THINGS THAT MAKE YOU GO

Hmmm...

A walk around the fringes of finance

“The best-laid schemes o’ mice an’ men
Gang aft agley,
An’ lea’e us nought but grief an’ pain,
For promis’d joy!”

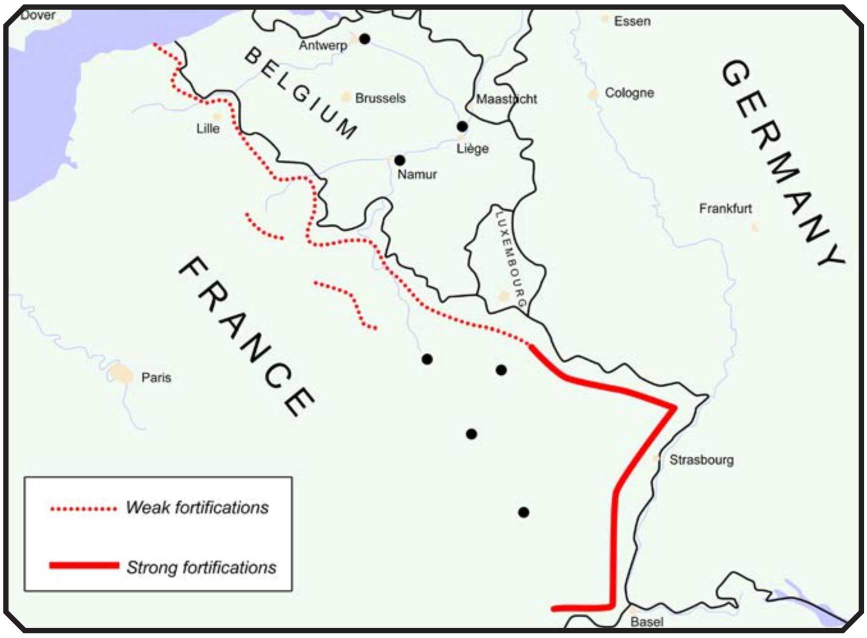
– Robert Burns, *To a Mouse, on Turning Her Up in Her Nest with the Plough*

“Generals always prepare for the last war, while diplomats try to avert the war they fear at the moment”

– UNKNOWN

“Complacency is a state of mind that exists only in retrospective: it has to be shattered before being ascertained”

– Vladimir Nabokov



Andre Maginot was born in Paris in February 1877 but would spend his formative years in the Alsace-Lorraine region of France, before returning to Paris at the age of 20 to take a civil service exam (how quaint a notion that now seems). He then spent an entire life in the service of his country (including active service in WWI which earned him the Medaille Militaire, France's highest military honour, for extreme valor), rising through the ranks of the Chamber of Deputies to become Minister for War – a post he held three times between 1922-1924, 1929-1930 and 1931-1932. Maginot was a strident critic of the Treaty of Versailles and highly suspicious of Germany during the period between the two World Wars when most people in France preferred to firmly accentuate the positive.

Maginot pushed aggressively for increased defense spending and, in 1926, he was successful in lobbying for money to be allocated towards an experimental section of a fortified defensive line - initially suggested by Marshall Joffre - that would one day bear his name. Three years later, during heated budget negotiations, Maginot was finally able to persuade Parliament to allocate him the Fr3.3 billion he needed to establish a line of fixed, fortified defences that would run the length of France's borders with Germany.

The Maginot Line was designed and built by Maginot in conjunction with Paul Painléve with a very specific set of goals in mind and took into consideration many lessons learned from the conflict that had engulfed Europe a mere decade or so earlier:

(Wikipedia): The French established the fortification to provide time for their army to mobilise in the event of attack, allowing French forces to move into Belgium for a decisive confrontation with German forces. The success of static, defensive combat in World War I was a key influence on French thinking. Military experts extolled the Maginot Line as a work of genius, believing it would prevent any further invasions from the east (notably, from Germany). It was also a product of a historical inferiority in population and birthrate, exacerbated by the losses in World War One, which had been developing for three generations.

The Maginot Line was impervious to most forms of attack, and had state-of-the-art living conditions for garrisoned troops, including air conditioning, comfortable eating areas and underground railways

So far so good.

We will return to the Maginot Line shortly to see how this 'impervious' structure fared when put to the test by the advancing German army in 1940, but before we do we are heading to Simla, India, birthplace, in 1918, of one Guy Penrose Gibson.

Guy Gibson joined the RAF at the age of 18 and within a year he had become a Pilot Officer – learning to fly at No. 2 Training School at RAF Scopwick in Lincolnshire. A natural in the air, Gibson was already a fully-fledged bomber pilot by the time WWII broke out across Europe a mere two years later and won the Distinguished Flying Cross in July 1940.

After an impressive early career, during which he proved both his skill and his courage repeatedly, gaining a bar to his DFC as well as the Distinguished Service Order, Gibson was selected, at the ripe old age of 24, to command the newly-formed 617 Squadron which was formed to carry out Operation Chastise – a mission that would become famous the world over not only for the daring and skill of the pilots involved, but for the breathtaking genius of another man who found a brilliant solution to a complex problem and managed to turn an idea into history.

The other man in question was Barnes Wallis, the idea was the Bouncing Bomb and Operation Chastise would bestow upon 617 Squadron one of the most widely-known and evocative soubriquets in modern history; The Dambusters.

The problem facing the RAF was to somehow destroy the Mohne, Eder, Sorpe and Ennepe dams in the industrial heartland of Germany's Rühr Valley, thus crippling the German war effort and, hopefully, hastening the end of WWII, but the dams were heavily fortified and, as their importance to Germany's war machine dictated, protected by a series of torpedo nets which were designed to prevent underwater attacks from breaching the dams.

And so, we have the impregnable Maginot Line - with its fixed defences lining the French-German border and we have the unbreachable German dams protected by three heavy-duty torpedo nets, both sitting, waiting to be attacked so they could demonstrate just how effective they were. The idea was that any attacks on these structures would be proven to be futile and cause those making the attacks to withdraw, perhaps permanently.

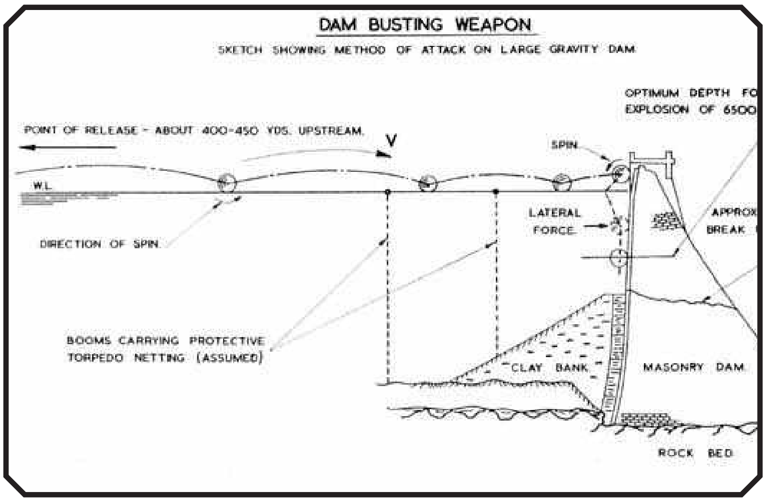
Of course, things have a habit of not always working out as planned (as Robert Burns so poetically informed us) and so it was that these two impregnable firewalls ended up being breached - albeit with each requiring remarkably differing levels of ingenuity:

The only possible way for Operation Chastise to succeed was for a charge of sufficient strength to be placed directly against the wall of the dam far enough below the surface to allow the pressure of the water itself to exacerbate the damage done by the charge. Getting the explosive in place was, at face value however, impossible.

Barnes Wallis was watching his son skimming stones across a pond one day when the idea came to him. What if a bomb could be designed to skip across the water before sinking when it hit the dam and exploding far enough beneath the surface to cause the necessary breach?

Time precludes me from spending too much space outlining just how incredibly difficult it was to design such a bomb, but once the process had been completed to such a point that it was, at least, feasible, the demands that would be made upon the skills of Gibson and his fellow pilots in 617 Squadron became apparent.

The bombs would have to be dropped from precisely 60 feet above the surface of the water and at an exact distance from the wall of the dam to ensure it would skip correctly, pass over the tops of the torpedo nets and, upon reaching the wall, its forward spin would cause it to hug the wall as it sank until the point where the water pressure was great enough to detonate the charge.



SOURCE: DAMBUSTERS

Oh, I almost forgot; the bombs had to be dropped at night under heavy flack and the low-level required rendered altimeters useless:

> *(The Dambusters): The problem was that the standard altimeter was useless at low levels such as 60 feet. On March 28th 1943 Gibson with Hopgood and Young on board, had flown over the Derwent reservoir to see how difficult it was to fly over water at 60 feet with hills all around. During the daylight he had no real problems but when dusk came he could not distinguish the horizon from the water surface and nearly flew into the lake.*
>
> *The solution to flying at 60 feet was found by the Royal Aircraft Establishment... After experimenting with it for a while, two lamps were fitted, one in the nose and one behind the bomb bay. They were angled so that the two beams would meet when the aircraft was at exactly 60 feet. It would be the job of the navigator to look down through the starboard (right) cockpit window and talk the pilot down until the lamps met at the required altitude.*

That just left the small problem of how far from the dams to release the bombs and that was solved with a simple wooden, hand-held bombsite consisting of three pieces of wood and two nails that, when lined up against the towers at either end of the dam would signal the aircraft was 450 yards away and the bombs could be released.

As a good friend of mine is wont to say; we really are clever little apes.

Gibson's 617 Squadron took off under a full moon on the evening of May 16th, 1943 in three waves and set out to make history. In the interests of moving our story along, I will tell you that the Dambusters managed to breach both the Mohne and Eder dams but failed in their attempts to do likewise with the Sorpe and Ennepe.

> *(Countless films and documentaries of this amazing raid have been made, but for those of you interested in doing a little more reading on the subject, I would recommend you visit this website: www.dambusters.org.uk)*

"But what about the Maginot Line?" I hear you cry... Well, the German army found a slightly simpler solution to that particular 'impregnable defense'; they attacked France through Luxembourg and then Belgium, completely bypassing the main part of the Maginot Line - thus rendering it virtually useless.

That's the problem with firewalls, you see; they ALWAYS seem as though they provide a solution to the problem they are built to mitigate but they rarely do.

Since 2008, the Central Banks of the world along with their respective governments have been moving heaven and earth to put in place the kind of firewalls that will protect the world from a 'collapse of the system' - even though we literally have no idea just what that 'collapse' would look like or entail.

Quantitative Easing, TARP, HAMP, LTRO I & II, Basel III and all sorts of other schemes have been dreamt up by those in power in order to protect the world from something that is, essentially, unavoidable; the after-effects of two decades spent bingeing on debt and free money. And what has been the single most often-used solution employed in the treatment of this particular problem? Yes, more free money.

Let's be clear, printing money out of thin air CANNOT fix this. If it COULD, then why not just give everybody in the world $10,000,000 in cold, hard cash and we can all go about our business? The question is redundant. The answer obvious. But that hasn't stopped the Keynesian geniuses at the wheel from persisting down this particular road for several years now in the misguided belief that just a LITTLE more free cash will finally get things flowing again.

It won't.

In actual fact, what happens is policymakers become addicted to this form of monetary heroin and, the second they see dark clouds on the horizon once again, they reach instinctively for the crack-pipe:

> *(UK Daily Telegraph): The case for more money printing to bolster the recovery has been strengthened by the UK's slump back into recession, a leading Bank of England rate-setter has said.*
>
> *Martin Weale, a member of the Monetary Policy Committee, on Thursday said: "The argument [for quantitative easing] is stronger than it would have been had the economy shown growth".*
>
> *His comments run counter to the Bank's clear recent signal that QE is likely to have stopped at £325bn.*

It used to be that the onset of a recession meant bankruptcies, the loss of jobs and lower interest rates to juice the economy again once the business cycle had been allowed to run its inevitable course. Now, with interest rates at zero (and, in real terms, decidedly negative) it means more funny money and, when it appears as though the next wave of newly-minted cash isn't forthcoming, the markets suffer from withdrawal symptoms:

"... Who are these people? They're the same idiots that never saw anything coming..."

> *(Forbes): Market reaction to the Fed's last statement, issued on March 13, was massive. Bond markets appeared to have finally accepted QE3 is off, for the moment, and that improved economic data meant rates could go up sooner than expected. Yields on 10-year Treasuries sky-rocketed as a post-FOMC sell-off took hold, breaking a four-month range and getting close to 2.4%. Gold prices suffered in tandem.*

That was in March when the mere *absence* of QE3 was enough to send shockwaves through markets. This past week, the FOMC meeting once again failed to 'come up with the goods':

> *(Bloomberg): Ben S. Bernanke's Federal Reserve signaled this week it isn't ready to buy more bonds to stimulate the economy. Mortgage investors aren't convinced.*
>
> *Trading in the market for government-backed mortgage bonds is showing a 37 percent chance of a third round of so-called quantitative easing, or QE3, according to Credit Suisse Group AG calculations. While that's declined from 40 percent last week, it's up from 25 percent after the April 3 release of the minutes of the Fed's monetary-policy panel meeting last month.*
>
> *Stocks, commodities and bonds declined after the statement, which showed certain members support easing only "if the economy lost momentum." Treasuries and mortgage securities pared losses yesterday with some investors speculating the Fed will eventually acquire more home-loan debt to bolster consumer spending and support a housing market the minutes described as "depressed."*

So, we have a market that refuses to believe that there won't be more free money, but that sells off on the prospect that this time, just maybe, the FOMC are telling the truth and there really WON'T be more QE to come.

I've got news for you, folks; there will be PLENTY more QE to come. In fact, QE will be used and used again until it is finally proven not to work and, when that day finally arrives, the world's Central Bankers will be out of ideas - and time.

But don't take my word for it. Here's Bill Fleckenstein:

> *(KWN): 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."*
>
> *"For this five minutes they think the economy is okay, and it isn't. They seem to think Europe's kind of okay, and it's not. So the next thing you know they will have to realize they are not so right about being sanguine and then they will have to do a U-turn.*

How is that any different than what we've seen in the last decade?....

"They basically said, 'We're going to keep doing what we're doing because we kind of think it's working and we don't think we have to do too much anymore.' Then he (Bernanke) comes out in the press conference and says, 'But if we have to, we will.'

So, now if the economic data hits them over the head or Europe goes down a rathole, when that happens I should say, they'll do something. Meanwhile they are patting themselves on the back for the great job they have done so far.

The fact of the matter is Europe is a basket case, the world is slowing down and the US was artificially aided by statistical seasonal adjustments. It's not as good as they think (in the US). They believe the data. They're wrong. It's going to get worse, they'll ease and then they'll say, 'Gee, aren't we smart?'...

We know what they are going to do. They are going to ease. The economy is not that strong, the Fed is wrong. What a shock, they're wrong. Do you remember when Ben (Bernanke) thought the subprime crisis was contained?

They don't know anything. They're idiots. 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? Why do we care that they currently think they are so smart and that everything is okay?

Harsh - but fair.

But let's move on to the firewall I really want to discuss this week: the EFSF/ESM.

The combined might of the EFSF/ESM is, to all intents and purposes a monetary Maginot Line that the market will simply find a way around.

Firstly, let's take a look at a table that outlines the contributions to the EFSF from the various members of the Eurozone (the ESM is not slated to enter active service until July - assuming, of course, it is ratified by *ALL* the required parties between now and then - *see table on page 19*):

	New EFSF Guarantee Committments (€m)	New EFSF contribution key (%)	EFSF Amended Guarantee Committments* (€m)	EFSF amended contribution key* (%)
Austria	21,639	2.78	21,639	2.99
Belgium	27,032	3.47	27,032	3.72
Cyprus	1,526	0.20	1,526	0.21
Estonia	1,995	0.26	1,995	0.27
Finland	13,974	1.79	13,974	1.92
France	158,488	20.31	158,488	21.83
Germany	211,046	27.06	211,046	29.07
Greece	21,898	2.81	-	0.00
Ireland	12,378	1.59	-	0.00
Italy	139,268	17.86	139,268	19.18
Luxembourg	1,947	0.25	1,947	0.27
Malta	704	0.09	704	0.10
Netherlands	44,446	5.70	44,446	6.12
Portugal	19,507	2.50	-	0.00
Slovakia	7,728	0.99	7,728	1.06
Slovenia	3,664	0.47	3,664	0.51
Spain	92,544	11.87	92,544	12.75
Total	**779,783**	**100**	**726,000**	**100**

SOURCE: EFSF

As you can see from the table, after the original levels were set to include contributions from Greece, Ireland and Portugal, that bright idea had to be scrapped when it became apparent that those particular countries would, in fact, be recipients *OF* EFSF largesse rather than contributors *TO* it. Consequently, their contributions were adjusted downwards from a total of approximately 7% to a total of exactly 0%.

Of course, the shortfall had to be made up somehow and, that somehow meant additional funds had to be supplied largely by the Eurozone's behemoths: Germany, France, Italy and..... Spain.

Spain?

Yes. That Spain.

Germany and France between them account for 51% or €370 billion of the EFSF's firepower, followed by Italy with 19% (€140 billion) and then, in fourth place, comes Spain. As it currently stands, Spain is on the hook for €92.54 billion in contributions to the EFSF which represents 12.75% of the total.

So how's Spain doing? Well, we've spoken about it at length in these pages - last year when nobody seemed to care, and again recently when it's all anybody seems to care about, but in the past couple of days Spain's problems have gotten worse still:

> *(Reuters): Spain's sickly economy faces a "crisis of huge proportions", a minister said on Friday, as unemployment hit its highest level in almost two decades and Standard and Poor's downgraded the government's debt by two notches.*
>
> *Unemployment shot up to 24% in the first quarter, one of the worst jobless figures in the developed world. Retail sales slumped for the twenty-first consecutive month as a recession cuts into consumer spending.*
>
> *"The figures are terrible for everyone and terrible for the government ... Spain is in a crisis of huge proportions," Foreign Minister Jose Manuel Garcia-Margallo said in a radio interview.*
>
> *Spain has slipped into its second recession in three years and fears that it cannot hit harsh deficit cutting targets this year have put it back in the centre of the debt crisis storm, pushing up its borrowing costs.*
>
> *Recovery and job creation are still two years off, Economy Minister Luis de Guindos said on Friday in a news conference where he forecast 0.2% growth in GDP next year and 1.4% growth in 2014.*
>
> *The government has already rescued a number of banks that were too exposed to a decade-long construction boom that crashed in 2008, and investors fear vulnerable lenders will be hit by another wave of loan defaults due to the slowing economy.*
>
> *S&P's head of European ratings, Moritz Kraemer, told Reuters Insider television that Spanish banks could need state aid and the country faced further downgrades if its debt troubles continue to escalate.*

"... "The figures are terrible for everyone and terrible for the government ... Spain is in a crisis of huge proportions," ..."

Does That Spain sound like a country with €92.54 billion laying around in spare cash that it can pledge to a bailout fund for the rest of Europe?

Thought not.

A distant 5th to Spain's €92.54 billion contribution are The Netherlands, who will account for €44.44 billion, or 6% of the total. How are The Netherlands doing? Well, as it turns out, not so good either:

> *(BBC): Dutch Prime Minister Mark Rutte has tendered his government's resignation to Queen Beatrix, paving the way for early elections.*
>
> *His cabinet was plunged into crisis when Geert Wilders' Freedom Party (PVV) quit talks aimed at slicing 16bn euros (£13.1bn) from the budget.*
>
> *Mr Wilders refused to accept austerity demands to bring the budget deficit in line with EU rules.*
>
> *His party was not part of the coalition but supported the minority government.*
>
> *Mr Rutte's government lasted just 558 days. Only three other Dutch administrations since World War II have been in office for shorter periods, Dutch news agency ANP says.*
>
> *The Dutch economy, the eurozone's fifth largest, has survived the eurozone crisis relatively well with a national debt of around 65%*

of economic output but its projected budget deficit falls foul of new EU rules requiring eurozone governments to keep below 3% of GDP.

A recent forecast from the Netherlands' Central Planning Bureau estimated that the country's public deficit would rise to 4.7% of GDP.

Hardly ideal.

The problem for The Netherlands could be compounded by those bastions of financial purity, the ratings agencies:

(WSJ): Fitch could very well announce a full-blown downgrade from AAA this quarter, well before any new government can come in to try and regain confidence of the markets and the rating agencies. Our sovereign ratings model shows the Netherlands as AAA, but growing political and fiscal risks have pushed the country closer to Austria, which was downgraded by S&P to AA+ and put on negative outlook by Moody's earlier this year.

"... we think both Austria and France are likely to come under negative scrutiny by Fitch as well, as we view both as inferior credits to the Netherlands..."

Fitch has not been as aggressive as the other two agencies, keeping Austria and France at AAA up until now. As such, its negative comments about the Netherlands are noteworthy and likely signal a harder line by Fitch in the coming months. As a result, we think both Austria and France are likely to come under negative scrutiny by Fitch as well, as we view both as inferior credits to the Netherlands. Furthermore, the uncertain outlook for politics and policy in France now put the nation on par with Belgium in our model, which we (and the agencies) view as a AA/Aa2/AA credit.

Some impregnable defence, huh?

But it's not just financial problems facing the 'United Europe'. A potentially far BIGGER problem than the lack of money (after all, that can simply be created out of thin air if the Germans can be persuaded to play ball) is that of the political shift currently beginning to sweep the region.

I have been saying for some time now that sooner or later, a politician will stand up somewhere in Europe and campaign with a copy of the Maastricht Treaty in his (or her) hand, vowing to tear it up if he (or she) were elected, and that he (or she) would win based on a growing disaffection with the idea of a common 'Europe'.

We have seen the waves the True Finns Party have made in Finland. We have seen the newly-elected Senor Rajoy's defiance over Spanish budget deficits in the face of stringent demands from Brussels. We have now seen anti-Europe and anti-austerity movements derail the Dutch government and an out-and-out Socialist, in the form of François Hollande, campaigning on a promise to 'rip up the Fiscal Compact' take the lead in the French elections (the real shock of which was the unforeseen strength of Marine Le Pen's far-right party which is stridently anti-Europe) and it is these developments that, somewhat ironically, present the biggest danger to the future of the Eurozone and the euro.

(UK Daily Telegraph): Bond yields, borrowing costs and bail-outs, which have overwhelmed Greece, Ireland and Portugal, and that hover over Spain and Italy, too, were no real threat in the north last week. Despite their debts, the Netherlands and France have retained their low bond yields and AAA-ratings (France has only been downgraded by S&P). Germany's economy is in rude health, relatively speaking.

Instead, the continent's northern core has been hit by the eurozone's other big crisis: the question of legitimacy.

For three years, Merkel and Sarkozy have imposed savage austerity with one overriding justification: to save the euro. As if in wartime, democracy has been sidelined and public opinion ignored under the assumption

> *that the state – or superstate – has a higher cause.*
>
> *With breathtaking audacity, Brussels installed its own technocrats in Greece and Italy to impose its policies in "sinner states". Extreme measures were needed to keep the eurozone intact, they said – without ever properly asking if the electorate wanted the prize, let alone had the stomach for the cost of winning it.*
>
> *The "legitimacy question" has been quieter than the rampaging debt farrago. Yet plenty reckon it poses the real danger to the eurozone – and is most likely to trigger its collapse. Over the next few weeks its pent-up energy will be unleashed in full – via a raft of ballot boxes across Europe.*

A generation of politicians have done anything and everything in their power to protect a political construct that, when looked at with a cold, hard and unflinching eye, should likely have been allowed to unravel - and take with it the common currency at its core. But, despite hundreds of billions of euros being thrown at the problem, we are no nearer to having the impenetrable defence that those in charge have been trying to build for the last several years. Instead, what we have, is a new breed of politician riding high on a wave of dissatisfaction and disaffection across the vox populi of Europe who all want what all politicians want - power. How do they get it? Pretty simple really; give the people what they want, or, in this case, what they don't want and what they don't want, is more pain.

A prime case in point has been the recent showing in UK opinion polls of Nigel Farage - outspoken leader of the UKIP (UK Independence Party) - a fringe organization which, up until recently, had almost exclusively been know for YouTube videos of Mr. Farage's attacks on the likes of Herman van Rompuy. In a recent survey, the UKIP garnered 11% of the vote (the same as the Liberal Democrats) based solely on their anti-Europe platform. Perhaps more worryingly for David Cameron - one of the bigger euro-skeptics amongst Europe's leaders - was the poll that showed 24% of Tory voters would prefer Farage as the Party leader to Cameron.

There are cheap votes to be had by being anti-Europe and once politicians figure this out, they will become more and more anti-Europe. Count on it.

But the EFSF/ESM is not the only 'impregnable' defense surrounding the Eurozone. Earlier this month, the IMF also stuck out their hand for additional contributions to a futher 'firewall':

> *(Bloomberg): Three months after waving her purse in front of global finance chiefs, Christine Lagarde filled it with more than $430 billion in pledges for the International Monetary Fund. She may not enjoy her victory for long.*
>
> *The lender's spring meetings ended yesterday in Washington with a doubling of its war chest and a number of sores exposed among its 188 members. Managing Director Lagarde fell short of her original $600 billion goal as the U.S. declined to chip in, while Canada proposed making it harder for Europe to tap aid. Big emerging markets demanded more power at the IMF before writing checks.*
>
> *The tensions leave Lagarde pushing her home continent to justify the show of solidarity with greater efforts to fight the crisis, as Spain's interest rates soar and Dutch austerity talks flop. If Europe resists, she could find it harder to rally support for sending the region more money or face criticism for bailing out undeserving governments.*
>
> *"Any further lending to euro zone economies is likely to be under even greater scrutiny from the IMF's other members," said Eswar Prasad, a former IMF official now at the Brookings Institution in Washington. "Lagarde faces a difficult balancing act."*
>
> *Concern that Italy and Spain are slowing down in cutting budgets and overhauling their economies reignited the turmoil, which prompted Lagarde's drive to ensure the IMF is able to protect troubled countries and*

> *global growth. Spain's notes last week extended their longest decline since 2007 and Italian bonds rose for a sixth week.*
>
> *"I need to have the umbrella in case the clouds break into a nasty rain," Lagarde told Bloomberg Television.*

But Lagarde's begging bowl was noticeably bereft of contributions from, amongst others, the USA and Canada.

IMF Bailouts (1976 - 2010)

Year	Country	Amount ($)
1976	UK	$1.84bln
1978	Greece	Unknown
1982	Mexico	$8.25bln
1991	India	$6bln
1994	Mexico	$50bln
1996	Russia	$10.6bln
1997	S Korea	$55bln
1997	Thailand	$20.9bln
1997	Indonesia	$23bln
1998	Brazil	$41bln
1998	Russia	$22.6bln
2001	Argentina	$48bln
2002	Brazil	$10bln
2008	Iceland	$6bln
2008	Hungary	$25.1bln
2010	Ukraine	$15.1bln

SOURCE: AL JAZEERA/IMF

There was a time, not so long ago, when a visit from the IMF and the promise of a bailout carried with it an onerous burden of devaluation and/or austerity that caused those in need of such funding to go through real hardship in order to win the financial backing of the global community. Of course, in *those* cases, the countries asking for the money were NOT amongst the largest contributors to the IMF's coffers and so the sway the IMF held over them was far greater. Now we find those looking to the IMF to ride to the rescue include some of the organization's biggest benefactors so it is hardly surprising that things are a little different.

And so, as we take a look at the defences being put in place around the Eurozone and its common currency, it's hard not to wonder how they will ultimately be breached - for breached they will be eventually. It could be that bond markets conjure up a convoluted and slow drawn-out way to breach the monetary dams of Brussels that requires a whole bunch of different conditions to be met before sufficient damage is done. Geniuses of the calibre of Barnes Wallis may be hard at work devising a devilish way to attack the defences head-on, lit up like a Christmas tree with only their daring and their refusal to bend in the face of great firepower and overwhelming odds to propel them to victory.

My own feeling, however, is that the electorates of Europe will approach the defenses like the monetary Maginot Line it is and simply vote out those who would preserve it and vote in those who would tear it down from the inside.

It really could be that simple.

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This week's Things That Make You Go Hmmm..... will likely be my last for a couple of weeks because I will be traveling to the United States and, with the best will in the world, time is always hard to find when I am on the road. I leave you, however, in very good hands as Eric Sprott and David Baker recheck their fundamentals, Robert Wenzel follows Jim Grant into the lions' den and acquits himself with equal aplomb, Ambrose Evans-Pritchard ponders whether China's property bubble has burst - forever, and the Economist takes an in-depth look at someone you will be seeing a lot more of in months to come - the 'dangerous M. Hollande'.

Gordon Chang outlines the best reasons to own gold, the Eurogroup mulls over direct aid to Spain's banks, bidding wars return to the US housing market and Europe's politicians brace themselves for the austerity backlash.

Greg Weldon weighs in on Australia, we look at European retail PMIs, the golden bull market, CDS rates and the upcoming ESM ratification votes and we hear from Messrs. Conrad, Grant and Black.

What's not to love?

Until next time...

Contents

30 April 2012

The Gonnie, Gonnie Banks

#	Bank	Assets ($m)	Deposits ($m)	Cost ($m)
18	Bank of the Eastern Shore, Cambridge, MD	166.7	154.5	41.8
19	HarVest Bank of Maryland, Gaithersburg, MD	164.3	145.5	17.2
20	Inter Savings Bank, fsb D/B/A Interbank, fsb, Maple Grove, MN	481.6	473.0	117.5
21	Plantation Federal Bank, Pawleys Island, SC	486.4	440.5	76.0
22	Palm Desert National Bank, Palm Desert, CA	125.8	122.8	20.1
	Total Cost to FDIC Deposit Insurance Fund			**272.6**

Beijing is planning to avoid U.S. financial sanctions on Iran by paying for oil with gold. China's imports of the metal are already large, and you can guess what additional purchases are going to do to prices...

As the Wall Street Journal noted in early January, the sanctions are "an attempt to force other countries to choose between buying oil from Iran or being blocked from any dealings with the U.S. economy." The strict measures put Chinese officials in a bind. They apparently believe their geopolitical interests align with those of Tehran, but their economy is becoming increasingly reliant on America's.

So how can Beijing keep both Iran's ayatollahs and President Obama happy at the same time? Simple, the Chinese can avoid the U.S. sanctions through barter. China has already been trading its produce for Iran's petroleum, but there is only so much gai lan and bok choy the Iranians can eat. That's why Iran is also accepting, among other goods, Chinese washing machines, refrigerators, toys, clothes, cosmetics, and toiletries.

> "... the Chinese, smelling blood in the water, will surely press the Iranians to accept the non-convertible renminbi...."

The barter trade works, but Iran needs cash too. As it is being cut off from the global financial system, the next best thing is gold. So we should not be surprised that in late February the Iranian central bank said it would accept that metal as payment for oil. Last year, China imported $21.7 billion in Iranian oil and exported $14.8 billion in goods and services. As the NDAA goes into effect, look for Beijing to ship gold to Iran to make up the difference.

Gold bugs, however, shouldn't get too happy about Iran's plight. There are five principal factors that will depress anticipated demand for gold used to buy Iranian oil. First, other countries will also be bartering agricultural and manufactured goods. Russia and Pakistan, for instance, will undoubtedly continue wheat-for-petroleum arrangements.

Second, Tehran, out of apparent desperation, in February said it would also accept local currencies, thereby avoiding the U.S. financial system. As a result, the Indians announced in January that they would not request a waiver from the Obama administration, and they began opening rupee accounts to pay for as much as 45% of their oil purchases with their currency. In 2011, India exported only $2.7 billion to Iran while buying $9.5 billion in oil. Similarly, the Chinese, smelling blood in the water, will surely press the Iranians to accept the non-convertible renminbi.

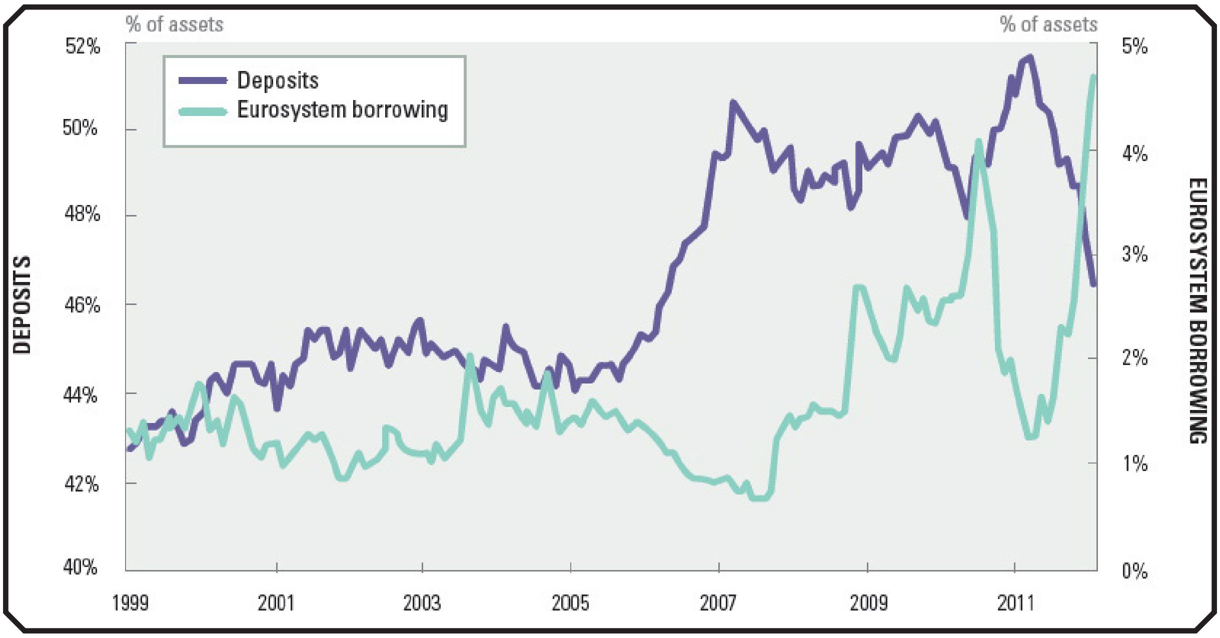
Third, the result of sanctions is that Iran's oil exports could be cut by as much as 700,000 barrels a day. China, for instance, is increasing its oil purchases from Saudi Arabia, its largest foreign supplier. The Chinese are also buying more from the Persian Gulf emirates as well as Vietnam, Russia, and Africa. Of course, every drop of other crude decreases China's demand for Iran's.

Fourth, China and other countries are taking advantage of Iran's plight by negotiating large price reductions.

Fifth, if the Iranians are willing to accept wheat and non-tradable currencies in payment for oil, there is nothing to say they won't start agreeing to silver too.

★ ★ ★ *FORBES* / **LINK**

Meanwhile, the situation in Europe continues to worsen. There's no point in mincing words: Spain is a complete disaster. This past week, the Spanish government managed to pull off two separate bond auctions, only to have the yield on their 10-year government bond shoot right back up the moment the second auction closed. Everyone's nervous because the Spanish banking system is up to its eyeballs in approximately €143.8 billion worth of delinquent loans, and the private sector is unwilling to lend Spanish banks the money to weather the potential write-downs. As we've seen before, the real culprit plaguing the Spanish banks is customer deposit withdrawals. It is estimated that €65 billion of deposits left Spanish banks



SOURCE: BANK OF SPAIN/ECB/CITI

this past March alone.14 People are taking their money out of the Spanish banking system, and without the help of the generous European Central Bank (ECB), the Spanish banks would likely be in a full collapse today (see Figure 1). As it stands, the Spanish banks have now borrowed a massive €316.3 billion from the ECB in order to meet the withdrawals and maintain the illusion of solvency.

Perhaps it's Euro-crisis fatigue, or maybe just plain denial, but the equity markets appear unwilling to acknowledge how close we are now to yet another round of Eurozone upheaval. Spain's economy is almost five times that of Greece. Spain also has over four times the amount of externally-held nominal debt outstanding. If the bond vigilantes choose to punish the Spanish 10-year bond (currently trading precariously close to a 6% yield), we could soon be back where we were this past September, only with a problem four times as large.

The rest of Europe isn't looking so hot either. Italy's bond market is in a similar situation to that of Spain, with the Italian 10-year bond trading perilously close to the 6%-yield threshold. Recent data showed the European Purchasing Managers Index (PMI) falling to 47.4 in March, well below the 50 mark which signals growth in industrial activity. German PMI recently confirmed this move with its April release of 46.3, down from 48.4 in March, representing the fastest rate of contraction since July 2009. These declines in economic activity, combined with the austerity measures most Euro countries are currently attempting to impose, almost guarantee more printed money will be pumped into the European bond markets before the year is over. It's simply a matter of time.

As expected, the powers that be are busy parading around in preparation for the next round of Eurozone panic, with the IMF using the renewed concerns as an opportunity to re-establish its relevance as a firewall provider. The IMF most recently secured $430 billion worth of new "pledges" from various G20 member countries to increase its potential lending capacity to $700 billion in the event of further problems in the Eurozone. Not unsurprisingly, the BRICS countries have expressed irritation at the disproportionate voting power held by Western powers within the IMF at the expense of themselves and the other developing nations. In prepared remarks at an IMF press conference, Brazil's finance minister criticized the skewed quotas that dictate voting power, stating that, “The calculated quota share of Luxembourg is larger than the one of Argentina or South Africa... The quota share of Belgium is larger than that of Indonesia and roughly three times that of Nigeria. And the quota of Spain, amazing as it may seem, is larger than the sum total of the quotas of all 44 sub-Saharan African countries.” This unbalance used to make sense when the IMF was designed to help fund ailing third world and developing countries through economic crisis. But that is clearly no longer the IMF’s main purpose.

SPROTT & BAKER / **LINK**

In present day America, the government focus has changed a bit. In the new focus, the government attempts much more to prop up the unemployed by extended payments for not working. Is it really a surprise that unemployment is so high when you pay people not to work.? The 2010 Nobel Prize was awarded to economists for their studies which showed that, and I quote from the Noble press release announcing the award:

One conclusion is that more generous unemployment benefits give rise to higher unemployment and longer search times.

“... Since the start of the Fed, prices have increased at the consumer level by 2,241%. that’s not me misspeaking...”

Don’t you think it would make more sense to stop these policies which are a direct factor in causing unemployment, than to add to the mess and devalue the currency by printing more money?

I scratch my head that somehow your conclusions about unemployment are so different than mine and that you call for the printing of money to boost “demand”. A call, I add, that since the founding of the Federal Reserve has resulted in an increase of the money supply by 12,230%.

I also must scratch my head at the view that the Federal Reserve should maintain a stable price level. What is wrong with having falling prices across the economy, like we now have in the computer sector, the flat screen television sector and the cell phone sector? Why, I ask, do you want stable prices? And, oh by the way, how’s that stable price thing going for you here at the Fed?

Since the start of the Fed, prices have increased at the consumer level by 2,241%. that’s not me misspeaking, I will repeat, since the start of the Fed, prices have increased at the consumer level by 2,241%.

So you then might tell me that stable prices are only a secondary goal of the Federal Reserve and that your real goal is to prevent serious declines in the economy but, since the start of the Fed, there have been 18 recessions including the Great Depression and the most recent Great Recession. These downturns have resulted in stock market crashes, tens of millions of unemployed and untold business bankruptcies.

I scratch my head and wonder how you think the Fed is any type of success when all this has occurred.

I am especially confused, since Austrian business cycle theory (ABCT), developed by Mises, Hayek and Rothbard, has warned about all these things. According to ABCT, it is central bank money printing that causes the business cycle and, again you here at the Fed have certainly done that by increasing the money supply. Can you imagine the distortions in the economy caused by the Fed by this massive money printing?

According to ABCT, if you print money those sectors where the money goes will boom, stop printing and those sectors will crash. Fed printing tends to find its way to Wall Street and other capital goods sectors first, thus it is no surprise to Austrian school economists that the crashes are most dramatic in these sectors, such as the stock market and real estate sectors. The economist Murray Rothbard in his book America’s Great Depression [4] went into painstaking detail outlining how the changes in money supply growth resulted in the Great Depression...

ROBERT WENZEL / **LINK**

When the euro backstop fund was first created, it was considered a taboo to use the money to directly bail out banks. Now, though, it appears a number of euro-zone countries as well as the European Central Bank are seeking to ease the rules in order to prevent a banking crisis in Spain from forcing the country to request aid from the common currency rescue fund.

The Süddeutsche Zeitung newspaper is reporting in its Thursday edition that the European Central Bank and Euro Group member countries are exploring strategies at the highest level to allow financial institutions direct access to funds from the European Stability Mechanism, the permanent bailout fund that is to be created this summer. The change would mean that banks, rather than countries, could turn to the fund for aid during a financial sector crisis.

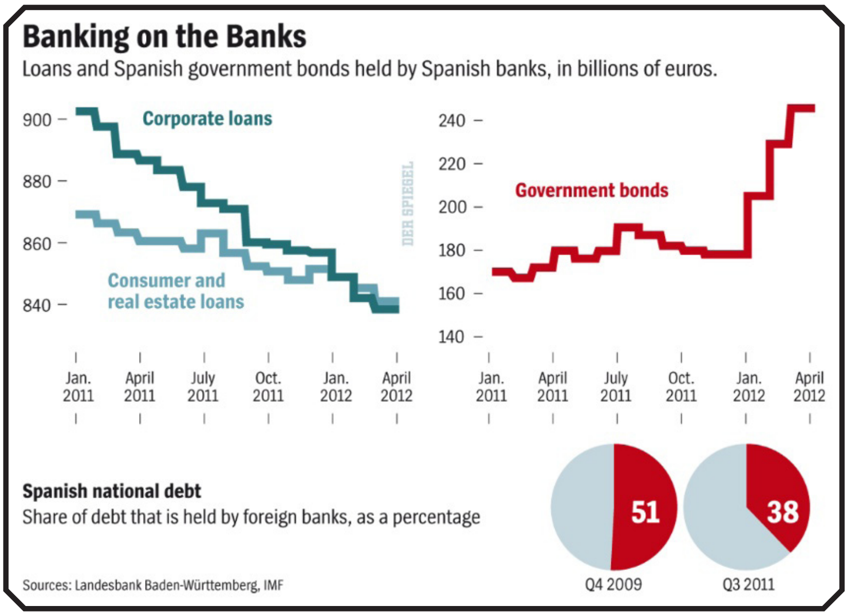
Although not named, the plan is clearly aimed at Spain, where many banks are in desperate need of additional financing in order to continue providing corporate loans. The banking crisis there is coming at a time when the Spanish government is being forced to push through stringent austerity measures. In recent weeks, the situation in the southern European country has intensified dramatically, with risk premiums on Spanish government bonds rising markedly on several occasions. Many fear the contagion could spread to other euro-zone countries. “Once Spain seeks a bailout, then the markets will focus on Italy,” one unnamed euro-zone source told the newspaper.

A working group of euro-zone member states is moving hastily to explore the options available. According to the paper, they plan to review in the next two weeks how the ESM could be adapted to allow direct access to the funds by banks it believes are capable of surviving but are experiencing a potentially deadly credit crunch. The Süddeutsche reported that the leaders are moving quickly because of the worsening situation in Spain.

Euro-zone member states are apparently concerned that recent efforts by the European Central Bank to flood banks with cheap credit were insufficient to stave off the crisis. In two steps, the ECB recently issued cheap longterm loans to European banks with a total value of €1 trillion. But this aid is only slowly reaching businesses. That’s why leaders are now considering providing the ESM with similar bank lending capabilities, according to the Süddeutsche.

The effort, assuming it materializes, is likely to provoke a heated debate within the European Union. Over the weekend, German Finance Minister Wolfgang Schäuble, of Chancellor Angela Merkel’s conservative Christian Democratic Union party, expressed his vehement opposition to allowing the ESM to provide direct loans to banks. The governments of the Netherlands, Austria and Finland also oppose plans to provide ESM aid directly to banks.

Under the current rules for the euro bailout program, only euro-zone member states can request money from the backstop fund. Countries can then in turn lend that money to banks, but the governments are also required to adhere to strict austerity and reform measures as part of the deal. These stipulations were an important precondition for getting Germany to agree to the EU bailout fund in the first



SOURCE: LANDESBANK BADEN-WURTEMBURG

place. If ESM were permitted to lend directly to banks, it would effectively nullify those provisions.

★ ★ ★ *DER SPIEGEL* / **LINK**

Here is some food for thought, if you are a China "take-over-the-world" bull.

I have just been listening to a talk on the Chinese housing market by Xianfang Ren, Beijing analyst for IHS Global Insight.

Land sales make up 30pc of total tax revenue for the central government and 70pc for local government. (For those of us who watched the Irish state balloon on the back of property taxes – when they had a fat budget surplus – this has a familiar ring.)

Construction makes up 10pc of total jobs, and a further 20pc indirectly in cement, steel, metallurgy etc. The government is building 36m homes for the poor, but that will start to run down in two years or so.

"... China has already reached the point where it can no longer offset soaring wage costs with productivity gains imported through Western technology. It has hit the time-honoured wall..."

Residential investment typically peaks at 8pc to 9pc of GDP for emerging nations during their catch-up growth spurts. It is already 12pc in China.

Japan's ratio peaked in 1973, long before the property price bubble burst. China has almost certainly peaked too on this crucial measure.

The minimum down-payment rate on mortgages is 30pc, so leverage is in theory low. (How this can be the case when the IMF says that the house price to incomes ratio is 16 to 18 times in the Eastern cities of Beijing, Tinajing, Shanghai, Shenzhen, and Guangzhou has long been a mystery).

"At first sight China looks fine. Unfortunately, there is a big problem of misclassification of loans. The financial system has much larger exposure to real estate than appears, and the weak links are the real estate trusts and non-bank lending. The smaller developers are cash-flow constrained and will find it hard to roll over debts. Any defaults will have to be recognised immediately."

This may be happening already, since housing sales slumped 25pc in the first quarter.

Meanwhile, the demographic crunch hit last year. China's dependency ratio – ie children plus elderly in proportion to those of working age – touched bottom at 28pc and has now begun a relentless climb that will get worse every year for decades. (The ageing crisis is not yet as bad as Japan at the onset of the Lost Decade in the early 1990s. The old-age dependency ratio is 11pc compared to 18pc in Japan in the early 1990s).

The urbanisation rate has just passed the "inflection point" of 50pc when growth in developing economies starts to slow sharply.

A week ago I heard a talk at the ChunQiu Institute in London by Nobel laureate Edmund Phelps (one of the truly great Nobel economists who first debunked "Keynesian" misuse of the growth/unemployment trade-off or Phillips Curve and has devoted the last part of his academic life to trying to understand China).

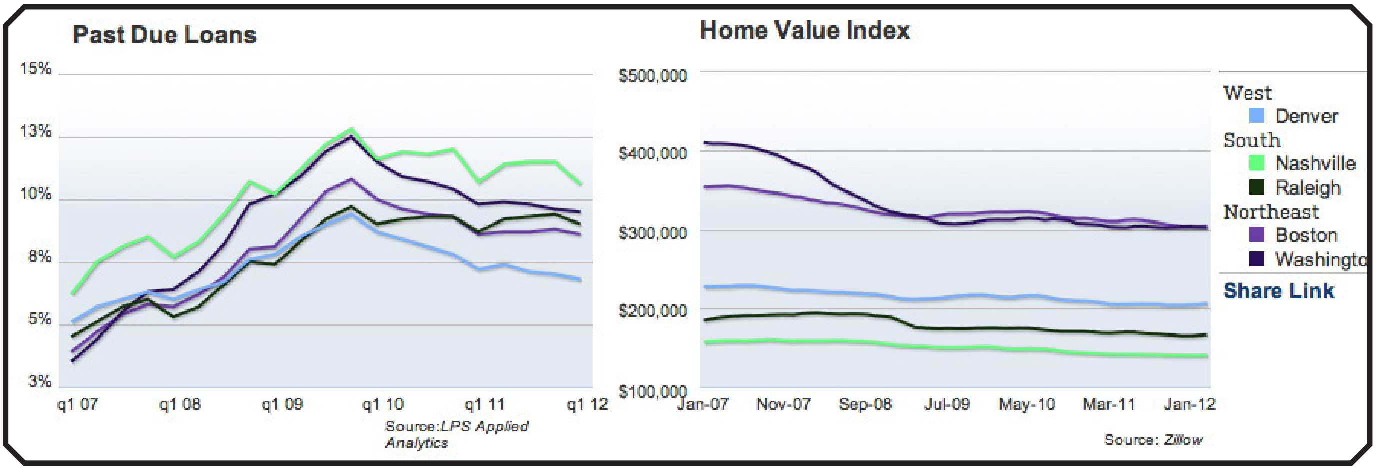
His view is that China has already reached the point where it can no longer offset soaring wage costs with productivity gains imported through Western technology. It has hit the time-honoured wall. Diminishing returns are setting in, and there lies the "middle-income trap" that ensnares most challengers.

★ ★ ★ *AMBROSE EVANS-PRITCHARD* / **LINK**

A new development is catching home buyers off guard as the spring sales season gets under way: Bidding wars are back.

From California to Florida, many buyers are increasingly competing for the same house. Unlike the bidding wars that typified the go-go years and largely reflected surging sales, today's are a result of supply shortages.

"It's a little surprising because we thought bidding wars were done with," said Andy Aley, who



SOURCE: ZILLOW/WSJ

is looking to buy his first home in Seattle's Beacon Hill neighborhood. The 31-year-old attorney was outbid this year when he offered up to $23,000 above the $357,000 listing price and agreed to waive inspections and other closing conditions.

Competitive bidding in the current environment isn't producing huge price increases or leaving sellers with hefty profits, as occurred during the housing boom. Still, the bidding wars caused by tight inventory provide the latest evidence that housing demand is starting to pick up after a six-year-long slump.

An index that measures the number of contracts signed to purchase previously owned homes rose in March to its highest level in nearly two years, up 12.8% from a year ago and 4.1% from February, the National Association of Realtors reported on Thursday.

"We very much believe we've hit bottom," said Ivy Zelman, chief executive of a research firm, who was among the first to warn of a downturn seven years ago. Earlier this week, she raised her home-price forecast for the year, calling for a 1% annual gain, up from a 1% decline.

The Wall Street Journal's quarterly survey found that the inventory of homes listed for sale declined sharply in all 28 markets tracked. Real-estate agents consider a market balanced when there is a six-month supply of homes for sale. At the height of the housing crisis, in 2008, there was an 11.1-months' supply. In March, there was a 6.3-months' supply.

Inventory levels in many markets were at the lowest level in years. At the current pace of sales, it would take just 1.5 months to sell all the homes listed in Sacramento, Calif., and 2.4 months to sell all the homes listed in Phoenix. San Francisco and Washington, D.C., each have 3.4 months of supply, while Miami has 4.1 months of supply.

Other markets have plenty of homes. Chicago, for example, has 9.4 months of supply, while New York's Long Island has 16.1 months of supply. Even in those markets, the number of houses for sale is edging down.

WSJ / **LINK**

...Although you would

never know it from the platforms the candidates campaigned on, France desperately needs reform. Public debt is high and rising, the government has not run a surplus in over 35 years, the banks are undercapitalised, unemployment is persistent and corrosive and, at 56% of GDP, the French state is the biggest of any euro country.

Mr Hollande's programme seems a very poor answer to all this—especially given that France's neighbours have been undergoing genuine reforms. He talks a lot about social justice, but barely at all about the need to create wealth. Although he pledges to cut the budget deficit, he plans to do so by raising taxes, not cutting spending. Mr Hollande has promised to hire 60,000 new teachers. By his own calculations, his proposals would splurge an extra €20 billion over five years. The state would grow even bigger.

Optimists retort that compared with the French Socialist Party, Mr Hollande is a moderate who worked with both François Mitterrand, the only previous French Socialist president in the Fifth Republic, and Jacques Delors, Mitterrand's finance minister before he became president of the European Commission. He led the party during the 1997-2002 premiership of Lionel Jospin, who was often more reformist than the Gaullist president, Jacques Chirac. They dismiss as symbolic Mr Hollande's flashy promises to impose a 75% top income-tax rate and to reverse Mr Sarkozy's rise in the pension age from 60 to 62, arguing that the 75% would affect almost nobody and the pension rollback would benefit very few. They see a pragmatist who will be corralled into good behaviour by Germany and by investors worried about France's creditworthiness.

> "... Mr Hollande is not suggesting slower fiscal adjustment to smooth the path of reform: he is proposing not to reform at all. No wonder Germany's Angela Merkel said she would campaign against him...."

If so, no one would be happier than this newspaper. But it seems very optimistic to presume that somehow, despite what he has said, despite even what he intends, Mr Hollande will end up doing the right thing. Mr Hollande evinces a deep anti-business attitude. He will also be hamstrung by his own unreformed Socialist Party and steered by an electorate that has not yet heard the case for reform, least of all from him. Nothing in the past few months, or in his long career as a party fixer, suggests that Mr Hollande is brave enough to rip up his manifesto and change France (see article). And France is in a much more fragile state than when Mitterand conducted his Socialist experiment in 1981-83. This time the response of the markets could be brutal—and hurt France's neighbours too.

What about the rest of Europe? Here Mr Hollande's refusal to countenance any form of spending cut has had one fortunate short-term consequence: he wisely wants to recast the euro zone's "fiscal compact" so that it not only constrains government deficits and public debt, but also promotes growth. This echoes a chorus of complaint against German-inspired austerity now rising across the continent, from Ireland and the Netherlands to Italy and Spain (see Charlemagne).

The trouble is that unlike, say, Italy's Mario Monti, Mr Hollande's objection to the compact is not just about such macroeconomic niceties as the pace of fiscal tightening. It is chiefly resistance to change and a determination to preserve the French social model at all costs. Mr Hollande is not suggesting slower fiscal adjustment to smooth the path of reform: he is proposing not to reform at all. No wonder Germany's Angela Merkel said she would campaign against him.

Every German chancellor eventually learns to tame the president next door, and Mr Hollande would be a less mercurial partner than Mr Sarkozy. But his refusal to countenance structural reform of any sort would surely make it harder for him to persuade Mrs Merkel to tolerate more inflation or consider some form of debt mutualisation. Why should German voters accept unpalatable medicine when France's won't?

ECONOMIST / **LINK**

At the end of last month, 5,000 people marched through Dublin to protest against the imposition of a €100 (£80) household tax that the Irish government was already struggling to collect from voters sick of austerity measures imposed on a stagnating economy.

It was a small demonstration by the standards of some that have taken place across Europe in recent months – in places such as Syntagma Square in Athens, or in Spanish cities during the general strike that took place just before the Dublin protest – but numbers on the streets are not everything these days.

As polls in Ireland revealed last week, support for the coalition government's policies is collapsing, while backing for Sinn Féin – which is calling for a "no" vote in next month's referendum on the EU fiscal compact that would bind member states other than the UK, which opted out, to budget deficits of 3% or less in perpetuity – has propelled it into the rank of Ireland's second most popular party after Fine Gael. Whether there will still be a fiscal compact to vote on, when the Irish go to the polls, is a moot point. The likely winner of the second round of the French presidential elections next Sunday, the Socialist, François Hollande – who some polls put nine points ahead of the incumbent, Nicolas Sarkozy – has said he would revise the deal.

> "... What is being demanded by voters, as European debt has continued to balloon along with unemployment, even as growth has evaporated, is nothing less than a "Plan B" – an alternative to the dominant anti-austerity drive..."

In recent days, the Dutch coalition government has been brought down by the departure of Geert Wilders's far-right Freedom party, which was unwilling to sign up to a budget in line with the EU's belt-tightening package, even though the Dutch government has been one of the most aggressively in favour of imposing harsh austerity measures on members such as Greece and Portugal. Indeed, opinion polls in the Netherlands suggest that if elections – set for September – took place today, parties opposing the austerity regime might, both to the left and far right, win up to a third of seats.

While some analysts have pointed to Hollande's emergence as the leader of a pan-European anti-austerity movement, others believe that something more complex is occurring – a "game-changing moment" in Europe in which individual electorates are emboldened to push back and debate new strategies by events they see taking place in other countries. What is being demanded by voters, as European debt has continued to balloon along with unemployment, even as growth has evaporated, is nothing less than a "Plan B" – an alternative to the dominant anti-austerity drive. Significantly, for the first time those calls are gaining real traction.

"The one thing you notice," says Eoin O'Malley, a politics lecturer at Dublin City University researching reactions to the European crisis, "is how the push back in one country [against austerity] is influencing politics elsewhere. You see Hollande's comments in France and the fall of the Dutch government influencing how voters here see the Irish referendum on the fiscal compact and believing increasingly they can say no. If you ask me now, I would bet that a no vote was more likely than it was last week."

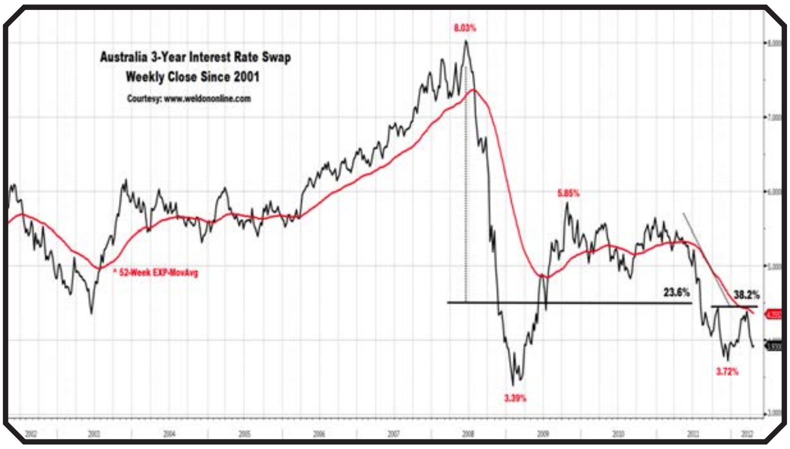
In just a few weeks, the long-running European debt catastrophe that has stumbled from summit to bailout to the fall of governments has been transformed into a far more corrosive crisis of legitimacy that is increasingly pitting electorates against the established political castes. From London to Madrid, from the EU's northern core to its periphery, voters have begun to resist policies tightly predicated on targets and deadlines for reducing debt to satisfy the markets and ratings agencies that have no means for encouraging growth.

UK GUARDIAN / **LINK**

As for the [Australian] labor market itself ... Employment has fallen in five of the last nine months, over which time total Employment has risen by +45,400, or by +5,044 per month on average. This contrasts with the 15 month 'run', from September 2009, through November of 2010, during which time 480,000 jobs were created, for an average monthly Employment gain of +32,000.

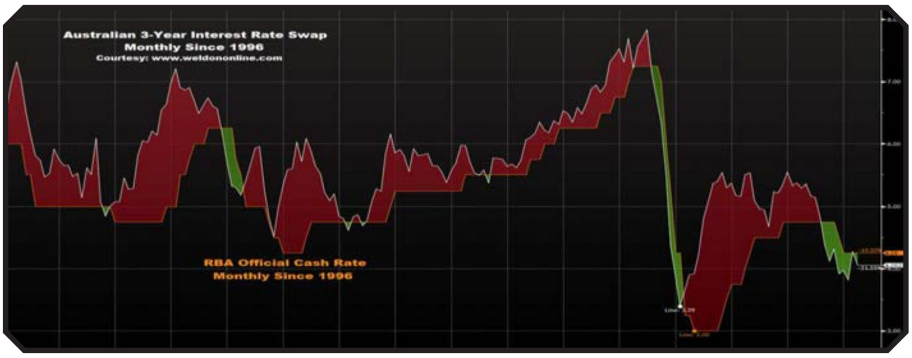
In other words ... the average month job gain is barely positive, and has plummeted by (-) 84.3% from the end of 2010.

Of great 'statistical' interest, and to the RBA's above-mentioned-point, we note that since September of 2009, despite cumulative Employment growth of +552,700 ... the Participation Rate is unchanged.

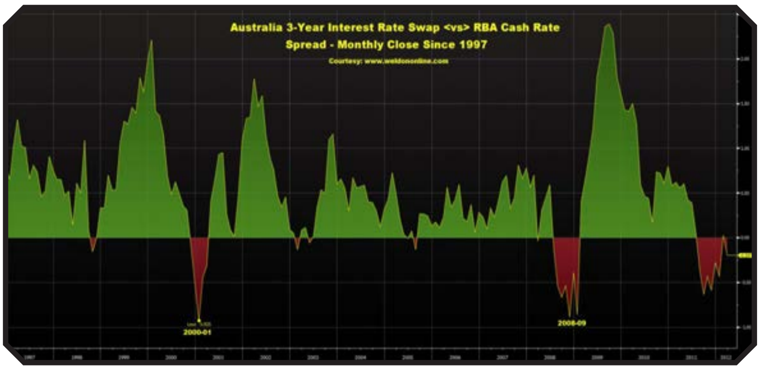


The market smells the macro-economic-blood, as implied by the pricing of Australia's 3-Year Interest Rate Swap, which has been flirting with a move below 4% this week. Witness the long-term weekly chart on display [left, top], revealing the downside run, with the December-2011 low at 3.72% in sight.

Moreover, as evidenced in the long-term monthly overlay chart seen [left, 2nd-top] the 3-Year Interest Rate Swap moved below the RBA Cash Rate in 2011, and has remained there since. Subsequently the most recent decline implies a sooner-rather-than-later move lower in the Cash Rate.



Ominous is the macro-message being delivered by the Australian fixed-income markets, as can be defined via an examination of the chart on display [left, 3rd-top], in which we plot the Spread between the Aussie 3-Year Interest Rate Swap, and the RBA's official Cash Rate.



Troubling is the fact that instances where the 3-Year Swap has moved below the official RBA Cash Rate, have occurred in line with intensified turbulence in the economy and the markets ...

... amid a rise in the influence of macro-deflation.

The Australian PM is politely asking for the RBA's support, while the market is BEGGING the RBA to cut rates, quickly and by a sizable degree.

SOURCE: WELDON

A more pronounced push towards reductions in the Aussie Cash Rate will most assuredly cause the 3-Month LIBOR defined short-term interest rate differential between Australia and the US to narrow.

Indeed, as pictured in the dual-window chart below, the current differential between 3-Month AUD and USD LIBOR is WIDE, nominally, and historically, at more than +400bp, or one of the widest levels in the last two decades !!!

GREG WELDON / **LINK**

The rock-solid "hardline"

leaders of France and the Netherlands were exposed as mere sandcastles, next in line to be swept away by the eurozone's economic woes.

Eight days ago, the Dutch prime minister, Mark Rutte was deposed. A day later, France's Nicolas Sarkozy, one half of the eurozone's twin-engine, lost the first round of the presidential race. The other half, Germany's iron chancellor, Angela Merkel, remained above water – but only as a dangerously isolated island.

The markets lurched in horror at the apparition of the deadly seventh wave of contagion. But the real shock was that this time the force wasn't debt, but democracy.

"... The "legitimacy question"... poses the real danger to the eurozone – and is most likely to trigger its collapse..."

Bond yields, borrowing costs and bail-outs, which have overwhelmed Greece, Ireland and Portugal, and that hover over Spain and Italy, too, were no real threat in the north last week. Despite their debts, the Netherlands and France have retained their low bond yields and AAA-ratings (France has only been downgraded by S&P). Germany's economy is in rude health, relatively speaking.

Instead, the continent's northern core has been hit by the eurozone's other big crisis: the question of legitimacy.

For three years, Merkel and Sarkozy have imposed savage austerity with one overriding justification: to save the euro. As if in wartime, democracy has been sidelined and public opinion ignored under the assumption that the state – or superstate – has a higher cause.

With breathtaking audacity, Brussels installed its own technocrats in Greece and Italy to impose its policies in "sinner states". Extreme measures were needed to keep the eurozone intact, they said – without ever properly asking if the electorate wanted the prize, let alone had the stomach for the cost of winning it.

The "legitimacy question" has been quieter than the rampaging debt farrago. Yet plenty reckon it poses the real danger to the eurozone – and is most likely to trigger its collapse. Over the next few weeks its pent-up energy will be unleashed in full – via a raft of ballot boxes across Europe.

Last week was just a warm-up. May 6 is a day of reckoning for Europe's leaders as France votes for a new president, Greece for a new parliament, and Italy goes to the polls for local elections. German state elections follow. On May 31, Ireland is holding a referendum on Europe's fiscal pact. In June, France has parliamentary elections. Then, on September 12, the Netherlands will go to the polls.

As last weekend has shown, the elections are fast becoming a vote on Europe's growth and stability pact – the German-led plan to impose binding austerity rules on all eurozone countries. Merkel said the pact was "non-negotiable" and would "last forever", but any national parliament that was ready to ratify the treaty is being roundly rejected.

François Hollande, the socialist front-runner to become France's president, has vowed to scrap the pact. In a week's time he could be tasked with co-driving the rescue mission with Merkel.

Meanwhile, Marine Le Pen, the self-styled Joan of Arc, put quitting the euro altogether at the centre of her campaign. Last weekend, she chalked up a record 18pc of the vote. Then, on the Left, is Jean-Luc Melenchon, an avowed anti-capitalist, describing financial markets as "parasitic".

In the Netherlands, Geert Wilders withdrew support from the coalition, saying he refused to back the "diktats from Brussels". He said: "We must be master of our own house."

Yet the crisis is advancing mercilessly, particularly in Spain, which is too big to bail out, even by prime minister Mariano Rajoy's admission.

So, will the eurozone's austerity drive be swept away with its proponents? If so, who and what will replace them? If it's not the fiscal pact, then what? If it's not the eurozone, then what?

UK DAILY TELEGRAPH / **LINK**

Ratification

Signatory	Conclusion date	Institution			AB	Deposited	Ref.
Austria		National Council					
		Federal Council					
		Presidential Assent					
Belgium		Senate					
		Chamber of Representatives					
		Royal Assent					
		Walloon Parliament (regional) (community matters)					
		German-speaking Community					
		French Community					
		Brussels Regional Parliament					
		Brussels United Assembly					
		Flemish Parliament (regional) (community matters)					
		COCOF Assembly					
Cyprus		House of Representatives					
		Presidential Assent					
Estonia		Assembly					
		Presidential Assent					
Finland		Parliament					
		Presidential Assent					
France	21 February 2012	National Assembly	256	44	131		[16]
	28 February 2012	Senate	169	35	138		[17]
		Presidential Assent					
Germany		Federal Diet					
		Federal Council					
		Presidential Assent					
Greece		Parliament					
Ireland		House of Representatives					
		Senate					
		Referendum					
Italy		Senate					
		Chamber of Deputies					
		Presidential Assent					
Luxembourg		Chamber of Deputies					
		Ducal Assent					
Malta		House of Representatives					
Netherlands		House of Representatives					
		Senate					
		Royal Assent					
Portugal		Assembly of the Republic					
		Presidential Assent					
Slovakia		National Council					
		Presidential Assent					
Slovenia		National Assembly					
		Presidential Assent					
Spain		Congress of Deputies					
		Senate					
		Royal Assent					

SOURCE: WIKIPEDIA

How big a task is it to get the ESM ratified? Well, take a look at this handy chart that lays out all the required approvals.

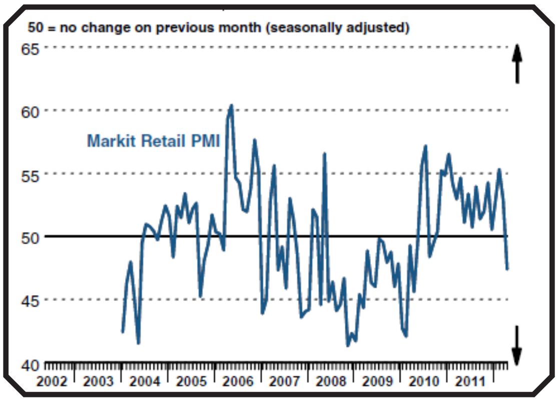
So far, so good. France voted in favour so that has to be good, right?

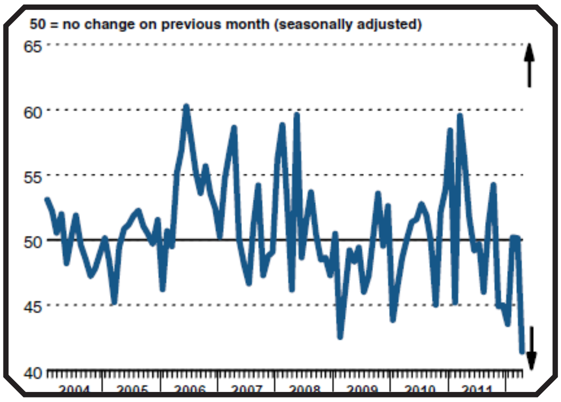
Two down; Twenty-nine to go

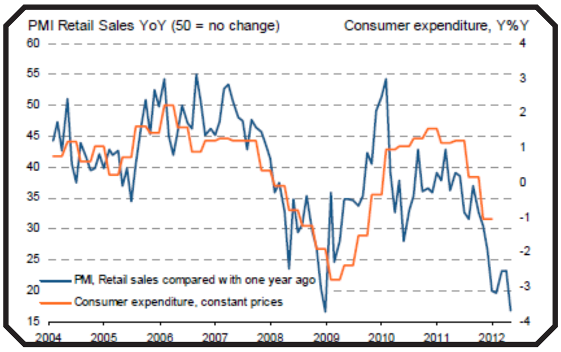
Hopefuly the NINE separate votes in Belgium all go the right way...

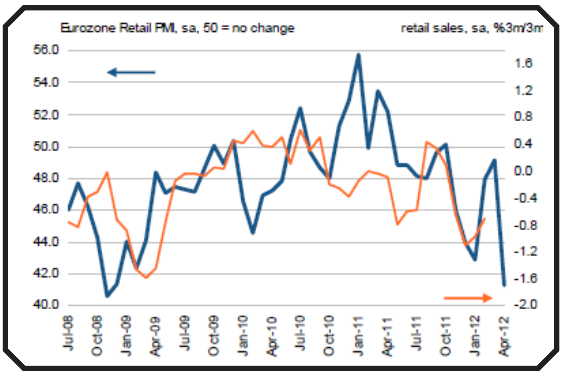
The word of the day is plunge. Retail sales fell like a rock in Germany and fell at a record pace in France. Jobs and retail sales plunged at a record pace in Italy, and in general, did a nose-dive across the entire Eurozone

MISH / LINK









SOURCE: MARKIT

Germany:

- Fastest drop in retail sales since April 2010 as year-and-a-half run of growth comes to an end.
- Retail PMI falls sharply in April
- Steepest decline in margins for two years...
- ...despite wholesale price inflation hitting 15-month low
- Sharp squeeze on operating margins

France:

- French retail sales fall at survey-record rate in April
- Sales hit by weak economy and presidential elections
- Targets missed to greatest degree in 18 months
- Margin squeeze continues amid widespread discounting

Italy:

- Sharp decrease in retail sales leads to survey-record job losses
- Sales fall at second-sharpest annual rate in series history
- Confidence sinks to four-month low
- Cost inflation slowest since December 2010

Eurozone:

- Retail PMI plunges to 41.3, lowest since November 2008
- All three countries surveyed post lower sales, with record decline in France
- Cost pressures for retailers at 16-month low

SOURCE: SHARELYNX

Nick Laird of Sharelynx shared this chart of the gold bull market move with me this week and it provides an interesting perspective on something that always seems to scare a lot of people.

Nick's message to me?

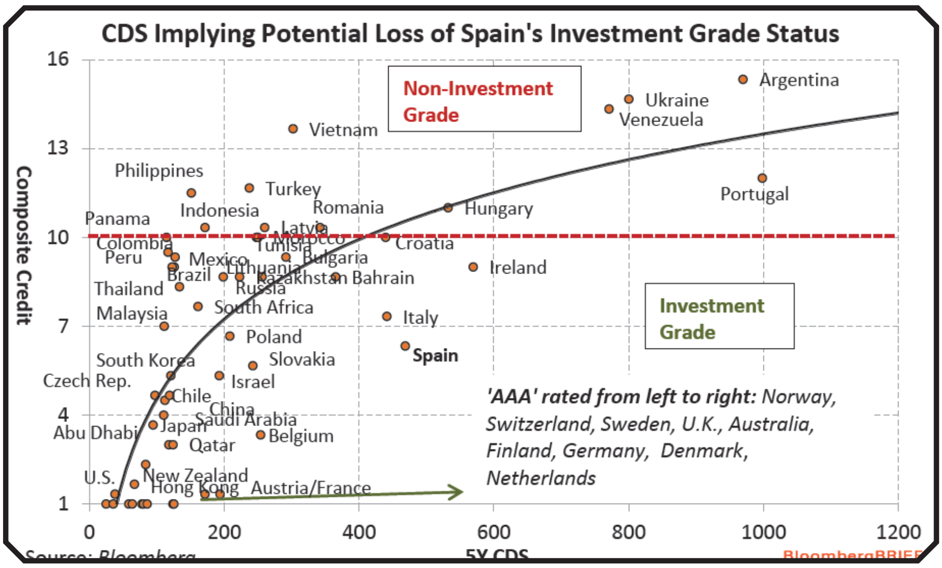
"Gold's bull run is just fine".

I'm inclined to agree with him...

"According to CDS-implied credit ratings, renewed escalation of the European debt crisis may place Spain's investment-grade status at risk, while France may face a downgrade to A- on S&P's rating scale.

he composite credit rating is calculated by quantifying the three primary agencies' ratings, where available, and averaging the results for each country. A score of one indicates the highest rating across all three companies. A score of 10 or better indicates investment grade.

The cost of five-year CDS is the amount traders are willing to pay to protect against a default on the country's underlying debt. The cost of protecting against a Spanish default through five-year CDS has risen to about 470 basis points, which is more than 200 basis points higher than similar protection on Turkish sovereign debt which holds a non-investment grade composite rating of 11.7. Spain's composite rating is 6.3, equivalent to A on the S&P scale. France may risk the largest nominal downgrade of the countries surveyed, with its CDS price implying a potential downgrade to 6.8, or A-, from its present composite rating of 1.3, or AAA. This would still fall within the investment grade range.



SOURCE: BLOOMBERG/RITHOLTZ

BIG PICTURE / **LINK**

CLICK TO WATCH

Jim Grant talks about his recent speech to the NY Fed and discusses the contents of his latest newsletter, some of the insight offered at his recent conference in New York as well as dissecting Ben Bernanke's recent speeches to a group of Georgetown students.

Jim is, as always, fantastic.

(Jim's interview begins around 4:30)

Jim Puplava spends a little time talking to Casey Research's Bud Casey about the direction of interest rates and finds Bud squarely of the opinion that they only have one way to go...The negative implications of this aren't exactly new to readers of Things That Make You Go Hmmm....., but, as always, Bud puts the situation into better context than I ever can...

CLICK TO LISTEN

CLICK TO LISTEN

Bill Black has featured regularly in these pages and, in this lengthy interview with Chris Martenson, Bill explains why, in the current system, fraud is not only likely, but virtually inevitable.

Bill was one of the central figures in the aftermath of the S&L crisis of the 1980s and has been a vociferous critic of the financial industry since long before the GFC erupted in 2008.

Fascinating.

and finally...

My favourite website of recent months was introduced to me by my friend Michael in NY and it constitutes a string of text messages between a dog and his owner. It is simply titled 'Texts From Dog'.

CLICK TO READ MORE

These conversations have had me in hysterics for weeks now.

Many of the messages are most definitely inappropriate so be warned - this dog is NO Lassie...

Enjoy!

Hmmm...

SUBSCRIBE UNSUBSCRIBE COMMENTS

Grant Williams

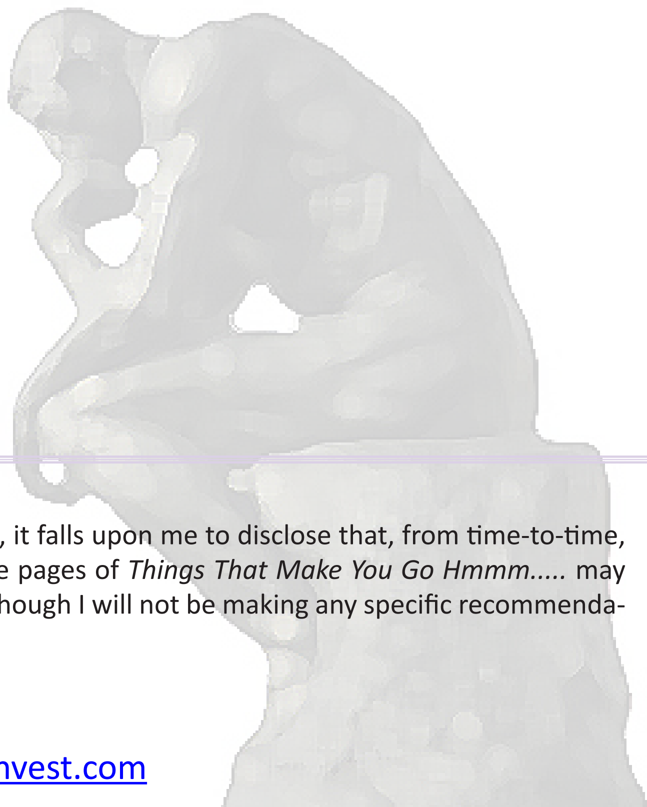
Grant Williams is a portfolio and strategy advisor to Vulpes Investment Management in Singapore - a hedge fund running $200million of largely partners' capital across multiple strategies.

In 2012, all Vulpes funds will be opened to outside investors.

Grant has 26 years of experience in finance on the Asian, Australian, European and US markets and has held senior positions at several international investment houses.

Grant has been writing 'Things That Make You Go Hmmm.....' for the last three years.

For more information on Vulpes please visit www.vulpesinvest.com



As a result of my role at Vulpes Investment Management, it falls upon me to disclose that, from time-to-time, the views I express and/or the commentary I write in the pages of *Things That Make You Go Hmmm.....* may reflect the positioning of one or all of the Vulpes funds - though I will not be making any specific recommendations in this publication.

Grant

www.vulpesinvest.com