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"History shows that once an enormous debt has been incurred by a nation, there are only two ways to solve it: one is simply to declare bankruptcy and repudiate the debt. The other is to inflate the currency and thus to destroy the wealth of the ordinary citizen" Adam Smith

"All rational action is in the first place individual action. Only the individual thinks. Only the individual reasons. Only the individual acts." Ludwig von Mises

China continues to buy gold

There has been a definite fixation about the likelihood of QE from the Federal Reserve or the European Central Bank. Indeed this has been the foundation of the risk-on versus the risk-off trade for a considerable period of time. China has not been caught up in this but instead has kept adding to gold reserves instead of purchasing further US treasury bonds. June saw China buy 68 tons, which was imported from Hong Kong bringing the six month total to 383 tons. This already exceeds the total amount of gold held by many of the world's central banks and brings China's reported gold total to 1,054 tons placing them sixth on the list.

WORLD OFFICIAL GOLD HOLDINGS
International Financial Statistics, August 2012*

	Tonnes	% of reserves**
1 United States	8,133.5	75.1%
2 Germany	3,395.5	71.9%
3 IMF	2,814.0	1)
4 Italy	2,451.8	71.3%
5 France	2,435.4	71.6%
6 China	1,054.1	1.6%
7 Switzerland	1,040.1	14.2%
8 Russia	918.0	9.2%
9 Japan	765.2	3.1%
10 Netherlands	612.5	60.2%
11 India	557.7	9.8%
12 ECB	502.1	32.0%
13 Taiwan	422.7	5.6%
14 Portugal	382.5	89.9%
15 Venezuela	365.8	74.8%
16 Saudi Arabia	322.9	2.7%
17 United Kingdom	310.3	15.9%
18 Lebanon	286.8	30.0%
19 Spain	281.6	27.6%
20 Austria	280.0	55.6%

Source: World Gold Council – Zerohedge

Readers should bear in mind that China has a history of not giving the full details on gold holdings and are presumably delighted to be able to accumulate gold at these prices without disturbing the market and therefore giving them the opportunity to keep on buying.

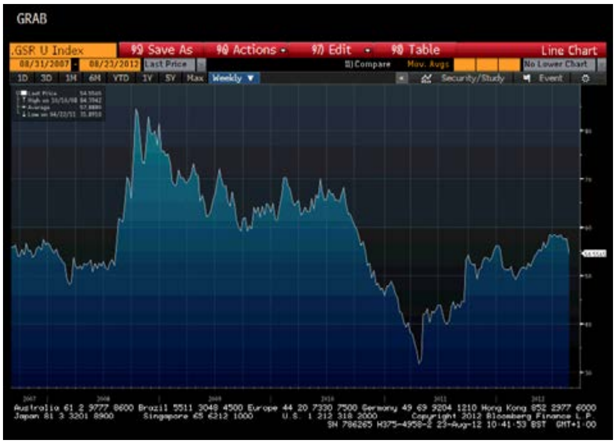
It is worth noting that recent reports of investments held by George Soros and John Paulson, both of whom have excellent track records as investors, register significant increases in gold investments in the last quarter of 2012. Soros famously talked of gold being *"the ultimate bubble"* which many took to mean that the then price represented an inflated level – his recent additions to his holdings shows this to have been a misinterpretation with Soros clearly thinking that the bubble price still lies ahead. Paulson has become particularly serious about the precious metal as his fund now holds 44% in gold investments. The smart money is getting ready for a move and we should pay attention.

Gold has been in a corrective consolidation for well over a year so it is natural that investors tire of the sideways moves. However, there are those who see recent price action as an indicator that gold is going to resume its bull market soon. For example, strong economic news is normally seen as a negative for gold but now we are seeing it able to hold its ground whatever the news flow.

Remember too that the structure of the market is such that there are significant short positions being run in gold (and in silver) so a price move could force these shorts to have to cover.

Gold Silver Ratio

This ratio is a very good indicator of the attitude to risk in the market – when the ratio drops there are more investors willing to bet on silver than on gold and shows a risk-on attitude. Recently there are some initial signs of this starting to happen.



Gold/ Silver ratio own calculation: source Bloomberg

The ratio is easily followed by dividing an ounce of gold by an ounce of silver – as silver rises in price relative to gold the ratio drops. It is also worth keeping an eye on the ratio between Royal Gold and Silver Wheaton as this is a good proxy for what is going on with the underlying shares of gold and silver mining companies respectively. It is confirming the move of the metals with Silver Wheaton gaining the upper hand for now.

Both measures currently favour silver as markets start to be more risk-on. It is early days for this trade but there are genuine grounds for optimism that this trend may continue (with gold also still set to perform well too).

Food Inflation

We have mentioned in previous reports the importance of tracking the prices of staple foods as rising prices are the sign of inflation that hurts the man on the street. Extreme heat of the US has pushed corn prices to a recent record, just as one example. Reuters reported thus:

"Global alarm over a potential repeat of the 2008 food crisis escalated after data showed food prices had jumped 6 percent last month and importers were snapping up a shrivelled U.S. grain crop, helping drive corn prices to a new record.

The United Nation's food agency warned against the kind of export bans, tariffs and buying binges that worsened the price surge four years ago.

"There is potential for a situation to develop like we had back in 2007/08," the Food and Agriculture Organisation's senior economist and grain analyst Abdolreza Abbassian told Reuters."

Food prices have of course been rising prior to the recent summer heat and this is explained very simply as demand rising faster than supply – too much money chasing too few goods i.e. a classic definition of inflation. The heat wave in America has now exaggerated the price movements. (See chart of DJUBS Grains on page 3).

HSBC recently released a research note posing the question in relation to commodity prices: *"Are current high prices the new norm?"*

The report draws the following conclusion:
"Growth is now more commodity intensive, so commodity prices are back to previous average levels in real terms. With the emerging economies expected to continue to drive global growth, it may be that the current high level of commodity prices is the new normal. We expect materials prices to settle well above the low levels reached in the 1980s and 1990s."

You may have noticed in your own daily life how quickly we all adjust to higher prices as they become part of your surroundings and routine – the new norm. Petrol is a very good example with the UK price now sitting at approximately 140p per litre of unleaded fuel. It was only a few years ago that the 100p level was a psychological barrier that took a long time to cross. Having made the move up there appears to be no going back and depending where you are in the world and which currency you spend, prices look to be heading higher. The charts that follow show how prices are moving higher in our supposedly non-inflationary world! The DJUBS grain index consists of wheat, corn and soybeans all of which are key staples. The peaks for this index came in 1996/ 1997 at approximately 108 so there is still room for these to move higher despite the rally that is already in progress. Brent Crude in Euros is at the level of highs in 2008 with a break higher looking possible.

Brent Crude Oil Priced in Euros. Source: Bloomberg

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DJUBS Grains Index Priced in Euros. Source: Bloomberg

JP Morgan and the mis-pricing of CDS paper

JP Morgan has been in the spotlight recently with the London-based trading team having to admit to significant losses in their hedging of the bank's interest rate risk. It turned out that the hedges were anything but perfect and the bank has lost money as a result. It is not clear quite how much money is involved and the investigation into what went wrong is only just about to get underway.

Hot on the heels of these losses comes news in an 8k regulatory filing from JP Morgan that questions the prices used by the bank in pricing hundreds of billions of CDS paper. The financial accounting rules are open to a significant and surprising degree of interpretation. The 8k filing by the bank says:

"the recently discovered information raises questions about the integrity of the trader marks, and suggests that certain individuals may have been seeking to avoid showing the full amount of the losses being incurred in the portfolio during the first quarter. As a result, the Firm is no longer confident that the trader marks used to prepare the Firm's reported first quarter results (although within the established thresholds) reflect good faith estimates of fair value at quarter end."

There is a lengthy review about the pricing of CDS and other derivatives available on zerohedge and it is well worth reading (http://www.zerohedge.com/news/jpm-admits-cio-group-mismarked-hundreds-billions-cds-effort-artificially-boost-profits).
Given what we have recently learnt about the pricing of interest rates in the LIBOR scandal (London inter-bank offered rate) the degree of mispricing and the potential to commit fraud in these complex instruments is staggering.

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What surprises us is that these issues have existed for years and regulators have shied away from taking control of the problem. Have you ever wondered why these instruments are not quoted on an exchange or cleared centrally? It is an area that is not under proper control as evidenced by the above.

Many years ago Warren Buffett said of derivatives in broad terms:

"When Charlie and I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we don't understand how much risk the institution is running."

For a fuller explanation we need to go back to the 2002 Berkshire Hathaway letter to shareholders written by Buffett and look under the section titled derivatives. In this letter he says, for example:

"When we purchased Gen Re, it came with General Re Securities, a derivatives dealer that Charlie and I didn't want, judging it to be dangerous. We failed in our attempts to sell the operation, however, and are now terminating it.

But closing down a derivatives business is easier said than done. It will be a great many years before we are totally out of this operation (though we reduce our exposure daily). In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit. In either industry, once you write a contract – which may require a large payment decades later – you are usually stuck with it. True, there are methods by which the risk can be laid off with others. But most strategies of that kind leave you with residual liability.
Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That's true because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years.

Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them.
Those who trade derivatives are usually paid (in whole or part) on "earnings" calculated by mark-to-market accounting. But often there is no real market (think about our contract involving twins) and "mark-to-model" is utilized. This substitution can bring on large-scale mischief.

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As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counterparties to use fanciful assumptions. In the twins scenario, for example, the two parties to the contract might well use differing models allowing both to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth….
The valuation problem is far from academic: In recent years, some huge-scale frauds and near-frauds have been facilitated by derivatives trades. In the energy and electric utility sectors, for example, companies used derivatives and trading activities to report great "earnings" – until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash. "Mark-to-market" then turned out to be truly "mark-to-myth."
I can assure you that the marking errors in the derivatives business have not been symmetrical.
Almost invariably, they have favored either the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive "earnings" (or both). The bonuses were paid, and the CEO profited from his options. Only much later did shareholders learn that the reported earnings were a sham."

If ever there was an advert to explain why investors need to exercise extreme caution in taking things at fact value and why they should consider investing in tangible real assets then this is it. Sadly the press has made very little of this so far so the majority of people are still in the dark.

We would like to remind investors that the SUNARES fund has not been allowed to use derivatives at all from the very outset, a policy that was implemented at our specific behest. We still think that this is an important and key difference compared to other funds and investments as we want to avoid all the problems that we think lie ahead in these complex derivative markets. Transparency and clarity of ownership will become more important as time goes on.

News from Australia

We received an interesting note from one of our Australian contacts in early August and it was a response to Draghi's comments about the European Central Bank's willingness to do whatever it takes to ensure the Euro continues. The note said: *"Welcome to August where we find just about every global hedge fund short risk, every domestic long only fund long defensives, private clients sitting on record cash holdings and corporations sitting on record cash holdings. Yet we also (hopefully) find a new willingness from the world's central banks to pump liquidity hard ("whatever it takes") and in Australia we enter the full year reporting and dividend season after a massive period of defensive outperformance and cyclical underperformance."*
The "contrarian sign" chart below shows how bearish the hedge fund community is in general and that this could act as an inflection point.

Source: Safehaven.com

He goes on to say that he thinks the 5-year bear market in Australia is coming to an end, that analysts are too bearish on China whilst investors have continued to chase safety at all costs: *"Risk has NEVER been cheaper and safety NEVER more expensive"*
We leave you with an extract from the recent Federal Reserve meeting minutes: *"Many members judged that additional monetary accommodation would likely be warranted fairly soon unless incoming information pointed to a substantial and sustainable strengthening in the pace of the economic recovery."* Watch this space!

With best regards from your SUNARES team

Colin Moor