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We can easily forgive a child who is afraid of the dark. The real tragedy of life is when men are afraid of the light. - Plato

Oil in Exchange for Gold

Iran is under pressure as a result of their nuclear development programme. The United States insists that Iran is developing a nuclear weapons capability and this will not be tolerated. Iran, on the other hand, insists that their work is to meet their energy needs and there is no intention to develop nuclear weapons.

As a result sanctions are to be imposed on Iran starting at the end of June this year so the country is being cut-off from international trade and their income stream generated by oil sales. However, there are a number of countries who would like to continue receiving Iranian oil and who are prepared to risk upsetting America by circumventing the sanctions.

In practice this is difficult to do because the oil has to be paid for. The standard settlement currency is US dollars and these travel over the electronic wire system called *SWIFT* (Society for Worldwide Interbank Financial Telecommunication). The US has said that they will cut Iran off from the SWIFT system and isolate the country further.

There is speculation that both China and India are prepared to go against American wishes and they intend to pay for Iranian oil in gold (see Forbes article here: http://www.forbes.com/sites/gordonchang/2012/04/22/the-best-reason-in-the-world-to-buy-gold/)

Whilst it is not officially confirmed it is reasonable to assume that these countries will have considered this option. India receives approximately 12% of its oil from Iran and are keen to expand ties with them including paying for oil in rupees despite the threat of sanctions from America.

These developments are forcing gold into the payment system bringing gold into direct competition with the US dollar as the currency of choice. It is Gresham's Law in action which according to Wikipedia can be defined thus:

"When a government compulsorily overvalues one type of money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation."

It is commonly stated as: *"Bad money drives out good"*, but is more accurately stated: *"Bad money drives out good if their exchange rate is set by law."*

Gold continues its inexorable march towards becoming *"good money"* and the effects of these recent developments should not under-estimated as this is a seismic shift.

Spain and the European Stabilization Mechanism

We have had to endure an endless fixation with Greece and its intractable debt problem, a situation that has played out in Groundhog Day fashion on a repeating loop. We also know that agreement was reached to bailout Greece so as to keep the country in the euro; financial gymnastics had to performed, in order for the remaining written-down debt to be deemed of a suitable size to enable the country to service it. For those who have followed this in detail, you will know that the numbers agreed upon still look unachievable, especially given the austerity programme that has been imposed on the country to meet the bailout conditions. Austerity means cuts and cuts mean GDP falling off a cliff (at least in the case of Greece). The magic number bandied about by the IMF and European politicians has been a debt to GDP ratio of 120%, which is deemed to be the right level. However, the country is far away from this because growth has stalled and numbers from the Greek Statistical Office confirm the current debt to GDP ratio of 165.3%. It is only a matter of time before more money will have to pumped in Greece's direction (a further tranche is planned anyway but we mean monies in addition to the already agreed amounts).

So much for the quick recap on Greece and Europe. We apologise for the summary but we wanted to bring this back into focus as attention now falls onto other countries in the euro that are struggling with past excesses/ booms. Ten-year bond yields for Portugal reached a high of 17.4% in January and are now at 11.18%.

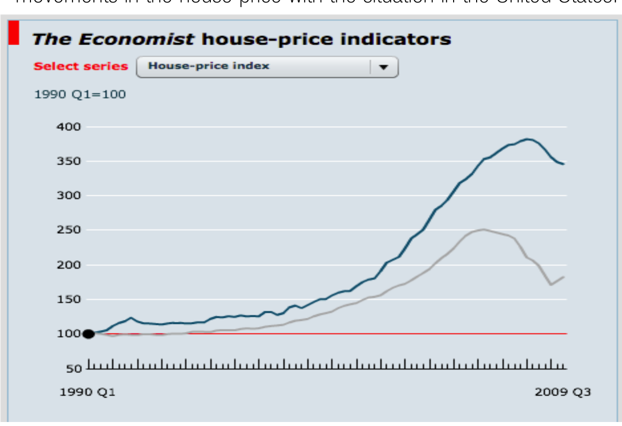
Both Spain and Italy have seen 10-year bonds yielding more than 6% (currently 5.82% and 5.63% respectively).

It is Spain that interests us in particular at the moment as it is a bigger country than Greece. Low interest rates in the country led to an enormous property boom with many ordinary citizens joining the frenzy, taking the easy money provided by the banks to build or buy second homes, holiday homes etc. Prices reached their peak in 2007 and have since fallen back by some 25%. With unemployment at very high levels (23.6% of the overall workforce in February, which is the highest in the 17-nation Eurozone and predicted to go over 27.5% by the end of 2012) prices are likely to drop further and put additional pressure on both lenders and borrowers.

Spain's debt to GDP level has risen to 79.8% this year having been at 35.8% as recently as 2008. The debt has expanded so rapidly because of the property collapse, as taxes paid into the treasury have dropped accordingly. Social security spending has gone up as workers have lost their jobs. There seems little doubt that the situation is only going to worsen further and the drive to austerity will make the situation even more desperate.

Spain has mortgage debt of some ¬660 billion and much of this is under threat of becoming delinquent i.e. people do not have the money to service their debt. Spanish banks are, of course, the biggest lenders and it is these banks that will require additional capital to stave off bankruptcy. This will not be forthcoming from the Spanish government as they are already labouring under their high debt to GDP ratio. It is currently estimated that Spanish banks will need at least ¬200 billion to keep them running. Incidentally Spanish Banks are currently drawing a record ¬316.3 billion from the ECB (up from ¬169.2 billion in February).

It is worth putting Spain's property boom in context by comparing the movements in the house price with the situation in the United States:



Grey = US house prices
Blue = Spanish house prices
Source: The Economist

Market talk has been that Spain (and Italy) is too big to bailout and this is taken as absolute fact by most market participants.

This brings us onto the ESM Treaty, which establishes the European Stabilization Mechanism (ESM), due to come into being in July 2012 after ratification by member states and which will provide an initial bailout sum of roughly ¬700 billion. However, there are certain key features of this mechanism that give considerable cause for concern. For example, it open-ended in terms of the amount of money that can be called from members. It does not need further agreement or ratification and monies have to be paid over to the fund within seven days once called for by the ESM. The treaty states:

"Article 9: Capital Calls

3. ESM members hereby irrevocably and unconditionally undertake to pay on demand any capital call made on them within seven days of receipt of such demand."

Quite a draconian clause as any open-ended promise tends to end up costing far more than is originally thought.

In addition the body enjoys protection from being challenged legally and there is a similar immunity from prosecution for those working at the ESM. This is staggering as it makes the ESM an unelected body that controls individual nation states and usurps their own sovereignty!

"Article 27: Legal status, privileges and immunities

2. The ESM…shall have full legal capacity…to institute legal proceedings.
3. The ESM , its property, funding and assets…shall enjoy immunity from every form of judicial process…
4. The property, funding and assets of the ESM shall . . . be immune from search, requisition, confiscation, expropriation, or any other form of seizure, taking or foreclosure by executive, judicial, administrative or legislative action."

For readers who would like to read more about this entity the full treaty document is reproduced here:

http://www.cfr.org/eu/treaty-establishing-european-stability-mechanism/p27328

The ESM therefore is scheduled to be a permanent rescue facility slated to replace the temporary European Financial Stability Facility and European Financial Stabilization Mechanism as soon as Member States representing 90% of the capital commitments have ratified it.

It is this very mechanism that opens the way for bailouts without end, what Jim Sinclair has called QE to infinity. Money continues to be needed by the financial sector to keep afloat so the ESM will act as the institution to provide what is needed. The ESM will eventually come as a shock to Europeans when they learn what has been created in their name, something that cannot be challenged or refused as it is an irrevocable and unconditional undertaking to provide money. There seems to be very little standing in the way of ratification of this new body so individuals and investors must act to protect themselves in the best way that they can.

In our opinion we continue to see companies producing real and tangible items as the antidote to the policy of QE. Price weakness, in our view, represents the opportunity to accumulate additional holdings of such companies for the long-term.

It is interesting to note that the mood within Spain is changing as a result of the European imposed push to bring the budget deficit down from 8.5% to 3% within just two years. The shock to the economy is too large to bear and this comes through in the press where there are increasing calls for the country to leave the euro. There is still a majority supporting membership of the single currency but the mood is no longer one of consensus. In the absence of a fiscal transfer or indeed money transfer/ loans from the core to countries like Spain, then the euro project risks coming apart at the seams. The European Stabilization Mechanism looks as though it provides the route for money transfer to take place (debauching the currency still further en route).

House Prices in the United States

The house price indicator chart above also shows the progress of house prices in America. The most recent data for February shows that prices declined for the sixth month in a row with prices falling in 16 out of 20 cities tracked by the S&P/ Case-Shiller home price index. House sales over the winter were the best in five years but this has not been enough to lift the market overall. The drop in prices in 9 out of the 20 cities tracked fell to its lowest point since house prices started to fall with average prices in Atlanta down 17.3% over the previous year.

Sales have picked up because of the number of foreclosed properties being sold and these houses are got rid of at discounted prices (foreclosures made up 20% of total sales in February). As with Spain, a sustainable and strong recovery in the housing market is dependent on rising employment - there have been marginal improvements in the US so there are signs that things are picking up. On the other hand the US also has massive enrolment in the food stamp programme to assist those who cannot afford to feed themselves properly:

As of January 2012 there are 46.5 million people receiving Supplemental Nutrition Assistance Program (SNAP or better known as Food Stamps). This is made up of 22.2 million households or put simply, 20% of all households in the country.

The latest Federal Reserve meeting which took place on 25th and 26th April talked about the economy expanding moderately, inflation *"has picked up somewhat"*, growth is to remain moderate and then gradually pick up. On the other hand they also still see *"significant downside risks"* and interest rates are going to stay low until at least the latter part of 2014. The Fed also said they are still prepared to take further balance sheet action and that further tools *"remain on the table"* i.e. quantitative easing. It remains a question of when and not if in our opinion.

Japan have their own thoughts on inflation targeting and announced additional stimulus with Yen 5 trillion (approximately US$62bn) to be added to the asset purchase fund (27th April 2012). This news was accompanied by the statement that powerful easing will remain in place until 1% inflation is in sight. QE is very much in motion!

With best regards from your SUNARES team,

Colin Moor