HINDE CAPITAL

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The Echo Bubble? Stagflation

Stagflation is a condition of the economy that is as inconvenient as the word itself is inelegant. "Stagflation is a condition in which the price level is rising despite the existence of substantial unemployment. "It connotes the simultaneous occurrence of economic stagnation and comparatively high rates of inflation.

Stagflation was coined by Ian MacLeod in 1965, the then UK Chancellor of the Exchequer. "Stag" expropriated from the first syllable of "stagnation", referencing a sluggish economy and "flation" from "inflation", referencing increasing if not spiralling consumer prices. So if "Stagflation" is the name of the dilemma that exists when a central bank has rendered itself powerless to fix either inflation or stagnation then I would contend we have Stagflation.

The UK and US for example want to reliquify the banking system but they are afraid to do so too much because it will stoke price inflation (more likely than asset inflation this time) and it is fearful of raising rates as it is fearful of crushing the economy irretrievably by inflicting higher debt servicing on consumers.

In the 1970's the United States and UK suffered from both high unemployment and high inflation, an experience that weakened economists' and policymakers' confidence in the traditional Keynesian approach, much as the Great Depression had undermined the traditional classical approach of Adam Smith's "Invisible Hand". Over the last 30 years advocates of both approaches have reworked them to improve their explanations of business cycles and unemployment in the case of classicists and Keynesians have worked on theories for the slow adjustment of wages and inflation. Today and then for that matter Monetarism (focusing on money supply and on inflation as an effect of the supply of money being larger than the demand for money) grew in following. Milton Friedman dominated this doctrine and argued that:

1. Monetary Policy has powerful short-run effects on the real economy. In the longer run, however, changes in the money supply have a primary effect on the price level.

2. Despite the powerful short-run effect of money on the economy, there is little scope for using monetary policy actively to try to smooth business cycles.

3. Even if there is some scope for using monetary policy to smooth business cycles, the Fed cannot be relied on to do so effectively.

4. The Fed should choose a specific monetary aggregate (such as M1 or M2) and commit itself to making that aggregate grow at a fixed percentage rate, year in and year out.

Although I do not necessarily agree that a constant money growth rate would provide a "stable monetary background" as it is just too inflexible I would agree with the other tenets of these 4 propositions. Monetarism holds more credence, now more than ever I would contend. Central banks such as the Fed have lost control over the supply of credit. It has been hijacked by financial innovation that has manifested itself in a world of "rudderless" currencies which do not have the support of a hard asset such as gold or silver. Don't get me wrong I still believe the central banks still abuse sound finance by buying paper assets, its just there is another more powerful money creator-"the shadow banking" sector a friend of mine coined it.

In last months investor letter we spoke of a 70s re-run with regard the credit crunch. Like then the outcome will be stagflation. I believe that inflation was more attributable to the failure of the Bretton Woods I (BWI) system. The failure occurred not when Nixon closed the gold window in 1971 but rather the day Bretton Woods was introduced in 1944.

Towards the end of the WWII at the Conference of Bretton Woods, New Hampshire 44 nations gathered to discuss the post-war international monetary system. This was nothing more than an American dictate resulting in official recognition of the supremacy of the dollar, the only currency convertible into gold by foreign central banks. So all the world's currencies were expressed in terms of and closely tied to the dollar, but in turn the dollar was still fixed to gold. Only the United States could change the price of gold, and all other nations were forced to value or devalue in terms of dollars. This power given to the US was heavily abused.

Bretton Woods also ruled that a nation's reserves could be composed either of gold or any currency convertible into gold. This last one was the killer because it included the dollar and later the pound when it was strong and freely convertible into gold, and in no way anticipated the way the dollar would be run into the ground. This subverted virtually every currency in the world and launched international inflation the likes of which had never been seen before.

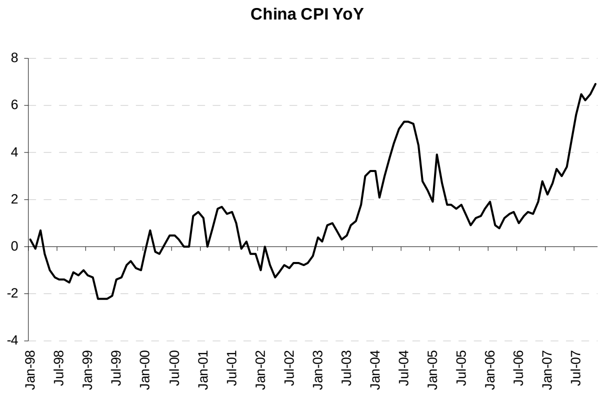
As a Fed central Banker, John Exter said of this time "My point is that from the very beginning the Fed violated the discipline of the gold standard (really gold exchange standard) by buying paper assets. They should have only bought gold, but it's almost irresistible to buy paper assets, which increases the total reserves of the banks and in turn enables them to make more loans. People by and large don't like discipline. The Fed is NO exception…"

1971 was a watershed in monetary history but I suspect the 70s "flation" element had been mounting since 1944, the moment the world went on "dollar-gold exchange" system. Rather it was Nixon's actions of1971 that ushered in the chaos we now know as the floating exchange rate non-system. The reverberations of this tumultuous event are being echoed today as we are experiencing the consequences of the abandonment of the link between gold and the dollar (in fact all currencies). For over 30 years the Fed and other central banks have had no restraints on the ability to create money through the purchase of assets. The result has been an unprecedented explosion of debt. The consequence of this has seen unparalleled low interest rates. This in turn has led to a de-regulated financial industry searching for more powerful and innovative ways to find yield. Herald the credit derivatives era, but more of this later.

Pork Pies and Lies

"Chinese Pork Prices surge 56% in November from a year earlier on pig shortage." (Bloomberg) A worrying precedent if you are Chinese and vying with the other 1.5 bn others who incidentally quite like their pork. I just came back from a trip to China and I for one can vouch for its existence as a staple food stuff. I had flash backs to "my everyone has to have a "year off" time" in Australia working appropriately on a sheep farm like all the other sheep, I mean gap students. It was Lamb cutlets for breakfast, mutton for mid morning tea break, Chinese lamb for dinner and so it went on for a whole month. I was only reprieved more lamb when I "skipped" off and went surfing instead. But I digress unlike Australia where there are countless sheep, pork it would seem has literally flown off. It could be a national issue but when I look at lean hogs and pork belly prices they looked to have fallen dramatically over the year. (Probably cost too much too feed?!) So have pork prices risen or not?

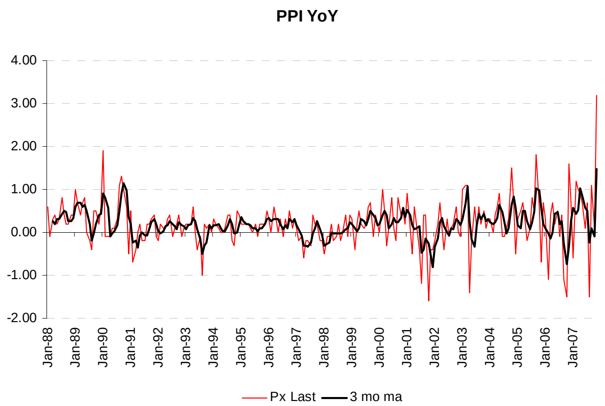
Honestly being bit pressed for time I haven't delved further, suffice to say the point of this section is actually too point out that we have inflation (but the Bloomberg news quote above I question the validity of….feedback welcome). Ironic as for years I have questioned the validity of inflation statistics which is a primary argument for the rising price of gold. We all by now are beginning to understand that we have politicalised inflation. You know the CPI number used to adjust your index linked pensions, oh yes its gone up b*gger all, so the government can at least attempt to meet its pension liabilities. Well pork lies aside there is no doubt that we are seeing rising global inflation. Continuing the theme China just hit 6.9% year on year; although not especially alarming for a country growing at 12 percent plus it is a number arrived upon at an alarming rate of appreciation.



Data Source: Bloomberg, Chart: Hinde Capital

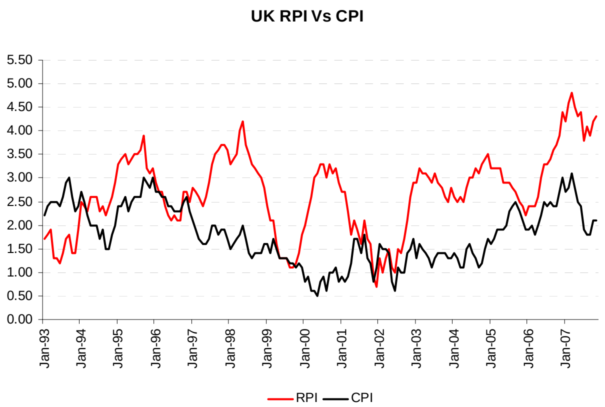
China Inflation Rising Strongly

Headline inflation is rising rapidly the US PPI soaring at rate of 7.2% the highest monthly reading since October 1981. Likewise US CPI rose to 4.3% and UK RPI similarly rising back to a four handle. I purposely refer to headline numbers as there has for a long time been a growing disconnect between headline numbers and core (ex food and energy) indices. Using core numbers in policy decision making in the US is similar to the growing disparity between the UK RPI and CPI numbers, the RPI being a truer reflection of inflationary events than CPI. Such glaring disparities lead to growing disquiet and eventual distrust by the public. Diminishing trust in Central Bank and government motivations to understate inflation undermines the social fabric of a country as fiat money becomes distrusted.



Data Source: Bloomberg, Chart: Hinde Capital

US PPI at 30 Year Highs



Data Source: Bloomberg, Chart: Hinde Capital

UK RPI and CPI diverge at Historic Highs

China inflation scares me the most, as to date surely they have been exporting deflation through cheap goods? Now we are seeing the reverse. An expanding trade surplus has led to an infusion of dollars into the banking system (Yuan equivalent) and the response of Chinese policymakers has and continues to be to tighten lending standards and allow a faster rate of Yuan appreciation against the dollar peg. Indeed these and other such PEGS “stink” and need to fall so as not to increase global inflation. The dollar will fall further but not necessarily against the majors much more but rather against the Riyal et al.

Pegs Stink

We have already established that since 1971 we have lived in a world of fiat currencies. We have what many call a Bretton Woods II system (BWII). This is where much of the world, primarily the Asian countries, have more or less informally pegged their currencies to the dollar, without the backing of gold. These countries do this in order to maintain their relative competitive ability to sell their products to the world and more specifically to the US. So the defining feature of this international and financial monetary system is that it finances the United States’ enormous external deficit and the associated fiscal deficit at low interest rates.

We contend this new system that is advertised as BWII, a semi-fixed exchange rate stable system, is inherently more unstable than the first Bretton Woods. It creates greater global imbalances and a much more speculative environment. Why? Because there is no gold conversion restraint upon the reserve currency, under BWI the natural equilibrating mechanism for trade balance was the transfer of gold from one country to another. (And we have already outlined how seriously flawed this was.)

China has the largest population in Asia and the peg of the Renminbi (RMB) to the dollar is the main driver; so how China handles its foreign exchange has a significant impact on all currencies in the region. Most Asian nations, such as Korea, Malaysia for example have to keep their currencies competitive with that of RMB. So the RMB/dollar peg or relationship is at the core of BWII. We need to understand China’s political agenda to understand this relationship. The agenda is to grow wealthy by becoming a self-sufficient industrialised nation. China wants internal political stability which means finding productive employment for its hundreds of millions of low skilled agrarian workers. To achieve this China relies on rapid export-led growth in order to absorb this surplus labour of workers into their new rapidly industrializing economy. If they didn’t grow they would face continuing civil unrest.

Large labour supply, begets cheap labour, which begets cheap goods. The world and primarily the US have consumed these cheap goods at the expense of their own produce. So the motivation has been high to keep funding the US current account deficit. To reiterate China, Japan and other nations have been fixing their currencies at undervalued levels relative to the dollar by funding the US current account deficit. Quite simply the Asian countries, primarily China, by having a cheaper currency make their exports attractive to the US. By protecting their economy from being flooded with too many dollars (another debate) they have been recycling the dollars back into US assets, namely US government bonds. By virtue of buying US government debt they are now foreign lenders, they are the financiers of the US economy via the current account. This recycling allows them to artificially stimulate their manufacturing exports even more as the Chinese are helping to stimulate American demand for Chinese goods.

How come? The purchasing of US debt supports the dollar, maintaining the undervalued RMB. Meanwhile interest rates have been driven lower than they otherwise would have been without their purchases of debt (see empirical evidence). In addition to this the Chinese have bought US mortgage-backed securities and US corporate and agency debt. So the US has had much lower interest rates generally. This has manifested itself in a US housing bubble due to the cheaper mortgages that have been afforded by this relationship.

China growth has been phenomenal and they now see it in their interest to move towards a free-float of their currency. For a start it’s a stipulation of them being a member of WTO and now also they want to use currency appreciation to dampen the growing risks of imported inflation from the dollar pegging. The more pressing issues are a function of basic economics. Two elements determine how far foreigners will go as lenders to the U.S. The first is akin to a credit test. The second is a portfolio consideration. It is becoming increasingly difficult for the U.S. to satisfy either of them.

Foreigners will accept T-bills and other dollar-denominated IOUs only so long as they believe U.S. borrowers can make good on their debts. The concern is not primarily about explicit defaults. It is about the likelihood of a slow-motion default via inflation. It is a concern about the future value of the dollar. Confidence that the dollar will hold its value is strained with every increase in the U.S. total budget deficit (which increases the U.S. government’s incentive to inflate) and with every increase in the overall level of U.S. debt to foreigners (which encourages the public’s tolerance for inflation.)

Eventually China and the other Asian countries will require a higher rate of interest for the stock of US assets they hold because the prevailing market rates do not provide sufficient compensation for the risk of holding so much stock. **The credit crunch that is in part a by-product of this semi-fixed peg in virtuous circle accelerates this process.**

Deutsche Bank labels emerging markets that link their currencies to the US dollar in two distinct groups: those predominately exporting goods and others exporting mainly commodities. China are an example of the former and I have explained in some depth that an undervalued exchange rate has contributed to current account imbalances that could trigger economic disorder by a destabilising exchange rate adjustments that have to pass. The latter are the major oil exporting countries of the Middle East, Kuwait, Qatar, Saudi Arabia and UAE to name but a few.

For commodity exporting countries the dollar-link undoubtedly reflects that most commodities, most notably oil have been priced in USD (a function of the dollar standard). As most of revenues are collected in dollars it is convenient to peg domestic currencies to USD. So long as the dollar is seen as store of value and a relatively secure medium of exchange (2 of the tenets of the role of money) the pegs remain. The decline of the dollar has raised the price of their imports in terms of domestic currency, although it has not changed the price competitiveness of their exports, oil. Recent events have rightly brought into question the suitability of linkage of domestic currencies to the USD.

The commodity exporting countries current account surpluses are inevitable as their domestic absorption capacity is limited. The wealth derived from this can most likely be spent now to grow infrastructure. The natural resources or oil reserves values will be held for future generations. But monetary policy is rendered useless and inappropriate whilst on a USD peg. Weak dollar "policy" induces higher inflation that requires tightening of domestic monetary policy. Norway is an example of an oil exporting country that has a free-floating currency the kroner. The central bank pursues a domestic inflation target and at same time export revenues of oil are ultimately transferred to a government pension fund which invests in foreign currency denominated financial assets paying dividends for future generations. Norwegian inflation has remained well contained by contrast to the Middle Eastern exporter.

It makes sense for these pegs to break. Kuwait has already made the first steps citing that a decline in the USD was eroding purchasing power and it was driving up imported inflation. "QED"! Bahrain, Kuwait, Oman, Saudi Arabia and UAE known collectively as the Gulf Cooperation Council were by 2010 due to move to a common currency with similar guidelines to the Maastricht Treaty applied to Euro convergence. This has been put in doubt as Kuwait and Oman have opted out. It would not be surprising to see a move a way from pegs by others in next year although the

Gary Dorsch of Financial Sense outlines an interesting and comprehensive analysis of the relationship between Oil and the USD pegs in his piece "The Epic Battle Over Crude Oil and US$"
http://www.financialsense.com/Market/dorsch/2007/1129.html

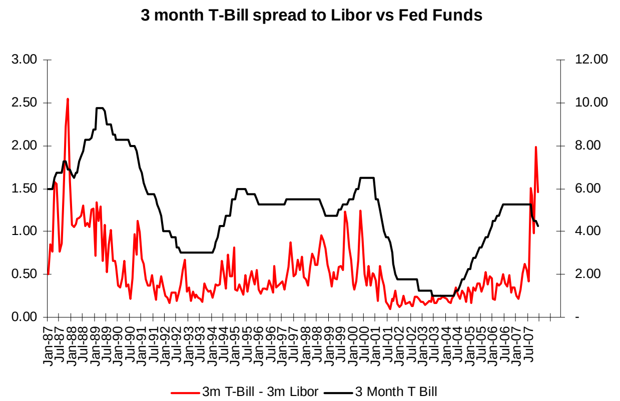
There is a growing list of dollar entities concerned about the validity of the dollar. In reality we are moving to the end of the dollar's reign as the world's international currency for trade, financial transactions and central bank reserves. Unless purchasing power is restored to the dollar we see only continued foreign exchange fractures and monetary instability, which threatens to bring back protectionism amongst the large trading countries. A fight over real assets is a source of continued global tension. USD Peg countries clearly feel a growing distrust in the US and there are potential political and geopolitical implications ahead. Dollar demise is threatening the global monetary system and all fiat currencies as can be evidenced by the return of the TED.

The TEDdy Boy Haircut

Teddy Boy subculture of the Bretton Wood era, made it acceptable for the youth to wear smart clothes (modelled on Edwardian styles) outside of one's work, or school clothes or Sunday best, whilst sporting the coiffured "duck's arse" slicked back haircuts. Fashion like finance often reverberates itself through history and the Teddy boy look saw a resurgence in the 70s.

Recently we saw the resurgence of another kind the TEDS and "haircuts". No the TEDS are not The Edwardian Drape Society who were hell bent on reclaiming the old look, but rather the T-BILL (US) Eurodollar Spread, the difference between the interest rate for the three month US Treasuries and three month Eurodollars contract as represented by the London Inter Bank Offered Rate (LIBOR). The TED spread is a measure of liquidity. It can be used as an indicator of credit risk. This is because the US T-bills are considered risk free while the Eurodollar (LIBOR) reflects the credit risk of corporate borrowers and banks. As the TED spread increases or widens, default risk is considered to be increasing. For the last 5 years the TED spread has essentially been null and void to such an extent that young graduate traders at my previous work place were blissfully unaware that the Libor to fed funds rate (or ECB refi rate or UK base rate etc) could trade beyond 12 bps. Incomprehensible to them that this was not the norm.

The TED has returned with a vengeance. At first it appeared to be widening to offer a more prudent appreciation of risk, but in November it blew out to levels that signalled the possible impecunity of a big bank or fund and even a possible systemic financial failure. Continental Illinois in 1984, or the 1987 Stock Crash, or more recently the LTCM crisis of 1998 were all bailout situations that came and went along with the TED spread blowing out and then back in. This time has been different we have traded at 215bps for weeks.



Data Source: Bloomberg, Chart: Hinde Capital

TED Spread Still Elevated

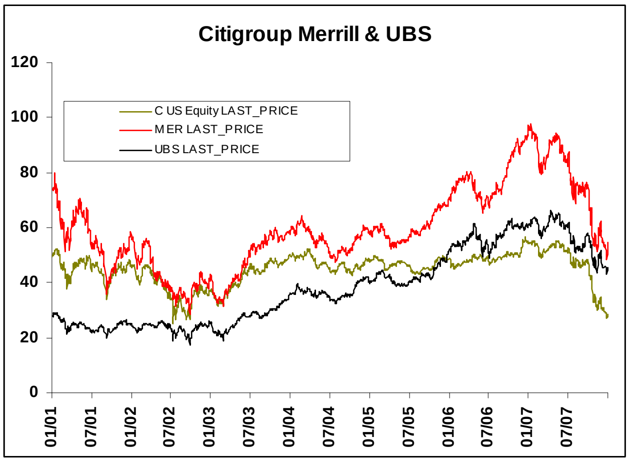
The onset of the TED spread has seen "haircuts" reintroduced where formerly they had been waved. These are the initial margin in a repo transaction, namely the difference between the market value and the value ascribed to collateral used in the transaction, generally expressed as a percentage of the market price. It is also used to describe realised investor losses in a debt restructuring. A realism that assets may be delayed in delivery as funding ceased up.

Frozen Assets and Central Bank Thaw

August time the effects of what has now been dubbed the "subprime crisis" manifested itself in a slew of subprime and mortgage lender closures e.g. American Home Mortgage. The equities of Investment banks, brokers who re-packaged these "loans" in CDOs, CLOs, CMBS and RMBS the list of acronyms goes on, came under pressure as fears over losses mounted. Arguably "chicken or egg", the first strains were seen in the TED spread where libor rates blew out as it became increasingly obvious banks would not lend to each other. Why would they? Not one analyst (or CEO most likely) could tell you what exposure these entities had to said acronyms and even if they could not one had any idea of the composition of these structures. Hence evaluating risk and value has been problematic. The consequence- the banking system froze over, caught rigid with the fear of the unknown, as if staring into the Medusa's icy stare.

Subprime paper was cropping up everywhere. Asset Backed Commercial Paper funds froze over in Canada, and SIVs poured money until they too froze. The SIVs which I touched on last month possibly were used by banks to skirt round the Basel Accord capital adequacy rules. These were originally designed to put constraints on a bank's exposure to higher risk assets. The holdings of these SIVs, comprising these worthless acronyms have undoubtedly been the undoing of the banks like Citigroup, Merrill et al.

Money market funds and other "sophisticated investors" like Florida State Pension Fund (incidentally they invested in Enron), Norwegian municipalities and other entities from around world have unwittingly bought assets supposedly backed buy the solid Tier 1 equity base of the parent companies of Citigroup et al. Shameful exploitation by Wall Street or greed and/or naivety on part of investors? I suspect all of the above.



Data Source: Bloomberg, Chart: Hinde Capital

Investment Bank Share Prices Plummeting

If we cast our minds back to early August the ECB started opening the liquidity gates with some USD130bn made available in Euros for the European banking system. Next the Fed slashed rates 50bp and provided funds, but he BofE stood fast in the face of mounting criticism over Northern Rock. BofE Governor Mervyn King understandably didn't want to foster more US styled liquidity pumping that brought us to this Minsky Moment (see October Investor letter). Widening Libor to base rate spreads prompted him to concede to a reflationary course of action, oh and the queues clamouring at the doors of Northern rock branches for retrieval of their worldly savings. Trust of the banking system was dead. To quote Don Coxe of BMONesbitt Burns Basic Points publication-were Mervyn King Churchillian he may have confronted the problems of CDOs thus "Never in the course of human history has so much **GARBAGE** been sold by so few to so many."

The Central Banks wanted to thaw the freeze before the onset of winter, like the Germans marching on Stalingrad, and Napoleon before them winter is never a good time to wage a battle. Better nip it in the bud before oil hits $100 and consumers have no more discretionary cash to burn. The policy response of CBs caught between a rock and a hard place is not enviable. On the one hand the disinflationary impact of credit contraction and on the other the rising spectre of slowing growth and rising inflation….that "Stagflation" word again. Better to opt for reflation than deflation, as Richard Russell has said all along "inflate or die". The consequence of all this is that GOLD is money again, as Central Banks have consigned their currencies to the waste baskets of history. Take the Bank of Canada faced with strong CAD appreciation vs. USD, Governor Dodge chose to cut rates, when arguably the current restrictive monetary policy in place was more than appropriate. This smacks of mid 90s Emerging market policies, leading up to the Asian crisis of 1997. Debasement is GOLD positive and I suspect we will see Gold perform in all currencies moving forward.

Misplaced trust in the credit markets is a funny thing. It's usually only restored with higher rates, not lower.

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 January 1st 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.

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