

Raiders of the Last Piggy Bank

By Adrian Douglas

On this day of relative calm; very few incoming e-mails, no markets open, no telephone calls, on this very first day of 2006 I sat down to ponder the characteristics of our financial system and the derivatives market. I would like to share this with the café

Our financial system for around 10 years has been operating as what might best be described as a "Piggy Bank" system.

- The US is importing more than it exports to the tune of \$70 billion each month. This means that the US, as an entire nation, is spending more than it earns EVERY month. The only way that this is sustained is for the US to borrow the difference. This money has to come from some one who has a surplus of capital. It comes from someone's or some country's piggy bank.
- The US government is spending more than it receives in tax receipts to the tune of \$30 billion EVERY month. The difference has to be borrowed. It has to come from someone's Piggy Bank. The Piggy Bank that has been raided is the Social Security Piggy Bank. The Social Security Piggy Bank should have been bulging with trillions of dollars ready to pay the retirement entitlements of millions of baby-boomers. It is empty.
- The world demand for copper has been exceeding mine supply for several years. The difference has to come from someone's piggy bank of copper. World stock piles have been depleted to fill the gap. LME copper stock piles were at a high of one million tons three years ago. They now stand at 88,000. A mere 91% drawdown!
- The world demand for silver has exceeded mine supply for almost 15 years. World demand has been exceeding supply to the tune of 100 million ozs per year. The difference has been met from someone's silver piggy bank. Fifty years ago the US alone had a reserve of over 4 billion ozs of silver. It now has none. Five years ago the worldwide stock piles of silver were estimated at around one billion ozs. That stock pile is down to around 400 million ozs today.
- World demand for gold has exceeded mine supply by around 1500-2000 tons per year for almost 10 years. The difference has been met from someone's piggy bank. Those piggy banks have been the world central banks. They have sold or loaned gold to make up the short fall from their stockpiles. The stock pile of gold in the Central banks was 32,000 tons ten to fifteen years ago. It is probably down to around 17,000 to 22,000 tons now. The Central Banks are so devious that they count gold that has been loaned out as if it is still in the vault, so no one can see that the piggy banks are being raided.
- Individuals in the US have been spending more than they earn for at least 5 years. The US savings rate is negative. The difference is met from someone's piggy bank. That piggy bank has been the home. People have been extracting equity from their home in re-financing deals to fund the difference between what they earn and what they spend.
- The world is almost at the point where it consumes more oil than it produces. When Katrina and Rita hit the US gulf coast causing damage that shut-in oil and gas production for months the World had to raid the strategic stockpile piggy banks.
- The internet and IT were heralded as a great leap forward in productivity because they allowed "just in time" inventories of finished goods to be held. While this is no doubt efficient it is another example of raiding the piggy bank and drawing down stockpiles

These are just a few examples but a trend is clear. The US and much of the civilized world is living beyond its means. This is being achieved by raiding the piggy banks of every description. Those piggy banks were filled by the hard work and investments of previous generations. This

generation is squandering it all and pretending it is prosperity brought about by increased productivity. It is not. This society can be typified as the **“Raiders of the Last Piggy Bank”**

At the same time as the piggy banks have been raided, coincidentally, a new financial instrument came to the fore. The **“DERIVATIVE”**. This market did not exist to any great extent more than 10 years ago. It has now mushroomed to around a \$200 Trillion (yes, I said trillion!) global notional value market. Greenspan has spoken often in favor of not regulating the derivatives market. He has lauded the derivatives market as allowing players to efficiently spread risk and, therefore, bring great benefits to companies. When anyone talks about the virtue of derivatives it is always in the context of risk. But given the above discussion of a society that is the Raiders of the Last Piggy Bank we can look at it differently. A derivative is a contract between two parties that requires one party to do something IF a certain triggering condition is met. If the condition is not met the contract expires and the purchaser of the contract will have paid the price of the contract for nothing in return. This is a bit like the insurance on your house. If your house burns down the insurance company pays you the value of the house, if it doesn't then you have paid the premium for nothing in return.

If we are raiding the Piggy Banks of the world and stocks of everything are being drawn down what better than to delay issuing items from the stockpile? “Don't take a barrel of oil, or a ton of copper, or an oz of gold, or a bar of silver from our stockpiles. If you really don't need it now why don't you take this piece of paper that says you can have X amount of item Y if the price of Y reaches a certain level?” What an excellent way to ration precious supply of anything. Just issue a conditional I.O.U. and hopefully the condition won't be met and they won't come back and ask for delivery. And even if it is met maybe it can be rolled over into another derivative contract.

This is why derivatives have mushroomed. They are a way to delay the day when the Piggy Bank is empty. It will be unfortunate for the derivative holders that they will get nothing except perhaps a stack of paper that can't be spent for at least an hour while the ink dries on it, by which time it may well be worthless anyway!

When I play golf with my son he agrees to bet a dollar per hole. I know he only has nine dollars in his Piggy Bank. He knows that too. When we reach the ninth hole and he owes me the princely sum of \$9 he offers me a derivative contract to ration the supply from his Piggy Bank. He says “OK! Double or Quits”. He has delayed the draw down on his Piggy Bank for another 9 holes. If he wins the next 9 holes he lives to fight another day keeping his \$9, if he loses he will have to default on half of the payment. The leverage of doubling my winnings makes the derivative contract very attractive instead of pocketing the nine dollars.

In making the second bet was my son reducing the risk of having to pay \$9 dollars or simply delaying the draw on his Piggy Bank?

The fact that derivative contracts have soared while stocks of everything have been drawn down suggests to me that the real use of derivatives is to delay delivery of anything from shrinking stock piles.

We are in a generational bull market in all commodities. Stockpiles are being drawn down but derivative instruments are being used to mask the real situation; to delay the day when delivery is demanded. Gold and silver are the premier commodities and this is where fortunes will be made in the bullion itself and in the shares of unhedged miners who extract it from the ground.

Happy New Year to all café members

Adrian Douglas
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