

Black Swan Plc

People who say it cannot be
done should not interrupt
those who are
doing it" George Bernard Shaw



BLACK SWAN NEW YEAR LETTER 2015

“Strange days have found us, Strange days have tracked us down” *Jim Morrison, 1967*

Euro Trash

So as 2015 dawns we can gaze upon the familiar wreckage that is the new norm for the Euro. The blood coming through the Greek bandages, which we were assured were merely little bits of residual bleeding, are now exposed to be the full-on broken limbs some of us said were always there. How much has been spent on Greece? Does any body know? €45 bil to start in 2010, two months later €130bil, €130bil in 2011, the default of 2012 for €206bil and another €130bil needed at the end of 2012...is this the same money: does anybody care?

Well they should care now with SYRIZA heading for power. Just to recap: SYRIZA's 2012 policies were to write off €320bil of debt, return the retirement age to 34 and pay everyone a pension of €100,000pa. OK, only the first one is true, and of course they have really toned down the first one: now they plan to write off only 50%. But of course that is on top of the March 2012 50% "default" which cost €206bil.

Never mind, the Germans have a solution. Their Finance Minister, Wolfgang Schauble, stated: **“Fresh elections won't change Greece's debt. Each new government must fulfil the contractual obligations of its predecessors. If Greece chooses another way, it's going to be tough”**. Clearly this is a threat, and not really too thinly veiled, but what exactly can the Germans do if Greece does default? I suspect not very much but nonetheless I would advise the Greeks to watch it as rumour has it that Schauble has a collection of vintage Tiger Tanks which would be more than a match for the bicycle mounted Greek army.

All this of course comes as the ECB finally says 2015 will be the year of Quantitative Easing for Europe. Even if this is a reversal of austerity (which has never been properly enforced anyway) I suspect that Germany will not support it. It will thus be a half-assed effort, which will produce instant devaluation of the Euro, a loss of confidence for the markets and very little else.

When good Americans die they no longer want to go to Paris

The Dow ended the year just off its all time high and US GDP data has been revised to show the economy grew at 5% in the last quarter. It certainly looks as though America has staged a Lazarean resurrection but here too there is the sign of bleeding through the bandages.

The Swan explained the problem of government promises and the unsustainable deficit a year ago (http://www.blackswanplc.com/download/BlackSwan%20New_Year_Letter2014-2.1.pdf) specifically using the USA as an example, and none of this underlying structure has changed. We know that the reason for the soaring equity markets is that these have been the home for the garbage trucks of cash from the flood of quantitative easing and my friends at Arabian Money suggest that the upward

GDP adjustment maybe the first hints of inflation rather than real growth. The Swan believes this to be a correct assertion.

The Chinese knew that inflation, in the US\$, was coming back in 2009 when the QE programs were announced. Luo Ping, an official at the China Banking Regulatory Commission said at a conference in New York: "Once you start issuing \$1tn-\$2tn...we know the dollar is going to depreciate so *we hate you guys* - but there is nothing much we can do".

What they have done is stop buying US debt. In November of 2014 a statement went out saying: "Better use should be made of China's foreign exchange reserves to support the domestic economy and the development of an overseas market for Chinese..goods". It can't get much plainer than that.

The American people, who regular readers will recall own the bulk of US debt, haven't got much appetite for more either: Joe Shmoe's MasterCard is pretty much maxed out. So the US will have a problem funding the current deficit without a substantial rise in interest rates.

So what on *Earth* is really going on?

Rather than looking back on 2014 as a year when the western (or American) economy turned around I see it as quite possibly the beginning of the final shift in the World's Economic Power base. In the last few years I have written many times about the rise of Asia and the future dominance of China in the world economy. Whilst there is probably now some general feel that in the future China will be more powerful there seems to remain a worrying complacency at a senior political level in the West that the general structure of the world economy and who controls it, will remain unchanged. David Cameron for example still appears to believe that his experience as a PR agent means he can lecture the Chinese about "human rights" and can send delegations of useless MPs to Hong Kong to "review policies implemented after the handover": unbelievable arrogance which has been treated with the contempt it deserves.

China is the pre-eminent power in the BRICS¹ and is leading them on a series of moves that will change the financial world for generations.

The Inexorable Rise of the BRICS led by China

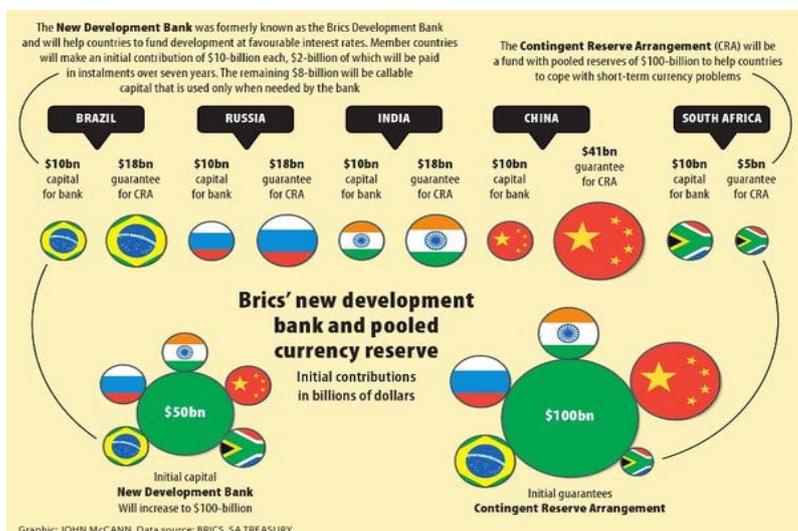
For me the last twelve months have been characterised by the thudding sound as the massive building blocks of the new economy fall into place. Some of these have barely been reported in the Western media, or if they have been, they have been characterised by a patronising tone normally reserved for watching children playing "house" or "hospital". So let's review these and see what has changed.

The New Development Bank

Having announced the idea in March 2013 as the "BRICS Bank" this institution was formally brought into being at the 6th BRICS summit in July 2014. The initial shareholders are the BRICS (Brazil, Russia, India, China, South Africa) but they do not rule out adding other participants in future. Of course the headquarters are in Shanghai and the first head of the bank will be from India. Ignore this at your peril.

¹ Brazil Russia India China South Africa: an acronym invented by Jim O'Neil of Goldman Sachs in 2001

Most western media reported the bank as capitalised at \$50bil: a fair amount of money, but not that much compared to the World Bank. However this is not really correct: have a look at the graphic below:



The \$50bil is only the *initial* capital: there is already a contingency reserve in place of a further \$100bil (41% of which comes from China) and there is provision for the capital to increase to \$100bil. So let's call it what it is: this is a \$200bil rival to the World Bank.



"Is Everybody Happy? You bet your life we are!" *The Scaffold, 1966*

Asian Infrastructure Investment Bank

In October 2013 China floated the idea of the Asian Infrastructure Investment Bank ("AIIB") and openly stated that they were fed up with the lack of reform in the Western dominated financial institutions. In November 2014 President Xi announced the doubling of the initial contribution **from China** to increase it to \$100bil.

The initial group of countries which formed this bank are: Bangladesh, Brunei, Cambodia, China, India, Indonesia, Kazakhstan, Kuwait, Laos, Malaysia, Mongolia, Myanmar, Nepal, Oman, Pakistan, Philippines, Qatar, Singapore, Sri Lanka, Thailand, Uzbekistan, and Vietnam.

A lot of these are obvious but Oman and Qatar are not: two Middle Eastern countries, which have resolutely refused American friendship. It is critical for China to bring countries outside Asia into their orbit to carry out the final stage of the new financial structure.

China specifically invited Australia to join and promised us a major role in the bank if we did. It has been well reported in Australia that many members of the government wanted to join, particularly the Treasurer Joe Hockey, but at a last minute National Security Council meeting (while Hockey was away on a visit to China) the government meekly bowed to American and Japanese pressure and stayed away.

The Chinese are normally feted when they visit the UAE but, for the moment, the UAE is too much in the thrall of the US to go against them on the matter of the AIIB. There is however a steady increase in trade denominated in Renmimbi between the Gulf region and China. Iran obviously has had no choice for some time and China has been keen to encourage them. However the UAE's first such agreement was in 2012 and there has been a steady increase ever since. Now, with some of the Gulf states joining China's new bank, the pressure to trade in Renminbi will continue to rise thus pushing the dollar into an ever diminishing role as the world trade currency of choice. This will not be an overnight sensation but in the Swan's view will return the situation to the 16th and 17th Centuries when China was a major trading power in the world order.

The Silk Road Fund

In November 2014 China announced the Silk Road infrastructure fund with an initial contribution from them of \$40bil. Other countries are invited to join with the objective of putting in place the infrastructure to create a new Silk Road economic belt. The goal is “to break the connectivity bottleneck”, President Xi was quoted as saying, with investments in infrastructure for both land and sea.

So lets put all this in perspective

How do all these numbers stack up against the existing institutions?

New Development Bank:	\$200bil
Asian Infrastructure Investment Bank	\$100bil*
The Silk Road Fund	\$ 40bil*
	\$340bil

*China contribution only

Well, the assets of the IMF in SDR's is around \$309bil; The World Bank is \$223bil; Asian Development Bank is \$163bil. So in the space of 24 months China has put in place new financial institutions, which, with contributions mainly from China, have nearly 50% of the assets of the existing major international financial institutions of the West.

That's quite a marker as regards the way things are going; and in the midst of all this America's contribution has been to pressure it's allies and vassal states into staying away from the new institutions. Particularly in Australia's case this makes no sense at all.

But what about Russia?

Russia is the other “Senior Partner” of the BRICS and the only other nuclear power.² Under Putin they have been strutting across the World stage and generally annoying the West. This has led to the current position with sanctions and the collapse of the Ruble, but there is another view.

In a cogently argued article in the FT, Eugene Rumer suggests that inside Putin's parallel universe the future is bright.³ First off who has done better over the last 15 years in power? Bush and Blair left office as war criminals, Gerhard Schroder works for Gazprom etc. etc. whereas Putin is still there with domestic approval ratings over 80%. GDP has increased six-fold and income per head seven-fold which is pretty good by most standards.

Of course China has outstripped Russia easily on every measure but this example is hardly a counter argument to the totalitarian thrust of the Russian state: more really an assurance that they are on a better track than the Western “democracies”.

² South Africa of course was a nuclear power as they tested the Israeli bomb and supplied the uranium for the joint RSA-Israeli program. However Mandela and de Klerk agreed that the stockpile should be destroyed before the hand over. They deserved that Nobel Peace prize for many reasons.

³ <http://www.ft.com/intl/cms/s/0/5012b062-8925-11e4-9b7f-00144feabdc0.html?siteedition=intl#axzz3Mdja52pO> “From inside Putin's parallel universe, the crisis looks bright”

It is also important to realise that Ukraine serves more purposes for Russia than simple territorial gain. It is an economic experiment for Russia (and China) to demonstrate what happens if you take money from the West. The headline IMF number early last year was that they had provided \$17bil to Ukraine. The EU said they would provide \$11.1bil. In December 2014 the IMF stated that they thought Ukraine might need “a further \$15bil”, the clear implication of this statement being that they had already received all of the money promised. Not so: of the \$28bil promised only \$8.2bil has been handed over yet all of the cuts and “austerity” measures have been put in place. So basically the West has made some big promises, harsh demands and under delivered.

Russia has also helped; yes, you read that correctly. Because Ukraine breached a debt covenant when it took the IMF money Russia could have demanded repayment of a \$3bil loan but instead they chose to extend it. Also, in December, they agreed to continue gas supplies at the old (low) rate.

In 2015 expect a “rescue” of Ukraine perhaps by the New Development Bank, but certainly orchestrated by Russia. It would be a great opportunity for the new and old orders to co-operate but in the Swan’s view that is extremely unlikely.

Sanctions have of course hurt Russia but they have also had a hugely damaging effect on Europe. Do not expect much German support for continuing zero supply to one of their largest car markets.

Oil Price Pressure

The pressure on the oil price comes from two factors: supply (which has increased) and demand (which has fallen). Historically in a situation like this OPEC has been the swing supplier and adjusted output to smooth or maintain prices but on this occasion they chose not to do this. Pushed by The Kingdom they elected to maintain output and let prices fall.

It is possible that Saudi are playing one of the shrewdest political games in their history by claiming on the one hand that they are supporting the USA by hammering Russia and Iran but also, by the back door, stuffing the US shale producers. If this is their game then it will not work, as they do not understand Chapter 11. Yes, US shale producers will go to the wall, they are by and large leveraged small players, but they will file for Chapter 11 bankruptcy protection, the banks will take the hit and the smarter bears in the forest will buy the production for cents on the \$ and turn it back on in a couple of years.

Whoever is playing whom on this one, do not expect \$100 a barrel anytime soon.

Conclusion

China and the BRICS are far closer to an alternative world financial system than the West believes or more possibly is prepared to state publicly. Nixon and Kissinger created a historic rapprochement with China in 1971 that was truly visionary as a way forward for the world. Pretty much ever since then, America has fought against China at every turn and particularly with the creation of the new financial institutions over the last 24 months. In doing so they are painting themselves, and their vassal states, into a nasty corner.

When major change like this happens, in the world, in companies and in relationships there are really only two choices. The change is going to happen so the choice for the current incumbents is whether the existing structure/relationship ends well or ends badly. So often people choose the latter and at the moment it would seem that this is America’s choice.

China has also been accumulating vast amounts of gold: quite possibly most of the gold America says they own, or have stored for others, is now owned by China (for the Swan's explanation of this see: http://www.blackswanplc.com/images/uk_investor_show.pdf). But there is no immediate prospect of a gold-backed RMB. For that to happen China would need a whole group of countries to agree to use the RMB for trade and possibly even to link their currencies to it, but with the new financial institutions in place this draws ever closer.

Do not view Russia as a failed or doomed state: merely a buying opportunity. China will always be there to rescue it, at a price of course, but they will never let Russia fail. Europe should also remember that as they jump to do America's bidding against Russia that Russia has not yet used their most powerful weapon: energy. There is absolutely no prospect of American shale gas replacing what flows into Europe through the Russian pipelines so if it looks as though the solids are getting too close to the fan and Russia turns off the gas taps it will be the Europeans sitting shivering in the dark not the Americans.

Quite possibly 2015 is the end of the Euro as we know it. The Greek elections (and the UK/UKIP ones) will be a major test for the rest of Europe as to how much they are prepared to pay to keep the show on the road. The combination of having to support the PIIGS⁴ and impose sanctions on one of their biggest trading partners I am sure will make the Germans think twice.

The US\$ is currently on a roll and that will probably continue as there is no attractive alternative currency at the moment (the Sterling rally was over last year and the Euro...well...). Ultimately though, gold is the best currency for a time of uncertainty. I freely admit that I (and some of my friends) have called this one wrong in the last couple of years: we floated Wishbone at least two years too soon, but I still remain committed to gold as a way of hedging against the massive market uncertainties that have built up since 2009 and the inflation which will in the end follow QE.

As a sub-point on this, just because the US has been the primary exponent of QE do not think that inflation will be limited to the US. As long as the dollar remains the main world trading currency that inflation will be exported to all the dollar linked currencies. It will also flow through to all of America's trading partners who will need to ensure that their currencies fall to keep exports competitive.

In closing, I wish you all the very best for 2015 and for the Year of the Sheep which starts on 19th February. To quote one of my daughter's favourite films: "May the odds be ever in your favour"⁵.

Very best



RP

⁴ Portugal, Italy, Ireland, Greece, Spain

⁵ "The Hunger Games"