



HOW TO SURVIVE AND PROSPER IN A STAGFLATIONARY ENVIRONMENT

Today's financial world is a minefield. There is massive divergence in performance in different markets and sectors; European stockmarkets are down around 15-20% this year, US slightly less whilst some Asian markets are down in excess of 30%. Certain sectors such as Banks and Property are down 50-80%. On the other hand we have seen substantial gains in commodities, especially food and energy (crude up 42%, corn up 59%) and also in precious metals. These trends are likely to continue for at least 2-3 years and probably a lot longer during which time commodities (especially precious metals) will outperform most other investment markets.

We have been warning investors about this scenario for the last few years. But ***let*** us be very clear, the economic and financial problems in the world have only just started. We will at best experience a period of high inflation and possibly hyperinflation in some countries (e.g. USA) combined with economic contraction. This is STAGFLATION. This will lead to serious economic problems for most countries in the world. The combination of credit contraction, low economic growth or even decline with very high increases in food and energy prices will put enormous pressure on consumption. This will lead to poverty and famine in the developing world where food prices represent more than 50% on income. It will also lead to severe hardship in the industrialised world. But all of this should not come as a surprise to our investors since we for some time have been forecasting stagflation and major problems in the credit markets.

In the last few years politicians, central bankers, bankers many so called experts have been forecasting a goldilocks economy. Not only did all these people not foresee the current problems but they are at regular intervals proclaiming that we have seen the worst. **DO NOT BELIEVE A WORD OF WHAT THEY ARE SAYING.** First of all they all have a vested interest in things improving, whether it is being re-elected or receiving big bonuses. Secondly since none of these people forecast the current crisis nor are they capable of forecasting the end of the crisis.

Let us look at where we are:

- The banking crisis has a long way to go. Writedowns so far are \$ 400 billion. We expect that this figure will rise to \$ 1 – 1.5 trillion at least. Governments will have to print massive amount of money to save the banking system.
- In addition there are derivatives outstanding of **\$ 1.1 quadrillion** (\$ 1,100 trillion). A major part of these derivatives are worthless. A ½% loss ONLY, would amount to \$ 5.5 trillion which is well above the market capitalisation of all the banks in the world.
- Inflation is a major problem and rising. Real inflation in most countries is above 10% although many governments are fudging the figures and showing much lower rates.
- Governments/central banks are paying lip service to fighting inflation but due to the weak economies and the massive amount of credit outstanding rates cannot be increased by any meaningful percentage.
- Banks worldwide are deleveraging substantially which will reduce economic activity.
- Many major banks are under severe financial pressure.
- The majority of western governments are running budget deficits. These deficits will rise substantially as economic activity turns down, leading to money printing.
- Most currencies will decline due to money printing with the US\$ going down the most.
- Gold will emerge as the strongest currency.
- Commodities, especially food and energy are in a long term uptrend.
- Most stockmarkets are down 40-50% against gold in the last 12 months.

INFLATION / STAGFLATION

The biggest problem facing the world is -flation. We have massive **inflation** or price increases in commodities especially food and energy and also in precious metals. At the same time we have **deflation** in property and stock markets. This trend of assets down and commodities up has many years to go.

In the US core inflation is currently 4%. Official high inflation is against governments' interest. Therefore the method of calculating inflation is manipulated in order to suit the objectives of the government. If the method used during Reagan's presidency was used the **official US inflation would be 11.6%! today** instead of 4%. It is similar in most countries. In the UK official inflation is 4% but every consumer knows that real costs are going up substantially more. A recent calculation showed a real inflation rate of 11% in the UK.

With massive increases in food, petrol, heating costs and electricity as well as mortgage rates, consumers in most countries are experiencing an intolerable increase in the cost of living well in excess of 10%. This will lead to hardship, a decrease in consumption as well as higher wage demand pressures. And all of this is at a time when most individuals have very high

debts (mortgages, credit cards, personal loans). During the period of rising property prices houses were used as a cash machine by increasing borrowings to finance consumption. But that is all gone now. With falling house prices and banks raising rates many individuals are starting to face real hardship.

In the 1970's which was the last period of high inflation (circa 15% in the US, UK etc), it was different. At that time there was house price inflation as well as wage inflation. Today that is unlikely to happen. House prices are in a strong downtrend. Most companies already have cost pressures and will resist higher wage demand. Also unions are substantially weaker today. In addition, credit outstanding was then substantially lower as a percentage of GDP. Therefore the situation is a lot more serious than in the 70's.

During the 1970's there was one economic figure which was more followed than any other namely **money supply**. This weekly figure had more influence on markets than any other economic data. Today money supply is totally ignored. In the US Greenspan abolished the publication of M3 (because it was going up too fast). Based on the distinguished Austrian school of economists (von Mises) inflation is not defined as increasing prices but as **increase in money supply**. Increases in money supply mainly arise from governments printing money due to budget deficits or credit crises. It is the increased money supply that creates inflation and nothing else. If money supply increases faster than real GDP that will create inflation. In the 1980's and 90's the increase in money supply resulted in asset inflation with equities and property prices going up. Today money supply is increasing by 20% in the US and 12-15% in Europe. Inflation in the East is a real problem and around 15-20% in many countries. **It is this increase in money supply that will lead to continued very high inflation in the world.**

But this time there will be no inflation (in real terms) in property or equities which are in a downtrend. Instead the inflation will affect food, energy and commodities. The combination of high inflation and economic decline is called stagflation and is the worst of all worlds. The USA which has the biggest credit bubble of any country could easily have a hyperinflationary economy within the next few years. This could lead to major asset destruction and a banking crisis.

BANKING SYSTEM

Many banks are fighting for survival - UBS, Citigroup, Lehman, Wachovia, Fannie Mae, Freddie Mac and many more are virtually bankrupt (the last two have combined capital of \$ 81 billion with equity of \$ 5.3 billion, a 65x leverage). So far the authorities have allowed them to drip feed the market with their writedowns in order to raise capital in an orderly way. But the next round of capital raising from banks will be more difficult. Sovereign funds which provided most of the first round capital now have massive losses on their investments since bank shares are in a strong downtrend. Therefore these funds are unlikely to throw good money after bad. Instead it will be the lenders of last resort – governments- which will rescue the banks. This will lead to more money printing and more inflation.

We have repeatedly been warning investors of the risks of the massive derivative mountain. The BIS in Basel (Bank for International Settlement) has produced revised statistics which shows that the total derivative value is now \$ 1.1 quadrillion. This is 78 times GDP of the USA. Over half of this amount - \$ 600 trillion - is in OTC (over the counter) instruments. They are not regulated, not traded on any exchange and there is no market to determine the price. The particular problem area is the Credit Default Swaps (CDS). There is \$ 60 trillion outstanding in this area and most of it is linked with the credit problems in financial markets. A major part of this \$ 60 trillion cannot be valued and is worth substantially less than the nominal value outstanding. This area is not likely to be resolved in any other way than by governments buying the instruments at full price with printed money.

International banks have so far laid off in excess of 50,000 employees. With the reduction in activity and the deleveraging of balance sheets banks are likely to show continued decline in profitability or worse – increasing losses.

DEBT

The US debt situation is totally out of control. In summary it looks like this:

| | |
|--|-----------------------|
| Government debt | \$ 10 trillion |
| Unfunded current government liabilities (Medicare and Pensions) | \$ 70 trillion |
| TOTAL US GOVERNMENT DEBT | \$ 80 TRILLION |
| Other US debt (private, commercial, state etc) | \$ 43 trillion |
| TOTAL US DEBT TRILLION | \$ 123 |

This is almost 10 times US GDP or \$ 1.1 million of debt per US household.

US taxpayers are not ever going to be in a position to repay this debt. It either has to be inflated away by the government printing money or alternatively there will be a debt implosion with severe deflationary implications. There is no other alternative.

Although the US has the highest debt of any nation per capita there are many countries in a similar situation. The UK is not far behind and there are major problems in many European countries, Ireland, Spain, Italy, Iceland and Greece to mention a few. Many Eastern European and Baltic states are also in trouble. For example, Latvia's current account deficit is 23% of GDP and Bulgaria's 22%.

INTEREST RATES

Real interest rates, especially if real inflation rates are taken into account, are negative. Central Banks have a massive problem; on the one hand their mandate is to combat inflation but on the other hand they must not kill off the economy. The US Fed is paying lip service to the inflation problem but is unlikely to increase rates due to the mortgage and bank problems. The ECB's only focus is inflation and not employment and might therefore raise rates marginally. It is questionable if in medium term they can withstand the political pressures from their masters to reduce rates with the economy slowing down.

Although the economic problems in the short term will keep US rates low, it is our view that a falling dollar and inflationary pressures will put upward pressure on bond rates with the manipulated short term rates to follow. This will eventually lead to much higher interest rates worldwide.

CURRENCIES

There is no change in our outlook for currencies. The combination of money printing and high inflation will continue to put pressure on all currencies. The US dollar will decline substantially against all currencies. Against the Swiss Franc our forecast of below 50 cents – a 50% decline for the dollar – still stands. When currencies fall dramatically there will be exchange controls so investors should keep some of their funds outside their own country preferably in Switzerland.

PRECIOUS METALS

There is only one currency - gold – which cannot be printed and therefore will appreciate against all other currencies. The escalating inflation that we will experience in the next few years combined with money printing will be extremely beneficial to precious metals. Gold production is declining worldwide. Total annual gold supply (including government sales) is \$ 106 billion. Out of this circa 85% is used for jewellery and industrial purposes. That leaves circa \$ 16 billion for investment. This amount is a mere **1 per mille of total financial assets**. Currently most asset managers are not investing in precious metals. This will change. But there is not enough supply at the current price to satisfy even a small increase in demand. This fact was confirmed in a recent private meeting we had with the Head of Gold Trading at one of the top US investment banks. He confirmed that when he buys more than \$ 30 million of physical gold he has real a problem covering himself in the market. He also confirmed that whenever gold declines Chinese banks are buying.

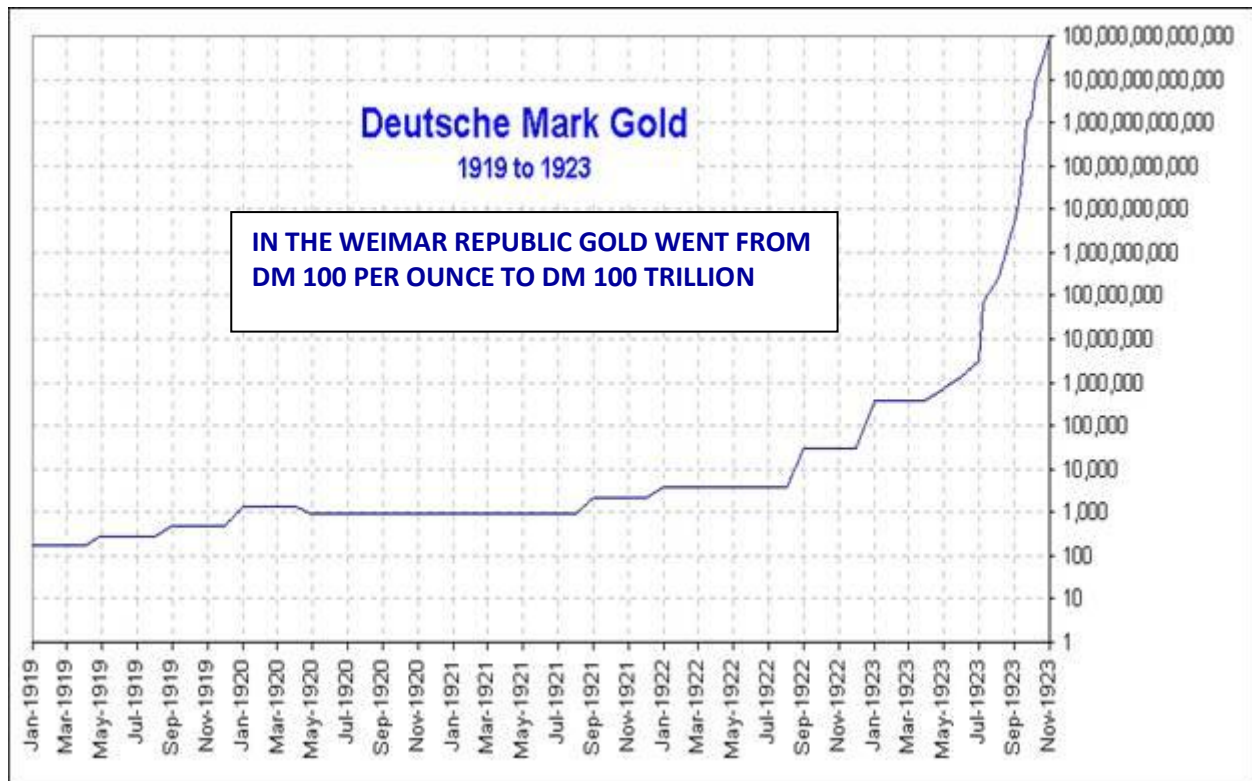
The consequence of the limited supply of gold (and even more so of silver) combined with increased investment demand will have a major impact on price. Gold has been correcting for the last three months but we now see the next strong up move starting. The move in precious metals in the last

few years, although considerable, is in our opinion only the beginning of a very strong move that at some point could become exponential.

The Dow Jones has declined 72% against Gold since the peak in 1999. See the chart below. Many stockmarkets show similar declines. The current ratio is now 12 i.e. the Dow stands at 12x the price of gold. We expect this ratio to decline to below par (below the 1980 bottom) in the next few years. The interesting question is if the two will cross at for example Dow 5,000 and Gold \$ 5,000 or maybe with both at 10,000. Time will tell!



Another interesting chart is what happened to Gold in the Weimar Republic. During the period of hyperinflation between 1919 and 1923 gold went from 100 marks per ounce to **100 trillion marks per ounce!** This is what money printing and hyperinflation can do to a currency. (see chart below)



Since we decided to put a major part of investors' assets into physical gold (stored outside the banking system), this is the performance in various currencies:

Performance Gold investment portfolio 2002-2008:

| Currency | Total return 2002-2008 | Average return p.a. |
|----------------------|------------------------|---------------------|
| US \$ | 205% | 34% |
| £ | 130% | 22% |
| Euro | 96% | 16% |
| SEK (Swedish kroner) | 90% | 15% |

THE NEXT FEW YEARS – INVESTING IN A STAGFLATIONARY ENVIRONMENT

We have been consistent in our views about the coming stagflation. We are now in it but only at the beginning or possibly the end of the beginning. Thus there is a long way to go. So far we have been well served and protected by our investment strategy in precious metals. This development is likely to continue in our favour probably in an accelerating trend.

Our views have not changed as a matter of fact they have been reinforced by recent market activity and government/central bank actions. Let us

repeat what we have been saying for quite some time; there **is only one solution to the current credit crisis and economic downturn namely money printing leading to inflation/stagflation**. The additional element of a commodity boom which is a function of demand outstripping supply will put enormous pressure on the world economy and financial system. Governments have to continue to expand liquidity by printing money thus fuelling inflation. If governments should fail in their efforts the risk of a deflationary implosion and credit collapse would be very high. In both scenarios precious metals will benefit greatly.

We still don't like the stockmarket although in a hyperinflationary scenario equities could go up in inflationary terms but obviously not in real terms. This happened in Weimar as well as in Zimbabwe. Cash will lose value with inflation and should be kept to a minimum preferably in Swiss government instruments. Property will continue to be under pressure in real terms.

What makes the next few years particularly interesting, in spite of the very difficult economy that we will experience, is that there are outstanding opportunities that investors should take advantage of.

27 June 2008

Egon von Greyerz
Matterhorn Asset Management AG
Bahnhofstrasse 28A
CH 8001 ZURICH
Switzerland

www.mamag.org