April 26, 2013

"Gold to me is not a commodity. It's money."
-JIM GRANT, author of Grant's Interest Rate Observer, in a CNBC feature interview this week with Maria Bartiromo.

POINTS TO PONDER

1. Although the US mortgage market is no longer a systemic threat, student loan debt is emerging as a smaller, but still substantial, debacle. Overall, student loan obligations amount to nearly $1 trillion (vs approximately $6 trillion in mortgages outstanding) and delinquencies are literally going vertical. (*See Figures 1 and 2*)

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2. Putting the Fed's impact on the mortgage market into perspective, new government-guaranteed loan originations total $450 billion per year and our central bank is buying slightly more than that amount ($480 billion). However, with reinvestments of cash flows from previously acquired mortgages, the Fed is scooping up nearly $900 billion annually of home loans. Further, by September 2013, at its current pace the Fed will own $2 trillion, roughly one-third of the entire Fannie, Freddie, and FHA-guaranteed market.

3. One of the most depressing and alarming trends in America is the stunning rise in food stamp recipients. It is particularly disturbing that in the recovery phase, post the Great Recession, the usage rate has actually accelerated. (*See Figure 3*)

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4. Graphically underscoring the US government's extreme dependence on the bond market, the Treasury needs to finance (and re-finance) $4 trillion annually. This staggering sum not only includes funding our trillion-dollar annual deficit, but also maturing Treasuries. The latter amount has become so massive due to the increasingly short-term nature of US Treasury borrowings at a time when the lowest interest rates in many generations would suggest the prudence of locking in bargain financing costs for many years.

5. While the US has an extensive litany of problems, mostly due to a chronically dysfunctional government, the inherent dynamism of its private sector is impressive. The man who coined the term "emerging markets," Antoine van Agtmael, was quoted in last Saturday's *Wall Street Journal* as saying the US is the new emerging market. He has been analyzing developing countries since 1971, and, for the first time, he is hearing complaints from Asian manufacturers about how competitive US producers have become.

6. One of the ongoing paradoxes of the US stock market is how expensively smaller, and generally lower quality, companies trade versus the blue chips. This is all the more perplexing given that the big blues are clearly producing much higher economic returns on their invested capital. (*See Figures 4 and 5*)

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7. You know an asset class is out of favor when its weakness is blamed on both good and bad economic news. First, investors were allegedly switching out of gold earlier this year due to

improving global growth (which this author questioned). Then, as April has brought a series of negative releases, bullion's recent face-plant was attributed to fears of a new worldwide recession.

8. Although gold's meltdown has gotten most of the press, the reality is the entire commodity complex is feeling the heat. Iron ore, like copper, is one of the more historically reliable bellwethers of global economic vitality. Despite a recent bounce, iron ore prices are down 30% over the last two years. Based on a looming supply spike, coinciding with diminishing demand, further price erosion appears likely.

9. In another illustration of Canada's inherent economic vigor relative to the US, inflation is running at just 1% north of the border while unemployment is 6.5%. Both of these important metrics are 1% below those prevailing in the US. As the acclaimed Canadian economist David Rosenberg observes, the only way his country could have both lower inflation and unemployment is if its GDP-growth potential is improving at a time when the same measure in the US is deteriorating. Essentially, Canadian productivity is superior to that of the US, likely due to much friendlier government policies with respect to private investment.

10. Mexico's new reformist government has vowed to attack waste and corruption at its bloated oil monopoly, Pemex. Given that its refineries have three times as many workers as non-Mexican operators with similar output, 11,000 of its 150,000 workers draw salaries with no duties whatsoever, and its headcount has increased 10% since 2001 as production has plummeted 26%, a radical restructuring is long overdue. (*See Figure 6*)

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11. As is the case with the social security system in the US and its illusory trust fund, France has a completely unfunded (i.e., pay-as-you-go) national retirement program. Even in 2006, prior to the global financial crisis, its unfunded liabilities were 362% of GDP, the worst status in the European Union.

12. In addition to a real estate bust, the Netherlands has a considerable debt problem (those two conditions do seem to almost always go together). In this important "core" eurozone country, consumer indebtedness amounts to 250% of available income, double the level of debt-crippled Spain.

13. Europe’s economy continues to be burdened by a euro exchange rate that gives Germany a decided advantage over all of its main EU competitors. Thus, it is no surprise that unemployment continues to worsen even in France, whose economic viability is essential to the great euro experiment. (*See Figure 7*)

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14. As Western investors seemed to be dumping their gold holdings en masse, Asian investors stepped up to take advantage of the selling frenzy. Retail demand in both China and India soared in the days immediately after the yellow metal’s sharpest two-day drop in 30 years, with sales of bullion and gold coins tripling in China, and on pace to rise 36% in India this quarter. More support may ultimately be coming out of Asia given that the Chinese government has less than 2% of its $3 trillion foreign currency reserves in gold. This compares to over 70% for the US and Germany.

15. Japan’s 10-year government bond yields are bouncing around the incredible level of 0.60%. This is despite the Bank of Japan’s avowed intent to force inflation to 2% by doubling its money supply.   Massive purchases of 10-year Japanese government bonds (JGBs) by its central bank with fabricated funds are clearly suppressing yields (much like in the US). However, volatility has rocketed lately, implying that rates may not stay anchored below 1% as private bond holders have begun selling their JGBs, likely in anticipation of higher inflation and further currency weakness. (*See Figure 8*)

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The bull run in bullion runs out. Where did all the bulls go? It's a question being asked by anyone who owns gold or gold mining stocks, including yours truly. In fact, there's quite a competition going on to see which of Evergreen's portfolio protection strategies—long gold or short REITs—is the biggest loser from the time Ben Bernanke decided to go nuclear with QE3. Thankfully, our hedges on the yen and the euro have worked much better, with our bet against the yen being particularly lucrative. And, even more fortunately, our beloved master limited partnerships (MLPs) have been on a tear of late, doubling the return of a strong US stock market (MLP investors: remember that performance stat the next time you get a K1!)

Presently, gold is winning the booby prize among our stable of hedging tactics, at least so far in 2013, courtesy of its epic mid-April cliff dive (gold bugs, surveying the wasteland they find themselves in, now completely agree with T.S. Eliot that April truly is the cruelest month). But, as noted in recent EVAs, this is much more than a gold issue. Numerous commodities, not to mention a raft of more economically sensitive stocks, even in the US, are staggering like Lindsay Lohan after one of her infamous Vegas benders.

There are copious conspiracy theories floating around, particularly among those who are chronically buggy about gold, that certain central banks have engineered this break in gold's 12-year ascent. Along these lines, it did catch my eye that the elder statesman of the gold mutual fund world, John Hathaway, who simply oozes smarts and credibility, believes that most of the selling has been of paper (like futures contracts) and not physical gold. Given that John's Tocqueville Fund has posted one of the best track records in this space, his views merit serious consideration.

Much more on the fringe side of things, I also read some comments from a less venerated member of the gold clique who maintains only central banks can marshal the firepower to have created the enormous selling pressure seen recently. Giving this view some plausibility, my pal Grant Williams observed in his excellent 4/22 missive (click here to access) that the two-day collapse by gold was a 7.5 standard deviation event. He quotes Howard Simons of Bianco Research that the odds against such an occurrence are a mere 20 trillion to 1! (Yet another example of the absurdity of the Efficient Market Theory!)

Yet, as noted in the Points to Ponder section, the carnage has not been limited to gold. In reality, it’s hard to find a commodity that hasn’t been pummeled like one of Floyd Mayweather’s sparring partners of late, with two exceptions being natural gas and iron ore. It’s likely that those items have held up simply because they already had the daylights beaten out of them over the last couple of years. Thus, unless the central banks are somehow driving down almost theentire commodity complex, I have to believe they aren’t the "perps" in this case.

However, that doesn’t mean the selling isn’t coming more from the derivative part of the gold world, such as the aforementioned futures contracts, where high leverage is the name of the game. As we all know—or should know—leverage is glorious on the way up but disastrous on the way down.

From what we’re now hearing, the hedge fund community was supposedly long excessive amounts of both gold and Apple. With both of them engaged in synchronized sinking, it’s possible that there has been some forced liquidations as margin calls hit hedge funds, which usually operate with abundant leverage. In contrast, cash buyers in Asia, as depicted in the photos below, are pouncing on this 20% off sale in gold (in the case of the shrunken big Apple, the mark down is 40%, but we haven’t heard reports of investors in Hong Kong lining up to buy it just yet).

Therefore, while over-leveraged players being forced to sell out is undoubtedly part of the weakness, I believe there is much more to the story.

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If it can happen to gold… As has been the case for almost 10 years, early May will find me heading to the La Jolla area, just north of San Diego, to attend the annual John Mauldin/Altegris investment conference. It doesn't take much to lure me to that Eden-like slice of California but, frankly, considering the line-up of speakers for this year's event, I'd willingly travel to a totally inhospitable venue where life and limb are constantly at risk—like New York City—to hear these folks.

No doubt more than a few EVA readers at times question my lavish praise of our partners at GaveKal Research. Yet, just to show you that I'm not the only one who holds them in high esteem, I thought I would display the agenda for this year's conference.

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Obviously, the fact that Louis and Charles Gave are sharing the stage with these luminaries says far more than I ever could about their qualifications. And, as I have written numerous times before, Charles is one of those unique thinkers, and writers, who can cut through all the malarkey and surgically separate fact from fiction.

Weeks ago, Charles was making the point that the government of Japan's decision to crush the yen by vowing to double its money supply (technically, the monetary base) would be deflationary, not inflationary. His reasoning, which the meltdown in gold and nearly all "hard" assets is proving out, was that having one of the world's biggest exporters effectively offering a 25% price reduction is an exceedingly deflationary development.

Imagine you are a German machine tool company and you compete directly with Japan's Fanuc for customers in China. Fanuc's machines just got effectively marked down by one-quarter. You either lose business or you cut prices. The same is true for producers in South Korea and even the US. As much as we are believers in the US industrial renaissance theme, the yen is now a serious challenge to America's newfound industrial competitiveness (and, frankly, when *Time Magazine* has the US manufacturing revival story on its front cover, as it did last week, we become a tad antsy that our once maverick view has become too mainstream).

Consequently, prices for stuff the Japanese are big producers of—be it machine tools, autos, computers, TVs, chip-making equipment—are likely to get stuffed. As a result, the prices of the stuff the stuff is made from—raw materials like commodities—are going to be under downward pressure. In fact, the Dow Jones commodity index has been feeling the pull of gravity for two years. (*See chart below*)

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Because this erosion has been in place for a while, it's logical to observe that the yen's nosedive has just accelerated the downtrend and that, accordingly, some other force must be at work. My vote in that regard would be overcapacity. The world simply has too much production in place relative to demand. Given that China has become the world's foundry, and the reality that its overall capacity utilization has tumbled from roughly 80% in 2008 to the 60% vicinity today, it's no wonder there is deflation in many goods. And looking at many other major economies around the world, it appears that China is far from alone in having substantial excess capacity.

Accordingly, those countries that have thrived on exports feel compelled to cheapen their currency, in an updated version of the "beggar-thy-neighbor" policies which became so widespread—and so economically crippling—during the 1930s. It's highly unlikely Japan will be the last major economy to force its currency down in order to gain a trade advantage.

Does that mean gold will be relegated to investment Siberia in the years ahead? While that's possible, I doubt it. Notably, gold, and gold mining shares, excelled during the 1930s. Further, considering the unparalleled amount of money printing that's going on around the world right now, and is likely to continue for the foreseeable future, it's hard to believe gold won't eventually stabilize and make at least another run toward $2000, if not higher.

To be truly long-term bearish on bullion, one needs to have considerable confidence that the central banks are doing the right thing by drowning the world in magic wand money (no doubt Ben Bernanke and his counterparts around the world would all agree the printing press was truly the greatest invention ever).

For my dough, I have more faith in gold than in Ben and his band of merry official counterfeiters, at least from the standpoint of protection against the Feds of the world eventually letting temporary commodity deflation turn into broad price inflation. After all, a key reason there is excess production right now is that growth is so anemic globally (and getting more so by the day).

We are definitely in the camp that believes excessively easy money is undermining rather than boosting growth—one of the ultimate ironies of the central bank's frantic efforts to print its way to prosperity. An example of this is lenders being reluctant to extend credit due to low interest rates that don't compensate for the risk. (In a future EVA, I plan to cover why my team and I are becoming more worried about stagflation in the years ahead.)

Yet, stock investors are borderline euphoric right now as the clear winner of the liquidity drench is the US equity market. The mantra is: Don't fight the Fed. As long as it is running its magical money machine flat out, this market really has no downside—just consider the almost perfect correlation between the size of the Fed's balance sheet and stocks over the last four years.

It's hard to quibble with that fact except for one thing; the same was true of gold until late last year. Therefore, I would offer up this caveat to those who see a cloudless sky for the market: if a perfect storm can hit gold, even a binge printing-Fed can't assure the sun will always shine on stocks.

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