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KEEPING OUR EYES PEELED FOR THE SILVER AND GOLD BASIS

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Setting up the trip-wire

Gamblers shorting the dollar and bonds beware. Rumors about the imminent demise of the dollar and the bond market are grossly exaggerated. Bear in mind not only that the casino owner rigs your odds. He is also rigging the value of chips in which payoffs are made, thereby confusing the issue further.

The teetering of the dollar at the 80 mark, according to some the most important chart point ever in the history of charting, smells like a bear-trap. A lot of analyst predict that if the dollar violates that support, then it is bound to go into a free-fall. Nobody is seriously considering the possibility that this chart point, like everything else about the dollar, is rigged. It is the trip-wire set to trip up the bears.

The demise of the US long-bond market has been talked about for years. Analysts are so busy in writing the *post mortem* that they have no time to look at the charts. Yet the charts clearly show that the price of the 30-year US Treasuries is in an *upward* channel, where it has been for past 25 years. This in spite of the dollar index being in a *downward* channel, where it has been for the past 35 years. How is it that nobody sees a contradiction here that cries out for explanation? That nobody sees the hand of the master-rigger setting up the trip-wire?

Ticket to riskless profits

Here is a question for the discriminating observer. How is it that interest-rate derivatives do not obey the Law of Supply and Demand? The more there are of them, the more they are in demand. Half-a-quadrillion (500 trillion) dollars' worth are out there at last count (in comparison the US GNP is a paltry 13 trillion), and it is increasing at the rate of 40 percent per annum. At that rate volume doubles about every other year.

Everything in human experience will tell you that such a thing is not possible. The more of anything exists, the less it will be appreciated. If the quantity of a security *increases* exponentially, then its value is bound to *decrease* exponentially for the stronger reason. Yet

here we are, derivatives doubling in quantity every other year and, far from losing value, they are ever more in demand. Why?

Because *derivatives are tickets to risk-free profits*. As such they are the straw on which the world's banking system swims or sinks. Swims, as long as interest rates are falling; sinks, as soon as they start rising in earnest.

Have the Chinese been tricked?

Enormous fortunes have been made on the long side of the bond market by the bulls during the past 25 years, among them by the Chinese, of all people. Make no mistake about it: their \$1 trillion kitty is not all trade surplus. So much of it is the wages of adroit gambling on the long side of the bond market for the past 25 years. In 1982 the Chinese were astute enough to realize that US 30-year treasuries yielding 16 percent per annum were a fantastic bargain. Not only did they lock in an income at 16% for 30 years, but they held out a promise for capital gains by doubling in value at least twice as interest rates fell from 16% to 8%, and then again from 8% to 4%.

The Chinese are not naive as suggested by the analyst. They wrote the book on irredeemable paper currency when the paleface treasurers in the Occident were still experimenting with the alchemy of diluting silver and gold coins in circulation for the benefit of Old Coppernose. The Chinese invented paper without which Helicopter Ben could not do his air-drops of Federal Reserve notes.

Noises from China about their efforts 'to diversify' the dollar portfolio is meant for the gullible. Whenever they are ready to diversify in earnest, the Chinese will not tell you about it in advance. Moreover, the fate of the dollar is already pretty well in their hands. The Chinese have the power, through their continued buying of US long bonds, to drive interest rates further down, all the way to the Japanese, chalking up fabulous capital gains on their bond portfolio in the process. Most importantly, *they can do it even in the face of continuing erosion in the purchasing power of the dollar*.

Fast breeder of bonds not fast enough

The bond market today is immensely different from that of the 1980's. Not only have T-bonds been created through fast-breeders, bond gambling has been further escalated through the creation of interest-rate derivatives. A new generation of derivatives is „invented” every few months. The first generation was to hedge the value of bonds. The second was to hedge the value of the first hedges. The third is to hedge the value of the second. And so on and so forth, *ad libitum*.

There is never enough of those derivatives because new risks crop up with the rise of every new generation of hedges. Academic economists see in them an admirable sophisticated instrument. Pity our poor forefathers. They had to do without them.

Financial journalists want to stay blissfully ignorant of the fact that derivatives have put the Law of Supply and Demand into abeyance. „See no evil, hear no evil.” Cockaigne is here. Perpetual motion has been invented. Enjoy it. Don't ask questions. Sit down, sit down: you are rocking the boat!

The con-conundrum

As I have said, the more of those derivatives have been created the more are demanded, because they are considered a ticket to riskless profits. So they are in Japan, and so they are in the United States. When the casino-owner sells tickets to riskless gains, the law of supply and demand is suspended. Both supply and demand tends to become infinite. Ask Charles Ponzi.

He's been there. Interest-rate derivatives are proxy for bonds. They are new chips that you can use at the casino. They augment a supply the size of which already boggles the mind. On that count alone bond prices should be approaching zero and, interest rates, infinity. Instead, what do we see? Bond prices are still marching upwards. A conundrum indeed, if there ever was one. *A con-conundrum.*

Who says higher interest rates are necessary?

Those who still believe in the dictum of 19th century textbooks on bonds, that it takes higher interest rates and lower bond prices to perk up excitement in a lethargic bond market, are victims of the most brilliant confidence trick of all times. The gambling spirit in the twenty-first century is being upheld, not by higher interest rates, but by issuing ever more tickets to risk-free profits, that is, ever more derivatives on interest rates. Those who still think that it is necessary to bribe foreign suckers to buy more US bonds by the stratagem of printing ever *higher* coupon rates on the new bonds are hopelessly antediluvian. They have never heard of the miracle of creating capital gains through pushing interest rates ever *lower*.

Analysts still fail to see the real purpose of the derivatives monster. It has been sprung on the world in order to keep bond values buoyant, so that the game of musical chairs could go on.

The dollar has fallen through 80. So what?

But what about the US dollar index, allegedly showing that foreigners are getting tired of the infinite supplies of US dollars of diminishing value that keep coming at them? It is nibbling at the all-time low of 80 which, if taken out, you may never hear the dollar to hit bottom. Analysts tell you that you cannot fool Mother Nature. The dollar's value is closing in on its intrinsic value: zero.

Don't buy that. The dollar index, just like the CPI number, is manipulated in order to fool the uninitiated. Should the dollar fall through 80 and approach 70, foreign central banks will see to it that *their* paper follow suit. They are all too eager to match every point of the fall of the dollar. That will reverse the trend. The Chinese, in particular, have a vested interest to keep the fall of the dollar controlled and orderly. What is more, they have the power to do so. They don't mind taking a loss on the dollar here and there, as long as it does not eat significantly into their mountain of paper profits on the bond portfolio.

Central bank bag of tricks

There is no way to predict the future scientifically. I would be a fool if I tried. I am simply saying that a dollar collapse is extremely unlikely at this juncture. I am inclined to lay far greater a store by the chart showing the US long bond in a 25-year uptrend, than by the chart showing the dollar in a 35-year downtrend. Of course, I know that the dollar, the yen, the euro are all being manipulated lower, each by its own issuer. Why, the name of the game is „all fall down“, isn't it? But fall they must *at a controlled pace*. Central banks have a bag of tricks with which they can slow down the depreciation of currency values. The bag is infinitely deep. Furthermore, central banks also have all the marbles. They make most of it. So you want to win by placing a wager against the dollar? Good luck to you, but your odds are infinitesimally small.

I stand by my earlier statement that US interest rates are likely to fall more, replicating that of the Japanese, violation of support at 80 notwithstanding. The world is *not now* at a crucial turning point in 2007, like it was 25 years ago, in 1982, when the Kondratyeff long-wave cycle switched from rising to falling mode. I expect more of the same: falling interest

rates, firms losing market-share and pricing-power, stockpiles of commodities ever more onerous to carry, which add up to a falling price level in disguise. The dollar index? Forget it. It's for the birds.

The Volcker-bluff

Why am I so stubborn in sticking to the deflationary scenario? Here is my reasoning. Hyperinflation almost engulfed the world in 1980. When in a spectacular *coup* interest rates were allowed to go to heights unheard-of at 20+ percent by the maverick Chairman of the Fed, Paul A. Volcker, virtually all the banks of the world became insolvent (as the value of their dollar assets was wiped out by the high-interest-rate regime). The banks were bailed out unexpectedly by the new regime of falling interest rates.

It is ridiculous to suggest that Volcker gave us a strong dollar in 1980 — a repeatable feat. In actual fact Volcker gambled: he staked the world's banking system on saving the dollar from sudden death. Luckily for him, the gamble worked. Before the bluff could be called, the cascading of interest rates started fuelling bullish speculation in the bond market.

Please note that the Volcker-bluff is non-repeatable. In 1982 the world was riding high on the Kondratyeff long wave; 25 years later, in 2007, it is languishing in the depths of the trough. Helicopter Ben could not take his foot off the throttle. If he did, all deflationary hell would break loose, and he knows it. The debt-pyramid would collapse in a fashion more spectacular than that of the World Trade Center.

Keep our eyes peeled for the basis

How could central banks work the miracle of making interest rates fall in the face of running the printing presses overtime, and keep them from rising again? That's just the best part of it. They have let the genie of the derivatives monster out of the bottle. The genie is mushrooming over the world economy, growing at a clip of 40 percent per annum. Right now it is half-a-quadrillion dollar strong, doubling in about every second year. *It is the derivative monster that keeps interest rates low, and makes them fall further.* Remember, derivatives are just tickets to riskless profits in bond speculation *on the long side*. It is as simple as that.

Does this mean that the Ponzi-scheme of derivatives creation will go on forever? Of course not. We have it on the authority of the Bible. Read the biblical story of the Tower of Babel. But how do we know when the Derivatives Tower of Babel will start to unravel? Forget the chart point 80, it is not your clue; nor is any other. *Keep your eyes peeled for the silver and gold basis.* This is the subject of a blue ribbon panel discussion at the next session of the Gold Standard University in August, 2007 (see below).

Do central banks have all the marbles?

It may appear that central banks have all the marbles. Indeed they do — except for one. They have foolishly let the most important marble slip through their fingers. That marble is the *gold marble*. The only wager against the dollar that has a chance of winning in the long run is the one staked out by the gold marble. Ironically, it is also the simplest, and anyone can play it, even people of modest means. That wager consists in scale-down purchases of physical gold. Buy on every dip of the gold price. Upon bigger dips, buy more. In doing so you may ignore all the indicators *with the exception of the basis*: the CPI, the dollar index, bond prices, foreign exchange rates, COT reports. You keep buying, and *never* sell. Your gold is fully paid for. It should be a source of infinite joy to give up worthless (well, make that *ultimately* worthless) paper against acquiring gold marbles.

The music stops when the basis turns permanently negative, heralding the curtain on the *last contango* in Washington. It tells the world that all offers to sell physical silver and gold have been withdrawn in the markets. The monetary metals are not for sale *at any price*. The game of musical chairs is up. Fear not: your gold marble has reserved a chair for you.

If personal misfortune overtakes before that happens, you still won't sell. In an utmost emergency you *borrow*, but not sell. Remember, interest rates are kept at an artificially low level by the managers of the con-conundrum, offering you a gift.

Theirs is a gift that you may accept.

Gold Standard University Live

Session Two of Gold Standard University will take place between August 17 and 29, 2007, at Martineum Academy in Szombathely, Hungary. It will feature a one-week course (13 lectures) entitled *Gold and Interest*, as well as a blue-ribbon panel discussion entitled *The Last Contango — Basis As an Early Warning Sign of the Collapse of the International Monetary System*. Tom Szabo will be present. He is one of the world's foremost expert on the gold and silver basis who on his website www.silveraxis.com has been tracking them for half a year. He is a member of the research team of GSUL.

The second week is reserved for sight-seeing and recreation, including the famous *Savaria Roman Festival* featuring Roman togas and other habits, Roman cuisine, Roman games, etc. Enrolment is limited; first come first served. For more information please contact: GSUL@t-online.hu

Reference

For a chart exhibiting the upward channel of the price of the 30-year US Treasury bond that has been in force since 1985, see:

Keeping Our Eyes Peeled on the Long Bond and the Dollar, Jay Taylor,
www.gold-eagle.com, July 21, 2007.

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