The Solari Report

May 11, 2017

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C. Austin Fitts: Ladies and gentlemen, it's a real privilege to welcome back to The Solari Report Rob Kirby, who is the proprietor of Kirby Analytics. He is here from Toronto, and joined us in March for an outstanding conversation about the Exchange Stabilization Fund (ESF). When we finished, I said, "Rob, we're going to have to do a Solari Report on interest rate swaps."

He has very kindly returned, and has prepared a wonderful piece called 'Understanding Derivatives'. We are going to put it on the website for subscribers and link to it from the Subscriber Resources in The Solari Report Commentary for The Solari Report. I strongly recommend you follow along. It has some great charts and information there and that way you can listen and digest.

We have in our subscriber base people who are extremely financially sophisticated and others who are very intelligent but not that interested in financial markets. So I'm going to have Rob walk us through the basics on what a derivative is. It will help if you access the 'Understanding Derivatives'.

If you want to understand the management and manipulation of our world, it's very helpful to recognize what has been happening in derivatives. Nobody has dogged it and pulled it out like Rob has over the last ten years. Part of it is because he had a significant career in the financial institutions trading some of these vehicles, so he is somebody who has a deep knowledge of the topic and we are very lucky to have him.

Rob Kirby, welcome to The Solari Report.

Robert Kirby: It's a pleasure to be speaking with you again.

C. Austin Fitts: Derivatives 101: What is a derivative?

Robert Kirby: The word 'derivative' is a very, very big umbrella. Underneath that umbrella there are many different instruments. To give you a 'for instance', underneath the derivative umbrella we would find items called futures; we would find items called options; and we would find futures on commodities. It could be commodities in the agricultural sector like corn futures or pork belly futures. We would find futures and options on currencies, so it could be a future on the US dollar, a future on the euro, a future on the yen, and/or options on all of the above. It could be more sophisticated products, which would be known as interest rate products.

The two specific interest rate products that we are going to delve into on a deeper level today are an interest rate product called an FRA (Forward Rate Agreement or Future Rate Agreement).

That particular interest rate product is short-dated, and it is classified as a swap. It's a short-dated bet on what LIBOR will be at a date in the future. The other interest rate product that we are going to discuss today is an interest rate swap. What happens in an interest rate swap is an exchange of fixed rate for floating rates between two counterparties.

That gives you a bit of a broad swatch of what is under the umbrella of derivatives. When you look at the derivative spectrum, for instance, in the American context there is a quarterly report that is published by the Office of the Controller of the Currency. They report in a publication called *The Quarterly Derivatives Report* the amount of outstanding derivatives in aggregate that are held by American banking institutions.

This data is published three months in arrears, so the most recent data we have published by them would be the Q4 (Fourth Quarter) of 2016 from the end of December. That report was just published at the end of March this year.

In that table it tells us that all American banking institutions in aggregate held at the end of December $220 trillion worth of derivatives. That would be everything under the umbrella that I just spoke of. Then when you look at the breakdown of the derivatives under the umbrella that make up the lion's share of the outstanding amount, you would find that somewhere between 75-80% of all the aggregate – of all the $220 trillion – is in interest rate contracts. So this is why we're going to be focusing on the biggest component of the derivatives pie, which is the first rate component.

C. Austin Fitts: Before we go further there, I want to stop and make sure we have two concepts on the table – or one concept and one definition.

One of the reasons we use the term 'derivative' – or I think of it very over-simplistically – is if you consider a stock or a bond, it's a financial instrument in an underlying pool of assets, which are usually real. So if I own a share of the cow, the cow is real. But if I make it an equity, then I have a financial instrument in something that is real.

A derivative is a financial instrument in a pool of financial instruments or other financial instruments. When we say a 'derivative', it is usually a financial instrument in another financial instrument. In other words, it derives its value from a financial instrument-the underlying in a financial.

Robert Kirby: Exactly.

C. Austin Fitts: So it's usually two steps back. People are used to thinking in terms of stocks or bonds, which is one step. A derivative is two steps.

So if I have a future in a pork belly, then I have an interest in an index on something that is real, so I am two steps back.

Robert Kirby: Exactly.

C. Austin Fitts: It's over-simplistic, but the other thing is most people are used to looking at stocks – many of which trade on an exchange, but very few of outstanding derivatives trade on an exchange, particularly interest rate swaps. So you have an expression called OTC (over-the-counter).

So, would you explain what OTC or over-the-counter is and what it means? The banking regulators say that they provide data on this, but there is not the same data collection and reporting that you will see on stocks or bonds.

Robert Kirby: You make a very good point. There are exchange traded derivatives where the product is uniform across the spectrum. For instance, if you buy a Eurodollar future, all Eurodollar futures are three months in duration, and they settle on the third Wednesday of December, March, June, and September. So these are uniform contracts that trade with specific dates known to everybody whereas if you do an FRA or if you do an interest rate swap, each individual swap is tailor-made and tailor-constructed for the two people entering the agreement. So they are not all of a uniform date. There are some that are, but typically they are custom and they typically trade on a spot basis.

An FRA traded today could be for value two days forward or it could be for value a week forward. It could be valued a month forward on the third Wednesday or the 2nd Tuesday. So they are custom every time you do a trade. They don't trade on arbitrary or preset dates.

Because they don't trade on arbitrary or preset dates on an exchange, they are referred to as OTC or over-the-counter. What 'over-the-counter' probably means more than anything is lack of regulatory oversight and custom – as in custom dates or tailor-made for custom dates for the players entering into the contracts.

Is that good? Does that clear it up?

C. Austin Fitts: That is very good. I think of it kind of like the Wild West – it's hard to get the information you need to understand it. As a pool of financial assets, it's hard to get an actuarial beat on it because it's similar as the Wild West, and there is not the same kind of data and transparency and regularity about all of it.

I just want to mention that I would be perpetually grateful to you because when I first saw your name through the GATA group, I was trying to explain to folks how they were engineering the slow burn. There was this big debate, and various people would say, "It's all going to crash."

I would say, "No, it's not going to crash."

So a discussion unfolded – and this was back in the 1990's – about derivatives and how the derivatives book was exploding. I didn't understand anything about derivatives at the time other than I watched them operate when I was on the Board at Sallie Mae – and there is a funny story there that I can tell you.

Then I started to read your work, and you made it very clear, "Look, we don't have a derivatives problem; we have an interest rate swap engineering which is not only making this game go, but it's driving interest rates down."

You were the one who kept banging the drum and saying, "Stop talking about derivatives - the whole umbrella; let's talk about interest rate swaps."

If you look at the total outstanding, if there is one dominant picture to the derivative story, it is interest rate swaps and what it's done to drive interest rates down. Is that fair to say?

Robert Kirby: Yes, and it's not just the interest rate swaps that have been used; it's also the short-dated product, the FRAs that have been used. The FRAs are what they use to entice banks and make banks captive to buy literally any amount of short-dated US government debt as in T-bills.

To make short-dated interest rates, it's one thing for the Fed to declare that they have the discount window open and they will lend money to banks on an overnight basis at 25 basis points, but to actually get people to buy three-month government paper or a T-bill at 30 basis points or 10 basis points, that requires a bit of secret sauce or mustard. The mustard that gets applied in a very generous way is an arm of the government that conducts trades with banks at rates that compels them to buy US government debt to lock in a risk-free profit.

So it doesn't really matter how low rates get. If you put the carrot out in front of the bank where all the bank needs to do – if they're going to do the business with you – is buy a Treasury bill at a rate, they will be compelled to do this if they can do it and make money risk-free.

C. Austin Fitts: Right. So you can float a near infinite amount of Treasury securities as long as you take away their interest rate risk, and you make sure the money doesn't cycle into the economy in a way that kicks off inflation.

So if you keep the proceeds headed into the insiders in certain ways, you can debase the currency in extraordinary amounts and grow debt in extraordinary amounts.

Robert Kirby: Yes, and this also provides a remarkable avenue for the powers that be or regulators to recapitalize institutions on a selective basis if they are deemed to be winners or in the national interest.

The other thing that might actually be a good thing to put in the listeners' minds is: When we started off by saying that there was $222 trillion in aggregate by all American banking institutions at the end of December of 2016, in saying that, 98-99% of this aggregate $222 trillion is held by five banks. I call them the 'Magnificent Five'. Those institutions are Citibank, JP Morgan, Bank of America, Goldman Sachs, and Morgan Stanley. These are the chosen counterparties of the US government to conduct this derivatives trade that controls the interest rate playing field.

C. Austin Fitts: Before we go deeply into what we think is happening with those five banks, let me just step back. Derivatives developed and grew during the 1990's and it really advanced with the ability of the computation systems to handle this kind of complexity and developing the mechanisms. So it grew in the 1990's.

Robert Kirby: They were actually largely pioneered – believe it or not – right here in Toronto in the 1980's.

C. Austin Fitts: Right.

Robert Kirby: They were pioneered here in the 1980's because of the quirkiness in the Canadian Bank Act. Prior to 1981, Canada as a country had six banks. It changed the Bank Act in 1981, and allowed foreign competition to come into the banking sector in Canada.

So Canada went overnight from having six banks to having 87 banks, with a lot of them being American banks. What happened was the banking fraternity in Canada had a lot of power. They got the government to put restrictions on the amount of capital that foreign banking institutions were allowed to have in Canada. When you restrict the amount of capital that a bank has, you really curtail the manner in which they conduct normal Treasury operations in the bank.

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I would like the listeners to understand that at the heart of banks is the Treasury. It's literally the lifeblood of a bank because it's where the bank raises money and where the bank funds all of the obligations that the bank has. It's all done from the Treasury. The Treasury is probably – and arguably – the most important profit center in a banking institution. But when you have restrictions as to how much capital you have, traditional banking at Treasury operations – and when I say that, a typical bank Treasury operation would be to lend money like long-dated money and fund it short-term and earn a spread – requires capital and it chews up a balance sheet.

So what banking institutions needed to do was develop a way that they could synthetically trade the yield curve without impacting the balance sheet. So what they did is, by using derivatives, were able to move the speculative part of playing the yield and move it off balance sheets and get around the capital restrictions that they had in Canada.

The three banks that were at the head of the list in developing these interest rate derivatives in Toronto were Citibank, Chase Manhattan, and Chemical Bank. They were the three leaders in developing and instituting the FRAs, and they were huge players in developing the interest rate swaps as well.

C. Austin Fitts: Right. I was on the Board of Sallie Mae. I'll never forget in 1994, the CFO gave a presentation on the interest rate swaps that they were doing. After the S&L debacle, the way the Feds recapitalized Citibank was the same thing; they floated Federal credit arbitrage profits that were enormous and recapitalized the bank out of basically risk-free trades between the long end of Treasury and short. It was quite remarkable to observe.

During that period, Sallie Mae was trading through treasuries because of the shenanigans happening in the Treasury market. They made a presentation on derivatives. We had Vice Chairmen of banks on the board. When the CFO made a presentation on how the interest rate swaps work, I realized that we had seven Vice Chairmen and nobody on the board understood derivatives. I thought, "Wow!"

Robert Kirby: That is very common that people at the heads of institutions have very little understanding of: A) What these trades are and how these trades are consummated, B) What the implications are, and C) How they can be used.

An analogy I like to make with people when they say, "Are derivatives good, or are derivatives bad?" is to answer it by asking a question in return. "Is a chainsaw good or is a chainsaw bad? If a chainsaw is used to cut down a tree to make lumber, it's very good. But if the chainsaw is used to do Texas Chainsaw Massacres, then it's not so good."

C. Austin Fitts: One of the reasons I was convinced that the NY Fed Member banks were taking most of these positions as agent for the Federal government is I thought every banking chairman would have known backwards and forwards and by heart how they worked otherwise. If that was a risk position for which they were responsible, I think there would have been much more knowledge.

Robert Kirby: I would suggest to you that somewhere in the timeframe of 1988 to 1990 – somewhere in that window, and I know that because I was a broker of these instruments and I was also a broker of government bonds at the same time – I noticed that there were players in the US who I could specifically reference (Chase Manhattan Bank) who would play the derivatives in a way that nobody else was playing.

When I say this, they would come into the market and in an interest rate swap between three and ten years of duration; in the inner-bank market typically what happens – because these instruments trade on a spread relative to treasuries expressed in basis points – the players exchange an underlying amount of government debt. We would call them 'on-the-run' government bonds.

To be a little more clear about that, if you were doing a $25 million five-year interest rate swap transaction, when you're doing the trade, one side of the trade would buy $25 million worth of US government bonds from the other side of the trade. So one side supplies the bonds and the other side buys the bonds.

I noticed that in that time frame, Chase Manhattan would come into the market and would offer interest rate swaps at a specific interest rate, and would state that they would not supply the bonds to the buyer. This would entice a spread playing counter party to go into the cash bond market to purchase these bonds.

Because Chase Manhattan would come in the market and take punts – literal naked risk – on interest rates for five years, the spread playing counterparty would then be forced into the cash market to buy bonds. What this effectively does is creates phantom settlement demand for US government bonds.

C. Austin Fitts: Right.

Robert Kirby: In this manner, instead of Chase Manhattan being one side of this trade as I just explained; if you substituted an institution like the US Treasury or the Exchange Stabilization Fund, which is a part of the US Treasury, you could effectively get banks to buy any amount of five-year government debt; it would be of your choosing.

So you could literally make banks captive buyers for trillions of dollars in five-year US government bonds.

C. Austin Fitts: Let's return to 1980. In 1980 an American citizen could get an 8% return on their bank CD, so you could have $100,000 at bank in a CD and get $8,000 a year interest. It was a good time to be alive. Now you're getting zero because interest rates have come down, down, down, and they have come down this way since 1980. Particularly in the post-9/11 world we've seen interest rate drops that we didn't believe possible.

Robert Kirby: Can we go back for a second? In my world and in the way I view what you just said, "Interest rates have come down, down, down," my response is, "Interest rates have been forced down, down, down."

C. Austin Fitts: Right.

Robert Kirby: Bear in mind that when you assign a zero rate to capital; just remember the human beings are capital, too. Nobody that I'm aware of works for free. Forcing interest rates to zero creates issues. It creates negative issues for humanity. What it does is effectively trivializes labor.

C. Austin Fitts: Right. The thing that I wanted to bring out was a study that McKinsey did on the capital markets recently. I forget the exact number, but they estimated that the government was getting several trillion dollars a year subsidy from low interest rates, and that was coming from people's pension funds and their retirement savings.

Robert Kirby: Exactly.

C. Austin Fitts: So what you're talking about is engineering $2 trillion of people's labor for free into government. It's one of the greatest taxation schemes in the history of the world.

Robert Kirby: It is fraud on steroids that you can't imagine.

C. Austin Fitts: Oh, I can imagine.

Robert Kirby: For most people, it's difficult to comprehend. What it represents is currency debasement in the extreme. Why most people don't complain about it is because currency debasement in the extreme causes things like the value of real estate to go up in nominal terms, and it causes stock prices to go up in nominal terms. If you happen to be a property owner or a homeowner, or if you happen to own stocks in your 401k, when you see that the value of these things are going up in nominal terms, it creates a false sense that you are getting rich and that you are very smart.

So this is how they pander and play to people's emotions – by debasing the currency. Debasing currency is dishonest commerce. If you ask most people straight up if they are fans or advocates of dishonest commerce, I think that they would say to you, "No, I'm not in favor of dishonest commerce."

C. Austin Fitts: It's phenomenal how they've engineered this in a way that people don't see it and can't see it. They make it look like market phenomena. "My interest rate is going down because that's how markets are working."

Robert Kirby: It's not only that, you are right; they like to disguise it, but they also will not allow people in the mainstream like the analysts and the people who wear the suits who work for the banks on Wall Street to report it because reporting things like this makes you as popular as Edward Snowden. You are persona non grata, and it's a great way to end a career.

C. Austin Fitts: Exactly.

Robert Kirby: I just want to make the point that you know a thing or two about that as a truth-teller and this is actually your history.

C. Austin Fitts: Right. So the American family of four, instead of getting 8% on their CDs for the last 20 years, is getting zero percent now. So they are out an enormous amount. If you study their pension fund, it is getting zero. So between their bank CD and their pension fund and their 401k and their IRA, they're out an immense amount of money. They explain, "Oh, it's markets." But if you look at the other part of their balance sheet, they are assuming the liability for the derivatives on the government's balance sheet – whether reported or not.

So the liability for the derivatives that has been used to engineer all this money out of their pocket, instead of getting the yield, are getting the liability. Their assets are going down instead of up. They're assuming responsibility for the derivatives that are used to engineer this. It's a double-whammy.

Robert Kirby: Sure it is. The other point I would like to make is, if there are people listening who say, "As long as the value of my house is going up and my stocks are going up, I don't really care whether they're manipulating rates to zero. I borrow money, and I like rates that are zero."

But to anybody out there who has a pension, to anybody out there who has insurance, and to anybody who understands how vital an ongoing and healthy insurance industry is to conducting commerce, if you think about it quickly, if there was no such thing as insurance, how would you be able to drive a car? How would you be able to protect your house from fire? How would you be able to protect?

With the pension industry, where would your monthly check come from if the pension plan that you contribute to goes to zero? When you artificially put interest rates at zero, just remember that pension funds and the insurance industry are mandated to hold a certain amount of their assets in fixed income. When their fixed income assets don't earn what they've modeled them to earn – and I can tell you that most pensions and most insurance companies model into their portfolios their fixed income portion of their portfolio will earn them 5% or higher.

With a zero interest rate environment with ten-year bonds yielding two and with five-year bonds yielding one or less, these guys are not making their nut. What it means is the viability of pension funds and insurance companies going forward is highly in doubt.

C. Austin Fitts: I would say that there is something even worse going on and I'll tell you what it is: You're engineering one set of players to have a zero cost of capital and another set of players to have a much higher cost of capital. You're literally taking money from the productive and giving it to the 'slime bags' and you're creating a dynamic where you're pulling from the productive and you're giving to the unproductive.

You have an entire world of insiders who are getting more and more free money and more and more free money and more and more free money. They're getting more corrupt and more wasteful.

Robert Kirby: You're hitting the nail right on the head. The list of negative consequences from imposing zero interest rates and assigning a zero rate of interest to capital has many, many negative consequences.

The other thing, which you just summarized and you could put an umbrella over, is that the zero rates of interest encourage negative or misallocation of capital because when there is zero cost to money, every hair-brained scheme on the planet will be tried by somebody because they can do it at a zero cost.

This is how you end up with a whole lot of white elephants. White elephants usually aren't in the best interest for humanity going forward on a productive basis.

C. Austin Fitts: I'm going to move back a minute. $220 trillion is notational value; it's not present value. Is that correct?

Robert Kirby: It's called a notional value because what an interest rate swap is by definition is a synthetic loan where you synthetically have borrowed money, but the principle amount has not changed hands. So what you're doing is effectively betting on the value of fixed versus floating rates on an agreed-upon amount.

If we do a five-year derivative, we are effectively betting on what the difference is between what a fixed five-year rate is that we agree on today and the amount of interest in five years.

Let me put it another way and use round numbers to make it very, very simple. If we take $25 million and we assume a 10% fixed interest rate for five years, you would have payments of $2.5 million worth of interest made annually. So then if we said, "Instead of $2.5 million a year, we'll give you $12.5 million in aggregate and interest rate payments." What would happen if we compared the $12.5 million guaranteed on the fixed rate if we invested the $25 million in three-month increments at the prevailing three-month rate as we moved along? Would that add up to more or less than $12.5 million?

The difference between what $25 million would earn invested at three months for five years versus what we know would be paid at a fixed rate is what you are actually betting on. But nobody really lends you $25 million in a five-year interest rate swap.

C. Austin Fitts: Right.

Robert Kirby: So we say that the notional amount that we're betting on is $25 million, and we're going to see who the winner would be between the floating rate accumulation versus the fixed rate accumulation of interest. That's what it really is; it's a bet on fixed versus floating.

C. Austin Fitts: Right, but I think that having a notational value – for people who are not used to dealing in notational values –makes it look bigger than it really is.

Robert Kirby: Yes, but when you're playing in extremely large numbers, a very, very small deviation makes a big difference.

If you look at somebody, for instance a player like Citibank, their derivatives currently book around $51 trillion in notional value – most of it being interest rate contracts and much of it being interest rate swaps. If they have a swap book of $40 trillion of the $51 trillion in notional, and if they have a one percent deviation in the value of that $40 trillion, you're talking about more capital than the bank has.

So one percent or half of a percent of an extremely large number – if things don't go the way you hope they go – could effectively wipe out a bank's capital.

C. Austin Fitts: Unless their dealing is on behalf of the ESF.

Robert Kirby: No. My comeback to you would be – assuming, of course, they actually have accounting – there is a law in the United States which grants officialdom the power to give a waiver to an institution if it is deemed to be in the interest of national security. Companies can be granted a waiver where they don't have to report their true economic situation, which effectively means a designate of the government can issue a waiver because not just anybody in government can issue this waiver.

Let's assume that Morgan Stanley was technically insolvent and bankrupt in 2008 – which I believe they were – and if they were granted a waiver saying that they don't have to report their true financial condition, they could keep two sets of books, and they could say that they're fine and everything is good even though they are bankrupt.

This is a law that has been on the books in America since 1934, and this law was put on the books at the very same time when the Exchange Stabilization Fund – this secretive arm of the US Treasury – was created. There is no doubt in my mind that these waivers have been in play. I specifically believe that they have been in play with the financial institutions through the financial crisis of 2007 and 2008.

From that standpoint, you can start asking yourself questions: Who gets to make the choice that Bear Stearns fails or Lehman Brothers fails and Morgan Stanley is allowed to continue? We have people who have enormous power, and they are making decisions on who the winners and losers are.

C. Austin Fitts: It was very interesting when all that rolled out because I knew they couldn't let AIG go down, and I knew that they couldn't let Morgan Stanley go down, but they could afford to let Lehman and Bear Stearns go down. So the question is: Who is the government dependent on operationally for both primary dealers, ESF, and a variety of different servicing and securities?

Morgan Stanley and AIG were deeply involved in the operational infrastructure of the government and, AIG in particular if you examine the Federal budget, we are, in essence, financing two civilizations out of one budget and keeping one of those civilizations secret. AIG was deeply involved in the liability management for the secret one, and there was no way that you could let those files go wherever they were going to go. You couldn't let AIG down.

Robert Kirby: Of course you couldn't. The implications of letting AIG go down in the 2008 timeframe would have created a chain reaction because AIG had to be kept whole and had to be bailed out because AIG had guaranteed many of the bad bets that the likes of Goldman Sachs and JP Morgan and Citibank had made.

AIG guaranteed trades that these other institutions made. Had AIG gone down and the insurance not honored, then Goldman Sachs would have been dragged down, too. So the decision was made to bail AIG out and make them whole so AIG could make good on their payments to the other banks. That is literally what it was.

C. Austin Fitts: That was part of it, but it was 'bigger and badder' than that.

Robert Kirby: Things were lined up like dominoes, and had AIG been allowed to go down, all the dominoes were going to topple. But this comes back to the point that I was making a little earlier. You have people making decisions on who lives and who dies and who is allowed to continue and who gets sent to the glue factory.

That is appropriate to keep the financial system operational, unless you work for one of the institutions that they've chosen to allow to perish.

C. Austin Fitts: So here is the way I would say it: To finance these two civilizations out of one and keep one secret, we've built a highly leveraged edifice of debt derivatives. Now that debt and derivatives have locked us into a future, because nobody can afford for it to collapse.

For example, if you look at who built that entire infrastructure when we bubbled the economy in the 1990's and the 2000's, in 1994 we bubbled the economy with debt and derivatives. We suck an enormous amount of capital out for that second civilization. My estimate is $50 trillion.

If you look at the team that engineered it, I would say that the Goldman Sachs team rising through the fixed income division where they oversaw both debt and derivatives and precious metals all in the same division were Lloyd Blankfein and Gary Cohn. It's not an accident that after engineering the financial coup d'état and being intimately familiar with the leveraged debt and derivative book – Goldman being a primary dealer and also big positions in the derivative – they sent Gary Cohn to be National Economic Advisor. One thing they wanted to make sure of was that whatever the new Administration does, they want to make sure that he doesn't upset the derivatives book.

Robert Kirby: It also speaks to the notion: Look who has controlled the US Treasury over the last 20 years. It's my view – and this is very consistent and lock-step with what you are saying – that the real prize for the deep state-yes the US military is an important muscle to put things into play around the world-but the real prize is control of the US Treasury. When you control the US Treasury, you control the Exchange Stabilization Fund.

The Exchange Stabilization Fund holds, what I call, 'dark money'. It's money that is not even acknowledged to exist. I suspect and believe that the amount of dark money that is housed by the Exchange Stabilization Fund very likely amounts to tens of trillions of dollars.

C. Austin Fitts: That is very interesting because one thing that I will tell you is, it is theoretically possible that these positions could be held on a different part of the Federal government balance sheet other than the ESF, but I don't believe it. I believe it is in the ESF. In theory, since we don't have access to the real financials, it could be in another part of the Federal balance sheet, so I want to point that out.

Robert Kirby: One thing that we do know for anybody who might be pooh-poohing this is that the financials that the government gives is, in so many instances, completely erroneous and false.

C. Austin Fitts: It was peculiar because I was the FHA Commissioner and I brought in what I believed to be the top accounting firm to do all sorts of things.

After it was all said and done, when I saw the lies coming out of Treasury, Department of Justice, and all the different infrastructures in the mortgage operations – Fannie, Freddie, and that accounting firm – that was the day when I saw the extent of the lies and the extent of the financial fraud and proved beyond the shadow of a doubt that they were all in on it and they all knew – at least at the top. That is when I said, "You know something? All these financial statements for Fannie, Freddie, the Treasury, ESF, I don't believe any of them."

Robert Kirby: That's just it.

C. Austin Fitts: I don't believe a word.

Robert Kirby: In your case you singlehandedly discovered, I believe, $50 to $60 billion worth of fraud in your department alone.

C. Austin Fitts: It depends on how you count it. What I discovered and what I believe is the amount of outstanding mortgages – mortgage insurance enforced at the FHA – at the time I was that there was three times or more what was on the books. That's a trillion dollars or more of only collateral fraud.

Robert Kirby: Let's say that there were people signing off on that on a yearly basis, effectively giving it their blessing and stating that all was well. Well, all wasn't well. I'm only making that point just to speak to people who might be saying, "How can you make such outrageous statements, that there could be that much dark money housed in an institution?"

What is it that the Pentagon alone has said that they can't account for?

C. Austin Fitts: Last year alone – they just released the reports for the year 2015 – the Pentagon was missing $6.5 trillion in undocumentable adjustments, which is more than ten times their entire budget. Now, with securities fraud you can do that. And don't think these derivatives haven't helped with that securities fraud.

Robert Kirby: Oh, absolutely they do.

C. Austin Fitts: Derivatives turbocharged what the Federal government could do in terms of collateral and securities fraud – absolutely turbocharged it. The proof in the pudding is that we had a housing market collapse in 2006 rolling into the bailouts. In 2009 we had $27 trillion in bailouts when $8 trillion would have paid off all the mortgages in the country.

Robert Kirby: And there you go.

C. Austin Fitts: That is a signal. In 2010 there was a firm from Australia that owned US mortgage securities. They had experienced a 50% default rate. Well, I'm sorry, that is fraud. That is collateral fraud; that is not sub-prime mortgages.

I think your theory as to one of the reasons they took over Freddie and Fannie; why wouldn't you take it back to private? They are using that as the collateral fraud and derivatives toxic waste dump.

Robert Kirby: I completely agree that to be the case. Just understand, folks, the numbers that we spoke of in aggregate held by American banking institutions being $222 trillion at the end of December 2016; those numbers don't include whatever might be being housed in Fannie and Freddie.

C. Austin Fitts: Exactly.

Robert Kirby: These institutions would both be natural repositories for this kind of nuclear waste to have much of it housed in there. So when we speak about the size of the derivatives market, nobody actually knows how big the derivatives market really is.

We can grapple and get a handle on what the banks have, but what is being held behind the curtain with the likes of Fannie and Freddie, we just don't know.

C. Austin Fitts: So here is what I keep trying to communicate, and I struggle with how to do it: Since 1980 interest rates have been going down, down, down, and we've been issuing more and more debt. So think of it, every year as a civilization we spend $100 but we only earn $80. We keep growing the debt, and the derivatives help us do it. We keep playing this game, and we've now reached the ceilings of the debt growth model.

I'm not saying that we can't kick the can for a little while longer, but if we're reaching the ceiling of the debt growth model, then we are probably approaching the ceiling of the derivative growth model.

Here is the thing: If we have to pay back that accumulated deficit by reversing out of the debt growth model and living within your means, we've been spending $100 but only earning $80. If we go to only spending $80, that still doesn't pay back the accumulated deficit. In theory to get this back in balance, we would have to go back to spending $60.

Robert Kirby: Or we could adopt the European model and have negative interest rates.

C. Austin Fitts: That would finish wiping out the middle class.

Robert Kirby: Absolutely. That would be the final assault on capital itself.

C. Austin Fitts: Right.

Robert Kirby: When you stop and think about the European system of governance and the way it's financed, there's a big reason interest rates were forced to zero. The biggest debtor on the planet, America, can't afford to pay market rates of interest.

If America was forced to pay market rates of interest, they would have to default on their debt because they don't have the income to support market rates of interest payments. This also speaks to the notion that people say, "What happens when rates go up?" Rates will never be allowed to go up in any material way. If rates do go up, I would offer and argue that that would imply that we have had a debt default and we've had a reset, which would mean that effectively the dollar has been displaced as the world's reserve currency.

In my opinion, that is what the implications of rates going up in fact means.

C. Austin Fitts: I think they're going to bump it a little. I think the Fed is going to take it up another 50-75 basis points.

Robert Kirby: Isn't it interesting that the last time they raised rates 25 basis points at the short end of the curve, the ten-year bond was at 2.5. Today's ten-year bond after raising rates a couple of times is at 2.18.

What we're seeing is the yield curve flatten.

C. Austin Fitts: Right. The yield curve is just flattening.

Robert Kirby: Flattening of the yield curve is usually a harbinger for very difficult times coming.

C. Austin Fitts: I don't know about you, but as far as I'm concerned, it's been difficult times for quite a while. From the moment 9/11 happened, we were in difficult times.

Robert Kirby: Yes. Quite frankly, we were in difficult times before 9/11.

C. Austin Fitts: Right.

Let me go back and talk a little about what is happening in the District of Columbia right now. One of the things we see is we see a Congress that looks like the Keystone Cops on healthcare or tax reform or any issue. Everybody is going around in circles. You have a President who is doing so many U-turns that it looks like he is going around in circles. But nobody in Washington can face or come to grips with this because we have an entire ecosystem of players who are in denial.

Let's return to my concept that we've been financing two civilizations out of one budget and keeping one civilization secret. I liken this to the stories of the man who has two families in two different towns. He has one job, and is financing two families, and the two families don't know that the other exists. He is trying to keep it all together. Finally he has a heart attack and everybody discovers what has been going on for the last 20-30 years.

We have a similar situation where Congress can't balance the books because they're not allowed to be transparent about what is really happening. So they're going in circles, and we have an entire society in a state of unbelievably deep denial. But one thing we know is that the derivatives and debt positions rule.

The question is: How do you get out of this? How do you help the entire ecosystem face reality and see what is really happening?

Robert Kirby: The answer to that question is: Frankly, I don't believe that there is an easy way out of this. I don't believe the people who have put us in the predicament that we're in are ever going to come clean or are ever going to give up or admit what they've done.

It is no wonder that what has been done is not sustainable long-term or forever. I sense that we are very likely getting close to the end of this road that we've been on. What scares the daylights out of me is that there is history with financial elites that their games with money and their games with debt – when they come to an end in history –seem to like to take people to war. Then they blame the war on the financial catastrophe that they created.

C. Austin Fitts: Let me talk a bit about the war that is being engineered right now. What you're looking at is the finishing of the Wesley Clark 'seven countries in five years' plan plus Korea which is essentially trying to bring into the central banking system all of the players. If you can bring everybody into the system and shift to a digital global currency and delete cash, then you have a way of harvesting the system much deeper in a way that will keep the game going.

Robert Kirby: I hear what you're saying. To my way of thinking, there are players in the world who will not allow this and will not conform to it. My worry is that we will have nuclear war before that mandate is ever going to be fulfilled. That is what bothers me the most.

C. Austin Fitts: What I want to point out is: If you're the player who doesn't want to see it happen, you have a reason to take it to that extreme to stop it. In other words, you are primarily fighting for the right to be human as opposed to be slave.

Robert Kirby: Exactly.

C. Austin Fitts: So this is a 'live free or die' kind of moment. That means that we could see a nuclear war.

Robert Kirby: That is what concerns me. The people, who control these financial levers that we're speaking of, are the globalists. These globalist people have written white papers and they are very much on record.

The entire globalist movement, at its core, is eugenics-based. These people believe that the planet is overpopulated dramatically. Instead of the 7+ billion people who are on the planet today, if they had their way, there would only be 500 million of us. This is why you see such globalist personalities – at least in my view – as Bill Gates being an investor in companies like Monsanto, the progenitor of all of our GMO foods, and GMO food is known in studies to be a sterilizer. They know that when they've fed rats GMO corn exclusively, within 90 days they have a completely sterile rat.

For some reason, we're told that GMO food is good for us and that there are no concerns. All I'm saying is that the spread of the GMO is very much speaking to the plans of globalists. They are eugenics-based, they want fewer of us, and what better way to do it than controlling birth rates?

C. Austin Fitts: I also think that they are very afraid of how you keep control.

There was one thing that I wanted to mention because, to get to where we've gotten with this debt growth model, one thing they've found to do is to shut off the fire alarm or the smoke alarm, which is the price of gold. So part of the derivatives bulge is creating enormous amounts of paper gold.

Robert Kirby: Absolutely.

C. Austin Fitts: Try to figure out how many derivatives there really are. I've tried a couple of times to figure out what the outstanding inventory of gold on the planet is, and I just give up.

But one thing that I do know is that there is a huge amount of paper gold that is only paper.

Robert Kirby: The issue also extends – and maybe even more so – to silver. Silver is consumed whereas gold tends to be stockpiled. Silver is consumed and used in many industrial processes in very minute amounts, but is not easily replaced with anything else. When you examine the COMEX exchange in New York and you look at the open interest in the paper silver futures contracts, the open interest on silver is something like 128,000 contracts. Each contract of silver is for 5,000 ounces of silver. That means it is over a billion ounces of silver.

Let's just make this clear to people: There is nowhere on the planet where you can go and get a billion ounces of silver. It doesn't exist anywhere in a stockpile. But yet people have sold over a billion ounces of silver on one exchange, the COMEX exchange. The volumes that are traded on COMEX pale in comparison to what is traded on the LBMA- the London Bullion Market Association.

C. Austin Fitts: There is a reason it is a big silver ETF; JP Morgan Chase services it.

Robert Kirby: Of course. In any case, the amount of paper that gets sold relative to the amount of physical metal there is available in the world; the amount of physical metal pales in comparison. So you essentially have people who don't own or possess any silver, but yet they can sell in paper form unlimited amounts. That also is not a sustainable model going forward. There are people who see through this fraud and who demand the physical good. When the physical good can't be delivered, this is when you have things called 'defaults'. This is when you can have very, very disruptive dislocations in markets.

This is something that, in my view, is going to come. It's a matter of 'when', not a matter of 'if'.

C. Austin Fitts: There are two more things that I wanted to discuss. One is that I had a conversation with a wonderful ally the other day who said, "When you talk about the $11.5 trillion of undocumentable adjustments in the government, you sound as if all you care about is money and you don't care about people."

I said, 'When I start talking about the $11.5 trillion, the reason I am is because I care about people. If a group of people can get together and steal that much money, then they can run everything no matter what our governance systems are, and they can control you financially no matter what our governance systems are. It can do terrible harm to people if you see what is going on."

"In my opinion, if there is any one problem, it's that. So it's because I care about people that I talk about the $11.5 trillion."

He said, "You have to explain it to people in terms of things that impact people. So how does $11.5 trillion mean to people who have to go out and get student debt instead of having reasonably cost college? You need to talk about it in those terms."

One thing I know is that you have always raised your hand and tried to explain about derivatives. You see these windfall taxations being applied to the general population through the derivatives book. To you it's a people issue. It's compromising freedom and it's compromising people's financial wherewithal.

If that much in a tax was formally announced and legislated and everybody had to hand over 25-50% of their net worth in a formal taxation, they would be up in arms. But somehow doing it through the back door – invisibly – they don't even notice. They just know that something is terribly wrong.

Robert Kirby: I agree with all you've said. Maybe to state it a little simpler, dishonest commerce does not make for good friendly relations with the people you're interacting with. If there is one thing that defines our world today, we have a number of countries that don't trust each other and are at loggerheads with each other. I would have it that this is all the result of dishonest commerce.

C. Austin Fitts: Yes.

Robert Kirby: If you even think back to biblical times, according to the bible, when is the only time that Jesus ever lost his temper? He flipped the tables on the moneychangers because they were engaged in dishonest commerce. Honest weights and measures are a good foundation for sanguine interaction amongst humanity.

C. Austin Fitts: Right. So they have destroyed the pricing function, and it has destroyed markets. Now no one trusts each other.

Robert Kirby: Exactly. What we try to do is illuminate or shed some light on what's been done.

This should bother everybody because this has all been done in our name.

C. Austin Fitts: Right. I don't know if you saw Jamie Dimon, the Chairman of JP Morgan Chase, explain on his annual letter: "Something was wrong with America, but JP Morgan Chase endeavored to treat their clients as you would want your mother to be treated."

Robert Kirby: Yes.

C. Austin Fitts: When I saw it, I almost fell off my chair. I said, "Jamie Dimon must have a memory wipe every night."

Robert Kirby: You know it's incredulous what comes out of the mouths of some of these captains of industry and people in the financial system.

C. Austin Fitts: It's a complete inability at this point to take responsibility or even see what the responsible position would be; talk about lost!

The one other thing that I wanted to mention to you – because you wrote a great article when I was in Canada about Community Wizard- the idea of a software tool that would allow everybody to see the government money for their neighborhood. I think part of the problem is whether it's derivatives or the Federal budget. It's all so big.

We need to see it contiguous to the world where we walk around and have an impact. I don't know if you saw this, but the CEO who left Microsoft, Steve Ballmer, has recently announced a huge effort to take all government money and spending and make it accessible through a new website called USA Facts.

Robert Kirby: Hear, hear!

C. Austin Fitts: My attitude is: Let the fireworks begin. Ultimately the real solution to everything you and I have been talking about is if every neighborhood or every place can start to affect and get the money productive place by place, that is how we are going to start to make real progress on this.

Robert Kirby: I agree with you 100%. It's not like we don't have the tools and we don't have the ability to do things in a responsible manner. It's having the will to actually do it.

C. Austin Fitts: I think the other thing is that the productive people are mighty depressed.

My father was a surgeon, and one thing that you learn is the body in trauma will shut off blood to the toes and the fingers and protect the blood supply for the heart and the lungs and the brain. We have an economy that is constantly pulling the blood from the heart and the lungs and the brain to the toes and the fingers.

If you're the heart or the lungs or the brain, you're tired of the extremities pulling all the blood, and you're tired of being asked to produce more just so it can be pulled down to the extremities.

I think what has to happen is we need to figure out a way to make sure that the blood is flowing to the productive, and that gets back to the question of allocation of capital. It's one of the many reasons the derivatives story is so important for everybody to understand.

Robert Kirby: Yes, and also so people can wrap their head around where derivatives came from in the very beginning, which points out how things that are meant with good intentions end up going awry and not being used in the manner in which they were intended.

Derivatives came from the agri sector in the very beginning. The reason they were developed was because farmers used to shoulder a lot of risk between the time that they planted their seed and the time that they would harvest their crops.

This goes back to the 1930's and the 1940's. When farmers would plant their seed, they would know what they had to pay for their seed and to get it planted, but the thing that they never knew was what the crop was going to be worth in the fall when it was harvested.

C. Austin Fitts: Right, and commodities prices can be very volatile.

Robert Kirby: The very first derivatives were in the agriculture sector for wheat and corn. What it allowed farmers to do after they planted their seed was sell a percentage of their harvest forward at a price known today, so they could somewhat insulate themselves. If it was a bumper crop year and the price of corn or wheat fell through the floor, farmers might not be able to recover the amount of money that they paid to actually plant the crop.

So the futures market in the agricultural commodities came about as a means of transferring risk away from farmers and into financial markets. So they financialized the agricultural commodities and that is where they got their start.

From there, they flourished through the other segments of the economy, whether it be financial futures or precious metals futures. It all came out of a rather honorable calling to help farmers. Look what has happened.

C. Austin Fitts: If we are going to turn this situation around, we still want to be able to use the chainsaw to cut down trees.

Robert Kirby: Yes.

C. Austin Fitts: We don't want to lose them. Chainsaws are not, in and of themselves, bad. I agree. I can think of historically wonderful applications for derivatives and hedging investment portfolios. I'm a big believer in hedging in all sorts of circumstances.

Before we close, do you have any other points that you want to make about derivatives or any way you want to summarize this information for the audience? This has really been wonderful. I have to tell you that over the last ten years, you have done incredible things to make this issue understandable for people and I really appreciate it.

Robert Kirby: I can only hope that anybody who has listened has gained a little more understanding than they previously had.

Be aware of your surroundings. If anything, I would like people to understand that the current path that we're on is not sustainable. That is why I am an advocate of people holding a certain percentage of their investable assets in physical precious metals. It's probably not a bad idea to have some storable food. As I see it, these are just prudent, prudent things to do in this day and age.

C. Austin Fitts: You represent the BMG Bullion.

Robert Kirby: I do indeed.

C. Austin Fitts: People do want to talk to you about it. I've always believed that the BMG is a very high quality custodian relation. . So if you want a custodian for the worst case, it's one of the crème de la crème of custodian quality.

They can talk to you about that, but they can also talk to you about Kirby Analytics. Could you describe your website?

Robert Kirby: You can catch me on the web at www.KirbyAnalytics.com. I would mention that there is an enormous repository of articles on the site. I've probably written 850 or 900 articles over the last dozen or so years. There is a lot of information that I wrote ten years ago that might be more relevant today than when I first wrote it.

I add new material as I feel commentary is appropriate and there you go.

C. Austin Fitts: Let me just ask you to engage in a wild speculation. How much do you think derivatives have had to do with the Administrative U-turns into war that we've seen in the last two or three weeks in the United States?

Robert Kirby: I think that they probably had an enormous impact on the thinking of Donald Trump. There was a time right after Trump was declared the winner in the election that he made a visit to the White House. He seemed– at a press conference after spending an hour and a half with President Obama – to be absolutely visibly shaken.

He used some words to reference knowledge that he had gained or information that he had gained, and I think the words that he used were, "High-flying assets."

I believe those were the words that came out of Trump's mouth, which would tend to make me think that what he was shocked to learn was probably something of a financial nature. He may have been told right upfront about the situation or the enormity of what the ESF is involved in. This is something that, in my view, might explain his stunned look.

It's interesting because there was a great article that was published by one of the British tabloids. They seem to cover this quite a lot, referencing this meeting in the fall. They had body language experts give a written critique on Trump's gestures and the look on his face at this particular media scrum.

It's very telling what they had to say. They said that he was shocked, and that he had clearly learned something that he didn't know, and it had him extremely concerned.

It might have been Donald's introduction to the world of derivatives and just what the ESF has been up to. I wouldn't be at all surprised if that is exactly what happened.

C. Austin Fitts: I think it's not just the ESF with the derivative position, but where all that money is going and how much more money is expected. I think that part of the problem is the system is maintaining an overhead in secret, and feel that they have to continue to maintain it, but they can't tell anybody what it is.

Robert Kirby: Exactly. This is a deep, dark secret and is national security. This is more secretive, in my view, than nuclear secrets.

C. Austin Fitts: Yes, I agree.

Robert Kirby: This is the very essence of our financial system. Knowledge and transparency in this area could bring the whole house of cards down.

C. Austin Fitts: Or it could give us the transparency we need to actually solve things.

Robert Kirby: Right. The size and scope of this issue is too big to be tinkered with. That is my view of it; it's just too big.

C. Austin Fitts: You know me; I'm always the optimist. I think that the wealth destruction that has come from maintaining it is reaching a tipping point. In other words, you've reached a negative return and have a negative return on investment, and it's going to keep getting worse until you change it. So the question is: How do you change it?

Robert Kirby: Exactly.

C. Austin Fitts: Well, Rob Kirby, you're a prince among men. I can't thank you enough for everything you've done for us over the years. Keep going, and we would love to get you back on The Solari Report. I know there are going to be many questions, so get ready for them to come your way.

Robert Kirby: I'm looking forward to it.

C. Austin Fitts: Have a great day.

Robert Kirby: And also you.

MODIFICATION

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