

Sovereign Alchemy Will Fail

Contributed by [Matterhorn Asset Management AG](#)

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by Egon von Greyerz – Matterhorn Asset Management

When we look at the world economy today, wherever we turn we see a wall of risk. And sadly this is an insurmountable wall with risks that are totally unprecedented in history. There has never before been a potentially catastrophic combination of so many virtually bankrupt major sovereign states (US, UK, Spain, Italy Greece, Japan and many more) and a financial system which is bankrupt but is temporarily kept alive with phoney valuations and unlimited money printing. But governments will soon realise that they are not alchemists who can turn printed paper into gold. The consequences of the global financial crisis are potentially catastrophic.

As the Austrian economist von Mises said: *"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion or later as a final and total catastrophe of the currency involved."*

In our view, governments like the US and the UK and many others will not abandon further credit expansion. They are committed to printing increasing amounts of worthless paper money in order to finance the growing deficits and the rotten financial system. **Therefore there is no chance of Quantitative Easing ending but instead it will accelerate in 2010 and after.** The consequence of this will be a hyperinflationary depression in many countries due to many currencies becoming worthless. No economy in the world, including China, will avoid this severe economic downturn which is likely to have a major impact on the world economy for many, many years to come.

Investors are ignoring the risks

What makes the current situation in the world economy so intriguing is that most investment markets have not recognised the risk. Stockmarkets and bond markets rallied substantially in 2009, totally oblivious of the risks. The housing market is down in the US and some European countries like Spain and Ireland. But in many other countries it is still near the bubble highs created by low interest rates and reckless lending.

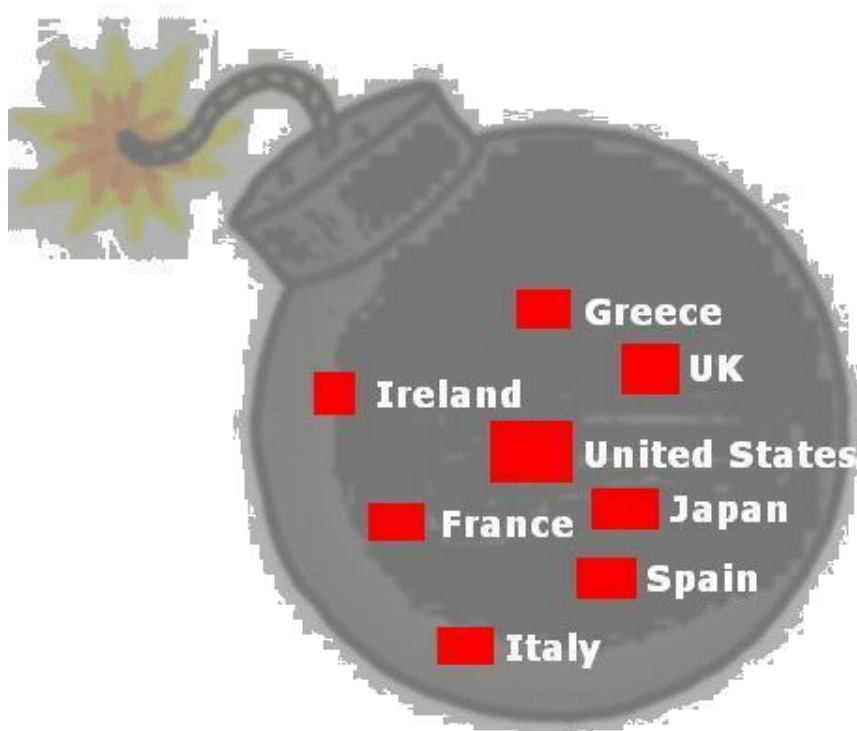
The most important criterion, when taking investment decisions, is understanding the risks involved. Matterhorn Asset Management has in the last few years warned investors about the risks in the financial system due to the massive worldwide credit expansion and money printing. We have found it difficult to fathom so few people realise that the world economy has become a time bomb waiting to explode or more likely implode. All the so called experts have declared that it is impossible to identify the problems in the financial system in advance. For example, Greenspan, Bernanke, Geithner, other central bankers and government officials as well as Blankfein of Goldman Sachs and many bank heads have all stated that they couldn't see it coming. Either they are lying or they are stupid. Sadly, it is most likely the former. It is virtually impossible to find an honest politician. They have one major objective – Power. To attain power they have to buy votes. But to buy votes they cannot tell the truth. No politician ever forecasts bad news because bad news does not buy votes. (Yes, there are exceptions like Ron Paul in the US). And as regards the bankers, it is definitely not in their interest to worry about risks to the financial system. For every year that they issue additional toxic debt and derivatives they earn more in that single year than most normal people earn in a lifetime.

Sovereign Defaults

The list of countries at risk of bankruptcy is increasing by the day. The acronym used to be PIGS (Portugal, Ireland, Greece and Spain). It is now PIIGSJUKUS and growing. The main contenders are currently: **USA, UK, Japan, Spain, Italy, Greece, Ireland,**

France, Portugal, Baltic States, Eastern Europe and many more. On a proper accounting basis all of these countries are already bankrupt, but since many nations can either print money like the US and the UK or increase their already high borrowings, like Greece or the Baltic States, they have technically avoided bankruptcy although in reality all the countries in the list above are basket cases with very little chance of a return to normality. Shown below is what we call the Sovereign Time Bomb. The bomb consists of countries that have a combination of budget deficit and borrowings relative to GDP which puts them into the category "Time Bomb" or high risk of default. These countries have budget deficits from 6% (Italy) to 12.5% (UK, Greece) of GDP and their Public Sector Debts are ranging from 60% (Spain) to almost 200% (Japan) of GDP.

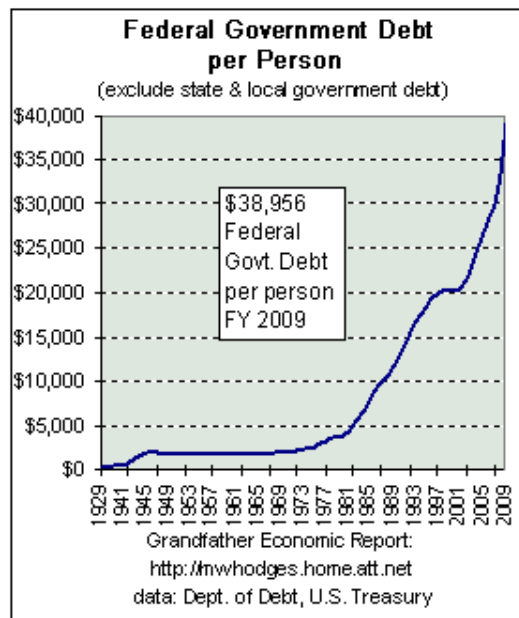
The Sovereign Time Bomb



The problem is not just the current debt levels of these nations, because the deficits in all the countries are rising. Tax revenues are collapsing and with rapidly rising unemployment, the governments' expenses for social charges are soaring. In the US for example the federal deficit in 2009 was \$1.5 trillion (10.7% of GDP) and is forecast to stay around that level for many years. The plight of the US states is just as bad. Out of 50 states only 4 are expected to have a balanced budget in 2010. Up to 40 states, including California, New York, Florida, Illinois, Michigan, Ohio, North Carolina and New Jersey, are virtually bankrupt.

It took almost 200 years for US Federal debt to reach \$ 1 trillion which it did in 1981. In 2009 the debt increased by \$ 1.9 trillion in just that year to \$ 12.4 trillion. In the next ten years the US debt is forecast to reach \$ 25 trillion. And this doubling of the debt does not include any funds to prop up a bankrupt financial system or the spending of tens or maybe hundreds of trillions of dollars on worthless OTC derivatives. The forecast also assumes growth in GDP which is extremely unlikely especially for the next 2-5 years. Currently US Federal debt is six times what it collects in tax revenue every year. With debt exploding and tax revenues collapsing, there is no chance that the debt can ever be repaid with normal money. Also, with debt out of control interest rates will rise substantially to 10-20% per annum. Applying a 15% interest rate to a \$ 25 trillion debt would give an annual interest bill of \$ 3.75 trillion which would be substantially more than tax revenues.

The chart below shows the US Federal Debt per person. In the last ten years it has gone from \$ 20,000 to \$ 40,000. **Total US debt, including private and corporate debt as well as unfunded liabilities, comes to \$430,000 per individual. It is an absolute certainty that every man, woman and child in the US cannot pay off almost half a million dollars with normal money. Only massive money printing will take care of that.**



With these levels of deficits for the next ten years on top of an already massive debt, there is no possibility whatsoever that the US economy can avoid bankruptcy. No country has ever abolished debts of this magnitude by printing paper and the US will not be the first one to succeed either.

Only Lose – Lose Options

Governments have two choices – continue to borrow and print money or reduce government spending. This is a lose – lose situation and whatever choice they make it will end in disaster. Countries within the EMU like Greece or Spain are introducing austerity programmes that forecast their deficits to come down to 3% of GDP which is the EU maximum deficit limit. These are totally unrealistic targets that are mainly based on an improvement in the economy which is total fantasy. The dilemma is that not one single country within the EU is below the 3% limit, not even Germany. And the effect of the austerity programmes will lead to such a major contraction of the economies that tax revenues will collapse, further exacerbating the plight of these countries.

The alternative is to print or borrow more money. Printing is not a luxury that individual EMU members have and for these insolvent countries to borrow money is becoming almost impossible or very costly. But the European Central Bank can print money and this is likely to be the path they will initially choose to save Greece and possibly Spain. Countries like the US and the UK can still borrow and print money. And this is what they will continue to do. With rising deficits, rising unemployment and the problems in the financial system re-emerging they have no choice. Both the UK and the US are set upon a course of self-destruction. We will see trillions of pounds and dollars printed in the next few years. But the only buyers of these government securities will be the US and UK governments. The rest of the world will dump their holdings which will result in both the dollar and the pound dropping precipitously and interest rates rising substantially.

Hyperinflation – Consequences

The effect of a collapsing currency will be a hyperinflationary depression. This is the inevitable outcome for the UK and US and there is sadly no action that the governments of these countries can take to alter this course. We discussed the consequences of this outcome in our July 09 newsletter – “The Dark Years Are Here”. There will be extreme poverty. None of the social safety nets will function. So most of the social security payments that people in need have been used to will disappear or be worthless due to hyperinflation. There will be severe shortages of food which will lead to famine and social unrest. Hungry people are restless people that will take the law into their own hands. This will lead to violent protests, lawlessness, theft and violent crime. And there is unlikely to be a force of law that is paid and functional to deal with the problems. Already today, many US cities and states are cutting down on the police force and their equipment. This trend will accelerate during 2010 due to budget cuts and lack of funds.

There will be massive cuts in education and many schools will close due to lack of resources. Pensioners will be major sufferers. Many pension plans are unfunded but also the funded ones will be decimated. Pension funds are invested in three areas – equities, bonds and real estate. All three are likely to go down by at least 50% but probably more like 75% at least, all in real terms.

Deflation and Inflation

Most economists and financial analysts disagree with the hyperinflationary scenario and believe that the deleveraging of debt will lead to a deflationary downturn. That scenario would be more likely if countries like the US and UK were not printing endless amounts of fiat money. As we have explained above the printing presses will not slow down but they will accelerate in coming years. The UK's announcement that they will cease Quantitative Easing is just a temporary measure that won't last. Governments detest deflation because they know that deflation after uncontrolled credit growth would lead to an implosion of the financial system and the economy. Virtually all bank loans and OTC derivatives have been issued against inflated and unsustainable asset values. In a deflationary economy with falling asset values, falling wages, falling corporate profits and falling government revenues, there is no possibility that the massive amount of bank credit outstanding can be serviced or repaid. Therefore the banking system would not survive due to their massively inflated balance sheets and low equity. This is why governments are petrified of deflation after a sustained period of asset and credit bubbles. So their only option is to print whatever money is required to stave off deflation. And this is what they will do. There is absolutely no doubt about it. But they are doing this in total ignorance of the consequences.

Governments created the financial crisis

The current financial crisis was not created by the banks. It was created by governments' irresponsible policies of buying votes by manipulating the financial system through constant money printing, especially since the creation of the Fed in 1913 and the abolition of the gold standard in 1971. In addition they have used interest policy as a popularity contest thereby creating a totally artificial market which distorts the normal laws of supply and demand. It is clearly ludicrous to artificially keep interest rates at 0% and print massive amounts of money. Neither governments, nor banks should be allowed to create money out of thin air or interfere with market forces by artificially setting interest rates. It is this corrupt manipulation of the financial system and the economy that has totally destroyed the value of money in the last 100 years. Measured against gold, the dollar and the pound have declined by 99% since 1913. This would not have happened if governments had not been allowed to use the financial system as a voting machine. But sadly this will continue at an accelerated pace in the next few years. **Governments seem totally incapable of comprehending that they cannot solve the world's greatest financial crisis by applying more of the same toxic medicine that created the problem in the first place.**

The prosperity illusion

When you live in the midst of history you don't realise that you are part of making extraordinary history. Therefore most people don't understand that the last 100 years has been an extraordinary period in history and even more so the last 20-30 years. The perceived prosperity and increase in living standards have been achieved primarily through massive increases in borrowing, both by governments and by individuals. Take away the enormous debt that has been created during this period and the world would be a lot poorer. Alternatively, apply a market rate of interest on the debt. If governments had not manipulated interest rates and set them at artificially low levels, the normal forces of supply and demand would have forced rates considerably higher, most probably in double digits. The higher rates would have reduced demand for credit and thereby prevented the credit and asset bubbles that have caused the worldwide financial crisis. In recent years, Greenspan reduced rates from 6% to 1% between the end of 2000 and 2003. And Bernanke again applied the only remedy that central bankers know, in addition to printing money, when he reduced rates from 5% to 0% between 2007 and 2008. These people seem incapable of understanding that simple laws of supply and demand would have repaired the economy automatically without their incompetent and desperate interventions. By leaving monetary policy to market forces we would have normal recessions and minor booms that would be totally self-regulating. What the central bankers instead have created is the most enormous bubble in world history. And sadly like all bubbles, this one can only end in a disaster of a magnitude that will affect the world for a very, very long time.

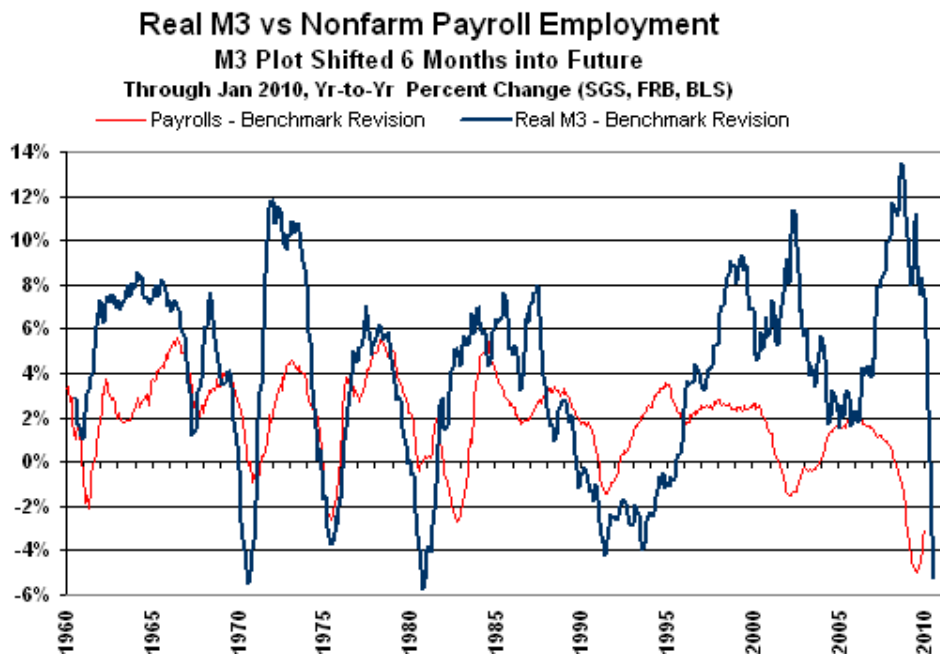
So the last 100 years will be seen in history as an extraordinary period when governments thought that they had invented a new economic miracle based on unlimited credit and money printing. But sadly this miracle will be seen by future historians as another failed delusional economic theory dreamed up by politicians.

Risk of systemic failure of the financial system

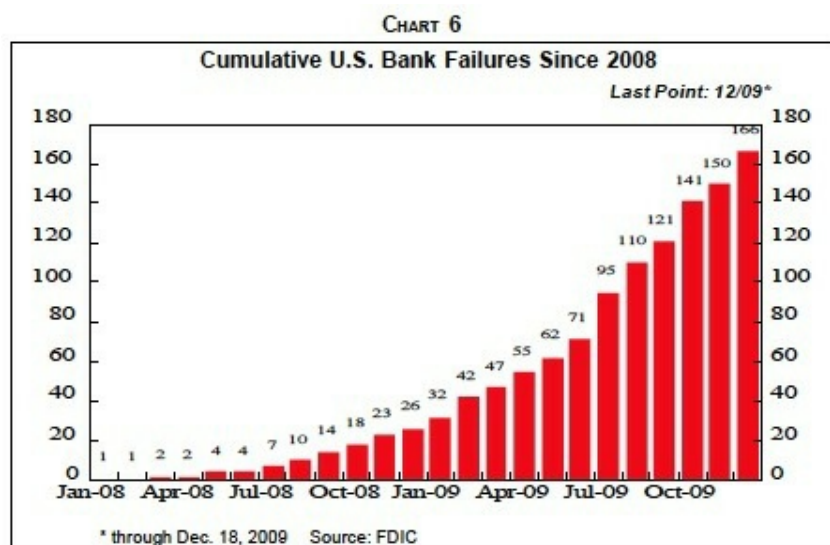
The current financial crisis started due to the uncontrolled, worldwide debt and asset bubbles. The subprime defaults were just the first symptom of the lethal concoction of credit and OTC derivatives that the bankers had constructed for their own personal gain with no understanding of the risks or the consequences. Governments and central banks worldwide injected or guaranteed around \$20 trillion just to save the financial system. But the only people who have benefited from this are the people who caused it. Very little of these enormous sums went into the real economy. In addition to this enormous liquidity for the benefit of the banking

system, governments have allowed banks to value their assets at totally false prices not based on market values but on the hope that they will achieve full value at maturity. To further assist the banks governments worldwide have reduced interest rates to zero percent. So with trillions in fresh liquidity, zero interest rates and valuing assets at fantasy prices, many banks have produced record profits and paid record bonuses.

Money supply in the US as measured by M3 is collapsing. The chart below shows how M3 has declined almost 6% year on year. This particular indicator has been very accurate in forecasting the major economic downturns in the last 40 years and is now at the same level as before the 1970s recession.



None of the problems that caused the banking crisis in 2007-8 have been solved. They have just been swept under the carpet. In the US 140 banks failed in 2009 against 25 in 2008 and only 11 banks in the five preceding years. So far in 2010 a total of 15 banks have failed and been taken over by the FDIC (Federal Deposit Insurance Corporation). Virtually all the banks that fail show losses that are far greater than the balance sheet valuations. Of the circa 6,000 US banks, a major percentage will fail in the next few years due to rapidly declining asset values. This will also be the case for many of the major international banks. If their assets, and in particular their OTC derivatives were valued at market, very few banks would be solvent today. In addition, resets of mortgage loans, commercial real estate loans, credit card loans, private equity loans etc are all problem areas that could bring major banks down.



The risk of terrorism

Terrorism is an imponderable and it is therefore impossible to forecast where or when it could happen. With 700 US bases in 120 countries and with the US, UK and other countries' involvement in Iraq and Afghanistan, the alienation that this creates especially

in the Muslim world, poses a major threat of terrorist attacks especially in the US and UK. The terrorists are almost always ahead of the intelligence agencies and security services. Therefore it is impossible to forecast how, where or when the next attack will happen. It could be planes, it could be shopping centres, or it could be a cyber war against major international computer networks. The more troops that the UK and US send to Afghanistan the higher the risks of terrorist acts against them. The greatest likelihood of preventing or reducing terrorism would be for the US and the UK to close all foreign military bases and to withdraw all troops. Sadly, that is a very remote possibility.

Markets

In January 2009 we forecast that stockmarkets were likely to correct up to 50% of the down move before continuing the bear market. The Dow Jones corrected just over 50% but it took a bit longer than we expected. The correction is now finished and the primary trend of all stockmarkets is now resuming its downtrend. We are expecting very substantial falls during 2010. This will not be a year to be invested in general equities. We expect precious metal shares to do very well even though initially they will come down with the market.

Bonds

One year ago we predicted that US long bond rates would rise. This is exactly what happened and the 30 year Treasury Bond yield went from 2.5% to 4.6% during the year. We expect US and UK bond rates to continue to rise in 2010. This will be as a result of foreign holders selling their holdings of these bonds due to the dire economic situation in the US and UK and the currencies weakening. International investors are not prepared to finance bankrupt sovereign states without getting ample reward for the risk.

Currencies

Most people judge currencies on a relative basis. This is a very poor measure of the value of a currency since it doesn't take into account the total destruction of paper money in the last 100 years. We showed in our December report ("Gold is not going up – Paper Money is going down") that most major currencies including the dollar, pound, Dmark/Euro and Yen have all declined 99% against real money – gold – since the creation of the Fed in 1913. Thus, all currencies are weak and they will continue to be attacked one at a time. Fundamentally the dollar is the weakest currency and we would expect the next leg down to start relatively soon.

The Euro also has its problems and is suffering from the problems of its weakest members – Greece, Spain, Portugal, Italy, and Ireland. Like all artificial currencies the Euro was doomed to have a relatively short life in its original form. We predicted this long before its birth in Maastricht in 1992. Short term the European Central Bank will support Greece and all other EU nations that need support. Longer term, once too much worthless money has been printed by the ECB without solving the problems, the European Monetary Union is likely to break up.

But the current fear over Euroland and the weakness of the Euro relative to the dollar is overdone. The Euro zone budget deficit to GDP is 6.7% and debt to GDP is 88% whilst the US deficit is 10.7% and debt 92%. So on this basis it is extremely unwise to shift funds out of the Euro and into US dollars especially since the underlying fundamental problems are much greater in the US.

All the countries of the major trading currencies – the Dollar, Euro, Pound and Yen – have major economic problems that can only be resolved by massive money printing. This is why it is a futile game to try to predict which currency will be the weakest out of the above four. They will all weaken substantially but not at the same time. Therefore, we will have incredible volatility in currency markets in the next few years whilst speculators lose their shirts jumping from one currency to the next. There will be very few winners in that game.

So are there any currencies that are better? Yes, relatively, the Norwegian kroner, the Canadian dollar and possibly the Swiss Franc and Australian dollar will do better. The Renminbi will also do well but is difficult to invest in.

Gold

So whilst many paper currencies become virtually worthless in the next few years, gold will continue to do what it has done for 6,000 years. It will maintain its purchasing power and therefore appreciate substantially against all paper currencies.

The recent correction in gold is the weak hands getting out of speculative positions in the paper gold market. There has been

virtually no selling in the physical market.

So far gold has gone up more than four times in the last ten years in a stealth market that very few investors have participated in. The table below shows the extraordinary return that investors in gold have achieved in the last 5 and 10 years. There is no other asset during this period that has given such an excellent return whilst at the same time providing the highest form of wealth protection (provided it is physical gold).

Average annual return on over 5 and 10 years

Period/Currency	US Dollar	Pound	Euro	Yen	Swedish Kr.
2000 – 2005	9.7% p.a.	5.2% p.a.	2.3% p.a.	8.8% p.a.	11.0% p.a.
2005 – 2010	20.4% p.a.	25.0% p.a.	19.1% p.a.	19.2% p.a.	19.4% p.a.
2000 – 2010	15.1% p.a.	15.1% p.a.	10.7% p.a.	14.0% p.a.	15.2% p.a.

Return last 10 years

Over the last 10 years a US and UK investor would have made an average return on gold of 15.1% per annum.

Return last 5 years

In the last 5 years until the end of 2009, the lowest annual return on gold was in Euros with 19.1% per annum and the highest in Pounds with 25% p.a.

These are absolutely outstanding returns which most investors are totally oblivious of.

But the awareness will change in the next few years as gold rises even faster.

Many investors, including George Soros, who have missed the bull market in gold (or the bear market in paper currencies), now believe that gold is overbought and therefore it is too late to invest. The next chart disproves that theory totally. The chart shows gold in 2009 dollars adjusted for real inflation. Shadowstats.com is a superb service which analyses government statistics on a true basis, taking out all adjustments, revisions and other manipulations. Applying the true inflation rate on the gold price shows that the gold high in 1980 of \$ 850 in today's terms is \$ 6,400.



Governments have suppressed the gold price in the last 30 years by both overt operations (official gold sales) and covert operations (manipulations in the paper gold market and unofficial sales). Central banks are supposedly holding 30,000 tons of gold but credible estimates suggest that this figure is around 15,000 which means that 15,000 tons of central bank gold has been sold covertly to depress the price. But the effect of manipulation of any market has a limited time span, especially if it is done in connection with a total mismanagement of the economy. Central banks have now stopped official sales and China, India, Russia and many other countries are major buyers. Production is falling steadily and investment demand is soaring. With the fundamentals so much in gold's favour, it should have no problem to reach the 1980 inflation adjusted high of \$ 6,400. With inflation or

hyperinflation gold will go a lot higher than that.

During the next phase up in gold which we expect to start within the next few weeks, main stream investors will discover what only a few investors have understood in the last ten years, namely that physical gold is one of the very few ways to protect their assets and preserve capital.

11th February

Egon von Greyerz

matterhornassetmanagement.com

http://beforeitsnews.com/story/17499/Sovereign_Alchemy_Will_Fail.html