

Returns, valuations, and allocations May 2015 update

Precious metals focus; gold: \$1,206 per Troy ounce, silver: \$17.17 per Troy ounce (5/21/2015)

Dollar price of gold per Troy ounce:



Source: <http://research.stlouisfed.org/fred2/series/GOLDAMGBD228NLBM>

Global financial situation developments:

Global stock of debt in mid-2007: \$142trn or 269% of global GDP

Global stock of debt in mid-2014: \$199trn or 286% of global GDP

OTC interest rate derivatives* outstanding 12/2007: \$393trn

OTC interest rate derivatives outstanding 12/2014: \$505trn

* Banks issue contracts that protect debtors against rising interest rates; banks' profound exposure to rising interest rates is a "systemic risk" magnified by "ZIRP" (zero interest rate policies); since mid-1600s, avg gov't bond yield: 4%

Sources: MGI Country Debt Database, McKinsey, BIS, James Dale Davidson

As stated in March, I want to continue to update you on developments I discussed in January's "market outlook" presentations. For additional commentaries, please click on the following link: <http://dkanalytics.com/wp-content/uploads/2016/10/16>Returns-valuations-allocations-January-2015.pdf>

While my March missive focused on energy, specifically oil/fossil fuels, this commentary will center on precious metals (gold and silver) as timely satellite allocation assets.

Summary:

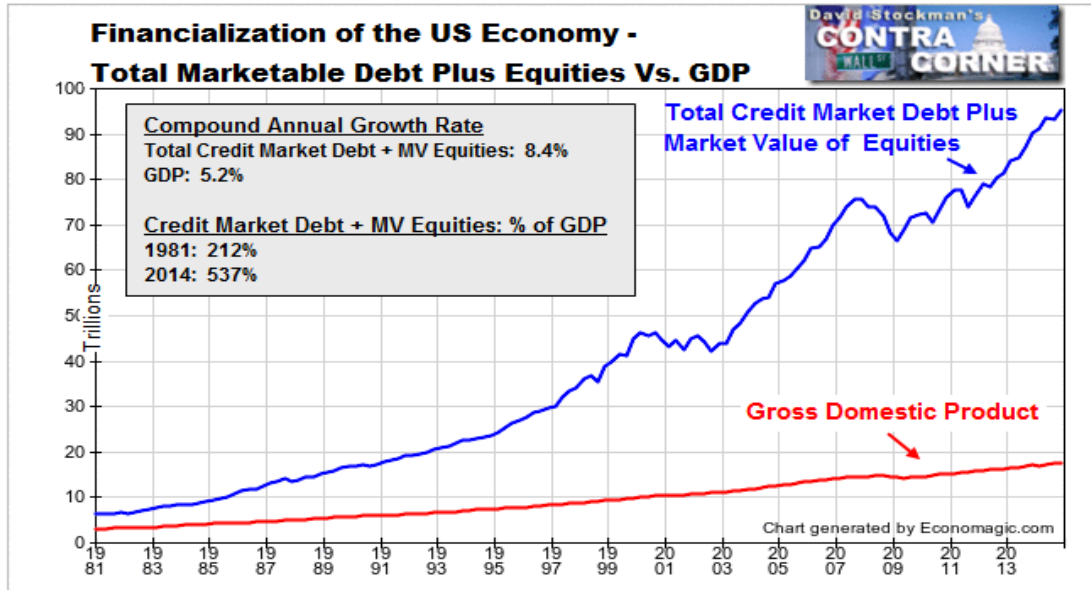
I continue to be of the opinion that physical gold is a timely "portfolio insurance" allocation. This is because a) gold typically rallies when confidence is lost/during financial crises (as in the 2008/2009 credit crisis and stock market meltdown), b) because there are signs pointing to a potential financial imbroglio "dead ahead," c) because gold (even more true for silver) is undervalued relative to the massive increase in the global monetary base since 2008, d) because precious metals prices have been in a nearly four-year bear market, and e) because gold and silver mining losses have multiplied, pointing to material supply bottlenecks down the road.

Plus, there is a possibly substantial 2015 gold upward revaluation wildcard: China's 2015 bid to be part of the SDR alternative currency regime, which will require it to disclose its gold reserves. China last updated its gold reserves in 2009. Based on upon large Chinese gold purchases since 2009 and on Chinese gold mining statistics (China has become the world's leading gold miner, and no domestically mined gold may leave the country), it is conceivable that China has accumulated up to 10,000 metric tons (MT) of gold, up from 1,054 MT in 2009. A declaration to this effect would shed light on just how much gold must have left western vaults to satisfy Chinese import demand. Such a declaration would highlight the scarcity of physical gold and point out that, as far as the Chinese are concerned, gold is money, which could precipitate a demand-based gold scramble. Meanwhile, robust BRICS demand for gold continues to soak up the increasingly challenged global mined supply.

Overview:

Sustained, outsized growth in the monetary base by the Fed leads to above real GDP money supply growth; this is how "fractional reserve monetary systems," such as ours, work. And this is what has occurred over decades, with a dramatic acceleration as of 2008 to a) initially provide liquidity, and b) to effectively assure solvency in a "\$1trn federal deficit era." That same monetary policy has led to a multi-decade trend of swelling "GDP financialization:"

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Source: http://davidstockmanscontracorner.com/a-tale-of-two-graphs-why-bubble-finance-will-fail/?utm_source=wysija&utm_medium=email&utm_campaign=Mailing+List+PM+Monday

The financialization of GDP is a testament to both outsized growth in debt relative to nominal GDP growth and to marked P/E expansion (“market value of equities”), which has been underpinned by a secular bull market in bonds extending over three decades. As benchmark interest rates fell, so did the “equity discount rate,” resulting in multiple expansions and thus elevated net present values (NPVs), also known as stock prices.

The financialization of the economy since the early '80 has continued in the new millennium, “the law of large numbers” notwithstanding, as is readily visible above. The great enabler: the FED, be it via its sustained and unprecedentedly low interest rates or zero interest rate policies (ZIRP) and/or via unprecedented purchases of government and agency bonds (obliquely labelled QE or quantitative easing) in the aftermath of the 2008 financial crisis, which have quintupled the Fed balance sheet in five short years:

Adjusted Monetary Base of the Federal Reserve



Source: <http://research.stlouisfed.org/fred2/series/BASE>

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Commensurately, both over-valuation and excessive debt levels have become large risks to portfolios heavily invested in stocks and bonds, be it of the domestic or international variety, for leading global central banks, as a group -- the Fed, the BOE, the BOJ, the ECB, and the SNB -- have been doubling down on bond and, increasingly, stock market “levitation” for over five years. In their collective wake: bond and stock market bubbles (overvaluations) as far as the eye can see, including a recent, brief, and unheralded \$5.3trn worth of government bonds featuring negative yields. Now even the People’s Bank of China is set to join the fray, and in big way. Copious details as regards galloping global monetary malfeasance can be found here:

- <http://davidstockmanscontracorner.com/this-is-nuts-5-3-trillion-of-government-bonds-now-have-negative-yields/>
- www.zerohedge.com/news/2015-05-13/its-official-boj-has-broken-japanese-stock-market
- www.zerohedge.com/news/2015-05-13/china-goes-unconventional-effort-tackle-trillions-debt-rescue-economy
- <http://dkanalytics.com/wp-content/uploads/2016/10/13-Strategic-allocation-musings-June-2014.pdf>, p. 5
- www.zerohedge.com/news/2014-06-15/cluster-central-banks-have-secretly-invested-29-trillion-market

To add insult to overvaluation injury, yield spreads (corporate yields less 10-year Treasury yields) have shrunk to levels that have severely eroded returns and simultaneously reduced the margin of safety from either an interest rate shock or an issuer balance sheet perspective, given sustained debt-based stock buybacks by Corporate America:

BofA ML US Corporate AA Option-Adjusted Spread



Source: <https://research.stlouisfed.org/fred2/series/BAMLC0A2CAA>

“Financial alchemy” has no more proven the test of time than alchemy, i.e., the transmutation of common metals into gold. Yet Keynesian dogma combined with suppression of market-based valuations thanks to unparalleled global financial repression in the form of central bank “QE” and “ZIRP” has resulted in unprecedented, global “too big to fail moral hazard” on the one hand and taxpayer financed fortunes for market speculators and banker bailouts on the other hand. Just as surely as common metals cannot be turned into gold, bubbles that get bigger and bigger, burst. When they do, investors flee to time-proven stores of value, physical gold and silver. The fact that global investors are historically very precious metals under-allocated -- gold recently represented less than 0.5% of global financial assets, down from nearly 5% in 1968 and almost 3% in 1980 (CPM Group, McKinsey, NAMCO calculations) -- suggests huge re-allocation-based upside price potential. This is all the more true considering that going from 0.5% to 1% at current asset prices would require about nine years of mining at current extraction rates!

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Gold price “emancipation:”

First, it is a well-established fact that the “paper gold” claims to physical gold outnumber available gold by 100:1 (<http://dkanalytics.com/wp-content/uploads/2016/10/19-Gold-update-slides-May-2015.pdf>, slides 9 and 10). Implication: at some point, settlement in physical gold, versus paper settlement, will be “forced.” This would uncover a huge shortage of deliverable, physical gold, thereby triggering a pronounced upward gold price reset. A potential catalyst: the Shanghai physical gold exchange. Trading there and/or at other Asian-based physical precious metals exchanges could well bring with it the beginning of a global arbitrage between paper gold and artificially cheap physical gold, catapulting gold prices higher (www.maxkeiser.com/tag/shanghai-gold-exchange/).

Second, there is a growing “disconnect” between financial repression and the gold price. The discrepancy between the bear market gold price and bull market in stock and bond prices (<http://research.stlouisfed.org/fred2/series/SP500>; <http://research.stlouisfed.org/fred2/series/IRLTLT01USM156N>), is arguably best captured by the nearly four-year divergence between the Fed’s balance sheet and the price of gold:

Fed balance sheet (yellow line) versus gold’s dollar spot price (white)

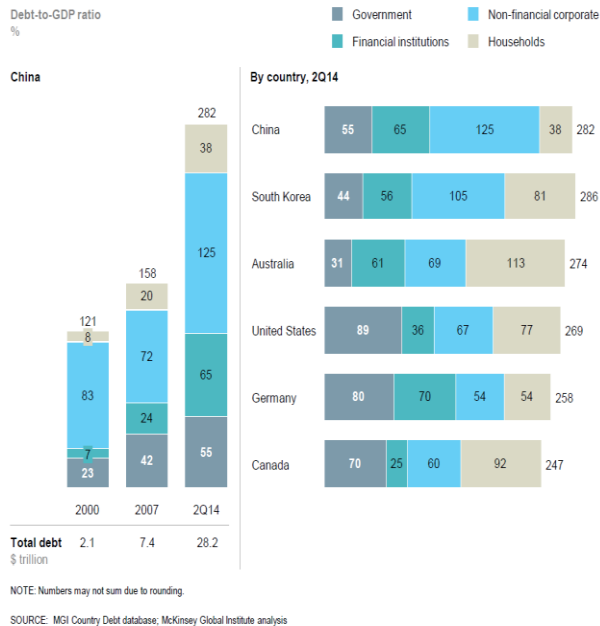


Source: Bloomberg

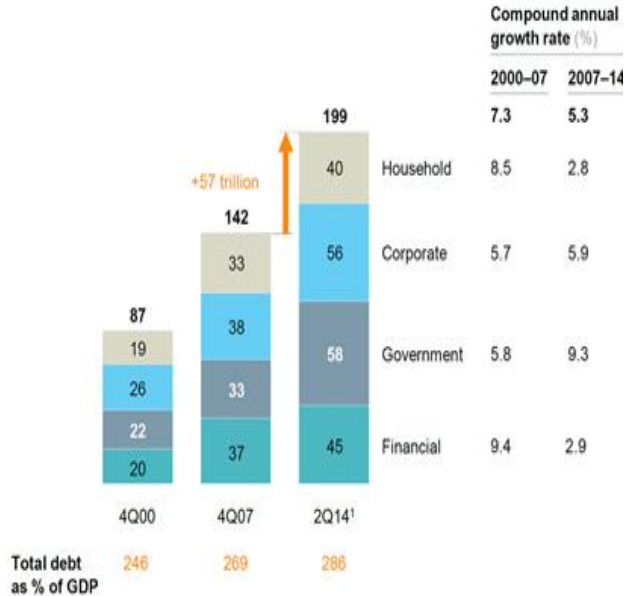
The above divergence also illustrates gold’s (and, by extension, silver’s) *current* upward potential to roughly \$1,900 per ounce. In a fractional reserve banking system, changes in the central bank’s balance sheet invariably get reflected, over time, at the money supply level and thus in inflation, else central bankers would have no justification for “balance sheet manipulation” and inflation targeting! Translation: the Fed (and other central banks) have not only been the liquidity-based lenders of last resort, but these institutions have become the enablers of debt-fueled Keynesianism, yield starvation, and cronyism, which collectively have come to increasingly typify economic/political policy not only the US, but of virtually all OECD nations. Even China is now turning to QE to prop up the corrosiveness of central planning, which has led to huge misallocations (“monuments” such as dozens of Chinese ghost cities) and a 13-fold jump in debt in less than 14 years:

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China's debt reached 282 percent of GDP in 2014, higher than debt levels in some advanced economies



Global stock of debt outstanding by type¹ \$ trillion, constant 2013 exchange rates



In other words, given governments' sustained "Keynesian QE" coupled with progressively more challenging global balance sheet and aging issues (https://www.credit-suisse.com/pwp/am/downloads/marketing/trends_05_2010_dossier_eng.pdf), investors can be virtually certain that our wealth of nations-detrimental, financially-and-economically-unsustainable trajectory will be carried forward until it can't be. That is, until investors lose confidence in the efficacy of financial repression and they begin to sell overvalued securities in possibly large numbers. This will result in bigger-than-ever capital markets overpowering central banks and in so doing, wresting back asset price determination.

If history is any guide, such asset valuation resets will happen with a vengeance, or "virtually overnight." This is all the more true given a) the markedly intertwined, global financial markets as typified by interest rate sensitive "bank-to-bank counterparty risks" of in excess of \$500trn (29x the size of America's 2014 GDP), b) the fact that asset price-determining central banks the world over have created thin bond and stock markets, and c) the reality that the QE-enabled, fractional currency-based global growth of debt to GDP greatly increases creditors' claims on economic output. Bondholder revolts can happen at any time if creditors believe that their capital is at risk, such as when interest rates are paltry or worse amidst rising monetary inflation and solvency risks, such as now.

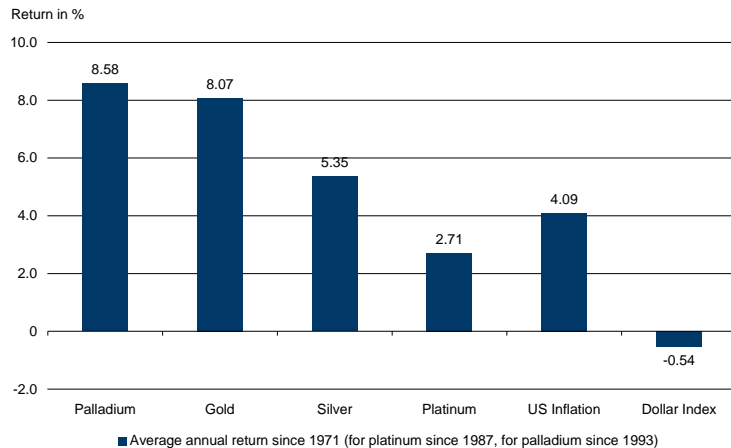
Precious metals-based portfolio protection:

Physical gold and silver ownership offer protection against any upcoming, likely swift, asset valuation resets -- *in this case, potentially materially lower global stock and bond prices*. A preview of coming attractions could be this January's Swiss franc liberation from its CHF 1.20 per euro peg and the ensuing, same day 15% – 30% currency, stock, and bond price fluctuations. In theory, future resets could potentially make 2008 look like a "warm-up," for our debt-mountain, misallocation, and valuation excesses have increased materially since then, given "policy."

Such resets will likely trigger a debt-induced deflation, profound losses of capital, and potentially a depression, as happened in the 1930s. Noteworthy is the fact that dollar price gold in the depressionary '30s rose by 69% (<http://onlygold.com/Info/Historical-Gold-Prices.asp>). Gold has also proven to be a great store of value/a purchasing power preservation asset during periods of continued currency debasement, such as in the post dollar gold standard as of August 1971:

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Returns of precious metals, inflation, and the USD Index



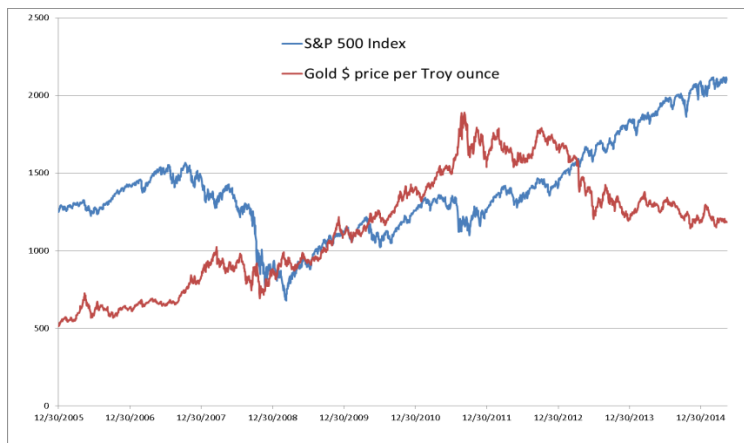
Requisite clarification:

“Real world” US consumer price inflation since 1971 -- i.e., stripped of “hedonic adjustments” & “substitutions” (e.g., from steak to hamburger) and endowed with a “real world” consumption basket (where medical outlays are 30% of a family’s budget vs. BLS’s 1%!) featuring “real world” inflation experience (24.2% health insurance inflation over four years thru 2012 vs. BLS’s 4.3% claim) -- **was approximately twice the BLS’s 4.1% p.a. tally below. Upshot: strategically speaking, physical gold preserves purchasing power!**

Sources: BLS, www.shadowstats.com/, www.europac.com/commentaries/inflation_propaganda_exposed, Bloomberg, CS

Let me “square the gold performance conundrum circle” with the following truism: historically, the path to hyperinflation has led through QE-enabled debt mountains, which over time lead to debt-induced (not constructive, productivity-driven!) deflation, which is “offset” progressively more with the printing press, which leads to currency debasement/inflation, which bodes well for nominal gold prices. Upshot: physical gold -- and in a typically leveraged, more volatile fashion, silver, if one includes the white metal’s historical monetary metal status -- has stood as an extraordinarily good store of value against the ravages of either debt-induced deflation or QE-fanned inflation. In reality, these two economic contortions are tied at the hip and gold, in a fiat currency era such as ours since 1971, anticipates the latter in the midst of the former.

Let us focus on the more recent past. Perhaps the valuation developments of 2008 and 2009 are of interest to investors looking to add precious metals holdings (physical holdings avoid counterparty risks) for diversification, negative correlation, and capital preservation purposes, should a credit crisis and/or a bear market be around the corner. Let’s take a look at how gold, priced in \$ per Troy oz., fared during the 2008 – 2009 financial crisis vs. the S&P 500’s performance over the same period. The S&P 500 ended 2007 at 1,468; gold stood at \$837 on 12/31/07. The S&P 500 ended 2008 at 903, down 38.5%; gold stood at \$865 on 12/31/08, up 3.3%. The S&P 500 ended 2009 at 1,115, up 23.5% for the year, but still down 24.0% from its 2007 closing price; gold stood at \$1,104 on 12/31/09, up 27.6% for the year and up 31.9% from the yellow metal’s 2007 closing price. For a graphical depiction:



Source: <http://research.stlouisfed.org/>

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That said, let us recall that credit (bond) markets are multiples of equity markets' in terms of capitalization, whether in the US, Europe, or Asia. And the world runs on credit, and credit IS currency (while gold is a store of value or "real money"). Without functioning credit markets, production, distribution, most services, real estate transactions, and all currency-based financial transactions would cease, and our daily lives would be turned upside down.

To repeat: all currencies today are a function of -- and exist solely as a result of -- operational credit markets. When confidence in debt-based currencies or in the soundness of money center bank balance sheets wilts, credit -- and thus liquidity -- can dry up in a hurry, as reflected by huge increases in interbank lending rates in 2008 and in the ensuing, unparalleled liquidity injections by the Fed and the Treasury. Declining confidence can also manifest itself in rapidly rising government bond yields. Case in point: the safest 10-year European government bond, the German Bund, yielded below .05% in late April 2015. That yield rocketed to .76% (+1,420%) just recently. The historical beneficiaries of a sustained reduction in confidence: scarce gold and silver (annual silver extraction < \$14bn!). <http://goldsilverworlds.com/physical-market/global-silver-production-fits-one-silver-pyramid/>

Risks for precious metals investors:

The fiat currency power brokers may continue to succeed in sustaining striking asset price manipulations, which would suppress precious metals prices, i.e., until economics trumped politics (question of "when," not "if").

Conclusion:

Gold and silver have long served as historical stores of value/as purchasing power preservation assets. Silver, demonetized by governments in the 20th century, was considered legal tender by Ancient Romans in 225 BC, by the Chinese early in the 15th century, and also by our liberty and property rights inspired Constitution of 1789. It is still considered money in much of the population-dominating developing world, and as such stands to be remonetized. Silver is also a very scarce metal that is experiencing ever greater industrial demand; call it a de facto monetary metal with significant industrial applications upside potential. Translation: much more volatile (than gold) silver could offer "gold on steroids" satellite allocation appeal to select strategic accounts capable of handling much larger valuation swings. As such, silver could complement, in a junior manner, a gold position. In summary, with:

- Financialization of global GDP at unparalleled levels post WWII levels even as GDP tallies become increasingly "inflated" (www.zerohedge.com/news/2013-04-21/us-gdp-will-be-revised-higher-500-billion-following-addition-intangibles-economy, <http://www.dw.de/german-gdp-swells-on-sex-drugs-and-weapons/a-17853092>, www.dailymail.co.uk/news/article-2888416/Who-said-crime-doesn-t-pay-Counting-prostitution-drugs-GDP-figure-seen-UK-s-economy-overtake-France-fifth-largest-world.html)
- Financial repression-based misallocations and asset bubbles the rule instead of the exception
- Global economic weakness becoming more pronounced amidst rising debt mountains and sustained QE
- Increasingly widespread evidence on hand that precious metals prices are being manipulated and the related "short squeeze-based" capital gains potential that this portends (www.amerigold.com/the_seer/index.php?content_id=61, www.bloomberg.com/news/articles/2014-02-28/gold-fix-study-shows-signs-of-decade-of-bank-manipulation)
- A four year bear market in gold and silver nearly in place amidst supply issues due to loss-making mines
- Confidence in the management of the global monetary/finance/political system ebbing ("slippery slope")
- Various monetary authorities moving to limit cash withdrawals from savings/checking accounts and to effectively reduce cash-based transactions, which paves the way for "money capture" and negative interest rates (www.gold-eagle.com/article/why-war-cash-really-war-freedom#.VV0lBTiBEEmM.mailto)
- Customer deposits in banks having the little-known legal status of "unsecured creditor funds" in the US and elsewhere in the OECD (www.huffingtonpost.com/ellen-brown/banks-confiscation_b_2957937.html)
- Bail-in legislation increasing across various jurisdictions and regulatory oversight forthrightness towards creditors being questioned more frequently
- The laws of economics always eventually trumping politics, ...

... negatively correlated (to stocks, bonds, and currencies) precious metals present strategic investors with valuable portfolio insurance.

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