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A rush from sugar or a rush to gold ?

"We think we have an agreement, but we are not sure what it is."

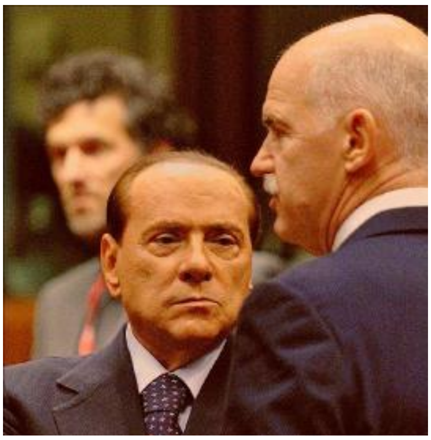
- Negotiator at the Euro zone "crisis summit" last week, as reported in The Economist.

"You don't have to be paranoid to be terrified."

- Ditto.

If a ballistics expert were so poor at his job that his artillery routinely fired missiles into the sea or, worse still, at his own men, he would soon be removed from office. He might perhaps be purged more dramatically, *pour encourager les autres*. No such logic would seem to apply, however, in either politics or economics in the west, where discredited practitioners of failed theories are allowed to pontificate ***and spend*** into absurdity. We cannot say with certainty what was spooking European investors prior to last week's make-or-break summit (the 14th such "crisis summit" in 21 months), but it seems plausible to argue that they were concerned about an unsustainable build-up of credit, credit risk and leverage. Happily, those concerns have now been put to rest, because the euro zone's leaders have pledged more credit, more credit risk, and more leverage. To put it another way, Messrs Sarkozy and Merkel have bought more time, albeit time paid for with yet more borrowed money. A three ring circus of blind, incontinent clowns would have more class.

The term 'haircut' seems somewhat redundant



Source: Financial Times

We know from previous climactic bailouts that money, being so debased by our central banks, doesn't get you very far these days. We have now had a €1 trillion bailout whose benign market impact lasted all of a day. By Friday last week, Italian 10 year bond yields were back up at 6% - the "danger zone" – which does rather make one wonder just what the hell our monetary and political "leaders" think they are achieving with all this thinly disguised but very costly can-kicking. Evolution Securities' fixed income research team called the bailout plan "a sugar rush" of stimulus. A one-day wonder is neither here nor there; what matters is where Italian government bond yields are in six or 12 months' time.

The euro zone's leaders faced at least three specific objectives. Resolution to each would have been and remains necessary but not sufficient to ease the crisis:

1. Put Greece out of our misery.
2. Recapitalise the banks.
3. Do something magical and sexy with the EFSF.

What we actually have is a peculiar fudge even by the standards of eurofudge whereby a Greek default mysteriously doesn't appear to trigger credit default swap protection, as Alen Mattich of the Wall Street Journal points out. Separately, and not for the first time, banks are being tasked with mutually exclusive objectives: keeping the lending taps open without compromising and indeed actively improving the quality of their balance sheets. This is impossible. The Economist (whose coverage of the summit this week has been excellent) cites Morgan Stanley's Huw van Steenis, who suggests that European banks might end up pursuing a "crash diet" that results in a shrinking of balance sheets by up to €2 trillion over the next year, which would be a disaster for SMEs and others. And in the meantime, a credit bust that is the natural response to too much inherent leverage and financial engineering is being "solved" by.. leverage and financial engineering. At least the acronym for the Special Purpose Investment Vehicle is a fair reflection of the intellectual bankruptcy being deployed. One summit attendee noted of the bailout plan that "the more zeroes the better". It is unclear whether he was referring to taxpayers' further involuntary capital commitments, or to political non-entities.

One cannot really avoid the conclusion first reached by writer Adam Fergusson in his study of the Weimar era collapse and hyperinflation, 'When Money Dies':

"What really broke Germany [and which may end up breaking the euro zone] was the constant taking of the soft political option in respect of money."

Talk of hyperinflation will, one trusts, ultimately be both premature and irrelevant, but wishful thinking is no sustainable basis for an investment approach when we have the current crop of political and economic no-talent ass clowns calling the shots. Last week we hosted our external investment panel, an oversight committee in effect, and one of the panellists pointed out that the anticipation and preparation for acute inflation, like that for financial panic, cannot be finely timed. One minute the system is deemed to be secure. The next minute, pensioners are queuing up outside Northern Rock.

Since we have mentioned the 'W' word, we have an obligation to discuss what strategies best preserved the wealth of German investors during that dark period. ("Life was madness, nightmare, desperation, chaos" writes Fergusson. We are not quite there yet – but we also note that sensible financial commentators have already begun to refer to Japan as our Weimar in waiting.) Other, more valuable foreign currencies, for example. In 1923, that meant the US Dollar. This time round, since the Swiss National Bank has lost the plot, we would favour the Canadian and Singapore

Dollars. Back then, the answer lay in gold, and we think it does this time, too, as the finest currency protection paper money can buy. One can also consider gold and silver mining companies – John Hathaway of Tocqueville Asset Management has written very nicely about the 'Golden Mulligan' being presented to investors who missed the gold bull on the way up. Markets very rarely offer second chances; investors without any form of gold exposure would, we think, be well advised to step on board now. Other forms of real assets will play their part (we note the substantial increase in the cost of British agricultural land). And since sins of omission can also be costly, investors looking for 'safe havens' would be well advised to be highly selective in their choice of bonds (if they choose bonds at all), as well as common stocks.

Those who have studied the Weimar experience suggest that the point of no return in the inflationary process did not come about through currency depreciation alone, nor from the growing velocity of money in circulation (as German savers tried desperately to spend their fast-eroding paper wealth), nor from the balance of payments deficit. In fact it came from a devaluation of political principles. Yale Economist Robert Shiller has suggested that one of the reasons for equity investors' irrational exuberance in the 1990s (it was Shiller, and not Greenspan, who coined the phrase) was the fall of the Berlin Wall – which seemed to conclusively display the superiority of western free market capitalism over the discredited Soviet model. Now the superiority of the western model is so apparent that we have cash-strapped eurocrats looking to raise money from the Communist leaders of a country, most of whose citizens live in abject poverty. This writer is proud to call himself British; he would be disgusted to be regarded as European.

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