Commodities represent a real alternative store of value

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THE MATTERHORN INTERVIEW – October 2012: John Butler

In this second October Matterhorn interview I am very pleased that Lars Schall had the opportunity to meet up with macro economist John Butler. John Butler, who is founder and Chief Investment officer of the Amphora Commodities Alpha Fund, explains in this exclusive interview, inter alia: what he sees as the consequences of the global financial booms and busts; why the fraudulent environment of finance does not surprise him; what enhanced the "Great Depression 2.0;" and why both gold and silver experience a renaissance in the monetary system.

Egon von Greyerz

"Commodities represent a real alternative store of value"

By Lars Schall

John Butler

John Butler, who studied economics, history, philosophy and international politics, has worked for over 15 years as an interest rate, currency and commodity strategist at major investment banks in North America and Europe prior to founding his own independent investment and advisory firm, Amphora Capital. He was Managing Director and Head of the Index Strategies Group at Deutsche Bank in London, and Managing Director and Head of European Interest Rate Strategy at Lehman Brothers in London. While at Lehman Brothers in the mid-2000s, he was ranked #1 for Interest Rate Strategy in the Institutional Investor Survey.

Lars Schall: Mr. Butler, why did you become interested in finance, and how did you eventually ended up being a professional in that industry?

John Butler: My interest in finance was originally academic. While studying economic history I found that international finance was not well covered or

understood. How were major industrial innovations and developments financed? What about wars or revolutions? The history books tend to gloss over this. Yet finance is absolutely central to history, to the modern, global economy and, by extension, international politics.

My academic interest in finance became a professional interest when I made the decision not to pursue an academic career. It was the early 1990s and the real world opportunities in finance seemed much better. So I found the best job I could, at Bankers Trust in New York, and from that point forward took the best opportunities that came my way. By 1995 I had moved to Germany, then I moved back-and-forth between banks in Germany and London for nearly a decade before settling in London. My primarily responsibility was for investment strategy but I also became involved in product development.

Along the way, however, I became highly disillusioned with the financial industry, observing numerous examples of what I believed to be myopic, excessively risky or even unethical behaviour. By the time the financial crisis hit in 2008 I had already decided to take leave from the financial industry in order to consider how I could use my knowledge and experience to become part of the solution, rather than remain part of the problem. My Amphora Report newsletter, and book, The Golden Revolution, are my most important contributions to date although I have more in the works.

L.S.: Is our current situation very different from anything you have seen in the past?

J.B.: Well my direct experience of finance only goes back into the early 1990s, although I do have an academic background in economic history. A historical perspective reveals a number of interesting parallels with today. There have been documented financial booms and busts going back centuries. There have been experiments with paper money, with leverage and securitization, with what we call today 'financial engineering', and with many forms of speculative excess. But while there are certain parallels, what is happening today is truly global in nature. The boom and bust of modern times, and the policy responses thereto, extend across the entire world. The linkages are massive and, for those concerned, there is not really anywhere to hide.

L.S.: Is the world marching into a Great Depression 2.0 – and if so, why?

J.B.: When future historians chronicle and analyze our era my guess is that 2008 will be seen as similar to 1929 and 2012-13 will be compared to 1931-32. So depending on how you define 'Great Depression 2.0', you could argue that we are already there. Things may not get dramatically 'worse' now from an economic growth standpoint—in the US of the 1930s the nadir in industrial production was reached in 1933—but the period of generally weak economic performance will be prolonged and huge elements of society will discover that their standard of living has declined substantially. That will be a rude shock for most.

L.S.: Could it still be prevented – and if this is the case, how?

J.B.: An economic de-leveraging of historic proportion cannot be prevented. It is necessary to correct imbalances, re-allocate previously miss-allocated resources and rebuild savings. This will take years regardless of whatever policies are in place. The damage already done is great, both prior and subsequent to 2008. The best thing that policymakers could do from this unfortunate point forward would be to acknowledge the failure of neo-Keynesianism—debt- and consumption-led growth—and to tear up those institutions and policies that have made the disaster possible, namely modern central banking (money manipulation, often for political purposes), huge hidden subsidies for financial leverage (embedded in the regulatory structure) and huge disincentives to save (in the tax code).

L.S.: Is the fraudulent environment of finance nowadays something that surprises you?

J.B.: No. When you look at history you find that essentially all financial booms and busts are associated with unusually high degrees of fraud. During a bubble, the evidence of fraud is obscured by monetary manipulation and a generally rising asset price level. Indeed, those inclined to fraud are lured into ever more aggressive forms when they sense that their activities are being 'cloaked' by the bubble. And the leadership of financial institutions becomes populated with those individuals who take the greatest risks, as they temporarily reap the greatest rewards and receive rapid promotion through the ranks. They may not engage in fraud per se but they do take excessive risks with their institutions and then end up lobbying for taxpayer bailouts when times get tough, denying their own responsibility in the matter. As I argue in my book, regulations won't solve this moral hazard problem. Indeed, regulations, including notably central banking itself, create this moral hazard problem!

L.S.: How do you think about the bailouts of investors by taxpayers?

J.B.: If there is a single development that made 2008 the beginning of a 'Great Depression 2.0' rather than just an unusually severe recession, it is the bailouts of investors by taxpayers. Given the scale involved, this is the single most damaging thing that has ever been done by policymakers to the global economy. A huge portion of present and future resources—labour and capital—has been diverted from potentially productive uses to failed financial institutions and governments, concentrating wealth in those institutions that took excessive risks and are now sitting on bad legacy assets.

The future worker, entrepreneur or saver, who could have contributed to a resumption of healthy growth in future will now need to be taxed (directly or via inflation) more heavily than before and will not be able to contribute to future economic progress to as great a degree. It is a great tragedy both at the individual level—where so many middle-class dreams are becoming nightmares—and at the societal level, where potentially large future economic advancements will be delayed indefinitely.

L.S.: Why did you become increasingly involved in the commodities sector?

J.B.: When central banks make it a matter of policy to debase their currencies as required to reliquefy their financial systems and bail out failing institutions, currencies can no longer function as stores of value. They might provide liquidity and be useful for day to day transactions but they no longer constitute a legitimate savings vehicle. The same is true of their bond markets. These might provide a basis for temporary interest-rate speculation but not for real wealth preservation: A future currency devaluation could wipe out all gains in bonds in a single day.

Commodities represent a real, alternative store of value, one that cannot be arbitrarily printed or devalued by governments. Gold and silver were long used as money because they could be trusted as stores of value but to some extent this characteristic is shared by essentially all commodities, some others of which have also been used as money from time to time. The glory days of what I like to call 'phantom finance' not linked to actual, real economic production are over. In future, wealth is going to be generated primarily by real economic activities, most of which require commodity input in some form.

L.S.: What drives the prices in commodities? Is it really supply and demand, or are there other things involved?

J.B.: Fundamental supply and demand are certainly the most important factors but there are others, such as occasional speculation or changes in taxes, subsidies or various regulations pertaining to commodities production and trading. However, as a general rule, commodity prices are less prone to direct manipulation by economic policy authorities because the authorities tend to work primarily through central banking and the financial system, that is, at the 'macro' level, and they can't 'print' commodities into existence no matter how much they might like to. So commodities, long regarded as more 'speculative' than traditional financial assets such as bonds or stocks, actually provide a 'safe haven' against market manipulation and counterproductive economic policies, such as those that abound today.

L.S.: Could you describe the investment strategy you follow at Atom Capital, please?

J.B.: The 'Amphora' strategy that resides at the heart of our investment process is one that seeks the maximum possible amount of commodities diversification across metals, energy, agriculture, etc, and then systematically de-correlates these positions to the financial markets, thereby isolating that aspect of commodity price movements that has essentially nothing to do with stocks, bonds and other instruments whose prices are being arbitrarily manipulated by policymakers. It is an answer to the investment challenges posed by deleveraging, by counterproductive economic policies and by pervasive market manipulation.

L.S.: Why are gold and silver reemerging in the monetary system?

J.B.: As gold and silver have the strongest historical claim to use as money and as reliable stores of value, when investors sense that fiat currencies are at growing risk of debasement, they seek out 'insurance' in the form of

gold and silver. As the supply of gold/silver is relatively fixed, however, higher insurance demand implies higher prices. The bull market in gold and silver is primarily a bull market in financial insurance. And by this I mean proper insurance, not synthetic insurance, such as that provided by financial companies such as AIG, which can and do go bankrupt right when insurance is most needed. Commodities, owned outright and unencumbered, carry zero credit risk, something that can never be the case with banks or insurance companies.

L.S.: You think a significant signal in that regard is the proposal to treat gold as a zero risk asset. (1) Why so?

J.B.: While still a somewhat obscure, technical issue, this one perhaps best highlights the extent to which policy responses in the wake of the financial crisis are counterproductive and inconsistent. On the one hand, policymakers want banks to lend. On the other, they want them to hold more capital. The problem is, these are contradictory policies, although they prefer not to admit this. There is, however, a subtle solution to this dilemma, which would be to increase the range of assets against which banks need not hold any regulatory capital.

At present this so-called 'zero-risk' basket only includes cash and highly-rated government bonds. Following numerous ratings downgrades, however, the available volume of highly-rated government bonds has shrunk. The IMF has written a paper about this development, arguing that there is now a shortage of collateral that is exacerbating the contraction in bank lending to the private sector.

As it happens, however, there is a discussion under way as to whether gold should be included in the zero-risk basket. To the extent that banks hold gold, or lend against positions collateralized by gold, this gold currently consumes some portion of their capital. Eliminate that capital charge and, voila, banks' effective capital ratios improve, enabling some expansion of lending. This partial 'remonetisation' of gold could thus be one step toward improving bank solvency, in particular in distressed euro-area countries, where the accumulated bad debts are enormous.

L.S.: The financial advisor Henry C.K. Liu told me in an email exchange related to this:

"NPRs are merely proposals the solicit comments. The final rules are generally much watered down after comments. At any rate, most of the new Basel III capital requirements will take effect January 1, 2013, but are subject to lengthy transition arrangements consistent with the Basel III framework. Thus, full compliance with most aspects of the new capital requirements would not be required until January 1, 2019. Notably, the second NPR, which contains the standardized approach, would not take effect until January 1, 2015, although banks could elect to apply it earlier. Bank reform moves at snail pace."

What are your thoughts?

J.B.: Yes, these sorts of changes normally occur only very gradually. But

where there is compelling political pressure for action, things can speed up. In any case, financial markets are concerned about the future, not the past, and any anticipation that gold is going to be de-facto remonetised as a zero-risk bank capital asset would almost certainly trigger a substantial rise in price

A key reason why the price of gold currently rises and falls along with risky assets generally is that available bank credit to finance gold positions is impacted by the same capital constraints that finance risky asset positions. Reclassify gold as 'zero risk' and this relationship will break down and gold will outperform in relative terms.

L.S.: Are the heydays of the US dollar over? And what do you think about the meme of a "currency war"?

J.B.: In retrospect, the heydays of the dollar were already over in the early 2000s. From that point forward, the global investor base, including central banks, has gradually diversified away from dollars as a store of value. The dollar remains the dominant global currency for reserves and transactions but is not as dominant as before.

As I am fond of saying, the dollar is in process of becoming a 'normal' currency, one that does not enjoy a lower risk premium—a lower real interest rate—than most other developed economies' currencies. Global currency arrangements are thus becoming 'multipolar', where multiple currencies will be competing. This competition can indeed be characterised as a 'war' of sorts, a term popularised by Brazilian Finance Minister Guido Mantega and also Jim Rickards, author of the book 'Currency Wars', who kindly gave me permission to use material from his book when preparing my own.

L.S.: A prime factor of the dollar hegemony since the 1970's is the fact that crude oil is solely priced in US dollars. Do you see evidence that this is changing, for instance related to gold?

J.B.: Possibly around the edges. There are reports that Iran is avoiding US-led economic sanctions by selling oil for gold rather than for dollars or other currencies through the banking system. If so, this sets an important precedent and demonstrates an important limit to US economic power. But it is far too early to conclude that for the global oil trade generally, gold is replacing the dollar.

When it comes to oil producing nations storing value however, rather than transacting in the oil market, there is more evidence that gold is displacing the dollar and indeed has been doing so for years. As I argue in my book, a confrontation between the BRIC countries and the US over Iran could be the tipping point that 'dethrones' the dollar as the world's pre-eminent reserve currency, triggering a huge US economic crisis larger than 2008.

L.S.: Do you think that a price mechanism "oil for gold" would make sense?

J.B.: It is interesting that you ask this question as the relationship between the oil price and gold price has been stronger than that between many

other commodities through the years. It is as if there has in fact been an informal ‘oil for gold’ mechanism in place all along, within a ‘trading band’ of sorts, perhaps the result of the oil producing nations periodically purchasing gold with their accumulating dollar revenues. Therefore I would not be surprised if, in future, oil producing nations were to implement a more formal ‘oil for gold’ arrangement.

L.S.: Is the gold market a free market (whatever that is), or do central banks and their commercial bank agents intervene in it like they do in other markets? If this is the case, why?

J.B.: I have no privileged evidence that central banks currently ‘intervene’ in the gold market in the sense that they seek to manage the price as an instrument of policy. This was the case under Bretton Woods, however, when there was an explicit link between the dollar and gold. The ‘London Gold Pool’ of the 1960s was an arrangement by participating central banks to suppress the price of gold. After France withdrew from the pool, it eventually broke down and the US was forced to formally abandon the gold price peg in 1971-73.

However, just because I have no evidence does not mean that central banks are not intervening. Clearly they are active in the gold market, buying, selling and swapping, as your own research and that of others indicates. And clearly it would be in the interest of central banks in overindebted countries such as the US or most of the euro-area to prevent gold from displacing their government bond markets as a preferred store of value.

If that were to happen, it would drive interest rates higher and prevent governments from running deficits. In an extreme scenario, it would result in a wave of national bankruptcies and currency devaluations. Policymakers have a strong, arguably existential interest not to allow that to happen. So they have the means and the motive to try and suppress the gold price. But are they doing it? I don’t know. And if they are, will they succeed indefinitely? History suggests not. So if we’re patient we will eventually learn the truth in this matter.

L.S.: What are your thoughts on the so-called “Conflict-Free Gold Standard”? (2)

J.B.: As with many policy initiatives, what sounds good on paper may not work in practice. Worse, it may be outright counterproductive. I would place the ‘Conflict-Free Gold Standard’ in this category. Why? There is the problematic definition of what is ‘conflict-free’, as only ‘unlawful’ conflict is included. Well who is to decide what that is? The UN? The US? Should we be confident that a ‘conflict-free’ standard can be fairly enforced? Or would it just be manipulated to the benefit of those adjudicating on what conflicts are lawful, and which are not?

Also, the entire point of gold as an alternative store of value is that it cannot be arbitrarily manipulated by governments, at least not in the long run. Only allowing ‘lawful’ gold to be traded and not other gold is just another form of market manipulation or financial repression, regardless of

whether it sounds well-intentioned or not. It is an invitation to abuse. For gold to provide a proper store of value it must be fungible. Gold must be gold, it must be free to flow from place to place, be it mined or traded in conflict zones or not.

L.S.: What do you think in that regard in general that "policy makers are finding it tempting to pursue 'financial repression' – suppressing market prices that they don't like"? (3)

J.B.: Financial Repression is a euphemistic term for wealth confiscation from the private sector to public and financial sectors. While monetary inflation in any form (QE, etc) is arguably wealth confiscation, at least in a free capital market savers can find effective ways to protect themselves from it. But financial repression is the limitation or removal of effective inflation protection from those who would desire it.

It is normally cloaked in regulations or guidelines of some kind but it is a confiscation of private wealth regardless. As the very wealthy tend to have much greater flexibility with respect to their financial affairs, including access to multiple jurisdictions and high-level politicians within them, they can normally escape such repression and perhaps even profit from it. Thus the burden tends to fall primarily on the middle class, which is hardly surprising as that is where the negative consequences of failed economic policies in general tend to concentrate.

L.S.: You think that "much official US data are misleading in some way, if not manipulated." (4) How did you come to that conclusion?

J.B.: The evidence here is overwhelming for those who care to look but most simply don't bother. US labour market and inflation data are particularly bad. Perhaps that is understandable as these data are somewhat 'political'. The headline unemployment rate, even if accurate, represents such a narrow part of the labour market that it is borderline useless. Broader measures are better but they too may be inaccurate as most of the data are based on surveys, estimates and theoretical models rather than on hard inputs.

Moreover, the data are frequently heavily revised a year or more later, showing just how misleading the original data were. With respect to inflation, the methodology used has changed dramatically through the years and in each and every instance has always resulted in measured inflation being materially lower rather than higher. Coincidence? I think not. Two particularly abusive statistical methods are so-called 'hedonics' and substitution effects. This is where you adjust prices for quality improvements and for consumers substituting less expensive for more expensive goods.

Now think about this for a minute. Who is going to judge quality? How? And at what point are consumers substituting lower quality for higher quality goods? Finally, note that these hedonic effects only work in one direction, not in reverse. They can never contribute to higher inflation, only lower. But we all know that quality per unit currency spent can decline as well as increase, in particular for services such as education, healthcare and

transportation.

L.S.: To what extent will the price of gold rise as it becomes remonetized?

J.B.: A full remonetisation of gold, where savers could exchange currencies on demand for gold as an alternative store of value, would require a huge rise in price. A common refrain from the pro-fiat crowd is that there is too little gold to provide a sufficient money supply. At current prices that is true. So were gold to be used as actual money, competing with dollars or euros, the price would have to rise to the point where supply and demand were in equilibrium.

To be credible, this would require a substantial gold backing of the narrow money supply, that is, central banks would need to hold sufficient gold reserves to back a large proportion of cash in circulation + bank reserves. This implies a gold price of about $10-15,000/oz or EUR6-8,000/oz (The eurosystem currently has proportionately more gold backing proportionately less narrow money, thus the price would not need to rise by as much). But in fact the price could be higher still because these prices assume that the narrow money supply would not continue to grow in the interim, for example, to monetise excessive government debt.

Given that central banks are desperate to reflate their economies rather than to restructure their debt (default), most probably the gold prices eventually reached will be even higher. But note that these price increases would not imply an increase in the purchasing power of gold. Rather, they would represent a huge inflation, in which the purchasing power of fiat currencies would decline spectacularly. This would not necessarily lead to a hyperinflation, however, as long as the intent of policy was clear, that currencies were being devalued with the specific purpose of enabling the remonetisation of gold. If that happens, then from that point forward, you would have a remarkably high degree of price stability, perhaps even mild price deflation, not hyperinflation, as is the historical experience of gold standard economies.

L.S.: Related to the ongoing crisis of the euro, the economist Guido Preparata told me a few months ago the following:

“The idea of the Euro is as follows: first, assign the lead to Germany as chief partner / banker / accomplice of the plan, chief economic force of the Union, and chief exporter; then let all the other weaker players (PIGs, Spain, Italy), who produce virtually nothing, indebt themselves vis-à-vis Germany and Anglo-American banks, which, in turn, make good money from the yield on these Euro-bonds (the debt spiral). Concomitantly, any kind of manufacturing / artisanal potential on the part of Europe’s minor partners is systematically wrecked and incapacitated by the flood of Chinese imports (China: the other key accomplice in this triangular crippling of Europe), which are themselves crafted by laborers slaving for wages that are less than a tenth of the West’s.” (5)

Is Mr. Preparata heading with this analysis in the right direction?

J.B.: He does offer an explanation of what has happened in Europe although I doubt that this is what Germany or France intended. The history of the euro goes way, way back. In large part it is a response to the dollar hegemony of the 1950s-60s. While France took the lead, most European nations had determined by the late 1960s that the Bretton Woods arrangements, with the dollar as the sole reserve currency, were not in their best, long-term economic interest.

Meanwhile, economic integration was under way, to some extent spontaneous and to some extent top-down, as a result of the common market. However, notwithstanding this process of integration, what was not occurring was convergence: The Germany economy was stronger and more competitive than most and the Bundesbank favoured a strong currency to maintain relative price stability. Other countries would periodically devalue to restore competitiveness, something that was disruptive for Germany.

In time, France came to embrace a strong currency as well, and from that point forward monetary policy convergence became a Franco-German political force that eventually resulted in the euro. The problem was, the political push for convergence ran ahead of real economic integration. Mitterrand and Kohl wanted their places in the history books and so they forced the issue, putting the single currency (cart) in front of the economic horse (integration). And so the seeds of a great crisis were sown. Was that the intent all along? Did France decide to embrace a strong currency in order to cause a huge crisis threatening its banks down the road? Didn’t Germany merely intend to extend the benefits of a stable currency not only to France, but to the rest of Europe? Or did both Germany and France risk the survival of their own banks and health of their own economies in order to serve Anglo-American banking interests? I doubt it.

Regarding the role of China, this idea that Chinese ‘slave-labour’ threatens Europe is logically inconsistent. Do Europeans want to pay more or less for the products they consume? Most would say less. Do they want higher or lower paying jobs? Most would say higher. But of course the only way in which we can both pay less for products we consume and receive higher wages for those we produce is through increased productivity, enabled by technology, specialisation and trade.

To blame China for Europe’s declining competitiveness is unfair and I detect an elitist, almost racist tone in much of the China-bashing. No, the blame should be placed squarely where it belongs: At the uncompetitive European welfare state. If a welfare state is economically competitive it must be able to grow without accumulating debt. It is no coincidence that every welfare state in existence today has been accumulating debt, with Norway and a handful of other small, resource-rich countries providing notable exceptions.

L.S.: What do you think about the solutions that are offered to solve the euro crisis?

J.B.: Bureaucrats are naturally drawn to bureaucratic, policy-driven solutions to the problems created by bureaucratic policies. Creating problems to solve is a nice way to stay in business but it hardly serves the interests

of society. Rather, it is self-serving. Thus I am not at all surprised by the proposed 'solutions' to the euro crisis being primarily various forms of bailouts, guarantees, and forced financial, fiscal and economic integration—to be managed by the bureaucrats of course. But these are not solutions at all.

The fundamental problem with the euro is not the euro. It is the lack of natural (rather than artificial) economic integration combined with the unserviceable debt accumulated by dysfunctional, inflexible welfare states that consume more resources than they produce. If you want to save the euro you must reform the welfare state bureaucracy and restore economic competitiveness. For economies to be fully competitive they must spontaneously trade and integrate as broadly as possible. So the natural economic integration necessary for the success of a single, strong currency would be achieved if the bureaucrats would just get out of the way. Sadly I see little chance of them doing so until the economic situation becomes much worse.

L.S.: What advice would you like to give our readers at the end of this conversation in order to survive the hard times we're going through?

It is important to remember that we are going through these times. They will pass. History has dealt us a difficult hand to play and we have limited options for how to play it. There is no 'solution' other than to focus our efforts on the long-term and confront short-term challenges with a healthy degree of stoicism and basic human virtue. It is frightening but also enlightening to learn that the system is broken and that to the extent it still functions at all it does so not in our interest but that of a financial and government elite.

While the coming decade is a historical write-off—there is just no way that our standard of living is going to increase materially in that time frame—thereafter we may be able to make great progress, if we start from a solid, deleveraged economic foundation including sound money and personal liberty. All the great technological innovations of modern times—communications, microengineering and health care to mention but a few examples—will eventually contribute to a great economic boom, as I argue at the end of my book. Just be patient and do your part to embrace the changes that are required in the meantime, even if they imply a degree of personal hardship or sacrifice. As a father of four children ranging in ages from eleven to one year in age, such thoughts are constant in my mind.

L.S.: Thank you very much for taking your time, Mr. Butler!

John Butler is now the Chief Investment Officer of Amphora Commodities Alpha Fund, an independent investment and advisory firm in London. He has written extensively on financial topics, and his work has been cited in the Financial Times, the Wall Street Journal, and the Frankfurter Allgemeine Zeitung, among other publications. He is also the author and publisher of the popular Amphora Report newsletter and is an occasional speaker at global investment conferences. In April 2012 he published the highly recommended book "The Golden Revolution: How to Prepare for the Coming Global Gold Standard,"

published by John Wiley and Sons. An archive of his writings is provided at Financial Sense under this link:

http://www.financialsense.com/contributors/john-butler.

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