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Update September 2011

"Everybody, sooner or later, sits down to a banquet of consequences" - Robert Louis Stevenson

To QE, or not to QE, that is the question:

Our apologies to the Bard of Avon for the title to this piece but it seemed to be an appropriate summary of what all Western central bankers are asking themselves at the moment. The opening soliloquy from Hamlet goes on to talk of *"The slings and arrows of outrageous fortune"* and *"a sea of troubles"*, which is an accurate description of what is yet to be faced.

Of course Hamlet's troubles existed in his mind whereas the troubles that haunt the markets are all too real and becoming more vivid by the day. This is expressed in the rise in yields for various bond issuers including those that would have previously been thought of as rock solid AAA-rated issuers. It is most visible in this regard with Greek as well as Italian paper and, in an echo of the 2008 financial crisis, the decline in financial stocks. Investors have caught on that balance sheets consist of weak assets and that many of the assets held are of questionable quality. Regrettably, the assets held that were previously thought of as being of decent quality are also caught up in the downward spiral and thus add to the pressure on values.

A speech by Josef Ackermann, the chief executive of Deutsche Bank contained some remarkably candid thoughts about European banks.

"It is an open secret that numerous European banks would not survive having to revalue sovereign debt held on the banking book at market levels. In recent weeks, the distrust of the financial markets has spread to the banks because they are now suffering from the debt crisis in Europe and have a lot of exposure to, for example, Greek bonds. Since the financial crisis, some European banks have lost a third or more of their market capitalization."

He also dropped the bombshell that:

"Most institutions have a rating of below the book value or at best."

Could he have been any clearer about the need for action in order for the banking system to remain solvent? Ackermann did also acknowledge that a forced injection of money into the banking system in Europe would undermine any attempts by politicians to resolve the sovereign debt crisis that Europe is facing. It is better to face the bigger issue of the solvency of governments, as an improvement in confidence would also lift the asset value of bank balance sheets. For now, politicians have been heading in the wrong direction…

As Nasim Taleb the author of Black Swan has pointed out, our world is complicated and intricate such that changes in one area will lead to changes and unexpected outcomes elsewhere. Indeed this was the lesson the markets ought to have learned from the failure of Lehman Brothers, as the loss of this one institution derailed the entire system.

"Owing to [...] misunderstanding of the causal chains between policy and actions, we can easily trigger Black Swans thanks to aggressive ignorance—like a child playing with a chemistry kit."

Politicians still do not seem to have grasped the absolute gravity and danger of the situation, as they have been unable to find a coherent and workable plan to deal with the crisis. They are far too concerned with being re-elected rather than taking the necessary actions to move forward and thereby instil confidence into markets once more.

Reports on the state of the economy in many parts of the developed world continue to give grave cause for concern – high unemployment, weak production and struggling consumer data. In fact, the latest set of employment data from the US (non-farm payrolls) has prompted some central bankers to raise the possibility that further central bank intervention will be needed just to keep things rolling. Critics of the first two rounds of quantitative easing (QE) in America are furious about the debasement of the currency and they point out that the economy has not recovered and that employment is not improving. However, they fail to picture what things would have been like if QE had not taken place!

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The deflationary depression that stalks the markets now would have been in full swing, with all the social problems this would have brought with it.

US official unemployment statistics. Source: Bloomberg

Having done so much already to keep deflation at bay it seems unlikely that central bankers will give in to it now, after all they have their reputations to consider!

A speech by Adam Posen who is a member of the Bank of England's policy committee, made on the 13th September called for additional QE of £50bn in the UK.

"If we do not undertake the stimulative policy that the outlook calls for, then our economies and our people will suffer avoidable and potentially lasting damage."

Posen went on to say that central bank officials had wasted too much time over the past year:

"worrying about how their institutions would appear to markets, to politicians, and to the public, were we to undertake more stimulus. Sometimes you have to do the right thing even if it may be misperceived".

He is not worried about inflation as it is a passing phenomenon in his opinion (the Federal Reserve also see inflation as "transitory". Consumers in the real world may of course beg to differ).

The Federal Reserve meet next on the 21st September and they announced at their recent meeting in Jackson Hole, that this meeting would be extended by a day in order to allow for a fuller discussion of the policy tools that the Fed can use to get the economy moving. In the meantime, economists and traders have jumped on this as a sign that QE will be extended. It is very much a case of print or die…

American Census

The US census results have just been published and they present a shocking picture of the country and there is confirmation of the *"jobless recovery"*. In 2010 another 2.6m people slipped into poverty with the number of Americans now below the poverty line standing at its highest ever – 46.2m people. This is 15.1% of the total population with poverty being defined as an income of US$22,314 for a family of four. The squeeze on the middle classes is also in evidence with median incomes falling back to 1997 levels. This is the first time since the Great Depression that median incomes have not gone up over such a long period. For many people it has truly been a lost decade.

The census was worse than had been anticipated and it gives support to President Obama's push to create new jobs, although it also shows how little has been done so far to aid employment. With stimulus money now at an end and with state and local government having to cut back on social programmes, this year is not going to be better and may be even worse. It is another part of the jigsaw that may well see further QE as the government attempts to get Americans back to work once more.

Operation Twist

The thought of the Fed acting has naturally prompted everyone in the markets to speculate as to what they will actually do in practice. The consensus that is forming goes along the following lines:

The central bank intends to extend the maturity (duration) of its bond portfolio and in practice this would simply involve holding less short term debt and more long term debt. This was something that has been done previously back in the 1960s in a programme entitled *"Operation Twist"*. The bank tried to *"twist"* the structure of interest rates so that long-term yields were lower than short term yields. Although consumers have been unwilling to borrow large amounts of new money it is still thought that such action would assist those focussed on long-term borrowing i.e. it would encourage home owners to refinance their borrowings and extend their loans.

The Fed may also stop paying the 0.25% interest rate they currently pay to banks that hold cash on deposit with them. Banks have been reluctant to lend and some believe that this would prompt money to be loaned out in an attempt to earn an income. Others think that this would not help and that it could have a knock-on effect in undermining money market funds – Taleb's chemistry set and unintended consequences again!

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The bigger option that is also possible is another large scale asset purchase plan (LSAP) to buy up additional paper being issued by the US Treasury. However, it seems more probable that there will first be the operation twist duration extension as mentioned above. This will involve amounts of approximately $450bn with purchases of about $55 to $65bn per month and lasting 6 to 8 months. At that point the large scale asset purchases will come into play (as surely they must in order for newly minted bonds to be purchased at all!). Incidentally, large scale will be upwards of US$2 trillion as this is the tide of paper that will hit the market…

Safe Havens

In difficult times money tends to seek out so-called *"safe-havens"* these being places where you are protected from harm or danger. Yet the world is never that simple and safe havens have a tendency to shift with time and perception.

Bond markets are a good example of this as they proved to be an effective safe haven during the 2008 crisis, as government balance sheets were considered to be in good order and liquidity in the bond markets meant that funds could be easily retrieved when required. However, in the interim period government balance sheets have been strained by the bailout of the financial sector that was undertaken, such that bond markets have become riskier places to be than previously. Conventional thinking has been turned upside down.

One other safe haven has been the Swiss Franc. Despite the small size of the country and its relatively smaller currency float, money has flowed into the Swiss Franc, as investors have seen it as a safe haven. This is based on the Franc's historical stability as well as the misplaced perception that the Franc has retained its gold backing. This has meant that the Franc has appreciated against other currencies to the extent that the Swiss Central Bank announced that they would peg the Franc against the Euro at a rate of 1.20. In practice this means that the central bank will use limitless amounts of its own currency to buy Euros in the market. By putting more of its own currency into circulation it is debasing its currency. Of course, bankers do have to live in the real world and in a world where all currencies are paper-based each country has to strive to remain competitive with its neighbours. The Swiss have acted logically in an attempt to be able to win business abroad. The chart shows just how quickly government intervention can undermine the free market:

Euro versus Swiss Franc – Swiss Franc strength followed by intervention. Source: Bloomberg

For those investors who wanted a safe haven you can see that they can very quickly become unsafe havens! This added volatility adds to the difficulty in making good asset allocation decisions for most investors.

It is likely that this policy will benefit gold in the time ahead as it still acts as an independent barometer of central bank foolishness.

Gold and Silver

All of what we have written so far leads us on to this item on the precious metals. Both have enjoyed strong runs, both are still under-owned by most people and pension funds and we remain firmly bullish about their prospects for further gains to come. Any move to further QE will of course lead to a rise in the price of both metals (there may be short-term moves against the metals if QE is announced as we saw with the Swiss Franc and its announcement about the peg to the Euro. However, beyond the short-term noise, further increases are logical if the metals have a relatively fixed supply and money has an increase in supply).

The former head of Goldcorp and current chairman and CEO of US Gold Corp, Rob McEwen recently spoke about gold having much further to run:

"If you look at the last gold run, gold went from $200/oz. in mid-1979 to $800/oz. in early 1980. During the 10-year period of 1970–1980, we saw a 20-fold increase in the price, from $40/oz. to over $800/oz. We also had a 20-year low in 2001 of $250/oz. If you apply that 20-times multiple, you're up to $5,000/oz.

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For silver, if you use the historic ratio of an exchange ratio with gold of 16:1, you get to $312, so $200 is conservative. I think we'll see these numbers within four years' time."

Eric Sprott the head of Sprott Asset Management has often spoken about the historical ratio between gold and silver of 16 to 1 as well i.e. 1 ounce of gold for 16 ounces of silver. He has recently sold a part of his gold holdings in favour buying more physical silver based on the belief that silver will reach its historical ratio again. With a gold price today of approximately US$1,830 that would mean that silver should trade at US$115 per ounce (current price is approximately US$41).

With prices as high as they are many sceptics ask where demand will come from to keep the price rising? In the case of gold it is central banks that are still keen to accumulate where they can. According to the IMF Russia increased its gold holdings again, as they have been doing consistently for years and Colombia raised its gold holding for the first time in 13 years. Although this may not seem significant it does demonstrate that central banks are keen to diversify their balance sheets and often this means reducing exposure to the US dollar. Central bankers are also keen to hedge themselves against the possibility that a new reserve currency will come into being, with gold being part of the mix, along with other existing currencies. They are especially worried about this because they hold only limited amounts of metal compared to the reserves held by Western countries. A revaluation with gold included in the basket would put China at a disadvantage, so they are also keen to raise their gold reserves as well.

The one person who has been right about gold all along has been Jim Sinclair. He predicted gold at US$1,650 years ago when everyone laughed at his, then, incredible price prediction. However, he has been vindicated and this ought to make investors listen to what he still has to say about what lies ahead. Interestingly he has mentioned the critical importance of gold crossing the US$1,764 level and likens it to the point where gold crossed the US$525 level. That price level was important technically as it brought his higher target into view. Similarly, gold crossing US$1,764 opens up the way for considerably higher prices and certainly means that the bull move is far from over. Of course, it is hard to calculate what might happen with prices and this is all linked back to where we started with our question about QE – how much money will eventually be created in the years ahead to keep the system running? It is worth looking at an example from history simply to demonstrate what has happened in a previous age and that we are at a very early stage even if we travel only a part of the distance that was covered in this timeframe:

Date	German Marks required to purchase one ounce of gold
Jan-19	170
Sep-19	499
Jan-20	1,340
Sep-20	1,201
Jan-21	1,349
Sep-21	2,175
Jan-22	3,976
Sep-22	30,381
Jan-23	372,477
Sep-23	269,439,000
02-Oct-23	6,631,749,000
09-Oct-23	24,868,950,000
16-Oct-23	84,969,072,000
23-Oct-23	1,160,552,882,000
30-Oct-23	1,347,070,000,000
05-Nov-23	8,700,000,000,000
30-Nov-23	87,000,000,000,000

Gold in the Weimar Republic 1919 to 1923

Gold and Silver Mining Companies

We cannot let this month's report pass without mentioning the performance of these stocks on the basis that they are doing things that we have not seen for a very long time – they are rising in the face of falls in the rest of the market. This is significant as it could be the beginning of the sector decoupling from the general market and becoming valued in its own right and on its own fundamentals.

The Amex Gold Bugs Index (HUI) has risen above 610 and is currently holding just above here. This too is significant as this could signal further strength to come. It also means that the underlying stocks are starting to perform better than the physical metal and this is something that has also not been the case for some time either. Gold and silver shares have been caught up in the current weakness of equity markets but this means that the shares have been trading as if gold were back at much lower levels and it also conveniently ignores the trillions of additional dollars that have been added to the market over the last few years.

The chart beneath shows how the HUI index has been rising against the S&P 500 index and it also shows that this trend has been in place for some time already but the effect has been muted up until now by a rising S&P 500. The real change came in early August when the Dow Jones dropped 625 points (5.5%) and the HUI held steady and then rose 4.5% the following day. It could be the beginning of a re-rating that is long overdue.

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Amex Gold Bugs Index versus S&P 500. Source: Bloomberg

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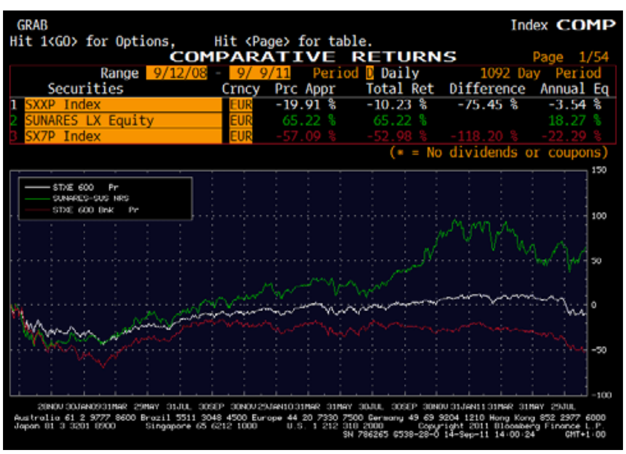
With the SUNARES fund specifically being forbidden from buying financials - something we set up from the beginning so that investors would know they had no exposure to this sector - we wanted to show you briefly how the fund has run on a one year period against the STOXX Europe 600 (broad-based market index) as well as against the STOXX 600 Banks index. For reference the STOXX 600 is in white, SUNARES in green and the STOXX 600 Banks in red.



We hope you agree that even though 2011 continues to be difficult, the managers of the fund are focussing in the right places and remain on track.

With kind regards,

The SUNARES team

Colin Moor