

# Thunder Road

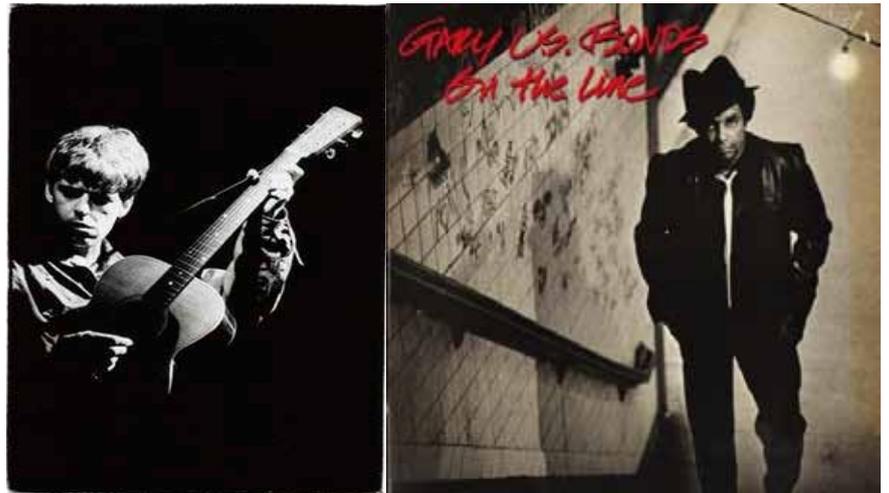
## report

5th July 2012

### Summary only

## Death march: approaching a new financial system

It's beginning to look like I'll never play up front for the red men of Liverpool FC and I'll never write literature with the power of Ayn Rand's "Atlas Shrugged". I can't write literature. Neither can I write a perfect three minute pop song like Lee Mavers' (of The La's) "There She Goes", or match the expressive voice of Gary U.S. Bonds singing "Soul Deep". Gary U.S. Dollars might have been even more appropriate for this report, but the album title ("On the Line") is spot on.



But all is not lost. Liverpool FC has a good new manager, there are great books to read, there is great music to listen to and there are always new Thunder Roads to write...and I think I know what's looming into view for the financial markets.

Let's get to the crux of our problem and the profound lesson I learnt about debt years ago was that:

- ☉ Debt brings forward consumption; and
- ☉ The acceleration or deceleration in debt growth has a "supercharged" effect on asset markets.

Get a loan and go into debt and you don't have to save for years for that house, car, loft extension or factory...it's yours tomorrow. And when everybody's doing it...

Contact/additions to distribution:

Paul Mylchreest  
paul@thunderroadreport.com

**Didn't we have a nice time!**

**Since debt brings forward consumption, the obscene amount of debt in western nations HAS (past tense) already been reflected in their GDP, i.e. a huge amount of GDP was "borrowed" from the future into the past AND is still being borrowed into the present (now primarily from governments and central banks, the supposed guardians of the value of currencies).**

**Remember the KISS principle "Keep It Simple Stupid" whose origin (ironically) was the military industrial complex:**

**"The acronym was coined by (Kelly) Johnson, lead engineer at the Lockheed Skunk Works (creators of the Lockheed U-2 and SR-71 Blackbird spy planes, among many others)."**

**Wikipedia**

**The relationship between debt and consumption is deceptively simple, but it has a very powerful effect on economies and financial markets which is largely ignored. For years, it could be ignored because the effects were all virtuous. Whenever the debt growth started to slow, some idiot stepped in with maestro-like precision and got all the plates spinning again.**

**Furthermore, GDP is purely a measure of spending and not a measure of wealth or value. If we think in terms of analysing individual companies, GDP would be nothing more than the expense/outflow half of the Cash Flow statement. Who, for example, would only look at a rising cash outflow in (let's say) a big cap mining company, like BHP Billiton, and conclude in isolation that this was positive for its share price? Shouldn't they also look at the balance sheet strength, contingent liabilities, credit rating, attitudes of lenders and the earnings outlook? In fact, fears that BHP Billiton is spending (on capex) too heavily have been a factor which has led to the poor performance of its share price in the last year.**

**Capital is being so badly allocated in today's financial system...mainly to bankrupt sovereigns... that it almost defies belief.**

**You can't spend your way to prosperity, but we are in an upside down world where spending and debt are considered to be "wealth". People will look back on this period and wonder how they allowed themselves to become so deluded? Although "It's the debt, stupid", it's funny how rarely central bankers mention the "elephant in the room". But then again:**

**"Let's take a step back for a second. Who are these people? They're the same idiots that never saw anything coming. So whatever they think they see, or whatever they want to talk about, is meaningless because they are probably wrong about what they think...They are the cause of the problem. So why do we want to know what the idiots think about the current state of the economy?"**

***Bill Fleckenstein on King World News***

**The only reason the "idiots" are worth listening to is to gauge the speed at which they will destroy the financial system.**

**Then there are the banks. The "asset" side of the banking system consists largely of loans to consumers and corporates (debt), bonds (debt) and the zero sum game of derivatives. The latter are opaque, but JPMorgan Chase now has a problem here. You didn't really think that the bankers could create nearly a quadrillion dollars of notional derivatives exposure and not cause a catastrophe along the way? WAY! And most bank analysts focus on earnings which, at times like these, is a bit like a fund manager pointing to the yield on his portfolio even though the capital value is either plummeting, or about to plummet. Wood from trees.**



**Fortunately for the TBTF banks, they get their balance sheets liquefied by the central planners. So far anyway, but next time there is going to be a bit of a problem with public opinion. Maybe, they'll have to shut the banks during a bank holiday and "re-boot" the system. Now that's a thought...!**

**The obscene amount of debt, which has built up over decades and been reflected in GDP numbers, is obviously reflected in the prices of all the assets you can see on your Bloomberg screen.**



**This is also a bit of a problem, to put it mildly!**

**In equities, the debt Ponzi is directly reflected in corporate earnings which have been boosted by the "brought forward" consumption. There is going to be tremendous turbulence in equity prices caused by the reduction in corporate earnings (certainly in real terms), punctuated by periods of hopium from centrally planned "stimulus" and compensated, as currencies get seriously debased, by "real" asset backing (unlike bonds). At least we might get a temporary "crack-up boom" at some point...which would be like being on morphine for equities.**

***"There she goes, there she goes again  
Racing through my brain  
And I just can't contain this feelin' that remains  
  
There she blows, there she blows again  
Pulsing through my vein  
And I just can't contain, this feelin' that remains"***

**There She Goes/Lee Mavericks**

**Being an equity portfolio manager is going to be one hell of a schizophrenic (or worse!) ride over the next couple of years!**



**If you are reading this, you are probably a member of what the sociologists would term middle class (albeit at the upper end). This is precisely the segment of society which is poised to come off worst from what is coming. Here is a very disturbing idea. As this crisis develops, if you are an equity portfolio manager and you want to outperform the market, you are going to have to position your portfolio so that it benefits most from your own wealth destruction and that of your family, friends and colleagues. Almost everybody is going to lose and there aren't many places to hide. This is deeply unpleasant but you can blame the central planners. I've written about my own investing, e.g. gold and silver, equities in terms of Maslow's Hierarchy of Needs, etc. In this Thunder Road Report (below) and going forward, I will discuss this middle class theme and highlight positions I have in individual stocks, etc. The only good thing that can come out of this is a rise in awareness. It's just awful.**

**In government bonds, the natural inflow of funds is approaching the end of the road – although there is probably one more short-lived and “wrong-footing” move downwards in the yield on the 10-year US Treasury. Increasingly, the flow of funds into government bonds is merely a direct reflection of newly created liabilities (debt) on the balance sheets of central banks like the Fed, ECB and Bank of England. Long-term US Treasury bonds are in their highest ever supply and at their highest ever price/lowest ever yield. Just another example of our “upside down” world.**

**Brief aside: besides (or maybe in conjunction with) inflation/currency devaluation, there is one other way the US could extinguish the Federal debt (US\$15.8 trillion dollars when I just checked the real time national debt clock) just like that...gone! Used in isolation, almost nobody would suffer! And some people (probably less than 1%) would gain...and boy would they GAIN! Do you know what I'm talking about? Got any? Don't know if it'll happen, but at least it would cheer my wife up. She is still trying to work out how I could have forecast the Great Financial Crisis and made so little money out of it?**

**“You knew Fannie Mae was bust, you should have made millions.”**

**At least she didn't add “you idiot”. She's nice like that.**

**Meanwhile the price of the only financial asset with zero counterparty risk in the biggest global debt crisis in history has been “locked down” for months. There is a reason. It must move in volume to where there is an insufficient quantity prior to the denouement of the current financial system. A new system is coming with a bigger role for gold. You see “the man” isn't**

stupid, even if some of his acolytes are. He has a plan. But there's one "person" who could make things difficult for "the man", so he had to be brought "onside" first.

Dr Kurt Richebacher was the publisher of "The Richebacher Letter" until his death in 2007. Paul Volcker commented that:

"Sometimes I think that the job of central bankers is to prove Kurt Richebacher wrong."

Ain't going to happen. Richebacher himself sagely remarked that:

"The only cure for a bubble is to prevent it from developing."

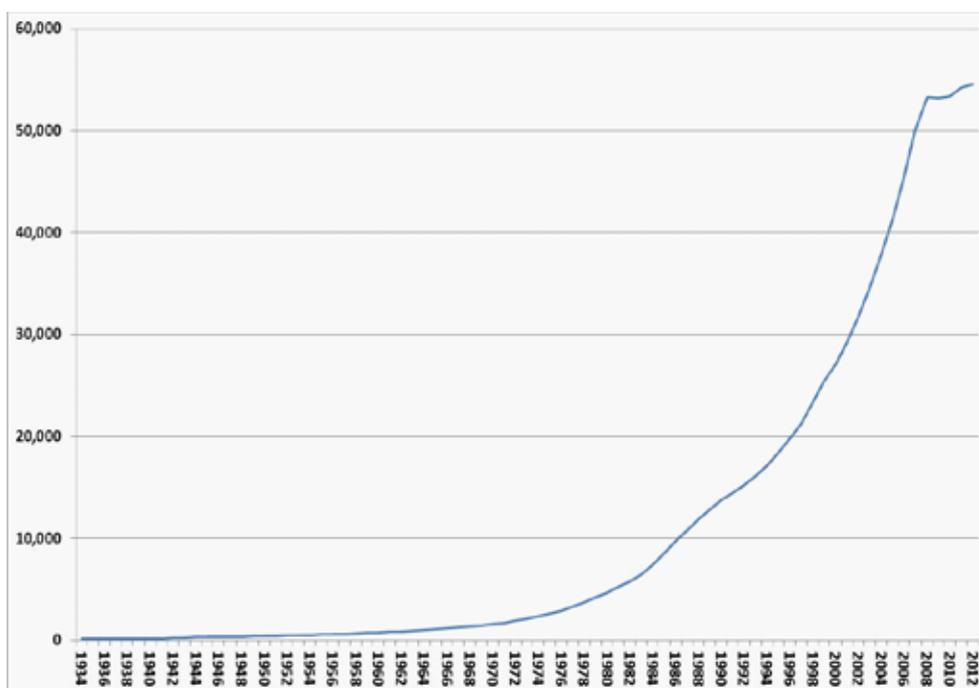
Well it's far too late for this financial system. Ten years ago, before the debt bubble became catastrophic, the free market could have resolved this issue. But Greenspan, the "Great Architect", had to create yet another bubble in real estate and the "point of no return" was left far behind. Then the helicopter-flying monetary psychopath took over and he is creating the bubble to end all bubbles in MONEY itself.

Cue a great comment from Damon Vrabel in "Harvard Lobotomies And The Disgrace Of The Economics Profession":

"The truth is that economics has been designed to completely hide the monetary system that hovers above the economy. Economics assumes money is just a medium of exchange floating through the economy to facilitate a free market and generate wealth. At times that has been true, but today it's probably the biggest lie of modern history."

Let's take most people's current favourite "safe haven", the mighty United (Socialist) States of America. This is the chart of the debt in the economy (total Credit Market Debt Outstanding) since the current Kondratieff cycle began.

*There She Goes - debt in the US economy (US\$bn)*



Imagine telling people that you'd set up a Ponzi scheme and asked them to invest in it. They'd be very offended that you could take them for being so stupid. But you only need to look out of the window, or in the mirror. Salaries, pensions, mortgages, savings, etc. are all paid in... MONEY. And nearly everybody is "all-in."

The Euro, or its purchasing power anyway, is clearly finished if they try to keep the system together, but what about the dollar?

The songwriter, Noel Gallagher, formerly of Oasis and now with his High Flying Birds, commented that:

**“There’s only one boy in this country who scares me and that’s Lee Mavericks.”**

**Raoul Pal, of the Global Macro Investor, said in May 2012 that:**

**“All that is left (to buy) is the Dollar and Gold”**

**I f-----` love reading Raoul Pal’s stuff when I can get hold of it, which is incredibly difficult. He grew up (at least for a few years) near where I did and not far from Lee Mavericks. I can’t recommend his work highly enough. I don’t disagree with him on much, but I do disagree with his view on the dollar (although he might be bullish on the dollar just from a trading perspective and he’s been right since May).**

**The two remaining “sacred cows” preserving the US dollar as the world’s reserve currency are:**

- 1. The belief that the Chinese will continue to buy US Treasuries; and**
- 2. The US dollar will maintain its monopoly on world trade.**

**Regarding number one, the Chinese have been sellers since the end of July 2011 (note the date). With regard to number two, have you noticed how China has set up currency swaps with nearly all of its trading partners? Have you noticed how Iran has been excluded from the SWIFT system and has begun selling oil to some countries in currencies other than dollars?**

**China has been preparing for dollar devaluation for nearly a year now, but hardly anybody has noticed. While everybody frets about the Euro, the dismantling of the US dollar’s reserve currency status is occurring within plain sight. I think a deal was done between the US and China in late Summer or early Autumn of last year. Have you also noticed how Ben Bernanke has used just about every unconventional method of monetary policy he’d discussed in his earlier writings on preventing deflation...bar one big one? Dollar devaluation. Let me repeat that, dollar devaluation.**

**We are heading into a truly mega-financial crisis. This is (another) classic “I hope I’m wrong, but...” report. I think the crisis is going to result in the transition to a new financial system as the current one implodes. Best guess is that it will be either happening, or perfectly obvious that it’s going to happen, within 6-12 months, i.e. within our investing time horizon.**

**This report connects a lot of dots and analyses each one of them. The dots include:**

**Dot - Loss of US AAA credit rating in August 2011**

**Dot - China lashes out at US “addiction to debt”**

**Dot - Peak in Chinese holdings of US Treasuries**

**Dot - China starts selling US Treasuries**

**Dot - Surge in the gold price in August 2011 followed by steep decline**

**Dot - Lock down of the gold price (using “paper gold”) ever since**

**Dot - Movement of large quantities of physical gold from London to Asia (notably China)**

**Dot - Collapse of MF Global**

**Dot - Radio silence on China being a currency manipulator**

**Dot - Exter’s Pyramid playing out in front of our eyes**

**Dot - Iran excluded from SWIFT system**

**Dot - BRICS countries signed the Master Agreement on Extending Credit Facility in Local Currency and the Multilateral Letter of Credit Confirmation Facility Agreement**

**Dot - US granted China a 6-month extension on sanctions for buying Iranian oil (India already had one)**

**Dot - Revisiting Bernanke's old speeches on deflation**

**Dot - Operation Twist**

**Dot - Comments by World Bank President, Robert Zoellick**

**Dot - BIS proposal to upgrade gold to a zero risk weighted asset in line with sovereign debt as part of Basel III**

**Dot - Comments by Robert Rubin ("consigliere" to the elite)**

**Dot - Recent meeting between Kissinger and Wen Jiabao**

**Dot - Why debt deflation now would paradoxically precipitate hyper-inflation**

**Dot - Demise of the middle class (theme)**

**Dot - Putting all of the above in the context of the fourth (and ongoing) price upwave of the last 1,000 years**

**Dot - How each of the three earlier price upwaves came to an end.**

*The rest of this Thunder Road Report will be sent next week to institutional investors who are clients via commission votes/direct payment.*

**Author:** I started work the month before the stock market crash in 1987. I've worked mainly as an analyst covering the Metals & Mining, Oil & Gas and Chemicals industries for a number of brokers and banks including S.G. Warburg (now UBS), Credit Lyonnais, JP Morgan Chase, Schrodgers (became Citibank) and, latterly, at the soon to be mighty Redburn Partners.

*Charts/photos: Thunder Road Report, Federal Reserve Z1, promotional materials for Gary U.S. Bonds, The Who's Quadrophenia*

*Disclaimer: The views expressed in this report are my own and are for information only. It is not intended as an offer, invitation, or solicitation to buy or sell any of the securities or assets described herein. I do not accept any liability whatsoever for any direct or consequential loss arising from the use of this document or its contents. Please consult a qualified financial advisor before making investments. The information in this report is believed to be reliable, but I do not make any representations as to its accuracy or completeness. I may have long or short positions in companies mentioned in this report.*