

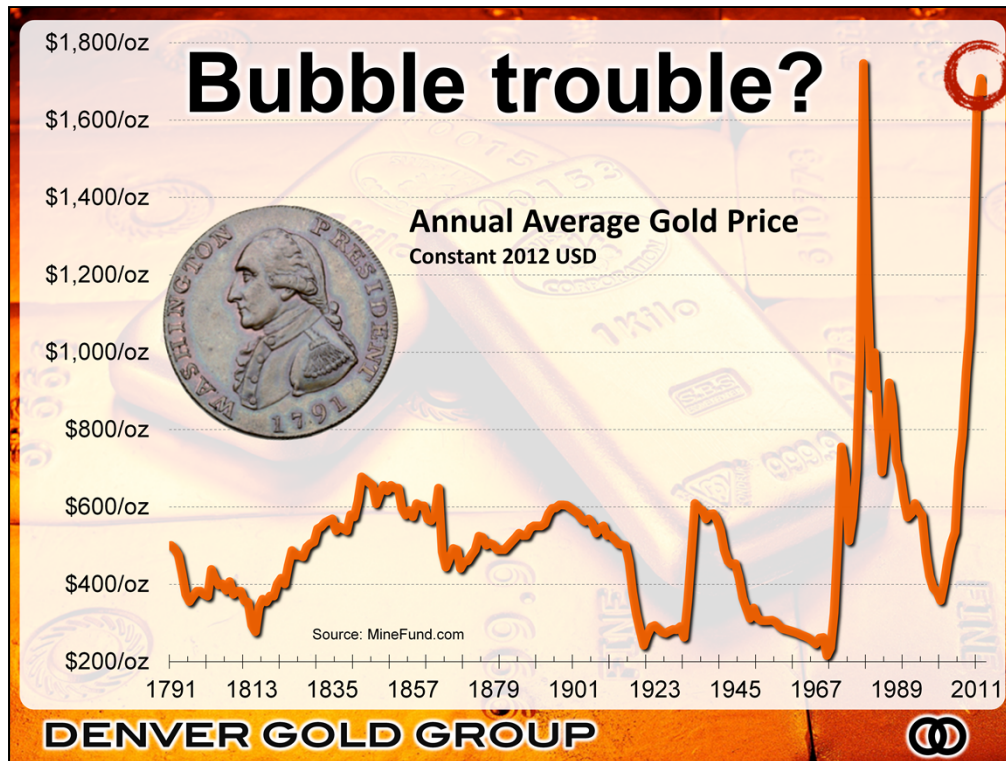


# **THE GREAT GOLD BULL MARKET: QUO VADIS?**



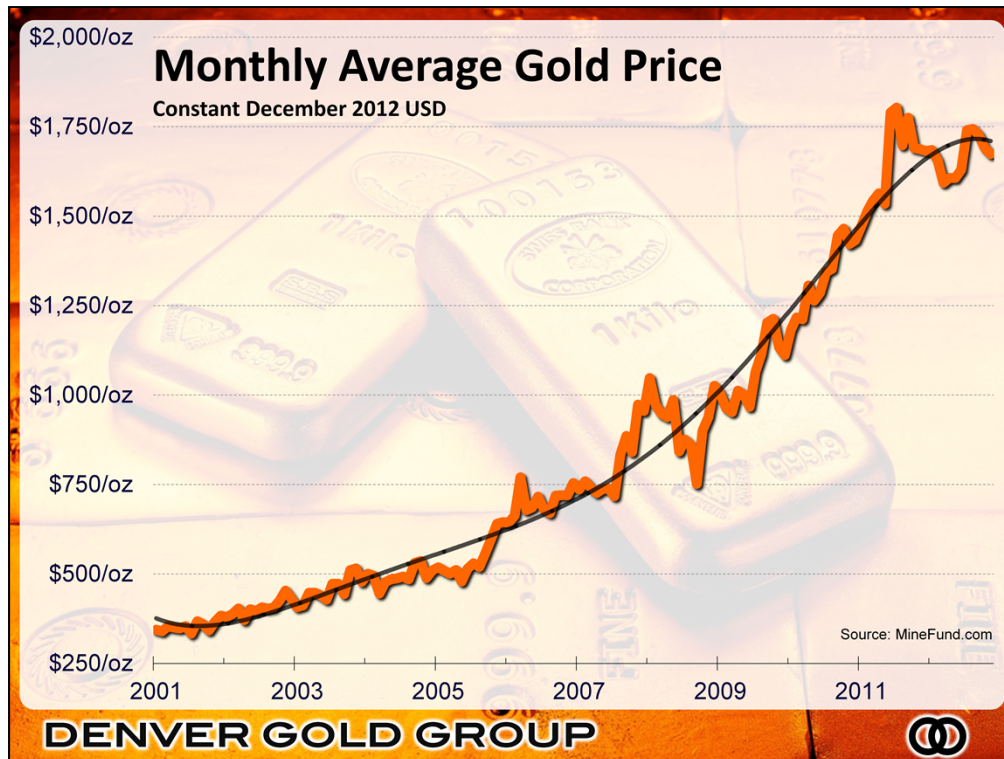
**Tim Wood, Executive Director, DGG**

23 Jan 2013, Denver Gold Group Monthly Luncheon

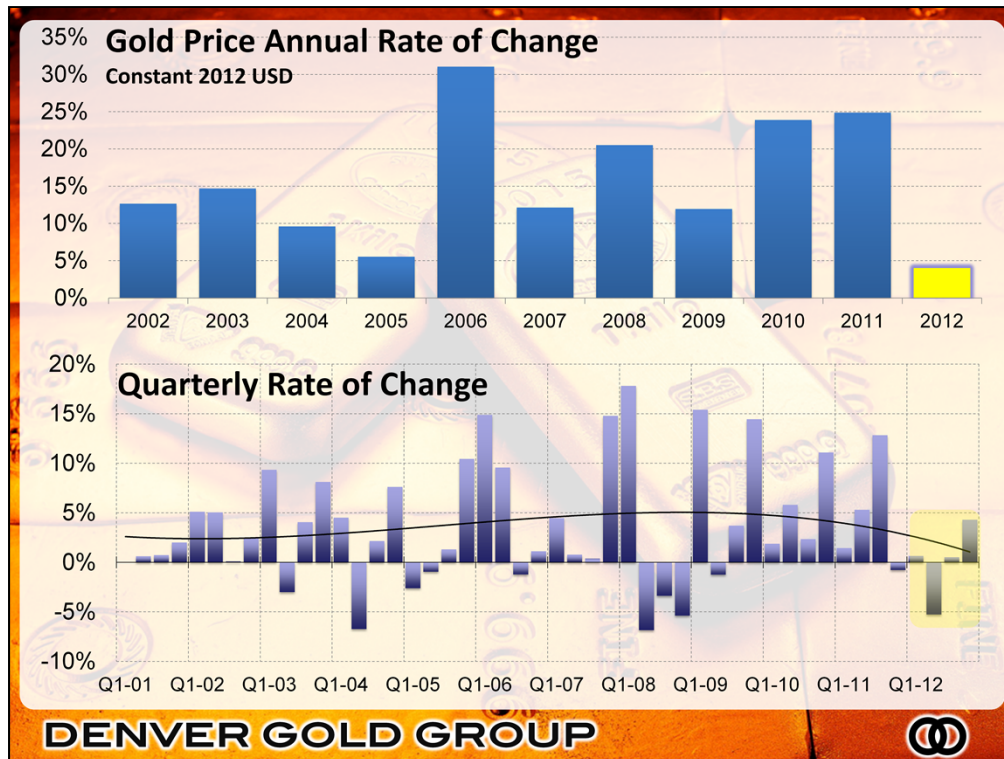


- When adjusted for inflation (2012 Constant USD, US CPI-U), this is the longest gold bull market in 222 years.
- 11 Consecutive years of annual price increases.
- However, the 2012 increase was, so far, the smallest of the current cycle.

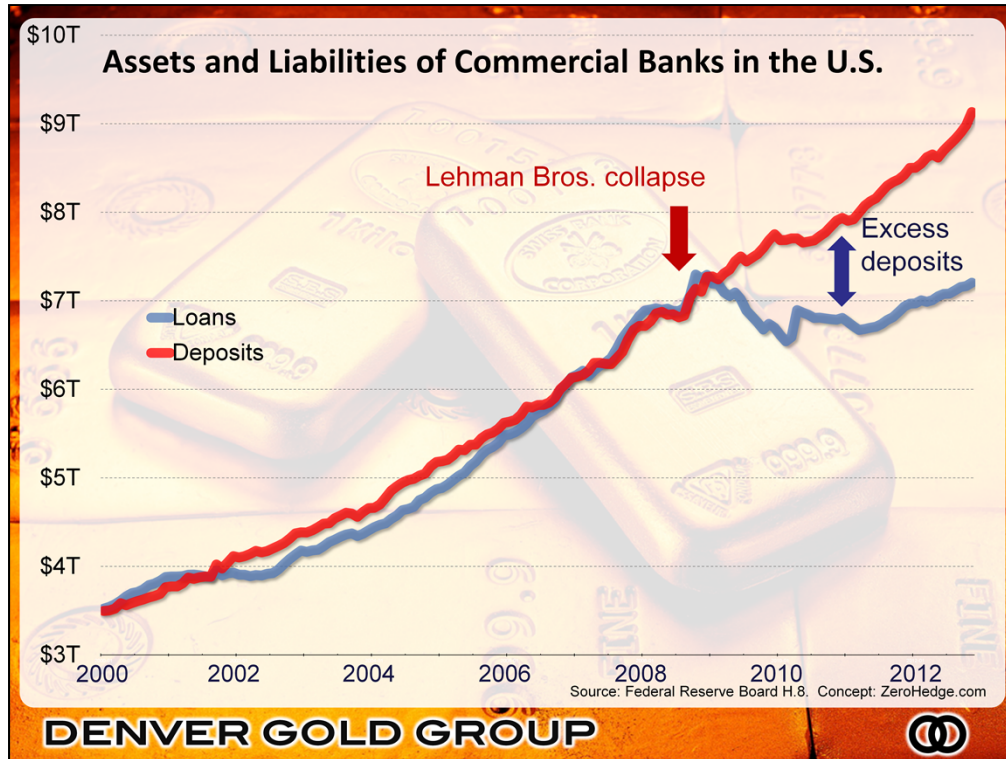




- At a higher resolution, it is also clear that the upward trend stalled in 2012.
- Failed to set a new high for the year compared with the previous year.

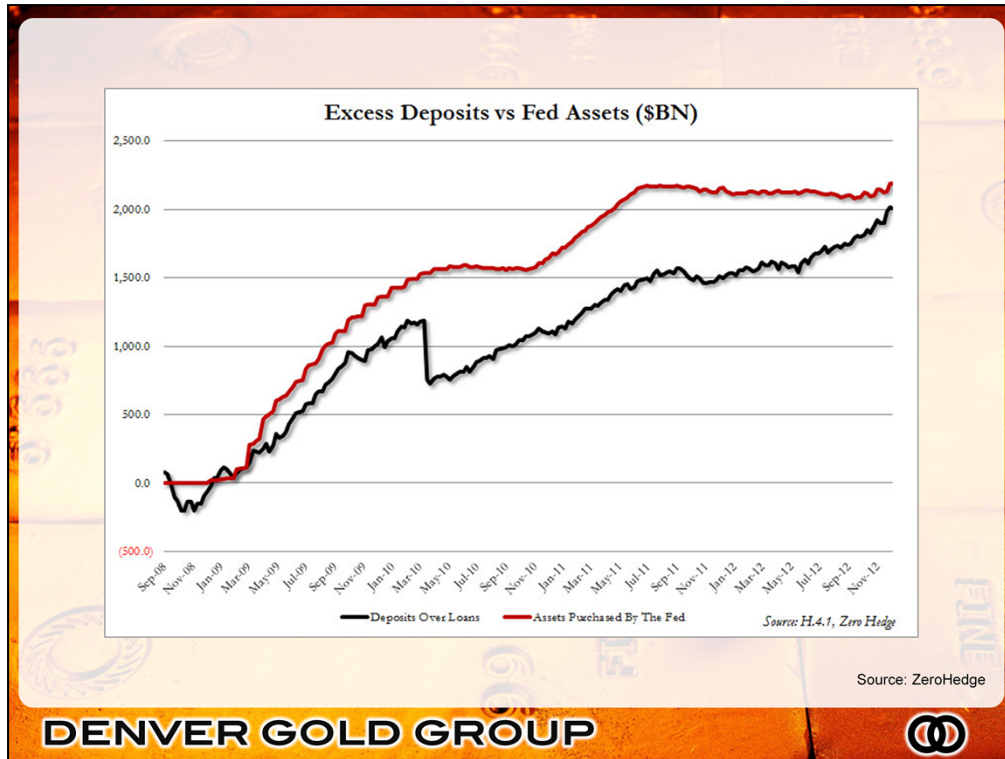


- The annual and quarterly rates of change illustrate the change in momentum.
- Five trailing quarters are unusual except for a period from 2006 into 2007 when real interest rates were rising.
- Gold equities have shown some value in acting as an early warning system for changes in the gold price – valuations are currently at historic lows. Many reasons contribute, but could feared price weakness be predominant in the sell-down of equities?



- Banks have nearly \$2T in excess reserves. Highly unusual in a fractional reserve banking system where deposits turn to loans almost immediately.
- So happens that Fed QE amounts to ~\$2T. i.e. Most of the stimulus poured straight into primary dealer balance sheets via Fed purchases of assets from banks.
- Since money is fungible and banks never miss an opportunity to leverage reserves, what is happening with the excess?

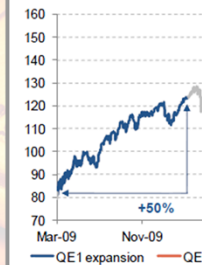




- Notice how the Fed's assets line up rather neatly with excess deposits.

# What Quantitative Easing Buys...

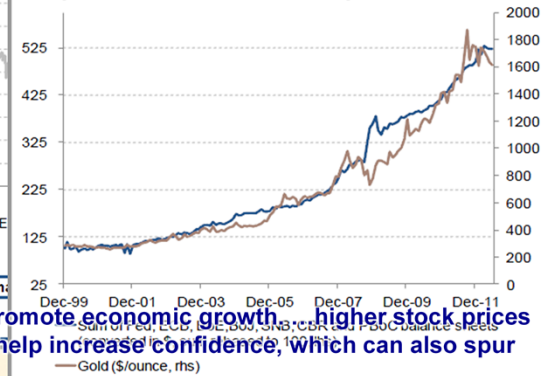
**S&P 500 peak performances during each Fed action**  
(cumulative performance)



**S&P 500 highest performance**

QE1 expansion 48%

**Gold price vs. balance sheets of major central banks**



**Easier financial conditions will promote economic growth... higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.**

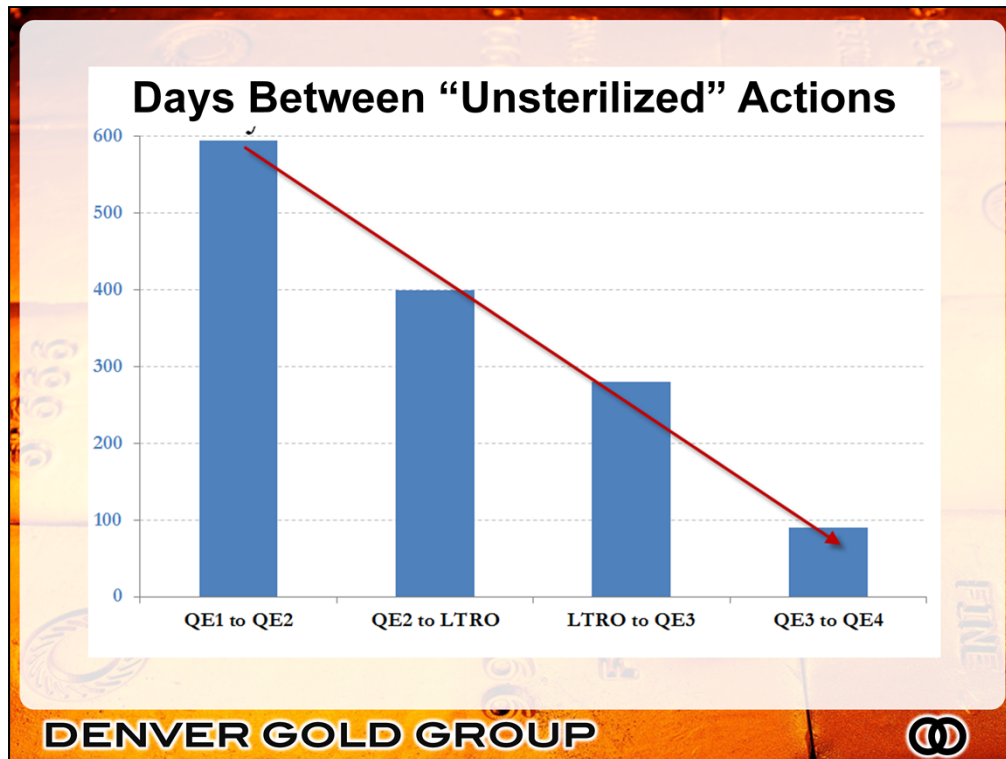
*Ben Bernanke, Chairman, Federal Reserve Board of Governors*

Source (charts): ZeroHedge | (quote): Washington Post: [www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html](http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html)

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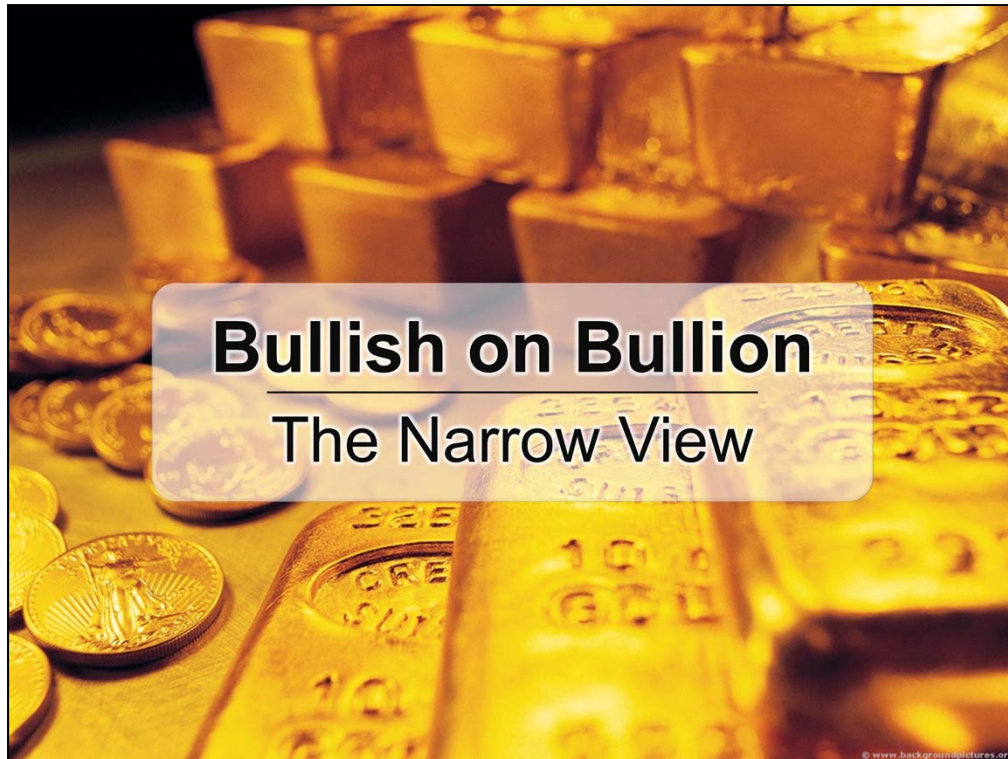


- Reasonable evidence that excess reserves have been hypothecated – banks are doing proprietary trading on an enormous scale.
- There is a clear correlation of QE with some asset revaluations. Since it's not the Fed buying them outright, banks are likely the generators – stimulus money is flowing to asset inflation, not loans.
- We have to acknowledge that there is some relationship between gold prices and central bank activity.
- Bernanke believes this will assist in kick starting a virtuous cycle although there is very little evidence to support this after 4 years of full-throttle Keynesian experimentation.
- One of the other issues to bear in mind is the rising multiples on many stocks despite weaker outlook – low to negative interest rates used to discount future earnings stream lowers the corporate cost of capital, and in turn raises the present value of expected future profits.

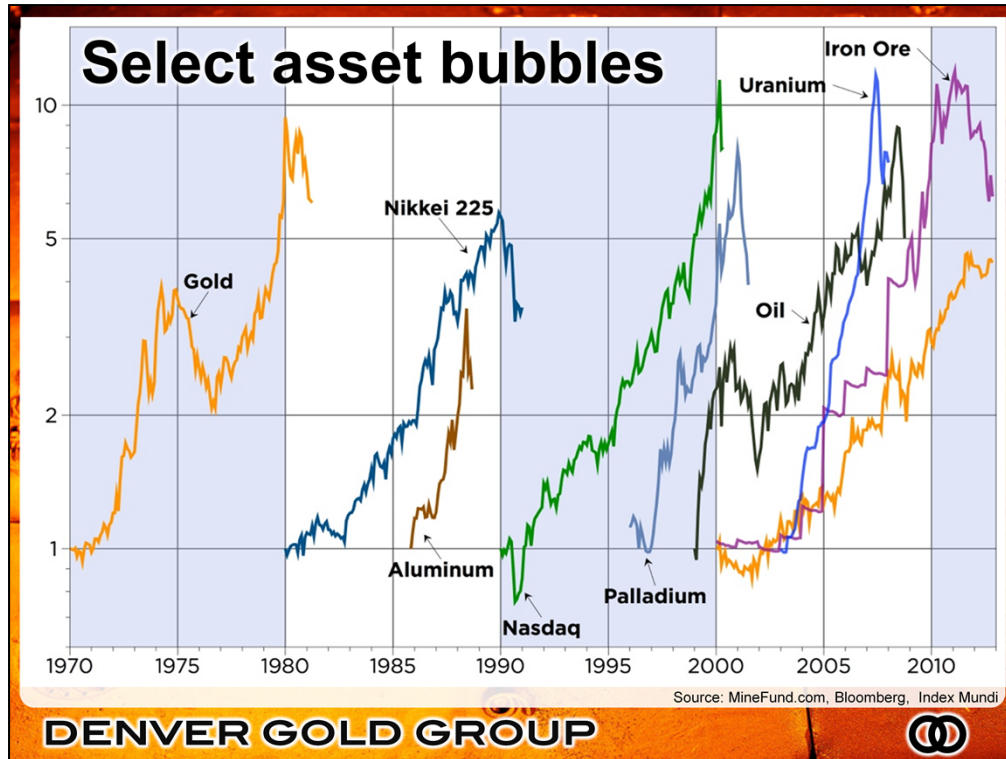


- Have to be concerned that any reduction in QE will take some of the wind out of the gold price.
- Law of diminishing returns. Even if the Fed continues with QE, it may not be effective which would also be negative.
- It is not improbable that Gold could fall very heavily in the near term – and for a brief time – especially with the compounding effect of asset rotation – hedge funds seem much less interested in gold.

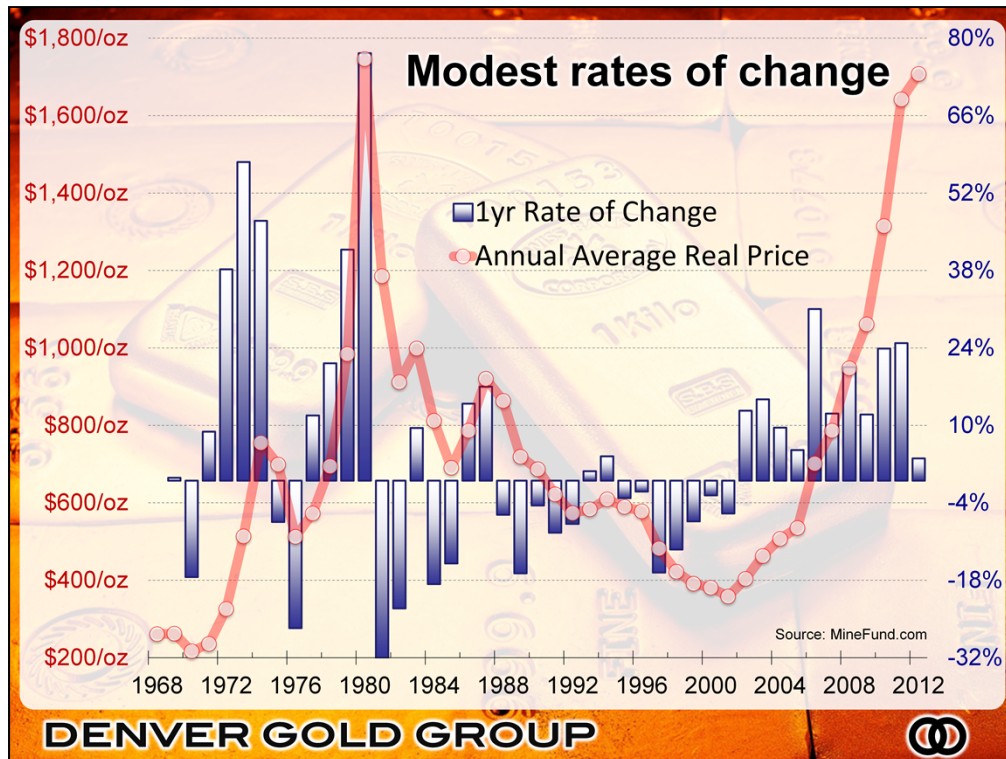




- It shouldn't be surprising that we are bullish on bullion and gold equities.
- That said, we're not ignorant of the risk of confirmation bias as we present a case for holding and adding gold.
- Let's examine some technical factors.



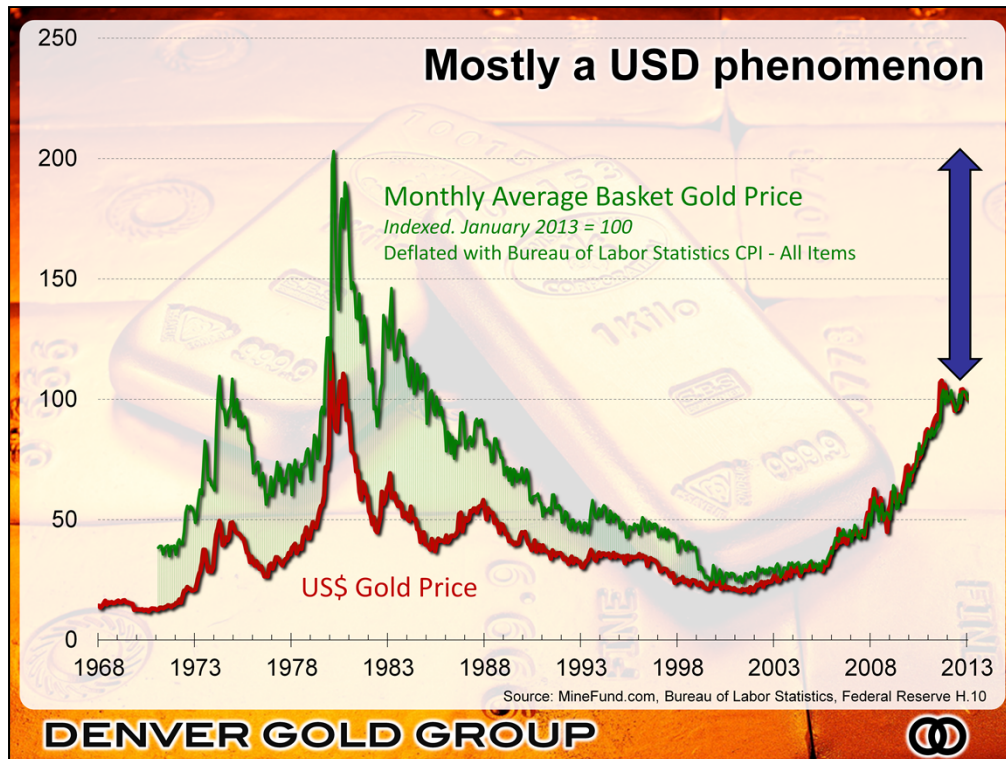
- We've seen gold go up quite far, quite fast. But how does it compare with other asset bubbles, including the previous big one in gold?
- Against these examples, gold's performance this time cannot yet be classified a bubble.
- We would expect the price to show parabolic behavior at some point; which it has not yet.
- There is no reason to think that gold would be immune from a speculative blow off like any other asset.
- It's also notable that most bubbles don't end until the asset has doubled at least three times. So far in this cycle gold has only doubled twice (adjusted for inflation).



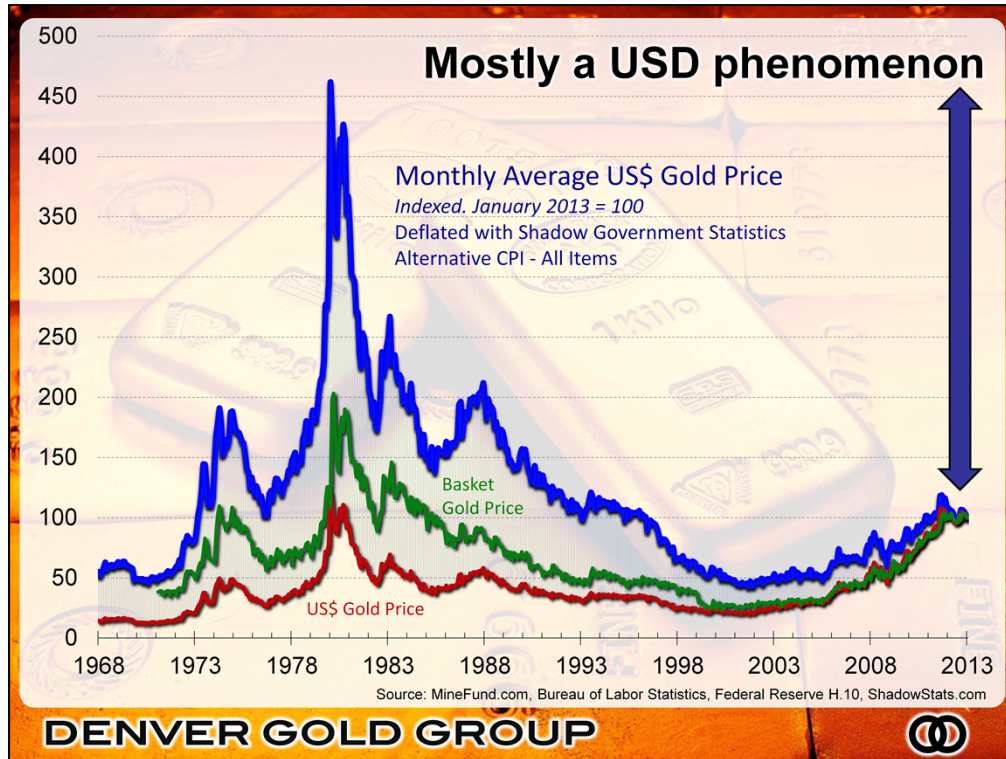
- This cycle has also been notable for the very mild rates of increase so far.
- In looking for a top we would be looking for at least one or two large annual increases (~50%+).





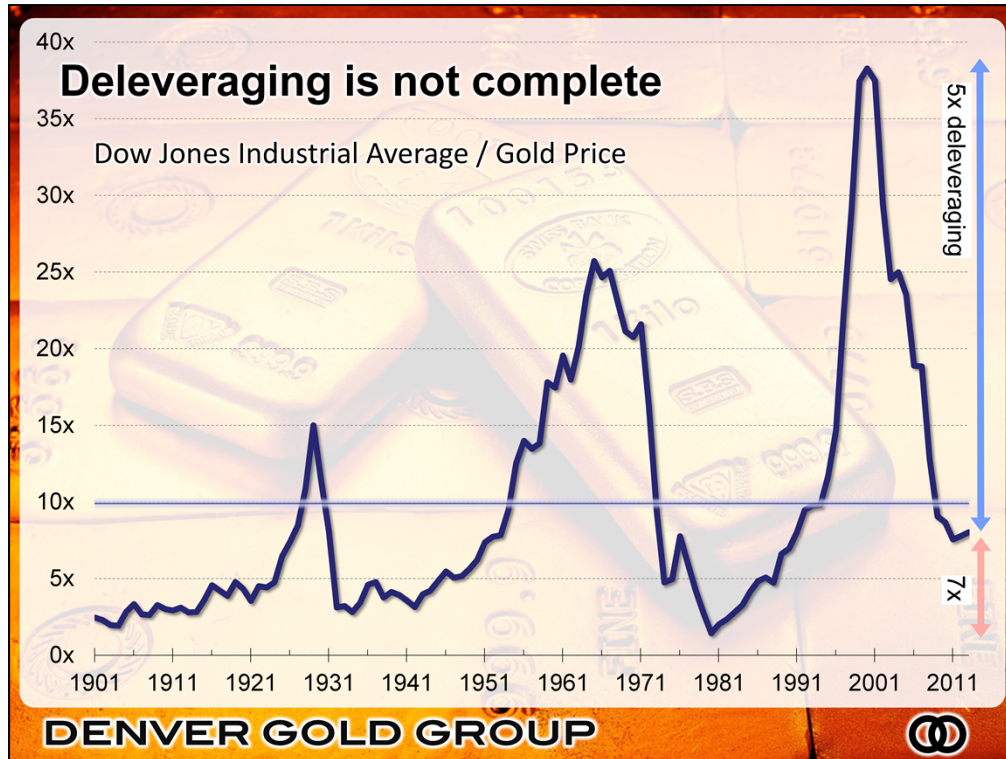


- If we put gold in a larger context, it is obvious that its performance has largely been a US dollar phenomenon.
- When you price gold in a basket of major trading currencies you can see that we're a long way off the 1980 highs.
- Given the developing currency wars, and especially Europe's serious problems, there is good reason to expect the basket price to eventually print much higher.

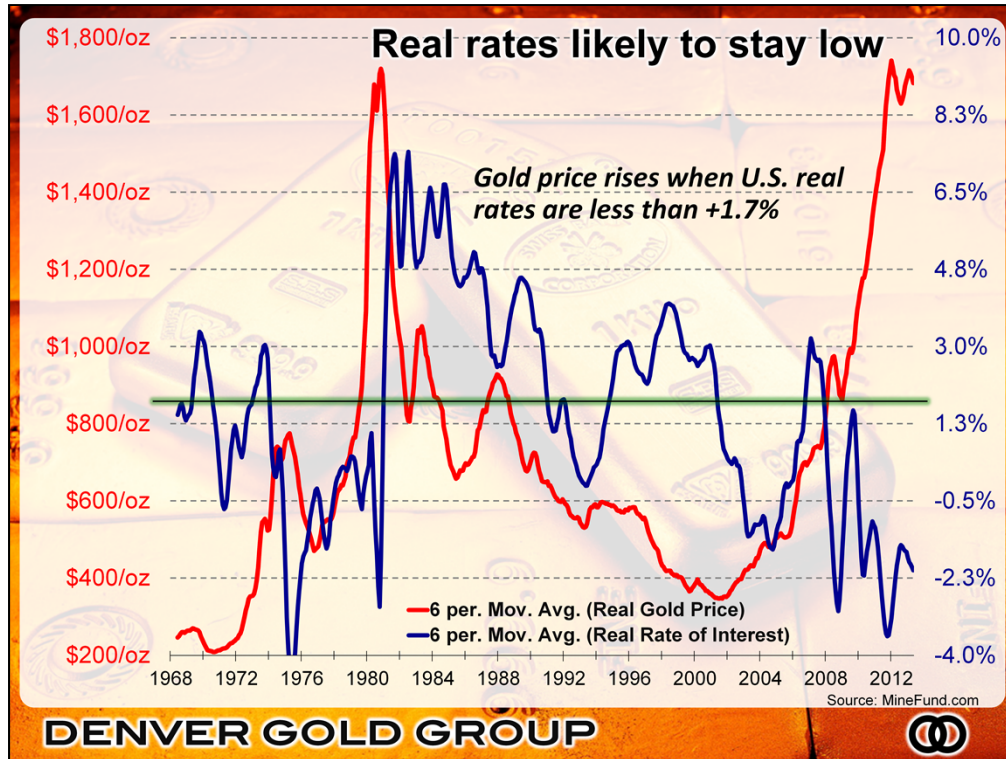


- The potential gains are even more pronounced if we deflate the gold price using the same CPI methodology prior to the change in 1980.
- Whatever your views on the change in CPI reporting methods, it is undeniable that it has a profound effect on valuations.

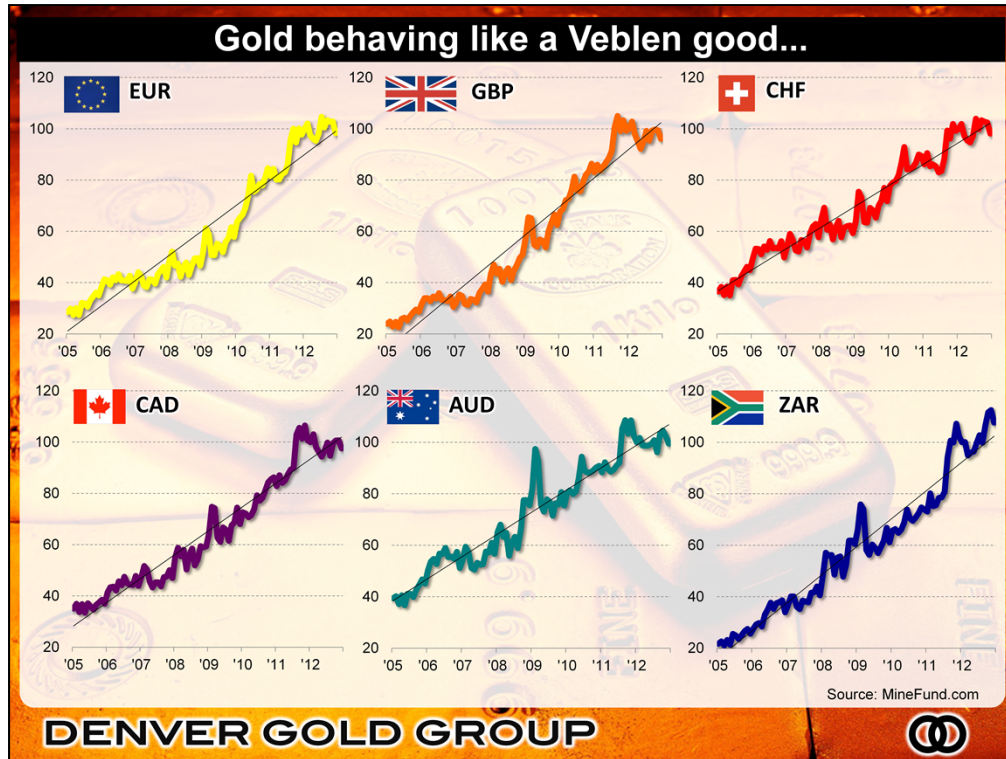




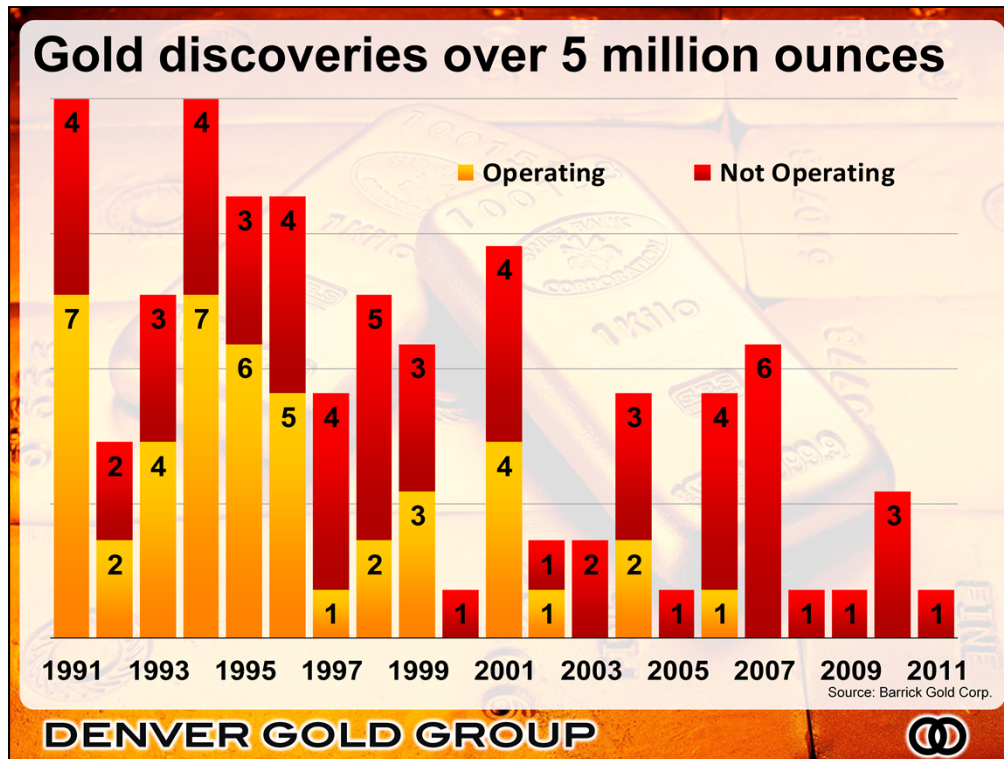
- There has been a notable asset value reversal since 2000. The master minds of global money and credit blew up a massive bubble that helped make gold ridiculously cheap.
- That is certainly not the case now as gold has outperformed nearly every other asset for the past decade.
- Following the two previous modern equity bubbles, the ratio reverted to 1:1. Given current conditions it seems rather too optimistic to think the deleveraging is over.
- Whether that means the Dow crashes to 5,000 points and gold rises to \$5,000/oz or – 8k:8k – is a matter of perspective.
- Notably, we have only seen a 5x deleveraging from the peak to now. If a 1:1 ratio is achieved again, then there would be a 7x deleveraging from here.



- US real interest rates are also a quite reliable indicator for gold prices.
- Generally, whenever rates fall below +1.7%, gold prices will rise.
- Most forecasts that we track expect sustained negative interest rates through this year.



- It is also interesting to see how gold has appreciated in value relative to any asset.
- Bad money drives out good – Gresham’s law. People are hoarding gold (example of old vs new \$20 bill)
- Even jewellery purchases, which might be expected to decline dramatically in the face of higher prices, have increased or held relatively steady in key markets.
- Giffen Good - consumer good that violates the law of demand is a Veblen good. Demand for Veblen goods increases as their prices increase because people perceive them to be of higher quality.



- Lastly, it's simply a fact that less gold is being found and mined.
- Combination of scarcity and increasing hurdles to bring deposits to account.
- Supply is not responding to price.

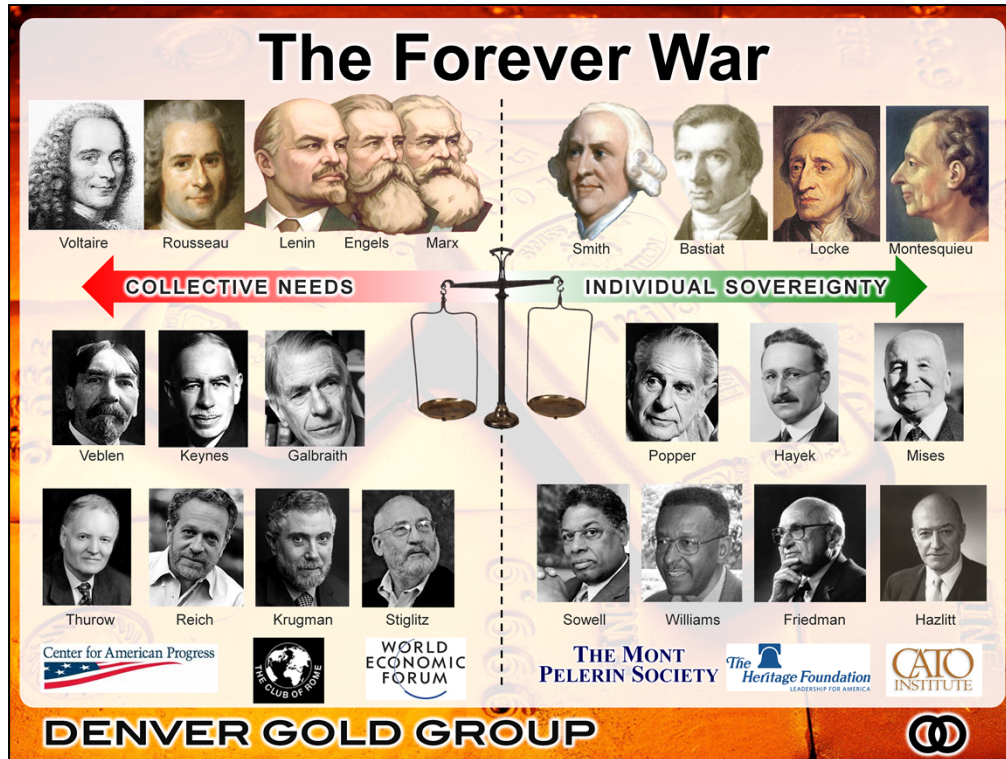




# **Bullish on Bullion**

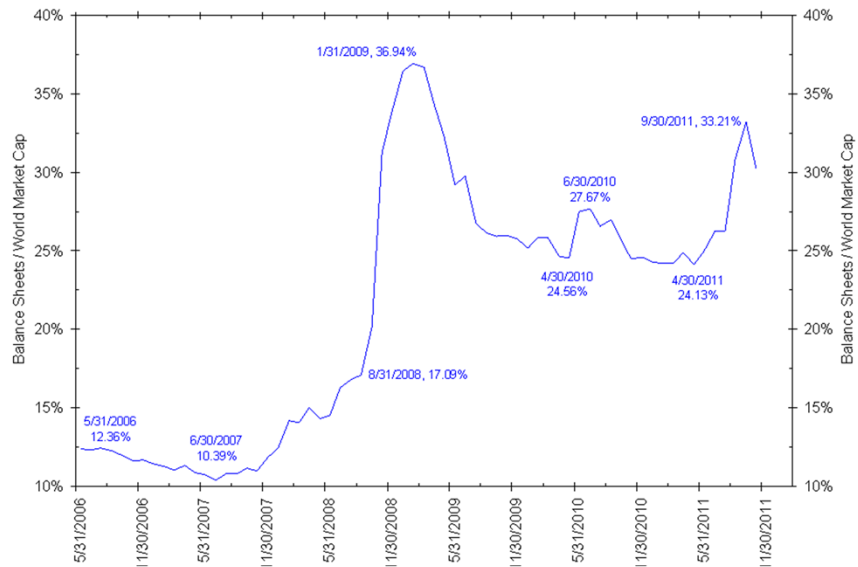
The Big Picture





- In looking at the big picture for gold we need to set it in a larger context of an age-old ideological struggle about the economic structure of societies.
- This is a crude representation, but I think it gives a reasonable sense of the face off between the two dominant armies.
- They are essentially ecosystems for propagating ideas for policy and governance.
- The ideas are disseminated and codified by networks / organizations who seek to influence political activity in support of their ideas – as per these examples.
- Notions about Money - and gold specifically as nobody's liability – is central to this activity, which ultimately revolves around how much of your life's labor is for your own use and enjoyment rather than someone else's.

## Eight Largest Central Bank Balance Sheets as per cent of World Market Capitalization

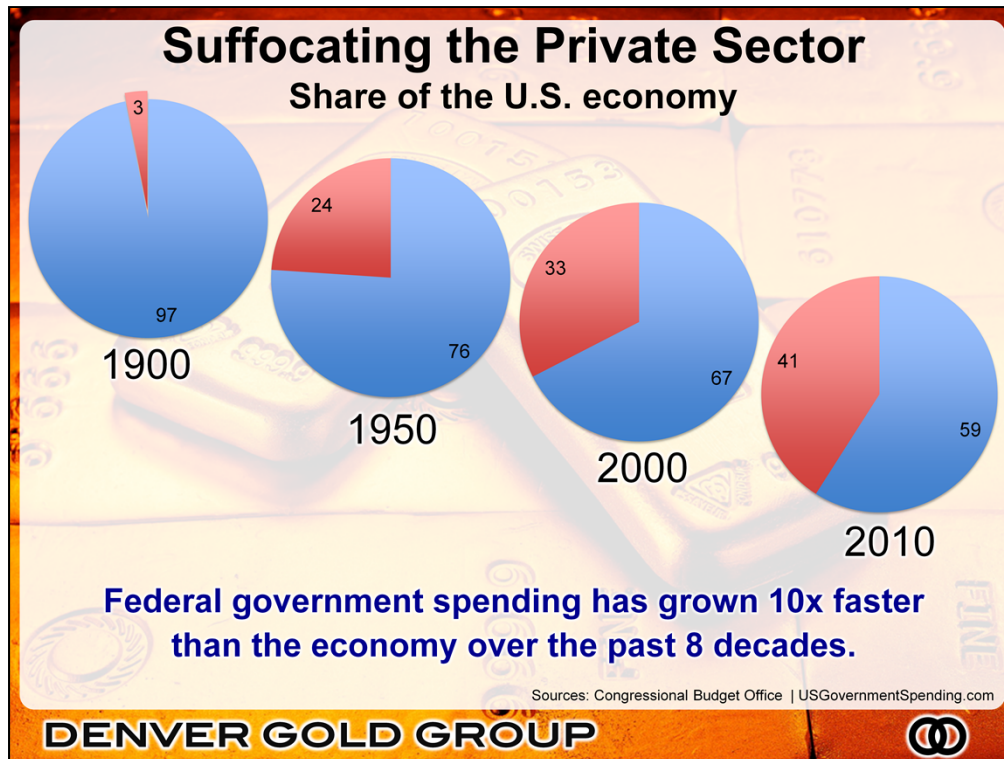


Source: Ritholz.com – The Big Picture <http://www.ritholtz.com/blog/2012/01/living-in-a-qe-world/>

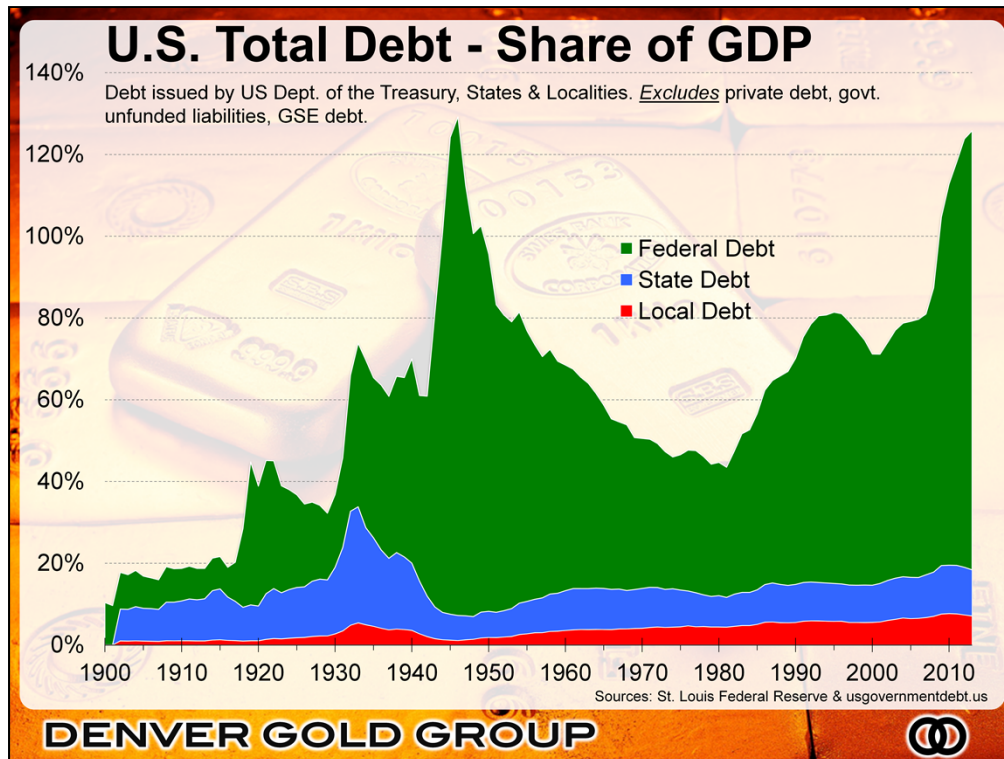
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- One way of expressing the current status of this ecosystem is by looking at control of capital by governments vs the private sector.
- We are clearly in a phase where government is ascendant – if not triumphant.

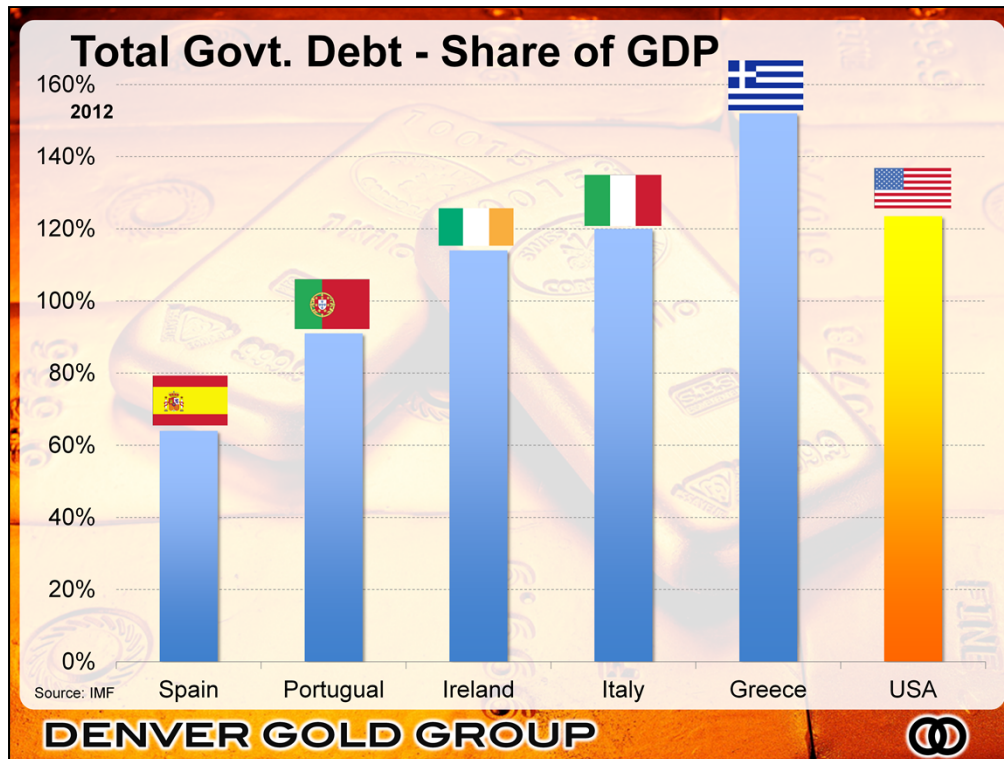


- In the case of the US, government has been ruthless in grabbing more of the economy for itself virtually without regard to economic conditions – govt doesn't know how to do with less.
- Grown not through productive enterprise that has attracted customers away from the private sector, but through coercion.
- It is notable that every country that has improved its competitive standing against the US over the last half century has done so by reducing government's share of the economy – notably Canada and China. Ironically, the changes there came under socialist administrations.



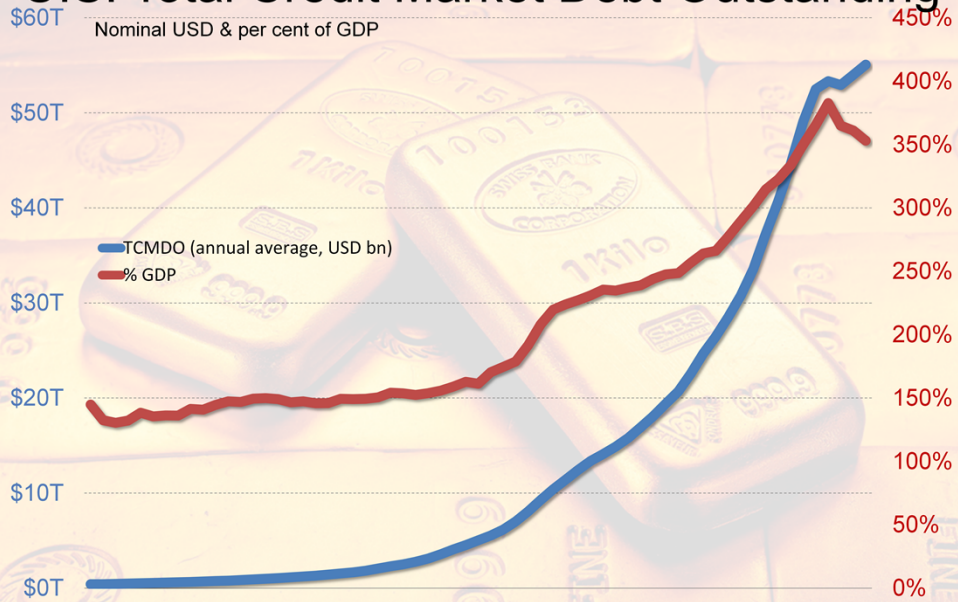
- More insidiously, government has forced itself into the picture with an unquenchable appetite for debt.
- Currently, Fed, state and local debt stands at 124% of GDP.
- There is very little to show for this accumulation, and we are now simply monetizing debt (printing money to buy treasuries).





- And to put it in some additional perspective, the US is keeping good company with other deadbeat nations; second only to Greece.
- These are numbers more familiar in aid dependent basket cases.
- Easy money = uncontrolled fiscal appetite. E.g. Democratic Party operatives turned Fannie Mae and Freddie Mac into gigantic and fraudulently managed hedge funds; reaped immense personal gain (Johnson, Raines, Gorelick et al).
- The only reason the US has not been spanked liked these countries have is that it prints the world's reserve currency.

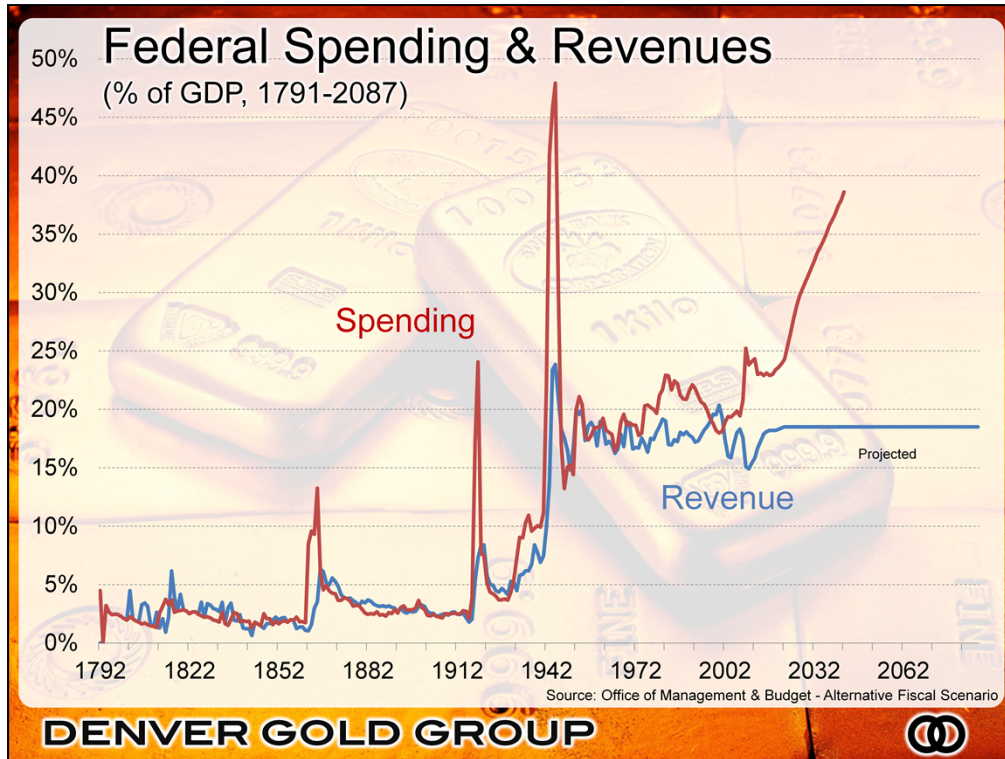
# U.S. Total Credit Market Debt Outstanding

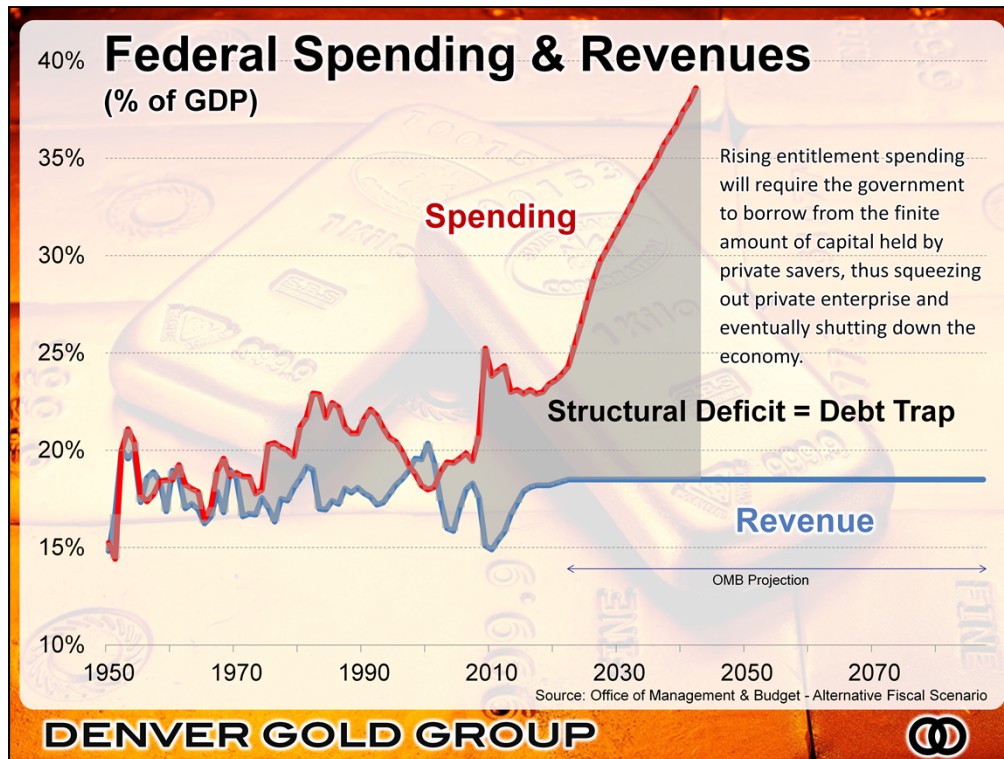


Sources: St. Louis Federal Reserve & usgovernmentdebt.us

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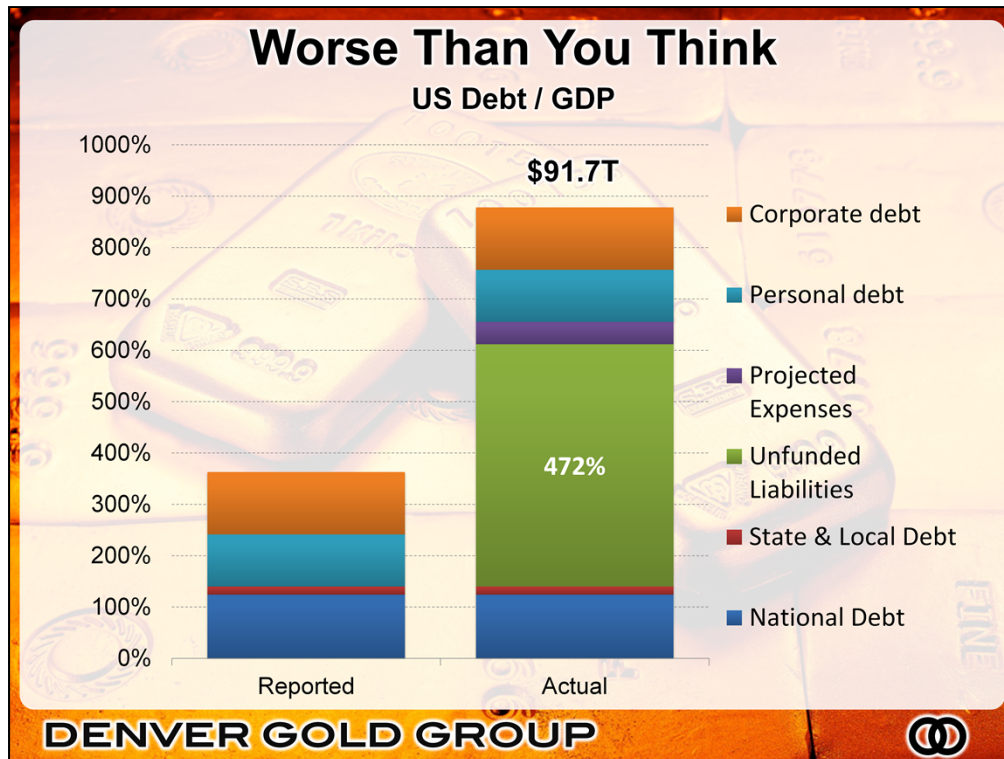


- Government projections – which tend to be hopelessly optimistic – nevertheless show that the US is headed for a debt trap.
- If the runaway spending is not radically reduced within the next few years, it is unlikely that we can avoid springing the debt trap which will manifest with a dollar crisis.
- Note that almost irrespective of marginal tax rates, the government is – on average – unable to collect more than 18% of GDP in revenue.
- The reason the spending goes parabolic is because of a melt-up in welfare and entitlement spending, but within 20 years the largest component will be interest.





- If we knock off 7 zeros, we can analogize the national budget to a family budget.
- The family takes in \$251k - Which makes them millionaires according to the Obama administration.
- They spend lustily, and fund the deficit with debt.
- The accumulated debt is massive and growing exponentially.
- That's not the end of the story though – the family has massive obligations.
- Altogether, long term and current debt amounts to more than 4,000% of annual income. That's another way of saying there is no hope of paying it off.
- And, just like a family, the earning potential is affected by age. There is also an influx of new members who are less skilled and with less inherited capital to deploy, and there are not enough of them to sustain their seniors.



- The chart shows you what the government's Enron style accounting debt is versus GAAP standards. The GAAP deficit in 2012 was \$6.9T compared with the cash deficit of \$1.3T.



**LIQUIDATION SALE**

**Everything Must Go... To China!**

**"Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate... it will purge the rottenness out of the system."**

*Andrew Mellon*

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- One way to resolve debt problems like this is with asset liquidations.
- The US experienced something similar in the late 1980s when Japanese investors were scooping up American assets – only to give them back at a discount when the crisis there hit – and never left.

## Traditional Resolutions



### 1. Economic Growth

- Cannot outgrow debt load + spending habits.
- Global trade & capital structure no longer a “gimme”.

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There are 5 traditional ways that debt crises can be resolved.

We could potentially grow our way out of the mess with unconstrained natural resource development focused on massively expanding land available for fracking.



## New competitors, fluid markets

### Large developing economies are moving up in global manufacturing

Top 15 manufacturers by share of global nominal manufacturing gross value added

Rank	1980	1990	2000	2010
1	United States	United States	United States	United States
2	Germany	Japan	Japan	China
3	Japan	Germany	Germany	Japan
4	United Kingdom	Italy	China	Germany
5	France	United Kingdom	United Kingdom	Italy
6	Italy	France	Italy	Brazil
7	China	China	France	South Korea
8	Brazil	Brazil	South Korea	France
9	Spain	Spain	Canada	United Kingdom
10	Canada	Canada	Mexico	India
11	Mexico	South Korea <sup>1</sup>	Spain	Russia <sup>2</sup>
12	Australia	Mexico	Brazil	Mexico
13	Netherlands	Turkey	Taiwan	Indonesia <sup>2</sup>
14	Argentina	India	India	Spain
15	India	Taiwan	Turkey	Canada

<sup>1</sup> South Korea ranked 25 in 1980.

<sup>2</sup> In 2000, Indonesia ranked 20 and Russia ranked 21.

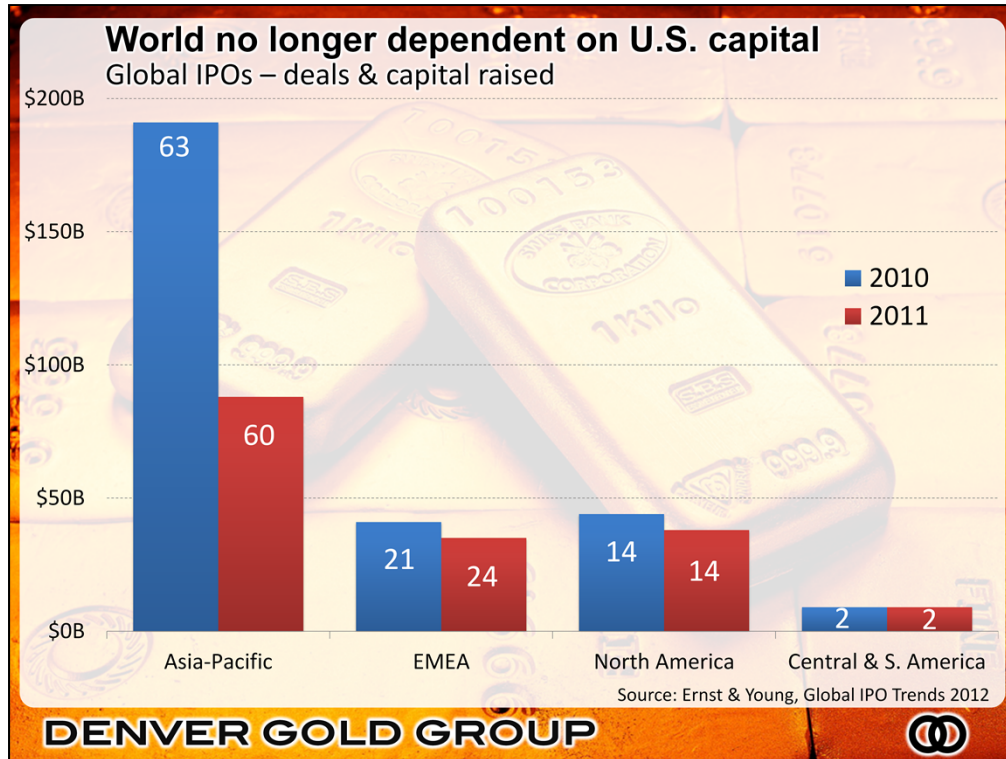
NOTE: Based on IHS Global Insight database sample of 75 economies, of which 28 are developed and 47 are developing. Manufacturing here is calculated top down from the IHS Global Insight aggregate; there might be discrepancy with bottom-up calculations elsewhere.

SOURCE: IHS Global Insight; McKinsey Global Institute analysis

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- Whilst the US still controls the largest share of world trade, it is a fraction of what it used to be.
- Compounding the problem, it simply makes less stuff and a lot of its export earnings are not repatriated because of punishing domestic taxes.



- Likewise, the US is no longer the capital markets powerhouse it used to be, and which allowed it to exercise its hegemony in much broader ways than just military power projections.
- Competing economies are able to deploy their own capital, or are effective in attracting it. Hence the chart.
- At the same time, the US has made itself unattractive through the arrogance of Sarbanes-Oxley and the imperialism of Dodd-Frank.

## Traditional Resolutions



### 1. Economic Growth

- Cannot outgrow debt load + spending habits.
- Global trade & capital structure no longer a “gimme”.



### 2. Austerity

- Never happens voluntarily.



### 3. Default

- Some way off unless Constitution abrogated or dollar crisis hits.



### 4. Inflation

- Politically tolerable - Already implemented.



### 5. Financial Repression

- Cynical & lethal to liberty; politically attractive. - Already implemented.

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- There is no political will for Entitlement Reforms / Downsizing Govt.
- Write Downs / Debt Restructuring are possible – look to city and state level.
- Currency Devaluation / Depreciation

## Boiling the Frog

The U.S. has commenced defaulting on its debt & entitlement promises through “GGTS” – Generational Grand Theft Savings

### 1. Inflation

- a. Hedonic manipulation.
- b. Under cover of low numbers.

### 2. Currency devaluation / depreciation

- a. Rising vulnerability to sudden dollar crisis
- b. Beggar-thy-neighbor / race to the bottom.

### 3. Persistent low-to-negative real interest rates

- a. Taxes bond holders and punishes savers.
- b. Dangerous instability in exchange ratios for what is available now & what is only available in the future.

### 4. Stealth austerity through class warfare

- a. Multi-layer taxation, graft, moral hazard (TBTF & socialization of risk), lawfare, crony capitalism, price fixing, capital controls, ineptocrats & *fonctionnaires*.



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We have been systematically stealing growth from the future to prop up the present. At some point the future will ask to be repaid...

1a. Changed the methodology for CPI calculations to deliberately understate inflation in order to reduce government obligations.

3. The Fed's intervention in capital markets has distorted the real economy: it has stimulated unprecedented capital mismanagement, where as a result of ZIRP, corporate executives will always opt for short-term, low IRR, and cash allocation decisions such as dividend, buyback and, sometimes, M&A, seeking to satisfy shareholders and ignoring real long-term growth opportunities such as R&D spending, efficiency improvements, capital reinvestment, retention and hiring of employees etc.

3b. Fed has fundamentally changed the relationship between stocks & bonds.

4a. Cronyism – whoever has “juice” gets ahead.



## An Inevitable Monetary Mishap

### 1. No obvious restraint to prevent U.S. submarining

- a. Dollar is no longer gold backed.
- b. Fed assassination of bond market 'vigilantes'.
- c. Governing elites sincerely believe economic reality conquered.
- d. Animating national cultural impulse transitioning from equal opportunities to equal outcomes.

### 2. Improbable that eventual inflation can be controlled

- a. Debt stock & maturity profile is overwhelming.
- b. Hiking rates to curb inflation will accelerate collapse.
- c. Rising risk of social / cultural dissolution compounded by demographic headwinds.

### 3. Economic entropy before markets reassert control.

- a. Reality shock-'n-awe will paralyze, then topple governments.
- b. Unprecedented global debt restructuring inevitable.
- c. High risk of mercantilist global wars & nation state breakups.

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1b. Interest rate policeman has been shoved off the road. Believe govt no longer dependent on debt market discipline.

1c. Self-reinforcing certainty that numeraire is immune from currency crises.

2a. - Non-linearity of outgo vs. income; debt maturity profile very short-term. Net debt issuance, is about \$1 trillion per year, one has to factor that there is between \$3 and \$4 trillion in maturities each year. So actual debt issuance ~\$4T/yr.

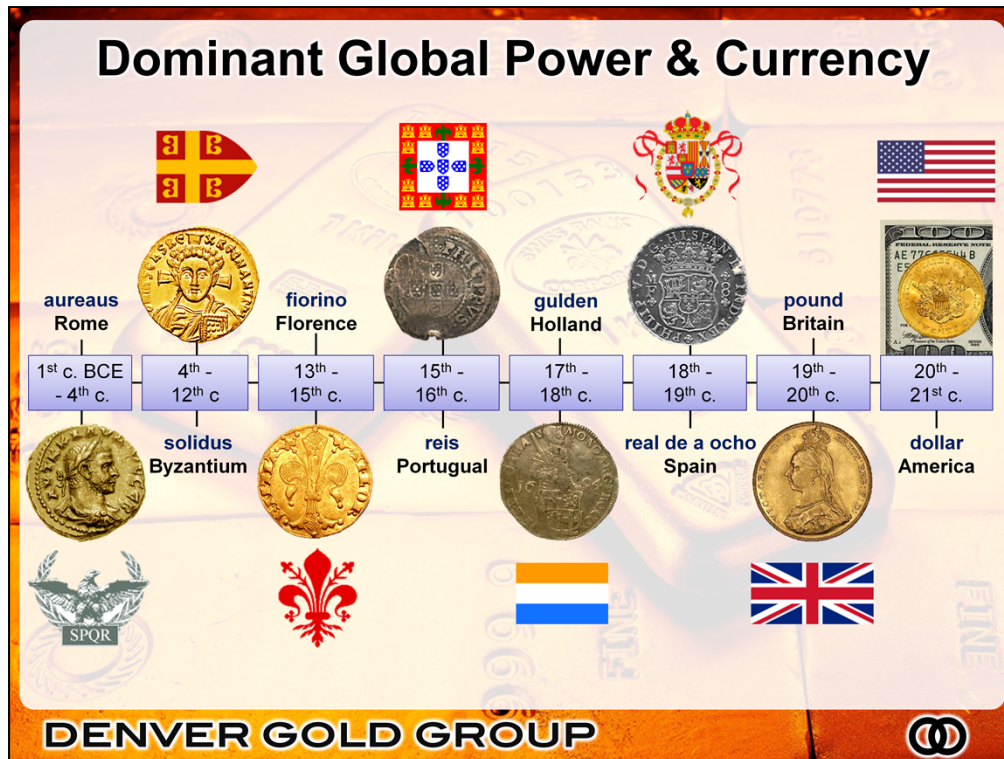
2b. - each 100 basis points in cost-of-capital = \$150 billion in interest. where a return to just 5% in blended interest means total debt/GDP would double in under a decade all else equal simply thanks to the "magic" of compounding). We are funding the buildup of China's military via interest payments.

2c. Constitutional crisis – executive branch takes control

3a. When govt is unable to raise cash to cover obligations will simply resort to the printing press.

3b. Financially prudent savers face risk of being wiped out.

3c. Washington Consensus is being replaced by China Envy Syndrome (everyone wants to sustain trade account surplus needing strong exports managed through weak currencies).



- Again, it's worth pulling back to look at an even bigger picture – being the owner of the world's reserve currency is a privilege. If it is not carefully managed, the privilege passes to someone else.
- America's stewardship of this responsibility has been unusual in that it has marked the first time that a reserve currency has successfully transitioned to a fiat currency without any precious metal backing. However, this experiment is only 41 years old.
- It remains to be seen whether the experiment can be sustained. Considering that even the Swiss National Bank has abandoned sound money, it cannot be too much long before a collapse or reset occurs.

# Gold May Need to Fill the Vacuum

Preferably as competing private currencies



There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.

*Ludwig von Mises*

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**THANK YOU!**

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