encourage more borrowing, more speculation, and more spending. As a result, your investment strategy should continue to favour inflationary outcomes.

Hyperinflation –Modern Day

Zimbabwe may seem an extreme example but well-respected writers like Marc Faber discuss how the "developed" world would like a good bout of inflation to balance their books. Overcook this and we may have a Weimar styled Hyperinflation or Mugabe's version. **Click here to experience Life in Zimbabwe - report by John Simpson:**

<http://uncutvideo.aol.co.uk/videos/3529c69984fd8701f3ab884bc86c35d4>

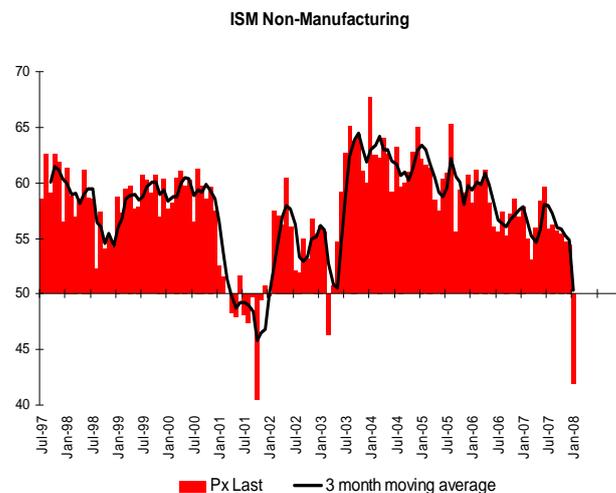
Stagflation in the US and UK?

We believe in more benign outcome in US/UK where asset prices fall, even in terms of paper dollars (important to note), but consumer goods prices rise even further. So we see inflation in things people buy and deflation in things people own. See previous Monthly Letters discussing this topic.

http://www.dailymail.co.uk/pages/live/articles/news/new_s.html?in_article_id=510936&in_page_id=1770

US Non-manufacturing ISM saw a collapse below 50 signalling a nation in severe contraction. Now a month doesn't make a series but we have never seen a drop in

this number before the GDP turned sharply lower. What I haven't shown here is Prices Paid rose sharply to above 70, that didn't happen in 2001 when we last saw a plummet of this magnitude.



Data Source: Bloomberg, Chart: Hinde Capital

UK Taxi fares to go up by 4.7%, almost double the rate of inflation –Evening Standard January 2008

Such headlines seem to be an everyday occurrence, where announced price changes are exceeding the "official" rate of inflation. Surely if everything is going up at more than the government's inflation rate, apart of course from your wages, then can this be the correct measurement of inflation? In fact, what does the man on the street think inflation statistics should tell us? If he was to discuss inflation and by now he is, then he would not be referring to inflation in terms of general price levels including wages rising (leaving actual purchasing power the same). In fact he will really bemoaning an inflation where the cost of his "basket" is increasing faster than his wages. This results in a loss of his purchasing power and a declining standard of living.

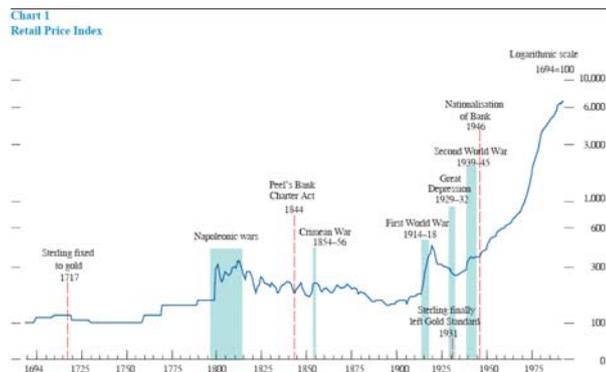
One of the first known episodes of inflation occurred in ancient Rome. Between the middle of the second century AD and the end of the third, the price of wheat rose 200-fold. The inflation that manifested then was caused by the debasement of the metal currency; a succession of Emperors assumed that their personal credibility would be sufficient to maintain the value of coins even if they were reduced in size. Ordinary citizens simply joined in the practice of cutting the edges off the coins. (By coincidence wheat prices have risen by 120% in the last 6 months to Jan 2008.)

Most inflation stories are relatively well known and have been studied at length. Take John Law's 18th century France where he experimented with possibly the first fiat paper currency to its natural conclusion, (he was last seen crossing the Swiss border with a horde of gold and silver coins). Or take the infamous hyperinflation of the Weimar republic (1919-33). In November 1922, one dollar was worth **3180 marks**, in November 1923 one dollar was worth **4.2 trillion marks**. Inflating the currency was how Germany chose to rid itself of their war reparation debts (the harsh payments demanded by the allies at the end of WW1.)

More recently, Russia took three zeros off their ruble in 1998 destroying buying power and likewise Argentina's 20

year flight with inflation has seen middle class saving wiped out many times over. The current Zimbabwe 24,470% inflation rate is no different. As John Simpson of the BBC leaves a 10 million Zdollar tip for a 290 million Zdollar meal there are no prizes to see where this once educated and resource rich country is heading.

Much less well known are the many periods of stable prices. Understandably as there was nothing to titillate economic historians. While every man and his dog in the UK would believe that you cannot go wrong by owning property over the long term, they might be surprised to know that from the great fire of London in 1666 till the outbreak of the WW1 in 1914 the retail price index was fairly stable and property prices rose and fell with fashion and location rather than experiencing a steady appreciation.



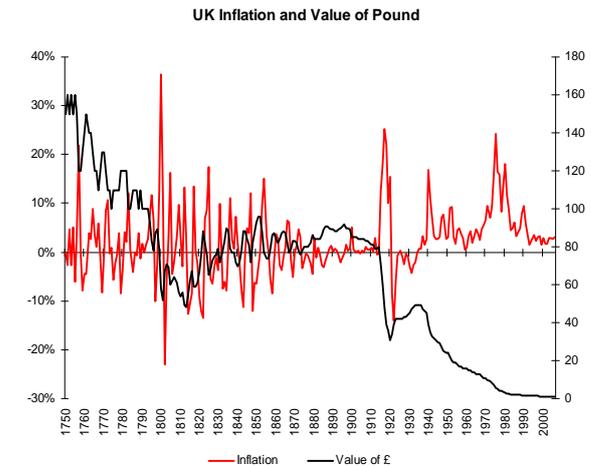
Data Source: B of E, Chart: B of E

The average price of bread in London in 1694 was 5.6d (about 2.3p) per 4lb (a standard loaf). In 1894, the price was just 5.5d, though it had risen to 1s 5d (about 7p) at the time of the Napoleonic wars (1797-1815). The retail price in London of a ton of coal rose by around 70% between 1700 and 1830 to 20 shillings and was much the same price in 1900.

Between 1830 and 1914, the great Victorian industrial age prices fluctuated, normally reflecting shortages and gluts of harvests but the general price level remained very much constant. How pleasant it must have been for the early rail travellers to not have their fares increase every January. To what can we attribute this seemingly amazing price stability? Could it be as simple as the relationship of the pound to the price of gold? In 1717 its value was fixed explicitly by the astronomer Sir Isaac Newton. The equivalence was maintained until 1931, except for brief periods at around the time of the Napoleonic wars and during and after WW1.

Since 1931 when Britain left the gold standard, the pound sterling has lost 98 per cent of its purchasing power. In Professor Roy Jastrom's book "The Golden Constant" he illustrated that the purchasing power of gold had fluctuated within relatively narrow limits, over a 400 year period from 1560 to 1976, and returned to a norm, even after distortions caused by wars. The purchasing power of paper currencies moves continuously though at varying rates, in the direction of inflation, and ultimately to zero. Paper currencies do not provide a long term store of value; gold does. In 1913, the year before the outbreak of WW1, the purchasing power of gold in England was a little higher- by about 10 per cent- than it had been in 1660, when Charles II was restored to the throne. During this period, Britain had undergone the first industrial revolution, arguably the greatest economic

development in human history. In 1800 land prices in English agriculture averaged around £40 an acre, or about 10 troy ozs of gold. In 2000, similar land was selling for about £2000 an acre, or about 10 troy ozs of gold.



Data Source: Bloomberg, Chart: Hinde Capital

If we fast forward to the current day the general accepted policy for inflation is to maintain the level at 2% ("official rate") but even if this were achieved, prices still double every 35 years!!! But compared to what is actually happening today that would be a godsend.

Before the Clinton Administration, the American Consumer Price Index actually tried to measure the prices consumers paid for an identical "basket" of goods each month. If chicken went up by 5% in a year that 5% was multiplied by the relevant weighting of its place in the basket and so on. Simple. The change in total cost from period to period determined the rate of inflation for maintaining a constant standard of living.

Enter Chief economist Michael Boskin and ex-Federal Reserve chairman Alan Greenspan who successfully lobbied for a change in the methodology. CPI would become a buying habits index rather than a price index. This would be used to reflect consumers' substitution decisions (If steak is too expensive, buy chicken) and the hedonic regression value points of improved goods or performance. (Car prices can stay the same but if next year there are more features for the same price, then they are deemed to have dropped.) Both of these arguments shouldn't tax a 16 year old to see the obvious shortcomings with this new methodology, but staggeringly this is what most of the world government statistics offices are now using.

So basically it goes something like this; If you buy a top of the range laptop this year for £1000 and next year it still costs £1000 but it now has a billion gigabytes more memory and double warp speed computing power, the actual price in the index for laptops will have dropped substantially to reflect the improved performance. The theory isn't that bad but in reality 99.999% of computer users outside of MIT PhD students studying advanced computing, don't use more than 1/100th of last years capacity and speed and so it is irrelevant. Accompany this with the reality that you can't buy last year's model very easily, then you cannot take advantage of this "deflated cost" opportunity.

Of course hedonic adjustment only works one way; lower! If the price of the commuter train journey you have taken over the last year has miraculously avoided a typical January rise you might feel that because it now takes on average 9 minutes longer (with increasing delays) and you have to

stand every day you are receiving a lower quality service. You would be right, but this will not affect the hedonic price point because it can only be adjusted lower. Are you getting it so far?

The substitution or replacement argument is even better. The idea is that the consumer will switch from higher priced goods and services to lower priced goods and services to maintain the same "standard of living" and its this continued buying preferences and their prices that should be measured. So as your weekly steak dinner increases in price, you change to chicken and then to pork, but as all food prices are increasing you are very quickly reduced to eating horse manure.

The same applies when buying clothes for example. There was a day when you bought a cotton T shirt with a great logo and wore it all summer. Now if you buy a cheap T shirt from China you can only wash it once before it is a dish cloth. So your options of not washing it all summer or buying 90 T-shirts to be able to wear it everyday leave you rather limited.

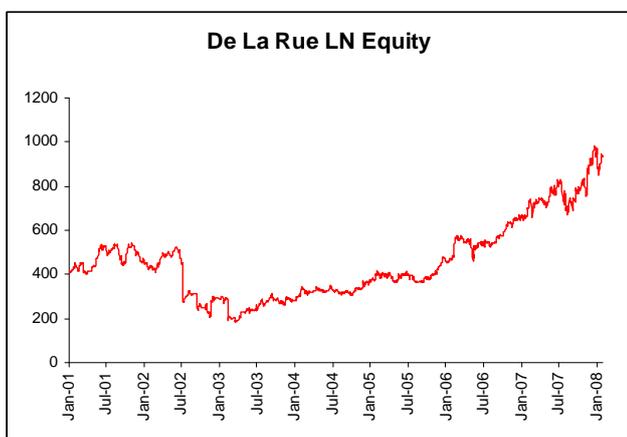
If it weren't all so serious it would be funny. It reminds me of the Blackadder series where the character Baldrick kept mentioning that he had "A cunning plan" to which Blackadder replied that there was only one small problem with the plan- "that it was absolute bollox".

Unfortunately the reality is no different to what it has always been. How do you rid yourself of indebtedness without producing more goods more efficiently? Easy. Inflate the money supply at ever increasing levels, erode your currency and watch your debts disappear while trying your best to pull the wool over everyones' eyes as you do so.

But you can't fool all of the people all of the time. Gold, long suppressed as part of the central banks' plan has awoken and it is doing what it has always done. It protects people in times of crisis whether it be war or foolish central bank policy. Its price is rising as it continues the same job it has been doing for 8000 years. Whether you are a Roman Emperor, the Reichsbank of the Weimar Republic or the current central banks, your plans will fail and civilisation will pay the price. History has told us this much.

(Courtesy to B of E Quarterly Bulletin & The Case for Gold, Pickering and Chatto Ltd/ Sir William Rees-Mogg)

Business is Good at Danny's



Data Source: Bloomberg, Chart: Hinde Capital
De La Rue Share Price

A great many of the world's banknotes are made in the UK by De La Rue's Currency operations in Overton,

Hampshire. Those banknotes, including the British notes, are made from cotton fibre and they have a normal lifespan of around two year. Why the surge in Danny's share price since 2001? One would have thought more credit availability, less banknotes makes more sense. Maybe population increases or replacement of old notes has spurred business revenue. Maybe or maybe its just good old printing of money to meet increases in monetary aggregates.

Abacadabra ARDINBRA Away You Go!

Repeat after me "Abacadabra ARDINBRA Away you go and again..." you can just hear Bernanke trying to magic this issue away. ARDINBRA or US Aggregate Reserves Depository Institutions Non-Borrowed SA

Instead of "Anybody seen our Gold?" see later, perhaps the question should be "Anybody seen our US Bank reserves?"



Whilst trying to understand the TAF auctions and affect on credit we came across an alarming chart that could signal impending peril for the US Banking system. Banking and monetary aggregates being the "minefield" that they are we contacted the FED for an explanation. Their response is outlined below. Clearly we were not alone in our concerns.



On Behalf Of MA-H3-H6-Staff@frb.gov

Subject: Re: Public Comments: H.3 - Aggregate Reserves/Monetary Base

I apologize for the delay in addressing your message. We have had many inquiries about this topic and are currently drafting a response. I will send it to you as soon as possible.

Thank you for your patience.

Sincerely,

Response from FED:

<http://www.federalreserve.gov/releases/h3/nonborrowedreserves.htm>

Recent Declines in Nonborrowed Reserves

The H.3 statistical release indicates that nonborrowed reserves of depository institutions have declined substantially since mid-December to a level that is now negative. This development reflects the provision of a large volume of reserves through the Term Auction Facility (TAF) and has no adverse implications for the availability of reserves to the banking system.

By definition, nonborrowed reserves are equal to total reserves minus borrowed reserves. Borrowed reserves are equal to credit extended through the Federal Reserve's regular discount window programs as well as credit extended through the TAF. To maintain a level of total reserves consistent with the Federal Open Market Committee's target federal funds rate, increases in borrowed reserves must generally be met by a commensurate decrease in nonborrowed reserves, which is accomplished through a reduction in the Federal Reserve's holdings of securities and other assets. The negative level of nonborrowed reserves is an arithmetic result of the fact that TAF borrowings are larger than total reserves.

H.3 Statistical release

So **Abracadabra** the problem has magically gone away. According to this convoluted FED statement and reading between the lines it's just an accounting issue. "ENRON" do I hear you cry?

Remember in our "Return of the Wombles" piece we outlined how the CBs undertook emergency lending facilities to get the GARBAGAE off bank balance sheets. It seems this has left them undercapitalised.

The TAF was an emergency measure introduced only in December last year as an alternative to the stigmatised discount window to help reliquify the system. Initially it was only meant to run until end Jan 08 but now they seem to be operating it indefinitely as the preferred method of conducting policy. The amounts offered via the TAF have increased from \$30 bn in Dec to \$60 bn currently. The fact that the TAF has been extended and increased in size suggests that the banking system remains under duress. The banks are definitely solvent (in aggregate) but the collapse in non-borrowed reserves still smells a bit simply because of its timing and the fact it has never happened before. **Incidentally as of FEB 13th this now stands at minus \$20bn.** Strange that it has happened at the same time as rates have been cut aggressively and various financial institutions have sought capital injections from foreign sources (very un-American) and on very generous terms. Hard to see how the banks will be in a position to

bail out the bond insurers if they can't raise a few billion \$dollars for reserves.

MONOLINES or MONOSHOES

The last point is a massive one. To our mind the MONOLINES, such as ACA, MBIA, AMBAC or FGIC to name the most notorious, cannot be bailed out by the banking system. As a former colleague of ours expressed it -"It's like asking car insurance policy holders to pay for their own claims". Under our headline Counterparty Risk and CDS the next shoe to drop! we examined the systemic risk to the global financial system that a full blown "solvency crisis" would entail. Well the first shoe dropped, hence MONOSHOES, the other shoe is now dangling precariously from the other foot.

The very real risk of a systemic foreclosure of the banking system brought the Fed together on the Monday holiday of Jan 21st where they rubber stamped the go ahead for 75bps of emergency Fed funds cuts and 75bp on Discount rate. February Fed Funds were pricing at least this and some. Jan 22nd we walked into a hailstorm of selling and limit down stock indices. Every asset class took it on the chin, gold was down 50 buck to all important 850 support and a crash looked imminent. However we reasoned Bernanke and his pal Mishkin would be true to their word and cut that day, most likely before open of US markets....

The cut duly came but despite the largest inter-meeting cut in history of Fed the market barely recouped the loss from the Friday closes and no doubt with the Plunge Protection Team buying equity indices the market would have succumbed to more losses. The market rightly reasoned "so what to cuts"; it doesn't bail out the MONOLINES. It took a 4 liner from the New York Insurance Superintendent Eric Dinallo's (who the hell?) inferring of bailout of bond insurers and Stocks soared.

This is excerpt from our Monthly NAV. Ever since the FED cut the world has focused on the viability of the bond insurers. Congress has debated them, including a panel of the CEOs of Ambac (ABK) and MBIA (MBI) and Ackmann the protagonist who has been shorting the holding companies of these two. **WHY? In a nutshell Banks, regulators, and state and local governments are worried that as the ratings agencies cut the insurers, the municipal bonds they insure will lose value. Governments worry that the cost of financing will increase. Regulators are concerned that ABK and MBI will not be able to pay claims, causing further write downs for the banks.**

Enter stage door RIGHT-Warren Beatty, I mean Buffett. Sorry, but so stage managed was Buffett's public offer for the MUNI insurance portion of these companies that it could have been scripted in Hollywood. Buffet knows value. Far from being the White Knight, he is preying on the distress of the monolines in order to pick up a fabulous annuity stream cheaply whilst leaving the "Garbage" behind. He has put the final nail in the coffin we would suggest, and unlike Mr Morgan whose handshake saved the banking system in the 1907, this clasp may unwittingly portend the unthinkable.

MBIA even tried a secondary offering to raise capital, which to be fair suggests the rating agencies have been told by "GOVT officials"- you cannot downgrade the MONOLINES if they do this...the NYS Commissioner of Insurance has suggested splitting the Muni bond business off from the rest of the firm. What's left is can best be described as a poorly run, derivative hedge fund led by people who have no business running a hedge fund of any sort, much less one of the poorly run derivative variety. But the fact that the

NYS insurance commissioner is suggesting this should tell you that this has reached a level of government involvement that cannot bode well for our friends at ABK, MBIA and FGIC.

To add another hammer blow to Buffett's nail-The FT reported that Eliot Spitzer, former NYS Attorney General, now New York governor, gave the bond insurers three to five business days to find fresh capital, or face a potential break-up by state regulators who want to safeguard the municipal bond markets. Oh, and that was BEFORE Moody's cut FGIC from to double AA -- effectively ending their ability to write muni bond business.

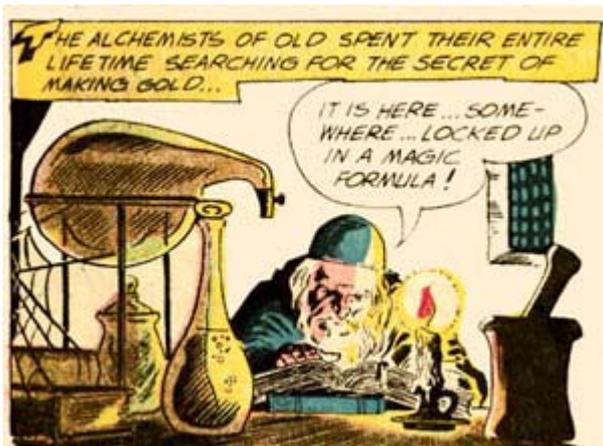
Our read is the credit or now solvency crisis has a long way to run, the FED will cut more. The financial situation is as bad if not worse in the UK and as extended in Europe. FED cuts won't help the UK, if that's what they hope for. Mervyn lost the war a long time ago, and we mean the war not the battle. Sure it is imprudent to slash rates, but faced with a banking crisis of untold proportions by holding firm on rates will potentially induce a deflationary slump in the UK. Add the ill conceived Non dom taxation equation and the UK is on brink of a real disaster. We want to be wrong on this one.

GOLD IS MONEY

Last month we discussed GOLD as a UNIVERSAL Currency. Expanding on this theme I suggest an erudite explanation of why gold is money can be found at Mish's Global Economic Trend website:

<http://globaleconomicanalysis.blogspot.com/2007/06/misconceptions-about-gold.html>

The "functions of money" according to any undergraduate economics book are comprised of 3 useful functions in an economy: It is a medium of exchange, a unit of account and a store of value. If you read this piece it is evident Gold fits all of these tenets.



"Greenspan unlocks the secret of making fiat money "as good as gold". I suspect history will tell us otherwise.

ESKOM & Load Shedding

Finally, we cannot move on without a nod toward what is happening in platinum and palladium. They are of course going parabolic, and they are doing so as the electricity problems in S.Africa become more and more severe. ESKOM is, in the new language there, "load shedding;" that is it is blacking out or cutting power to various industries

and to the public given that it is no longer capable of producing the electricity demanded of it.

ESKOM, as S. Africa's poorly run monopoly supplier of electricity, has been supplying cheap... indeed very cheap... subsidised electricity to the nation while not doing what is necessary to increase power generation. For years that worked; now it is not, and the result is "load shedding." The platinum and palladium mines are shuttering in, fearful of sending miners miles underground and at the mercy of "load shed" power supplies. This problem is not going to go away soon...perhaps not for years.

The common consensus across the board, from a gold and PGM mining standpoint, is that the future remains wholly uncertain. While producers do believe that Eskom will "cobble" together a short term plan, uninterrupted power remains a long term issue for the industry. There is certainly no quick solution, and a guarantee that Eskom will provide 90% electricity capacity is not a watertight agreement, as many mining houses learned at the end of last week. Faced with these uncertain conditions, safety is paramount. Workers will not be sent underground if sufficient power cannot be guaranteed. It was this lack of assurance that led producers to shut down their mines on the 25th January

The debacle began with Eskom, a monopoly that we have now all become so familiar with, being forced to load shed as a result of a shortage of supply capacity. Load shedding is a new term in the vocabulary of the precious metals industry and implies a black out or power cut. This measure was a final resort to prevent a total collapse of the national supply system. As the last in a series of measures that can be taken by Eskom to reduce demand on the electricity system, the recent actions synthesise the emergency situation facing the South African economy.

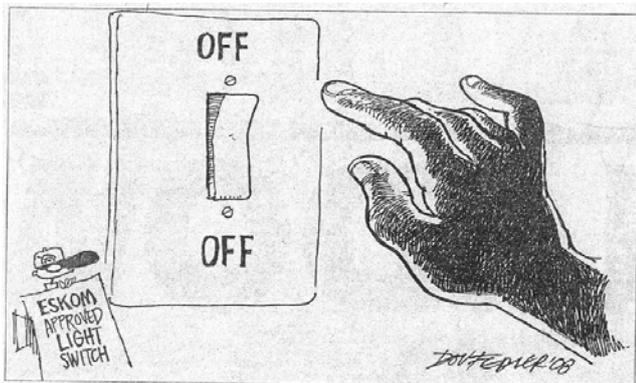
According to Eskom figures, electricity consumption grew 4.3% in 2007 compared to 2006. While this increase may not appear to be a sizeable amount, it does signify how pressured the electricity network was just one year ago and how a relatively small increase in consumption has acted to temporarily cripple the South African precious metals mining community. Furthermore, peak demand consumption was greater for each week in 2007 than that of 2006. **So the obvious question therefore is how did the power situation come to fall apart?**

- Firstly, South African electricity historically has been extraordinarily cheap. The gap between electricity prices of South Africa and the rest of the world expanded significantly over the years and is now 74% cheaper than the next low cost nation – Canada. Therefore, while South Africa enjoyed very economical electricity, there was no incentive or consumers to alter their consumption patterns and the continuance of this situation was taken for granted. Furthermore, the inexpensive electricity ensured that competition in the market was an impossibility as private companies simply could not compete with Eskom prices. Therefore, Eskom's state monopoly continued. As early as 1997, the government recognised that major investment in the electricity network was required or the country would suffer a power crisis by 2007. The utility company and the government failed to invest in the network infrastructure or plan for the future. Here we are in 2008, and the scenario predicted more than 10 years ago has become a firm reality.

- Secondly, the South African economy has been a resounding success story with GDP close to 5% since 2004. The expansion of the economy, fuelled by investment from both home and abroad, placed additional pressures on

an already stretched electricity network. The reserve capacity of the national grid, which represents the spare power available to meet all electricity needs at any point in the day, was pushed to unprecedented levels. The reserve margin, the surplus electricity that exists when demand is at peak levels, has fallen from a historically high level of 25% in 2002, to just almost nil in 2008. At this level, the carrying out of essential maintenance becomes very difficult. Eskom report 15% as their minimum preferred reserve margin. With this flexibility, maintenance can be carried out regularly and power station equipment does not operate at overly stressed levels. The fall to such a low reserve margin has led to few opportunities for essential maintenance and power stations have effectively been overworked. The present situation has also been aggravated by serious issues with coal supply and poor coal quality (wet coal after heavy rain). This has all culminated in the significant hike of unplanned outages and generator trips. We need to get a little technical to understand in more depth why the recent outages occurred. South Africa has a generating capacity of just under 40,000 MW. Nearly two weeks ago, the system lost over 5,000 MW due to boiler leaks and failures, additional equipment failure, poor coal quality and issues with coal supply. In addition to this, close to 3,700 MW was lost to essential planned maintenance. Therefore, supply fell below 80% capacity and the lack of sufficient supply capacity to meet consumption led to Eskom having no choice but to "load shed".

The current calamity is compounded by a lack of direction and clarity from Eskom and also by a government unwilling to take responsibility. The Eskom showdown was described by one producer as a "comedy of errors". It certainly is a farcical situation, in that South Africa now finds itself on the first page of international newspapers for all the wrong reasons. The knock effect to foreign direction investment in this region will be palpable to all.



This is a huge problem for the auto industry which depends on both platinum and palladium for catalytic converters.

(Notes on Eskom courtesy of Mitsui)

Gold according to the WGC could soon be a viable alternative? for platinum catalytic converters. Gold production out of SA accounts for some 10% of world supply so silver and platinum have been benefiting from this slow down in production, which looks likely to continue.

Global Gold Outlook

The Rush to Gold article of January 31st was an excellent piece on how undervalued gold was relative to the Dow and Oil and on inflation-adjusted basis. (see link below for charts). Pity it hadn't been done 5 years ago. Although this was not "new" news, and not the ringing of the bell for a

gold top, it did halt the market in its tracks. February 1st Gold dropped 2% after making nominal new highs.

We have been experiencing a stealth bull market in precious metals which the populace is beginning to awaken to. However all bull markets need to take pause for breath. With no coincidence we run into the seasonally weak period for the sector. Post Diwali, February to mid March is typically a slow period or corrective one for the market.

STREET JOURNAL.

JANUARY 31, 2008 - VOL. CCLI NO. 25
 ** \$1.50
 OIL \$92.33 ▲ \$0.69 GOLD \$920.60 ▼ \$4.50 EURO \$1.4882 YEN 106.43

Fed Moves to Curb Risk of Recession

Investors Flock to Gold As Metal Hits New High; Fans in the Mainstream

BY E.S. BROWNING

The new gold rush is on. As inflation has picked up and the stock market has tumbled, investors seeking a safe haven have piled into gold, driving the metal to all-time highs. Since mid-August, New York gold futures have risen more than 42%. After finishing down at the early-afternoon close yesterday, they shot above Monday's record of \$927.10 in later electronic trading. The peak occurred after the Federal Reserve cut its target lending rates, which sent the dollar—gold's big competitor—lower. Historically, the world's most enthusiastic buyers of the metal have been catastrophe-fearing "gold bugs" in places like India, where banks aren't always trusted and currencies can be unstable.

Hot Commodity



Street are betting on what had long been a losing investment. After hitting \$847 an ounce in January 1980, gold futures fell for almost 20 years, grinding down to \$253 in August 1999, a 70% drop. Gold remained dull until 2001.

Central Bank Lowers Target Rate by Half Point, Open to Further Cuts

BY GREG IP

Seeking to nip an incipient recession in the bud, the Federal Reserve cut interest rates for the second time in nine days. In one of its most aggressive campaigns in decades to boost the nation's economy, the Fed lowered its target for short-term interest rates by 0.5 percentage point to 3% yesterday, and left the door open to further cuts. In its statement accompanying the move, the Fed said "downside risks to growth remain," and that the central bank would "act in a timely manner as needed to address those risks." Investors widely expect the Fed to lower its benchmark rate again in March by 0.25 percentage point to 2.75%. Yesterday's rate cut comes as the latest news suggests the economy con-

<http://online.wsj.com/public/resources/documents/info-launch.html?project=Gold0801&w=980&h=530>

Likewise on January 31st 2008 GATA (the Gold Anti-Trust Action Committee) placed a full spread advert in Wall Street Journal asking for accountability of Gold Reserves which haven't been independently audited since 1950s. They claim rather coherently how the FED may have manipulated the gold price via leasing of gold and use of gold derivatives market. The implication is the US does not have as much Gold as it once did, and is losing the ability to intervene in the markets, leaving the way forward for Gold to **RE-RATE higher**.

Anybody Seen Our Gold?

The gold reserves of the United States have not been fully and independently audited for half a century. Now there is proof that those gold reserves and those of other Western nations are being used for the antiprecious manipulation of the international currency, commodity, equity, and bond markets.

The Federal Reserve's general counsel, J. Virgil Mattingly, acknowledged as much when he told the Federal Open Market Committee on January 31, 1995, that the Treasury Department's Exchange Stabilization Fund had undertaken gold swaps.

Federal Reserve Chairman Alan Greenspan acknowledged as much in testimony to Congress on July 24, 1998, when he said that "central banks stand ready to lease gold in increasing quantities should the price rise."

Bank of America Corp. acknowledged as much in a filing in U.S. District Court in New Orleans on February 28, 2003, asserting that the missing company was the instrument of the central banks in distorting the gold market.

The Bank for International Settlements acknowledged as much on June 27, 2005, when the head of its monetary and economic department, William S. White, declared at a convention of central bankers in Basel, Switzerland, that a major purpose of international central bank cooperation is "the provision of international credits and joint efforts to influence asset prices — especially gold and foreign exchange."

Since last May the U.S. Treasury Department's weekly report of the government's international reserve position has cited loans and swaps from the U.S. gold reserves.

Since 2004 four major international investment houses — Sprout Asset Management, Citigroup, and Edborn Partners — have issued reports stating that Western central banks have been manipulating the gold market.

The objective of this manipulation is to conceal the mismanagement of the U.S. dollar so that it might retain its function as the world's reserve currency. But to suppress the price of gold is to disable the barometer of the international financial system so that all markets may be more easily manipulated. This manipulation has been a primary cause of the catastrophic excesses in the markets that now threaten the whole world.

Gold's recent rise to around \$900 per ounce shows that the price suppression scheme is faltering. When it is widely understood how central banks have been suppressing gold, its price may rise to \$3,000 or \$5,000 or more.

Suspicious market manipulation by government is leading the world to disaster. We want to expose it and stop it.

Who are we?

We're the Gold Anti-Trust Action Committee Inc., a non-profit, federally tax-exempt civil rights and educational organization formed by people who recognize the necessity of free markets in the monetary metals. In May 2001 we gathered representative of five gold-producing African countries in Durban, South Africa, at the GATA African Gold Summit. In August 2005 we brought gold market experts and investors from around the world to the Gold Rush 21 conference in Dawson City, Yukon Territory, Canada, excerpts of which you can watch on the Internet here:

www.GoldRush21.com

Now GATA is marching on the Treasury Department as demanded, via the Freedom of Information Act, that the U.S. government come clean about its gold reserves — to disclose how much gold is left and how much has been compromised by lease, swaps, and other circumstances undertaken for antiprecious market intervention.

So that we may explain how the unfolding world financial disaster can be mitigated and why free markets in the monetary metals are essential to free markets everywhere, we invite you to join us at our next conference — "GATA Goes to Washington: Anybody Seen Our Gold?" — to be held Thursday through Saturday, April 17-19.

For information about that conference and GATA, visit www.GATA.org.

William J. Murphy III Chris Powell Ed Steer Wistar Holt Catherine Austin Fitts

See <http://www.gata.org/>

February we suspect will turn out to be a consolidation month. As we consolidate at higher prices investors will begin to feel comfortable with the knowledge these prices are not a flash in the proverbial gold pan. Couple this with reduced volatility and jewellery consumers likewise may well come back to the table.

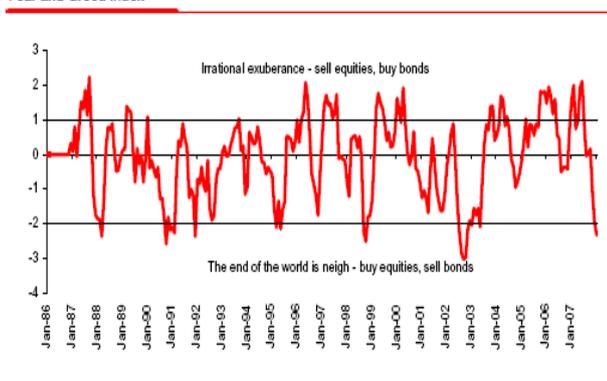
The issues of South Africa reinforce how supply issues are adding to the potent bullish mix, but patience must be maintained for both the metals and the miners. The equity has performed dismally along with down beaten markets, but also along with fears of unsustainable prices. We spoke last month of our belief on this sector of the market and maintain it will take several quarters of earnings to convince the mainstream that these are not just speculative instruments but real investments. We reduced our holdings substantially, but the miners have really behaved dismally.

Our main concerns for equities is despite reality that gold prices drive the share price, a full blown financial hiatus which we do not rule out for all of the above, keeps us very defensive on overstaying our welcome. Preservation of capital will be paramount then. We had a taste of this in January.

The recent share sell-off in generalised markets has left participants bruised and battered. Many though are still in denial about potential risks. The market seems to think the worst is over. Indeed, we are in camp that right now there is enough fear to suggest the market could have a nasty short cover back to 1400s again on SP500 (we use this as our stock barometer for Western world).

Golden Ray of Hope

Fear and Greed index

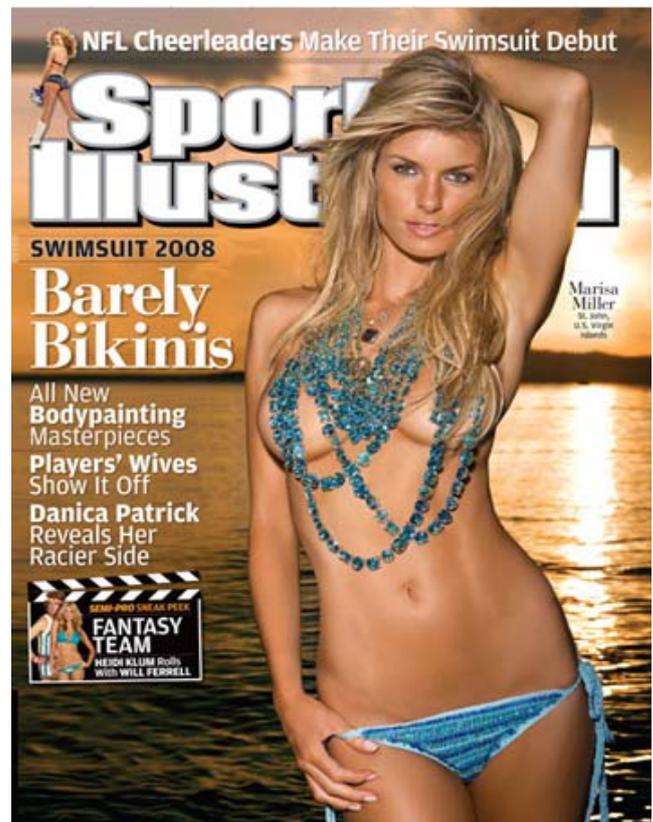


Source: SG Equity Research

Data Source: SG Equity Research, Chart: Hinde Capital

Sports Illustrated Swimsuit Indicator

This "high tech sentiment model" suggests there are fair odds of good "inflationary" returns in the US. Stock market. Over the last 30 years, an American has appeared on the cover of the annual Sports Illustrated Swimsuit issue in 15 different years. The average performance of the S&P500 during those 15 years is a gain of 13.9% with 13 positive years (87%). Of the fifteen years where no American appeared on the cover, the S&P500 has averaged a gain of only 7.2% with 11 positive years (73%). Gold Bless Marisa Miller. A thanks goes to the Bespoke Investment Group for this "uplifting" and profound insight. In the medium term a rally in the generalised markets would certainly not hinder our mining equity positions. The seeming beta to the markets still appears to be relevant. In time we do see this decoupling, as we have discussed ad nauseam.



Comments and thoughts

Consider the following;

Contrary to the view of market pundits the US Federal Reserve Bank has never in its entirety moved funds lower in such magnitude and in such short period of time.

We have seen 5 potentially vast stimuli packages

1. Mortgage Bail out
2. Fiscal Stimulus package of \$150bn over \$1,000/citizen
3. 225bps of rate cuts from Sept 18th to Jan 30th
4. Potential Bond insurer bail outs (maybe Nationalisation?)
5. Foreclosure Bailouts

The US is experiencing unprecedented levels of stimulus, but then the occasion undoubtedly calls for it as the ramifications of none are just too severe. We suspect by time all is said and done the deleveraging will result in several trillion of write downs not the \$400bn touted.

Does one advocate such monetary behaviour again, as this is precisely why the US and other Developed nations are in this mess.

We suspect at some point the FED will be powerless to dictate economic events.

What is the answer then? A return to a Gold Standard? Perhaps, but a topic for another time you will be relieved to read.

Economist Ludwig von Mises stated the endgame brought on by reckless expansion of credit (*debt*): ***There is no means of avoiding the final collapse of a boom brought about by credit (debt) expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit (debt) expansion, or later as a final and total catastrophe of the currency system involved.***

New Investment/SIPP

Hinde Capital Ltd is actively seeking investment for Hinde Gold Fund. The Fund is working with a select group of marketing professionals, both in the high net worth arena and on the institutional level. It is currently expecting additional funds for the March share issuance and is working to gain exposure on many investment platforms including most of the SIPP providers to enable all investors an ability to take advantage of this opportunity.

Our website is www.hindecapital.com. All documentation on Fund and how to subscribe can be accessed there. In the interim please send all subscription requests to info@hindecapital.com