Agcapita Update
January 2011

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THE POLITICIANS AGAINST THE MARKETS

If it is possible for two short phrases to encapsulate the problems we face in the west please give some consideration to these as contenders:
"In some ways it's a battle of the politicians against the markets. That's how I do see it. But I'm determined to win this battle." Angela Merkel, German Chancellor

"How did you go bankrupt? Two ways. Gradually, then suddenly." Ernest Hemingway

Western governments are hopelessly addicted to deficit financing while refusing to address looming funding issues - with apologies to the embarrassingly foolish Angela Merkel, politicians can no more successfully "battle" the markets than you and I can successfully "battle" gravity. How long will governments continue to ignore the fact that countries, like people, can and do go bankrupt - often quite suddenly as Mr. Hemingway reminds us.

Going into 2011 I thought it might be useful to revisit some themes from my 2010 commentaries...

- The financial sector has not been stabilized
- Western government balance sheets are seriously impaired and deteriorating
- Central banks are monetizing government deficits
- The deflation versus inflation debate
- Global growth will not be uniform
- Government pension funds - perhaps not gold plated after all?
- Is the Renminbi peg one of the last things keeping western currencies alive?
- Ask not how high hard assets like gold can rise; rather ask how low fiat currencies can fall

My reason for shamelessly plagiarizing old material is a belief that these critical issues that we face in the west remain largely unaddressed - worse yet many are actually growing. As such they are worth another look if only to act as counterpoints to the inevitable avalanche of "bullish, equity centric, long only" analysis that invariably emanates from the banks, mutual funds, and the mainstream financial media at the start of every new year.

THE FINANCIAL SECTOR HAS NOT BEEN STABILIZED

By subsidizing failure and creating even greater moral hazard the bailouts will increase the amount of mispriced risk in the system - not reduce it. The financial sector has barely begun the process of recognizing and accurately provisioning for existing losses. Examples of large yet mostly ignored exposures abound. Here are just two:

- Commercial real estate debt
- Non-sovereign, government debt - e.g. municipal bonds

Rest assured that current low interest rates will create a host of new problems. Problems that are likely to arise on a scale and in ways that we cannot foresee today - the law of unintended consequences will not be denied. Ask yourself what unsound risks are being taken on to bank, hedge fund, corporate and personal balance sheets today because long-term funding rates are under 3% in many cases?

WESTERN GOVERNMENT BALANCE SHEETS ARE SERIOUSLY IMPAIRED AND DETERIORATING

EU and US net liabilities add up to around $135 trillion - approximately four times the capitalization of the world's equity markets. On top of this mountain of existing liabilities, fiscal deficits are now rising nothing short of spectacularly. The US federal deficit is now over 10% of GDP. These are the worst levels since WWII for the US. By comparison, the US deficit in 2007 was around 2% and peaked at around 4% during the inflationary 1970s. Such massive debts can probably only be repaid with some combination of inflation, tax increases and/or forced austerity - with the smart money betting on inflation.

CENTRAL BANKS ARE MONETIZING GOVERNMENT DEFICITS

By printing money to buy distressed assets, central banks are monetizing government deficits. The mechanism is simple - recipient banks take the newly printed money they receive in exchange for their badly impaired assets and buy sovereign debt. Indirect monetization to be sure, but money is fungible so monetization nonetheless. I would also argue that this monetization is an explicit policy objective. Don't believe me? Here is a summary of some recent central bank printing activity:

- The Bank of England printed £200bn = 2009 UK government deficit.
- The US Federal Reserve printed $1.25 trillion = 2009 US government deficit
- ECB printing €750 for Greek bailout = 2009 EU 27 government deficit

The monetary Rubicon has been crossed so to speak. Once central banks are rid of the philosophical hesitation to print the money to directly fund government financing shortfalls what is left to stop them from any amount of printing, for any purpose? Note that this type of money supply expansion historically has been strongly inflationary.

THE DEFLATION VERSUS INFLATION DEBATE - SELECTIVE ASSET PRICE DECLINES ARE NOT THE SAME AS GENERAL PRICE DEFLATION

Heavily geared asset classes - e.g. banks, sovereign debt, residential and commercial real estate - should suffer further nominal price declines as solvency continues to be an issue and credit is re-allocated within the system. However, selective asset price declines are not the same as a general falling of prices throughout the economy. Money/credit will flow out of falling asset classes and move into new areas of the economy - likely those sectors whose fundamentals remain unimpaired and where debt levels are moderate. Hard assets, such as commodities, appear to be logical candidates.

GLOBAL GROWTH WILL NOT BE UNIFORM

The recovery in the West is not being built on the sound fundamentals for growth:

- Favorable demographics;
- Low national debt levels;
- High savings rates; and
- Persistent trade surpluses.

Compare and contrast this list to the typical situation in most of the developed world:

- Aging populations;
- Large unfunded liabilities for social benefits;
- High total debt-to-GDP levels;
- Low savings rates;
- Increasing government intervention in the economy;
- Large fiscal deficits; and
- Overly accommodative monetary authorities.

By insisting on printing over the systemic solvency issues in the financial sector, by actively preventing the liquidation of decades of mal-investment, by subsidizing speculation and consumption to the detriment of production (and so on) central bankers will not create a recovery. Unless these problems are addressed they are creating an inflationary environment with poor real growth dynamics - i.e. the ideal raw materials for stagflation in the west.

Meanwhile, the emerging economies have most if not all of these critical growth components and are experiencing a once in a life-time industrialization process that is creating a new middle class and a step change in the demand for key commodities.

GOVERNMENT PENSION FUNDS - PERHAPS NOT GOLD PLATED AFTER ALL

I believe we are seeing just the very beginning of the problems we will have to face with pension finances - particularly in the government sector. Aggressive central bank interest rate policies are sacrificing pensions and savers to bail out the banking system. The issue arises because a significant number of pensions assume annual returns in the range of 8% when they are planning how to meet their obligations. As a large portion of pension portfolios are in fixed income securities that are now yielding a fraction of that number, these return assumptions are challenging to put it mildly. The longer zero interest rate policies ("ZIRP") continue the worse the problem will become.

Just how serious is this funding shortfall problem? A recent pair of US studies on municipal and state pension obligations by the Kellogg School of Management found a total funding shortfall at the municipal and state levels of around $3.5 trillion - more than the banking bail-out to date. Retirees who have been promised benefits are going to exert powerful political pressure to be paid in full. Unfortunately, it does not appear that there will be enough cash to pay them and stay solvent. Ultimately, benefits will have to be reduced and/or large amounts of additional capital in the form of higher contributions or newly printed bail-out monies will have to be collected. Barring this pensions may go bankrupt. Global QE 3 and 4 anyone?

IS THE RENMINBI PEG ONE OF THE LAST THINGS KEEPING WESTERN CURRENCIES ALIVE?

The developed world's largest export seems to have become inflation. With few exceptions the west is following expansionary monetary policies and running large current account deficits, most often with China. China in turn seeks to maintain its peg against inherently weak western currencies by accumulating foreign exchange reserves and printing the local currency - the Renminbi. Though increasingly demonized in the western media, the Renminbi peg has acted as an inflation-importing mechanism - without which inflation would be rising even faster in the west due to our profligate monetary and fiscal policies. When China decides to loosen or eliminate the peg - inflation in west will surely receive an unwelcome boost. In the meantime, China is balancing the utility of using the Renminbi peg to fuel domestic industrialization against the cost of importing western, primarily US, inflation that impoverishes Chinese citizens with an artificially devalued currency. The Chinese government is beginning to face the domestic inflation problems inherent in its strategy and is trying to take steps to reduce that inflation without adjusting the peg - akin to trying to have your cake and eat it too. It remains to be seen how this turns out.

ASK NOT HOW HIGH HARD ASSETS LIKE GOLD CAN RISE; RATHER ASK HOW LOW FIAT CURRENCIES CAN FALL

If you believe that gold prices, like most hard assets, are rising because gold is being remonetized then its ultimate price is dictated by how much further fiat currencies will be devalued. Here is an interesting valuation methodology assuming some form of full remonetization: determine what gold price is necessary for each unit of central bank paper to be backed by that country's gold reserves. If, for example, you perform this calculation for the US using M1 as the monetary numerator you obtain the following results:

– Gold reserves - 8,133 tonnes, M1 - US$ 1.8 trillion = gold price of US$6,888/oz

In the spirit of the somewhat whimsical though alarming, I will repeat this calculation for the Canadian dollar:

– Gold reserves - 3.4 tonnes, M1 - C$ 500 billion = gold price of C$4,574,146/oz

Despite the market perception of Canadian dollar strength against the US dollar, the US has much higher, relative gold reserves. Therefore, a move to new de jure or de facto gold standard might have far greater consequences for the Canadian dollar than the US. The Canadian dollar would face an almost 100% devaluation in order to be backed by Canada's current gold reserves. Granted this is a simplistic thought experiment but interesting nonetheless.

The current financial environment gives us almost unlimited material with which to work - unrestrained money printing, government bailouts and even de facto nationalizations of large swathes of the economy, rampant fiscal and current account deficits, banking kleptocracy and so on. In fact, there is so much happening every day, often unprecedented, that it can be difficult to pull out relevant threads. I believe that the most important investment considerations for the next decade are the deteriorating finances of the public sector; a willingness by monetary authorities to fill the gap with newly created money; and a step change in the real growth of the emerging economies. I believe if you can understand and take advantage of these drivers then you should be well positioned.

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