



IS THE BANKING SYSTEM A HOUSE OF CARDS?

The answer to the above question is an unequivocal **YES!** We have for a long time warned investors of the fragility of the banking system due to the combination of the unmanageable mountain of OTC (over the counter) derivatives totalling \$ 525 trillion combined with reckless lending in mortgage loans, personal credit, credit cards, car loans as well as too aggressive commercial lending both in real estate and private equity. Without the rescue of Bear Stearns we would have had a systemic crisis with catastrophic consequences for the world economy. But in the short term the Fed (and other central banks) are solving the problem by printing whatever money necessary to save the system. This is the only option available to them to stop the house of cards from collapsing.

Bear Stearns – rapid Fed intervention gives banking system a temporary reprieve

As we have argued since the credit crisis started in August 2007, this is not just a liquidity crisis, it is a solvency crisis. Without the Fed's and US treasury's intervention on 16 March Bear Stearns would have gone under. But the Fed wasn't just worried about Bear Stearns but was fully aware that the domino effect would have led to a major financial crisis. Therefore the Fed "gave" JP Morgan Chase \$ 30 billion to facilitate the purchase. If these funds prove insufficient (which they most probably will) the Fed will have to continue to inject funds by printing more money. Many banks are on the verge of bankruptcy. Without the rescue of Bear Stearns it was said that Lehman and Morgan Stanley would not have survived. But we also know that Citigroup, UBS, Credit Suisse and many others are under enormous pressure for survival. UBS just announced another writedown of \$ 19 billion on top of the \$ 18 billion in 2007. Without capital injection UBS would by now virtually have consumed all its equity and been bust. Deutsche Bank also announces a \$ 4 billion writedown today. Lehman's just raised \$ 4 billion to prop up its balance sheet. It is likely, due to the precarious financial position of Lehman's, that the Fed had a direct or indirect involvement in supporting this fund raising. The Fed (and other central banks) are working behind the scenes in order to prop up a financial system which is on the verge of collapse. The direct and indirect support by central banks will temporarily postpone the problem. But the system is toxic and at best central banks will through money printing manage a semi-orderly wind down of the credit excesses leading to massive monetary inflation. Should this rescue operation by the worlds' central banks fail the result would be unmanageable.

Writedowns will be in the \$ trillions

When we last November forecast that bank writedowns linked to the mortgage market would amount to \$ 400-500 billion there were few believers. Total writedowns so far amount to \$ 250 billion but we have only scratched the surface. The subprime writedowns are now spreading into the normal mortgage market. The housing bubble in many countries is currently bursting (USA, Spain,

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Ireland etc). But there are many markets which have just started a decline which has a lot further to go (UK, Australia, France, Scandinavia etc).

In the US there are currently 9 million mortgages with negative equity exceeding \$ 800 billion. House prices have officially fallen by 12% but distressed sales are taking place at values of 25-50% below peak value. The same trend will spread to most other overextended property markets worldwide.

Due to unsound lending against inflated security or no security at all the estimates are that total writedowns just in the USA could reach **\$2 trillion** or more. This includes home loans, commercial loans, personal credit, car loans, monoline insurers, private equity loans, hedge funds etc. This massive amount of \$ 2 trillion exceeds the total capitalisation of US banks, government agencies and savings banks which have total equity capital of \$ 1.7 trillion.

Leverage

Several hedge funds have gone under in the last few months. The market was astounded when Carlyle Capital (a hedge fund set up by the private equity group Carlyle) went under whilst leveraging investors funds 32 times with investments in AAA mortgage instruments. This magnitude of leverage is not unusual in the hedge fund industry. More importantly it is common place among US investment banks. Goldman Sachs, Merrill Lynch and Morgan Stanley to mention a few have all leveraged their capital by around 30 times. Thus, the reason for the high historical profitability of these banks is due to their massive leverage and risk taking. They call themselves banks when they in actual fact have been operating as hedge funds. In addition to the leverage of around 30 to 1 they also carry massive off balance sheet exposure to derivatives which increases the leverage exponentially.

Derivatives – an accident waiting to happen

The above losses do not include any significant losses arising from the \$ 525 trillion OTC (over the counter) derivatives issued by banks and other financial institutions. These are instruments that are not traded on any exchange, have no market price and where real values are substantially below assumed values. Since there is no market for most of these derivatives banks are valuing them “to model” which conceals additional substantial losses. Furthermore there are virtually no reserves held against these instruments since all parties assume that their counterparties will pay up. But if a counterparty fails the domino effect will lead to the gross value of \$ 525 trillion being at risk. This is why the Fed had no option but to save Bear Stearns. This bank has \$ 13 trillion of derivatives outstanding which all would have been exposed. But who does the Fed choose to support to rescue Bear Stearns? Well obviously the Fed needed to choose the bank – JP Morgan Chase - with the highest derivative exposure of the whole banking system, by a wide margin. JP Morgan Chase has **\$ 77 trillion** of OTC derivatives. Therefore the Fed did not only save Bear Stearns with its intervention but also the bank which was most at risk. JP Morgan Chase /Bear Stearns now has a combined derivative exposure of **\$ 90 trillion** or 17% of the total outstanding worldwide. A 1.3 per mille loss on their gross derivative position is enough to wipe out their capital.

You don't have to be a financial genius to understand that an exposure which is almost 6000 times greater than your capital is a time bomb or as we said in our last report a financial weapon of mass destruction.

Inflation

The published inflation figures in most western countries are still under 5 %. Increase in money supply is the only real measure of inflation. Money supply in most European countries is going up at above 12% and continuing to increase. In the USA it is above 16% and going a lot higher. Governments have always opted to manipulate inflation figures to suit their political ambitions. It is against governments' interest to publish high inflation figures since it does not rhyme with economic stability. Also for all index linked government expenditure such as pensions a low inflation figure keeps costs down.

Most governments are today running major budget deficits. In the next few years, with an economic downturn government revenue will decrease whilst expenditure will increase thus exacerbating the deficits. Our estimate for the US in 2008 is that the deficit will be at least \$ 600 to 800 billion or 4.6 to 6% of GDP. The US Federal debt will exceed \$ 10 trillion in 2008. George Bush will have increased the debt by 70% or over \$ 4 trillion during his presidency. To this must be added the unfunded US liabilities of \$ 53 trillion for Medical Care and Pensions. These are current liabilities for which there are no corresponding assets.

It is evidently clear to us that the Fed/US Government (as well as the rest of the world's central banks and governments) only have one option. They must continue to flood the markets with money.

They must print money (since they have no money) to finance/rescue:

- The housing market
- The Banking industry
- The poor (poverty will increase dramatically with rising prices and falling incomes)
- Budget deficits
- Current account deficit (foreigners will withdraw their dollar holdings requiring the US Government to finance the deficit).

The amounts required to finance the above areas will amount to many \$ trillion over the next few years. This will be highly inflationary possibly to the extent of the Weimar republic in the 1920's.

Inflation and poverty

The major increase in commodity prices in the last few years has a catastrophic effect on the Third World. Food prices for basic food like rice, wheat, corn have doubled or tripled in the last few years. This is leading to world famine and poverty of terrible proportions. The fact that it takes place with a simultaneous downturn in many industrial nations will exacerbate the disastrous consequences.

Currencies

The actions of the Fed are highly inflationary and foreign investors will not continue to finance the increasing deficits of the USA. Most central banks are printing money in order to prop up the ailing financial system. In addition the contraction of credit, which has been the fuel for the world's economic growth in the last few decades, will lead to a downturn in growth and increasing budget deficits in most countries. Governments will continue to engage in competitive valuations by printing

money thus debasing paper money. Some currencies will decline more than others and the US dollar will be the weakest. Currencies with major negative current account balances such as the British Pound and the Australian dollar will also be very weak. There are many secondary currencies including the Icelandic Krona and many Eastern European countries which will also be particularly weak.

The decline of the dollar still has a very long way to go. For example we expect the dollar against the Swiss Franc to decline by a further 60% in the next few years to around 42 centimes (current price 1.01). The Swiss Franc due to the stable political and economic situation of the country has always acted as a safe haven in times of instability. We expect Far Eastern currencies such as the Chinese Renminbi to appreciate considerably over the next few years.

The weakness of the dollar and other currencies is likely to lead to exchange controls in many countries. It is therefore essential for investors to keep some of their funds in a different country like Switzerland.

What should investors do?

Our message might sound like doom and gloom to many investors. But it is our responsibility to tell the story as we see it. As far as possible we endeavour to be unemotional about what investment actions to take. What makes investment markets particularly interesting is that there are always outstanding investment opportunities whatever the economic conditions.

We outlined in our February report the areas that we like and the ones we dislike. In brief, nothing has changed:

- Stockmarket rallies should be sold not bought
- Any cash should be in short dated government securities in Swiss Francs or possibly Euros
- Property (both residential and commercial) has a lot further to fall
- Commodities will continue to appreciate
- Precious Metals will continue to appreciate considerably

Precious Metals

When paper money is debased due to incessant credit creation and money printing there is only one serious alternative currency which is precious metals.

We forecast the inflationary/stagflationary scenario already back in 2002 when we recommended to investors to invest 25-50% of their assets in precious metals. Since 2002 **gold has more than doubled or trebled and silver trebled or quadrupled** depending on the base currency of the investor.

Although we have seen substantial increases in precious metal prices in the last few years we still believe that the real moves have not started yet.

The continued inflation or money printing to save the world's financial system will be highly beneficial to the metals. Should the rescue of the financial system fail we would have a systemic

failure which would threaten the survival of the banking system. The Fed Chairman Bernanke himself admitted in a statement that without the rescue of Bear Stearns the repercussions could have led to a systemic failure.

Production of gold and silver is static to declining. Out of total annual gold supply of \$ 106 billion (including government sales) \$ 87 billion is used for jewellery and industrial purposes. This leaves \$ **19 billion only** of new physical gold available for investment annually. In today's investment markets which measure in the tens of trillions of dollars, \$ 19 billion is a miniscule amount. The amount of physical silver available annually is a **mere \$ 1 billion** after industrial and jewellery demand have been satisfied.

Consequently we have a political and economic situation which is highly beneficial to precious metals. But we also have a supply situation which is so infinitesimally small in world investment terms that a minor increase in physical demand will have a massive impact on the price of the precious metals. It is for this reason that, in our view, we have only seen the very beginning of the rise of precious metals. Obviously for wealth preservation purposes precious metal holdings should be held in a vault outside the banking system and preferably not in the country of residence of the investor.

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

www.mamag.org

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