

INSTITUTIONAL ADVISORS

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HOW A SOUND CURRENCY CAN FIGHT THE FED

Our technical advisory, The ChartWorks, ably called the low on the dollar at 84.5 in January and its recovery. Technically, this move could reach around 94. Let's call this the short term and quickly move to the longer term, which could be a lengthy recovery in the US \$.

At a time when the Fed has promised and threatened to depreciate the currency and when everyone knows that China is going to buy commodities forever, the call for a strong dollar may be unacceptable.

In order to get over the hurdle of orthodoxy, it is necessary to return to first principles. One is that the senior central bank has to have a soaring asset class against which to inflate its portion of a credit expansion. The notion that its "stimulation" of credit forces a business expansion is just plain wrong. In logic, it's called a primitive syllogism, which considers that because two events occur at the same time they are causally linked.

Yes, credit does expand with the business cycle, but this is well documented back to Roman times – well before interventionist economists modernized the ancient, and we mean ancient, notions of mercantilism.

The classic causal relationship is that the rooster crowing "causes" the sun to rise. Of course, the "Austrian" economists have known this for years and there are no real reasons for the status quo to continue to ignore how the currency/credit markets really work. Chances are, in the typical post-bubble restoration of sobriety, the public will figure out the main errors of policymaking and impose the practicality of sound money upon financial adventurers in government policy. A disgruntled public has done it before.

In which case, the "New Paradigm" will not be that the dollar will suffer catastrophic repudiation but that the concepts long ruining the dollar will be repudiated. The prospect is compelling.

For decades, our case has been that the Fed would aggressively accommodate virtually every aspect of a great financial mania and would never voluntarily do anything to curb it. No matter how reckless and absurd the speculation became, this was the case. Some would claim that the Fed tightened as administered rates increased to 6% in 2000.

As with the senior central bank's behaviour through the culmination of previous bubbles, increases in the discount rate *followed* the rise in short rates normal to any bubble. The other measure of officialdom being swept up by universal speculation has been the decline in real interest rates.

In 1966, Alan Greenspan correctly condemned the 1920s' Fed for being too "easy" during that obvious mania. On that one, real long rates fell from 9% to 4%. During the late 1990s' bubble, rates plunged from 9% to 1.8%. The low was recorded in 1 Qtr. 2001, well after the collapse of speculation was underway.

When the street was becoming gravely concerned about increasing short rates, our observation in July, 2000 was that such rates soaring was part of the boom and, ironically, that there was no need to "worry" until treasury bill rates declined. Chronically plunging market rates with the senior central bank following the action down with a series of discount rate cuts has been one of the key signatures of the post-bubble condition.

This explains why the Fed hasn't raised administered rates in the face of the most outstanding speculation in commodities since the early 1980s. Short-dated market rates of interest don't want to go up so the Fed, with its usually lagging behaviour, has had no guidance to raise its rate, which is curious as it has been threatening the "print" to prevent deflation.

On this one, our position has been that the Fed would not voluntarily tighten but, as with any speculative bout, the phenomenon has its own ability to tighten. This is better understood by considering that most of the so called "liquidity" apparent during a boom is actually money borrowed against the convictions that soaring asset prices will continue forever.

The consequence of this manic condition before or during the construct of central banking has been that the moment prices turn down the real power shifts from promoters to margin clerks, whose job description is vastly different to that of a central banker.

Quite simply, soaring asset prices permit an equivalent credit expansion and, with the exhaustion of speculative abilities, prices turn down, which forces a credit contraction. This is clearly described in an editorial in the July 11, 1932 edition of **Barron's**: *"The Federal Reserve policy of cheapening credit through the purchase of government bonds has been unable to make a dent in the conservatism of borrower or bank lender, in short, every anti-deflationary effort has yet to provide positive results. The depression is sucking more and more bonds into its vortex."*

With adequate to ample evidence, this has been the pattern of booms and contractions since one of the earliest recorded examples hit the Roman Forum in 34 A.D. What's more, as with that one, there have always been attempts by officialdom to prevent or ameliorate the consequences natural to rampant speculation – always without material significance.

The now short-term uptrend in the dollar is part of the exhaustion being displayed in the hot action in both tangible and financial assets ranging from low-grade bonds to international shipping rates.

The key question is – can the Fed continue to "print" and thereby force asset speculation to even greater heights? Part of the answer would include the distinctive contraction in the money supply since August.

First of all, the 1990s' bubble recorded the greatest recklessness by the senior central bank since the first one in 1720 when the Bank of England was quite naïve about market furies. History's record is that no matter how responsible the senior bank has been, "New Financial Eras" have not run shorter than nine years. Going the other way, no matter how accommodative, the party has never extended beyond nine years.

For example, the duration of the 1990s' example was 116 months, which compares with the 116-month duration for the mania that ended in September, 1929.

The next point is that, and again using previous examples, the third year out from the climax of a bubble can be a good one and this has been the case. As the good times returned beginning in October, 2002, our position has been that it would be a cyclical bull market within a secular post-bubble contraction.

The top for the remarkable speculation in tangible and financial assets has been accomplished along with the low in the dollar index and the big question is – how long can the dollar strengthen and can it deny the Fed's ambition to depreciate? (That through the nonsense of a "flexible" currency it has depreciated the dollar by some 90% and seems intent to accomplish the final 10% will be left to another review.)

Fortunately, history provides a sound argument that this ambition may be thwarted. Since the 1500s, the record is fairly complete and during a financial boom that follows the "old" era of inflation, confidence soars such that lenders in the financial capital seek higher yields from risky borrowers in other countries.

As with all subsequent examples since the "classic" 1560s' liquidity collapse (this was comprehensively described by Thomas Gresham), once the party is over the monumental concern is the problem lower credits have in servicing their debt in the financial capital.

As with more recent times, the collapse of speculation is followed by a contraction in business and tax revenues so the return of sobriety changes the mood from borrowing as much "low-cost" money as possible to a compulsion to pay it down. Often this required selling raw materials, goods, or other countries' currencies to obtain the amounts of senior currency so necessary to meet obligations in the financial capital.

Essentially, Gresham's letters were concerned about the problem of servicing England's debt when sterling was weak into Antwerp, with a strong guilder the senior currency. In particular, this becomes very acute in the liquidity vacuum that is the consequence of any big speculative boom.

On every example since, the mechanism seems to be best explained in street terms (or, as it was spelled in Elizabethan times – streat). Following a period of great financial recklessness, all that is needed to make the senior currency relentlessly strong is to have most of the debt expanded during the boom to be contracted in the senior currency.

Such money owed can be described as a short position in the senior currency and since the 1930s it has been the U.S. dollar. During our boom, it is reasonable to conclude that by far the largest amount of debt has been financed in New York, with both interest and principal payable in dollars in New York.

The world has experienced the biggest financial boom in history and this has included the biggest debt issuance in recorded history. And the majority of this in "street" terms is equivalent to a huge short position in the senior currency. The eventual problems in servicing debt, which in a world of traders can be construed as "short covering", in the past became intolerable.

The recurring pattern starts with the euphoria of issuance, then doubt and consternation follows, and finally, with seemingly insurmountable debt and foreign exchange problems, a revulsion for debt develops.

Obviously, the final of the sequence is a long way off, but in the meantime investors should be aware that the U.S. dollar can, despite policymakers opposing ambition, become chronically strong.

COMMENTS FOR METAL AND ENERGY PRODUCERS

Energy: Producers and investors should get prepared for a long period of generally weaker prices. We will, of course, cover the shorter term swings as such trading opportunities arise.

Base Metal Prices: Much the same outlook applies to base metal prices.

Gold: Our fundamental research of gold's behaviour through and following a new financial era was essentially completed 25 years ago. Fortunately, we have not had to change the "model". Originally, the prospect of gold's real price declining with falling real interest rates, which is one of a great financial boom, was unthinkable.

Most people, from CEOs at big mining companies to goldbugs and their letter-writing pundits, said it was impossible. Gold suffered a relentless decline as the financial markets enjoyed declining, and at times plunging, real long interest rates. Once the top for the bubble was accomplished in 1 Qtr. 2000, it was automatic that the real price would end the secular bear and begin the secular bull in 4 Qtr. 2000. This has been the case and it has been accompanied by a bull market in gold shares.

On the latter, a speculative rush developed based upon the 1970s' notions of dollar weakness and soaring commodities. We have not argued against the move, but noted that it was not of the outstanding character of the typical post-bubble secular bull market for gold shares.

Over the past few months, we have had questions from big mining companies and investors on how we can be bullish on golds in the face of a firming dollar. Our response is that, as with the hopeless decline with the bubble, it's how financial history works.

New Paradigm: Although it is only weeks into a potential change, gold has been rising against stocks, bonds, and commodities, which is what we have used to define a real bull market. Our gold/commodities index has recovered from a multi-year low of 183 on March 1 to 195. Hey, no big deal, but it was at 263 last summer.

Within this, gold should be rising in most other currencies as well.

In euro terms, gold has increased from 317 in late February to 348. The last high was 350 in July, 2002 and above this would set a breakout from a 10-year high. Providing some considerable support to this is that the treasury curve (bonds to bills) has been steepening since the middle of March.

Investors and traders should be fully invested as the bull market for gold in real terms can run, with cyclical corrections, for many years.

Using the term "New Paradigm" is, in this case, no more accurate than when it was over-employed during the 1990s' financial mania. Along with its historically more often used "New Financial Era", the party was invented with the first one that blew out in June, 1720. Ours was number six.

As they occurred in the world's financial centre, each since has been celebrated as "new" and equally consistent has been the typical and very long bull market for gold shares that followed. Ironically, the crowd and policymakers will eventually discover this as a "New Paradigm".

BOB HOYE, INSTITUTIONAL ADVISORS