“Drilled in my head
What does it mean
Numb
Can’t
Feel
Open wounds
Never heal
Conditioned to react
Without thought
Without tact
Bleeding
I sense no pain”
– PAVLOV’S DOGS, RORSCHACH

“The problem with socialism is that eventually you run out of other people’s money”
– Margaret Thatcher

“What is being requested is financial assistance. It has nothing to do with a rescue”
– Luis de Guindos, Spanish Finance Minister
Sometimes the stars just align.

The beautifully bearded gentleman on the left was born on September 14, 1849 at Rayazan, in Central Russia to a village priest called Peter Dmitrievich Pavlov. After being educated at the church school, Ivan Petrovich Pavlov entered the theological seminary, destined to follow his father into a religious career, but, inspired by the ideas of D.I. Pisarev—Russia’s pre-eminent literary critic of the 1860s—and I.M. Sechenov, the father of Russian Physiology, the young man turned his back on the church and decided that mathematics and science were his calling.

He became fascinated with physiology and demonstrated a significant aptitude for the science of the function of living systems—so much so that he was awarded a gold medal and a fellowship by the Academy of Medical Surgery where he conducted research under the famous Russian Clinician S. P. Botkin.

In 1890 Pavlov was appointed Professor of Pharmacology at the Military Medical Academy and five years later he was appointed to the then vacant Chair of Physiology, which he held till 1925. It was during this time that Pavlov conducted a study that would become famous the world over and elevate him to the ranks of those rare men and women for whom a new adjective is coined:

Pavlovian [pəˈlʌvɪən], adj

1. (Psychology) of or relating to the work of Ivan Pavlov (1849-1936), the Russian physiologist

2. (Psychology) (of a reaction or response) automatic; involuntary

Pavlov’s experiment was in what became known as Classical (or Pavlovian) Conditioning:

(Wikipedia): Classical conditioning (also Pavlovian conditioning or respondent conditioning) is a form of learning in which one stimulus, the conditioned stimulus or CS, comes to signal the occurrence of a second stimulus, the unconditioned stimulus or US. The US is usually a biologically significant stimulus such as food or pain that elicits a response from the start; this is called the unconditioned response or UR. The CS usually produces no particular response at first, but after conditioning it elicits the conditioned response or CR. Classical conditioning differs from operant or instrumental conditioning, in which behavior emitted by the organism is strengthened or weakened by its consequences (e.g. reward or punishment).

Conditioning is usually done by pairing the two stimuli, as in Pavlov’s classic experiments. Pavlov presented dogs with a ringing bell (CS) followed by food (US). The food (US) elicited salivation (UR), and after repeated bell-food pairings the bell also caused the dogs to salivate (CR).

In short, by associating the sound of a ringing bell with the appearance of food, Pavlov conditioned dogs to salivate merely at the sound of the bell.

For many years, this classical conditioning has been prevalent across financial markets the world over but, while its prevalence cannot be doubted, it has remained unobtrusive for one reason and one reason only—it has worked almost flawlessly. On Wall Street, however, no successful idea was ever an orphan and so classical conditioning’s fruits were passed off as those of heightened intellect amongst the great and good of the financial world.

This classical conditioning can be broken down into a grid which I will simplify enormously for the purposes of our discussion today:
Over the last 27 years of watching the technological means of delivering financial information improve in both quality and speed, one thing has remained constant and that is the Pavlovian reaction of markets to various economic conditions, data releases, natural disasters and, lately, Black Swans.

When the economy is booming and greed is in the ascendancy it is all about making the big killing. Equities and commodities are the only games in town. It is ‘Risk On’.

When the tables are turned and we find fear and loathing in the air amidst weak growth, then nobody wants to know about anything but the safety of bonds and precious metals. But market ‘reactions’ are strange birds indeed.

Think about it: on an individual basis, if a payroll number (subject to all kinds of after-the-fact revisions) misses, what do people do? They ‘sell the ‘equity market’ and they buy the ‘bond market’? Why? Is it because at that precise moment the world is suddenly worse than it was two seconds earlier? Is it because they have taken their time to look into the report, analyze the various metrics that make up the headline number and decide upon a course of appropriate action? No. They ‘sell’ and ‘buy’ the respective ‘markets’ because that is what they have been conditioned to do and that is what they subconsciously know that everybody else has been conditioned to do’ (though I will concede that anyone positioning themselves ahead of a number in anticipation of a market reaction to a specific number and getting it wrong has a valid reason to move swiftly).

If payroll numbers are down, does that mean Johnson & Johnson is instantly worth less? If it is the beginning of a long and large increase in unemployment, perhaps, but selling ‘the market’ on a bad number is a Pavlovian response.

Selling ‘the market’ on bad news for a particular asset class is the expected reaction and so the desire to either conform with the pack or, more likely, to try and get ahead of it, drives an instant investment ‘decision’ and, in my experience, the words ‘instant’ and ‘investment’ are two of the most mutually exclusive terms in the English language and ought to remain so.

The events of 2008 will have a lasting effect on the world for many years to come and the severe dislocations that were seen a mere 44 months ago will reverberate far longer than I suspect many realize—in fact, a good number of market participants seem to believe that 2008 is ‘over’ and that it is all behind us. Nothing, and I mean nothing, could be further from the truth (except perhaps “2012 World Champion New York Mets”).

Right now, the world is undergoing a crisis the like of which hasn’t been seen since the Great Depression. Do NOT let the absence of long lines of elegantly-clothed and behatted men and women queuing for soup fool you. The world—you world—has changed.

Like Banquo’s Ghost, the spectre of a terrible collapse of a kind never before seen in modern
history stands in our midst—visible only to those willing to see it—but Pavlovian conditioning has taken hold of the vast majority of investors who are applying tactics instilled in them through relentless conditioning. How else do you explain the current foolhardiness evident in the sovereign bond market?

Let’s put the current state of world affairs into a little perspective (if we can stand back far enough) and then see if we can marry that reality with the activity in sovereign bond markets.

As you can see from the chart above (courtesy of Barcap) which I have used in these pages previously, we have recently had the largest nominal sovereign default in history, by a factor of about 6x when little Greece—the ‘irrelevant’ Eurozone country that constitutes a ‘mere 2% of GDP’—did what everybody knew it would ultimately have to and defaulted on its debt. Call it a PSI, call it what you will. Greece defaulted.

Now we have Spain at the front of the cab rank and suddenly things are serious? Well, yes.

As you can see from the same chart, Spain is twice the size again of Greece and Italy is almost three times the size of Spain.

With the fear of these sovereign defaults hanging in the air, the Pavlovian response has overwhelmed the intellectual response and we have seen money pouring into the sovereign bonds of other countries in search of safe havens.

“fear = buy sovereign bonds”

The extent to which this fear has manifested itself is apparent when we look at the chart of various ‘safe haven’ sovereign bond yields at the bottom of the page.

<table>
<thead>
<tr>
<th>Country</th>
<th>5-year Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.7115%</td>
</tr>
<tr>
<td>UK</td>
<td>0.704%</td>
</tr>
<tr>
<td>Japan</td>
<td>0.190%</td>
</tr>
<tr>
<td>Germany</td>
<td>0.445%</td>
</tr>
<tr>
<td>France</td>
<td>1.3911%</td>
</tr>
</tbody>
</table>

This chart shows the 5-year government bond yields for:

Now, some of you may be wondering why I would include France on a chart of safe haven sovereigns, but, judging by the fact that France, with its newly-elected socialist government can borrow money for 5 years at 1.3911%, many
people have fled to it as a safe haven.

The absurdity of this particular situation was made abundantly clear this week when François Hollande—coincidentally a matter of days before nationwide legislative elections—made good on a campaign promise and LOWERED the French retirement age by two years from 62 to 60. Genius! If you WANT to make a dent in a €24 billion fiscal shortfall, surely it makes sense to add several billion to it first—take a longer run-up, if you will.

An article that appeared this week on Bloomberg (which I have included in its entirety on page 14) provided me with many surreal moments this week:

(Bloomberg): ...Hollande has stuck to his pledge to shrink France’s budget gap while gaining from predecessor Nicolas Sarkozy’s record of repeatedly beating the nation’s deficit-cutting targets. For bond investors, the combination has put France -- which was stripped of its AAA rating by Standard & Poor’s in January -- in the league of Europe’s creditworthy north rather than its struggling south.

So far so good, kind of—but is this an intellectual response or Pavlovian conditioning? Let’s go deeper down the rabbit hole:

(Bloomberg): ...“An absolute majority of Socialists would increase the probability that the government will be able to deliver tougher fiscal austerity,” said Dominique Barbet, an economist at BNP Paribas SA in Paris.

Including now, I have read that statement about 50 times and I have the same look on my face now as I did the first time I set eyes on it. Glee? Hardly.

Wikipedia: Socialists hold that capitalism is an illegitimate economic system, since it largely serves the interests of the owners of capital and involves the exploitation of other economic classes. As such, they wish to replace it completely or at least make substantial modifications to it, in order to create a more just society that would guarantee a certain basic standard of living.

One of the ‘basic conditions’ of socialism is the ‘Right to Existence’; a concept explained by Von Mises in his ingeniously-titled book; ‘Socialism’:

...Their definition is: “that each member of society may claim that the goods and services necessary to the maintenance of his existence shall be assigned to him, according to the measure of existing means, before the less urgent needs of others are satisfied.”

Now, these pages never have been, nor will they ever become a forum for debating political idealism. I am merely making the point that, generally speaking, Socialism dictates heavy State involvement in both society and the economy and has historically provided for far higher state-funded benefits than other economic and social systems.

In short, Socialism is expensive.

To put it another way:

Austerity is to Socialism as demureness is to Kim Kardashian

M. Barbet’s comment is yet another example of Pavlovian conditioning taking over the intellectual response. In this case the logic is:

“A unified legislature with a healthy majority is a good thing because they will be able to enact laws more easily, therefore M. Hollande will be able to get through tough austerity measures without a fight”

However, this Pavlovian twitch flies in the face of a more intellectual approach that would also weigh up this:

(UK Daily Telegraph): France’s new socialist government cut the country’s retirement age in the face of the eurozone’s deepening cri-
sis, citing “social justice” to explain a move that goes against austerity efforts across the region...

The €1.1bn (£890m) annual cost up to 2017 - €3bn thereafter - will be met by a 0.1 percentage point rise in payroll charges, amounting to an extra €2 a month on the average monthly French net salary of €1,600, it said.

Taking the intellectual high road was French Opposition leader, Jean-Francois Cope:

...Cope, leader of France’s conservative UMP party, called the policy move “madness”.

“It risks the downgrade of France’s credit rating and at this rate tempts fate,” he said.

Let’s get this straight: A country with a 4.5% budget deficit (in breach of Maastricht limits, but let’s ignore that for now) and which needs to find savings or new tax revenues of about €24 bln to close said gap, elects a Socialist President who immediately ADDS several billion euros to the bill and actively sides with the Southern anti-austerity bloc within the Eurozone.....and investors BUY French bonds? Hmmm.....

How about the UK?

The UK Treasury has been issuing ‘gilts’ for centuries and, as you can see from the chart (below, left) which goes back to 1750 (January, 1750 to be precise), the UK government has NEVER been able to borrow money more cheaply than it can today. NEVER.

Why? Is Britain a ‘safehaven’? UK Chancellor George Osborne seemed to think so in August of 2011:

“While other countries struggle to command confidence in their fiscal forecasts we have created an internationally admired and respected independent office for budget responsibility. These bold steps have made Britain that safe haven in the sovereign debt storm...”

I’m sure quoting oneself is not the done thing, but in the March 25 edition of this publication I wrote the following:

Britain’s ‘austerity drive’ really has been nothing of the sort when you look at the numbers (which we shall do in a moment), but somehow, in a brilliant piece of marketing, the coalition government have managed to talk tough whilst simultaneously bringing the UK’s Public Sector Borrowing Requirement (PSBR) to a little over 60% ABOVE where it was when they took office in May 2010...

Britain’s budget deficit currently stands at 8.24% of GDP (admittedly, an improvement upon the 11.14% it reached in 2010) so even if David Cameron HAD acquiesced to the pleas from the rest of Europe to join the fiscal compact, it is abundantly clear that there is absolutely zero chance that he would have been able to comply with its terms.

In fact, by comparison, Spain and the Netherlands look positively austere...

The event that had prompted me to write about the UK was the announcement that they would be issuing 100-year bonds:

Firstly, Britain’s ‘safe-haven status’ is a fallacy. It is no more safe than many of the other major economies who are choking on debts that cannot be paid off.
The only reason it HAS that status currently is because of the very Achilles Heel that will ultimately prove to be its demise - the ability to print its own currency. By NOT being a part of the euro experiment, Britain has kept control of its fate and has been able to print its way out of trouble - so far - while its neighbours to the east have all been lashed to the deck of the same sinking boat, but the day is coming when Britain’s profligacy will become important again. As I keep saying; none of this matters to anyone until it matters to everyone.

Secondly, interest rates may have ‘fallen to a record low’ but they have done so in the same way heavily-indebted gamblers often ‘fall’ from hotel rooms - with a big push (only this time from the Bank of England and not a guy called Fat Tony). Like US Treasurys, the price of UK gilts would be nowhere near these levels without a captive and very friendly buyer in the shape of the central bank. And then there’s the ‘treasury source’ who spoke of ‘locking in for the future the tangible benefits of the safe haven status we have today’ before finishing with a flourish when he tugged at the heartstrings of investors by referring to great-grandchildren who would be paying less in interest repayments than they otherwise would have done because of (and I’m going to give this last comment the space it deserves; “...the government’s fiscal credibility”)

I have yet to find anything remotely credible about the UK governments fiscal policy - it’s marketing policy, yes, but fiscal policy? Not so much.

And yet, with Pavlovian flourish, investors have driven UK government bond yields to their lowest level in three centuries. Not a whiff of an intellectual response there.

The US and Japan we will leave for another day because their debt dynamics deserve an edition all to themselves, but, perhaps the biggest puzzle comes in the form of Germany’s bunds.

Let’s use the 2-year bund as our example in this case (I think it’s fairly safe to say that, within two years, Europe will be a very different place and the current troubles will have been dealt with either by choice or necessity).

Back in 2008, Germany was paying 4.7% pa to borrow money for 2 years but, as the fear grew after Lehman Brothers’ demise, money understandably flooded to the safety of government bonds—nothing Pavlovian about that, it made perfect sense—but as the problems in Europe have increased and it has become more and more apparent that the only possible way for the Eurozone to stay together is for Germany to assume a prohibitive degree of responsibility for the debts of the weaker peripheral countries, the Pavlovian response has gone what can only be described as Hog Wild. Now? You are receiving 0.043% in interest for those same bonds.

With every negative headline about Europe and every hint that the Germans may capitulate and backstop the debts of the South (do NOT believe that for a second) investors have been rushing headlong into the safe arms of the debt of the country they are hoping will ruin its balance sheet by taking on vast external debts.
THINGS THAT MAKE YOU GO  Hmmmm...

Why? Because its what they have been conditioned to do.

The biggest bubble in the world right now (apart from that in political incompetence) is the sovereign bond market and the bubble has inflated for PRECISELY the same reasons that all other bubbles do—investors stampeding into an asset without thinking about the underlying dynamics of the instrument they are buying. Often it’s based on greed; this time it’s based on fear. The outcome is the same in both cases I am sorry to say. It was ever thus.

To illustrate the point, let’s return to Germany and imagine you invested €1mm into 2-year bunds today. At the end of your 2 years, you would receive back from the German government €1,008,618.49. Pretty good, huh? Nobody ever got poor making a profit, right?

Well let’s see.

On the day you received your money back from the German government, a basket of goods that would have cost you €1,000,000 today will cost you €1,052,676 (assuming Eurozone CPI stays constant at 2.6%).

How’s that $8,618.49 profit looking now?

My friend Mac emailed me as I was putting this piece together and his words were a perfect summation of what I have been talking about:

"...they have absolutely no idea how “unsafe” these investments might turn out to be.....Do they have any idea that if their 3% 30-Year Bonds move to a 5% yield, they’ll be showing a 30% loss in principal?"

"Retail wants to be “safe,” but also is in dire need of yield......so they buy long-dated US Treasuries......they have absolutely no idea how “unsafe” these investments might turn out to be......Do they have any idea that if their 3% 30-Year Bonds move to a 5% yield, they’ll be showing a 30% loss in principal? Ouch. If long bond rates move from 3% to 7%, (assuming a 3% coupon, 30-year bond) they’ve lost half their savings....."

This is the situation facing buyers of government bonds across large swathes of the world right now and yet, yields keep going down and real interest rates head further into negative territory because investors have been conditioned to flee to the safety of government bonds whenever things get shaky.

But who are the buyers making these foolish mistakes? Well, in the US, the Fed has been the largest buyer of Treasuries for some time now (and one can always rely on government institutions to overpay for pretty much everything), but lately—and just in time for some real damage to be done—a new set of buyers has emerged and it’s another group who really ought to know by now that they should stay away from the hornet’s nest:

(CNBC): Mom-and-pop investors, and not the Federal Reserve, have been the ones most responsible for driving the mad dash to government debt, according to newly released data.

The Fed’s ambitious Treasury-buying program has pushed the central bank’s balance sheet to $2.83 trillion and, by many accounts, the benchmark 10-year Treasury yield to record lows, most recently to 1.56 percent.

But despite the low yields, it’s been retail investors most responsible for the recent move plunge.

“The conventional view is that 10-year Treasury yields have been pushed down to 1.5 percent and 10-year (Treasury Inflation Protected Securities) yields to -0.5% by the actions of the Federal Reserve and the safe haven demand from foreign investors,” Capital Economics said in a research note. “The reality, however, is slightly different.”

The demand among average investors has swelled so much, in fact, that they bought more Treasurys in the first quarter than foreigners and the Fed combined.

Households picked up about $170 billion in the low-yielding government debt during the quarter, while foreigners increased their...
Never before has it been the ‘safer’ of governments which have been the very entities that investors need protection against. Central bank balance sheets have exploded and are stuffed to the gills with bad collateral after four years of being the repositories of last resort for a banking system overloaded with toxic garbage and yet, rather than pausing to think about the quality of the instruments they are buying or the likely outcome, Pavlov’s dogs just hear the bell ringing and they start to salivate.

The list of governments that are, essentially, bankrupt is a veritable who’s who, and yet, in a conditioned world where people flee to traditional safe havens on instinct alone, they are able to borrow money at ridiculously low rates - seemingly in spite of their policies.

Mark my words; like Japanese real estate in the 1980s, technology stocks in the 1990s, and US housing in the 2000s—hell, like tulips in the 1630s and every bubble in-between—this one will burst, only when it DOES, it will be unlike any bubble we have ever seen before because it will simultaneously remove all the backstops to the world financial system upon whose largesse the recent ‘recovery’ has been built. When that happens, where are the herd going to run to?

There is, of course, one monetary asset which cannot be printed at will by feckless governments and which has performed its role as a ‘safe’ store of wealth in troubled times throughout the centuries stoically and without fanfare and that, of course, is gold. But currently, as Pavlovian conditioning trumps intellectual reasoning and investors stampede into the burning building of government debt, gold has become somewhat unloved—a ‘trading vehicle’ tossed around by an investment community looking for an anchor in today’s stormy seas. Consequently, gold has been a victim of the Pavlovian rush and has acted rather strangely on ‘panic’ days.

At some point—and I suspect that point will arrive sooner rather than later—intellectual reasoning will overcome Pavlovian conditioning and the same people who poured trillions into the debt of bankrupt and irresponsible governments will realise the folly of their instincts and they will go looking for a real safehaven asset. When they do, they will find that, unlike government debt which, like a gas, can expand to meet any demand, trying to hide trillions of dollars in a real asset such as gold (or farmland) will prove to be singularly difficult.

Those overcoming their Pavlovian conditioning and allowing intellectual reasoning to win out first, will find themselves at a tremendous advantage once reality is forced upon the masses. That day is rapidly approaching.

************

And there I was going to leave it for another week but I wake up on Sunday morning to find that my friends in Spain couldn’t do the decent thing and leave the bailout until just before markets open on Monday morning like they used to do in the good old days—no. They have to make the announcement on a Saturday night.
So... a very quick look at the headlines (I’ll add a couple of articles to the end of the next section) leads me to the following thoughts:

- What happens now with Ireland? Seems to me they may want to have a little sit-down with those handing out the cash
- What happens in Greece next Sunday? Seems to me Syriza just got a major boost amongst any potential voters who are actually paying attention to the world outside Greece
- What happens to Spain’s promised ~€100bln commitment to the EFSF?
- How did we go from this:

  Wednesday, June 6th:
  (Reuters): Spanish Economy Minister Luis de Guindos said on Wednesday there were no immediate plans to request a bailout of Spain’s banks

  To this:
  Saturday, June 9th:

  GUINDOS SAYS SPAIN WILL SEEK EUROPEAN BAILOUT FOR ITS BANKS

...in THREE DAYS? (Actually, I guess the answer to that is “the same way we went from no bailout to €40bln to €100bln in the same timeframe).

There is so much more to digest but I want to hit the send button now so it will have to wait, but I’ll leave you with one final thought before I do:

Europe’s politicians are running around trying to find ways to solve every problem that arises in Europe and they are continuing to do so long past the point where any rational, dispassionate observer can see it is a futile exercise of throwing good money after bad. They are mortgaging their future in what looks like an utterly hopeless cause. Why?

Could it be because that is what they have been conditioned to do?

*************

So what do we have for you this week? Well, at the end of this edition you will find a couple of hastily inserted articles on the Spanish bailout, but before that, we read how a big Japanese pension fund may have just rung a rather noisy bell in the gold market, China moves to open a junk bond market (I will want an airtight definition of ‘junk’ before I take a look at it. Sino Forest, anyone?), before-the-fact, Spain’s bailout would seem to be too big for China and we look at a Europe ‘slouching towards a banking union’. The fabled US corporate cash pile may be, well, a little smaller than thought according to the fantastic Jim Bianco, the ‘London Trader’ comments on a ‘staggering’ gold sale and you get a chance to read the amazing Bloomberg article on M. Hollande that I referenced in my introduction—don’t miss that one, will you?

Charts? We’ve got charts. Global gasoline prices, CBO budget estimates, Indian and Chinese gold buying and Target2 balances all make the pages of Things That Make You Go Hmmm..... this week and we round things off with a speech given by Daniel Hannan a year ago that bears watching today, an interview with a slightly less-bombastic-than-usual Nigel Farage and my friend Simon Mikhailovich’s views on derivatives which he discusses with Jim Puplava.

That’s all from me—I’ll see you on the other side. For the record, I do NOT need a bailout (please timestamp that June 10, 2012).

*************

I am on the road again for the next two weeks traveling in the USA with the CEO of Vulpes’ agricultural land vehicle about which I spoke a couple of weeks ago. I will attempt to put something together on the various planes, trains and automobiles I will be taking but no promises—if you want those, may I politely suggest you contact your nearest Greek politician.
Japanese Pension Fund Switches To Gold
Spain Too Big For EU Rescue Fund As China Recoils
Big Investors Don’t Know Where To Put Their Cash
Hollande Deficit Vow Lures Investors To French Debt
China’s First “Junk Bond” Market Opens For Business
Staggering 515 Tons Of Gold Sold In 4 Hours
Slouching Towards A Banking Union
Corporations Not Hoarding Cash
Spain Seeks Eurozone Bail Out
Spain’s Bank Bailout Will Not Assuage The Need For Strong Economic Measures
Charts That Make You Go Hmmm.....
Words That Make You Go Hmmm.....
And Finally.....
Okayama Metal & Machinery has become the first Japanese pension fund to make public purchases of gold, in a sign of dwindling faith in paper currencies.

Initially, the fund aims to keep about 1.5 per cent of its total assets of ¥40bn ($500m) in bullion-backed exchange traded funds, according to chief investment officer Yoshisuke Kiguchi, who said he was diversifying into gold to "escape sovereign risk".

The move into a non-yielding asset comes as funds in the world's second-biggest pension market are under increasing pressure to meet promised payments, as domestic interest rates remain rooted near zero. This year, the first of Japan's baby boomers turn 65, becoming eligible for payouts.

Mr Kiguchi said the lack of yield was a concern for the fund’s investment committee, but he persuaded them that “from a very long-term point of view, gold may be one of the safe currencies”. He added that he had sold Australian dollars this month to meet his initial target allocation for gold for the fund, which has 20,000 members.

Mizuho Trust & Banking, a unit of Mizuho Financial Group, has begun to offer investment schemes allowing smaller pension funds to invest in gold.

While few fund managers are counting on a crash in core assets such as Japanese government bonds, said Takahiro Morita, head of the Tokyo arm of the World Gold Council, a producers’ association, they were increasingly receptive to the idea that gold could act as a buffer against shocks. “Last year’s tsunami and the eurozone debt crisis shows that it was wise to expect the unexpected,” he said.

Historically, institutions in the $3.4tn Japanese pension market have clung to traditional assets. Bonds accounted for 59 per cent of industry assets in 2011, the highest share in the world, according to Towers Watson, a consultant. Just 6 per cent — the lowest share — was invested in alternatives such as property, private equity and hedge funds.

Within Japan the image of gold has struggled to recover the lustre lost after a scandal in the mid-1980s involving Toyota Shoji, which duped thousands of elderly investors by promising gold bars that were never delivered. Now, though, households are showing more interest.

Nomura, Japan’s biggest wealth manager, added a gold option to its monthly survey of 1,000 randomly selected retail investors in February. Every month since, gold has been ranked the third most desirable addition to portfolios, well ahead of competing assets such as investment trusts, bonds or foreign securities.

With institutions warming to gold, too, demand could grow further.

“If you look at assets over the past couple of decades, equity has been a loser, while fixed income offers tiny coupons,” said Yoshio Kuno, Japan head of Newedge, the futures broker. “Gold is becoming an acceptable currency substitute.”

As Spain edges closer to a full sovereign rescue, economists have begun to doubt whether the EU bail-out machinery can raise such large sums funds at viable cost on global capital markets.

While the International Monetary Fund thinks Spanish banks require €40bn or so in fresh capital, any loan package may have to be much larger to restore shattered confidence in the country.

Megan Greene from Roubini Global Economics says Spain’s banks will need up to €250bn, a claim that no longer looks extreme. New troubles are emerging daily. The Bank of Spain said on Thursday that Catalunya Caixa and Novagalia will need a total of €9bn in new state funds.
JP Morgan is expecting the final package for Spain to rise above €350bn, while RBS says the rescue will “morph” into a full-blown rescue of €370bn to €450bn over time – by far the largest in world history.

“Where is the money going to come from?” said Simon Derrick from BNY Mellon. “Half-measures are not going to work at this stage and it is not clear that the funding is available.”

In theory, the European Financial Stability Fund (EFSF) and the new European Stability Mechanism (ESM) can raise a further €500bn between them, beyond the sums already committed to Greece, Ireland, and Portugal. “There is sufficient firepower available. In addition, the EFSF/ESM can leverage resources,” said Christopher Frankel, the EFSF’s chief financial officer.

It may not prove so easy to convince global investors to mop up large issues of debt. “Our clients won’t touch the EFSF because nobody knows what it really is. They have cut it out of their benchmarks altogether,” said one bond trader.

The Chinese issued their own verdict on Thursday. The country’s sovereign wealth fund said it will not buy any more debt in Europe until the region takes radical steps to restore credibility. “The risk is too big, and the return too low,”

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“Europe hasn’t got the right policies in place. There is a risk that the euro zone may fall apart and that risk is rising,” he told the Wall Street Journal. The EFSF had hoped to sell yuan ‘Panda bonds’ but this may prove hard.

Eric Dor from IESEF School of Management in Lille said Spain would have to step out of the EFSF as a creditor the moment it asks for funds. This has instant effects on the residual core. Italy’s share rises from 19pc to 22pc, and italy is in no shape to face extra burdens. France’s share rises from 22pc to 25pc, and Germany’s from 29pc to 33pc.

“The credibility of the guarantees given to EFSF bonds would collapse. This would cause an incredible turmoil on the European sovereign debt markets,” he said.

Mr Dor said it would be wiser to let the EFSF recapitalise Spanish banks directly but Brussels said on Thursday that this would be illegal. Germany has in case blocked any move towards mutualization of eurozone bank costs, fearing a slippery slope towards eurobonds and debt pooling.

The man who controls more than €450 billion ($558 billion) is wearing purple, pink and red striped socks and a polka-dot tie, and his bald head looks as if it has been polished. In other ways, too, Yngve Slyngstad is a relaxed Norwegian type. He laughs a lot and has a tendency to inject nuggets of irony into his responses.

So what’s it like to be one of the world’s most powerful investors in 2012? “In the past, we searched for risk-free returns.” He pauses for effect. “Today we know that what we mainly have are investments with return-free risk.”

It’s a common experience for the 49-year-old investor these days. His constant challenge is to find ways to invest a lot of new money and reinvest old money.

As head of the Norwegian sovereign-wealth fund, Slyngstad collects his country’s oil revenues, which currently total more than £100 million – per day. The fund is supposed to use these revenues to provide the country with prosperity for the long term. It’s no easy task, because the government expects Slyngstad and his staff of more than 300 people to generate a 4 percent return on investment.

In the past, investment professionals would have dismissed this requirement as uninspiring. But times have changed. Between 1999 and 2007,
14. THINGS THAT MAKE YOU GO Hmm...

the Norwegian sovereign-wealth fund achieved an average annual return of almost 6 percent, but during the last four years it has only been about 1 percent on average. “The situation in the financial markets has become extremely difficult,” says Slyngstad. Interest rates are plunging worldwide, and Germany, more than any other country, is benefiting from the fear that the eurozone could break apart.

Now that a Greek exit from the monetary union has become a realistic option, Spain is desperately fighting to retain its financial independence and the citizens of Southern Europe have started emptying their bank accounts, the flight to Germany -- perceived as Europe’s safest haven -- has intensified once again.

In the week before last, the German finance minister borrowed money for two years, without having to pay a single cent in interest. Even investors lending the German treasury money for a decade are currently satisfied with a premium of only 1.2 percent per year. The yields on US Treasury bonds and Japanese debt securities are at similarly low levels.

But what is helpful to many a finance ministry is frustrating for investors. When today’s very low bond yields are adjusted for inflation, many investors end up with negative returns. Investing money is becoming tantamount to the destruction of assets, because there are few investments that actually produce any returns.

Professional investors around the globe currently manage more than €60 trillion, more than twice as much as they did 10 years ago. There is talk of an “investment emergency” in the international financial markets, and the most disconcerting thing about it is that the problem is not affecting billionaires or greedy corporate raiders as much as the biggest players in the financial market: sovereign-wealth funds like Norway’s, Japanese insurance companies and US and German pension funds.

French voters head to the polls this weekend with at least one material benefit from President Francois Hollande’s three-week-old reign: record low borrowing costs.

The yield on France’s benchmark 10-year bond slid last week to an all-time low of 2.07 percent. The spread with equivalent German securities has narrowed to 107 basis points from 142 when Hollande took office on May 15. The government plans to take advantage of the drop by issuing 50-year debt today for the first time since 2010.

Hollande has stuck to his pledge to shrink France’s budget gap while gaining from predecessor Nicolas Sarkozy’s record of repeatedly beating the nation’s deficit-cutting targets. For bond investors, the combination has put France -- which was stripped of its AAA rating by Standard & Poor’s in January -- in the league of Europe’s creditworthy north rather than its struggling south.

“What we’ve seen is investors becoming more
comfortable with French risks,” said Harvinder Sian, a senior fixed-income strategist at Royal Bank of Scotland Group Plc in London. “We are happy not to short France anymore.”

French voters choose lawmakers for the National Assembly in two rounds of voting on June 10 and June 17. Hollande’s Socialist Party probably will win the largest bloc of seats, although it may have to rely on other parties for a majority, according to an OpinionWay poll taken June 4 and June 5.

“An absolute majority of Socialists would increase the probability that the government will be able to deliver tougher fiscal austerity,” said Dominique Barbet, an economist at BNP Paribas SA in Paris.

While the European Commission said May 30 that France may need to take “significant” steps to meet its target of reducing its budget deficit to 3 percent of gross domestic product next year, Hollande has reiterated that he expects to meet that goal and plans to introduce fresh budget measures after the parliamentary elections.

His Finance Minister Pierre Moscovici said yesterday that “it’s a promise that will be kept.”

French bonds, Europe’s second-best performers in May after Dutch debt according to indexes compiled by Bloomberg and the European Federation of Financial Analysts Societies, may extend the rally as investors seek shelter from the region’s crisis.

“The outperformance of French bonds reflects demand for high-quality paper with some yield,” said Ciaran O’Hagan, head of European fixed-income strategy at Societe Generale SA in Paris. “This demand should continue in coming months as long as concern about Spain lingers.”

The Shanghai Stock Exchange has begun issuing approvals for companies to begin issuing “junk bonds”, as Beijing seeks to help cash-starved private Chinese firms find credit.

A statement issued through the Shanghai exchange’s microblog approved seven Chinese companies to issue high-yield bonds via private placements to qualified investors. The bonds may then be bought and sold - albeit under highly restricted conditions - on Shanghai’s fixed-income trading platform.

Issuers, analysts and brokerages who spoke to Reuters were enthusiastic about the launch of the new trial programme.

“The new category of bonds offers us a new channel for capital operations,” said Xie Hongbo, chairman of Beijing Ninestar Technology Co, an Internet service provider which is awaiting permission to raise 10 million yuan through 18-month bonds on the Shenzhen Stock Exchange.

“It will be quite easy for us to obtain funding that banks are typically reluctant to offer to us small companies.”

Analysts expect about 4 to 5 billion yuan in high-yield bonds to be issued in 2012, growing quickly to around 100 billion yuan in the following year.

The market could house more than 300 billion yuan worth of outstanding high-yield bonds by 2015, they said.

An official at Beijing Hongyisifang Radiation Technology Corp, one of the seven firms approved by the Shanghai exchange on Friday, also expressed optimism. The company is preparing to issue 20 million yuan worth of 24-month bonds, he said.

Small and medium-sized firms, which generate around 80 percent of the jobs in China, frequently complain about difficulty in getting bank loans, which is driving some into the massive shadow banking system. State-run banks often channel the bulk of their annual lending targets straight to other state-backed firms.

Prior attempts by the central government to help the private sector raise money have pro-
THINGS THAT MAKE YOU GO Hmm...

Reduced inconsistent results.

Beijing recently encouraged banks to direct more money toward private lenders through a high-profile pilot project in Wenzhou, an entrepreneurial hothouse in Zhejiang province which has been hard-hit by the downturn in exports.

However, critics say the Wenzhou reforms are too limited and too localised to make a real difference at present.

With many global investors still rattled by the recent price action in gold and silver, today King World News interviewed the “London Trader” to get his take on these markets. The source told KWN that not only was a shocking amount of paper gold sold in just 4 hours yesterday, but it was also confirmed that the mainstream media is not reporting the staggering amount of physical gold that has actually been purchased by China recently. Here is what the source had to say:

“China has purchased hundreds of tons of gold in the last couple of months. China is not disclosing what their true reserves are. Russia is delaying disclosure and so is Iran. We saw record gold imports of over 100 tons through Hong Kong to China in April, as reported by the mainstream media, but what has been reported is just the tip of the iceberg.”

The London Trader continues:

“What we’ve seen is a dramatic acceleration of physical gold purchases as the price has been drawn down. Staggering amounts of physical gold are being purchased.

I want to be very clear about this, in addition to what is being reported by the mainstream media, we have seen hundreds of tons of additional physical gold being purchased by China over the last three months....

“What happened yesterday in the gold market was very interesting. One full hour before Bernanke’s testimony, the bullion banks started selling. Over the next 4 hours, the bullion banks sold the equivalent of 515 metric tons of paper gold. This was in just 4 hours, and again, the selling started one hour before Bernanke’s testimony.

The selling went on for another 3 hours after the Fed Chairman began to speak, and as I said, over 515 metric tons of paper gold was sold. During this entire takedown, there was zero physical gold available for sale in the market. However, this action did create tremendous supply for the Eastern buyers to lock in the spot price of gold. This will patiently be converted to physical in the coming weeks.

The real question here is, how could an entity begin selling such a massive amount of paper gold when there hadn’t been any news (starting to sell before Bernanke’s testimony)?

During this coordinated attack on gold, hedge funds and managed money were being forced out of their paper positions. A large wave of selling entered the paper gold market and traders saw the price of gold drop $40 in a matter of minutes. So the action was orchestrated by the Fed, and Fed-speak was used to assist in the takedown.

On the opposite side, the rise we saw last Friday was not a natural rise, it was a squeeze of the hedge fund shorts. After squeezing the hedge fund shorts on Friday and actually getting them to take on some long side exposure because gold took out key resistance levels, they then dropped the gold market like a stone yesterday. So the commercials are ringing the register at both ends of the tape. But in reality, what the bullion banks are trying to do is to get out of some of the massive
naked short positions that are on the books. During all of the chaos of the last couple of months, the Eastern hemisphere has been vacuuming physical metal out of the market. However, supply is very tight out there. As I mentioned earlier, no physical gold was for sale yesterday during the takedown, just paper gold. Gold actually went into backwardation, and silver has actually been in backwardation for weeks. For immediate delivery of gold, in size, we are seeing delays, but silver is extraordinarily backlogged.

Also, there was an absolutely staggering amount of silver that was purchased by an Eastern buyer three weeks ago near the $27 level. This order was breathtaking in terms of the size. It is currently queued up at two refiners, but has been backlogged for the last three weeks and running. In other words, we are looking at serious backlogs for physical silver.

Blink and you might miss it. Amid the headlines over Spain’s deepening banking crisis, two smaller members of the euro area quietly moved along with plans to recapitalise their own banking systems. Portugal, which is already on life support, said it will inject €6.6 billion ($8.2 billion) into three of its largest banks. To its east, the Cypriot government said it too may need European help to raise €1.8 billion to recapitalise its second-largest bank.

The growing number of capital calls across banks on Europe’s periphery is leading to a freeze in funding markets, as investors fret that banks may be hiding big losses and as banks lose trust in one another. “The interbank market is totally closed,” says the boss of one large European bank, adding that he is keeping excess cash at the European Central Bank (ECB) rather than lending it to other banks.

It is also causing jitters in government-bond markets as risk-averse institutional investors such as pension funds and insurers worry that governments in the periphery may be swamped by mounting losses in their banking systems. Money is flooding into the safest option, Germany, where the government borrowed five-year money at just 0.41% on June 6th. Despite these signs of panic, the ECB left rates on hold at its June meeting.

The crisis is intensifying calls for the establishment of some sort of banking union, with centralised powers and funding to regulate and supervise banks as well as to recapitalise ailing ones and to insure retail deposits. On June 6th the European Commission took the first steps towards this with a proposed framework for dealing with failing banks that includes plans for sharing some of the costs of recapitalising cross-border banks.

The crisis is most acute in Spain, mainly because the sums of money involved are largest. On June 5th Cristóbal Montoro, the budget minister, said the country needed help from European institutions to recapitalise its banks because the “door to markets” was closed to the Spanish government. This was preventing it from issuing €19 billion of bonds to recapitalise Bankia, a troubled agglomeration of local savings banks that in-
ocurred huge losses on property loans. Two days later the Spanish government sold €611m of ten-year bonds at 6.04%, compared with 5.74% in April.

Were the capital hole in Spain limited to €19 billion the country would probably have little trouble raising the money, although an idea to bypass markets and hand bonds directly to the bailed-out bank fizzled out. Yet many people now think this sum is just the tip of the iceberg. Analysts at Credit Suisse reckon that Spanish banks may have to set aside another €150 billion against losses, mainly on loans to property developers. To remain solvent after such losses the Spanish banking system may have to raise €50 billion-70 billion, or 4.5-6.5% of Spanish GDP, analysts reckon.

That figure looks relatively manageable when set against Ireland’s recapitalisation of its banks, which has so far amounted to almost half of its GDP. Yet the call for government cash in Spain comes at a time when the country is already struggling to retain the confidence of bond investors amid growing capital flight. Almost €100 billion, about one-tenth of GDP, was pulled out of the country’s banks and bond markets in the first quarter.

$496.5 Billion: How much less cash U.S. corporations had at year-end 2011 than previously believed.

The Federal Reserve on Thursday came out with its quarterly “flow of funds” report, which for two years now has reflected the steady increase in the amount of cash on corporate balance sheets. Sure enough, the report showed that corporate cash ticked up yet again in the first quarter of the year by around $12.6 billion, to $1.74 trillion.

But here’s the funny thing about that figure: Back in March, the Fed said nonfinancial companies ended the year with a record $2.23 trillion. The new release revised that figure down to $1.72 trillion. Even for the Fed, a half-trillion-dollar revision is a big deal.

$1.7 trillion is still a lot of money, close to an all-time high. But more significant than the actual number is the implication for what had been one of the most enduring narratives of the recovery: the massive pile of cash that was sitting on the sidelines.

The old story went something like this: The 2008 financial crisis wiped out the cash reserves even of seemingly healthy companies. The ones that survived scrambled to rebuild their reserves as a buffer against renewed turmoil, then kept saving even after markets stabilized and profits rebounded. This has been paradoxically both a cause and an effect of the slow recovery, as companies’ reluctance to spend has reduced economic activity, giving spooked executives yet more reason to remain cautious. Depending on your political leanings, the problem is evidence either of the dangers of corporate greed or of the pernicious effects of over-regulation.

The revised data — at least if it is to be believed — changes all of that. Under the new narrative, companies still rebuilt their reserves in the wake of the financial crisis, boosting their cash holdings from $1.4 trillion at the end of 2008 to $1.7 trillion in mid-2010. Since then, however, the cash hoard has barely budged, as companies neither draw down their reserves nor continue adding to them.
The long-term trend makes the cash hoard look even less remarkable. As a share of assets, cash has been trending upward since the 1980s, rising from about 3% in 1982 to just shy of 6% at the end of 2005. Cash reserves tanked during the financial crisis, then soared in 2009, quickly returning to the earlier trend line. Since then, they’ve more or less held to their prior trend.

In other words, the big pile of cash sitting idly on the sidelines? “Boom, it’s all gone now,” says James Bianco of Bianco Research.

Spain is to seek EU aid to rescue its struggling financial sector, in a bailout that will impose no new economic reform conditions on Madrid other than existing EU budget rules.

After months of denials by Spanish leaders that the country needed a bailout, it fell to Luis de Guindos, the economy minister, to declare in Madrid on Saturday that “the government of Spain declares its intention to request European financing” for its banking system.

Although Mr de Guindos did not say how much money Spain would seek, the eurogroup of finance ministers said in a statement it was prepared to lend “up to” €100bn.

“The loan amount must cover estimated capital requirements with an additional safety margin,” the eurogroup said in a statement, issued by Jean-Claude Juncker, the Luxembourg prime minister who heads the group.

The decision, taken during a two-and-a-half hour call between eurozone finance ministers on Saturday, allows funding to be channelled through the Spanish government’s Fund for Orderly Bank Restructuring (Frob), which would then inject capital into the country’s teetering banks.

Because Frob is part of the Spanish government, bailout loans would still be on Madrid’s sovereign books and the government would bear ultimate responsibility for repayment.

Mr de Guindos said the loan was “on very favourable conditions, more favourable than in the market”.

The conditions will be applied to the banks, not Spanish society.

Spain sold more than €2bn of bonds this week but had feared that rising bond yields would make access to the bond market impossibly costly and so push the country into a full international bailout such as those of Greece, Ireland and Portugal.

Spain is trying to put a brave face on its request for funds, insisting its agreement is different from those of the other rescued eurozone members because the aid is aimed solely at banks and does not involve additional macroeconomic or fiscal conditions imposed by the European Union or the International Monetary Fund.

“What is being requested is financial assistance. It has nothing to do with a rescue,” Mr de Guindos said.

“The conditions will be applied to the banks, not Spanish society,” he added, arguing that the agreement showed the “absolute commitment” of member states to the future of the single currency. “It’s good for the Spanish economy and it’s good for the future of the euro.”
But this is an extraordinary moment. Spain’s is not a tiny economy on the fringes of the continent, but the fourth largest in the eurozone. Delivering modernity and prosperity to a country that was a semi-rural backwater almost within living memory was meant to be one of the crowning achievements of the single currency project.

Yet the acknowledgement that Madrid can no longer safeguard its own banks, which are riddled with bad loans from a decade-long property frenzy, reveals the harsh truth that far from keeping them safe from a rapacious economic world outside, being part of the euro club has drawn them into a frenzy of cut-price credit, and a catastrophic crash.

Though €100bn – the figure cited by European ministers, if not by Spain itself – was a far larger figure than initial reports suggested, many analysts believe that, with capital flooding out of Spain, it will still not be enough to prevent a full-blooded bailout of the government at a later date. Fixing the banks will help the vital task of preventing the entire European financial system from freezing up; but it will do little for the Spanish economy, which is on its knees.

When financial markets reopen on Monday morning, traders will have to decide whether they are reassured that eurozone leaders have opted to act; or whether to start worrying about which country will be next. Italy, widely seen as the next domino to fall, could come under concerted attack.

It was not yet clear exactly where the cash to help Spain would come from. But if a fifth of the brand new bailout fund, the European Stability Mechanism’s €500bn of lending capacity, has been used up before its official launch at the start of July, number-crunchers in financial mar-

“...share prices will soar in sheer relief that something has been done; but then slide once more in the days and weeks ahead as they remember that Spain is still deep in recession...”
Data from the World Gold Council and compiled by beyondbrics show that Chinese demand for gold, both in terms of jewellery and investment, has overtaken India on a quarterly basis. On a rolling four-quarters, China is just – just – behind India. The chart below shows the rolling total, and the pattern is clear.

In 2011 China’s gold purchases totalled 769.8 tonnes, compared to India’s 933.4 tonnes. But the reduction in demand from India may see a drop under 900 tonnes for 2012, and China surge to over 900 tonnes.

Overall, gold demand is down – around 5 per cent from 1,150.7 tonnes in Q1 2011 to 1,097.6 tonnes in the same 2012 period. China and India together make 42 per cent of the world total.

Germany’s Target2 balance—a subject discussed in these pages frequently—has hit €700 billion.

Not good.
I can’t put it any better than the CBO itself when they lay out what they call their “Extended Alternative Fiscal Scenario” so I’ll leave it to them:

“The explosive path of Federal debt underscores the need for major changes to current policies”

One last thought.... when was the last time a national budget came in at the base case?
Worried about that $4/gallon gasoline in the US? Well if you are and you’re thinking of moving abroad to find a cheaper alternative I have some good news and some bad news for you;

The good news is, there ARE some countries which will enable you to have cheaper gasoline. The bad news? Well, just take a look at the list, left.

Oh, and in case you think the price couldn’t increase any more at home. the chart below seems to suggest that, just supposing the US needed to raise more revenue in a hurry (I know, right? Fat chance) they might have some room...

(thanks Gary)
This video, from a year ago, is perhaps even more pertinent today than it was then. A beautiful speech, beautifully delivered by British MEP, Daniel Hannan to a British and German audience during a debate on Europe.

My very good friend, Simon Mikhailovich has been making waves recently and with very good reason. He’s as smart as they come and readers can learn a lot from listening to his wise words.

In this great interview, Simon talks with Jim Plavala about the ticking time-bomb of financial derivatives.

Whenever Simon talks, I listen and I wholeheartedly recommend you do the same...

Nigel Farage’s thoughts on Europe are always worth listening to and so, in a week where the end-game moved significantly closer we check in with him to hear what he makes of the events of the last week or two...Farage is a little more subdued than usual but no less interesting
These incredible pictures capture the stunning moment waves roll on to a tropical beach.

The breath-taking images show the split-second in which each one breaks and crashes on to the sand, and are the work of two keen photographers who wish to remind people just how beautiful Mother Nature can be.

Photographers Nick Selway, 28, and pal CJ Kale, 35, position themselves in the magnificent Hawaiian water - and then wait for the waves to crash into their heads.
Grant Williams

Grant Williams is a portfolio and strategy advisor to Vulpes Investment Management in Singapore - a hedge fund running $250 million of largely partners’ capital across multiple strategies.

In 2012, all Vulpes funds will be opened to outside investors.

Grant has 26 years of experience in finance on the Asian, Australian, European and US markets and has held senior positions at several international investment houses.

Grant has been writing ‘Things That Make You Go Hmmm.....’ for the last three years.

For more information on Vulpes please visit www.vulpesinvest.com

As a result of my role at Vulpes Investment Management, it falls upon me to disclose that, from time-to-time, the views I express and/or the commentary I write in the pages of Things That Make You Go Hmmm..... may reflect the positioning of one or all of the Vulpes funds - though I will not be making any specific recommendations in this publication.

Grant

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