A PEEK AT THE WEEK THAT WAS - December 21, 2013

Patient Capital.... Positioned for Profit

Editorial Note: Once again, this week's Peek will be an abbreviated issue due to the holiday madness and related frivolity, which we sincerely hope you are all enjoying.

Do give books - religious or otherwise - for Christmas. They're never fattening, seldom sinful, and permanently personal.
Lenore Hershey (1919 - 1997)

Well, how about that...Mr. Market got his mojo back this week. All it took was Bartender Ben announcing that he would cut back on his pours just a little...a measly $10,000,000,000 (that's 10 billion) a month, or about a 12% reduction from the regular 85 billion. Partygoers at Club S&P took that as a sign that all is well with the world. The booze will keep flowing, table top dancing is now the rage, the music is still blasting...the neon 1800 sign is flashing. Mr. Market took out another record as he piles chair upon chair in his quest to swing from the chandeleir at Club S&P.

The other great news from Bartender Ben, ***unless you're a saver, of course***, is that interest rates will stay effectively at zero forever...or at least as long as he and Janet can get away with it. Here's what he said...from Bloomberg, December 18:

> *....the Fed reinforced its assurances that it's a long way from raising borrowing costs, saying that its benchmark rate is likely to stay low* ***"well past the time that the unemployment rate declines below 6.5 percent, especially if projected inflation continues to run below"*** *the Fed's 2 percent goal.*

In other words, Ben and Zesty Janet Yellen will try to keep interest rates as low as they can for as long as they can. But interest rates are tricky things to manage...as we'll see when we take a quick peek at the Middle Kingdom this week, where we notice that those increasingly capitalistic Confucians are not enjoying the same festive cheer as our Mr. Market.

Meanwhile, over at the Gold Bar, those beleagured patrons still hanging like barnacles to their battered bullion, copped another whupping from the Commercial thugs this week. Under the (false) auspices of Bartender Ben espousing sobriety, the shiny stuff was pushed down from $1,250 or so to a new low for the year at $1,187. It subsequenly recovered a little on Friday to close the trading week at just over $1,200 per ounce.

We do hope you are picking up some gold and silver for your Christmas stockings while the traders continue to play their games. The clever lads and lassies at JPMorgan certainly are. You might even say that they are starting to hoard the stuff (click here to read more about this). Perhaps you should become a bit of a hoarder too, while you still can. From Seeking Alpha, December 21:

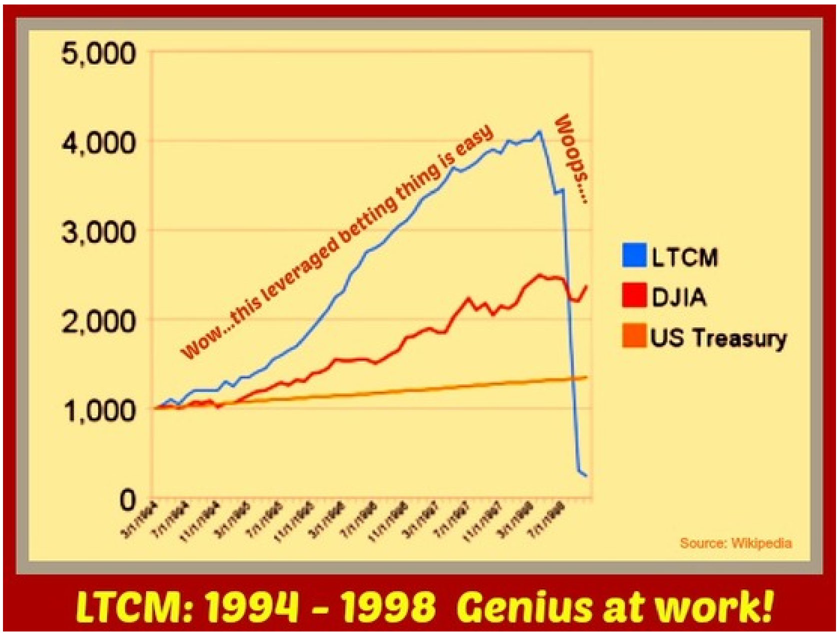
Weekly COMEX Gold Inventories: Gold Available For Delivery Hits New All-Time Low

Last week we noted that registered gold inventories saw a large drop as action in the JPMorgan (JPM) warehouse started to get heavy, while this week we saw more of the same but at significantly higher levels. Registered gold inventories plummeted to the lowest levels on record under 500,000 ounces - a stunningly low level for registered gold. Additionally, almost all of the activity involved the JPMorgan warehouse as someone (we believe the JPMorgan house account which we will explain below) is transferring all the gold they can get their hands on into undeliverable eligible gold. You can read the rest of the article by clicking here.

Ms. Bond stayed relatively calm during the week but became mildly aroused after Bartender Ben's announcement on Wednesday, when her 10 year Treasury rose to almost 2.95% before settling a little under 2.89% at week's end. And speaking of Ben's announcement, let's put a little historical perspective on that big deal of cutting the funny money printing back by $10 billion per month. Some older Mr. Market watchers may recall a mob named Long Term Capital Management (LTCM) We've written about these geniuses before but basically, LTCM was a hedge fund that couldn't fail, until it did....in 1998.

It fell apart because it made too many bets with too much borrowed money (hmmm...a bit like John Corzine at MF Global in 2011...but let's not go there right now). The point is that back when LTCM hit the wall, it was thought that the financial world was at risk (isn't it always?). Wily old Warren Buffet offered to buy the failing fund for a song but ultimately, our Friendly Fed had to organize a bail out for these bozos to the tune of just under $4 Billion bucks. At that time, $4 Bill was considered an astounding amount to spend to bail anyone out. Yet here we are, just 15 years later and no one is the least bit concerned that the Fed is still spending almost 20 times what it cost to bail out LTCM...**every month!** Think about that as you munch on some delicious rum spiced plum pudding this Christmas.

You can click here or on the graph below to read the whole silly LTCM saga from Wikipedia.



And speaking of our friendly Fed, don't forget to send them a birthday card on Monday. After all, you don't turn 100 every day. Yes folks, the creature from Jekyll Island that was created by bankers, for bankers was passed into law by a poorly attended congressional assembly on December 23rd, 1913. Presumably the wiser congressfolk were already munching on their rum spiced plum puddings. But that's the trick with tricky and unpopular legislation...push it through when no one's paying attention.

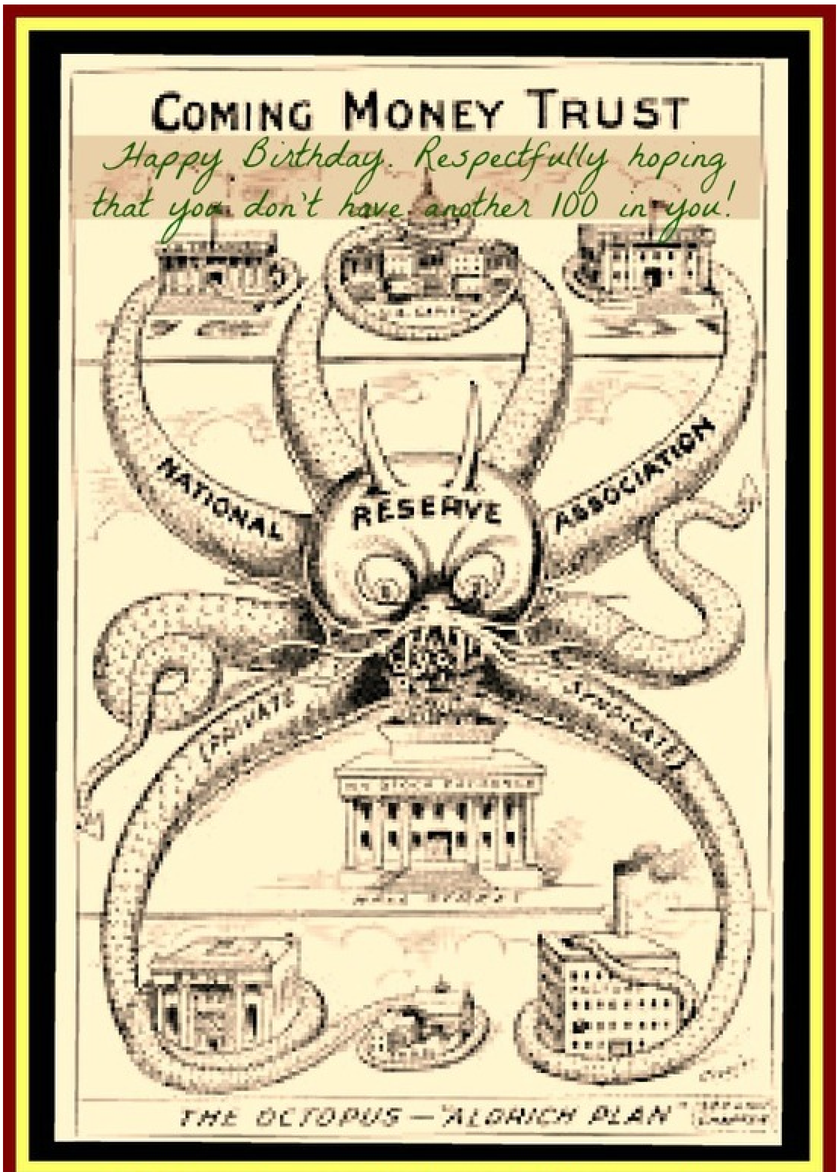
As a regular reader, you know all too well that we have written way too much about the Fed already. So let's just leave it the only politician who has consistently spoken out about this failed experiment in political and financial expediency, Ron Paul.

Now we are reaping the noxious effects of a century of loose monetary policy, as our economy remains mired in mediocrity and utterly dependent on a stream of easy money from the central bank. A century ago, politicians failed to understand that the financial panics of the 19th century were caused by collusion between government and the banking sector. The government's growing monopoly on money creation, high barriers to entry into banking to protect politically favored incumbents, and favored treatment for government debt combined to create a rickety, panic-prone banking system. Had legislators known then what we know now, we could hope that they never would have established the Federal Reserve System.

Today, however, we do know better. We know that the Federal Reserve continues to strengthen the collusion between banks and politicians. We know that the Fed's inflationary monetary policy continues to reap profits for Wall Street while impoverishing Main Street. And we know that the current monetary regime is teetering on a precipice. One hundred years is long enough. End the Fed.

Amen to that, Dr. Paul, amen to that. WIth the fabled Yankee dollar having lost 98% of it's purchasing power over the past century, we're not sure we can take another 100 years of "Fed help". And as the cartoon below shows, we can't say we weren't warned.

No chart of the week this week. Just our sincere best wishes for a safe, festive, peaceful and joyous holiday season. And a joyful letter about Santa.



1912 cartoon caricature of the pending Federal Reserve (vampire squid anyone?)

Christmas is not a time nor a season, but a state of mind. To cherish peace and goodwill, to be plenteous in mercy, is to have the real spirit of Christmas.
Calvin Coolidge (1872 - 1933)

There is a party going on at Club S&P but not so much at the formely glamorous Shanghai Club, where the party goers are not happy. In the past month, while the S&P has headed north, the Shanghai Club has headed seriously south, especially in the past couple of weeks (see the chart below for a comparison of the two stock markets over the past month).

Why is that so?

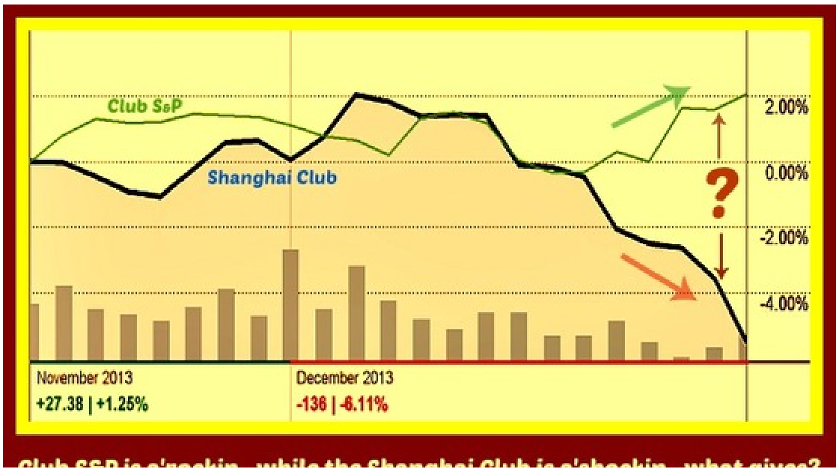
As usual, it has something to do with money. Or more accurately...a lack of it.

What the hey? With so much money floating around in the Middle Kingdom and seemingly everywhere else, how can there be a lack thereof...or as they say in the financial world...a "liquidity crunch". Couple of things...firstly, Ben has reduced his pour. As we wrote about several months ago, a lot of Bartender Ben's funny money has been finding its way to exotic places chasing speculative opportunities offshore. Just the rumor of a taper in mid year sent the shivers up a lot of emerging nations, especially in Asia. Ben kept pouring and the party reignited. Now he is pulling back and the jitters are returning. From Marketwatch, December 20 [emphasis ours]:

> *Chinese stocks closed at a 17-week low on Friday, as local **money market rates hit a six-month high**, while the rest of Asia was mixed as regional investors continued to digest the Fed's decision to cut back its stimulus measures.*
>
> ***The Shanghai Composite CN:SHCOMP -2.02% dropped 2% as a benchmark for interbank-borrowing rates hit 7.8%**. Money-market rates have climbed sharply in recent days, and continued to rise on Friday even after the People's Bank of China said it undertook short-term liquidity operations to offer an "appropriate" amount of funds to the money market Thursday.*
>
> *Chinese stocks have been sensitive to changes in money-market rates after a **cash crunch early in the summer** and a sharp jump in corresponding interest rates sparked a **hefty selloff** in Shanghai and Hong Kong.*

And from the New York Times...same day...December 20:

> ***Fear of Credit Crisis Resurfaces in China as Interest Rates Rise***
>
> *HONG KONG — **Money market rates in China surged again on Friday**, shrugging off the central bank's efforts a day earlier to provide more liquidity to the market and raising fears that the Chinese financial system could be hit by a **credit crisis** similar to the one that occurred in June*
>
> *Banks in China are struggling to borrow money to meet their short-term financing needs after **interest rates in the bank-to-bank market doubled over the last five days**. On Friday, one such rate, **the seven-day repurchase rate, briefly rose as high as 9.9 percent**. That was a level last seen in June, when China's money markets froze up and **some banks defaulted on their payments.***
>
> *Fears of an interbank cash squeeze began to weigh on broader financial markets on Friday, with the benchmark Shanghai Stock Exchange Composite Index closing down 2 percent.*



We suspect that something will ultimately send Mr. Market into a manic depressive tailspin. Will it be a bad case of Chinese flu. We don't know, but in taking a closer peek at the Middle Kingdom, we find a few things to give us pause, not the least of which is its huge shadow banking system.

Just what is a "shadow banking system" you may justifiably ask? From Wikipedia...[emphasis and wisecracks are ours, of course].

> *The shadow banking system is a term for the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks. Federal Reserve Chair Ben Bernanke provided a definition in April 2012 [oh great...that same Ben who missed the subprime crisis completely]: "Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions--but do so outside, or in ways **only loosely linked to, the traditional system of regulated depository institutions** [hmmm...same regulators who missed the same subprime catastrophe?] . Examples of important components of the shadow banking system include **securitization vehicles** [what could go wrong with them], asset-backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements (repos) [another disaster waiting to happen...again], investment banks, and **mortgage companies** [you mean like New Century and Countrywide...simply super, old sport]." **Shadow banking** has grown in importance to rival traditional depository banking and **was a primary factor in the subprime mortgage crisis of 2007-2008** [don't worry...nothing like that could ever possibly happen again] and global recession that followed.*

Last week we learned that money supply in Europe is falling fast along with bank lending. This week we have problems in China. What's up?

Here is the problem with money and banking...without real collateral backing like, say...you guessed it...gold. A system built on paper money cannot function without two primary elements, **confidence** and **trust**. When one banker loses trust in another, his confidence is eroded. When confidence erodes, interest rates increase. When interest rates increase, borrowers get pinched. When they spike higher, borrowers get squeezed. Defaults inevitably follow. Then the lenders feel the bite...deeply. Shades of leveraging and LTCM indeed.

We learned above that the thinly regulated shadow banking system in the USA was a primary factor behind the great recession. Here's the rub...the Chinese shadow banking is the absolute wild west by comparison. From The Diplomat, December 12:

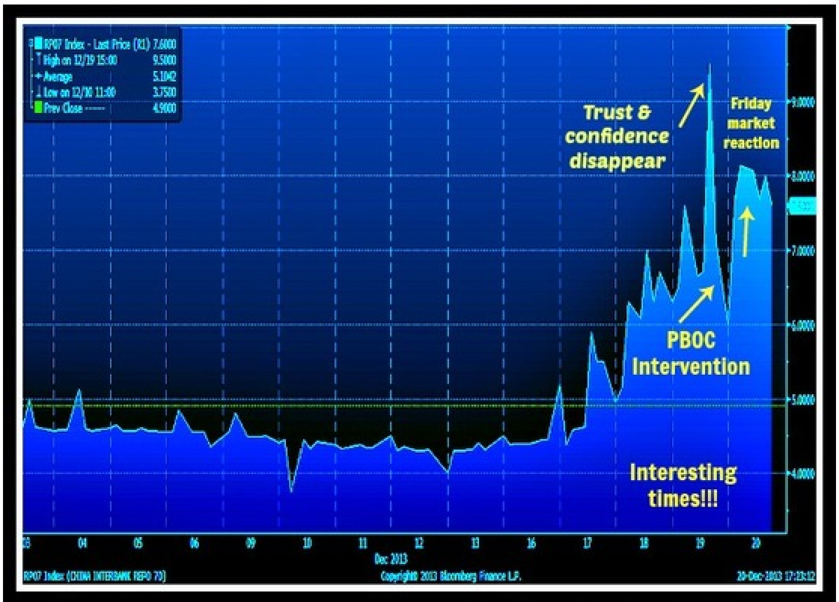
> *China's economy is straining to keep up a semblance of its former growth rate. The surest sign is the way a shadow market in bank paper has evolved to substitute the commodity that **China is increasingly running short of: cash**.*
>
> *Bankers are passing around their own ersatz currency, stimulating trade with what, in effect, are **off-the-books loans**. **As in the wildcat currency era of the United States**, the antebellum period before America had a national currency, **this paper trades at a discount from province to province**. It is **increasingly used for speculative purposes, is potentially inflationary, and is hard to regulate**. The People's Bank of China (PBOC) has been unable or unwilling to crack down, lest it provoke a serious slowdown. But **when the world's second largest economy must resort to passing around IOUs, the financial community should take note**.*

You can read the whole piece by clicking here.

Now, while our friendly Fed may have an uncanny knack for getting things screwed up, at least they have had a 100 years experience at it. The Peoples Bank of China (the Confucians' central bank), on the other hand, is relatively new and inexperienced at this whole fiat money game. Moreover, the whole country and its 1.3 billion happy souls are managed by a committee. The chances for a minor or monumental blunder are high. In a place like China, hundreds of millions of happy souls can become unhappy souls very quickly.

Although it's a long way away, we suggest you keep a respectfully close eye on China. After all, they are the world's second largest economy and America's biggest creditor. Oh...and let's not forget, they just imposed a "fly at your own risk" zone above some deserted rocks in the East China Sea.

As that old Chinese curse goes..."may you live in interesting times".



Seven day money market rate in China

HOLIDAY GREETING

Christmas... is not an external event at all, but a piece of one's home that one carries in one's heart.
Freya Stark (1893 - 1993)

A young Virginia O'Hanlon wrote to the New York Sun in **1897** to inquire if there really was a Santa Claus. Herewith - the letter and response.

DEAR EDITOR: I am 8 years old. Some of my little friends say there is no Santa Claus. Papa says, 'If you see it in THE SUN it's so.' Please tell me the truth; is there a Santa Claus?

VIRGINIA O'HANLON.
115 WEST NINETY-FIFTH STREET

VIRGINIA, your little friends are wrong. They have been affected by the skepticism of a skeptical age. They do not believe except [what] they see. They think that nothing can be which is not comprehensible by their little minds. All minds, Virginia, whether they be men's or children's, are little. In this great universe of ours man is a mere insect, an ant, in his intellect, as compared with the boundless world about him, as measured by the intelligence capable of grasping the whole of truth and knowledge.

Yes, VIRGINIA, there is a Santa Claus. He exists as certainly as love and generosity and devotion exist, and you know that they abound and give to your life its highest beauty and joy. Alas! how dreary would be the world if there were no Santa Claus. It would be as dreary as if there were no VIRGINIAS. There would be no childlike faith then, no poetry, no romance to make tolerable this existence. We should have no enjoyment, except in sense and sight. The eternal light with which childhood fills the world would be extinguished.

Not believe in Santa Claus! You might as well not believe in fairies! You might get *your papa to hire men to watch in all the chimneys on Christmas Eve to catch Santa Claus, but even if they did not see Santa Claus coming down, what would that prove? Nobody sees Santa Claus, but that is no sign that there is no Santa Claus. The most real things in the world are those that neither children nor men can see. Did you ever see fairies dancing on the lawn? Of course not, but that's no proof that they are not there. Nobody can conceive or imagine all the wonders there are unseen and unseeable in the world.*

You may tear apart the baby's rattle and see what makes the noise inside, but there is a veil covering the unseen world which not the strongest man, nor even the united strength of all the strongest men that ever lived, could tear apart. Only faith, fancy, poetry, love, romance, can push aside that curtain and view and picture the supernal beauty and glory beyond. Is it all real? Ah, VIRGINIA, in all this world there is nothing else real and abiding.

No Santa Claus! Thank God! He lives, and he lives forever. A thousand years from now, Virginia, nay, ten times ten thousand years from now, he will continue to make glad the heart of childhood.

This gem is courtesy of Art Cashin, UBS market legend. Thank you for sharing.

Til next week...

"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."
William Shakespeare

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