Murray's Market Letter

No matter how we say it, people just don't care about our suggestion that a flight out of money is under way. However good we think our arguments may be, the topic makes people's eyes glaze over as though we were discussing the finer points of nuclear physics. They also glaze over when we argue that shares (in many cases) are a proxy for underlying assets. Shares, most people still feel, are a financial asset, not a hard asset even though day in, day out, gold (the hardest asset) now usually leads the TSX Index up or down.

This is a significant change from the traditional model in which gold has always been seen as a contrarian indicator, i.e.: market down, gold up. And, of course, we attribute this to a conscious, or perhaps subconscious, shift into so-called hard assets. Whatever the value of a currency, people will always drink beer and breweries will generally have value during inflation or deflation, war or peace. The day will come when people say the Belgians stole Budweiser.

A recent Globe headline stated that (Bank of Canada Governor) "Carney counts on consumers" and "consumers will keep recovery going." This is the wish of all Western policy makers – it's almost all they know. Consumer spending produces sales tax revenue and, of course, it mainlines into GDP. So do the billions that governments throw at housing. For the captains of the universe it seems that, statistically, a guy buying a BMW is as important as a manufacturer producing $50,000 worth of widgets. Rubbish, of course, but that's what drives them. (Now for Germany, where the car is made, that's real GNP.)

The consumer economy has side effects. It's all English-speaking banks care about, as the idea of financing wealth creation is an almost historic idea. Governments have to keep the consumer cashed up with low interest rates and easy mortgages. (This is covered in our Wrap of December 21.) In addition governments must keep themselves cashed up with lots of debt issues and lots of printing. These days it is not unusual for Central Banks to buy half of all fresh government debt offerings. But now, even half is greater than 100% of what was being issued a few years ago and the first signs of indigestion and rating downgrades are appearing.

Greece and Ireland (and lots of others) are in trouble. This is hardly the time for austerity, but Euroland will insist. But austerity won't work in a recession – it will just cause more misery, more unemployment, less consumer spending and bigger deficits. Will weak members opt out of the Euro? Not yet. Will they walk away from obligations? You bet. Article 73(d) of the Maastricht Treaty says that a country's commitment to free capital flows "…shall be without prejudice to the right of Member States… to take measures which are justified on the grounds of public policy or public security." In other words, if push comes to shove, Club Med bonds look vulnerable. In fact, the Club Med countries, the Euro and the whole concept of "one currency fits all" look vulnerable. But before the Euro breaks up, look to a serious attempt (it's already begun) to devalue the Euro in an effort to rescue Club Med.

The rating agencies, which got it so wrong two years ago on sub-prime paper, are now squirming. Will their slavish obeisance to bankers be matched by slavish obeisance to governments? Or will they dare to call a spade a spade? Who will be the first to pull the plug on big fish like Britain? Or Ontario? Can Ontario sell assets fast enough to avoid a huge downgrade? We don't think so. This raises the question: how good will the loonie look when half of Canada is under water?

In considering challenges for governments, economists talk about unemployment, deficits and so on. They talk about interest rates, as in "when they go up" with nary a mention of the impact of higher interest rates on deficits. And they always assume that, by tweaking fiscal and/or monetary policy, governments can set things right, even in the face of mounting evidence that they can't. Realization of this, the "O my God there is nothing we can do!" sense of helplessness will be a main feature of 2010. [Forecast #1]

But the biggest challenge facing policy makers going forward is to continue to persuade suckers to keep buying, and holding, government paper. After all, governments have ever more to unload.

Enter the unwelcome guest at any economic discussion: gold. For almost five decades (since before the blowing up of Bretton Woods) Western governments have been

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both selling* gold and trashing it, all with a view of enhancing the image of currencies. Almost to a man, government types see gold as an enemy, as an unwelcome alternative to paper, and people like Paul Volcker have spent a lifetime deprecating it. Governments are more sophisticated, but their message is the same as that of the clowns on TV who have spent the past two years telling everybody to scrap their gold jewellery (at 50¢ on the dollar): "The gold price is high, wouldn't you rather have our nice money?"

Well, the gold price is a bit higher, but, from a miner's point of view, it's still lousy. Total global gold mining profits are still peanuts and, while there may be a slight uptick in mine production in 2009, the long-term decline in mine supply is assured, whatever the price. It's also pretty clear that Russian and Chinese mine production, rather than hitting the market, is going into their Central Banks. Some other Central Banks are also buyers and only the most vapid Western Central Banker will now be a seller. After more than four decades of being net sellers, Central Banks have now become net buyers. We think 2010 will see the investment community digest this and the huge implication (remonetization) it carries with it. [Forecast #2]

Finally, still on gold, there are two principal gold markets, London (OTC) and New York. London is reputedly larger, but is totally opaque. The Comex in New York is reasonably transparent. Now the near Comex contract (Feb) has over 300,000 contracts outstanding. That's over 30 million ounces, or almost half a year's total mine production. London is probably bigger. Who's long and who's short? In a rabid bull market the longs would be mostly speculative, but today we suggest that most of the longs are hedge funds or dealers who owe gold to, say, SPDR or clients to whom they have sold gold or clients with gold certificates. But who is short these tens of millions of ounces? Doubtless a few accounts hedging inventory, but not the mining industry, not anybody who has gold hoarded in the basement and not likely any government. Then who? We don't know, but these are derivative instruments and who holds all the derivatives? Who can afford to be short? Even Barrick gave up and covered its positions (which were OTC). These developments in the gold market will likely lead to an explosive and crisis-filled 2010. [Forecast #3]

As for the economy in 2010 we worry, not only about the obsession with consumption, but also we worry about how out of touch our leaders are. Recently the Canadian Finance Minister dismissed the staggering collapse of our historic industries with a cavalier suggestion that oil sands, high tech and financial services will fill the export gap. Oil sands, OK. But high tech? Has he noticed that Nortel has filed for bankruptcy? And to think financial services will help our trade or unemployment stretches the imagination.

All Western leaders appear equally out of touch, while the rest of the world (RoW) is working harder than ever to create wealth and better themselves, just as we did a hundred years ago. With heavy burdens and light leaders Western economies will disappoint, but RoW will continue to grow. Money will, perforce, remain easy and inflationary stocks everywhere will continue their climb. [Forecast #4] And 2010 will also see, for the first time, a dealer other than ourselves, use the term "flight out of money." [Forecast #5]

* Perhaps 400 million ounces, and this doesn't count the Central Bank gold (almost certainly including the US) that has been "mobilized," as in borrowed and sold.

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