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It's Time

Gold bugs can't understand how the public can be so unaware, how highly intelligent policy makers can be so immoral, and how the mainstream media can be so incurious. We can't understand why more men and women in the investment business haven't joined some of the more successful ones that have come around to precious metals and have taken substantial positions in them for their funds and personal accounts. The list of high profile independent-minded investors that have come out of the proverbial closet is impressive and growing: Kyle Bass, John Paulson, David Einhorn, George Soros, Bill Gross and Paul Singer, to name only a few.

Conventional financial asset selection guidelines for professional investors are becoming increasingly uneconomic and problematic. Current macroeconomic conditions leave little doubt as to why. A zero-bound rate structure across developed economies, heavy monetary policy intervention, guaranteed negative real returns of benchmark financial assets and cash, impossible discount cash flow models, cacophonous (and economically meaningless) fiscal political wrangling diverting attention from legitimate budget arithmetic ($800 billion over ten years when we're running $1 trillion-plus annual deficits?), dubious short and intermediate-term prospects in already-emerged emerging economies, and non-trending financial markets, all suggest something has changed.

Regardless of whether one is investing personally or as a fiduciary, conventional financial asset allocation models and procedures are obviously failing and the reason is simple: the currencies in which financial assets are denominated are gravely flawed – levered beyond reconciliation and incapable of generating positive real returns for assets denominated in them, or ongoing consumer and business confidence while the leverage is being transferred from banks to central banks, and from central banks to government balance sheets.[1] The political/policy dimension is boxed. We think prudence demands stepping away from conventional financial asset allocation models.

Our Experience

We have advocated for precious metals and natural resource plays since 2007 and so our endorsement is grain-of-salt worthy. On the other side of that has been recognized confirmation of trends and events that initially drove our view: the bursting of the credit bubble, home price declines, GSE nationalization, debt monetization, ZIRP and ongoing QE. (We have no informed opinion about fiscal matters presently, but we do not see them as material to secular financial asset pricing. We are in the midst of systemic balance sheet restructuring mandated naturally by overwhelming unreserved credit. There can be no solution by fiscally shifting the unreserved credit.)

Exposure to a contrary investment theme is justified by sound reasoning, which helps cure investors of toxic doubts raised by opposing (less informed?) opinions. Whether or not we will be proven right in our analysis and expected outcome, our investors have been well-aware of their exposures and have allocated accordingly. (As of November 30, the Fund had about 1.4 turns of leverage and was 83% long / 17% short, with long exposure comprised of 90 % precious metal plays and 10% natural resources.) Our exposure to precious metals has never been higher or more concentrated, and is based on our sense of relative asset valuation and current events. We are excited to have more than 100% of fund equity

[1] According to IMF data, global bank balance sheets are just shy of $100 trillion while global bank reserves total about $9 trillion. The $90 trillion difference is the nexus of systemic leverage because it represents the amount of global unfunded bank deposits. The "Shadow Banking System" is a misnomer for the fully-funded bond market.

invested in what we perceive to be very cheap assets at a time when their fundamental outlooks could not be brighter.

The fundamentals are staggering, in our view. Multiples more high powered money has already been layered over more or less the same global supply/demand equilibrium, suggesting significantly higher forward prices for goods and services. Meanwhile, the ratio of bank assets to base money remains incredibly stretched, implying far more money dilution will be necessary. This is the closest thing to physical science economics has to offer: more money (or credit) chasing relatively constant supply demands higher prices because producers of resources, goods and services are also of this world and want fair value. (Call it "cost-push inflation" if you like.) Desire is infinite. Demand requires means. Supply (at current pricing) is relatively scarce. Value is constant. Price follows the quantity of money. We are following the money.

Boundless inflation will become apparent to the public either when: 1) banks begin using their new reserves to try to issue more credit; 2) mysterious "animal spirits" (i.e., when leveragable balance sheets meet common greed) spontaneously combust, or; 3) next Tuesday for no apparent reason. Why all the fuss about what the catalyst will be or when it might occur (especially when risk-free real rates are negative)? Most bonds with any sort of duration and stocks held mostly by levered entities or representing businesses that sell goods or services to leveraged consumers are likely to be losers in real terms. Alternatively, precious metals (physical held above and below ground) and natural resources with inelastic demand properties are significantly under-owned.

We see very little cogent analysis that argues against our view. Inflation indicators are like yesterday's closing share prices – contemporaneous at best.

Good Company

We have been fans of Pimco's Bill Gross and our admiration is growing. Imagine running the world's largest bond fund and publicly warning about the perils of adhering to a cult of financial assets? He is warning against inflation and suggesting investors look to precious metals and natural resources to insulate their portfolios against the near certainty of future inflation. We think of him as the historically progressive billionaire that seems to have placed the secular importance of capital formation within legitimate capital markets above a program of confidence-eroding economic policy intervention.

There is a difference separating investors from financiers. Leverage is the element that defines "Wall Street" and Pimco is not Wall Street. When a bank or a leveraged fund using a bank's balance sheet buys a stock, bond or a piece of real estate it is ultimately done with central bank credit, and so the purchase is almost completely unreserved (even if there is investor equity in the fund). Pimco and other mostly unlevered funds are vehicles in which pensioners deposit unlevered money, which is then invested without leverage. When Pimco buys a stock or bond it is fully funded.

To be clear, we do not think there is anything wrong with leverage, and as noted above we use it (and have used it for twenty-five years in fixed income markets before that). But we think it is important to not conflate advice ultimately derived from market observers with incentive to constantly increase the size of their entities' balance sheets and market observers with incentive to call them as they see them. Gross is the latter. As we have long argued, every investor everywhere should be concerned with only one thing: sustained or increasing purchasing power. It seems Bill Gross is just that.

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Our definition of "conspiracy theory" is a reasonable idea supported by historical precedent that is not yet officially endorsed and therefore not yet printed in the New York Times. One thing that should not be considered conspiratorial is private sector incentives (or, if you will, common greed accompanied by motive and means).

According to most dyed-in-the-wool hard money advocates there is a "Gold Cartel" that suppresses the gold price. They tend to argue that US banks continually short gold (and silver) futures nakedly, clipping significant yield each quarter without sufficient metal in stock to deliver to futures buyers if exercised. They further argue that these banks do not fear regulatory reprisal, and in fact that their actions are blessed by *the powers that be* because runaway gold prices would signal to the world that there is something wrong with the currencies gold competes with, notably US dollars. Thus, as the argument goes, banks have the means, motive and implicit sovereign go-ahead to suppress the gold price.

Mmmm, maybe. We certainly agree that gold should fundamentally be priced much higher than where it is presently and that the way gold futures seem to be reliably stepped-on before Treasury auctions and Fed meetings is a bit snarky, but as for the progenitors of the crime? It might be better to look east. Conspiracy theorists should consider foreign dollar reserve holders that would like to take delivery of as much <u>physical</u> gold (and silver?) as possible in a very short time, and do so at cheap prices. It would be simple to do: fund offshore hedge funds that continually short gold futures through US bank accounts, thereby keeping the spot price and London fixings down. Physical gold could then be delivered to sovereign accounts directly from mines and through exports at the suppressed prices.

Why would sovereigns like China, Russia, even Japan and South Korea want to take physical possession of bullion at current prices and so quickly? The short answers are that they could not buy size required on exchanges without driving prices multiples higher and because there is likely to be a reset of the global currency system, soon. Again, we have discussed this before and are talking our book so take it with a grain of salt, but the logic supporting a coordinated move is too clear to ignore.

First, we think all currencies are in the process of being devalued against global resources. Ask yourself what $3 trillion in Chinese dollar-denominated reserves is worth when it takes an act of parliament to spend CAD $15 billion on an energy acquisition? Clearly, the future purchasing power of surplus dollar reserves is not equal to its current notional amount in natural resource terms. What is the motivation of Chinese businesses to continue trading cheap human resources for US dollars so that they may use those dollars to buy global natural resources (at any price)?

We expect the rational Asian (and South American) mind is already discounting the real forward purchasing power of the US dollar and all other fiat currencies exchangeable for it. Given the necessary future currency de-leveraging among debtor nations, we would not be surprised if economic policy makers of creditor nations have already discounted the present value of their currency reserves (e.g., $3 trillion in today's USDs should have the purchasing power equivalent of $500 billion in a few years).

Our speculation goes beyond natural market incentives and how economic participants have already reacted. We presume Western policy makers have also been quite aware of currency-based incentives, which would explain why ongoing meetings between representative treasury officials have also included State Department officials (check). And diplomatically, we would speculate that creditor nations would also continue purchasing US Treasuries at negative real rates until they amass enough of whatever it may be that US dollars would be devalued against (check, check).

Along these lines, global gold (and silver?) price suppression makes sense (just as FX currency intervention has made sense). We think it does exist and that it serves two purposes:

1) the redistribution of public/official bullion holdings, from public entities overweight them to those underweight them, to create balance for the launch of a modified (bullion-backed) SDR, which would be the new global reserve currency (and which would allow banks to continue their fractionally reserved business models after draconian nominal deleveraging via coordinated base money inflation)

2) the redistribution of public/official bullion holdings at current pricing, from public hands to smart-money private hands, which would provide substantial gains to targeted global parties following the implementation of the fiat devaluation/monetary reset, noted above.

The only necessary "conspiratorial" leap of faith required to accept such a scenario would be accepting the following logic:

a) currencies are naturally being devalued versus resources in the marketplace already

b) they could easily be devalued formally by policy administration

c) behavior among official parties already implies knowledge of such an outcome (e.g., intense bullion importation and hoarding of bullion production by large dollar reserve holders)

d) the Fed is increasing and extending its QE bond buying program amid substantial evidence it has no material impact on the US economy, (other than a counterfactual were it to stop), which sets the table for the withdrawal of foreign lenders

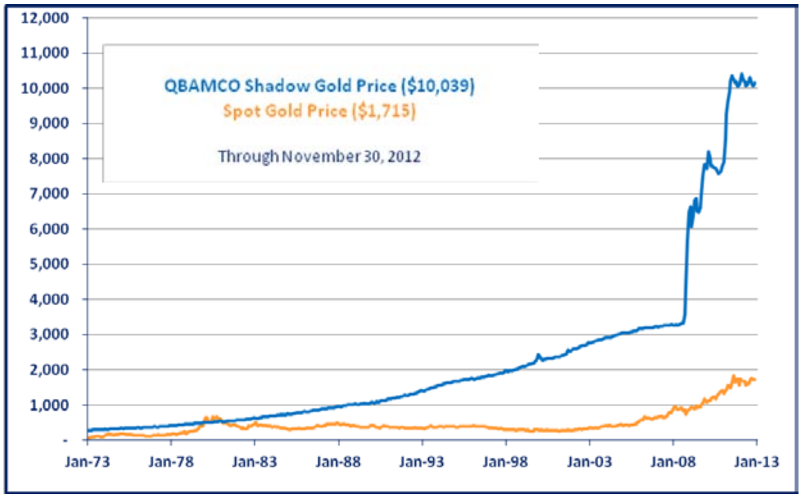
e) currency devaluation (i.e., monetary inflation) has a long history of usurping the severe contractionary impact of credit/debt destruction, and

f) those that figure it out, now or later, will express their greed and push policy makers to act.

Whether or not our speculations prove correct, it seems that the vast majority of investment allocations have virtually ignored the obvious beneficiary of the scenario above. Is its probability zero? Or, have the vast majority of allocators chosen not to educate their constituents about the impacts of monetary inflation when none is visible because it is not good business? (At the end of the day, smart portfolio managers with dumb investment constraints are dumb money.)

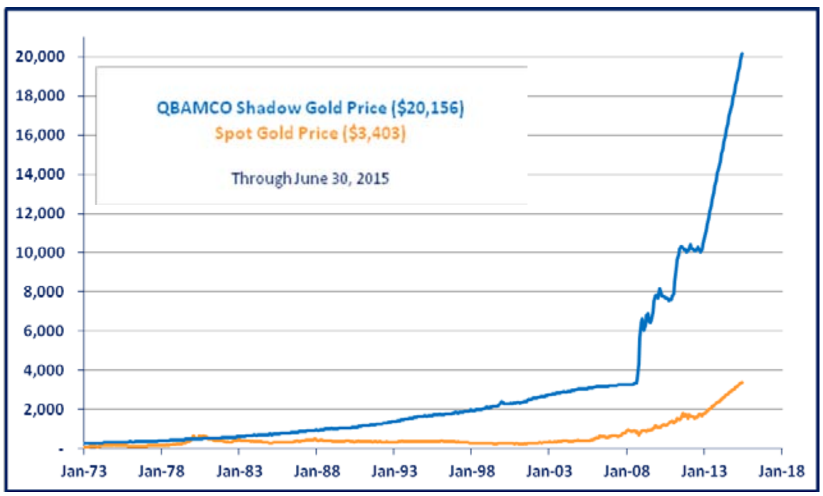
Is it worthwhile to make such a speculation? We published two graphs on the following page. The first is a time series of spot gold and our Shadow Gold Price (SGP) from 1973 to November 30, 2012. (The SGP uses the Bretton Woods monetary calculation for valuing the fixed exchange rate linking gold to the US dollar – Base Money divided by US official gold holdings.)

As the top graph shows, since the US dollar has been baseless with a floating exchange rate, there has been significant base money creation, with the vast majority of it coming following the 2008 credit event. The SGP implies the level where spot gold would trade if the purchasing power of base money were held constant. The gap separating the SGP from spot gold indicates the implicit arbitrage representing already reduced implicit purchasing power from holding US dollars vis-à-vis the potential gain of purchasing power from holding spot gold now.



Sources: QBAMCO; Bloomberg; St. Louis Fed

The graph below extends the same graph consistent with the most recent Fed announcement of the newly announced debt monetization levels ($85 billion per month through June 2015):



Sources: QBAMCO; Bloomberg; St. Louis Fed

Purchasing power parity is the basis of this currency arbitrage, and it seems very worthwhile to us.

So we think it's time for professional investors and fiduciaries take their spines out of the closet, strap them on, explain to investors where risk-on and risk-off really is, lengthen their investment horizons, and take possession of stores of purchasing power on behalf of their constituents. Then, sit back and watch policy makers and media talk back and forth to each other about fiscal theory while real economies atrophy and real returns in levered financial asset markets sink deeper into negative territory, ultimately demanding a coordinated currency reset.

We think it's a rare chance to do well by doing good. It's time for reasonable investors to objectively consider the risks and merits of precious metals. We are confident intense scrutiny would further lead to confidence, conviction and long market expressions in PM plays holding significant relative real value.

Kind regards,
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