THE STAINES LETTER

TSL THE STAINES LETTER
A MONTHLY REPORT
Written by STUART STAINES

Volume 01 / Issue 04

Mind Wars

07-08 2010

INSIDE THIS ISSUE:

Mind Wars	1
Summary	9
Make a buck ... ?	9
Inside the press & other	14

"Facts do not cease to exist because they are ignored."

—Aldous Huxley, English writer, 1894-1963

"Reality is merely an illusion, albeit a very persistent one."

— Albert Einstein, Princeton professor, 1879–1955

The website!

http://www.thestainesletter.com

This month, the subject of my letter has been driven by the desire to share with you an investment idea. As much as I would like to tell you that this idea hit me whilst screening thousands of securities in a complex and proprietary multi dimensional excel sheet linked to a neuronial network bluetoothed with Goldman Sachs servers, it is not. The inspiration for this trade opportunity can be traced directly to the delightful May 2010 commentary by Hugh Hendry of Eclectica Asset Management. I have been most fortunate to meet Hugh at his offices in the autumn of 2008, pretty much at the exact time when our financial world appeared on the verge of collapse. What impressed me above all during our conversation is the ease with which he could bring any economic event into an extremely detailed historical context. The breadth of his historical knowledge gives him an unparalleled advantage and I can't recommend enough that you "yahoo" him (can't get around using google) to discover his interesting trip to China.

But before I go over the details of this domesticated grass I believe offers an attractive risk/reward opportunity, let me first clarify a particular aspect of money creation mentioned in my two latest letters.

I was excited to notice that last month's letter has been much appreciated by so many of my readers, so much so that it was actually posted on a number of financial blogs. There were many encouraging and congratulatory comments and I was clearly surprised to discover that it gathered that level of coverage. But this new born *fame* did not come without some vehement critics. Interestingly many can be categorized by either conspiracy theorists (often difficult to differentiate from the usual gold bugs) or libertarians (sometimes but not always indistinguishable from plain government haters). Don't misunderstand me, I am a great fan of critics and if anything, I hope this letter can contribute to create a debate which helps us all reach a higher level of understanding of the world we live in.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"It is better to keep your mouth closed and let people think you are a fool than to open it and remove all doubt."

—Mark Twain, American writer

"Mr. Bernanke will take charge of the Fed at a particularly tricky time, when the American economy looks unusually unbalanced, with a record high current-account deficit, the biggest housing bubble in history and rising inflation. Awkwardly, his need to establish his anti-inflation credibility may leave him little room to cut interest rates to cushion the economy when the housing bubble deflates."

—*The Economist*, October 29, 2005, with Fed funds at 3.75%

So with this wish to debate I will devote the first few pages of this month's letter to clarify the concept of government money creation as opposed to private money creation (our fractional reserve system).

The Himalayan task here is not so much about explaining the reality itself but more about escaping the shortcuts our rationality imposes on us. Just as with the art of investing, it is the process or path we take to understand an issue that is the key.

Private money creation in our fractional reserve system is like an almost ever growing inverted pyramid. Banks create money by extending credit. As banks receive deposits, they keep only a fraction of these in reserves and lend out the remainder. The more they extend credit the larger the money supply. The reason our brain is not screaming with outrage as we grasp this process is that in such a system, every liability (the loan held by the customer) has a corresponding asset (this same loan owed to the bank). These net to zero. Every new amount of money is an asset for one and a liability for another, which is why money is said to be *loaned into existence*. Our mind is bothered by the vague sense of size and lack of limitations but not repulsed by the concept. An image of an inverted pyramid comes to mind where the larger the amount of credit the taller the pyramid. At the very top you have derivatives with their gigantic notional amount and at the very bottom you have gold, just below hard cash, which is no one's liability. This is better known as John Exter's liquidity pyramid, central banker at the Federal Reserve in the 1940's and 1950's. Should we all decide to reimburse our debts, the pyramid would shrink until it reaches base money (vault cash, circulating currency and bank reserves).

Government money creation on the other hand is utterly counter intuitive. The process clashes with every cell of common sense we may have and is rejected as an unconceivable reality. It shakes the very foundation of the relationship between value and scarcity. So how on earth is this medium of exchange that more than ever rules our world really created? Understanding the process will bring us a long way in understanding government solvency and monetary inflation.

In our fiat monetary system, money is issued by the government. The government, through the Federal Reserve, may increase the amount of money in circulation. But there is a crucial difference between money creation by the private sector (banks) and by the public sector (government). Although debt must be the basis for the creation of money by banks the same does not hold true for the government. Let me explain.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"This means that whilst all money creation by banks always follows the rules of double entry book keeping with every debit having an equivalent credit somewhere, double entry book keeping between accounts of the Treasury and the Federal Reserve should be considered as consolidated accounts."

The Federal Reserve is an independent entity within the government having both public purposes and private aspects. As the Federal Reserve is an entity within the government neither can be indebted to the other. This means that whilst all money creation by banks always follows the rules of double entry book keeping, with every debit having an equivalent credit somewhere, double entry book keeping between accounts of the Treasury and the Federal Reserve should be considered as consolidated accounts. If so, a debit in the Treasury accounting books and a credit in the Federal Reserve accounting books cancel each other out as neither can be indebted to the other.

The Treasury may either spend (disbursements) or earn (taxes) money. When the Treasury receives tax payments these are deposited on so-called "Treasury tax and loan" (TT&L) accounts with commercial banks. When the Treasury needs to make disbursements it may call on the accumulated deposits of its TT&L accounts. To do so, the Treasury will transfer the funds from the TT&L accounts to the Treasury accounts at the Reserve Banks. The Federal Reserve Banks are authorized to transfer the amount of the Treasury call from the bank reserve account held at the Federal Reserve directly to the account of the US Treasury at the Federal Reserve. As the deposits in the TT&L accounts fall, this loss in deposits for the commercial banks translates in an equal amount of loss in reserves; therefore calling on deposits of TT&L accounts reduces the amount of reserves by an equal amount.

Suppose the Treasury now decides to spend the amount it has just called from the TT&L accounts. As the Treasury makes expenditures by drawing on its balances at the Reserve Banks, the funds find their way back to the banks in the form of deposits and the amount of reserves has been increased by the amount of the Treasury's expenditures.

"…in a balanced budget world there is no accounting change in the level of reserves, only a transfer of wealth from the private sector to the public sector (tax collections) and then back again to the private sector (government spending)."

Putting all the above together, in a balanced budget world there is no accounting change in the level of reserves, only a transfer of wealth from the private sector to the public sector (tax collections) and then back again to the private sector (government spending).

Now let's take this a step further and suppose that the Treasury must disburse more money that it has earned through taxes on its TT&L accounts or put plainly, the government is running a budget deficit.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

In this case, the act of spending (adding reserves) is larger than the act of collecting taxes (withdrawing reserves). Therefore, government deficits should add reserves and as we know from simple accounting identities, a public sector deficit is a private sector net saving (as detailed in my previous letter).

The Treasury has theoretically two ways of proceeding. The first, and not one day passes without being front and center news, is by issuing debt (Treasury securities). If the Treasury issues bonds these will be purchased either by the banks or by the non-banks private sector (in both cases it will be purchased by the private sector of course). Whether the non-banks or banks purchase the Treasury bonds, these will be settled by a drain from the reserve accounts by the same amount. In the case where it is the non-banks it will simply impact deposits before reserves. At this point there is a reserve drain from the banking sector. However, the act of spending the money received from the bond sale by transferring it back into the private sector will reinstate the previous level of reserves by adding that amount of deposits in the banking system.

"…the fact of withdrawing deposits from the TT&L accounts or issuing government bonds, the result is a drain in reserves by that same amount or put simply, a reduction in the money supply. The fact of the government then spending the money by transferring it back to the banks deposit accounts reinstates the level of reserves."

Notice that in all cases described above, the fact of withdrawing deposits from the TT&L accounts or issuing government bonds, the result is a drain in reserves by that same amount or put simply, a reduction in the money supply. The fact of the government then spending the money by transferring it back to the banks deposit accounts reinstates the level of reserves.

But there is another important element of this process that is often overlooked. This whole process of spending and issuing debt takes place in parallel. Said differently, deficit spending grows in parallel with private sector savings with deposits and excess reserves created equally in the banking system. Why care about the famous Bid-to-Cover ratio constantly monitored by the doomsayers in a process that creates the demand in parallel with supply? The idea that a government bond auction can fail is a clear misunderstanding of our monetary system. Demand is loaned into existence. If it's not the non bank sector that purchases the issued bonds it will be the banking sector, eager to transform their low yielding excess reserves into high yielding government debt.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

The second spending option, is by not issuing any government debt at all. Remember that one should consider the Treasury and the Federal Reserve as a consolidated entity as they are both government entities but with different mandates. In this case the Fed would simply credit the reserve balances held at the Fed while simultaneously instructing the banks to transfer that amount onto the account of the beneficiaries of government spending. The difference however, is that the amount of reserves in the banking system will have increased by the amount of spending by the Treasury without the ensuing reserve drain of bond issuance. The other important difference is that in this option, the government is not paying interest on its new expenditures. The choice of the Treasury between these two options comes down to whether they wish or not to conduct a reserve drain. At this point you might be thinking that this option is theoretically feasible; however this interest free money creation process is called monetization, and is highly inflationary!

"The choice of the Treasury between these two options comes down to whether they wish or not to conduct a reserve drain."

This process is deemed inflationary for one and only reason: If these excess reserves are used by banks to provide loans, the money supply will increase exponentially as the fractional base of reserves grows in tandem with deficit spending. So goes the theory…

"…banks do not seek reserve balances prior to making loans, money supply and credit creation are not influenced by their level of reserve balances but by the amount of opportunities to lend at a profit."

This is a fallacy of composition. Contrary to popular opinion banks do not seek reserve balances before they decide to offer loans. And if banks do not seek reserve balances prior to making loans, money supply and credit creation are not influenced by their level of reserve balances but by the amount of opportunities to lend at a profit. An increase in loans will increase the need for reserves, not the other way around. Banks generally increase their level of reserves in order to meet reserve requirements, or even in excess of reserve requirements when it is profitable to do so, by obtaining funds in the Fed funds market which are basically reserves traded amongst financial institutions (borrowing deposits from each other). These transactions do not alter the overall amount of reserves in the banking system. If the overall amount is insufficient, the Federal Reserve will always provide additional funds.

There are two ways the Federal Reserve may inject additional reserves into the banking system. It can either provide loans through the discount window or it may purchase government securities (open market operations).

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"Going to the discount window is like someone on the Upper East Side being seen in a Wal-Mart. The Tshirts may be cheap, but why would you?"

—Charles R. Geisst, Professor of Finance at Manhattan College"

"The supply of reserves through open market operations is not determined by a desired level of lending, it is the result of aiming to control the fed funds rate."

Banks provide acceptable collateral to borrow at the discount window and will be charged the discount rate which is generally higher than the fed funds rate. Purchasing government securities from a bank will increase reserves at that bank and reduce its holding of securities. Repos (repurchase agreements) work in the same way although they are of a less permanent nature as the bank agrees to repurchase the security at the same price plus interest at a given date. This role of central banks providing reserves to the banking system leads us to believe that there is a causal role between money and reserves and that the central bank controls the money supply by adjusting the quantity of reserves. Makes sense, but it's absolutely wrong. The supply of reserves through open market operations is not determined by a desired level of lending, it is the result of aiming to control the fed funds rate. If the Fed does not provide sufficient reserves through open market operations, banks will borrow reserves from each other which will bid up the fed funds rate. If the fed funds rate rises above the discount rate, banks will start borrowing from the Fed instead of borrowing from each other in the fed funds market. This mechanism does not limit in any way the access to reserves. Reserves are available to any bank that needs them, a bank never checks its reserve balance before providing a loan.

Open market operations do not seek to increase or reduce overall lending. The Fed must always provide enough reserves to meet known reserve requirements, either through open market operations or through the discount window. The only purpose of open market operations is to control the fed funds rate by providing additional reserves when it rises above the level targeted by the Federal Reserve and by draining reserves when it falls below the target. Excess reserves will ultimately tend to push the fed funds rate to zero, whilst insufficient reserves will simply switch demand from the fed funds market to the discount window. As for controlling the amount of lending, policy makers target a specific fed funds rate that will determine whether it is profitable or not for banks to borrow. A high fed funds rate will simply reduce the amount of profitable lending opportunities for banks. This is the tool to manage the amount of lending, not reserve levels.

Having showed that the amount of reserves provided by the Fed does not determine the amount of lending, let's go back to the two available options of the Treasury for financing expenditures in excess of receipts. As we have seen, in the first option, the issuance of Treasury debt acts as a drain on reserves of the banking system, draining the same reserves it created by spending. If the Treasury chooses option two, it fails to drain the reserves it created by spending, thereby creating excess reserves.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

These excess reserves will push the fed funds rate lower as banks will seek to lend the additional reserves in the fed funds market. Excess reserves don't entice lending but a lower fed funds rate does.

Fast forward to the emergency Economic Stabilization Act of 2008 that enabled the Fed to start paying interest on required and excess reserves. The interest rate paid on reserves acts as a floor on the fed funds rate, keeping the rate from falling below the rate paid on reserves as banks become indifferent on holding the reserves or offering them on the fed funds market. As both rates are now equal, the Fed no longer needs to issue government debt to support the fed funds rate. As a result, even if central banks generate a large quantity of excess reserves, these no longer need to be sterilized. The excess reserves do not change the target rate (lending policy) and have no effect whatsoever on bank's incentives to lend to firms and households. When the central bank pays interest on reserves at its target interest rate, the textbook money multiplier model ceases to exist. There is no opportunity cost in holding reserves and the money multiplier becomes irrelevant. Taking this a step further, paying interest on reserves has simply given the Fed a new and efficient policy tool to adjust lending incentives without the need of removing excess reserves. I would not be surprised that this new tool remains part of the Fed's normal operations in the future. The only remaining reason for issuing government debt is to offer banks an opportunity to exchange the interest paid on reserves for the interest paid on government securities.

"When the central bank pays interest on reserves at its target interest rate, the textbook money multiplier model ceases to exist."

So we know that reserve levels don't influence lending and with the Fed now controlling the interest rate paid on reserves these can in no way be a trigger for inflation. Only a policy mistake, keeping rates too low for an extended period, could lead to inflation by stimulating excessive lending. In this world, monetization is not inflationary.

"…reserve levels don't influence lending and with the Fed now controlling the interest rate paid on reserves these can in no way be a trigger for inflation."

You may be thinking by now that I have written an ode to profligate spending. That sovereign issuers of currency in a non-convertible floating exchange rate system have no real spending constraints and that these have no economic consequences. Absolutely not. What I have tried to demonstrate is that these consequences are not those most evident at first sight. Government deficits do not have to lead to government debt issuance and if the alternative path of monetization is chosen, there is no direct link with future inflation. These are misguided shortcuts that lead to false assumptions.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"Interest rates will not rise under the weight of government debt issuance. Excess reserves will not lead to a new wave of lending. There may be correlations at times but there are no causations."

Interest rates will not rise under the weight of government debt issuance. Excess reserves will not lead to a new wave of lending. There may be correlations at times but there are no causations. In our fiat monetary system, large increases in government debt levels will not translate into higher yields unless it is the government's wish that they do. The system is designed in such a way so that they have complete control over the yield curve. In effect, it could be argued that their policy mistake was failing to intervene on the abnormally low long term rates between 2002 and 2007. Had they significantly modified the supply of government debt in favor of issuance of 30 year paper, they might have been able to prick the real estate bubble years before.

The next time you read an article warning of the impending rise in long term rates because the government is unable to sell bonds, or that the government may reach insolvency, or that Beijing is Washington's banker, remember that the government has no technical obligation to finance itself through the issuance of debt obligations. Prior to 2008 the technical reason for government debt issuance was to support the targeted fed funds rate. That reason no longer exists. Countries that enjoy currency sovereignty have no technical limits on the amount of deficits they can run. Interest rates are entirely determined by the Federal Reserve which has complete control on the entire yield curve by controlling the supply and demand of government debt issuance.

"The exchange rate will bear all the pain needed for the economic adjustment to take place. If the monetization is excessive or the spending perceived as irresponsible the currency will gradually be sold driving it to lose value relative to others."

So what are the consequences of deficits and elevated debt levels? Remember rule number one in economics: there is never ever such a thing as a free lunch. Somewhere, something will have to give and act as an adjustment factor and in the case of a country with double sovereignty, that factor is the currency. The exchange rate will bear all the pain needed for the economic adjustment to take place. If the monetization is excessive or the spending perceived as irresponsible the currency will gradually be sold driving it to lose value relative to others. The fall in the value of the currency, the adjustment factor, is the process that could lead to inflation, not the amount of excess reserves. The cause of inflation would be the result of a loss of purchasing power. This is the adjustment factor. As explained in my last letter, a weakening of the currency will have to continue until it reaches a level that would gradually lead to an increase in exports which would ultimately reduce the deficit by creating a large current account surplus.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"Correlation is not the same thing as causation, especially when you are looking at complicated global trends.
It is said that in the decades between the two world wars, German intelligence agencies divided the world into countries where people tucked in their shirts and countries where they didn't. That classification made some sense because people in industrialized countries feared that loose shirttails could get stuck in machinery. But it didn't mean that a country could mandate that its citizens tuck in their shirts and vault its way into the league of industrialized nations."

—Nicholas Thompson, Sr. Editor of *Legal Affairs*, *"Common Denominator"*, February 2005

Summary

As a conclusion I thought I would evoke another insane theory that is often referred to in an effort to promote fiscal austerity. We have seen that government spending cannot lead to a rise in interest rates. If so, then government spending cannot lead to a fall in investment. If investment does not slow because of government spending the whole notion that government borrowing can crowd out private investment is bogus. In other words Ricardian equivalence does not hold. More so, the rational expectation hypothesis (another nonsensical theory) underlying the Ricardo equivalence, implies that as we know that an increase in government deficits will be met with future tax increases, we save all the increased government spending therefore canceling out all the government stimulus provided. In what world other than in textbooks does this happen? In the real world, people save and spend the stimulus depending on their needs and financial situation.

I believe it is essential to understand how our monetary system works if we wish to find the most appropriate way to jump start a new and strong economic cycle. The question of whether economies need more stimulus or more austerity is paramount. But when seeking the answer, beware not to be fooled by some aberrant economic theory.

Make a buck ...?

There has been much talk these days about a "bond bubble". The subject is of interest as it concerns my highest conviction trade, namely my holding of long term government bonds. Annaly Capital Management's blog has probably best addressed this issue in a post dated the 27th of August (see reference on last page). In it, they explain that an essential characteristic in the making of a bubble must be extreme overvaluation. Treasury securities in the long run are valued by estimating future inflation. Granted that just as with stock valuations, this implies forward looking estimates based on a highly uncertain future. As you know from reading my letters I believe that there are significant headwinds to inflation and growth in the coming years. The macroeconomic forces that have been self reinforcing the global economy (leverage, plutonomy, demographics, globalization and cheap oil supply) over the past few decades appear to have reached a tipping point.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

If I am correct, our focus should be on avoiding deflation and not inflation. I have therefore recommended to purchase long duration government bonds. As described in Annaly's post, many investors and professional money managers have avoided long duration government bonds so far this year because of the "recency effect". The recency effect in behavioral economics is defined as the bias to overweight recent experience. Seeing yields at below 4% early in the year, investors avoided Treasury securities thinking that the risk/reward was unattractive and the bond price upside was limited. Similarly, in the 1980's, yields failed to fall down in line with inflation as the memories of higher inflation levels during the 60's and 70' were still fresh as can be witnessed by the spread between the 10-year and core inflation which remained abnormally high. The average spread between the 10-year and core inflation since 1953 is 2.66%. Using Professor Robert Shiller's longer data set reaching back to 1871 the average is 2.42%. The spread today with the 10-year yield close to 2.5% is 2.03%, clearly not a sign of overvaluation. Low yields today are only expressing the view that there will be little or no inflation in the coming years. Early this year, my initial target on 10-year Treasury yield was 2%. I will stand by this view as I still see no reason for inflation expectations to rise. As we approach my target, some readers have asked whether I believe yields could march significantly below that level. I suppose so, however, I am coming to believe that this is not the wish of the Fed, and as just shown, the Fed has complete control on the yield curve. At a certain point I suspect the rally in bond prices will raise concerns at the fed that expectations of ever lower yields will create an unwelcome permanent investment flow out of equities and into bonds. Given the necessity to avoid an abrupt fall in asset prices that would cause spiraling private sector balance sheet losses, the Fed might decide to fix the curve and therefore limit speculative flows. At that point, bond price gains will be limited and unattractive.

"The average spread between the 10-year and core inflation since 1953 is 2.66%. Using Professor Robert Shiller's longer data set reaching back to 1871 the average is 2.42%. The spread today with the 10-year yield close to 2.5% is 2.03%, clearly not a sign of overvaluation."

Now to this month's trade. The first leg is long MOO with a second leg short SPY, a trade that seeks to benefit from the outperformance of agriculture stocks versus the overall stock market.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"Had you bought gold in 1980 and held it the following twenty years you would have lost close to 10% on an annualized real basis. Had you invested in the Dow Jones instead, well let's just say that the irony is that both gold and the Dow were trading at about 850 at the time. Even if your ancestors had successfully stored it for future generations since 1500, you would have found yourself five hundred years later with a depressing 90% real wealth loss."

I was initially going to recommend the purchase of December corn futures and publish this letter in July. Since then, the price has risen by over 12% and I have therefore had to adjust my trade idea to my slow writing skills. I have chosen the DB Powershares Agriculture fund for the sake of simplicity although there are a few well managed agriculture funds that may be more attractive (the Eclectica Agriculture Fund just to name one of them). This is a particular space where I believe a money manager with extensive expertise in the agriculture sector can offer real value in excess of his management fees. I will spare you with the long term investment case of emerging market demand on the back of rising incomes and increased protein consumption. The trigger here is short term and its name is China. The US is the largest producer and exporter of corn with 40% of world corn production and 60% of world exports. China accounts for both 20% of world corn production and demand as well as the second largest consumer of corn behind the US. This Chinese consumption/production ratio of about one clearly misses the mark on Buffet's recommended margin of safety.

This tight ratio is further aggravated by corn inventory levels that have remained close to record lows since 2004. The fresh memories of 2007/2008 food shortages served as a clear warning for such low stock-to-use ratios. Of course, no one appears to have learned the lesson and the media attention just moved onto another *sujet du jour* like who is Paris Hilton dating or who sells the most expensive chocolate in Dubai. As per Hugh Hendry's May commentary, particularly intriguing is the wide disparity between the price of corn in Dalian, a port city to the east of Beijing, trading just above 8$ per bushel and the Chicago corn price trading just above 4$. This wide disparity is in stark contrast with the reassuring Chinese statistics showing stock-to-use ratios above 30% (also keep in mind that these stock-to-use ratios were above 100% in the late 90's). Considering that northern China saw a drought early 2009 that led it to go as far as firing rockets in the skies to make it rain and sent out divisions of the People's Liberation Army to water the fields with little more that hand buckets, it appears not insane to at least question these statistics. As Hugh writes *"The issue with Chinese data is that which has afflicted all communists governments over the years. Key economic indicators, whether they are in GDP, credit growth or grain production, stipulate a desired (and not always realistic) level of ouput, rather than the sum of individual achievement."*

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

"Seek the truth through facts."

—Deng Xiaoping, Chinese politician, 1904-1997

He writes further as a striking example how the 1950's Chinese forced collectivization caused massive starvation whilst communicating yields to the media that we up to hundred times higher than even those achieved today on the best of lands.

Since May, his investment case has only gained in credibility as China purchased over a million tons of corn as of August 19th. In addition, the chairman and chief consultant of Shanghai JC Intelligence Co. Ltd. said his organization anticipates that China will import some 1.7 million tons of corn this year, 5.8 million next year and as much as 15 million tons in 2014-2015. To put this last number in perspective, 15 million is almost equivalent to Japan's total yearly corn consumption.

Finally, in a perfect example of bad luck at the worst of times, the total grain crop in Russia looks likely to fall by a third compared with the last couple of years, resulting in an export ban on wheat. Secondary effects of the sharp rise in wheat prices will be a switch to corn by chicken and pig producers whilst farmers switch acreage from corn to wheat in an effort to cash in on the higher prices.

In the bigger picture, the ethanol percentage limit in US gasoline will be increased from 10% to 15% later this year. Considering that 33% of US corn demand is for ethanol this 50% limit increase will significantly raise domestic demand in the coming years. Corn yields are up 37% over the past 20 years but the yield curves in China and India are now flattening and failing to keep up with demand. Over the past 50 years, fertilizer usage has increased by over 700% but yields are still flattening. It is more than likely were are entering a period of generally higher soft commodity prices. Just as with wheat and corn, there will be substitution effects that will transfer the higher prices from one commodity to the next. Despite the deflationary economic environment, demand for grains is likely to continue to rise steadily. Supply is going to be compromised by the lack of investment and fertilizer application has fallen these past two years on the back of their huge price rise in 2008. Despite China's thirtyfold increase in Potash usage since 1986, it remains only half the European average. We are on a supply/demand collision course and a perfect storm may be awaiting soft commodities in the months to come as the smallest change in output can cause massive shortages of supply.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

Since the markets bottomed on the 6th of March 2009 the S&P 500 has risen by about 60%. The Market Vectors Agribusiness ETF has risen by over a 100%. My bet is that this outperformance will continue.

My portfolio

New trade:

30.08.2010	LONG 1 UNIT OF MOO @ 43.95 SHORT 1 UNIT OF SPY @ 106.86	

Past trades still open:

30.06.2010	LONG 1 UNIT OF GOLD IN EUR (XAU/EUR) @ 1'016 EUR	**- 4.33%**
14.05.2010	LONG 1 UNIT OF TLT @ 94.88 +dividend TLT 0.33 01/06/2010 +dividend TLT 0.31 01/07/2010 +dividend TLT 0.32 02/08/2010	**+ 12.05%**
9.04.2010	LONG 1 UNIT OF XLU @ 30.24 SHORT 1 UNIT OF XLY @ 33.97 +dividend XLU 0.32 18/06/2010 – XLY 0.11 18/06/2010	**+ 6.91%** **long/short trade**

To read all past and coming letters for free just follow this link and click "follow" below my name and logo :

http://seekingalpha.com/author/stuart-staines

Yours truly,

Stuart Staines

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter

IN THE PRESS & REFERENCES

In the press:

Bloomberg – China Enters "New Era" of Corn Buying, Council Says by Luzi Ann Javier
http://www.businessweek.com/news/2010-07-26/china-enters-new-era-of-corn-buying-council-says.html

GRAIN
http://www.grain.org/front/

References:

Bond bubble? Blog by Annaly Salvo on the Economy and Markets:
http://annaly.com/blog/2010/08/27/BondBubble.aspx

Eclectica Asset Management - The Eclectica Fund Manager commentary, May 2010
http://www.eclectica-am.com/template.aspx?target=home

Federal Reserve Bank of New York Staff Reports – Why Are Banks Holding So Many Excess Reserves? By Todd Keister & James McAndrews - July 2009
www.newyorkfed.org/research/staff_reports/sr380.pdf

Information contained in The Staines Letter publications and website is not intended to constitute individual investment advice and is not designed to meet your personal financial situation. The opinions expressed in the publications are those of the publisher and are subject to change without notice. The information in such publications may become outdated and there is no obligation to update any such information. The information is obtained from sources believed to be reliable, but its accuracy cannot be guaranteed. Any TSL publication or website and its content and images, as well as all copyright, trademark, and other rights therein, are owned by The Staines Letter. No portion of any TSL publication or website may be extracted or reproduced without permission of the publisher, The Staines Letter. Unauthorized use, reproduction or rebroadcast of any content of any of The Staines Letter publication or website, including communicating investment trades mentioned in such publications or website to non-subscribers in any manner, is prohibited and shall be considered an infringement and/or misappropriation of the proprietary rights of The Staines Letter. The Staines Letter reserves the right to cancel any subscription at any time, and if it does so it will promptly refund to the subscriber the amount related to the remaining subscription period.

Free Version printed on 09.11.2026 (c) 2026 - TheStainesLetter