HINDE CAPITAL

October/November 2007

Hinde Gold Fund was launched on October 19th 2007 with starting assets of US$4.4m. With gold at 27 year highs and enjoying renewed popularity we received good press. (See website next week for articles). We would like to thank everyone at Laven Partners, Fimat and Swiss Financial Services for getting the fund set-up completed in record time and with such efficiency and professionalism.

1970's Re-run

The French's navy's seemingly main job in the late 1960's, on De Gaulle's orders was to escort the container ships across the Atlantic as they carried gold back to France that had been exchanged for paper dollars. Despite his waning domestic popularity at that time ('La France s'ennuie' as Le Monde famously wrote) and his out-spoken antagonism to US hegemony, his comment, 'How much can a dollar really be worth when they can print it at will? I will have the gold, you can't make that,' has never been more timely. President Richard Nixon soon stopped De Gaulle's transatlantic voyages as he closed the gold window in 1971, ending the Bretton Woods era; a new inflationary era began.

In the early 1970's, similar to the start of the 21st century Britain and the United States enjoyed a period of rapidly rising asset prices fuelled by easy money conditions and also inflating stocks to the record bull market highs of a few years earlier. In the U.S, free of any gold standard restraint, Federal Reserve Chairman Arthur Burns inflated the money supply by over 10% a year during the years 1971-1973 in order to lift the United States from recession and allegedly assist Nixon's 1972 re-election. The U.K. government moved to a free market ending credit controls and opened the monetary spigots spurring a real estate bubble at a time of global economic prosperity which saw oil prices rise from $2 to $10 a barrel at a time of heightened Middle East Conflict which culminated in the Yom Kippur war on October 1973.

The main "difference" between 1973 and now is the official level of inflation, which ran in the U.S. at 6.2% and in Britain at 9.2% in that year. The authorities have learnt a few tricks since then to try and pull the wool over people's eyes regarding inflation statistics, but as the old saying goes "you can't fool all of the people all of the time". In today's London Metro, there were no less than 9 articles on price increases. Whether it be bread, energy, transport or tobacco price hikes are becoming widespread. As Federal Reserve Chairman Ben Bernanke would like us to believe, inflation is in the 2% area. As long as we don't eat, drink, smoke, drive, travel, heat our homes and ensure that we buy all of goods from China (regardless of suspect quality) we most certainly might enjoy that privilege. Unfortunately for us mere mortals who reside in the real world, unlike Ben, we are staring down the barrels of double digit 1970's style inflation.

While interest rates were higher in nominal terms than today, with the Minimum Lending Rate in the U.K. at 13 % in late 1973 long rates were around zero in real terms as today. Tighter policy is not an option today, political suicide and immediate financial catastrophe lie too close to the surface, better to delay the day of judgement and keep the Greenspan rate cutting theme in place.

The U.K. suffered two harsh years as the credit crunch took its toll. London and County Securities, a secondary bank (the Northern Rock of the day) went into insolvency and the Bank of England fought tooth and nail to try and preserve liquidity in the market place, desperately arranging 'lifeboat' support packages in an attempt to allow an orderly sale of the secondary banks' portfolios. With the 3-day work week and the miners strike in full flow, the U.K. stock market dropped 70% (the F.T. Index fell from 500 to 150). By the end of 1975 many of the once invincible financial institutions had closed their doors for good.

Internationally the situation was no better. The Eurobond market had effectively closed and credit dried up worldwide. The final nail in the coffin was the collapse in the medium sized German bank I.D.Herstatt, which took place on June 26, 1974. This would normally have caused only a modest ripple internationally, but the ill-advised German authorities closed the bank in mid-afternoon, while New York was still trading. A number of banks had entered into spot foreign exchange transactions, and had paid Deutschemarks into Herstatt, expecting to receive dollars from Chase Manhattan, Herstatt's New York correspondent. The dollars were never paid. This proved to be utterly destructive of international banking confidence; a period of illiquidity followed which was similar only to that after the Creditanstalt failure of 1931. (This changed FX settlement procedures forever and every new FSA student will have now read of Herstatt risk.)

In the U.S. we can recall the near bankruptcy of New York City which did not occur until the autumn of 1975, while Cleveland's default did not occur until 1978. Despite the easing of financial conditions inflation continued to soar. The economy in the UK took a new twist as the effects of North Sea Oil began to take effect. Inflation in 1976 was at 16% and continued pay demands culminated in September of 1978 when a strike at Ford produced a pay settlement of 17%. The engineering union asked for 33%, the miners 40% and public sector workers started their strike. The Winter of Discontent had begun. Against a backdrop of rubbish in the streets, the Russian invasion of Afghanistan and the American boycott of the 1980 Moscow Olympics, Gold made its all time high of $880.

Can history help us in this current climate? A few observations might be made with the 1970's in mind.

Credit crunches invariably come like earthquakes, as a series of tremors or fore-shocks give authorities time to act and people to maintain confidence long after it is clear that a rally selling rather than a dip buying mentality should be followed. They often occur after periods of excessive monetary growth which appear to produce halcyon economic conditions of rapid worldwide growth, albeit with rising commodity prices.

Crunches can drag on for years and will force many seemingly strong institutions to the wall. Despite the severe contraction of credit actual inflation will increase for many years after as it becomes entrenched into the economy and politicians continually refuse very tight money policies and in today's case are actively cutting rates.

At the end of this episode, many things will have changed. Prices of goods in different markets will change drastically. Wealth will have been transferred, actual and relative. Unfortunately civil unrest will increase and governments will change as outright war threatens many.

The investors who survive this period of time intact and emerge relatively wealthier at the end will have probably made early decisions to exit any investment reliant on cheap financing and sold assets that have appreciated too far and switched into hard, relatively cheap assets that are protected from currency debasement and inflation and have stood the test of time better than the average CDO structure.

An M2 surge or Minsky Moment

Hyman Minsky (1919-1996) a post-Keynesian economist best articulated the process that leads to a potential credit crunch. "Stability breeds instability". The longer a period of economic stability lasts, the more society moves towards taking more risk, they borrow excessively and overpay for assets, until the entire economy is a house of cards, built on excessively easy credit and speculation.

He also offered a theory of the behaviour of lenders. They become lax as the economic health of a nation booms. Borrowers indulge in poor due diligence as they fear missing lucrative lending deals. Unscrupulous lenders driven by earning the most fees, steer unwitting borrowers to inappropriate structures that are susceptible to higher payments or penalties if lending conditions tighten.

The "Minsky Moment" is the deflating of this speculative bubble. Lenders become increasingly cautious, and leveraged as well as non-leveraged financing encounters difficulty. There is a tipping point as financing cannot only be serviced but the principal debt cannot be paid back as investors have speculated like a "Ponzi" borrowing scheme. (Borrowers receive short term high returns based on fraudulent payout of other borrowers principal.). The unwinding of such a bubble will be more damaging the longer it has been in place and the longer it takes for institutions to come clean on devalued assets. Investment only occurs when there is trust and credibility in that asset or structure. The implication for democracy can be taken a step further.

Minsky's tutor Joseph Schumpeter most famous for his work "Capitalism, Socialism and Democracy" coined the phrase "creative destruction". In essence it means the old is thrown out in favour of the new, e.g. technological innovation obsoleting old computers or in financial innovation credit derivatives altering lending practises. But he was also espousing a view on democracy. Far from the electorate identifying the common good and politicians in acting this, politicians set the agenda and manipulate events to their own end. Now the "good times" are waning the public is awakening to the inevitable payback of their excess. For when times are good we all tend to get complacent and expect the body politic to be right and moral. Perhaps we can call this a Schumpeterian seizure?!

The policy response of financial authorities to stave off a financial crisis and unrest in the democratic state is to quite simply increase money supply. M2 in US has risen eagerly as money has been made available for institutions to fund their overvalued loan exposure. Which wins M2 or Minsky Moment? We suspect we get a Schumpeterian seizure as people wake up to the confiscation of their assets by the body politic. Maybe SIVs a one of those many tremors?

Money pouring through a SIeVe???

SIV or a Structured Investment Vehicle issues short term commercial paper to raise money to invest in long-term assets, such as mortgages etc. The profit is the difference between the spread over Libor on the asset bonds, and the (often negative) spread on the funding (senior liabilities).

When short–term liquidity dries up and LIBOR and Commercial paper rates widen these vehicles lose money. Unfortunately Money market funds have invested in SIVs and other such conduits, because of the slightly higher returns they offer relative to cash rates. This means the average "Joe" in the street has been affected. The amounts are small, some $700bn, just over a quarter of the $2.5 tln invested in money market mutual funds. However an investor doesn't expect to lose any money in such a fund. At worst you are redeemed at par if you come out too early.

The loss may not be great but the psychological impact is and underscores how a nation's citizens come to question the safety of financial vehicles, credit and cash. There is no doubt that the financial markets are concerned about the funding requirements of these funds as December rates have increased to reflect the need for cash for SIVs and other investment positions.

Global Gold Outlook

The traditional seasonal performance of Gold could further be underpinned by such events. Credit crunch's are like tremors and the policy response to them will be/is very positive for undervalued asset as gold. (Our focus this week is on Gold and Silver)

Gold briefly surged to $848 last week, the highest level since the Russians marched into Afghanistan 27 years ago.

As it enjoys new popularity amid CDO/Level 3 mark-downs and bank runs, the talk of its demand and supply dynamics returns to the discussion table. So when we talk of supply and demand what does it really mean?

Supply is usually defined as mining production plus scrap and to some extent central bank sales. Demand is primarily jewellery, investment and to a much lesser degree industrial uses. After we extract roughly 2500 tonnes a year from the ground (only adding 1.5% to the total above ground supply which is peaking currently due to a number of factors) we spend the rest of the time moving it around securely depending on price.

Generally speaking gold is bought or sold depending upon its price relative to other assets and one's wealth at the time, the current fashion, the level of global conflict including the faith in the banking system and the belief in the current reserve or home currency. Unless your name is Gordon Brown and your agenda might be somewhat different, people tend to buy gold when the price is relatively low and sell when it is high, all of the above being equal.

The current climate is changing and the price of gold is beginning to reflect those changes. As the inflationary pressures increase the production costs of extraction rise rapidly, the continued dollar weakness and strains on the banking system all support the bull trend. Despite the passing of the Indian festival of Diwali, the rise of wealth in the new world increases their demand and the latest refining report shows lessening scrap recycling. The bullish seasonal patterns for gold remain in place until January/February as Muslim and Christian festivals continue the jewellery demand.

The supply factor that is now coming under more scrutiny is the central bank sales. The new year in the Washington agreement limiting central banks to sales of 500 tonnes a year started in late September. Since then the latest figures suggest a pace of 7.5 tonnes a week, not far off the 390 tonnes sold in the previous 12 months but it is becomingly less likely that this pace will continue. The European central banks, notably the Swiss and Spanish who were most prolific in 2006/7 are now at reduced levels of gold reserves. Germany, the largest gold holder outside of the US has stated they have no plans to sell their holdings. All of them are presumably concerned with the dollar's freefall and banking system worries. Couple this with the potential for the new world central banks, (with relatively light gold reserves, as a percentage of their dollar balances) to diversify before Ben Bernanke has reduced their new found wealth to a nice green tinted wallpaper stash and one has a potent underpinning for the gold price.

Even with the current shocks of unsold art threatening prices, (Sotheby auction) gold remains cheap to other asset classes, inflation and dollar weakness aside. The current bull market is underpinned by many factors and the continued potential changes will probably only add to the demand/supply equation. It will be a choppy ride as speculators fight with commercials at times, global margin calls upset the applecart and as interest becomes temporarily overdone. But it continues to remain the smallest allocation of any one's assets relative to the usual favourites at a time when it should probably be the highest.

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 of $2m for the December 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.

The website www.hindecapital.com is in middle of a re-vamp but should be ready by end of this week. All documentation on Fund and how to subscribe can be accessed there. In the interim please send all subscription requests to info@hindecapital.com