JANUARY 21, 2016
IN THIS ISSUE:

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"What is the 'real reason' this is happening? What is the end game?" A hypothetical interview with the head of a foreign creditor of the United States.

ONE of our best relationships on the Street thought it might be helpful to our customers if we conducted a mock interview with a fictional head of a foreign sovereign creditor of the US. This would allow us to illuminate some of the thought processes and events we have been describing in our work and observing in markets as well as allow us to hypothesize about some of the potential reasoning behind those events. So without further ado, our interview with "Mr. X" (*hat tip reader DC.):*

FFTT: Thank you for joining us Mr. X. Why don't we start out the interview by touching on one of the biggest hot-button issues these days, the oil market. Are you surprised oil has fallen as far as it has?

Mr. X: You're welcome, thank you for hosting me. I am somewhat surprised how low oil has fallen. In the short run, there is an oversupply of oil and this is weighing on prices. Perhaps what has surprised me more is how most western investors continue to ignore what appears in my eyes to be a very significant change in the global oil market that has occurred in the past 18 months or so.

FFTT: We have been writing about that quite a bit, but for the benefit of our readers, what "very significant change in the global oil market" are you referring to?

Mr. X: Well, most western investors seem to be focused on oil purely from the same USD-centric fundamental supply/demand angle they have for the past 40-50 years and as a result, many actions of major global energy players (both importers and exporters) over the past 18 months seemed to have not made sense.

In contrast, virtually no western analysts I have read are focused on oil from a global balance-of-payments angle, which is how many of the biggest US foreign creditors look at the oil market. However, if western investors were to look at the various oil export and import players' actions through an "oil balance-of-payments lens" instead of a "USD-centric lens," many of those seemingly-puzzling actions of the past 18 months suddenly start to make a lot more sense.

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FFTT: We assume that when you refer to "a USD-centric lens", you are referring to the Petrodollar system?

Mr. X: Yes, exactly. Let me preface this statement by saying I love the United States. I maintain a residence there and have met countless wonderful Americans, many of whom I count among my dearest friends. The US is one of the greatest nations on the planet…

FFTT: We feel a "…but" coming on (laughing)…

Mr. X: (Smiling). Yes…and here it is: But I have always been surprised how little most US citizens generally and investment professionals specifically understand how much of the style and standard of living most in the US have become accustomed to is a function of "the Petrodollar system."

As you know, under the Petrodollar from 1973 until about 18 months ago, oil was only priced in USD globally. When oil prices got too low, oil exporters like OPEC and Russia found their budgets under pressure and burned down FX reserves and it usually fell to Saudi Arabia as the world's swing producer to cut oil production and stabilize oil prices.

On the flip side, from 1973 until about 18 months ago, when oil prices got too high the US Fed began raising rates to slow down the US economy (which was also the world's biggest economy and energy importer) to bring oil prices back into an acceptable range.

There has been much discussion about this "Petrodollar system", but in the end I would say the non-US world tolerated it. The world worked. Your Fed chairman Paul Volcker in particular earned the Petrodollar system a tremendous amount of credibility in 1979-1981 when he showed he was willing to put the US economy into tremendous distress by raising rates into a vicious US recession to fight rising oil price inflation. He showed a commitment to keep the USD "as good as gold" for oil, even though the US had defaulted on its gold commitments to its creditors like us only 8 years before.

FFTT: So if that was "the old system" that most western investors have remained focused on, what is the new "oil balance-of-payments lens" you referred to through which we can perhaps see some of what you said were "very significant changes in the global oil market"?

Mr. X: The clues to the very significant change in the oil market have come from both major global oil importers and exporters. The most recent one just came last month from your US Congress when they repealed the 40-year old US crude oil export ban.

Tell me, why would the US ever export crude oil for USD's when from 1973-2014, the US could simply print USD for ever-growing amounts of imported oil? That makes no sense using "the old lens."

FFTT: That's a great point, it does not make any sense. That is something we've written about a number of times. What are some other clues you are referring to?

Mr. X: Well, the clues started in fall 2014, when Saudi Arabia led OPEC in declining to support USD oil prices and continued to run production at high levels – that was a very different direction from OPEC's actions of the prior 30 years or more.

OPEC then emphatically reinforced their fall 2014 decision with their announcement in early December 2015 that amounted to this: "If the Russians and Americans have no production limits, we will not enforce them either. We would rather maximize oil production and dis-hoard UST's/USD's than maximize oil prices and hoard UST's/USD's."

Of course all I read in the western mainstream financial media in the aftermath of that OPEC decision and the ensuing drop in oil prices was how screwed Saudi was because of how rapidly they were burning down their USD reserves, which made me laugh out loud…the western mainstream financial media doesn't get it in my opinion.

FFTT: Why did that western media assessment of the Saudi position post-OPEC meeting make you laugh?

Mr. X: Because they write as if the USD is the center of the world.

FFTT: Well, it is, isn't it? Western financial media have a point, don't they? I mean don't the Saudis have USD-denominated debt and extensive social obligations?

Mr. X: Oh sure, but let me ask you – what nation would not lend to Saudi or supply Saudi social needs in exchange for the right to price Saudi oil in their own currency? Do you think ANY nation would decline that offer?

This is why the western mainstream financial media makes me laugh. They think the USD is the real value rather than the Saudi oil that has effectively backed those USD's for 40 years. The same USD that the Fed was not so long ago printing $85B per month of out of thin air!

For those that think that the USD is the real value, I would challenge them – next time you need to fill up your car, why don't you take it to your local Fed branch and fill the car up with USD's and see how far it takes you? Westerners have become so accustomed to the USD equaling oil that they have forgotten it is oil that is the real value, not the USD.

You have kids, have you watched the "Harry Potter" movie series with them? What is it they say in "Harry Potter?" "The wand chooses the wizard, not the other way around?" Well, most Americans seem to have forgotten that it is oil that chose the USD as the world's monopoly reserve currency for oil, not the other way around.

And just as Americans have forgotten that it is oil that chose the USD as reserve, your American politicians have forgotten that if oil chose the USD as the world's oil monopoly reserve currency, there is no theoretical reason why oil could "un-choose" the USD.

FFTT: FFTT understands that (and we agree with you), but we have had people respond in the past to us that if the Saudis did that, wouldn't the US just invade Saudi and take over the oil fields?

Mr. X: A very American response indeed! I suppose the US could make such a move were Saudi to "un-choose" the USD as the world's oil monopoly currency, but let me ask you as before – do you think no other nation would be willing to move their army to Saudi's aid for the promise of future Saudi oil priced in their own currency? China perhaps?

Let me assure you: Any nation with an army would be willing to move to Saudi's aid for the promise of future cheap Saudi oil…and even a nation without an army might be willing to help out; heaven knows the Russians would be happy to sell them the weapons!

FFTT: Good point…let's move back to a less grim topic and further discuss the major change in the global oil market you mentioned. Are there other clues about this major change? If so, what are they?

Mr. X: Yes. In addition to the change in the way the US and OPEC have acted in the past 18 months v. the prior 40 years, global oil exporters and commodity producers have "flipped the script" if you will by de-pegging from or devaluing versus the USD. Russia, Kazakhstan, Iran, Nigeria, Angola, Azerbaijan, Venezuela, Argentina, South Africa...that's a lot of countries in just 18 months all choosing to do the same thing:

Rather than burning FX reserves down and then devaluing their currency, they have shown a willingness to de-peg earlier on and take the inflationary pain to their economies.

FFTT: What do you think accounts for their change in behavior on that front?

Mr. X: The answer to that question is also the final clue something big has changed in the global oil market. I think it is at least partially because the world's new biggest oil importer, China, is willing to pay for oil in CNY instead of USD's and then offer credible physical gold settlement of that CNY oil.

FFTT: Pricing oil in CNY? Hasn't selling or buying oil in any currency that is not USD historically been a big geopolitical no-no? To ask more directly, didn't changing the pricing of his oil to EUR contribute to Saddam's downfall?

Mr. X: That is generally not something talked about in polite company.

FFTT: Well lucky for you, we're from Cleveland.

Mr. X: (laughing) In that case, it would seem to strain credulity to believe that Saddam's move to switch oil pricing from USD to EUR in fall 2000 had absolutely nothing to do with his fate. Interestingly, recently-released Hillary Clinton emails suggest that oil pricing currency issues may have also been a factor in Qaddafi's downfall in Libya in 2011 as well.

FFTT: Chalk one up for the "conspiracy theory" crowd, perhaps.

Mr. X. Indeed.

FFTT: So if that is the case and Russia and Iran began selling oil to China in CNY instead of USD, why hasn't the US reacted?

Mr. X: What makes you say the US hasn't reacted? Since shortly before or shortly after these "Holy Grail" energy deals were discussed and signed between Russia and China (that were later shown to be CNY oil deals), there has been a spontaneous outbreak of open war in Russia's client state Syria, a color revolution in Ukraine, sanctions on Russia and Iran and heightened tensions with China over a group of tiny artificial islands in the middle of nowhere…that strikes me as quite an incredible string of coincidences.

(Smiling) Perhaps your American media has convinced the American public to believe those geopolitical events were all mere coincidences, but please tell me young Luke that you do not ascribe all of those events to mere coincidence…

FFTT: No, no we don't unfortunately…and your point is well-taken. Let us return to your original point about CNY oil pricing: Why would any oil exporter like Russia or Iran agree to take CNY instead of USD for their oil?

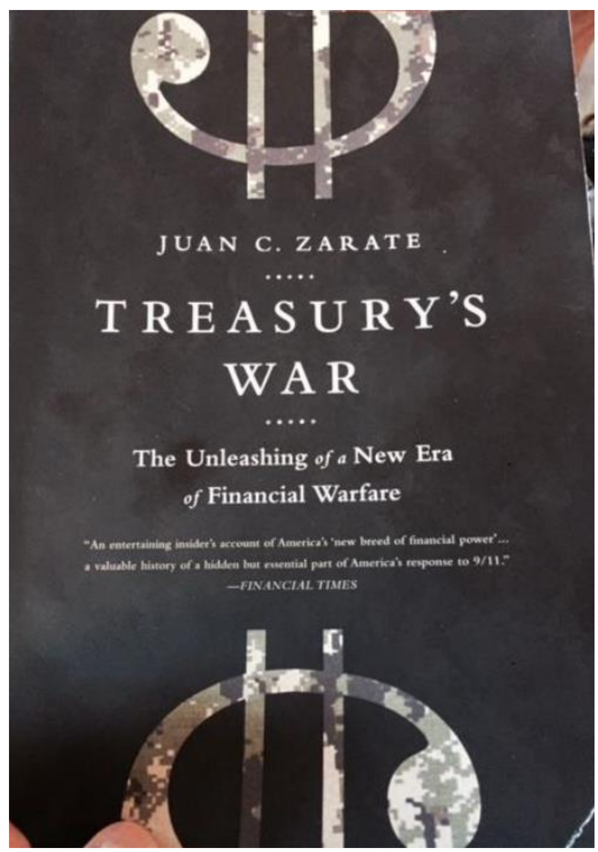
Mr. X: The easy answer is that China is now many of these nation's biggest customer, and these nations need Chinese goods for their people.

The more nuanced answer is China is offering credible physical gold settlement, which then gives both China and these oil exporters the ability to get away from the USD that over the past 15 years the US has increasingly been using as a weapon against any nation that does not do Washington's bidding.

[By way of background on the "weaponization" of the USD, from a recent FFTT:

By the mid-2000's was the only thing the world really needed the US for on a net basis anymore anyway (besides certain defense and technology products). Given this, the US government decided the USD was an effective foreign policy tool. As noted by former senior US Treasury official Juan Zarate in his 2013 book "Treasury's War"]:

> *"The dollar serves as the global reserve currency and the currency of choice for international trade, and New York has remained a core financial capital and hub for dollar-clearing transactions. <u>With this concentration of financial and commercial power comes the ability to wield access to American markets, American banks, and American dollars as financial weapons."</u>*
>
> *"Treasury's power ultimately stems from the ability of the US to use its financial powers with global effect. This ability, in turn, stems from the centrality and stability of New York as a global financial center, the importance of the USD as a reserve currency, and the demonstration effects, regulatory or otherwise, taken by the US in the broader international system. <u>If the US economy loses its predominance, or the USD sufficiently weakens, our ability to wage financial warfare could wane."</u>*



FFTT: What do you mean by "credible physical gold settlement?"

Mr. X: In 2015, the NY COMEX gold exchange settled less than 50 tons of physical gold all year. In contrast, on average the Shanghai Gold Exchange settled over 50 tons of physical gold every single week of 2015. If you want physical gold, which exchange is more credible?

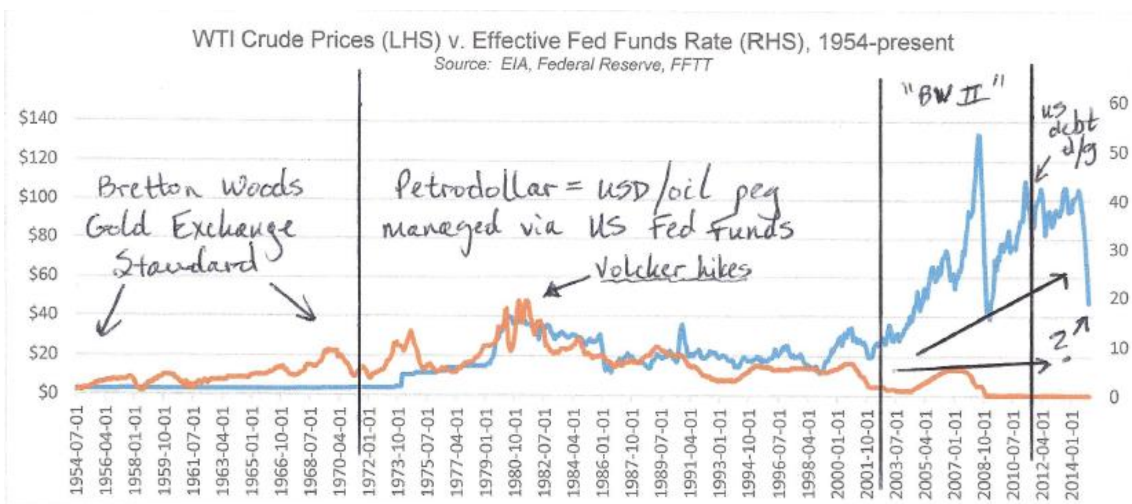
FFTT: Why the difference between "paper gold" and "physical gold"?

Mr. X: "Paper gold" is merely an obligation of a TBTF bullion bank, which was shown in 2008 to be an obligation of the US government in extremis. In other words, "paper gold" = "USD's". If you are going to take paper gold as trade settlement, you might as well just stick with UST's.

FFTT: Got it. So when I put all of your clues together, from the US exporting oil, to OPEC no longer limiting production to support USD oil prices, to other oil exporters de-pegging from USD, to China pricing oil in CNY and settling in physical gold, I am left with a string of compelling clues but no overriding theme to connect them. What am I missing? Why are these things happening?

Mr. X: To see what is happening through the "oil balance of payments lens" I referenced earlier, you must put yourself in my shoes, or Russia's shoes, or Saudi's shoes or China's shoes. From 1973 until about 2000, the US managed the USD responsibly for the benefit of all in the world, including creditors. Even when it required Paul Volcker taking rates to the teens and crushing the domestic economy, America managed the USD to be "as good as gold for oil."

If you look at a chart of US Fed Funds Rates v. oil prices, this relationship is pretty obvious between 1973 and 2000.



FFTT: So then what happened in 2000?

Mr. X: The USD became a victim of its own success in a way. The moves Volcker made in the early 1980s established a fertile breeding ground for financialization of the US economy during a time of rapid financial innovation anyway. The net of it was that by 2000, the US economy had become too financialized to withstand much more than a token rate hike, as evidenced by how badly the US tech bubble blew up in 2000.

Not long after the tech bubble blew up, the historically-unique combination of geological realities that began developing in the global oil patch (rising cost curves) and rapidly-growing Emerging Markets led to a sharp rise in the price of oil. Under the Petrodollar system, that should have required the Fed to raise rates to keep the price of oil relatively steady in USD terms, but the Fed did not do so.

FFTT: But they didn't, because they were afraid of popping the housing bubble.

Mr. X: Perhaps that was the reason, but regardless, the Fed didn't raise rates like they should have. That much can be seen in your chart above.

FFTT: So why didn't the world move to ditch the USD in global oil trade at that point, if the US wasn't holding up its end of the "Petrodollar system" bargain?

Mr. X: Well, for some nations, seeing what happened to Saddam was probably motivation enough. For others, like Russia and much of SE Asia, they were still recovering from their own EM crises that occurred in the mid-late 1990s.

And China probably didn't do anything because by virtue of getting into the WTO in late 2001, the Americans essentially traded large remaining chunks of the US industrial base for steady Chinese purchases of UST's, which was something the Americans desperately needed after the formation of the EUR because the Europeans basically stopped funding the US government (buying UST's) after 1999. China was getting a great deal – the staggering amount of US IOU's they bought were essentially being collateralized immediately by US production capacity with ready contracts to sell back to the US.

FFTT: Wow…I never thought of it that way. Washington essentially pawned large remaining chunks of the US' industrial base in exchange for a UST buyer willing to fund Washington's largesse for just a little longer?

Mr. X: It's sobering when you think of it that way, isn't it? But you have to remember – these aren't the only reasons the world didn't try to ditch the USD for oil trade in the early 2000's when the US started to fail keeping its end of the bargain.

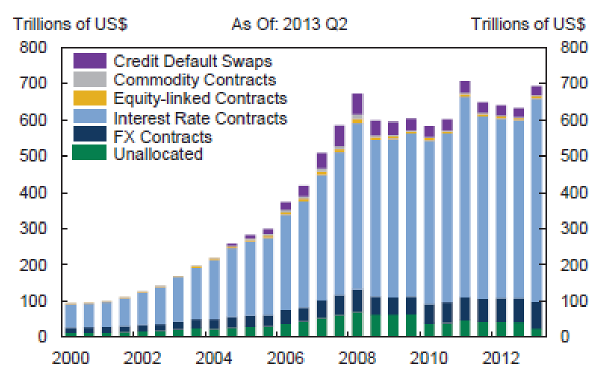
You must remember the zeitgeist of the times: Everyone knew that the US financial system was the strongest in the world, the envy of the world. The world abided by the "Washington Consensus" and the neoliberal economic values it espoused.

And so beginning around 2000 or so, when the American and global banks began offering us these new "interest rate derivatives" that allowed us to hedge our exposure to rising interest rates that rising oil prices would normally have portended, without having to sell our UST's, why would we have ever questioned them? They were the smartest guys in the room. The strongest system on the planet.

FFTT: So their pitch to you was *"Don't sell your UST's due to higher oil prices like you might have done in the past, buy an interest rate swap from us instead that will hedge your risk, and we will make you whole if rates rise."*

Mr. X: Effectively.

5.6.1 Global OTC Derivatives Market



Source: BIS, Haver Analytics   Note: Notional values.

FFTT: And you believed them…at least until 2008, when the US and global financial system imploded.

Mr. X: Yes. You have to remember, the "Washington Consensus" and neoliberal economics had decades of proof of success behind it. The vaunted American financial system was the strongest in the world.

FFTT: And then in the span of a few months, the vaunted US financial system was revealed to be made out of little more than "balsa wood and baby tears", to borrow a phrase from Jon Stewart.

Mr. X: Yes. Our first concern was acting with our partners in other nations around the world and in the US in preventing a total systemic collapse…and let me tell you, that was much closer than most would care to admit! However, once the system was stabilized, there began to be grumbling around the world as US creditors all came to the realization that something needed to change with the system.

The reality is that the rest of the world knew that the system would fail someday. We had known for a long time. Jelle Zijlstra was a brilliant man – read what he describes here, understanding that "the 3rd Oil Crisis" he describes was 2008:

> *"…the 2nd Oil Crisis could be worked through, slowly, but the international financial system could not survive a 3rd Oil Crisis – the inflation would make it impossible to recycle the petrodollars to the oil importing countries with any hope of repayment, trade would crumble, and the system would be brought to its knees."* -BIS Chair Jelle Zijlstra, 1980

FFTT: Interesting…did Zijlstra also offer a prescription for a fix by any chance?

Mr. X: As I said, Zijlstra was a brilliant man, so naturally he did offer such a prescription:

> *"…the 1960s saw a growing disequilibrium in international payments, consequent on the deficit in the US balance of payments. The dollar became overvalued and the US found it increasingly difficult to meet its obligations to convert the dollar (into gold.) It is my firm conviction that a devaluation of the dollar combined with a substantial increase in the price of gold (as provided for in Article IV of the then Articles of Agreement of the International Monetary Fund) would have meant a real improvement of the situation.* -BIS Chair Jelle Zijlstra, 1981

FFTT: OK, so in light of what Zijlstra said so long ago and what happened in 2008, you mentioned once the system was stabilized, there was grumbling internationally about the system. What did that grumbling say? What needed to change?

Mr. X: Not too long after the 2008 crisis I was visiting the US and saw a protestor on TV somewhere holding a sign that said "No more capitalism for the poor and socialism for the rich." I doubt that protestor realized it, but that sentiment was being echoed with the world's creditor nations, many of which were Emerging Markets.

Judging by the triumphalism in US financial media about the Fed's role in saving the financial system, the "Washington Consensus" and neoliberal economists don't seem to realize it, but their policies were totally discredited after 2008.

FFTT: Why?

Mr. X: Because the policies they implemented in the US in response to the crisis were nothing in severity like those implemented in Russia in the mid-1990s, in SE Asia in the late 1990s, in Argentina in the early 2000's. It was, like the protestor's sign said, "Capitalism for the poor (EM/creditor economies) and socialism for the rich (the US economy.)" That caught creditor nations' attention; we knew we needed the system to change.

FFTT: Change in what way? And does that change relate to the oil market change we discussed earlier, and if so, how?

Mr. X: Very good question! Yes it relates to the oil market change, in fact, it has everything to do with the oil market change, because the oil market is being used to force the change!

FFTT: As if we weren't intrigued enough already! Please elaborate.

Mr. X: For a deceptively-simple reason: Under the Petrodollar system, one of the biggest drivers of global balance-of-payment imbalances has always been the oil market.

To oversimplify, the Petrodollar meant that the Americans got 10-15% of the world's oil for free, every single day, and in return the Emerging Markets got US production capabilities, access to US consumer markets (that EM's also indirectly supplied the lending capital into) and a great big pile of US Treasury bonds.

There are those that say US creditor nations stockpiled UST's as a way of keeping their currency weak relative to the USD to remain competitive, but that doesn't matter for purposes of this discussion, because it too hints at the same long-standing imbalance that is being remedied through the oil market. As proof, now that oil is at $27, those EM's sure are selling those UST's rapidly now, are they not?

FFTT: Okay, so then what is the critical change in the global oil market hinted at by the clues we discussed earlier?

Mr. X: Remember what Zijlstra said. Sometime after 2008, the world realized it could no longer afford to give the US 10-15% of the world's oil for free every single day because everyone realized it had become impossible to recycle the Petrodollars back to US debtors with any hope of repayment in real (oil) terms. Around the same time, the US began to realize that the Petrodollar, its "exorbitant privilege", had become more of a burden than a privilege.

FFTT: Given what happened in 2008, I can understand why the world would realize it could no longer afford to give the US 10-15% of the world's oil for free every single day, but why do you say the US realized the exorbitant privilege had become a burden?

Mr. X: Oh, there have been numerous clues. Joe Biden's chief economist Jared Bernstein wrote an op-ed to that effect in 3Q14 in the NYT entitled "Dethrone King Dollar." Larry Summers wrote and spoke numerous times right around that same time that it was critical the US begin exporting oil. Consummate insiders like that do not speak out of turn. Have you ever read what Sen. Elizabeth Warren said Larry Summers told her about "being a Washington insider"?

[For those unfamiliar with the quote, it is here]:

> *Larry leaned back in his chair and offered me some advice. ... He teed it up this way: I had a choice. I could be an insider or I could be an outsider. Outsiders can say whatever they want. But people on the inside don't listen to them. Insiders, however, get lots of access and a chance to push their ideas. People — powerful people — listen to what they have to say. But insiders also understand one unbreakable rule. They don't criticize other insiders.*
>
> *I had been warned.*
>
> *Source: https://www.washingtonpost.com/news/wonk/wp/2014/12/14/elizabeth-warren-is-changing-washington-without-giving-up-her-outside-status/*

FFTT: We have read Sen. Warren's quote, and so we don't disagree with your point about Summers and Jared Bernstein's op-eds.

Mr. X: So do you see what is happening in the oil markets yet, through the "oil balance-of-payments lens"?

FFTT: At the risk of sounding thick to you, we don't. We apologize, but could you lay it out more explicitly?

Mr. X: You are not thick at all my friend, and I'd be happy to be more explicit. It is very straightforward:

No one is allowed to write IOU's they never have to cash and can always roll over for oil any longer. Any net trade imbalances caused by oil will be settled in physical gold, and that physical gold will float in every currency in local currency terms so that energy creditor purchasing power can be maintained in oil terms, unlike what the US has done since 2000 with UST's (but tried to fake like they were still doing so with interest rate derivatives from 2000-08.)

FFTT: Why gold?

Mr. X: Because there are only a few currencies that are big enough to be "global oil currencies" – aside of the USD, only the EUR and CNY. And neither the Germans nor the Chinese are willing to pay the price needed to become the world's sole global oil currency, which they learned from watching the Americans. So if the EUR and CNY do not want to become the new sole oil currencies, then a neutral reserve currency must be chosen.

FFTT: But the physical gold market is nowhere near big enough to handle the physical oil market…

Mr. X: No, it is not. But it will be made "big enough" – in fact that is what is happening in oil markets right now. If gold is to be the new neutral asset for settling oil transactions, then gold needs to be made much bigger relative to oil (and relative to all other global assets.)

But since roughly April 2013, somebody for some reason has refused to allow record global physical gold demand to translate into record physical gold prices in USD's. While this "pegging" of USD/GOLD worked for a while, once Russia and China began moving away from USD oil, if gold was the new oil settlement asset but gold not allowed to rise in USD (pegged to USD) then the only release valve was oil and the USD…and so the price of oil began collapsing as the USD skyrocketed due to its de facto gold peg.

When Russia and China began settling oil in physical gold, the physical oil market was some 25x the size of the physical gold market. Today, the physical oil market is only 10x the size of the physical gold market…this has been reflected in the Gold/Oil ratio (GOR), which has risen from 13x in fall 2014 to 41x today, an all-time high.

FFTT: So whoever is "pseudo-pegging" the USD to gold is effectively forcing the oil market to get small enough to fit into the physical gold market instead of allowing the physical gold market to get "big enough" to settle the physical oil market?

Mr. X: Yes! But this situation cannot persist for very long, not for very long at all!

FFTT: Why not?

Mr. X: Because while "gold isn't used for anything", oil is! And yesterday on CNBC, I saw David Rosenberg say that at current prices, nearly 90% of the world's global oil production is uneconomic!

Perhaps "somebody" thinks they can cap the price of gold to maintain the hegemony of the USD, but there are more important things in the world than the hegemony of the USD! Let me ask you: If 90% of the world's oil production is uneconomic at current prices and before too long goes offline, what will happen to the global economy, to humanity?

Then "King Dollar" will have no kingdom to rule over, no? And with no kingdom, tell me again, what would back "King Dollar?"

Ironically, as western financial media so often notes, gold is "not used for anything"…but this means that it can be inflated as much as it needs to be in order satisfy its role as the world's new oil reserve asset, and I believe it will be before too long, because certain people do not wish to see what happens when 90% of the world's oil production goes offline.

FFTT: "Certain people?" Like whom?

Mr. X: People like the BIS, who per Zijlstra's comments knew this crisis was coming 35 years ago…or perhaps even China, who will soon have the ability to price physical oil and physical gold on their own in CNY, and who have said that suppliers may have to pay the local CNY gold fix price and that the CNY would be fully convertible under the CNY oil contract.

It could even be an oil nation. They all hold lots of gold reserves, right? What would happen to "King Dollar" if Russia or Saudi announced that they would now value physical gold at 1,000 barrels per ounce? The widely-trumpeted Saudi and Russian FX reserve "problems" would disappear quite rapidly, would they not?

Washington thinks "King Dollar" has the last say in this game, but I think Washington's hubris has clouded its judgement.

FFTT: Why couldn't Washington just raise rates again like Paul Volcker did to defend "King Dollar", to make the USD "as good as gold for oil" again?

Mr. X: Oh, they could. But USD oil cost curves suggest rates would have to rise hundreds of basis points, not just 100 basis points…and every 100 basis point hike is $180B in interest expense when you have $18 trillion in Federal debt…and $180 billion is some 6-8% of US Federal tax receipts in good times.

Furthermore, the $18T figure ignores the fact that your government owes over $200 trillion in entitlements to its citizens, and the Baby Boomer demographic has either already turned or will soon turn a number of these entitlement programs cash flow negative, which will necessitate a further acceleration in US Federal borrowing.

If you raised rates hundreds of basis points to make the USD "as good as gold for oil" again, US Federal interest expense would spike even as Federal tax receipts plummeted as the financialized US economy imploded. The math doesn't work, and even if it did, it is a moot point as the US economy is already not weathering its first 25bp hike in 10 years very well.

Already US mainstream economists are pushing the Fed to pause or reverse course…they do not have the fortitude of your man Volcker…but then again they can't. The US economy is very differently-structured and much more indebted now than it was then.

FFTT: You said neither the Germans nor the Chinese are willing to "pay the price" needed to become the world's sole global oil currency, "which they learned from watching the Americans." Why not? What is the price?

Mr. X: Running ever-growing deficits and hollowing out your manufacturing and export infrastructure. In short, bankrupting your country in the long-run for a debt-fueled consumption and government spending boom in the relative near term.

FFTT: Ah, gotcha. Clearly neither the Germans nor the Chinese would want that to happen.

Mr. X: No, which is why they have structured their currencies the way they have. The EUR and CNY are ingeniously structured to be the diametric opposites of how the USD is structured.

FFTT: What do you mean?

Mr. X: US Treasury Secretary John Connolly famously said "The USD is our currency, but it's your problem." That's because after the gold window was closed, the dollar was backed by a promise to manage the USD to be as good as gold for oil. In other words, if gold prices start rising in USD terms, it's a sign to creditors that the USD is being mismanaged, that creditors are getting screwed. The USD gets weaker when gold rises. That's why Paul Volcker once said "Gold is my enemy."

But gold really isn't the enemy…that's like blaming the thermometer for the temperature in Phoenix in the summertime. The enemy is unconstrained US government spending.

In contrast, both the EUR and CNY mark their gold reserves to market quarterly. This means that the gold reserves of the EUR and the CNY rise when gold rises. Both currencies strengthen when gold rises. Both currencies are aligned with the interests of EUR and CNY energy creditors, as opposed to the USD, which is aligned against US creditor interests.

FFTT: Whoa…so this whole "leaving the USD" trend is not just driven by Russia and China and some other EM's?

Mr. X: Oh no. The Europeans kicked it off back in 1999 with the formation of the EUR when they surprisingly put 15% of Eurozone reserves into physical gold, marked to market quarterly. If the Europeans were so happy with USD hegemony, they never would've done that. They would've simply put those 15% of reserves into UST's and inextricably tied their fortunes to the USD forevermore, but they didn't.

It is not well understood among US investors that it was the EU who fired the first shot in what has come to be called a Currency War way back in 1999 with the rollout of the EUR. But that doesn't mean it isn't true.

FFTT: So why didn't the Europeans tie themselves to the USD?

Mr. X: Because the people that run the EU are net creditors and net energy importers, which means it is a matter of national security to Germany and others to have and maintain cheap energy cost inputs of production.

This is something that is probably deeply ingrained in the German psyche because lack of access to cheap oil is a key reason they lost World War II. Most World War II historians would tell you that the Germans had better military equipment than everyone else…but the US and the Russians had the cheap oil.

The architects of the EUR must have understood that US entitlement obligations would eventually require massive USD printing which (through the Petrodollar link) would manifest as USD oil inflation that the EU and other net USD creditors and net energy importers would have to pay…unless the EU came up with its own currency that was constructed in such a way as to preserve its energy creditors' purchasing power, which means that those creditors will then be willing to sell oil cheaply in that currency.

Guess who else are net exporters and net energy importers? China. And they are constructing the CNY in the same way as the EUR. Aligned with energy creditors.

FFTT: OK, so you're telling me that post-2008, once things were stabilized, the world essentially agreed to end the USD-centric Petrodollar system in favor of a system where every nation either had to become oil independent or settle oil imbalances with physical gold?

Mr. X: I'm not telling you anything as I was not privy to any such discussions. I am merely describing what is happening as it is developing…I am merely the little boy noticing that "the Emperor has no clothes", if you will.

FFTT: And so if this is the case, and if "somebody" continues to not allow USD gold prices to reflect the reality of physical demand seen since 2013, then the price of oil in USD must continue to fall…

Mr. X: It sure seems that way, doesn't it?

FFTT: So then how do we get out of this?

Mr. X: Do you know who William White is?

FFTT: Yes. Former chief economist of the BIS, famously warned of the 2008 crisis well ahead of time. Consummate insider, spent 39 years advising global central banks in a variety of capacities. Why?

Mr. X: He has recently begun making some interesting and vocal pronouncements. Here's what he said on December 6, 2015:

> *"We will need another global crisis, and one whose roots can be clearly identified in the shortcomings of the current non-system, for this to happen," said William White, an adviser to the Organization for Economic Cooperation and Development. The G-20's agenda can also become dominated by pressing issues of the moment.*
>
> *"I suspect that geopolitical issues will trump economic ones," White said.*

China begins G20 leadership with ideas to reduce USD's role – 12/6/15
http://www.bloomberg.com/news/articles/2015-12-06/china-starts-mapping-out-g-20-plan-after-year-of-market-turmoil

Mr. X: More recently, William White warned this week of coming debt defaults and then used a most curious phrase: "Debt jubilees."

> *The global financial system has become dangerously unstable and faces an avalanche of bankruptcies that will test social and political stability, a leading monetary theorist has warned. "The situation is worse than it was in 2007. Our macroeconomic ammunition to fight downturns is essentially all used up," said William White, the Swiss-based chairman of the OECD's review committee and former chief economist of the BIS.*
>
> *"It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something,"…The only question is whether we are able to look reality in the eye and face what is coming in an orderly fashion, or whether it will be disorderly. Debt jubilees have been going on for 5,000 years, as far back as the Sumerians."*
>
> > ***World faces wave of epic debt defaults fears Central Bank veteran White – 1/19/16***
> > *http://www.telegraph.co.uk/finance/financetopics/davos/12108569/World-faces-wave-of-epic-debt-defaults-fears-central-bank-veteran.html*

FFTT: Fascinating comments coming from such a consummate insider – what do you make of them?

Mr. X: When I hear "debt jubilees", I think of unsecured lending. After all, debt that is collateralized doesn't need a jubilee; the lender simply repossesses the asset and takes any associated loss. So what is the biggest source of "unsecured lending" to be found in the world today?

FFTT: Sovereign debt.

Mr. X: Very good young Luke! Sovereign debt. Full faith and credit and all that good stuff. Now because we have a system without a "neutral reserve asset", the unsecured sovereign debt of nations are the assets of the rest of the world, no?

So we couldn't very easily simply just write off the sovereign debts of the world in one big debt jubilee, now could we? Doing so would bankrupt the nations and wealthy elites holding those sovereign debts as their wealth! People would starve, wars would be fought, not a good situation.

No, double-entry bookkeeping requires that any such "debt jubilee" (which I agree is necessary) must be accomplished not by writing down sovereign debt, but rather, by writing up some other asset that appears on every single Central Bank balance sheet, to keep the system whole.

Do you know of any neutral reserve asset that appears on every single global Central Bank balance sheet that can be inflated to infinity with no practical direct impact on the real economy because "it is not used for anything" and which global Central Banks have recently begun buying in record amounts for the 1st time in 40 years? (Smiling.)

FFTT: Gold…

Mr. X: Yes, that is the only asset I can think of too. And if the creditor nations are allowed to acquire gold at a low price ahead of any "debt jubilee" achieved by writing up gold against all currencies, should they care whether they hold UST's or gold as their reserve asset?

FFTT: No, they wouldn't care. They only care about the ability of their FX reserves to buy them oil.

Mr. X: Correct…they only care about the ability of their FX reserves to buy them oil. So if we let oil exporters and creditors load up on gold and then massively devalue oil (and by extension, all currencies) against gold, do those oil exporters and creditors care?

FFTT: No, they don't care because they have been made whole for past production surpluses through the write-up of gold. In other words, <u>a debt jubilee</u>.

Mr. X: Correct again, young Luke. This is the real game that is afoot in my opinion. And it seems like we are "in the late innings" as I believe is said in America? As William White said, all that is needed is a crisis that indicts the current USD-centric system.

FFTT: Yes…I guess it is interesting then that all we hear on heavy repeat in western financial media is how the strong USD and/or weak EM currencies are causing enormous problems, isn't it?

Mr. X: Indeed. Since William White spoke on December 6, oil has fallen from $42 to $26, infecting US credit markets and leading US stocks on their worst start to a year in the history of the US stock market…seems like the makings of a pretty good crisis to me, no?

FFTT: Yes it does. But this could go on for another year or more, couldn't it?

Mr. X: Not if Mr. Rosenberg was correct when he said that 90% of global oil production is uneconomic at these levels. If he is even directionally correct, the world is going to have a huge problem in months, not years.

FFTT: Yes, but consensus is that the EM's will crash first, while the US will be the last man standing, just like happened in 1982 and 1998. Do you agree with that?

Mr. X: I think the world is a very different place than 1998. EM's have $11T in FX reserves to burn they didn't have then. The US Federal debt is over 100% of GDP, when in 1998 the US was running a surplus.

The US is now one of the world's 3 biggest oil producers and has a middle class that looks more like an EM than the US in 1998. So I think conventional wisdom may be in for a surprise this year, but let's assume it's not. Let me ask you a simple question:

If oil stays at $26 and the US goes into a recession, who will buy the $1-2 trillion in UST issuance that is a virtual mathematical certainty in the case of a US recession in 2016E, especially since EM's will likely be selling another $750B to $1T in UST's in that case…not OPEC, not Russia, not China, not Europe…who? The BOJ perhaps?

FFTT: We've been wondering that same thing, but Wall Street is not yet.

Mr. X: No, I agree that Wall Street is not wondering that yet. But I think it may be interesting to watch how the USD trades once Wall Street starts wondering that same thing.

FFTT: So if you had to guess the most likely path from here, how do you see all of this playing out?

Mr. X: If it is a crisis we need to drive changes that will be for the good of all in the world (except for Washington politicians and lobbyists), then it is a crisis we will get.

FFTT: What does that mean?

Mr. X: I think most investors are beginning to see the potential for a financial Hurricane Katrina and so they are flocking into the safety of the strongest financial bunker they know – the USD.

The USD bunker will indeed protect them from this crisis for a time, but ultimately, the very USD bunker that protects them from the early stages crisis will quickly create an existential risk to energy production and the banking system, the very lifeblood of modern civilization.

With 90% of global oil production already uneconomic at current oil prices, the lifeblood of modern civilization is already under threat!

Once that life blood of modern civilization is put at existential risk by the strong USD, then global authorities will do what needs to be done for the good of all (again, for all except Washington politicians and lobbyists.)

FFTT: Which is what?

Mr. X: They will hit the "USD bunker" with the monetary equivalent of a 10,000-lb (gold plated) "Bunker Buster" bomb. Everyone that will have safely ridden out the first part of the storm will poke their heads out of the bunker to see what happened and find gold at say $13,000 or more, oil at $150-200 per barrel or more and realize that their USD purchasing power has been massively haircut in an instant.

FFTT: Why do you think this is the only outcome? Why can't the USD just keep strengthening for years?

Mr. X: Because of what I said earlier. Remember, it is oil that is the real value in the global economy, the center of the global economy, not the USD. And 90% of global oil production is uneconomic today.

FFTT: OK, so what is your point?

Mr. X: What is the value of a USD if 90% of the world's oil production is shut down? What is the value of the US bond market if 90% of the world's oil production is shut down? What is the value of the US stock market if 90% of the world's oil production is shut down?

Oil is the real value, not the USD. Once too much of the world's oil production shuts down, the USD's that will have kept you safe up until that point may as well turn into wallpaper, because without the world's oil production, there will not be a US economy worth mentioning to give value to those USD's.

FFTT: So let's say you're right, that we wake up one day to find gold at $13,000/oz. and oil at $200/barrel…why do you say this is something that is good for all of the world (except Washington politicians and lobbyists)?

Mr. X: Broadly-speaking, the debtor nations would find their currencies devalued and the creditor nations their currencies revalued higher. The debtor nations would have to consume less and produce more, while the creditor nations would have to consume more and produce less…but conveniently, the creditor nations (EUR, CNY, OPEC, RUB) all have currencies that strengthen when gold strengthens, and the nations themselves own much gold outright!

A giant global consumer middle class will be created overnight! Oil and American goods will suddenly be <u>very</u> cheap to them, and even expensive German goods will be very cheap to anyone that owns gold!

The US will become nearly oil independent with oil at $200/barrel, spurring a renewed manufacturing renaissance in the US that was just barely getting started from 2011-2014 until oil prices crashed.

FFTT: Sounds like a win/win for everyone, what's the downside? There has to be a downside.

Mr. X: Well, setting aside the obvious that $5.00/gallon gasoline in the US that will likely weigh on consumer spending for a time, there is a big downside: This move means that the world will no longer fund the US government by stockpiling ever-greater amounts of UST's.

This move amounts to the world doing what US politicians could not or would not do: Rein in Washington spending. If we look where Washington spends the most money, well that is probably a good place to start looking for areas that will be hurt in this new currency system.

FFTT: Defense and entitlements.

Mr. X: Yes. But even some forward-thinkers in your American defense establishment have been advocating for shifting defense spending to domestic infrastructure spending in recent years, so that too could end up being a net positive for the American people, if not the US defense sector.

But healthcare? If the world is no longer going to stockpile UST's, that means that the American people are going to have to pay more for their own care. Given the entitlement obligations in question and the health of your general population, they are probably going to spend a lot more for their own healthcare.

All I can say about that is perhaps Americans should have cast a more critical eye at legislation called the "Affordable Care Act" coming from the same government that gave them "Operation Iraqi Freedom." From my readings, both seem to be misnomers.

FFTT: Wow…well, there's a lot to absorb here. Why don't we end it there by thanking you for your time and thoughts.

Mr. X: You are welcome. Always a pleasure.

SO HOW DO WE MAKE MONEY WITH THIS?

To reiterate, the above was a hypothetical conversation between FFTT and the head of a global US sovereign creditor (or that nation's sovereign wealth fund), based on a wide variety of our personal readings on a wide variety of subject matters. The goal was attempting to frame up some of the issues and events we have been highlighting and analyzing from the perspective of "the party on the other side of the table."

While we readily admit we may have taken some liberties in some of the comments, we nonetheless think this is a critical perspective to consider, because while the world has been a USD-centric world for the past 70 years, economic reality has shifted dramatically in recent years. When the USD-centric era started, the US was the world's largest (and cheapest) oil producer, largest oil consumer, largest gold holder, largest industrial base, largest Army and biggest (and fastest-growing) middle class.

Fast-forward to today, and the EM creditor nations as a group are now the world's largest and cheapest oil producers, largest oil importers, largest gold holders, largest industrial base, and biggest (and fastest-growing) middle class. For the 1st time on record, the EM's represent the majority of oil imports and for the 1st time in 350 years, they are the majority of global GDP.

The fundamentals underpinning the USD-centric world of the past 70 years are no longer true, yet most investors expect the USD-centric world to continue ad infinitum. We think assuming that would will continue ad infinitum is a bad idea, and the fact that oil has fallen so much that fully 90% of global oil production may now be uneconomic likely puts a very short fuse on this crisis, for reasons highlighted earlier. So how do we make money with this?

1. **We expect gold to outperform not just oil in 2016E but virtually all other asset classes:** In April, China will have the mechanical ability to massively devalue the USD through a CNY gold fix whether the US likes it or not, and basically the entire global monetary system would be VERY fixed (and it would be VERY inflationary) if China decided to value gold at say $13,000/oz. (to pick a random round big #.) *The gold/oil ratio (GOR) has begun 2016E by setting a new all-time high and we expect gold to outperform not just oil in 2016E but virtually all other asset classes as China values it highly enough in USD terms to allow it to become a proper oil settlement asset globally so EM's can escape the "weaponized" USD.*

2. **Short US subprime auto ABS:** Admittedly, we're not sure how to play this, but the thought process is very straightforward: If we are wrong that the USD does not get massively devalued, the US economy is likely going to come unhinged and these debtors will likely be the first people hit. If we are right about the USD devaluation, USD oil prices are likely to rise meaningfully and these debtors will likely be hurt immediately by the rise in gasoline prices but won't see the employment benefit for a number of months.

3. **The two charts we have showed before of the Dow/CRB Commodity Index and the Gold/Oil Ratio:** We expect more near term pain for "anti-USD" assets until the pain is great enough to force some sort of USD devaluation, but the two charts we have shown numerous times in recent reports allow us to step back to see where history suggests we should be deploying incremental capital for what is likely to come as we move further into 2016E and beyond, and both of those charts suggest that is "anti-USD assets."

Thank you for reading this edition of "Forest for the Trees." LG

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