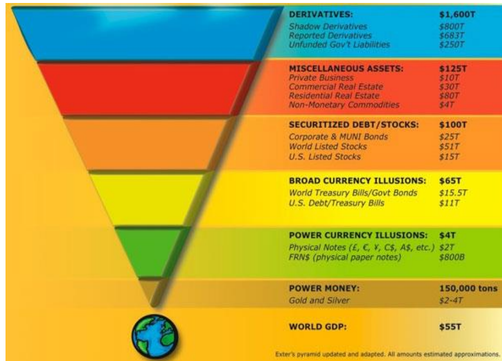
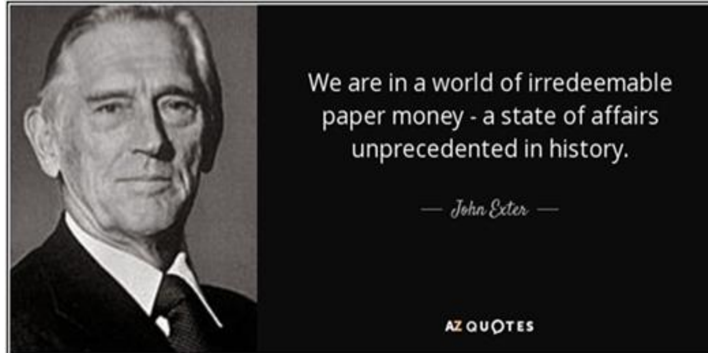
DK Analytics, Post #13: Gold in debt-based deflation offset with increasingly unbridled QE 01/26/2016
10-year Treasury: 2.01%; S&P 500: 1877.60; Oil: $30.67; Gold: $1,112.28; Silver: $14.37 (01/26/16 quotes)





Sources: www.silverbearcafe.com/private/05.09/upsidedown.html; http://www.zerohedge.com/news/exter-inverted-pyramid-refresher

Introduction:
Traditionally, during times of gold/silver-anchored monetary systems that a) limited debt excesses and b) were accompanied by stout rule of law adherence and vigorous property right protections, such as in the US for long stretches of time prior to the founding of the privately-held Federal Reserve Board in 1913, deflation was associated with increasing productivity, rising purchasing power, and growing, society-wide wealth. If this concept of "healthy deflation" sounds foreign, thank the Keynesians ("we are all Keynesians now," declared Nixon in 1971, when the US severed the dollar gold standard or Bretton Woods) and decades of statist/Keynesian indoctrination by the educational establishment, the media, and "Hollywood" and their "symbiotic" relationship with a perennially expanding government ("statism"). Moreover, thanks to Keynesianism "empowered" by the electronic printing press, we now have globally unstable debt mountains, huge derivative exposures, peerless misallocations, sharply declining productivity growth, and asset bubbles. These threaten the viability of our global monetary and economic system. Thus Keynesianism has ironically spawned and fanned, not avoided, debt-based deflation risks. How gold, and by extension, silver, stand to protect investors when the market and economic reality push aside central bank created and enabled manipulations (and, quite possibly, "dark" Exchange Stabilization Fund manipulations by the Treasury), is what this post will examine.

A closer look:
Keynesianism focuses on artificial demand (debt creation-based) stimulation instead of on optimal supply incentives, forgetting that production creates the goods and services that are consumed by gainfully employed workers enjoying increasing purchasing power thanks to heightened affordability/falling prices enabled by "productivity." When this virtuous cycle is short-circuited due to Keynesian polices displacing sane fiscal and regulatory policies and usurping stout property rights and sound money -- they are all joined at the hip -- then lower standards of living for the vast majority of people are but a question of time. Call it the "Keynesian harvest" of the past four decades. Call it "2016." In fact, here's what "the man" (Keynes) himself said about the inherent dangers of the policy named after him early in the 20th century and how reinstitution of gold-backed money could arrest improvident national finance/Keynesianism:

> "If gold standards could be reintroduced throughout Europe we all agree that this would promote, as nothing else could, the revival not only of trade and production, but of international credit and the movement of capital to where it is needed most. One of the greatest elements of uncertainty would be lifted. One of the most vital parts of prewar organization would be restarted, and one of the most-subtle temptations to improvident national finance would be removed; for if a national currency had once been stabilized on a gold basis, it would be harder (because so much more openly disgraceful) for a finance minister to so act as to destroy this gold basis." Quote appeared in a Guardian article in 1922

Let us expand on our introductory remarks. Would it surprise you that our conventional monetary and fiscal policy stew -- Keynesianism underpinned by accommodative central banks -- has so polluted the meaning of deflation so as to render productivity-based deflation, or a wealth of nations' trajectory, politically undesirable? For example, consider central banks around the world targeting not price stability, much less productivity-based deflation, but inflation! If this isn't a recipe for the very currency debasement that has brought us our current economic and financial quagmire, we don't know what is.

Yet conventional investors, and typically policy makers, ironically cheer on growth companies, the very embodiment of successful capitalization of sustained deflation, also known as "secular productivity machines!" Consider Standard Oil, Carnegie Steel, Ford, and Intel, to mention a few "household names." Our point: these seminal growth companies long grew their bottom lines by making their "wares" cheaper to manufacture and thus more affordable, which grew volume in excess

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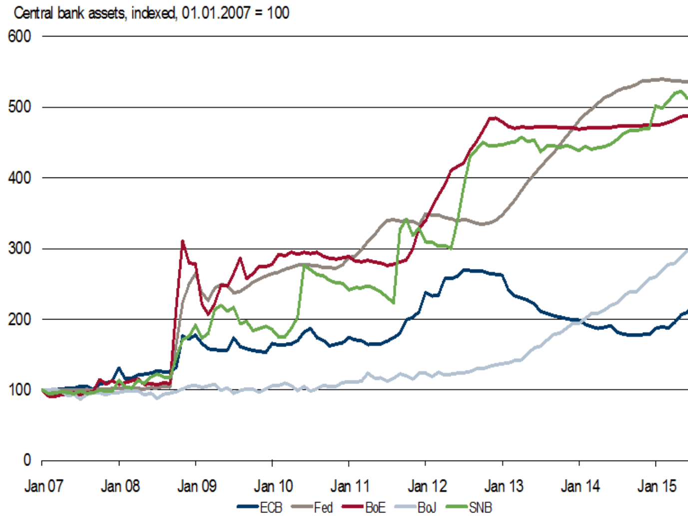
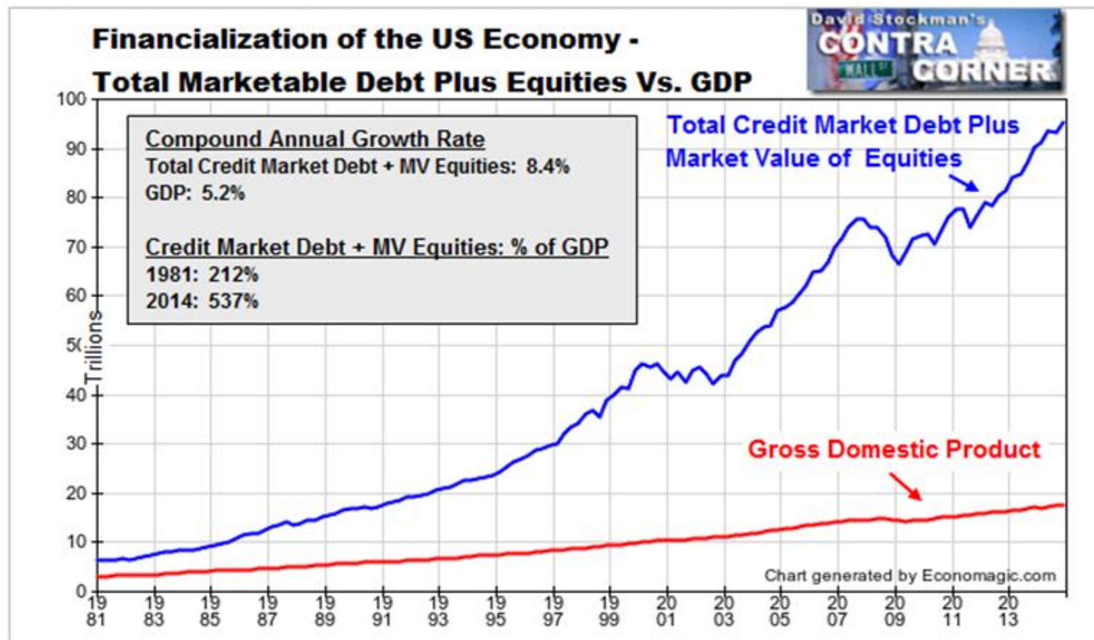
of declining average selling prices, which drove sales higher while reducing unit costs, which in turn allowed these corporations to bring top line growth down to the bottom line, benefiting shareholders and consumers! Said is the epitome of productivity-based deflation; when widely harnessed, it constitutes the only lasting "wealth of nations" trajectory. Sadly, it is also the polar opposite of both our current global trajectory and our errant policy as enabled by the "money printing parents" of the globally unparalleled debt surge, namely the world's leading central banks. Central bank asset growth (QE) has, in unrivalled fashion, "seeded" sustained outsized growth in global debt while, together with ZIRP and NIRP, artificially holding down interest rates (rising global debt/global GDP is also a testament to materially lower productivity growth!):



Sources: Datastream, CS, Haver Analytics, BIS, IMF, www.mckinsey.com/insights/economic_studies/debt_and_not_much_leveraging, http://www.marketwatch.com/story/global-stock-market-cap-has-doubled-since-qes-start-2015-02-12

Claims on global output (GDP) or total debt/GDP keep rising thanks to unparalleled central bank-based debt creation. Upshot: each unit of output is encumbered with more financial claims on it, i.e., more stakeholders; call it the "financialization of GDP." This financialization sets the stage for a) greatly heightened economy-wide interest rate sensitivity, b) rising risk premiums/higher interest rates, and c) eventually the inability to service mushrooming debt obligations (interest and principal repayments) as they are tethered to relatively stagnant underlying units of GDP:



Source: http://davidstockmanscontracorner.com/wp-content/uploads/2015/05/financialization1.png

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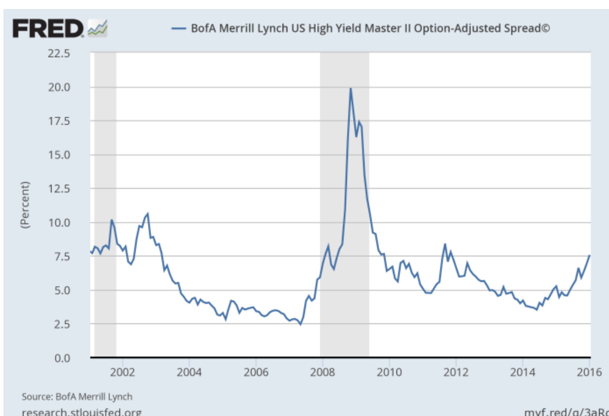
Even more harrowing, much like a company doesn't pay interest or repay its debt with its top line (sales) but with its bottom line (actually, with its free cash flow), an indebted government doesn't service debt obligations with a given country's GDP, but with its GDP generation-based tax receipts. In the US, federal government debt was up $674bn in the month of November 2015 to $18.8trn, and debt equated to 5.9x federal government's 2015 tax receipts! No bank would give an individual a loan whose debt exceeds income by six to one; he/she would be shown the door. Ultimately, the same holds true for a country, which is nothing more than a collection of individuals and their (collective) solvency.

"A bridge too far?"

So our nearly 45-year old global "Keynesian consensus" coupled with increasingly widespread and aggressive "central bank financing" has brought us unprecedented moral hazard, misallocations, debt mountains, sovereign solvency risks, derivative "weapons of mass financial destruction" liquidity/balance sheet risks, interest rate normalization susceptibility, and fiat currency instability. This toxic public policy stew has set the stage for massive deflation as claims on output and the associated assets inevitable prove "a bridge too far." Even if a political mandate -- policy driven by makers instead of takers -- could be achieved that would underpin an ASAP return to rule of law, property right protection sanity/sanctity, and thus functioning free market capitalism or the invisible hand of Adam Smith and the associated and vital "creative destruction," the global statist/fascist legacy damage is so profound and prevalent that a huge debt-based deflationary collapse would be very difficult to avoid, in our view. (Noteworthy corollary: the same collapse would almost certainly usher in a globally unrivalled "beggar thy neighbor round of "money printing"/bond buying, which would ultimately lead to a worldwide fiat currency supernova repudiation.)

It is precisely this "bridge too far" that will eventually arrest the cancer-like growth in economic output claimants, especially creditors. Moreover, these same creditors, unfortunately including Main Street pension asset owners, will find that the more synthetic (derived from underlying assets), tertiary, and especially subordinated their claims toward the top of the "inverted pyramid" at the top of page one are, the larger their losses will likely be. When central planners/central bankers can no longer overwhelm, at least initially and certainly not permanently, via financial repression-based Keynesianism, a loss of investor confidence related to rising insolvencies, the laws of economics will once again trump the laws of politics. When, not if, this happens, creditors will seek to flee illiquid assets featuring poor creditworthiness. This will, once again, literally collapse non-investment grade asset valuations, as has already been happening around the globe in domestic junk bonds and EM junk bonds as evidenced by rapidly rising spreads (above 10-year Treasuries):



A continuation of collapsing junk bonds, many of which feature material exposure to collapsing commodity prices as well as to emerging markets, are the precursors to what will likely prove to be numerous bankruptcies and the threat of a complete loss of capital for those invested in insolvent enterprises/states. Moreover, the upcoming bankruptcy-based deleveraging will exert material pressure on global savings as invested in bonds and in terms of overall portfolio values. An "asset repricing" has arguably already commenced, with stock markets off to a record bad new year kick off and spreads rising markedly. The repricing, if sustained, also threatens to unleash a daisy chain of derivative losses so massive (e.g., there are over $400trn in largely off-balance sheet, unbacked interest rate derivatives outstanding) that the entire global banking system may be threatened. *In short, faith in the redeemability, much less capital preservation capacity, of an unprecedented quantity of QE-birthed bonds as well as a growing plethora of derivative assets* which either a) feature progressively lower interest rate coverage ratios, and/or b) are far removed from the underlying, and/or c) are held in "Street name," and/or d) contain substantial hypothecation/re-hypothecation ("your" securities lent out once or more as collateral) risks, *will likely crumble*. And so could faith (confidence) in the whole worldwide, dollar-based "fiat currency edifice."

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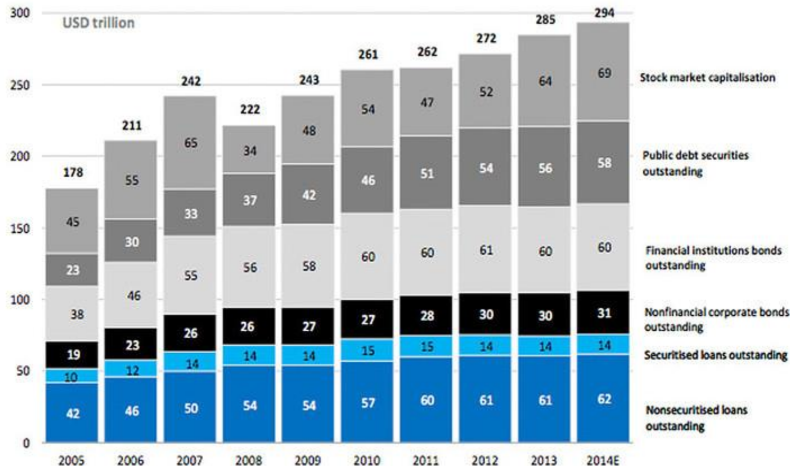
In a nutshell: if the past is any indication of the future, rapidly vanishing confidence "reinforced" by spreading insolvencies will cause valuations of assets removed from the solid "silver and gold" bottom wedge of the inverse pyramid to plummet rapidly -- think reversion beyond the mean. As such, global financial assets, which exceeded $300trn for a time in 2015 (consider that the value of global financial assets or the claims on output rose by a stunning $8.3trn p.a. in value on average from 2000 through 2014, out-legging global nominal GDP growth by approximately 3.5:1 over the same time period and making annual gold extraction of roughly $110bn look like a peanut), are set to fall materially in value, potentially extinguishing significant amounts of capital in their wake, including increasingly "shaky" and still overvalued bonds. This suggests huge deflationary forces ahead as wealth, pension assets, purchasing power, and confidence all take it on the chin.



Sources: McKinsey Global Institute, Haver, BIS, Deutsche Bank estimates, author Wallace Witkowski

Confidence in wanton central bank "counterfeiting" ultimately transient; is the end nigh?

History (the Tulip Mania, the Mississippi Bubble, Argentina, the former USSR, etc.) has shown that when fiat currencies -- or currencies whose monetary base expansion is not governed by growth in above ground silver and gold reserves, which expand by 1% – 2% p.a. or roughly in sync with real economic growth since we've harnessed dense energy -- are "printed" into new creditor/owner claims existence at a rate substantially above an economy's output growth for a protracted period of time, those same debt-laced currencies and the bonds they are inexorably tethered to are typically either reduced to a fraction of their earlier value/buying power or rendered worthless. Clearly, the enormous and cumulative distortions related to the unequaled, global "post 2008" QE-financed Keynesianism, be they misallocations, drooping productivity, a decline in the rule of law, property right eviscerations, "too big to fail" moral hazard, and/or unsustainable financialization-based bond and stock bubbles, will not stand the test of time.

Said differently, our progressively more global toxic public policy stew (fiat politics) will be pierced by economic reality. Each time the laws of economics trump politics and asset price manipulations are pushed aside by "market forces," the statists double-down on yet more QE-financed Keynesianism, resulting in even bigger bond and stock valuation bubbles and perpetually growing solvency risks/debt. Eventually, confidence in unrivalled and increasingly worldwide central bank counterfeiting will be shattered (unlike "QE Greenspan being knighted," if you or I created money out of thin air, we'd be in the slammer for a mighty long time!). It will manifest itself in a potentially massive decline in the value of bonds, which dominate global financial assets, as investors again insist in achieving real yields as well as being compensated for hugely increased insolvency and monetary inflation risks. It will conspire to get people to reallocate a portion of their dissipating wealth into the only true historical store of value and the ultimate form of money, otherwise known as silver and gold.

We think that a global flight to liquidity and solvency may well have already commenced in the early days of 2016. Physical gold, and by extension physical silver, is a monetary metal whose value is based on its scarcity, the extreme difficulty and rising cost of mining, its universal acceptance as money and as a store of value over the ages, its fungibility, its portability, and its permanence (it doesn't rust). Paper money is "somebody's debt," and there's never been so much; US debt has risen over 70% or by $7.7trn from $11.1trn to $18.9trn and counting since Obama was first sworn in, and federal government

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debt accumulated under Obama's administration thus far constitutes 70% of all the accumulated debt by the federal government since America's founding (prior to Obama's presidency)! And the rest of the world doesn't look any better.

Gold, on the other hand, is pure wealth. As both growing illiquidity and expanding losses impact the top half of the inverted pyramid, history suggests a rush will be on for scarce physical gold and silver. Plus, on balance global investors are very "precious metals light," assets which constitute less than 0.5% of portfolio value versus upwards of 1.5% previously. Moreover, because newly-mined silver and gold are so scarce (at current prices per Troy ounce, only about $13bn worth of silver is mined annually and only about $110bn worth of gold) and because deliverable above ground stocks are a "rounding error pittance of global portfolio value," limited supply and "manipulated down" precious metals prices juxtaposed against what could be a multifold increase in precious metals demand suggests a substantially higher equilibrium price for silver and gold (the supply curve "shifts up") in the making.

Is a perfect asset valuation reset storm in the making as investors rush to the narrow bottom of the inverted pyramid on page one? We think so. Moreover, we think you should consider selling what the central banks buy (bonds and even stocks) and buying what the central banks, directly or through their surrogates, legally or illegally, pummel, such as physical gold and silver. Plus, and harking back to this post's title, let's look at how gold performed during the deflationary 1930s when President Roosevelt "stole it" from citizens via his "Executive Order 6102" issued on April 5th, 1933. FDR's gold confiscation meant private owners were obliged to take their coins, bars or gold certificates to a bank, and then to exchange them for dollars at the prevailing rate of $20.67 per ounce. Over the next year, FDR raised the official gold price to $35 per ounce, yielding a bonanza of 69.3% for the government and property right theft of 40.9% for those citizens that sold their gold to the government! Is this a preview of coming attractions on the gold price front in light of the massive OECD government-based gold and silver-based price suppression? We think so.

Conclusion:

We know from history, from endlessly regurgitated central bank press releases, and from "QE action" that central banks will (continue to) fight debt-based deflation with the printing press, "results be damned." Untold monetary base expansion will most likely be initiated, as Keynesians double-down on monetary debasement insanity, the ultimate inflation threat that has rendered paper money worthless or near worthless time and time again. History is replete with examples, from early China (inventor of paper money) to numerous Latin American countries to African nations to the Weimar Republic to Hungary to the former USSR. In contrast, a fine suit could long be purchased with an ounce of gold, regardless of how much fiat currency was called for.

The likely sequence after several rounds of QE already under our chafing belts, if history and our "long in the tooth" business (up)cycle are still apt guides: markedly increasing global economic weakness, collapsing asset values, and debt-laced deflation followed by absolutely mind-bending global money printing setting the stage for global fiat currency destruction/untold inflation as countries engage in "beggar thy neighbor" currency wars and finance yet more destructive Keynesianism (our toxic public policy stew). Hello to a truly virulent form of stagflation (negative real economic growth juxtaposed against galloping inflation) building in the global pipeline. Hello Brazil, hello Venezuela, hello Angola. And what about South Africa and perhaps even Canada if their currencies continue to plunge? Are these previews of spreading global stagflation attractions that follow on the heels of debt-induced deflation? We think so.

Whether we stagnate in debt-based deflation, or our counterfeiting central banks propel us into Latin American style stagflation, either scenario is very bullish for physical gold and silver prices as currently expressed in US dollars. Given our "unwealth of nations" global trajectory, satellite precious metals allocations are surely the best portfolio insurance/wealth maintenance assets available. But time may be short. And, to top it all off, when fiat currency regimes implode, countries inevitably revisit silver and gold-backed currencies. We have never, ever, until the August 1971 termination of the dollar gold standard, been in a world where all currencies are fiat currencies, i.e., unbacked by physical silver and gold holdings. Consider, as an adjunct to substantial potential portfolio reallocation demand toward more traditional precious metals holdings, the demand for very scarce precious metals if the upcoming currency reform(s) bring back silver and gold backing, which history clearly suggests will be the case. Then juxtapose this against precious metals scarcity.

They say that a picture is worth a thousand words, so we will leave you with this potential preview of coming attractions: a Silver certificate (guess what this could be?!). Silver, not just gold, has historically been a monetary metal, and silver is currently artificially undervalued relative to gold at over 75:1 per Troy ounce versus its natural "get it out of the ground ratio of approximate 15:1." For recent proof of silver's monetary history, which dates back to Imperial China, consider what was written on a one-dollar bill 52 years ago: **One Treasury** (not Federal Reserve Note) **dollar payable in silver** to bearer on demand! Silver was money in the US from 1787 (when the US Constitution was signed) through to 1964.

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We hope you've found this post of interest and use as we look into the abyss of global debt-based deflation which will, no doubt, be addressed with the only "toolkit" used by increasingly totalitarian governments the world over, the (electronic) printing press. "Run" to the bottom of that inverted pyramid on page one with a portion of your investable assets, and consider silver on par with gold! Traditional Swiss private banking customs suggest up to 10% of your portfolio value should be in precious metals. Do remember that only physical precious metals held outside of the banking system are called for. And please recall this: gold's and silver's store of value/purchasing power protection attributes are not only debt-induced deflation-based, but QE-engineered currency debasement/inflation-based. Call precious metals a debt-deflation, QE-inflation-based satellite allocation diversification barbell for an era in which we have forsaken sound money, the rule of law, and property rights!

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Greetings,

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