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The Committee to Save the World

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Eleven years ago, the cover of *Time Magazine* (above) featured Alan Greenspan, Robert Rubin, and Lawrence Summers posing heroically over the headline: "The Committee to Save the World." The sidebar was: "The inside story of how the Three Marketeers have prevented a global meltdown—so far." The reverent tone of the 2/15/99 article strikes a note of discord in the sour investment climate of today. The article gushed: "In the past six years the three have merged into a kind of brotherhood………What holds them together is a passion for thinking and an inextinguishable curiosity about a new economic order that is unfolding before them.." In today's less exuberant world, the picture, the headlines, and the content of the article are laughable and mildly irritating.

The "brotherhood" perfected the recipe of papering over market crises with layers of debt financeable only by negative real interest rates. Their passion for thinking about the new economic order gave birth to capital markets more akin to casinos than rational allocators of capital. In the words of Ambrose Evans Pierce: "Central banks were the ultimate authors of the credit crisis since it is they who set the price of credit too low, throwing the whole incentive structure of the capitalist system out of kilter, and more or less forcing banks to chase yield and engage in destructive behaviour."

Subsequent iterations and mutations of world saving committees have become routine. The committee of Jean Claude Trichet, Angela Merkel and IMF Managing Director Strauss-Kahn attempted to rescue the euro, the euro zone, and by extension, the global financial system. Their

effort came a scant two years after Henry Paulson, Timothy Geithner, and Ben Bernanke teamed up to rescue the mortgage market and the U.S. banking system. The price of these two bailouts alone exceeds $2.6 trillion and still counting.

In a December 23, 2007 Op-Ed piece penned for the *NY Times*, Harvard Professor Greg Mankiw wrote: "The truth is the current Fed governors, together with their crack staff of Ph.D. economists and market analysts, are as close to an economic dream team as we are ever likely to see." Two years later, the number of those who still believe in the magical powers of policy making leadership has plummeted.

While most commentary on gold seems to focus on the question of inflation versus deflation, we believe that there is a significant political dimension that transcends even these existential considerations. The global economic system has become fatally dependent on the issuance of sovereign debt to finance the incomes of government employees and transfer payments. Income created by political largesse has become a cornerstone of the American economy. The vaunted pocket book of the American consumer would shrivel without its accustomed ration of pork. But here's the rub: fiscal austerity, politically difficult in the best of times, is the scalp that markets seem to be demanding.

Meaningful austerity, a freeze or an outright shrinkage of government spending, is almost unthinkable in the Catch 22 of this macro moment. Reconciling the entrenched post war political tradition of income redistribution and entitlements financed by debt issuance with market demands for austerity could be a supremely difficult political task. Whether the elected politicians of today are capable of grasping these issues, much less sticking to the protocol for a painful withdrawal from decades of fiscal excess for an extended period is a legitimate question.

Many observers believe robust and sustained economic growth is the only way to get out from beneath the debt burden that has been incurred. We agree, but doubt that sufficient sustained growth is in the cards. Economic activity seems destined to advance or decline in fits and starts. A solid foundation for the kind of growth necessary to shoulder the debt legacy of world saving committees seems difficult to identify. The schizophrenic macro economic backdrop makes rational investment thinking all but impossible. Investment horizons are truncated leading the private sector to hunker down in a safety mode, while carry trade investors shoot for the moon. The chances for sustained growth in such a setting seem remote.

George Bernard Shaw said: "A government that robs Peter to pay Paul can always count on Paul's support." According to the American Enterprise Institute, federal spending accounts for 25% of GDP. State and local bring the government slice to nearly 50%. Ninety-seven percent (97%) of personal income taxes are paid by 50% of the population, and 70% is paid by only the top 10%. Based on these numbers, the constituency for more government spending and further income redistribution would seem to be well entrenched.

The sober-minded BIS (Bank for International Settlements) asserted (in a March 2010 Working Paper):

> Our projections of public debt ratios lead us to conclude that the path pursued by fiscal authorities in a number of industrial countries is unsustainable. Drastic measures are necessary to check the rapid growth of current and future liabilities of governments and reduce their adverse consequences for long-term growth and monetary stability.

Seth Klarman of Baupost Group asks: "Will money be worth anything if governments keep intervening anytime there's a crisis to prop things up?"

Some view the Greek farce as a phenomenon particular to Europe and the indolent ways of Club Med. However, this superficial take misses the point. Gold has broken out to all time highs in every imaginable currency. The implosion of the euro as a safe haven and the furor over the Greek fiscal crisis provided the energy for gold's recent lift off. The real message we find in these events is that the financial markets are in full scale rebellion against the capricious issuance of sovereign debt. The viability of the economic model of the modern democratic state would, in our opinion, be in serious jeopardy if there are finite limits imposed by markets on deficit finance.

What is the alternative to tax and spend? It is no surprise to us that legions of disoriented politicians have reconvened under the banner of austerity. However, anyone with a sense of history will not take such posturing seriously. Didn't FDR promise to balance the federal budget in 1932? Clamor for belt tightening is likely to further damage the consumer psyche and strengthen the forces of deflation. The recent embrace of spending freezes by European politicians reflects desperation to gain distance from failed Keynesian and welfare state policies. However, infatuation with fiscal prudence promises to be short lived once the deflationary consequences of these actions blossom into stark reality.

Economic policy on both sides of the Atlantic is in turmoil. European leaders push for austerity. Not so fast, say their U.S. counterparts who fear the deflationary implications of such a course. Keynesian stimulus packages seem to be losing their effectiveness as the economy sputters. Former Fed Chairman Greenspan suggests the U.S. may have reached the limits of its borrowing capacity. If so, how will bigger stimulus packages be financed? How can interest rates, already at record lows, be lowered further to spur economic growth? What are the political implications of economic stagnation? According to George Soros, they are nationalism, social unrest and xenophobia.

What all of this adds up to, in our view, is the end game for paper currency. When dollar convertibility ended in 1971, it became nothing more than a social contract, similar in many ways to food stamps or air miles. As fissures in the social consensus widen, the fiscal viability of the governments that issue paper money is threatened and public confidence, essential to the acceptance of paper money, is at grave risk. An accelerated decline in confidence would be the perfect recipe for hyper-inflation.

Such an outcome is by no means guaranteed, but the odds seem greater than at any time since the establishment of the dollar as an international reserve currency. Failing a resolution of these seemingly intractable issues, the bid for gold seems likely to remain strong.

In our opinion, the standoff between deflationary market forces and inflationary policy responses will find its ultimate resolution in the form of unprecedented inflation. It is a matter of time before the tension between deflationary market pressures and inflationary political responses is resolved by sacrificing the dollar to political exigency. Another round of quantitative easing, which seems to be a real possibility, could trigger powerful inflation that would further discredit political leadership, financial institutions, and even social conventions.

The prevailing economic consensus is that inflation is nowhere in sight. However, conventional economic analysis, in our opinion, is ill equipped to assess the prospects of inflation in the current setting. Our view is that market acceptance of paper currency as an exchange media and store of value may have reached a tipping point. The greatest fear of central bankers today is that the inflationary expectations of the public get out of hand. When it comes to inflation, it is not capacity utilization, unemployment, and other objective data typically scrutinized by mainstream economic thinking that matters. Our view is based on the soft data of fragile public psychology and faltering confidence in the integrity and efficacy of established conventions and institutions of finance and commerce. Our friend Murray Pollitt notes: "The worst inflations come during hard times because with reduced tax revenue, governments must print to meet the payroll." (May 21 Pollittburo Newsletter).

The fact that gold has become a popular topic of media conversation does not make it a bubble. The chirping of naysayers usually comes from assorted wallflowers that have simply missed the boat. Against a backdrop of wilting confidence in financial assets, gold is under owned by central banks, institutions, and individuals. One must distinguish between a near term overbought condition, to which any investment class in a secular bull market can become prone, versus a full scale mania. We are a long way from silly season when it comes to gold.

In terms of Hyman Minsky's framework for understanding bubbles, gold is somewhere in the middle. According to Minsky, every bubble begins with a disturbance that causes investors to see it in a different light. With respect to gold, we would argue that the new paradigm is the replacement of reverence for government and the expectation that it can create positive economic outcomes with cynicism. The new paradigm is cynicism towards politicians, the political process, and by extension fiat money. The rising gold price reflects the spread of this cynicism. In stage two, prices start to increase and as the increases gain momentum, people start to notice. In our opinion, that is where gold is on the bubble roadmap. Stages 3 to 5 are easy credit, over trading and euphoria for this new paradigm. These still lie ahead, in our view.

When gold was written out of the script as a monetary anchor by the Nixon administration in 1971, it became difficult and cumbersome to acquire. For most financial institutions and individuals, it was not included in the menu of mainstream investment options. For many, it became forbidden territory. That all changed with the launch of gold backed ETFs in 2004. These instruments, backed by physical metal, have grown in popularity because they are user friendly securities which accurately track the price of gold. By enabling the flow of investment capital into the metal, they have become important components of the supply and demand equation. Still, with an aggregate market cap of $79 billion, investment gold in ETF form is hardly more than a speck in the midst of the $100 trillion of global financial assets. The gold

mining share sector has a market cap of perhaps $340 billion. Against this backdrop, it is hard to argue that gold is universally owned and therefore a crowded trade.

It is true that a certain but incomplete form of an investment case for gold can be readily articulated by anyone reasonably conversant with the market landscape of today. Paper money is bad, government spending is too high, deficits as far as the eye can see, politicians are incompetent etc. etc. It should come as no surprise that the top performing investment strategy of the past ten years would have gained a number of noisy sponsors who have in turn influenced the thinking of many others. What's not to like about a winner? But how many occupants of the bandwagon understand gold beyond its P&L impact on their investment performance?

The consensus investment case for gold as stated by most is incomplete. What does it mean if the global system of paper currencies based on the dollar as a reserve asset is in its final chapter? The social and political implications of a rocketing gold price are adverse for mainstream investment strategies. Because of this, gold is not taken seriously by the vast majority of conventional investors who almost always prefer a sugar coated prognosis. To the extent that the consensus expects, wishes for, or believes that there will always be committees to save the world, the bubble in gold still lies ahead.

Are there more rescue packages with attendant money printing to stave off deflationary market forces in our future? The answer is yes if one extrapolates the macro economic dynamic that was set in motion by the first committee to save the world. Only one question remains with respect to successive efforts to prop up a monetary and political regime against which market forces are arrayed, and that is the matter of time. It is impossible to know when an awareness of these realities settles into the investment consensus and political consciousness. In any event, we anticipate that day will be marked by an absence of hope that there is any establishment policy maker who has the slightest clue as to the next step.

The peaks of the previous two bull markets in gold were accompanied by political sea change as reflected by the Reagan or FDR electoral land slides in the U.S. Solutions to vexing and chronic political, social and economic issues, reflected by accelerating debasement of paper currency will depend not just on intellectual insight but on the presence of unified political will. Whether this can be achieved in a democratic system, in which the majority of eligible voters have a vested interest in expanding the size and presence of the role of government in the economy, without unprecedented political and social divisiveness remains to be seen.

The investment case for gold versus paper money is political, because paper money is at its core a political instrument. The political underpinnings for the dollar based reserve system for conducting international commerce have deteriorated significantly in recent years. In our view, only a miraculous renaissance of the private sector will reverse the flow of capital into safe havens, including gold. For this to happen, the political landscape must undergo fundamental transformation. If such is to be the case within anything other than a multi-year time frame, it will in our opinion, turn out to be one of the greatest surprises in history. In the meantime, political leaders are likely to face a wave of unprecedented distress at the level of state and municipal finance that will exert a deflationary impact on economic activity. A Houdini-like

escape from this gargantuan mess is theoretically possible, but those who harbor doubts will not be able to avoid considering gold and gold mining equities.

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