*Tocqueville Asset Management L.P.*

# Liar's Poker*:
## How Central Bankers Fritter Away Their Time (and Ours)

*A trivial game of bluff. It is played using randomly picked currency from your wallet. The denomination does not matter.

Gold has topped $600/oz. for the first time in 25 years. Unfortunately, for real contrarians, it is making front page news. However, financial media commentary remains fairly ignorant on the subject. The preferred explanations for gold's rise are mostly benign: it's the Chinese and the Indians (ooh, they just love bangles, it's part of their culture); it's the allocation to commodities that has grown so popular (tangible assets are the rage with all the savviest hedge funds-the Chinese need so much more stuff); it's the difficulty of bringing new mines into production (you know, the tree huggers hate mining so much); it's the central banks who have decided that selling gold was not such a great idea in the first place and have now shied away from dumping their reserves (just a bunch of stupid bureaucrats, anyway). These "explanations" all have an element of truth. Any reader of our past website articles would have seen it coming.

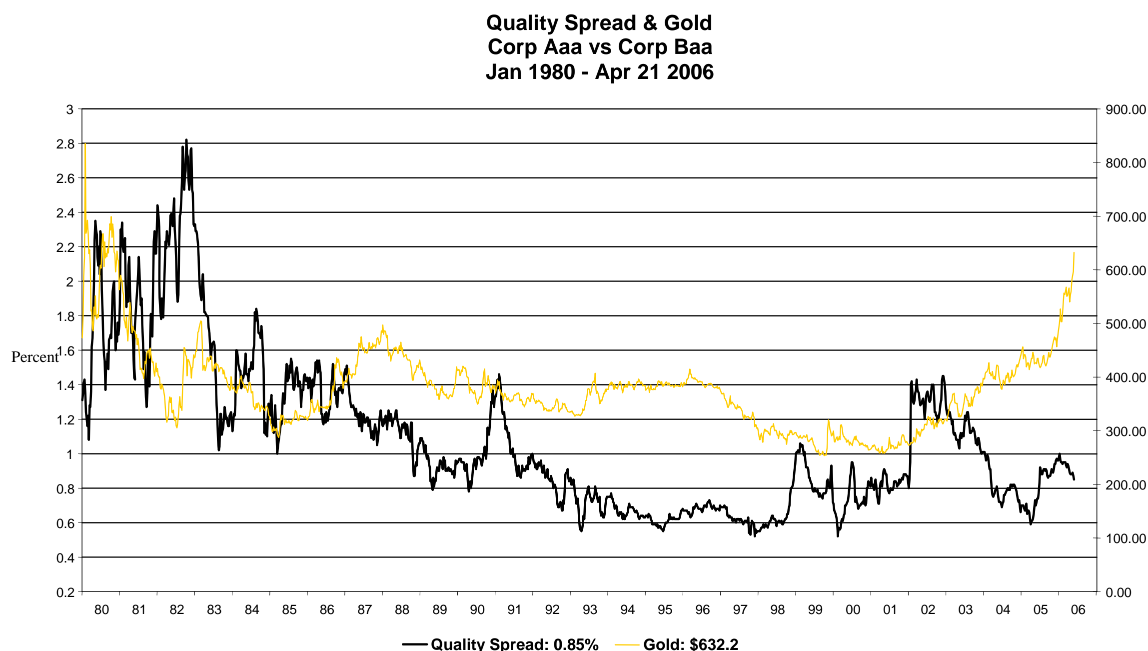
However, the Wall Street Journal, CNBC and the equivalent will not tell you that gold is rising because there is a surfeit of paper assets. They will not tell you that a rise in the gold price has historically been a harbinger of bear markets in bonds and stocks and hard times for the financial business. The Pavlovian response of the financial media to the crossing of the $600 threshold was as predictable as their inability to comprehend or to portray the significance.

In truth, the price of gold at $600 is no big deal. In 1980 dollars, it is only $300. If prior highs mean anything, a target of $1700 in today's dollars is what investors should be thinking about. In our view, gold remains cheap, another sign that the financial markets continue to under-price risk. Investors should worry less about whether this particular moment is a good or bad entry point and ponder the implications of sailing through uncharted waters without a lifeboat.

A seasoned investor, looking at the recent histrionics in the precious metals markets, could be forgiven for thinking: (1) wait for a substantial pullback, or (2) it's all over. Bull markets conspire to throw most investors off the scent so that as few as possible climb aboard or last for the entire ride. Recent volatility is not climactic, terminal action, but rather, a demonstration of how little physical gold there is in relation to paper assets seeking safety.

As with most markets, gold is smarter than those who observe it. One can only try to guess what the surge in the metal is saying. We know that gold thrives on credit worries causing investors to re-price safety by marking up the metal. But on the surface, there appear to be no credit worries. Foreign central banks continue to extend credit to US consumers and businesses by accepting dollar denominated IOU's for their exports. Domestically, not even the weakest of borrowers, sub-prime and junk credits, are turned away from the spigots of liquidity. How then can we explain the puzzle of a

rising gold price against contracting credit spreads? The chart below shows that the history of gold versus credit spreads has correlated positively until very recently:




The recent disconnect in this series suggests the possibility of a tectonic shift in the structure of credit. One very good explanation might be the proliferation of credit default swaps (CDS). In a recent interview (March 24, 2006-Welling @Weeden) by Kate Welling, Michael E. Lewitt states: "Credit derivatives have been a major enabler of the current credit bubble. The advent of credit derivatives freed speculators from the constraints of the cash bond market, enabling them to place bets on individual credits—regardless of the amount of debt actually outstanding." Mr. Lewitt added that in many cases, the notional value of credit derivatives exceed the amount of underlying debt by several times. The OCC numbers below reflect CDS exposure for banks only and does not include that of hedge funds.

Top 5 Derivative Dealers*

| | |
|---|---|
| Notional Value | $ 58,991,674,900,000 |
| Credit Exposure | 1,010,187,000,000 |
| Total Assets | 3,394,284,000,000 |
| Trading Revenues | 4,069,000,000 |
| Credit Exposure as % Risk-Based Capital | 343.3% |
| Trading Revenue as % Total Revenue | 7.1% |

*Source=Office of Comptroller of Currency* *(*JP Morgan,BofA,Citibank,Wachovia, HSBC)*

Hedge funds and money center banks dominate credit swap issuance and this activity is an important component of their income. Could the phenomenon of unregulated sectors of the financial industry extending de facto credit be a recipe for disaster? Without credit default swaps, marginal borrowers would be shut out from credit, the global economy would lapse into recession, and bad investments

would be wiped off the books. Instead, CDS's keep weak credits afloat, compound bad investment decisions, and deepen the ultimate retribution from misdirected capital.

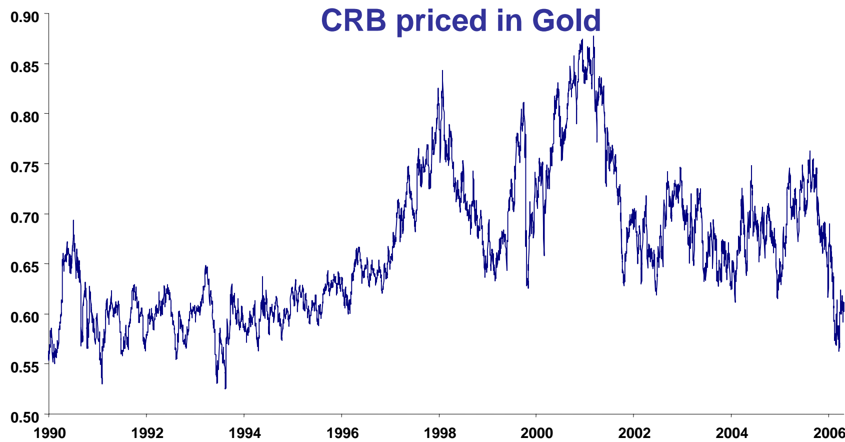
Traditional credit analysis centered on how the borrower would repay his debt based on the study of balance sheet and cash flow statements. In our new system of credit default swaps, traditional credit research is replaced by a financial market version of particle physics applied to bets on the future trading price of debt instruments. Debt repayment is an incidental thought.

As long as interest rates all along the yield curve do not become unruly, the game can continue. Market confidence in Fed policy is a key component of this apparent stability. By raising interest rates so far, the Fed appears to be in control, and the financial markets are soothed by the perceived wisdom of their actions. But who will be comforted if the Fed is still raising rates a year from now to 8% or 9%? Lewitt notes that the Fed should keep raising rates not because inflation is the big issue, but because of credit speculation. What is the tipping point on the cost of money for credit basket cases? Gold knows that there is a ceiling to the Fed's "discipline" and is anticipating the day when the Fed's affectation of sure handedness becomes patently meaningless.

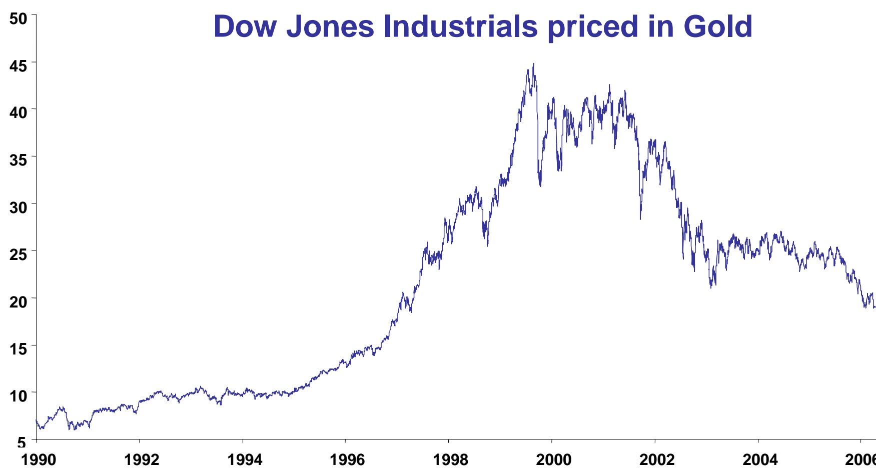
Signs of trouble ahead for financial assets frequently emerge in the foreign exchange market. It is true that the recent weakness in the dollar reinforces a bearish outlook for financial assets. But because the foreign exchange value of the dollar reflects government policies rather than free market forces, those expecting the dollar to "fall out of bed" may have to wait a while longer. We expect a dollar crash, but later rather than sooner. No important trading nation wants the dollar to implode because it would deflate American buying power and cause global recession. For the foreseeable future, it is in the common global interest to pretend that the dollar is worth more than it is.

While there may be some further weakness ahead, be prepared for coordinated intervention to prop up the greenback. This could even include attacks on the gold price. For what the matrix of CDS derivatives is to the universe of weak credits, the dollar is to global commerce. There are no present day analogues to Jacques Rueff or Charles de Gaulle to speak the truth about the dollar. Instead, muddle-headed policy makers of all nationalities prefer to play liar's poker to distract attention from substantive issues. They would prefer to be overtaken by a monetary crisis, which would allow some to play the hero, instead of dealing proactively.

Is the price of gold rising or is the value of assets measured in dollars, yen, or euros falling? It would be an easy question to answer if currencies were anchored to a fixed, universally accepted benchmark of value. In the absence of such a reference point, it is much more difficult to ascertain economic returns, and more likely that investment mistakes will continue. The common perception is that the price of gold has been rising. However, it is more illuminating to see that assets, commonly thought to be generating acceptable investment returns, are falling in terms of gold or real money. The underperformance of home prices, commodities, equities, and bonds relative to gold (see charts) anticipates that the mass culture of the investment world will come to reassess the attractiveness of these capital destinations.




*Source: MacroMavens, LLC*

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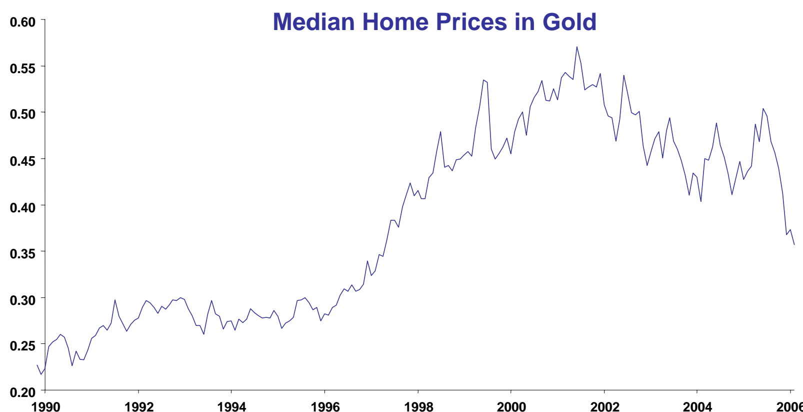
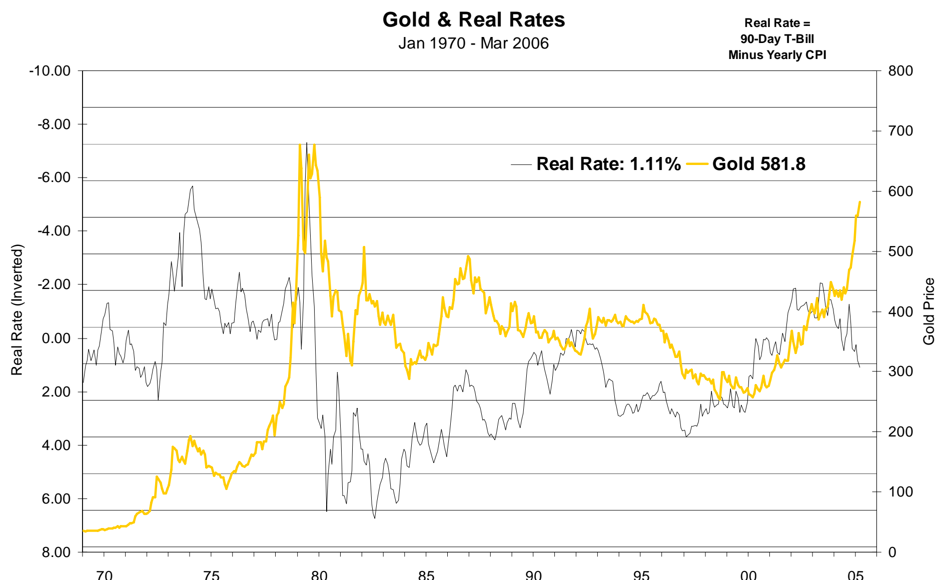



*Source: MacroMavens, LLC*

Dollar denominated treasury debt, not gold, is the modern world's benchmark of value, the global unit of account and store of value. Gold was written out of the script long ago. The metal was demonetized and demonized by policy makers in the 1970's. For example, William Simon, Secretary of the Treasury under Nixon, complained that there was just not enough of it to go around. The risk free treasury rate has displaced the barbaric relic as the universal anchor of financial asset valuation. Equity market valuation models are dependent on the "risk free" returns from government debt. Home

mortgage rates have a similar link, and by extension, housing prices. Tradable goods, pouring across our borders from recently built (and theoretically profitable) foreign factories, are attractively priced to US consumers because foreign governments accept and hold for investment US government issued paper at yields deemed suitable for such purposes by a committee of Fed governors.

But how does the world figure out the real investment return on US government paper? It is a simple proposition, and it must, to be so widely used. The chart below shows the relationship between the so called real interest rate and gold. The "real" is the nominal rate on 90 day treasuries less the latest twelve month consumer price index (CPI). It can be seen from the chart that the historical relationship between gold and real rates is inverse. High real interest rates are poison to the metal.

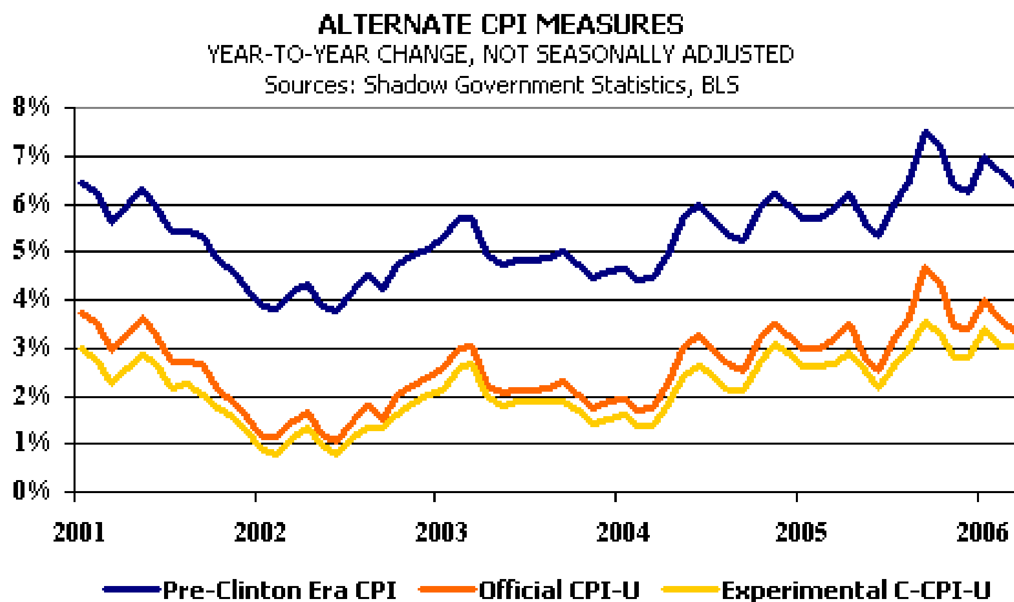



What the chart does not show is that the "real" interest rate is qualitatively different from its antecedent of 25 years ago when gold scaled the $800 mark. The real interest rates of the 1970's and those of 2006 are not apples to apples. What has changed is the measurement of the CPI. Had that index been measured consistently over the past twenty five years, today's real interest rates would be a negative 300+ basis points instead of a positive (but still paltry) 1.1%. What has changed and why? Policy makers, of all political persuasions, felt that a fixed measure of inflation was every bit as inconvenient and restrictive as the gold standard. The intent and effect of such changes has been to deceive the public as to the real value of the dollar and thereby to devalue all government obligations including, and possibly especially, social security payments.

How did they get away with it? The Byzantine answer reflects the machinations of unaccountable "public servants" remote from public oversight. The first notable change was courtesy of Arthur Burns. He introduced the notion of a "core" inflation rate in 1973-74 to marginalize the impact of food and energy. That clumsy and artless first step set the precedent for multiple successive tweaks in the measurement process which are expertly documented by John Williams on his excellent web site, www.shadowgovernment.com. The changes include geometric weighting, hedonic pricing, chain weighted pricing, seasonal adjustments, intervention analysis and more. Please go to the website for extensive discussion of the details.

The bi-partisan movement to alter the CPI gained full force during the Clinton administration and was driven, according to Williams and others, by Michael Boskin, chief economist to the first Bush

administration and Fed Chairman Alan Greenspan. The Boskin Commission proposed numerous changes to the calculation of inflation and the recommendations were implemented during the first term of the second Bush administration. The Commission produced a lengthy report, cloaked in the rhetoric of academia and therefore incomprehensible to public understanding, similar in spirit to the pages of disclosure one can find in the footnotes and prospectuses of the junkiest of junk investments. The chart below shows the CPI calculated in a manner consistent with pre- Boskin methodology compared to what is reported to create the appearance of tame inflation. Today's inflation rate exceeds 6%, versus the supposedly tame 3+% widely reported. Among other side effects is the reduction of social security benefits, which Williams calculates would be 43% higher under the old methodology.




Our simple thesis is that a unit of account as flawed as the dollar renders intelligent capital allocation decisions all but impossible. The macro economic implications are not good. False reads on investment returns across a wide spectrum, if repeated over many years, lead to capital destruction and potentially severe economic contraction. If the dollar is not what it seems to be, so are returns on capital.

The central investment rationale for gold is that paper is untrustworthy. The trust in dollar assets displayed by world central banks and public officials is a mere convenience to camouflage disorder in public finances and unmanageable economic imbalances. Dollar deception, both intentional and unwitting, has succeeded for decades. The pictures below show a few paper currencies vaporized by inflation.

Is there a fundamental difference between the Reichsmark, the Zimbabwe Dollar, and the US dollar? The answer is no. They are all government backed cash notes. There is a relative difference, however, in that the current global monetary regime centered on the US dollar has far greater resources to back it up than the others. This explains why it has taken 25 years for the dollar to lose half of its value. (All data based, of course, on official statistics.) Poor Zimbabwe, without such resources, introduced the latest version of its dollar in 1999, only to see it lose every bit of its value by the close of 2005.

Not the least among the resources propping up the dollar is the residue of trust enjoyed by this brand of paper currency that has been earned over centuries of history. Its demise has been managed with great skill and subterfuge. Therefore the pace has been slower and at times imperceptible compared to the more notable flameouts. Still, the end result, however long it takes to materialize, will be the same. It will be replaced, redesigned and redefined. Do not doubt that the game of liar's poker will continue with replacement dollars. It is unlikely that politicians will ever appreciate or understand the difference between cash and money. For the political class, cash in the form of state issued IOU's will always be the preferred form of legal tender. How else would they ever be able to play liar's poker? Imagine trying to do that with real money that has kept its value for more than two millennia.

**John Hathaway**

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