Ghost

When it comes to markets we are all early, or late, but rarely on time. The great problem in the investment business is to think something has "turned the corner" or is "close to a sure thing," only to be handed your head in one final delay or collapse.

In his book "The Big Short" Michael Lewis highlighted the plight of some players who correctly called the top in American real estate, but did so three or four years early.

After the Volcker credit crunch of the early 1980s (the worst in memory) was over the bond market started what was to be a huge rally. Short rates fell, the bond market appreciated impressively and all the sharp traders jumped on the bond wagon to make some easy money. But, even as short rates continued to ease, bonds took one last dive down to the old lows in one final, cleansing operation. Then the huge rally began in earnest, but not too many were on board.

In the 1950s and 1960s the most ironclad trade of all time screamed at investors. The law of the monetary world, which every Central Banker and every Finance Minister applauded, was Bretton Woods, widely acknowledged to have been essential to the post-WW II global boom.

Bretton Woods meant fixed exchange rates between all (convertible) currencies and the greenback, with the greenback being convertible into gold (at $35 to the ounce). The dollar was seen as, and advertised as, being as good as gold. Nobody doubted it, although it became clear (a matter of public record in the 1950s and 1960s) that the US was issuing more and more dollars while holding less and less gold.*

Nobody, but nobody, thought the US would ever renege (as it had in the 1930s) on its commitment to accept greenbacks in exchange for gold but, as time went by, it was increasingly clear that the exchange rate would have to be stepped up to, say, $50 or even $70. After all, it wasn't such a big deal – you had to be brain dead not to acknowledge the tons of inflation since the US had set the $35 price back in 1934. And in the 1960s Britain had devalued and Germany had revalued, so the idea of another shift within the confines of Bretton Woods was well established.

And because Central Banks effectively had a plug bid at $35, commercial banks lent speculators money to buy gold (from the same Central Banks at $35¼) on a 10% margin basis. Speculators bought gold, sat back and waited for the inevitable revaluation.

The moment of truth arrived in March of 1968 when a real run on Fort Knox took place. But, instead of revaluing gold (devaluing the dollar) the big boys reneged. After closing the gold market (in London) for two weeks they said they were demonetizing gold (except for themselves). They scrapped the Bretton Woods system, extolled the virtues of no system (go and float), removed the plug bid, announced that the "non-monetary" value of gold was $8 per ounce (!) and left speculators hanging with over 100 million ounces of long positions. Banks, naturally, removed margin privileges.

It was all rather amazing. The gold price, which had climbed to $43, collapsed to slightly below $35 where the Swiss plugged it and the IMF bailed out South Africa by buying gold that country couldn't sell in the market. It took four years to clear the overhang and by the time the real bull market (the one that should have begun in the early 1960s) began in 1972, nearly all bulls had given up. So much for the sure thing.

As we all know, timing is a killer for ordinary mortals. Who amongst us said "load up" in early 2009? We have been howling about a flight out of money for over a decade, but even now there is no general acceptance of it. On the other hand, according to the FT, the Glencore inside crowd bought control of their company at a valuation of about one-hundredth of the price of the pending public flotation. That's timing. We have been betting on inflation, and will continue, but you have to swallow hard to step into the base metal pool.

We ramble on about timing because we feel this is a

* Fort Knox holdings fell by a half in less than twenty years

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major juncture. Back in 2008, when the US was really ramping up the printing, the general view was that "this was a short-term expedient," necessary to re-start the economy and of no serious inflationary consequence. The inference was that soon things would be back to normal. Meanwhile the Europeans talked tough and those people who worried about the greenback could always buy the Euro. And the Yen was always a third choice, safe because of Japan's industrial strength.

Well, here we are, three years on, and the US is in worse shape. Grim realities have now surfaced in Euroland where discipline (or the perception thereof) has been replaced with desperation. There is a real chance the Euro will hit the wall in a few years. And Japan's problems make the Yen look very vulnerable. In fact, hardly a currency in the world looks "safe" yet trillions have been wagered on one currency or another. Regardless of inflation, interest rates are not going to be increased materially because governments have other priorities.

But not only are the dollar, Euro and Yen (the big three) in trouble, politics and economics in all sorts of jurisdictions are in trouble. Will the US really bail out the many States which are under water? Maybe, but it will hardly help the Federal mess. Will Canada bail out Ontario? Probably, but that will be the end of the illusion that Canada is in good shape. As for establishment policies, well, they are treated with more and more disrespect. Besides the Arab spring we see signs of Iceland, Ireland, Greece and now Finland all going in their own direction.

With this all going on at the same time, investors are finally starting to realize that problems are terminal, not temporary. Particularly, problems with the big three currencies. Markets have given governments lots of time to clean up their acts, but they haven't done a


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thing, and now sovereign, institutional and individual investors are reacting. All those trillions of currencies sloshing around are starting to search for lifeboats. But there are not nearly enough.

The time is rapidly approaching when the collective exodus from the big three currencies begins in earnest. In the past these guys have supported each other, but there is nobody to support all three. When the exodus happens it will be far more dramatic than the Asian meltdown a decade ago.

Hide carefully now – the ghost of Bretton Woods is watching.

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