PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4NA
020 7400 1860

www.pfpg.co.uk

8th April 2013

Weird Scenes Inside The Gold Mine

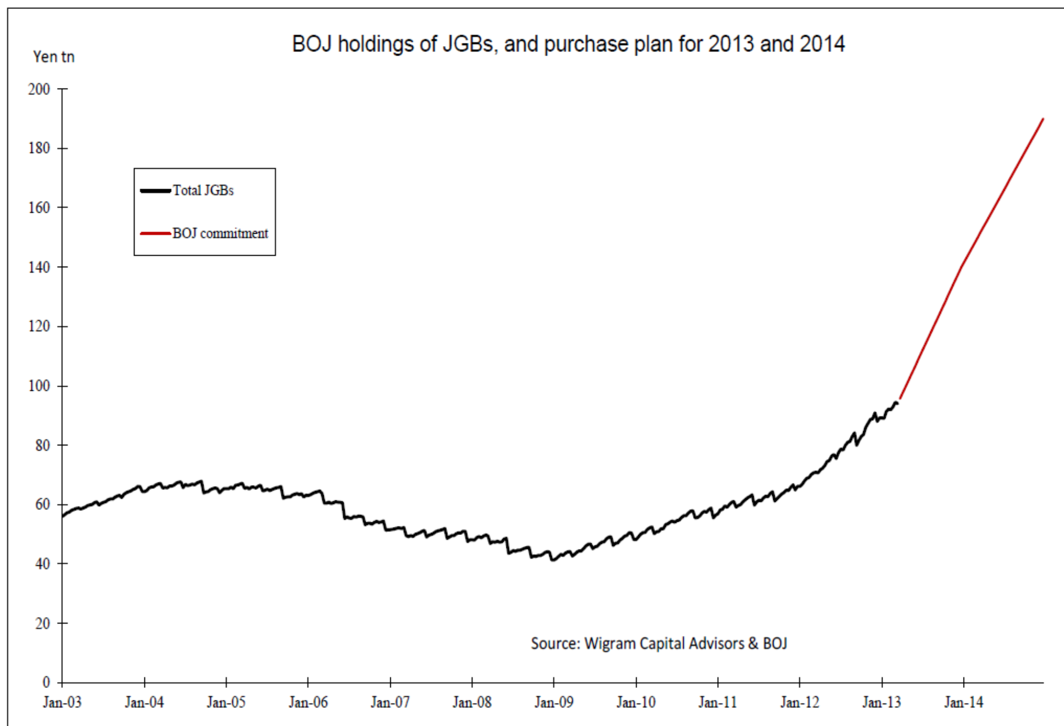
"The modern Keynesian state is broke, paralysed and mired in empty ritual incantations about stimulating 'demand', even as it fosters a mutant crony capitalism that periodically lavishes the top 1 per cent with speculative windfalls."

- From 'The Great Deformation – how crony capitalism corrupts free markets and democracy' by David A. Stockman.

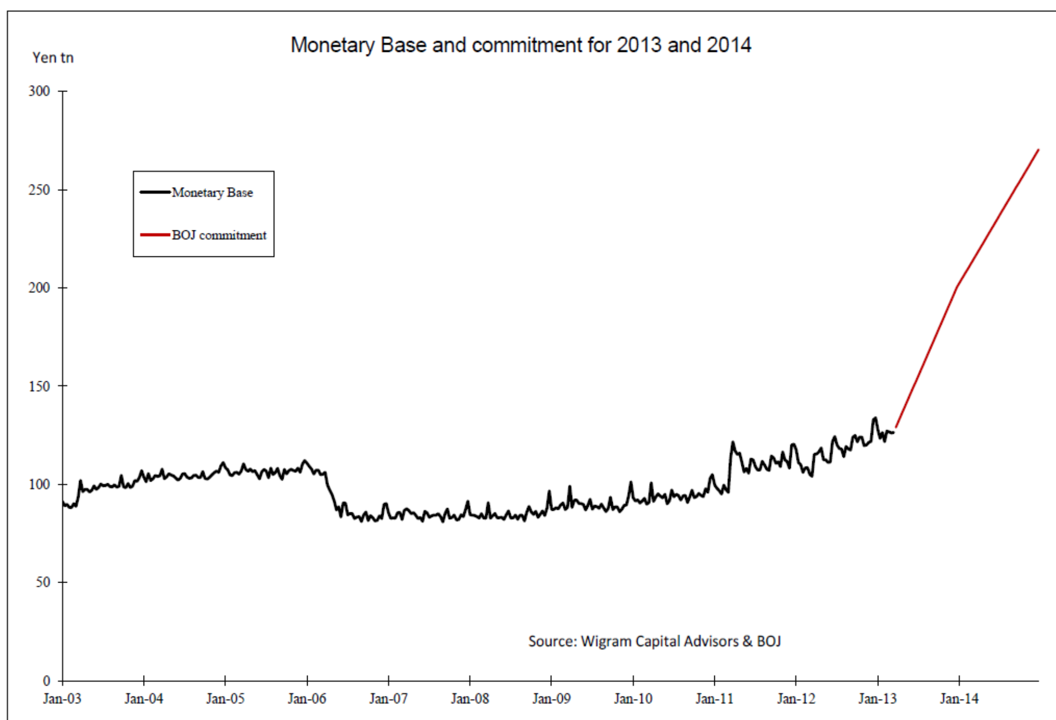
First they ignore you, said Mahatma Gandhi. Then they laugh at you. Then they fight you. Then you win. On the basis of the vitriol that David Stockman's new book has stirred up, he is close to winning – the debate, if nothing else. Someone called Jared Bernstein described Mr. Stockman's book as "a horrific screed, an ahistorical, dystopic, *Hunger Games* vision of America based on debt obsession and wilful ignorance of macro-economics and the impact of market failure". Sounds like America to us. Someone else called David Frum labelled it "primitive" as economics, "silly" as advice and suggested that Mr. Stockman might be suffering from elderly depression. "As an insight into the gloomy mindset that overtakes us in middle age, it's a valuable warning to those still middle-aged that once we lose our faith in the future, it's time to stop talking about politics in public." Perhaps. Or perhaps Mr. Stockman's new book is an accurate portrayal of a dysfunctional kleptocracy beset by venal politicians and inept and greedy financiers in which "politics" is reduced to an endless clown parade of the economically illiterate attempting to perpetuate an illusory boom fuelled only by ever more desperate spasms of unsustainable credit. Thanks to Amazon, we will soon know one way or the other.

These are certainly days of miracle and wonder. Well, of absurd and extraordinary financial experimentation, at any rate. Last week saw the Bank of Japan abandon any last pretence of restraint and topple headfirst into a gigantic pile of monetary cocaine. The scale of the policy is daunting (and could perhaps prove terminal for Japan Inc's finances, if Kyle Bass is correct): the Bank of Japan intends to ***double*** the country's monetary base over two years via the aggressive purchase of long term bonds. In their so far fruitless fight against deflation, the Japanese have finally wheeled out the big guns, what Gavyn Davies called "one of the largest monetary injections ever announced by the central bank of a major developed economy.. a deliberate change in philosophy, and a complete abandonment of everything that the Bank of Japan has said about monetary policy in the past two decades. Those who believe in quantitative easing certainly have their experiment, writ large in Tokyo.. The doubling in the Japanese monetary base over a period of 21 months is in itself remarkable. Taken together with the extension of the duration of bonds purchased from less than 3 years to an average of 7 years, the injection becomes of historic proportions."

Wigram Capital Advisors illustrate the scope of the stimulus. The chart below depicts planned purchases of Japanese Government Bonds (JGBs) over the coming two years:



The chart below indicates the scale of the monetary expansion:

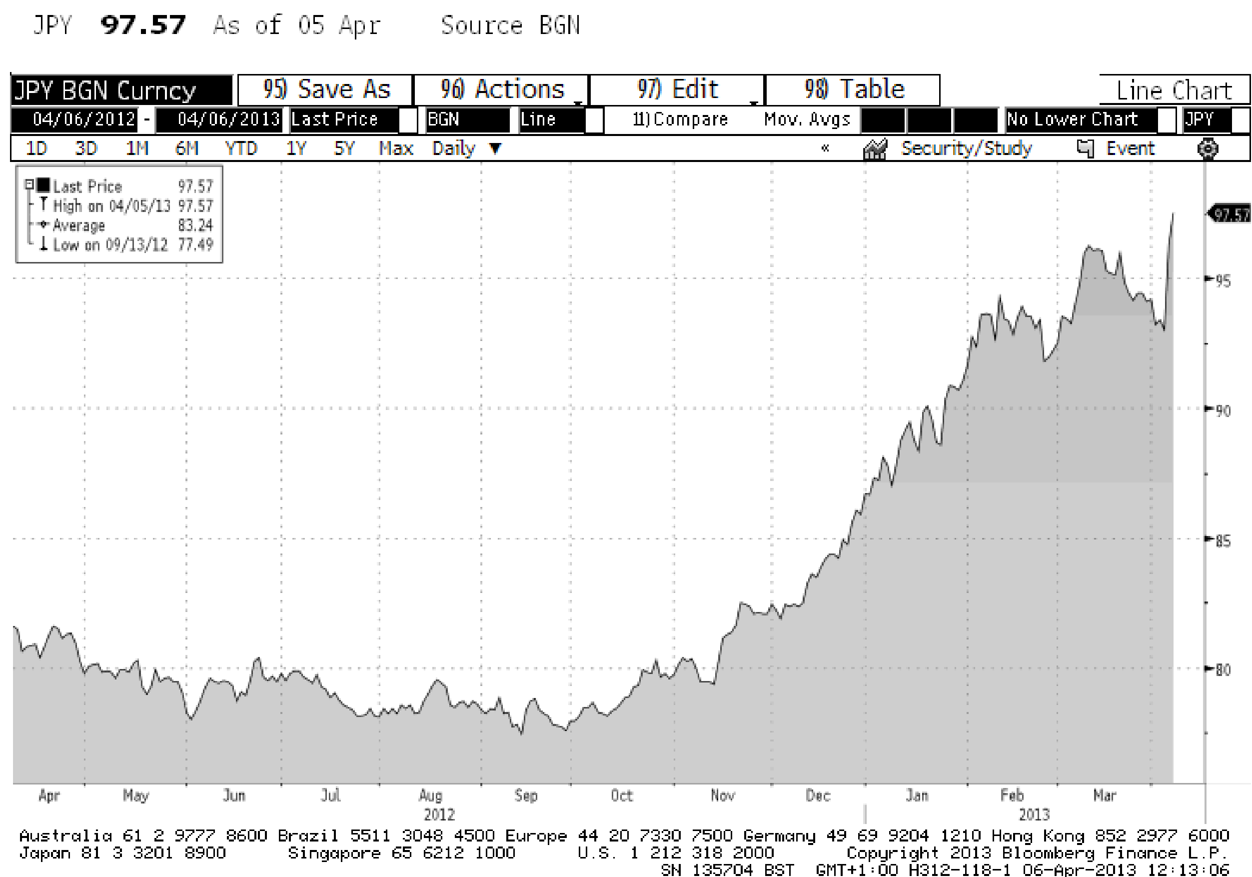


It would be difficult to overstate the drama of this monetary stimulus (although we favour the word ***debauchery***). Japanese traders struggled to come to terms with the enormity of the announcement in its immediate aftermath, and Japanese financial markets enjoyed some wild swings. As Espirito Santo's Marcus Ashworth points out, the BoJ bond purchase machine is going

to gobble up between Y200 to 300 billion of long-dated bonds every week, raising its consumption from Y4 trillion to 7.5 trillion a month, which will account for between 70 and 75% of monthly debt issuance and 45% of all debt issuance beyond 10 years in duration. 10 year JGB yields gapped down to 0.315% (no, that is not a typo), and the 30 year yield, which had been sitting at 1.55% earlier in the week, gapped down to 0.935%. But as the markets struggled to comprehend the implications of a nuclear strike launched effectively at themselves, JGB futures very nearly went limit down three times in a row as circuit breakers kicked in – volatility not seen since Lehman Brothers failed. 10 year yields then ***doubled***, blowing out from that 0.315% low to 0.625%, although one doubts whether much paper actually changed hands. And then one of the Japanese megabanks apparently came in and bought JGB futures in huge size which steadied the ship. As Marcus asks, "Was this ordered by the BoJ to protect the market just as it had launched the biggest buying programme in history ? How weird is that ?"

Plenty weird, obviously.

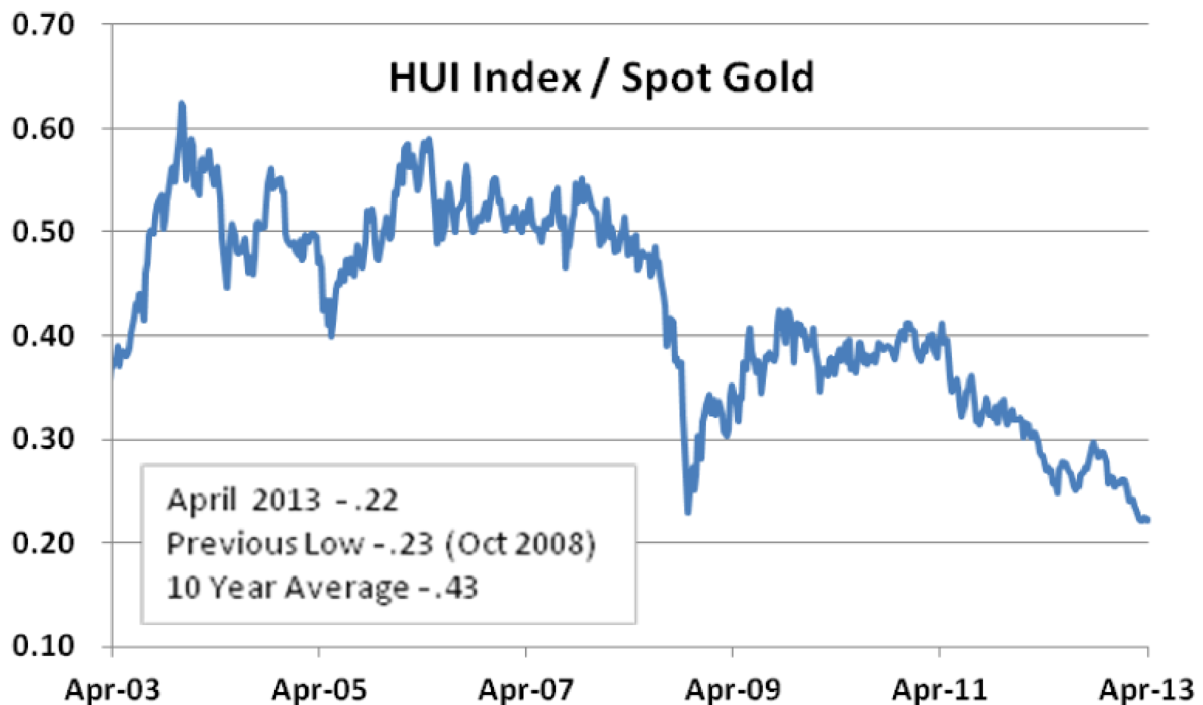
While JGB markets oscillated like a weeble being flicked by Godzilla, the Japanese stock market abandoned any semblance of sobriety and decided to go moon-rocket. Unlike the Yen, which reacted as one might expect on the foreign exchanges when one's central bank has suddenly decided to double one's supply. The recent collapse of the Yen against the US dollar is shown below:



Given the enormity of the BoJ's announced stimulus, long Yen positions for the foreseeable future should either be avoided or else undertaken with extreme care.

As the Japanese monetary authorities declare a holy war against deflation, it would only be fair to draw attention to the colossal opportunity being presented by current markets as the antidote to

monetary intemperance, namely gold and gold miners. We think that the temporary weakness of the price of bullion is closer to being a buying opportunity than anything else in the light of Japan's vast money-printing experiment, and the same likely holds for the price of gold mining companies. QB Partners point out the mismatch between the prices of gold and silver mining shares and spot gold; the HUI is an index of gold and silver miners:



Source: QB Partners Ltd

As they observe, the lower the ratio, the weaker the relative performance of precious metal miners. Quite why the miners are trading so poorly relative to the physical is unclear to us. It may be because the market expects the price of gold and silver to fall (not a belief to which we subscribe, given current monetary events for example in Japan). It may be because the rise of gold exchange-traded funds has removed a natural bid for shares of the miners. And it may be because the market is waiting for goldbug hedge fund manager John Paulson to capitulate on his own holdings of precious metal mining stocks. Whatever. We don't know, and are merely content to play the long – and rational – game. As the good folk at QB point out,

"the ratio [HUI Index / spot gold] is again at its ten year weekly low. If there is any remaining validity to the merits of investing in financial assets based on historical value, this would be the time to buy miners. Obviously, we are aware that value is being suspended by central bank monetary policies; however, we also think the great unpopularity of precious metals in developed economies with large financial asset markets, and the attendant ignorance and small size of the precious metals mining industry, have further forced an almost complete lack of sponsorship. Market cap to reserve ratios remain at insane levels."

They go on to add (and we concur),

"Our strong bias is that prices of bullion will rise significantly. Selling the miners at current absolute and relative valuations would be tantamount to throwing in the towel on the entire

concept of value investing, now and in the future. Our strategy is to buy low and sell higher, which turned into buying low and lower (and lower still) because our sense of value has increased.

"The reality is that we cannot be 100% sure of the outcome from all the monetary mayhem in Europe, Japan and the US, and we do not have a good sense of timing if and when our outcome proves correct. (A capital control template for the EU and yet gold can't find a bid ?!) All we can do is try to recognize value within the context of current and extrapolate-able events."

Doubt is uncomfortable in this environment, but certainty is absurd. We supplement our precious metal holdings (physical and equity) with debt holdings of unimpeachable quality (a hedge against outright deflation), mostly defensive non-metal equities, and uncorrelated funds. Courtesy of the sort of activity now being aggressively pursued by the Japanese, cash has long been a source of liquidity but irrelevant as an investment.

The money printing ritual goes on. In response to the increasingly strident shrieking of the crowd, the monetary fairground ride managers run their machine faster than ever. What price sanity in an insane world ? When the prices of everything are being so grievously distorted, this is not an easy question to answer.

Tim Price
Director of Investment
PFP Wealth Management
8th April 2013.

Follow me on twitter: timfprice

Email: tim.price@pfpg.co.uk

Homepage: http://www.pfpg.co.uk

Weblog: http://thepriceofeverything.typepad.com

Bloomberg homepage: PFPG <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710. Ref 1016/13/JB 080413.