Redstone Advisors

Economic and Market Review

Fourth Quarter 2013

"For the leaders of this people cause them to err; and they that are led of them are destroyed . . . .

Woe to those who enact evil statutes and to those who constantly record unjust decisions, so as to deprive the needy of justice and rob the poor of My people of their rights, so that widows may be their spoil and that they may plunder the orphans. Now what will you do in the day of punishment, and in the devastation which will come from afar? To whom will you flee for help? And where will you leave your wealth?"

Isaiah 9:16; 10:1-3

"To appreciate the disruptive nature of inflation in its full extent we must keep in mind that is springs from a violation of the fundamental rules of society."

Jörg Guido Hülsmann, Economist, 'The Ethics of Money Production'

To the valued clients of Redstone Advisors, allow us to offer a belated 'Happy and Merry'. We have enclosed our latest polemic against central planning, dishonest money and social injustice - in a word, modern political economy. And while we know that to *"kick against the goads"* is futile, nevertheless as someone once said, *"hope is a good thing, perhaps the best thing."* Therefore it is our most sincere hope that 2014 will be both joyous and prosperous for you and yours.

Nicholas Orseme is said to have delivered a celebrated sermon before Pope Urban V on Christmas Eve 1363, denouncing the corruption of the world and the Church, and calling for repentance. Orseme, philosopher, mathematician and physicist, Bishop of Lisieux and a counselor of King Charles V of France, also wrote the first treatise on inflation. Writing in the forward to his work entitled *De Moneta*, Orseme wrote; *"Some men hold that any king or prince may, of his own authority, by right or prerogative, freely alter the money current in his realm, regulate it as he will, and take whatever gain or profit may result: but other men are of the contrary opinion."* As a contrarian, Oresme's treatise, not unlike his sermon, was a strong rebuke against the *"successive debasements of the coinage by the moneyers"* and the consequent *"derangement of trade and social relations."* The *De Moneta* reflected the opinion of the Scholastics who held that the *money changers*, the modern day equivalent of those who benefit from monetary inflation, engage in *"disgraceful injustice, drawing wealth against God and justice."* Oresme concluded his treatise by declaring monetary debasement to be *"fraudulent, tyrannical and unjust"*, and therefore *"impermissible"*, calling on sovereigns to *forethink and repent*. Juxtaposed against the strident opinion of the Scholastics, stands that of the modern-day *"moneyers"*. Responding to populist disapproval over the size of staff bonuses in the aftermath of the Great Recession and the involuntary tax payer bail-out of insolvent banks, Goldman Sachs CEO Lloyd Blankfein declared in a November 2009 interview with The Times of London that bankers *"have an important social purpose"* and that he is *"just a banker doing God's work."* Happy indeed must be Mr. Blankfein and his associates for to be sure, God has promised that He will most certainly, *reward every man according to his works*.

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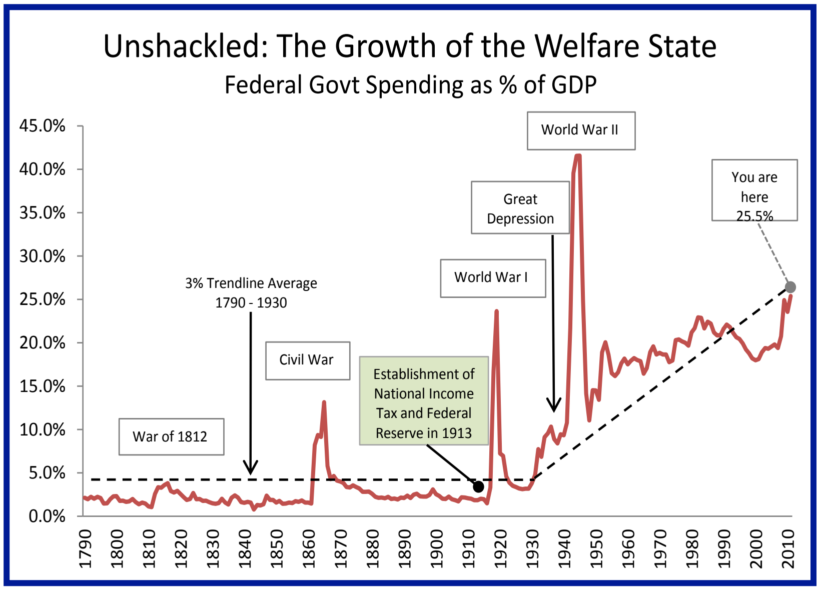
It is with the *work* of the *moneyers* and those officials, elected and appointed who have leadership responsibilities, that we continue to take issue. We have for years agitated against both the injustice as well as the disutility of the continuing policies of intervention and inflation, the results of which have been a massive *degree of disorder* in both the financial markets as well as the economy. We have stubbornly maintained that the current global financial and economic crisis is not a single, isolated black swan event, but rather is the predictable outcome of decades of unconstrained monetary meddling. The current economic malaise facing both the US and most western developed economies, which we have characterized as a ***rolling recession*** consisting of persistent below-potential economic growth, intractable unemployment, exponential growth in unproductive debt, chronic sovereign deficits, and a massive famine of income, is **structural** not cyclical. It represents the distortive impact of the culmination of over 40 years of increasing intervention and monetary inflation. In the words of Yogi Berra, *"the future ain't what it used to be."*

Yet despite the tireless work of the stabilizers, deflation is still *the* fact that threatens global markets, and by extension the banking cartel, with a systemic risk of collapse and therefore informs all policy decisions and impacts all market movements. We are not alone in this assessment. Week by week, month by month and year by year, the cacophony of voices warning of an impending deflation has grown to a veritable uproar. To give but two recent illustrations, writing in a publication entitled, 'The United States: Are the Seeds Already Sown for the Next Macro-Market Deflation Crisis?', author Greg Weldon of Macro Research said; *"Now the history books are being re-written, while the un-written mandate of the US Federal Reserve and other global Central Banks has subtly-yet-significantly shifted from preventing a repeat of the 1970's inflation, to circumventing a full-blown debt deflation and macro-economic depression."* And just very recently the Financial Times reported that ECB President Mario Draghi, while speaking on a panel at the World Economic Forum in Davos, said the *"ECB was poised for battle to ward off deflation in Europe."* For years we have traced the history of the decline in the monetary standard of the US; from the seeds of central banking sown in our founding, through the events leading up to the epic legislation of 1913, through the overthrow of limited republican government in favor of the massive expansion of statism in the shadow of the Great depression, to the final abandonment of any vestige of monetary restraint with the 1971 closing of the gold window as the United States defaulted on its obligation to keep the dollar as good as gold. All along the way, it has fundamentally been injustice, not disutility, that has been at the core of our argument. (Though we have time and again by economic argument, demonstrated the utter fallacy of inflation as a constructive policy tool) An argument against the creation of a money monopoly anchored by a quasi-private central bank and operated for the benefit of a sacrosanct banking cartel, free and unfettered from any constitutional restraint or political oversight, to produce any volume of money and credit the planners may determine, the ultimate outcome of which has been the devaluation of the currency, the gradual impoverishment of society and the negation of personal liberty. Writing against the debasement of a nations' monetary standard nearly a millennium before Oresme, the Roman statesman Cassiodorus said; *"For what is so criminal as to permit oppressors to sin against the very nature of the balance, so that the very symbol of justice is notoriously destroyed by fraud."*

Following in the footsteps of Orseme and the Scholastics, Jörg Guido Hülsmann is one of the few modern economists to address this issue of monetary *fraud* by considering the ethics of inflationism as a policy of the state. Writing in his book entitled 'The Ethics of Money Production', Hülsmann holds that when by fiat, governments pursue perpetual inflationism, *"we observe the formation of inflation-specific institutions and habits."* Among these acquired "habits" he lists first that of **"hyper-centralized government"**, by which he means the unbridled expansion and encroachment of the modern welfare state, a topic we have addressed regularly. (**Figure 1**) With the assistance of a central bank, the state has within its grasp that which the Constitution had heretofore expressly denied it – a money power consisting of nearly inexhaustible funds at its ready disposal which could be freely used to make all citizens prosperous and happy. In this way government could expand its spending, and its reach into the private sector on an unprecedented new scale without the necessity of troubling the taxpayer or burdening the democratic process. In short, **inflation benefits the government that controls it**.

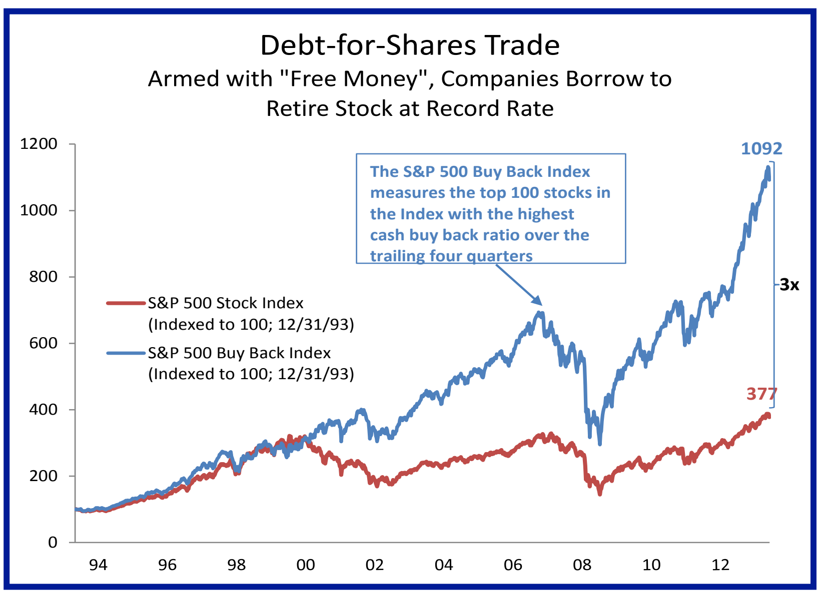
Figure 1



The next bad habit Hülsmann mentions is closely related to the first, that of **war and tyranny**, specifically that the unlimited production of money enables governments to extend the length of wars (the War on Terror is open-ended) and to pursue initiatives contrary to both the will and the interests of the people (NSA's Utah data storage facility). This is another of our regular "chestnuts". By permitting the state to circumvent the need to raise public support and increase taxes, fiat inflation effectively **unshackles government** from constitutional oversight, freeing the state to pursue their goals without genuine support from their citizens.

The third bad habit on Hülsmann's list is broadly defined as the **impact on business and corporate finance**. In essence, he suggests (and we concur) that the combination of fractional reserve banking and fiat money (the ability of banks to create a nearly unlimited volume of credit ex nihilo), increases malinvestments and financialization whereby businesses become increasingly more dependent on banks and credit markets. To see just one illustration, refer to **Figure 2** where we can see that since the collapse of the Dot-Com Bubble in 2000 and the initiation of extraordinary monetary meddling by the stabilizers, the trade of choice for many large public companies has been the **debt-for-shares trade**, whereby companies have levered-up their balance sheets with low cost debt, not to expand production or even to acquire new business, but rather to **retire existing shares**. Stocks in the Buy

Figure 2

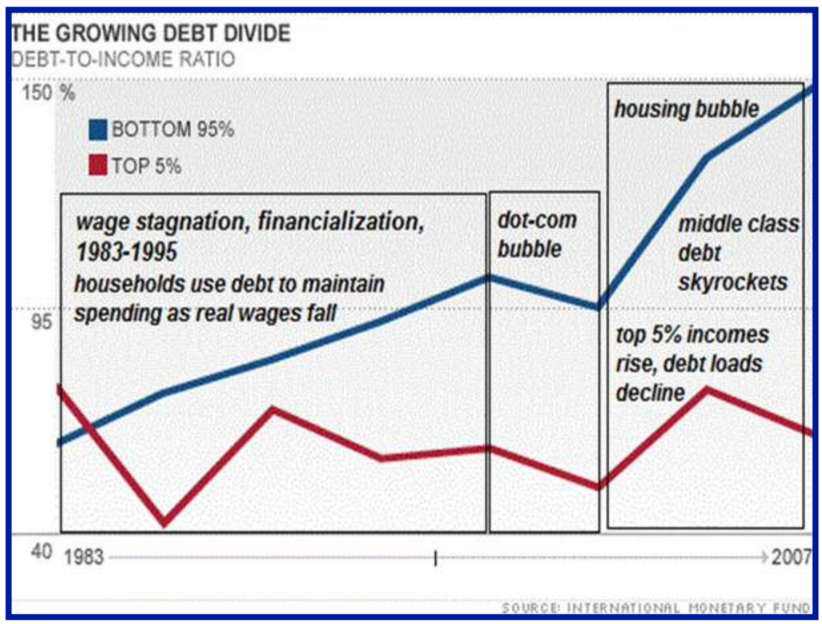


Back Index have outperformed the S&P 500 Index by a factor of 3! While no doubt beneficial to the short-term interests of management, either in terms of compensation or earnings-per-share management, the longer-term implications of loading up balance sheets with debt are less sanguine. Clearly fiat inflation encourages many forms of reckless behavior by management. If you are in doubt about this, we refer you to Mr. Jamie Dimon, the CEO of JPMorgan Chase, whose firm agreed to pay more than **$23 billion** in fines and settlements in 2013 alone. Those settlements covered charges of bribery, mortgage fraud, investor fraud, consumer fraud, forgery, perjury, and untold violations of SEC regulations. And what was the outcome of such monumental misdeeds? According to the headline in TIME Magazine; **"After losing billions, JPMorgan Chase Gives CEO Jamie Dimon a Raise."** Who was it who said crime doesn't pay?

Fourth on his list is that of a ***"race to the bottom in monetary organization."*** This is the old, old story of which we never tire of telling. The history of the decline of monetary standards in the West in general and the US in particular, has clearly demonstrated that **inflationism turns moral hazard and irresponsibility into an institution**. Amen and pass the gold.

Last on the list of bad habits is the **"debt yoke"**. While we have discussed this problem from nearly every possible vantage point, in essence it holds that while paper fiat money cannot "fail" by running out of it, it does "fall" in value, driving people, through the gentle coercion of rising prices and falling real wages, to the money oligarchs to become slaves to the debt yoke. (**Figure 3**) Truly, *"the borrower shall be the slave to the lender."*

Figure 3

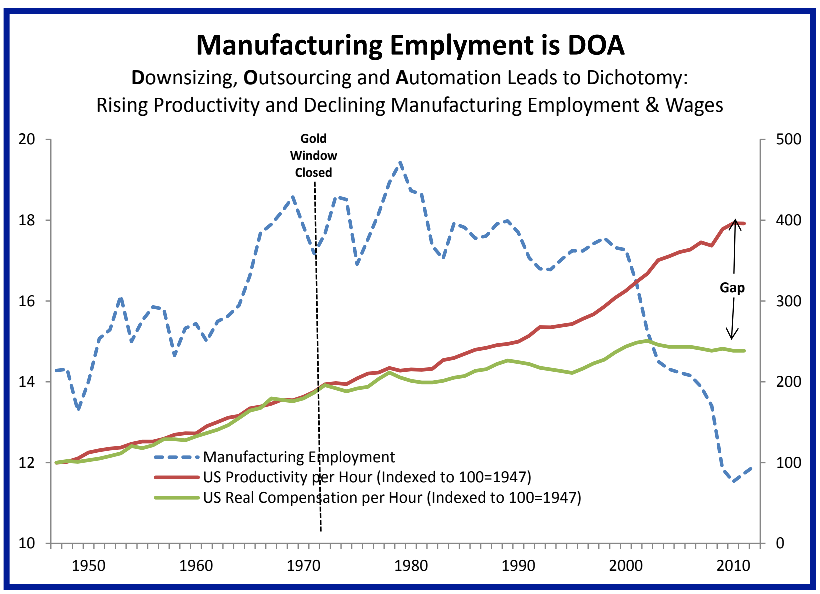


The moral implications are clear. In economics, as in all things, there is always the question of the "ought." We have always been willing to concede that the stabilizers can produce without limit, legally or technically, any quantity of money they may chose, nevertheless we have always insisted that they should not. To create money *ex nihilo* (from nothing) is to favor some at the expense of others. This breeds contempt for morality and civic virtue. By promoting a *theory of abundance* through **inflationism**, the stabilizers' have encouraged the repudiation of the immutability of the relationship between work and income, in favor of the Keynesian heresy of ***'something for nothing.'*** Yet even Lord Keynes himself conceded that *"by a continuing process of inflation"*, governments **confiscate** the wealth of their citizens, *"**impoverishing many**," and "**enriching some**."* We have written extensively regarding the nature of the injustice due to the uneven redistribution of wealth and the polarization of incomes that results from the stabilizer-induced **boom-bust-boom cycles**. It is through these hidden, yet insidious processes that the ***"vital some"*** are enriched and the ***"trivial many"*** are impoverished almost imperceptibly, day by day. It is that loss, that small, undetectable act of **legalized theft called inflationism** which, after forty years, has swollen into a massive deprivation which today threatens many in the US and throughout the West with what we have described as a coming famine of epic proportions – **a famine of income** – which may ultimately place the US irrevocably on Hayek's ***'road to serfdom'***.

That we have entered through the broad gate of inflationism onto the road to national profligacy, we have for years labored to establish. One of our most recurrent themes has been the twin-trends of **wealth polarization** and the **growing famine of real income**. In our opinion, these trends represents the most debilitating and intractable headwinds acting on the prospective growth and welfare of the US economy. We are, however, not singular in that opinion for so great has become the maldistribution of income, that in remarks made to the Center for American Progress on December 4th, 2013, President Obama described the **growing income gap** as the ***"defining challenge of our time."*** Despite their newfound political appeal, neither of these trends, which are in fact causally related, are new, as we have been developing them for many years now. Over that time we have maintained that contrary to the illusion conjured by the unprecedented production of money since the onset of the crisis, the economy, far from cyclically improving, remains **structurally impaired**. We have steadfastly maintained that to date, while we will concede to the existence of a **"statistical recovery"**, there has been no **"organic recovery"**. In the words of Daryl Montgomery, *"government spending didn't just stimulate the recovery, government spending was the recovery."* That is because perpetual inflation through credit expansion has led to overconsumption and malinvestment on a massive scale replete with a severe and systemic distortion of the underlying factors of production, the financialization of the economy and an increased concentration of wealth and a consequent decline in the growth of real income. All of these impairments, which are the direct result of the dis-coordinating effect which inflationism exerts on the productive structure of the economy and the relative relationships of all economic actors, remain. But to our way of thinking, none are as important as the problems surrounding the accumulation of wealth and the generation of income, for these are the DNA of healthy and robust economic growth. In a word, they *are* **demand**. And demand, according to Bastiat, *"determines the direction of capital and of labor, the distribution of population, and the morality of professions -- in short, it determines all."*

Referring to **Figure 4**, we can see that far from being small and cyclical, the **"demand problem"** is both a large and growing **secular trend**. The chart highlights the growing divide or **"gap"** between US productivity per hour and real compensation per hour. In theory, labor productivity growth becomes the basis for wage growth as wages *grow out of* production. For this reason economists closely watch changes in productivity growth because it is believed to be the limiting factor in determining how fast wages and living standards can rise. Accordingly, the only way that wages can rise on a sustained basis, absent inflation, is for productivity to rise. Unfortunately as Yogi Berra once quipped, *"in theory, theory and practice are the same, but in practice they are different."* After rising in near lock-step with measured productivity for the period between the end of WWII and the early 1970s, productivity and real compensation per hour have since parted company. What could account for this permanent and growing gap between real wages and productivity?

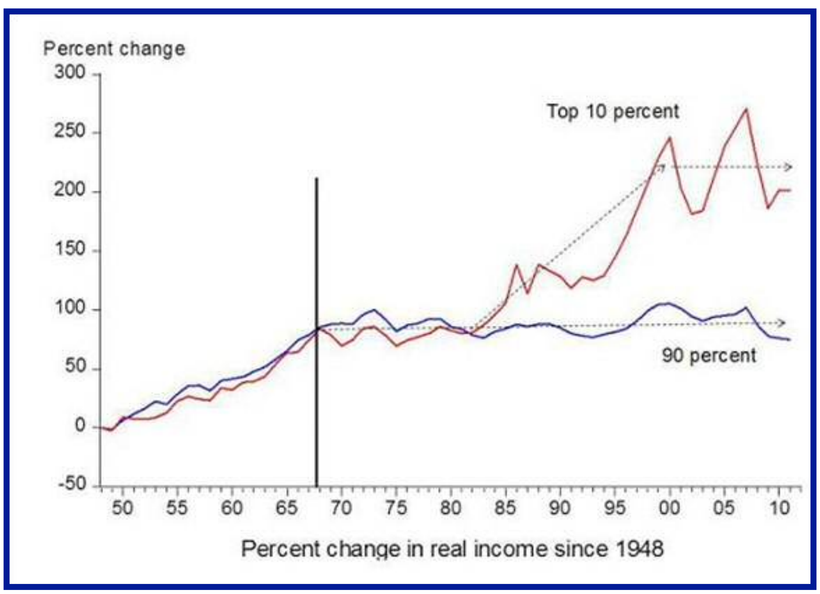
Figure 4



In our opinion, only the distorting impact of inflation. It is no coincidence that the two series part company and manufacturing employment began its well documented secular decline following the closing of the gold window and the death of honest money in the early 1970s. **Figure 4** reflects our long running story of the **DOA of manufacturing employment** - **d**ownsizing, **o**utsourcing and **a**utomation. Driven by perpetually low artificial interest rates, the evergreen emission of credit and financial deregulation, there has been a massive global overinvestment in productive capacity, first domestically then increasingly directed to emerging countries where labor rates were dramatically cheaper and regulatory burdens were greatly diminished. As a result, productivity has soared while high-paying manufacturing jobs, and the wage incomes that attend them, have been pronounced DOA. Against this backdrop, the US has secured its' place as the consumer to the world while mercantilistic (and opportunistic) economies such as China, have gladly stepped into the role we vacated, that of manufacturer to the world. Not unlike the story of **'Jacob and Esau'**, the US, in 1971, abandoned the **'birthright'** which we secured subsequent to WWII under the Bretton Woods monetary agreement, when the US reneged on its pledge to maintain gold convertibility. Subsequently, the world monetary system moved by default to a dollar standard, whereby other sovereigns were not only free but were, by *force majeure*, compelled to manage their respective currencies against an unanchored dollar. This established the basis for the ongoing **'faustian bargain'** which continues to influence today's terms of trade so that high paying manufacturing jobs are outsourced or off-shored in exchange for low-priced import goods, predominantly from Asia. Clearly our leadership has driven a hard bargain. We give them our jobs and they give us "always low prices." Tradition holds that in 1626, Dutchman Peter Minuit purchased the island of Manhattan from Native Americans for "beads, bobbles and trinkets" totaling 60 Dutch guilders, or the equivalent of around US $24 at that time. Today's *bargain*, like that of the mythical Manhattan transaction, is a trade that just keeps on giving. More beads anyone?

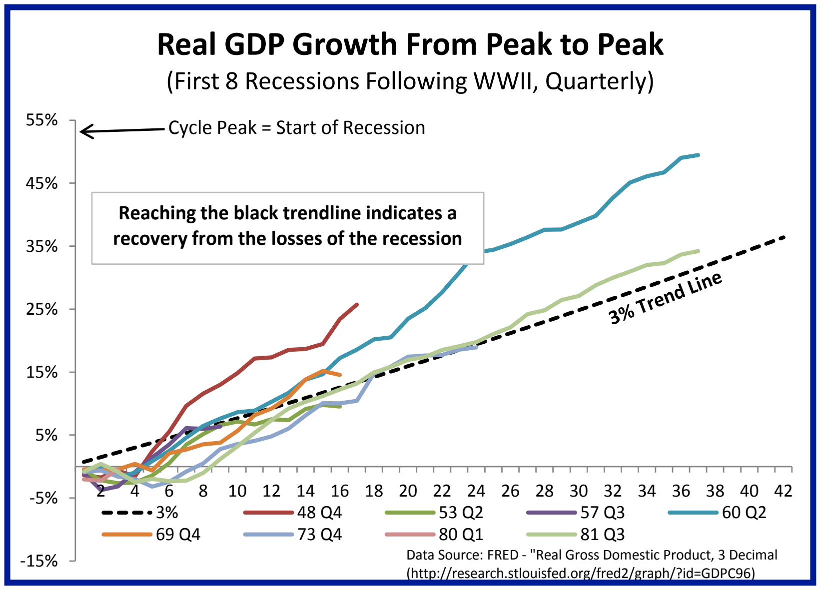
The discoordinating influence of inflation on income becomes even more apparent in **Figure 5** which isolates the change in real income between the top 10 percent and the remaining 90 percent. This underscores our contention regarding the existence of an **income famine** as the growth in real income for the "trivial many" - the bottom 90 percent -- has been stagnant for forty years, and has in fact been declining since 1999. In these two illustrations, lies the intractable problem of "supply" and "demand". How can real wage and income growth, a proxy for economic demand, be reconciled to production, a proxy for supply? Clearly not by more of the same; the production of money in order to alter its' purchasing power. We find it more than a little ironic that by faithfully following the Keynesian prescription of perpetually altering the purchasing power of money through the production of money (inflation) to fight the mythical monster of **underconsumption** (lack of demand), the stabilizers have, after over forty years of faithful adherence, brought about a **real demand problem**. But it is not the one predicted by Keynes, but rather the one that Austrian theory

Figure 5



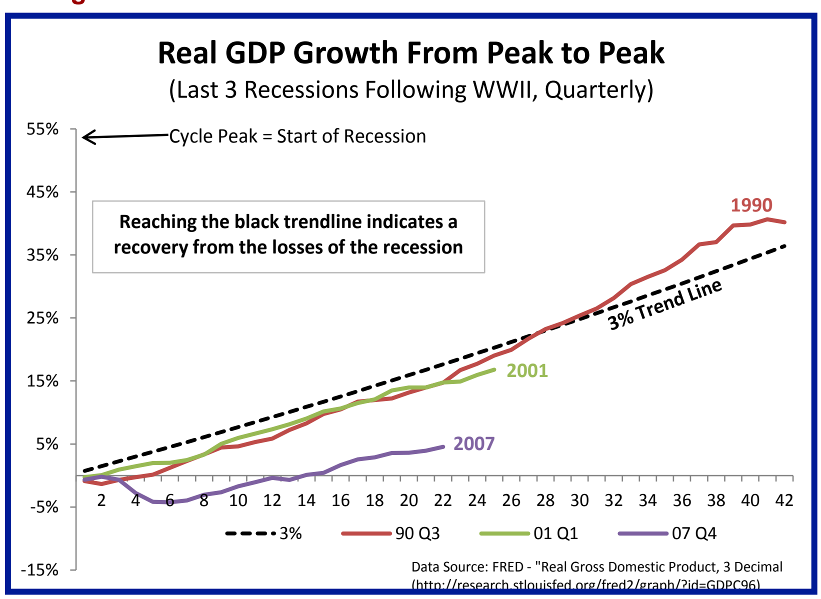
predicted would be ***caused*** by Keynes. A state of **perpetual imbalance** that is pulling the US economy into the morass of a long, slow decline. As Austrian economist Ludwig von Mises reminds us: "*And then, very late indeed, even simple people will discover that Keynes did not teach us how to perform the miracle of turning a stone into bread, but the not all miraculous procedure of eating the seed corn.*"

Figure 6



That we have in fact been eating the seed corn, is a warning that both we and others have devoted much attention to over the past few years. We have discussed a number of studies by eminent economists such as Drs. Carmen and Vincent Reinhart, Dr. Kenneth Rogoff, Dr. Peter Linneman, and Dr. Robert Gordon, all of which warn of a potential secular decline in future economic growth. **Figure's 6** and **7** represent two charts produced by Dr. Edward Leamer of UCLA Anderson Forecast that we first introduced in our first quarter of 2013 review. The first chart, **Figure 6**, graphs the cumulative rate of growth in real GDP as measured from peak to peak, for each of the **first eight recessions following WWII**, while the second chart, **Figure 7**, measures the **last 3 recessions since WWII**. Each recession is indexed to a starting value of 100 representing the cycle peak or the start of each recession. As such we can track both the depth of the recession from the peak of each business cycle, and the height of its associated recovery. The X-axis measures the length of each cycle, peak to peak, in quarters. Additionally both graphs contain a trend line which represents **3-percent annual growth**, a proxy for the long-term historical average of real economic growth. (The actual long-term growth rate has been 3.1%) As such we can readily see how many quarters it took each cycle to fully recover from the losses of the recession and return to trend growth, if at all, by observing when each cycle-line crosses the 3-percent trend line.

Figure 7

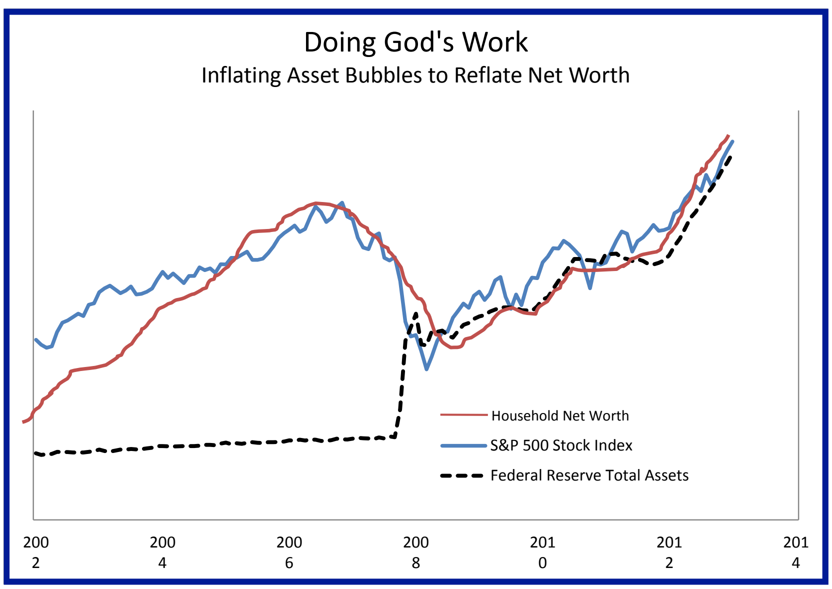


Referring first to **Figure 6** which depicts the **first eight recessions since WWII**, we notice a similar pattern for all recessions except the brief recession of 1980. Beginning with the cycle peak at time zero, economic growth falls below zero or the horizontal axis as we enter the recession. We then observe a period of **super-normal growth** which at some point causes each line to return to and exceed the 3-percent long-term growth trend, signaling a complete recovery of the economic growth lost during the recession. Referring to

Figure 7 which depicts the **last three recessions since WWII**, a completely different picture emerges. Looking first at the 1990 cycle, we notice that as measured by the severity of the drop below the horizontal axis, the recession was quite moderate compared to previous recessions, with a decline of only 1-to-2 percent. However it took fully 28 quarters or **seven full years** for the expansion to return economic growth to its pre-recession trend and so fully recover the growth lost during the recession. As we can see from the graph, the economy was expanding but due to the **absence of super-normal growth**, it was not growing fast enough to make up for the growth lost during the recession. Turning next to the 2001 recession cycle, we observe a similar pattern to 1990. Once again 2001 involved a very shallow recession followed by an extended period of below trend growth with real GDP growing **parallel to**, but **permanently below** the long-term trend. Importantly, after the end of the 2001 cycle which lasted 25 quarters, **the economy never fully recovered the growth lost from the recession**. As a result, the next cycle began from a level below potential representing a **permanent loss** of economic growth. Finally and most revealing, we look at the 2007 cycle. At down 5-percent, the severity of the recession was worse than any recession since the Great Depression but most importantly we can see that to date, there has been no recovery whatsoever relative to the long-term trend, vindicating our contention of no organic growth. In fact, the gap between the current expansion and trend growth is widening, suggesting not only a **permanent loss of economic growth** but a **deteriorating condition** as well, establishing a cascading pattern of permanently lost growth. What is critical to understand is that the pattern of the last three recession cycles, and most particularly the recessions of 2001 and 2007, has been markedly different from all other post-WWII recession cycles due to the absence of periods of **"super-normal growth."** This, we believe, is due to declining real incomes and increasing indebtedness, and as such, there is simply no means for satiating pent-up demand. Recall it was the Austrian economist Böhm-Bawerk who said; *"debt if future consumption denied."* To repeat our long-standing contrarian call; this time it is Austrian.

Yet despite the mounting evidence of secular decline and economic atrophy, the stabilizers continue *"doing God's work."* Among those hopelessly unproductive works, none has been more visible than the stabilizers efforts to underwrite stock prices in order to reflate net worth, and so by the mysteries of Keynesian priestcraft, reignite the borrow-to-consume, beggar-thy-neighbor, race-to-the-bottom paradigm that shamefully passes among our leadership today as the model *par excellence* for economic growth. (**Figure 8**) Aside from the doubtful efficacy of the proposed **"wealth effect"** whereby consumers are presumed to increase their spending based upon an actual or perceived increase in their wealth, the most obvious problem with this policy is the unparalleled concentration of wealth into the hands of the **"vital few"**. As we have discussed previously, the polarization of wealth is at all-time extremes. According to the **Credit Suisse Global Wealth Databook** for 2013, **75.4 percent** of all wealth in the US is owned by the **wealthiest 10 percent** of the population. By way of comparison, the same statistic for Canada is 57.4 percent, for the UK it is 53.3 percent, for Germany 61.7 percent, for Singapore 61.1 percent and for Japan 49.1 percent. Worldwide, the **richest 10 percent** of the population own **86 percent of the worlds wealth**, while the **richest 1 percent** own

Figure 8



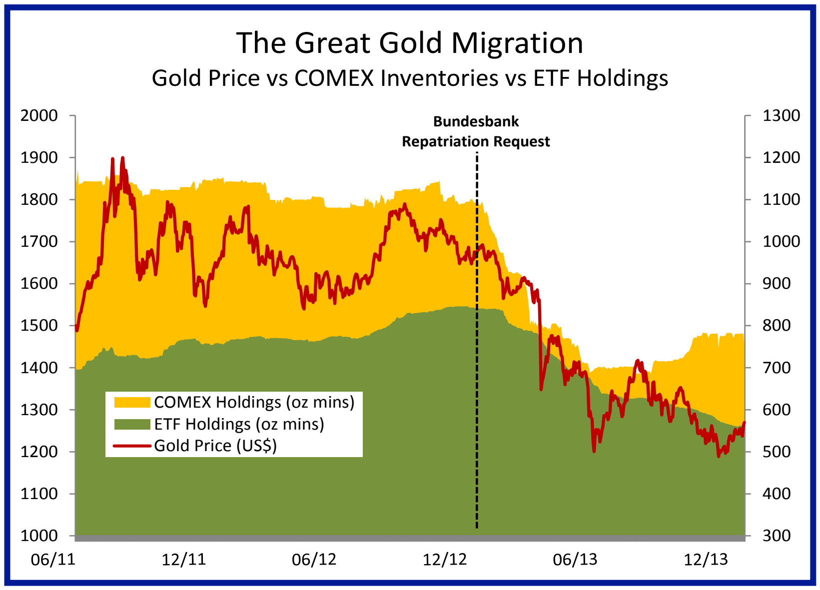
46 percent. In an unrelated report released by **Oxfam** appropriately entitled **'Working for the Few'**, the author's reported that **the wealthiest 85 people in the world own as much wealth as one-half the world's population combined.** That's over 3.5 billion people! What's more, Oxfam reported that *"in the US, the wealthiest one percent captured 95 percent of post-financial crisis growth since 2009, while the bottom 90 percent became poorer."* Commenting on the report, the Huffington Post reported; *"Under Barack Obama, the US has, for the first time in this nation's history, increased the concentration of its privately held wealth during an "economic recovery" from a financial crash."* Owing to the extreme polarization of wealth in the US, not only will levitating stock prices offer no positive benefit to the **"trivial many"**, but by continuing to concentrate capital gains into fewer hands, the problem will only be exacerbated. Today's "wealth effect" is really a retread of what economist John Kenneth Galbraith referred to as the **"horse-and-sparrow theory"**: *If you feed the horse enough oats, some will pass-through to the sparrow."* Now you know what to hope for.

Time has passed; the danger has not. The panic currently emanating from emerging markets, ostensibly attributed to the taper by the Fed, is a reminder of both the instability and the fragility of the "current calm". Eerily reminiscent of 1997, too many high-risk borrowers from vulnerable economies with non-transparent credit markets, have accumulated too much debt denominated in US and other foreign currencies. Driven by over five years of zero interest rates, the stampede into higher-yielding emerging market debt, replete with a massive mis-pricing of risk, has set the table for yet another high-stakes game of international whack-a-mole, as currencies wobble and hot money seeks safe haven status. As we go to press, Turkey's central bank announced after an emergency late-night meeting, that it would immediately raise its overnight lending rate from 7.75 percent to 12 percent in order to defend their currency. The immediate response to Turkey's action by SocGen bank analyst Benoit Anne was; *"Governor Basci, you have avoided a domino crisis in EM."* In a post elsewhere we read this; *"So... a 3% drop in the S&P from all time highs, a $10 billion taper, and the world was on the verge of an EM "domino crisis" - is this your centrally-planned stability?"* In addition, China, perhaps the biggest risk of all, yesterday announced a eleventh hour deal to bail-out investors in a $496 million high-yield trust investment and avert a potentially calamitous default. On top of this, China is exposed to a massive housing bubble. According to economist Gan Li, professor at Southwestern University of Finance and Economics in Chengdu, Sichuan; *“The Chinese housing market is clearly oversupplied. Existing housing stock is sufficient for every household to own one home, and we are supplying about 15 million new units a year. The housing bubble has to burst. No one knows when.”* Officials in China confront a delicate and dangerous situation with a growing credit crisis, a housing bubble and rising instability within their large and growing "shadow banking system", where a rapid outflow of hot money could trigger a credit crisis which could quickly reverberate around the globe. And as mentioned earlier in this review, Europe remains mired in their own banking crisis, with ECB President Mario Draghi preparing to do battle with the dreaded deflation. At the same time the German Bundesbank shocked the Eurozone recently when they announced that *"countries which are about to go bankrupt should draw on the private wealth of their citizens through a one-off capital levy before asking other states for help."* Last minute **bail-outs** to pre-emptive **bail-ins**. This has a ring of familiarity to it. Far from being stable, the bubbles blown by kicking the can down the road, increasingly appear to be in search of a pin. In a recent warning to investors, Marc Faber noted: *"The problem with bubbles is that they force one to decide whether to look like an idiot before the peak, or an idiot after the peak. There's no calling the top."* Note to investors: *caveat emptor*.

Perhaps more disconcerting still, has been the price action of gold over the past year. This is a topic we believe is long-overdue for consideration. After reaching an all-time high of $1900 per ounce in September of 2011, and trending sideways for most of 2012 at around $1800, gold declined sharply during 2013, falling over 35 percent to a low of $1188 in December of 2013. After the long run up -- a pause, a pull back, a consolidation, a correction -- any one of which would not have been completely unexpected, particularly in light of the exceptional performance in "risk-on" assets [stocks] last year. But gold, which according to Alan Greenspan, *"still represents the ultimate form of payment in the world"*, did not just undergo a correction, gold was **monkey-hammered**.

Figure 9 plots the gold holdings at the COMEX, the known holdings of ETF gold, and the price of gold. It also denotes the now-famous and surprising request by the German Bundesbank in January of 2013 that **700 tonnes** of their gold be repatriated from the vaults at the New York Fed and Banque de France in Paris to Frankfurt. Now this is not all of Germany's gold, but it is a fair piece. This is gold that had been on deposit in New York and Paris for nearly 60 years. Why bring it back now? What is clear from the chart is that coincident with Germany's repatriation request, the holdings of gold, as evinced by both the COMEX and ETF inventories, and the price of gold, collapsed. What is less clear is why. However, certain facts are known. To begin with, in response to Germany's request for the return of their gold, Germany was told by the Fed that it would take **eight years** to comply with the request. That in itself is quite interesting. If the physical gold is just lying in the vault, free and unencumbered, why would it take eight years to return? Hold that thought and fast forward one year later when Bundesbank President Jens Weidmann, admitted that over the first year, just **37 tonnes**, or a mere **5 percent** of the repatriated gold had arrived in Frankfurt. The original time table was eight years but at this pace it will take 20 years to complete the operation.. Perhaps it coming by way of a *slow boat to China?*

Figure 9



Alright, where did the gold go? Thankfully, that is no mystery. Referring to **Figure 10**, we can see that since the price of gold topped out, China has literally gone **"Bunker Hunt"** as they have massively ramped up their purchase of physical gold. Writing in the December 2013 Thunder Road Report we read; *"The other aspect of China's strategy is its diversification into "hard assets" and, as far as we can tell, China is attempting to "corner" the market for physical gold."* But why the sudden fondness for the Midas touch? Returning to the Thunder Road Report; *"We believe that the significance of the monetary pivot is under-estimated as China accelerates preparations to undermine the dollar's role in world trade."* We have also openly discussed what appears to be China's intentions to *get a seat at the geopolitical table* and become *pari passu* with the US and Europe. Over the past several years, China has canvassed the

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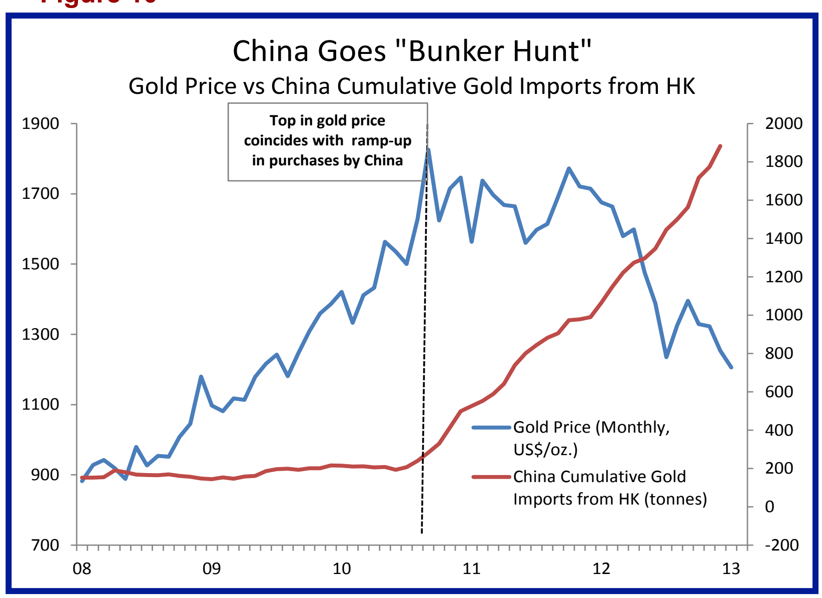

world hammering out bi-lateral trade and currency swap agreements in an effort to create an renminbi trade zone. They have also secured energy assets with the purchases to be settled in renminbi. We have also detailed their efforts to gradually wean themselves from over-reliance on US dollars by carefully and ratably appreciating their currency by approximately 3 percent per year over the last eight years. Also, they have recently increased their bellicose harangue of the US dollars 'exorbitant privilege', calling for a *de-americanization* of the world monetary system. Such actions strongly suggest execution of a long-term strategic plan. That China is attempting to take the lead role in diminishing the dollar's global hegemony is, we believe, undeniable. Whether or not they will succeed, however, is a matter capable of question. Nevertheless what is not in doubt is the middle kingdom's voracious appetite for the yellow metal and the existence of a large and growing cache of excess currency reserves, accumulated through that *faustian bargain* with the US, that are funding the operation.

So, to quickly recap, after 60 years of gathering dust in the vaults of New York and Paris, Germany surprises the world and asks for a chunk of its gold back. The response, however, is even more surprising; give us eight years. Coincident with their request, the price of gold tanks into the worst bear market in over 30 years, perhaps triggered by Germany's unusual public request for their gold. Okay, interesting but not exactly up to Tom Clancy standards. Next, at around the same time, China, which has long been preparing to challenge the US for global monetary supremacy, is suddenly smitten with gold fever. Coincidence? Perhaps or perhaps it was just opportunistic. What if neither the Fed nor France have Germany's gold? By that we do not mean that there is no gold in the vault, but rather, there is no *unencumbered physical gold* in the vault. In that case, a falling price for gold would make it *easier* for the US and France to purchase bullion off the open market to replace Germany's "misplaced" gold. However, enter a complication. Unlike the West were momentum trading is the driver of "value", in the East (and China in particular), where they define value differently, they are buying up as much physical gold as they can get, and by doing so they are making physical gold purchases by the Fed next to impossible. By putting gold **"in play"** over the past 40 years in an effort to **manage gold**, the stabilizers have figuratively made Germany's gold hostage to China's self-interests.

That central banks **"manage"** the price of gold is not a conspiracy, it is a fact. Quoting from a paper prepared for then Secretary of State Henry Kissinger, and forwarded for consideration to Under Secretary of the Treasury for Monetary Affairs Paul Volcker on March 6, 1974, we read: ***"US objectives for the world monetary system are incompatible with a continued important role for gold as a reserve asset."*** Later in the paper we read; ***"There is, in fact, still a considerable emotional attachment to gold as a monetary asset, and a basic distrust of bank or paper money not having intrinsic value."*** And finally; ***"If successful, we will keep gold from regaining strength as an international reserve asset."*** Agree or disagree, the unabashed US stance on monetary policy since abandoning Bretton Woods has been, and remains, all paper, all the time, with no room for gold. Gold, as the document states, is **"incompatible"** with paper. Like oil and water, they do not mix. If you are going to control the world's sole reserve *fiat paper* currency, you must be free to emit as much or as little as you deem necessary. And if your objective is to perpetually create inflation by emitting dollars, gold, as the **monetary asset *par excellence***, interferes with this operation as a rising gold price clearly shows up the ~~swindle~~ devaluation. As such it must be de-monetized . . . anesthetized . . . silenced. And so it was. Gold, what Friedman called a *barbarous relic*, was relegated to the status of any other commodity, no different from fuel oil or hog bellies However, a funny thing happened on the way to emancipation, as both the document and Mr. Greenspan remind us, people still have a *basic distrust of paper money* and *gold still represents the ultimate form of payment in the world*. So what's a "paper hanger" to do? Please read carefully the following translated explanation from Zhang Jie of the China Gold Association in a paper entitled 'Gold Leasing Is a Tool for the Global Credit Game':

"Gold leasing is an important innovation in the gold settlement system. Through continuous gold leasing the gold in the market can be circulated and produce derivatives, creating more and more paper gold. This is very significant for the Unites States. Gold leasing is a major tool for the Federal Reserve and other central banks in the West to control and regulate the gold market. If one wants to control gold, it is necessary to have the ability to short-sell the same. A central bank that directly suppresses gold would be suspected as a market manipulator. However, gold leasing by the central bank can take place unnoticed. For the Fed, it is crucial that the dollar dominates the world and so the Fed will store reserves from countries all over the world to control the gold settlement system. If there were another gold settlement system, it would compete with the dollar's trust. Natural gold credit would be a nightmare for the continuous dollar. The dollar can only be the world currency as a result of the United States controlling global gold settlement. However, if other countries want their gold back from the Fed, the Fed will lose its gold settlement position."

According to Andrew Gelman, the **law of unintended consequences** is what happens when a simple system tries to regulate a complex system. *"The political system is simple, it operates with limited information (rational ignorance), short time horizons, low feedback, and poor and misaligned incentives. Society in contrast is a complex, evolving, high-feedback, incentive-driven system. When a simple system tries to regulate a complex system you often get unintended consequences."* We believe that the attempts by the stabilizers to manage bond yields, stock prices, LIBOR rates, currencies and gold, just to name a few, over long periods of time, will ultimately prove the rule. Instability and fragility are increasing, not diminishing, as demonstrated by the increasing number and severity of financial crises over the past few decades. As Polish poet Stanislaw Jerzy Lec reminds us, *"no snowflake in an avalanche ever feels responsible."*

Much is uncertain but this much is clear. With no leadership on the horizon, we shall have the consequences as the west appears to be exhausting the reserve fund inherited from the past. The stabilizers around the world will continue in their "race to the bottom" because they must do "whatever it takes" to **protect the cartel**. And have no misunderstanding, despite all the happy talk coming from the shills on Wall Street or their sycophants in the main stream media regarding the underlying strength of the financial system, in our opinion, the systemic risks to the global financial system are greater today than they were in 2008. Leverage and derivatives exposure is greater today than at the peak of the last crisis. Banks that were too big to fail in 2008, may be too big to bail today. The expedient application of more of what caused the previous crisis -- monetary inflation and a massive overhang of unproductive debt -- has, far from mitigating the crisis, only served to postpone and exacerbate it. Owing to the institutionalization of moral hazard and irresponsibility attendant to the efforts of the stabilizers, the restructuring of economies and financial systems has never taken place. And to make matters worse, as part of the unprecedented salvage operation, sovereign governments *heaped up to themselves*, public debt on a massive scale, reducing their capacity to backstop the next systemic crisis. And come it will. For to quote John Mills: *"Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal in hopelessly unproductive works."*

Perfectly anticipating the chain of corruption identified by Orseme that results when the "prince" unjustly debases and manipulates the money of the realm, are the words taken from President Andrew Jackson's farewell address given on March 4, 1837: *"If your currency continues as exclusively paper as it now is, it will foster this eager desire to amass wealth without labor; it will multiply the number of dependents on bank accommodations and bank favors; the temptation to obtain money at any sacrifice will become stronger, and inevitably lead to corruption, which will find its way into your public councils and destroy at no distant day the purity of your Government."*

"Where there is no vision, the people fail." Proverbs 29:18