Paul Brodsky's comments delivered to:
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Frame 1: Thank you, David (Abramson). I'm honored and delighted to be here.

I'm going to take what many in this room may see as a radical point of view -- that our almost 40 year-old global monetary system has already been irreparably harmed, and that it's well on its way to being replaced.

For those that saw Barry Ritholtz this morning, I assure you I'm not just back from Roswell searching for UFOs. I don't think the world will end after the current monetary system does. We won't wake up one morning to find our property has been taken away, at least not in nominal terms. But I do think there will be a major transfer of wealth – manifest through unimaginable inflation -- and that investors that begin to view asset values in real, inflation-adjusted terms today will benefit at the great expense of those that don't.

My argument is grounded in history and macroeconomic fundamentals that my partner Lee Quaintance and I find very compelling. For the record, prior to opening a macro fund we spent twenty-odd years apiece as bond traders, running government and credit trading desks for one of the world's largest banks and on the buy-side running fixed income investment funds. We went off the ranch only when we began to follow the money, or to be more precise, when we began to define and count it.

Frame 2: This graph shows how the US economy levered itself through what we term "unreserved credit". The green line is the growth in M3 and the blue line is output growth. As you know M3 was the only monetary aggregate that included overnight repurchase agreements Wall Street banks use to finance their balance sheets. We can see that from '94 through March 2006, (when the Fed stopped reporting it), M3 grew almost 12% annually.

The point here is that Wall Street consistently tapped into an ever-increasing supply of *overnight* credit and then helped distribute *term-funded* debt throughout the system. <u>From this systemic debt mismatch the entire global economy ultimately became dependent on the US Fed</u>.

At first this term credit flowed broadly into financial asset markets. When equity markets blew up in 2000, it flowed into housing. When that credit finally blew in 2007 there was nowhere for it to go except back to the Fed. This is what we're seeing today.

So while it may seem that great wealth was created from '94 to 2006, we would argue the majority of it was not wealth at all. It wasn't capital either. It wasn't even money in the real sense. Ultimately it was overnight, unreserved credit.

Frame 3: Let's take a look at how far over our skis we currently are. The top row in this table shows the US Monetary Base, which is basically all outstanding currency and electronic bank reserves held at the Fed. We can see it almost doubled from '94 to 2006 and then it really took off in the last few years from Quantitative Easing. Yet despite this enormous growth in base money, there still isn't nearly enough money in the system to repay our debts.

You can see total Treasury obligations in the second row. The Fed would have to manufacture about 7 times more dollars than exist today for the Treasury to be able to meet its obligations. That's an obvious problem both fundamentally and for the global perception of dollar hegemony, which of course we see playing out today in FX markets.

The seventy trillion dollar figure in the fourth row is an estimate of total dollar-denominated claims. This includes Treasury debt and unfunded federal obligations, as well as mortgage, auto, consumer, corporate, state and municipal debt. Think about this: 70 trillion in dollar denominated claims on top of 2 trillion in currency and bank reserves with which to repay it! <u>The US economy is levered roughly 35 to 1 today</u>.

Certainly the gap doesn't need to close completely – there will likely always be credit balances larger than the base money stock. But given the sheer size and maturity of the US economy, it seems obvious this gap is biased to widen.

Frame 4: We've found that in the current environment it's best to ignore what policy makers say -- or even what they may intend to do -- and better to rely on logic and history.

There are only two ways economies can de-lever. Either the value of credit can deflate naturally, or the stock of base money can be expanded to an amount that would let debtors meet their obligations. Pick your poison. Credit deflation implies shrinking output and rising bankruptcies, unemployment, and maybe even social unrest. Monetary inflation, on the other hand, implies a general cheapening of the currency's relative purchasing power.

In the end we think there's only one outcome. Monetary inflation is the only politically practical answer because most voters are debtors, and most debtors would greatly benefit from having the burden of repaying their debts inflated away.

We expect politicians to be politicians and policymakers to execute policy. We don't expect familiar post-War monetary policies, or true austerity measures, or a strategy of waiting over time for everyone to accept their fate.

Frame 5: The facts are that Western economies are now too big *in nominal terms* to sustain *real* production value. As a result, our public markets are financing very few capital-producing enterprises. More than ever we are funding speculation rather than production.

In a fiat system there is no formal capacity constraint on money creation, and so in Western economies, where policy is dominated by Keynesian political economists mandated to actively solve economic problems, there is literally no mechanism to limit money creation.

In such policy-centric economies we can have debt *deflation* and monetary base *inflation* at the same time. This odd combination challenges modern economic orthodoxy at its core, yet it describes precisely the current economic environment. Most contemporary economists and investors see "disequilibrium" today because their models have broken down. We think in reality they are mis-diagnosing inflation's pathology.

For example, they call price increases "inflation", which of course is wrong. Money growth *itself* is inflation, as Von Mises, Hayek and Friedman showed. Most Western economists also model increasing demand versus supply as necessarily inflationary, which is wrong too. In a fiat system the supply of goods and services may overwhelm the demand for them, *however* price levels may be kept constant or even rise as demand falls -- simply because central banks can decide to digitize more money.

The point here is that money growth ultimately *leads* to price increases that may then show up in price baskets. Want proof? Most everyone didn't see the runaway inflation of the seventies until it was too late. The CPI, interest rates and capacity utilization were falling in 1972, much as they are today. But just two years later US CPI had risen from about 3% to 12%.

Why did prices suddenly jump? Not because there were bad guys in the Middle East hiking oil prices or because there was bad weather in the US Midwest. Prices rose in the seventies because Washington started printing money in the sixties. This drove down confidence in the Dollar.

Frame 6: Most investors today are not prepared for inflation. The pervasiveness of debt has shortened investment horizons. The almost universal objective is to seek *relative-nominal*, not *absolute-real* returns.

Have you asked yourself why interest rates are near historic lows in the face of open-ended Quantitative Easing? Clearly it's because most bond buyers are generally unconcerned with positive *real* returns. As a result, today's low nominal rates are very negative when adjusted for the substantial base money inflation already experienced and the further inflation needed to de-lever the system. As in the seventies, the majority of capital won't position assets that promise to maintain purchasing power over time.

So yes! We think bonds are in a bubble, but only when we view them in *real terms*. Even though they may send all money back at par, investors will get back bad money.

Frame 7: Policy makers across economies are now actively targeting lower interest rates so their exports are more attractive. It's a Whack-A-Mole world. Today's competitive currency devaluations are tantamount to a high-brow food fight among governments, each having the primary goal of keeping their domestic economies going.

Against this backdrop, Secretary Geithner wants to persuade surplus economies to sacrifice themselves so the US can maintain control over the global system. Clearly, this is a silly and dangerous state of affairs for global investors. Are we supposed to protect our future purchasing power by picking the currency managed by the politicians most willing to disappoint their home constituents?

We don't think any fiat currency provides safe harbor because all will be inflated. What we're living through today is a textbook case of rotating debasement occurring just prior to the fall of a global monetary regime. No paper currency has survived in the history of man. They've all gone away.

Frame 8: Solving for real returns narrows the list of acceptable investments. We like anything scarce and unlevered and precious metals and scarce consumable resources fit the bill. In periods of high inflation, wealth holders – wherever they are -- don't confuse nominal price for real value. It's pretty straightforward: the *supply* of unencumbered necessities drops at low price levels, while the demand for them stays constant or rises. Prices must increase.

Frame 9: We think the greatest upside and least risk is in precious metals, specifically gold. Why? Because gold is a currency, not a capital asset, that does not rely on output growth for appreciation. Its appreciation depends on the dilution of paper money vis-à-vis goods and services with inelastic demand properties.

Gold is not an investment in the normal sense. It is cash in a scarcer currency. It has no more or less intrinsic value than the Dollars, Euros or Loonies in our wallets but it will maintain its relative scarcity to them. So then - the bubble we're seeing today is not in gold but in paper money, which has grown in the US by 130% in the last two years and is about to double again. Gold's so called "exchange rate" versus paper money will continually be re-priced higher.

Frame 10: Have you asked yourself how the gold price has climbed for 10 years when consensus has been there's been no price inflation? We think it's because confidence in paper currencies has been dropping as their supplies have been increasing. Individual investors, hedge funds and now central banks have begun to dabble. Institutional investors are sure to follow. Goods and service providers and wage earners across the globe will continue to demand increasingly more paper for their goods and services.

Frame 11: So how preposterous is it to expect a new global monetary system backed by inert rocks? Actually, it's not preposterous at all.

Paul Volcker, as Undersecretary of the Treasury in 1971, was an influential voice when President Nixon broke the dollar/gold exchange standard -- an idea that just a couple years before had seemed preposterous itself. Unsurprisingly, prices rose significantly in the following decade, even as output stagnated. Economists hadn't seen such disequilibrium before and called it "stagflation".

Ten years later the same Paul Volcker as Fed Chairman had to raise overnight rates to a "preposterous" level at which paper money would again generate positive real returns. Yes, he whipped inflation but what he really did was save the dollar. By raising short rates to 20% he lowered the supply and stopped the ballooning velocity of money.

Can higher interest rates save the day this time? We don't think so. The difference between 1980 and today is the pervasiveness of debt. Ben Bernanke can't raise rates even if he and the markets wanted to because it would trigger wide spread systemic defaults. We would have a substantial contraction in US economic output *that wouldn't be shared by surplus economies* (not to mention Western banks would be annihilated in the process).

In practical terms, we can't lower rates below zero and we can't raise them. What about debt-focused quantitative easing? That won't work either. An economy can't be de-levered by issuing new debt or by transferring existing debt to government balance sheets.

And consider this: in the last two years the US monetary base grew over 130% and yet output grew a total of only 7.5%. This compares to 88% growth in overall output over the previous twelve years on a 95% growth rate in base money. The point here is that the efficacy of monetary inflation on output growth has diminished substantially.

So we think there has to be an unconventional way for policy makers to press the economic reset button -- something as "preposterous" as breaking the gold exchange standard in 1971.

Frame 12: We think we know what to expect: ultimately the Fed will formally devalue the dollar to gold and then it will conduct monetary policy on the much higher dollar/gold exchange rate, just as it has conducted credit policy with interest rates over the last generation.

A few years ago, Lee and I modeled gold using the old Bretton Woods formula and we came up with a "Shadow Gold Price". When we divide today's US Monetary Base by official US gold holdings we arrive at a dollar value of about $8,000 an ounce. A big number to be sure, but math is math. An $8,000 gold price would represent the magnitude of dollar devaluation necessary to reconcile all past monetary base inflation. It is a price based on fundamentals, modeled using post-War experience.

Is $8,000 a realistic target for gold? Why not? In fact we could see it rising even higher given the ongoing political imperative for monetary inflation.

We shouldn't be price anchored. At its speculative peak in 1980, spot gold traded at a premium to the Shadow Gold Price. Today, it trades at an 80% discount. When gold was trading at $50 back in the seventies, who thought it would peak at $850, or who thought the NASDAQ would peak at 5000, or, for that matter, that 2-year Treasury notes would trade at 35 basis points today? As with all other multi-year bull markets, we think gold will go parabolic at some point before its bull run is over. Maybe it'll look like this blue line?

Frame 13: And finally, despite all the chatter the data show that financial asset investors simply don't own gold yet. Gold ETFs total about 67 million ounces, which is only about $90 billion. The aggregate market cap of gold and silver miners is less than Google's. Only $2.6 billion flowed into all resource mutual funds in the third quarter.

These small figures compare to about $26 trillion in pension money alone – a sector that has dedicated only about 56 basis points to precious metals. If we include all investment portfolios, we get a gold commitment of just 15 basis points. If you want to round that it would be 0%!

Physical bullion is held in strong hands. Financial asset investors holding derivatives like Comex futures won't be able to take gold's price down for any length of time because fundamentals are not on their side and because they have no staying power in their positions. Besides, we know several central banks holding billions and trillions in paper dollar reserves that would have a bid for all they own – and more.

Frame 14: So it is with great humility and rationality that I admit to you today: my name is Paul Brodsky and I am a gold bug…at least until the ratio of debt to base money contracts to the point where we can get positive real returns in financial assets again.

Thanks for your time and I look forward to our discussion.