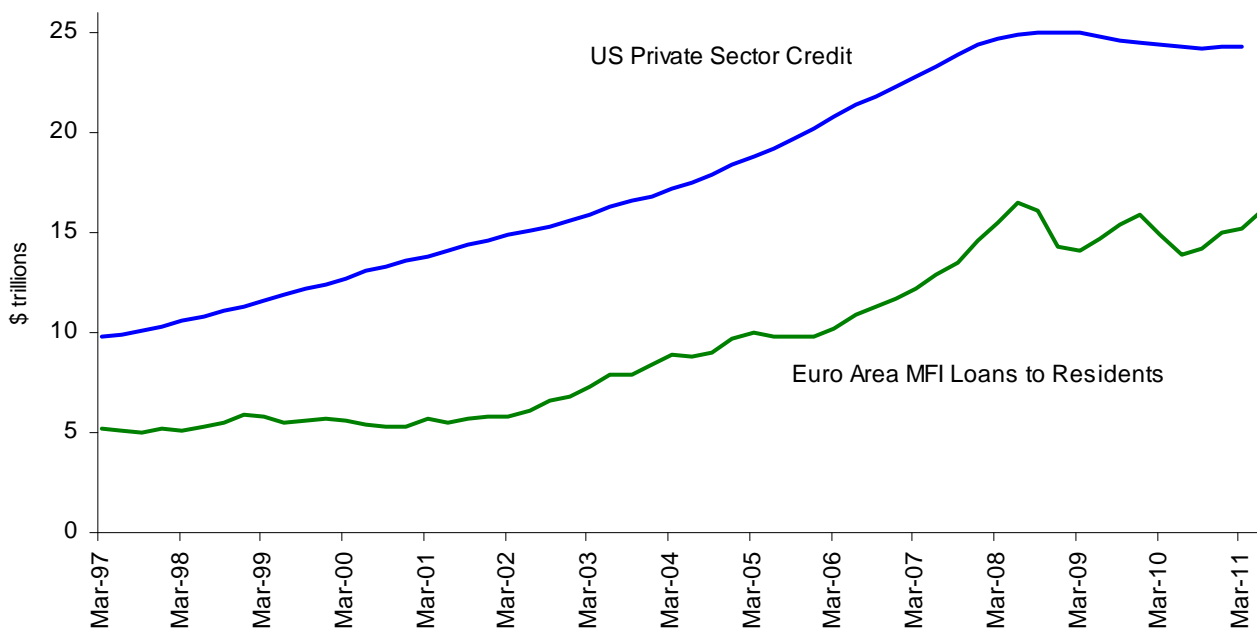


August 23, 2011

Gold and Bonds Priced For Collapse

Markets are pricing in a huge risk to the global financial system. We don't think it's justified. The Fed and ECB bond purchases are being sterilized – the ECB uses term deposits, the Fed pays interest on excess reserves. The central banks are not expanding private sector credit, causing monetary stimulus, or providing “too much money chasing too few goods.” This undercuts the inflation rationale for record gold.

U.S. and Euro Area Private Sector Credit (last obs. U.S. data Q1 2011, Euro data Q2)

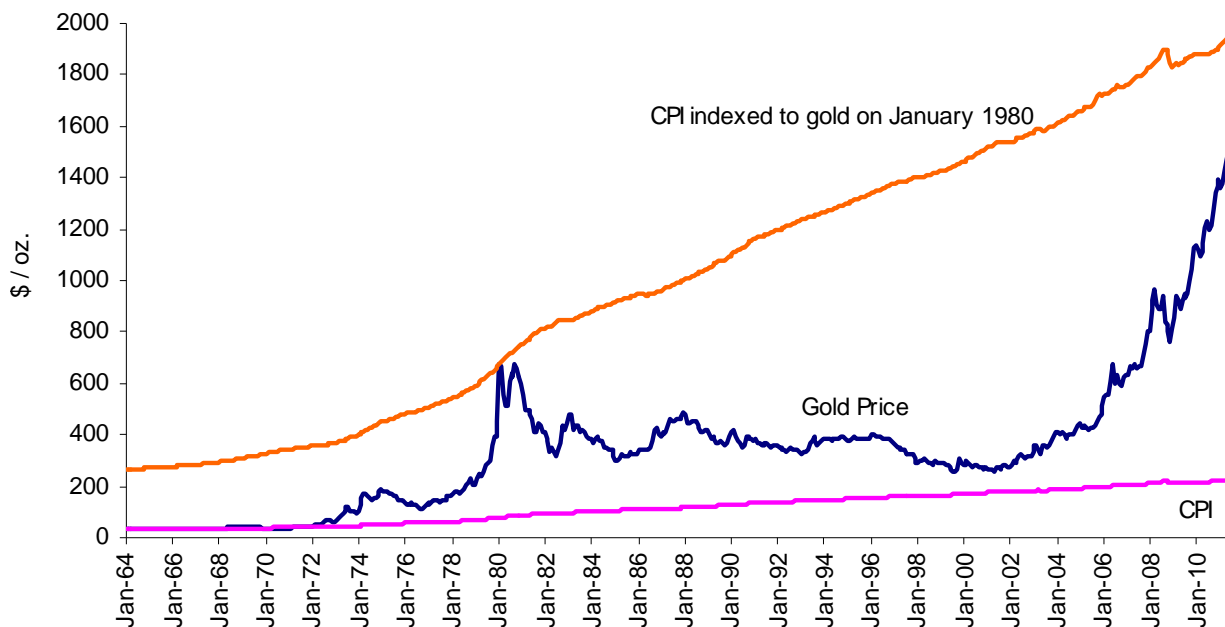


Source: Federal Reserve; ECB; Encima Global

Central banks have powerful crisis tools and stand ready to supply unlimited liquidity, undercutting the deflation and systemic rationales for high gold and 2.1% ten-year Treasury yields. Credit markets aren't frozen as they were after the Lehman bankruptcy filing. Europe's debt crisis has many more innings to play, but EU borrowing costs are very low, there are no signs that the euro's value will collapse, and banks are backed by their governments, a sharp contrast with the disastrous Lehman bankruptcy filing. Under current policies, we expect the U.S. and Europe to suffer dissipation of their net worth but not the breakdown of global finance priced into gold and bonds.

- At \$1900 per ounce, gold is priced for an Armageddon in fiat money – as if the euro is going to shatter into multiple devaluations that sink the continent and/or CPI is going to go through the roof worldwide to offset paper money’s loss in value. We’re critical of the Fed’s near-zero interest rate with CPI inflation at 3.6%, but don’t see signs of “too much money chasing too few goods.” Instead, we think gold will decline in a miniature of 1980 when it becomes clear that the financial system isn’t breaking and central banks aren’t monetizing – that there’s little growth in currency or private sector credit.
- Some are arguing that gold is fairly priced in real terms. As the graph below shows, that claim requires starting the analysis from the peak of the 1980 gold price bubble (the top line). **Indexing the analysis to any period other than the 1980 bubble shows that gold is massively overpriced in real terms.** Rather than an argument for gold, the “inflation-adjusted gold” analysis implies that gold prices are in as big a bubble as 1980 (after which they fell for 20 years in the 1980s and 1990s as the Volcker Fed and Reagan Administration used sound money to restart the economy.) Absent a Volcker moment, the Fed or ECB would still need to decide to monetize their balance sheet expansions (meaning allow banks to lend wildly for years as was done in the 1970s and the 2000s) in order to justify today’s gold price.

Gold Price and CPI (last obs. August 22, 2011)



Source: Wall Street Journal; Bureau of Labor Statistics; Encima Global

- Like gold, **bonds are priced for Armageddon** -- a long, deep recession starting now. TIPS yields reflect real growth expectations. **One interpretation of the negative 10-year TIPS yield last week (first time ever) is that the economy will be smaller in real terms ten years from now that it is now.** If this happened, we agree that investors would probably be happy to have owned gold and bonds, but **the issue is whether markets should be pricing in such a deep economic catastrophe.**

10 Year Treasury Inflation Protected Yield (last obs. August 22, 2011)



Source: U.S. Treasury; Encima Global

We've criticized the Fed's unstable monetary policy. It's been causing wild swings between deflation and inflation in recent decades. This is the result of wide variations in the value of the dollar, in the Fed funds rate and in the looseness of bank regulatory policy. **To defend against the Fed, investors have been channeling more and more resources into gold, silver and sovereign bonds, a barbell trade that sucks investment away from growth and jobs.**

- Recently, the value of the largest ETF for gold (symbol GLD) topped the largest ETF for equities (symbol SPY). "Spiders", as they are known, had held the number one spot since 1993. Both these ETFs hold more the \$70 billion in assets.
- As the fear of a systemic breakdown takes over, the barbell trade has become even narrower, leaving out platinum, oil and other commodities on the inflation side and even AAA corporate bonds on the deflation side. **This is characteristic of a bubble – when fewer assets contribute more of the gain as occurred during the 1999-2000 Nasdaq bubble.**

Aaa Spread (last obs. August 19, 2011)

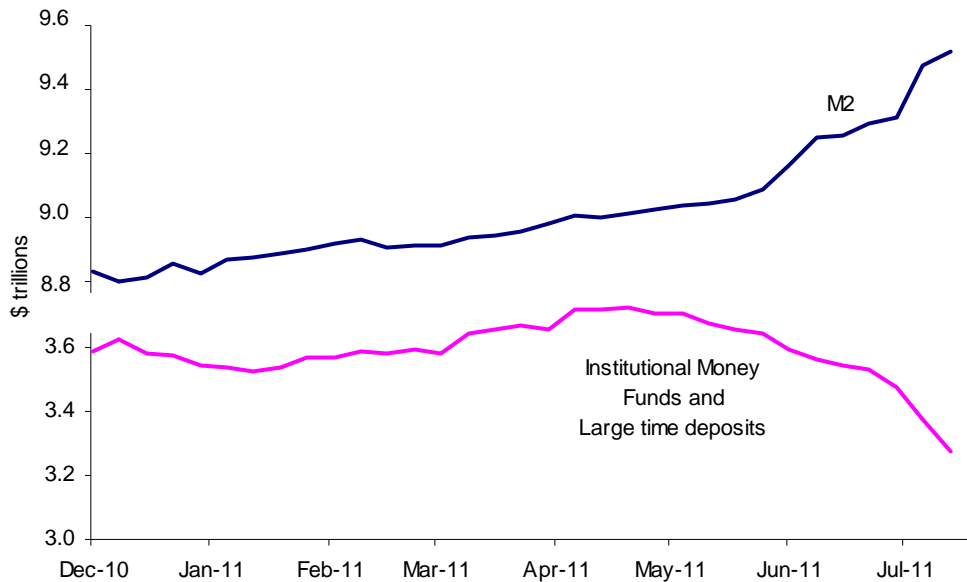


Source: Federal Reserve; Encima Global

- Illustrating the narrowness of the gold and silver bubble, platinum often trades at more than an 80% premium to gold, but now suddenly trades even with gold. One explanation: a deep recession will slow industrial and automotive uses of platinum and a catastrophic failure of the financial system will favor only gold and silver, not platinum, as hard money. Similarly, one ounce of gold buys more than 22 barrels of oil (versus 15 average.) That wide a gold-to-oil spread has only occurred after the 2008 Lehman bankruptcy when oil collapsed to \$34 and after the 1998 Long-Term Capital failure when oil fell below \$11. We expect gold to fall relative to oil and platinum unless there's a catastrophic failure in the global financial system.
- **It's possible this black hole process of investing in gold and government bonds will be self-fulfilling.** If it goes on long enough and big enough chunks of capital are diverted away from growth and jobs, it could cause the financial system to collapse under the weight of recession and devaluation. In that scenario, the euro might break apart or a major bank be allowed to declare bankruptcy. **That's the bet in markets right now.**
- Growth in the M2 money supply has surged to a 25% annual rate over the last 13 weeks (versus 5% average). The reason: excess liquidity is flooding to too-big-to-fail banks which are becoming a substitute for money market funds. For monetarists, M2 growth usually means economic growth, and M2 has a 32% weighting in the leading economic indicators. In our view, this weighting is an anachronism given the distortions in monetary policy from the near-zero Fed funds rate. With interest rates near zero, we think regulatory policy dominates over monetary policy, causing or removing stimulus. M2 growth is normally associated with an expansion in private sector credit as banks

lend new deposits. That's the backbone of financial intermediation. This time, M2, mostly bank deposits, expanded at the expense of non-M2 components of M3, not through Fed liquidity injections that spur bank loans. Banks have dead-ended the growing deposits into cash and repo financing. The banks are basically taking the place of money market funds in short-term corporate finance. Our view: the M2 surge isn't stimulative and doesn't justify high gold prices or low bond yields.

M2 vs. Institutional Money Fund and Large Time Deposits (last obs. 8/10/2011)



Source: Federal Reserve; Encima Global

Bottom line: A valid market concern is the industrialized world's dissipation of assets through weak structural policies. This explains equity weakness but not the assumption of a high degree of systemic risk that is now reflected in gold and bond prices.

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