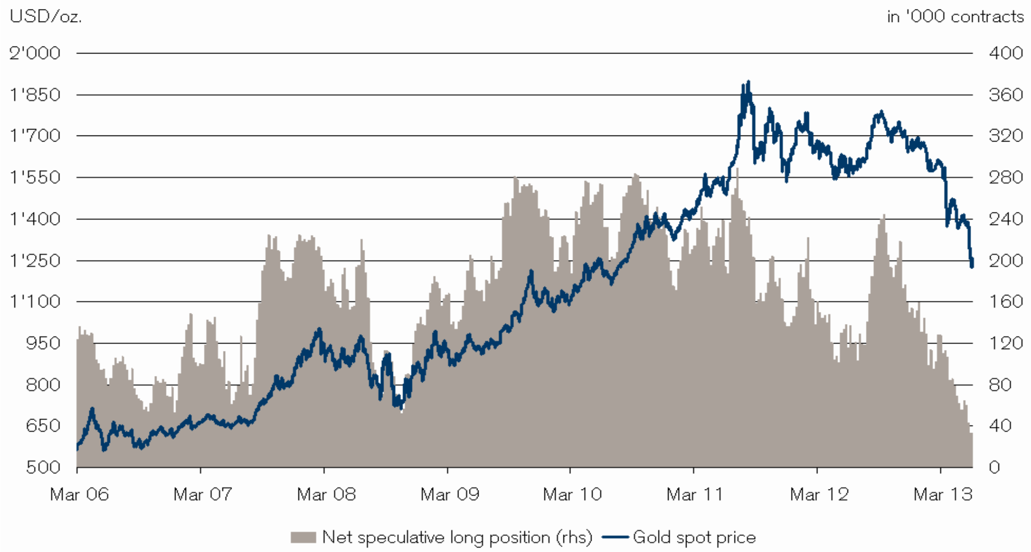
Scarce physical gold: a new purchase opportunity

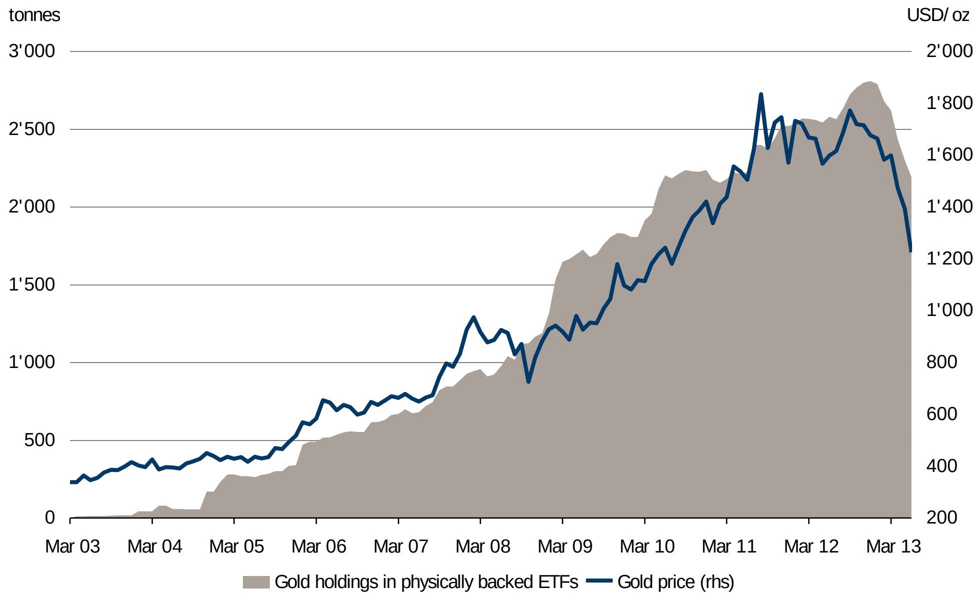
July 13, 2013, Dan Kurz, blogger

Summary:

The price of gold per oz. plummeted by 23% in Q2:13 to just over $1,200, the largest quarterly drop on record, in sync with plunging speculative long positions and marked liquidations of gold holdings in physically-backed ETFs:



Sources: Bloomberg, Credit Suisse



Sources: Bloomberg, various fund providers, Credit Suisse

In sympathy with the gold price rout, Wall Street has loudly proclaimed that the gold bull market is officially over; that we are now embarked on a solid economic recovery featuring smaller government deficits and well-behaved inflation, to boot. Looks like "Goldilocks, revisited," to many investors. Downside gold price speculation is the new order of the day; will we dip to $1,000 per ounce or go lower still? This report will argue that the underpinnings of a sustainable, "hard money," productivity-endowed, inflation-free economic expansion are not in the cards. In fact, continued spectacular increases in federal regulations (6,500 new postings during the past 90 days), the implementation of the Affordable Care Act or Obamacare (http://www.washingtonpost.com/blogs/post-politics/wp/2012/10/03/obama-likes-obamacare/), rising taxation, growing indebtedness, a sustained decline in the rule of law (http://online.wsj.com/article/SB10001424127887323981504578177913940268102.html?KEYWORDS=America+as+rule+of+law+nation), and a still very accommodative monetary policy suggest that the deck remains stacked against the purchase of highly-valued, "yield deprivation-impacted" paper assets and tilted in favor of scarce real assets. This rings especially true for scarce physical gold (supply rising at 1.5 – 2% p.a.), the only timeless medium of exchange (money) that appears poised to continue to serve as a store of value during periods when a "wealth of nations" trajectory is not on offer, such as now. Upshot: the current correction will likely prove to be an attractive physical gold buying opportunity given the economy's and the financial markets' "quantitative easing (QE) addiction," which will not be masked for long. It is in this sense that strategic allocations of 5 - 10% of portfolio value are suggested.

Why it's unlikely to be "Goldilocks, revisited" (economy not too hot, not too cold, but just right)

When the annual US cost of regulatory compliance (http://cei.org/studies/ten-thousand-commandments-2013) reaches an estimated $1.8trn, an amount which exceeds the combined GDP of Canada and Mexico, regulations continue to grow explosively (http://www.regulations.gov/#!home;tab=search; http://news.cnet.com/8301-13578_3-20014563-38.html), and taxes are on the rise (http://www.hoisingtonmgt.com/pdf/HIM2012Q4NP.pdf), private sector incentives to employ workers, risk capital, and produce affordable services and goods diminish. And this is prior to considering the costs of an increasingly litigious society (http://townhall.com/columnists/carlhorowitz/2013/01/05/obama-race-and-affirmative-action-why-the-second-term-will-be-worse-part-i-n1479259/page/). It is also prior to the ramp-up of Obamacare, which is over 2,700 pages long with another 13,000 pages of regulations that will call for an additional 16,500 IRS agents to administer, while encouraging small businesses to forgo personnel expansion beyond 49 employees and/or to push full-time workers into the part-time (29 hours or less) category to escape punitive Obamacare payroll contributions. Meanwhile, healthy consumers will not only be in for sticker shock, but they will see their purchasing power for other services and goods eroded, further denting economic vitality (http://online.wsj.com/article/SB10001424127887324251504578577760224985382.html?mod=ITP_pageone_0).

In light of "all that," is it any wonder that June 2013 full-time employment plunged by 240,000, that part-time employment rose by 360,000, and that the U6 unemployment rate has remained stubbornly in "double-digits" since 2009, jumping to 14.3% in June 2013 from 13.8% a month earlier? Or that short-term discouraged workers rose by 247,000 in June, to 1,027,000, from 780,000 in May? Or that full-time employment year-to-date (YTD) is only up by 30,000 positions while part-time jobs YTD grew by 570,000 (BLS)? Or that food stamp recipients rose from an average of 28.2m in 2008 to an average of 46.6m in 2012, a 65.2% rise, to one out of seven Americans by year-end 2012 (http://www.fns.usda.gov/pd/SNAPsummary.htm)? Or that disability benefits have risen from $37.2bn in 2008 to $46.2bn in 2012, a 23.9% increase (http://www.socialsecurity.gov/policy/docs/statcomps/ssi_asr/2012/sect01.pdf)? Contrast these developments with all nonfarm employees inching up only 0.2% from December 2008's 134.4m tally to December 2012's 134.7 million number (http://research.stlouisfed.org/fred2/data/PAYEMS.txt) for a "Goldilocks, revisited" reality check.

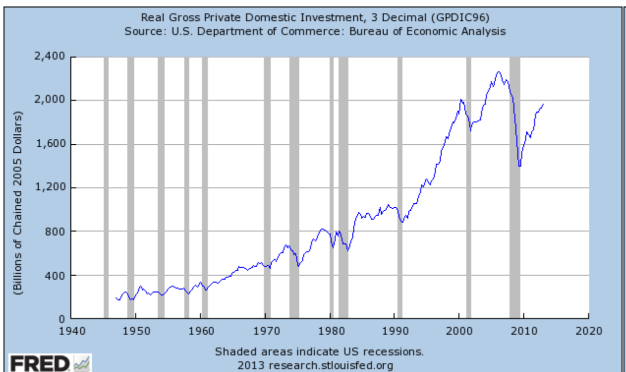
Suffice it to say that neither the aforesaid "public policy cocktail" nor the rising dependency rates are likely to boost private sector employment, lift consumers' purchasing power or rein in government deficits (the federal government has been borrowing roughly 50 cents of every dollar it has spent over the past four years) and, by extension, debts. As such, substantial public sector deficits are apt to continue to be materially financed by "fiat money/QE." (Sustained QE is the wellspring of an outsized increase in money and credit relative to available services and goods, otherwise known as inflation.) Current case in point: according to an American Business Analytics & Research July 9th, 2013 report, from the beginning of 2013 through early July, the Fed, via QE3, has purchased 90.5% of the US government's net issuance of debt. The Fed's total holdings of Treasury securities as per end June 2013: $1.928trn.

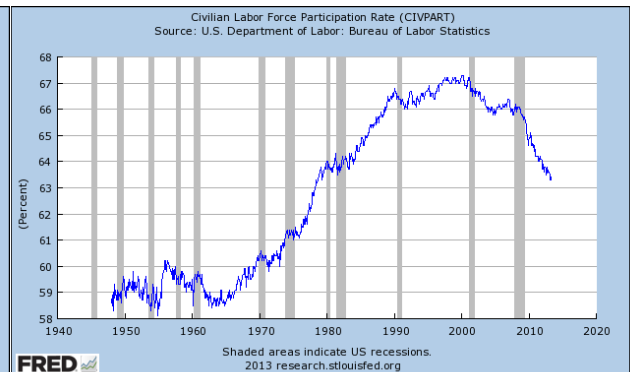
For those reading a lot into the recent FY2013 federal deficit contraction projection by the CBO, to a not exactly pedestrian $642bn, some words of caution:

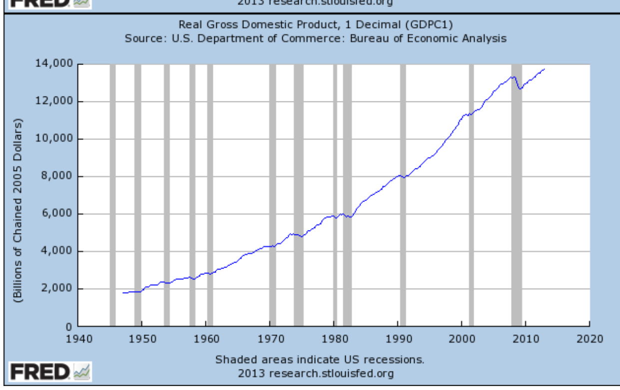
- The CBO's forecasts are to be taken with a grain of salt: "In 2000, both the OMB and the CBO projected decade-long budget surpluses. Moreover, both agencies projected that publicly held government debt (then about $3.5trn) would be eliminated by 2010." (http://research.stlouisfed.org/publications/review/12/01/21-40Kliesen.pdf)
- FY2013 federal tax receipts are being flattered by substantial nonrecurring tax receipts derived from taxpayers' accelerated asset sales in late 2012 in order to avoid higher tax rates in 2013
- Fannie's and Freddie's recently "fat" portfolio profit checks to the Treasury, on the back of QE-sponsored mortgage rate reductions, will rapidly morph into large taxpayer losses when interest rates normalize

- Current public policy (http://finance.townhall.com/columnists/danieljmitchell/2013/07/06/new-academic-research-confirms-the-high-price-of-high-tax-rates-n1634944) is not targeting accelerated economic growth, the wellspring of sustainably higher tax receipts
- Demographically-based (principally aging and immigration-centric) federal spending will expand markedly, adding secular "deficit spending pressure"
- A $642bn federal deficit, if achieved, is still unsustainably large. Should foreign creditors lose confidence in US fiscal policy, heretofore very substantial purchases of US Treasuries by foreign accounts ($2.934trn held as of 6/23/13) could ebb or reverse at any time, potentially creating "funding pressure," which would likely be manifested by rising Treasury yields/rising interest rates. Rising rates would threaten traditional asset prices, economic growth, and the debt financing/refinancing of the federal government

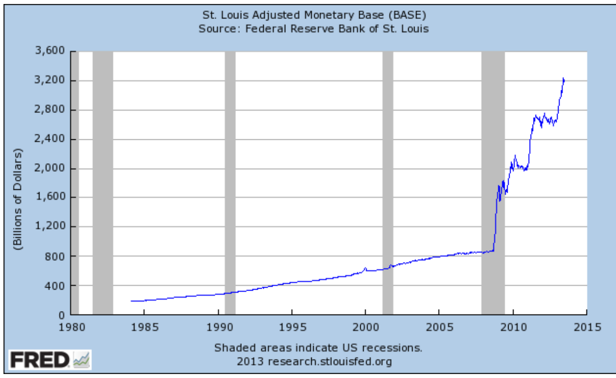
Collectively, the aforesaid "statist" (big government) developments have proven to be incentive-robbing and misallocation-promoting. This economic stewardship has resulted in subpar real investment, declining economic participation rates, and a plummeting real US GDP growth rate: real US GDP growth tabulated a 1.7% compound annual growth rate (CAGR) over past ten years through 01/2013 versus a 3.3% CAGR between 01/1993 and 01/2003 (http://research.stlouisfed.org/fred2/).

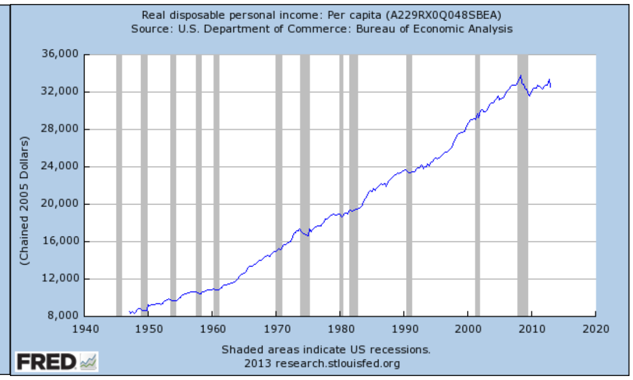




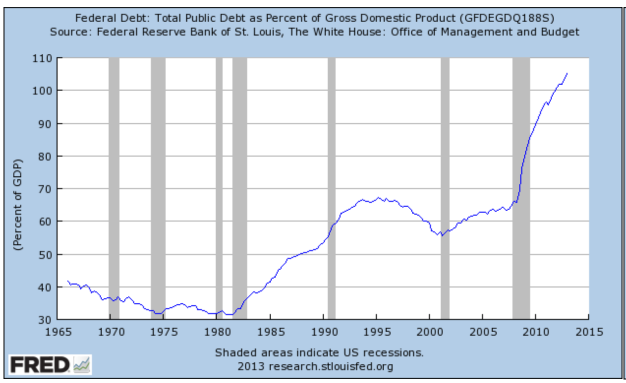


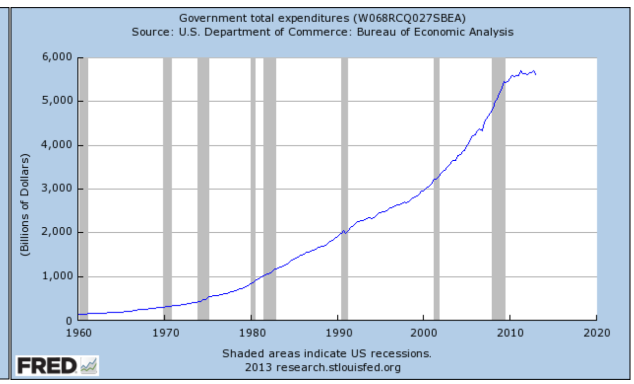
Most affected by anemic real economic growth: the middle class to lower income-earning population -- the bulk of the economy and the nation's population -- making a livelihood in the shrinking free market sector of the economy that can neither avail itself of government's fiscal largesse nor protect itself from the corrosive effect the Fed's "printing press" has had on this group's real disposable income -- and, by extension, on its ability to save. To wit: the adjusted monetary base grew by 14.3% p.a. over the past ten years through 01/2013 versus a CAGR of 6.9% between 01/1993 and 01/2003 (http://research.stlouisfed.org/fred2/). Meanwhile, real disposable income per capita increased by 0.8% p.a. over the past 10 years through 01/2013 versus a CAGR of 3.3% between 01/1993 and 01/2003.





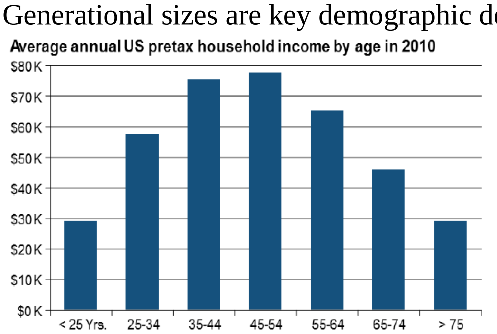
In addition, it is both an intuitive and an established fact (http://scholar.harvard.edu/files/rogoff/files/growth_in_time_debt_aer.pdf) that excessive -- 100% plus -- government debt to GDP (over the past ten years to 01/2013, US federal expenditures grew by 10.0% p.a., while nominal US GDP grew by only 4.1% p.a.) will result in reduced economic growth in the future. The Harvard study points to more than one percent lower real GDP growth p.a. than was the case during less debt-encumbered periods. This is related to the fallout from stabilizing, much less reducing, government debt to GDP. Specifically, higher taxes will pinch consumer spending, which accounts for some 70% of GDP in the US.





Clearly, American economic growth headwind comes from the fact that the nation is increasingly governed by "redistributionists" versus being governed by "constitutional federalists" or rule of law, free market adherents. Going forward, demographics will also start to weigh more on economic growth rates. Our society is aging; each day for the next 16.5 years, 10,000 baby boomers will reach the traditional retirement age of 65 (http://www.pewresearch.org/daily-number/baby-boomers-retire/), adding 3.65m Americans p.a. that will be receiving social security and Medicare benefits (average annual healthcare spending for those aged 65 plus is four times those aged 18 – 49). Meanwhile, those same boomers are moving out of their peak earning/peak taxpaying years:

Generational sizes are key demographic determinants



The 70m strong "GI Generation" born 1904 – 1924; current age: 89 – 109

The 53m strong "Silent Generation" born 1925 – 1944; current age: 69 - 88

The 78m strong "Baby Boomer Generation" born 1945 – 1964; current age: 49 – 68

The 69m strong "Generation Xers" born 1965 – 1984; current age: 29 – 48

The 100m strong 2010 "Generation Yers" born 1985 – 2010; current age: 3 – 28

Sources: Bureau of Labor Statistics and "The Age Curve," by Kenneth W. Gronbach

Aging consequence: federal tax revenues from households, by far the biggest source (46% in FY2012) of government revenues (http://www.cbpp.org/cms/?fa=view&id=3822), are likely to come under mounting pressure even as

Medicare/Medicaid/pension spending (48% of FY2012 budget; http://www.usgovernmentspending.com/piechart_2013_US_fed) is set to rise markedly. Implication: thanks to government policy and demographics, it will be exceedingly hard (unpopular) to pursue sound economic growth policies on the one hand and to reduce US government spending expansion on the other hand. Commensurately, rising structural deficits appear all but "baked in." This will increase calls on the Fed to effectively finance (monetize) US deficits far into the future, i.e., until bond vigilantes, including major creditor nations, "reappear," forcing the Fed to conduct monetary policy for the benefit of savers, not debtors (don't hold your breath). In the interim, the reasons to introduce/add to physical gold-based portfolio diversification couldn't be much stronger.

Is inflation truly benign and real GDP growth actually as robust as a 2 – 2.5% CPI continues to suggest?

Doubts about how representative of consumption reality CPI-based inflation readings are continue, fueled by the growing disconnect between consumers' sense of inflation and what the government reports. Consider, for example, how much gas prices, electricity prices, airline fares, food prices, insurance costs, healthcare costs, tuition rates, and communication costs (and the associated government taxes) have been increasing over the past four to five years; does two or three times the low single-digit annual CPI index's rise sound "reasonable?" Well, there's a good reason for it: the CPI has mutated from an inflation tally in the early 1970s that measured a stable basket of consumer goods to a "substitution exercise." In plain English: if steak got too expensive, it got taken out of the measured consumption basket and replaced with hamburger. Also, hedonic calculations, or increased quality of goods-based "price adjustments," entered the CPI inflation reduction fray (Bill Gross of PIMCO has called the US CPI a "haute con job"). For yet more insight, please consider these recent paragraph excerpts from Euro Pacific Capital's CIO/CEO, Peter Schiff (http://www.europac.net/commentaries/inflation_propaganda_exposed):

> *Magazines and newspapers provide a good case in point. The truth has not been exposed through the economic reporting that these outlets provide, but in the prices that are permanently fixed to their covers. For instance, from 1999 to 2012 the Bureau of Labor Statistic's (BLS) "Newspaper and Magazine Index" (a component of the CPI) increased by 37.1%. But a perusal of the cover prices of the 10 most popular newspapers and magazines (WSJ, Washington Post, Time, Sports Illustrated, U.S. News & World Report, Newsweek, People, NY Times, USA Today, and the LA Times) over the same time frame showed an average cover price increase of 131.5% (3.5 times faster than the BLS' stats). This is not even in the same ballpark.*
>
> *Another stunning example is found in health insurance costs, which is a major line item for most families. According to the BLS we can all breathe easy on that front because their "Health Insurance Index" increased a mere 4.3% (total) in the four years between 2008 and 2012. Interestingly, over the same time, the Kaiser Survey of Employer Sponsored Health Insurance showed that the cost of family health insurance rose 24.2% (5.5 times faster).* ***But even if the BLS had reported higher costs, it wouldn't have made much of a difference in the CPI itself. Believe it or not, health insurance costs are assigned a weighting of less than one percent of the overall CPI. In contrast, the Kaiser Survey revealed that in 2012 the average total cost for family health insurance coverage was $15,745, or almost one third of the median family income.*** (Bold emphasis is the author's.)
>
> *If the BLS could be so blatantly wrong in reporting the prices of newspapers and health insurance, should we believe that they are more accurate on all other sectors? If the inaccuracy of these two components were consistent with the rest of the CPI's components, inflation could now be reported in double-digits!*
>
> *Even more egregious than the manner in which prices are currently reported is the way that CPI methods have been changed over the years to insure that most increases are factored out. Since the 1970's, the CPI formula has changed so thoroughly that it bears scant resemblance to the one used during the "malaise days" of the Carter years.*

Why is an accurate read of inflation so vital? Because it quantifies the true attrition of our dollar-based purchasing power, which is critical in the production, purchasing, and investing decision making of all economic participants. More globally, our understated CPI has overstated real GDP growth, shedding light on the disconnect between a purportedly relatively healthy economy on the one hand, and lingering high unemployment and dissipating savings in the face of extremely weak consumption growth on the other hand. Meanwhile, an understated CPI also serves to extend the Fed's accommodative "Fed funds rate and QE runway," eventually leading to much more virulent monetary inflation down the road while continuing to "underwrite" asset misallocations to the detriment of the overall economy and its sustainable growth prospects. Finally, import prices and the real cost of capital are going to rise, courtesy of faltering productivity growth in Asia as well as a rapidly aging Chinese population (http://blogs.cfainstitute.org/investor/2012/06/04/relocalization-an-emerging-undertow-of-globlization/#more-3879). Physical gold holdings, in the interim, help to protect portfolios against traditional asset class (bonds and stocks) "NPV resets" triggered by higher discount rates associated with mounting sovereign solvency and inflation risks.

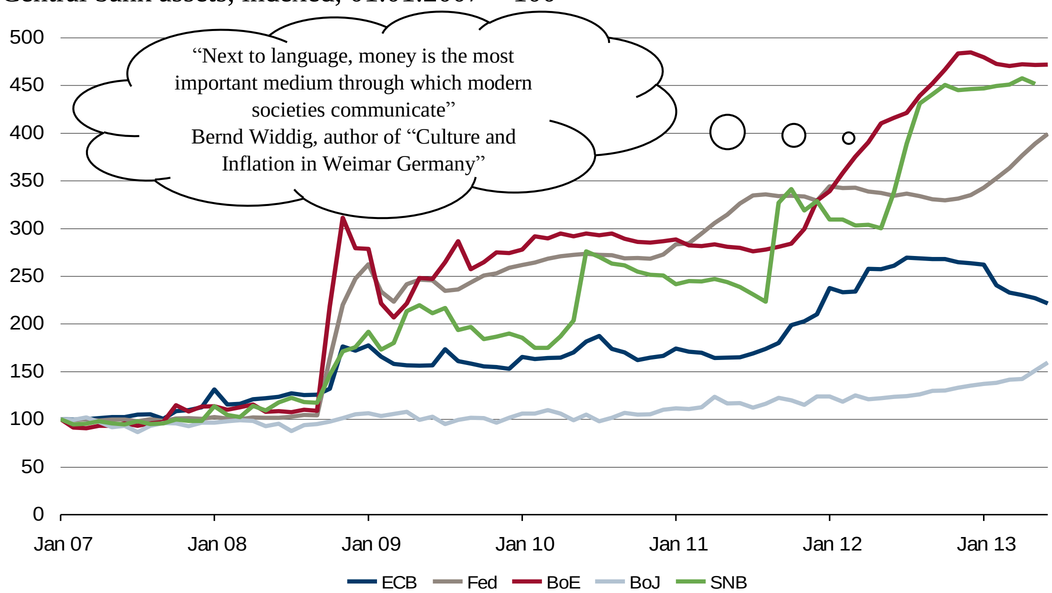
Monetary and fiscal policy

In the global fractional reserve lending, fiat money (not linked to/limited by central bank gold stocks) monetary system of today, central banks are free to increase or decrease the size of their monetary base (central bank assets) via purchasing or selling securities, typically longer-term government bonds/agency bonds, in the open market. The monetary base times the money multiplier (the propensity/ability of fractional reserve member commercial banks to lend their pro rata increase in the monetary base or "reserve") generates the money supply. If the money supply grows in excess of real GDP, monetary inflation results (too many dollars chasing too few services and goods) and vice-versa. Over time, the money multiplier is mean reverting, i.e., growth in central bank assets is reflected in the money supply.

Takeaway: unless leading OECD central banks withdraw the historically unrivalled expansion of their monetary bases since the financial crisis of 2008, the onset of potentially stout monetary inflation over time is all but a given (please see central bank assets chart below). For the Fed, as well as for most other OECD (developed country) central banks, shifting from buying to selling securities in a bond market perennially challenged by large government bond issuance related to intractable deficit spending will prove difficult to do. The reason: OECD governments and thus OECD economies are much more indebted nowadays (please see government debt chart below), and thus much more interest rate sensitive. This makes it problematic for central banks to withdraw from purchasing yet more government bonds, much less selling such portfolios, without triggering a potentially steep rise in 10-year bond yields and a politically unpalatable recession.

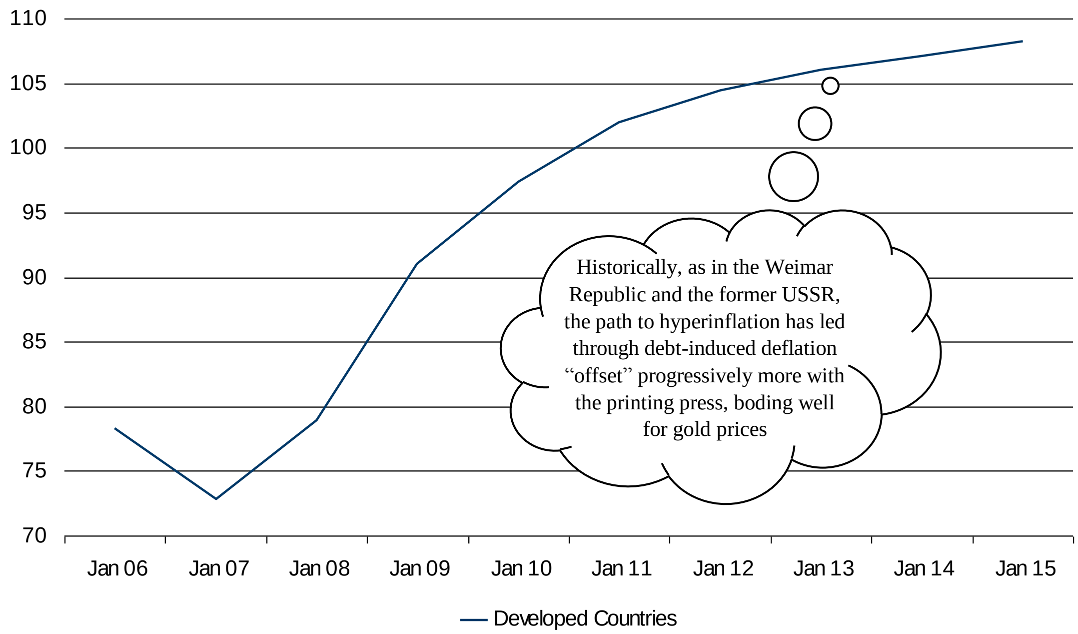
Combine this reality with the fact that leading central banks the world over are seeking to promote either low interest rates or a weak currency or both, and it is difficult to imagine a scenario in which central banks would stop buying interest rate-setting government bonds.

Central bank assets, indexed, 01.01.2007 = 100



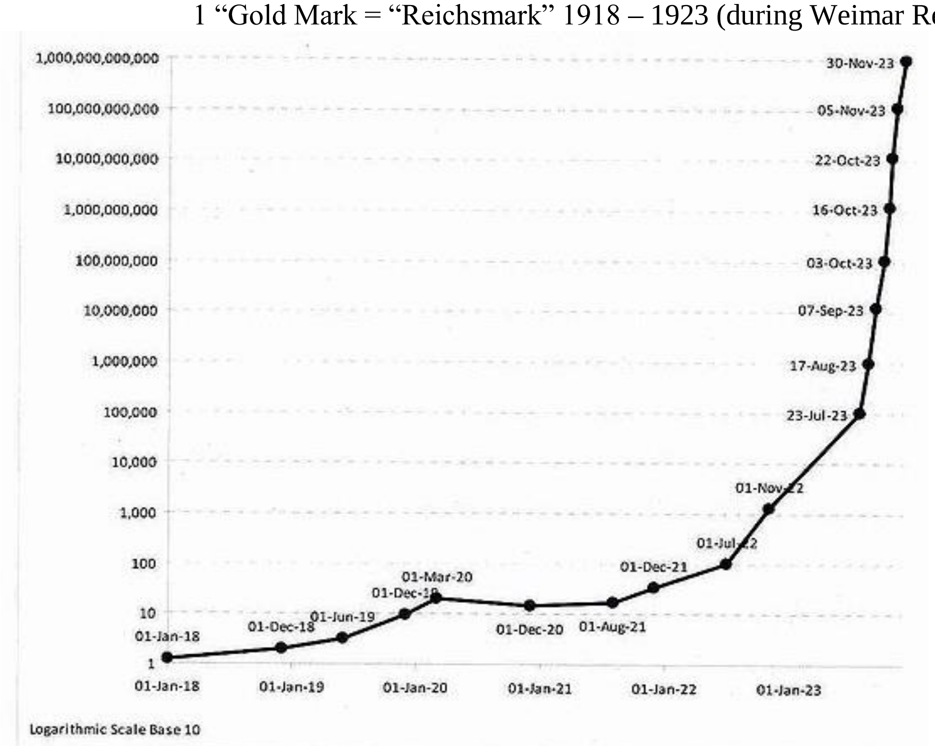
Sources: Datastream, Credit Suisse, http://www.ucpress.edu/book.php?isbn=9780520222908

Government debt (% of GDP)



Sources: http://iis-db.stanford.edu/pubs/22468/No_108_Stoner-Weiss_domestic_and_international_influences_on_collapse_of_USSR.pdf, IMF, Credit Suisse, http://en.wikipedia.org/wiki/File:German_Hyperinflation.jpg

1 “Gold Mark = “Reichsmark” 1918 – 1923 (during Weimar Republic)



Note: 1 “Gold”Mark value in grammes of fine gold (1913) = 0.35842g;
“Reichs”Mark = Currency not tied to the goldstandard in 1918 to 1924.

Source: Law about the Revaluation of Mortgages and other Claims (Revaluation Act 1925), issued the 16th of July, 1925 (Aufwertungsgesetz, Reichsgesetzblatt, Teil I, 1925, p.133-135) and Author's calculations.

<u>How has gold performed historically under various economic scenarios?</u>

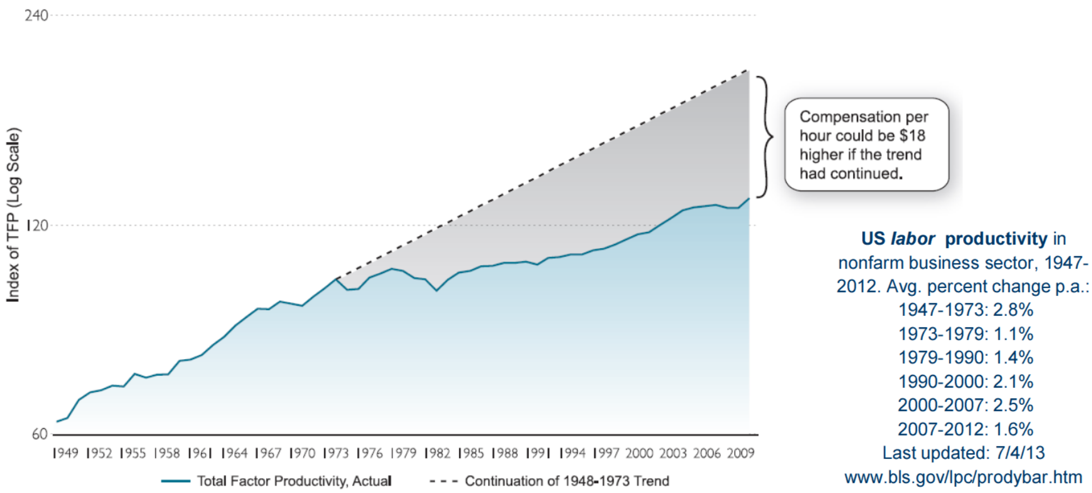
Consider:

- Gold has typically lost value during disinflationary/deflationary periods of productivity-based real growth, e.g., through much of second half of the 19th century, and through 1932 in the 20th century (http://mises.org/journals/qjae/pdf/qjae9_2_5.pdf), after which private US gold ownership was made illegal
- (People tend to equate deflation with negative real growth even as they buy growth companies, which are the ultimate secular productivity/deflation plays in that they lower prices to increase volume and sales!)
- Gold has generally maintained/enhanced purchasing power during debt-induced deflationary periods when private gold ownership was legal
- Gold has usually trumped inflation, i.e., generated real returns during inflationary periods featuring declining productivity, such as during the post-Bretton Woods dollar gold period starting on August 16th, 1971

Let us briefly examine generally declining US productivity since the early 1970s:

Total US factor productivity

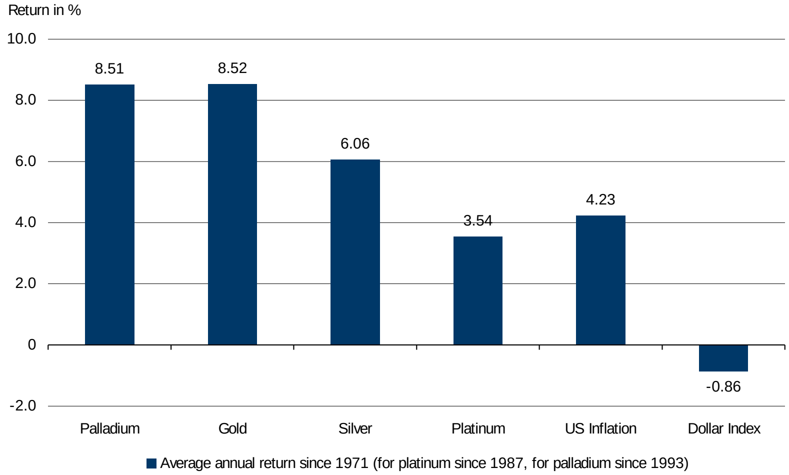
(Accounts for effects in total output not caused by traditionally measured inputs of labor and capital. If all inputs are accounted for, then total factor productivity (TFP) can be taken as a measure of an economy's long-term technological dynamism)



Sources: BLS and Hamilton Project calculations (http://www.hamiltonproject.org/blog/how_you_can_use_the_cloud_for_rapid-fire_innovation/)

And let us now turn to a chart showing how gold performed relative to inflation and the dollar since 1971, the year the current fiat currency era began -- en era that we are still in, and arguably ever more so, given expanding QE:

Gold's long-term store of value track record in dollar terms



Sources: Bloomberg, Credit Suisse

Global gold supply and demand

The most recent quarter on record, Q1:2013, shows a 52.6% collapse in quarter-over-quarter investment demand for gold (in tons) and a 49.2% year-over-year slump in the same category. Gold supply in tons during the same periods remained virtually unchanged. As a result, gold swung from a net shortage in both Q1:2012 and Q4:2012 to a surplus of 120 tons in Q1:2013. Needless to say, and especially given the tight supply/demand nature of the gold market, the shift to an oversupplied position exerted marked recent pressure on the gold price. The converse is also true, and should be considered in the context of gold scarcity:

- Mined supply has been satisfying only 64% of gold demand over the past few years, with gold scrap sales making up the balance; both sources are very price sensitive, yet mined supply can only be raised gradually
- Above ground gold supplies are increasing at 1.5 - 2% p.a.; "OECD" central bank balance sheets are up ca. 200% over the past 5 years, implying a monetary base compounding rate of roughly 25% p.a.
- Currently only 0.6% of estimated global financial assets of $212trn (http://www.economist.com/node/21524908) are in gold -- a shift towards greater gold exposure could push gold prices substantially higher given supply limitations; going from 0.8% to 1.6% = 31,000 tons or 11 years of production at current rates!
- (As one point of reference, gold accounted for 3% of global financial assets in 1980, a post WWII peak.)

Gold supply and demand in tons

Supply	**Q1 2011**	**Q2 2011**	**Q3 2011**	**Q4 2011**	**Q1 2012**	**Q2 2012**	**Q3 2012**	**Q4 2012**	**Q1 2013**
Total mine supply	671	725	746	710	662	697	745	714	685
Old gold scrap	358	408	461	422	383	389	433	386	367
Total gold supply	**1029**	**1133**	**1206**	**1132**	**1045**	**1086**	**1178**	**1099**	**1052**
Demand	**Q1 2011**	**Q2 2011**	**Q3 2011**	**Q4 2011**	**Q1 2012**	**Q2 2012**	**Q3 2012**	**Q4 2012**	**Q1 2013**
Jewellery demand	570	500	472	432	503	423	487	482	520
Industrial & dental demand	116	118	115	103	106	103	102	96	102
Investment demand	342	390	507	462	396	284	422	424	201
Official sector purchases	137	66	141	113	115	161	110	146	109
Total gold demand	**1164**	**1074**	**1235**	**1110**	**1119**	**972**	**1121**	**1149**	**932**
Market balance	**Q1 2011**	**Q2 2011**	**Q3 2011**	**Q4 2011**	**Q1 2012**	**Q2 2012**	**Q3 2012**	**Q4 2012**	**Q1 2013**
Stocks movements	**-135**	**59**	**-29**	**22**	**-75**	**114**	**57**	**-50**	**120**

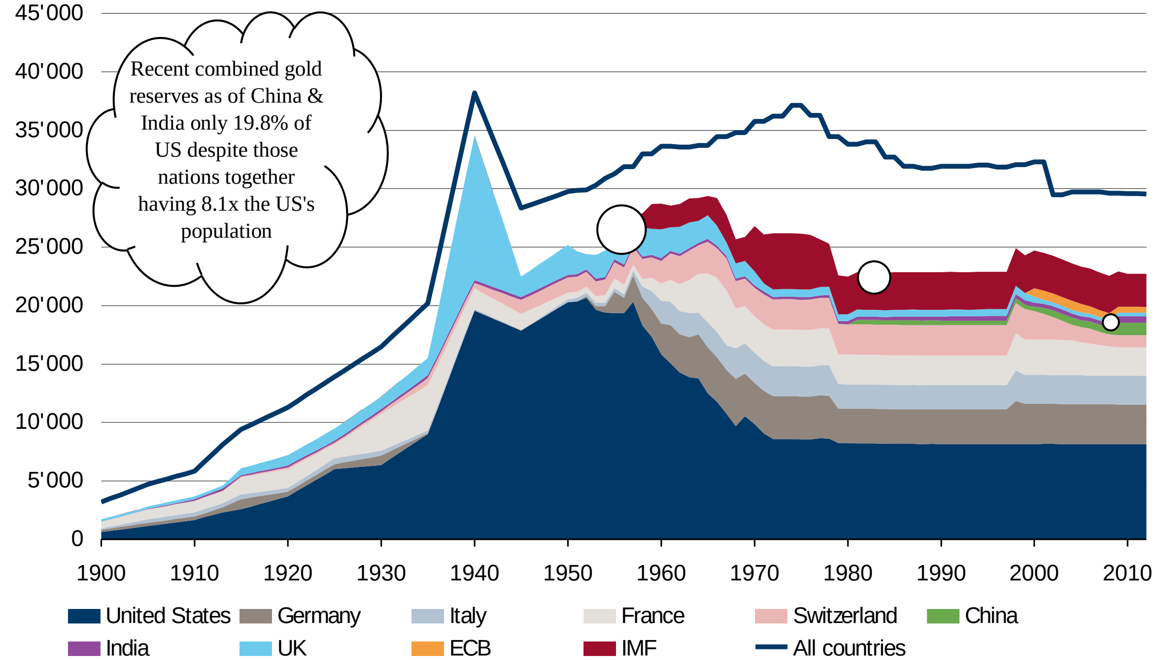
Source: Credit Suisse

More globally, on the supply side, and thanks to sustained inflation in mining costs (material, equipment, compensation, and geology-related) over the past decade, fully-burdened, average breakeven mining costs per ounce have exploded from the low $300 range a decade ago to roughly $1,200 currently. Upshot: at current price levels, production should begin declining, auguring well for firmer gold prices, assuming of course demand "holds up." (Worthy of mention: once mines shut down, they don't reopen quickly.)

On the demand side, gold is moving from weak to strong hands; from over-indebted, unable to "print money" nations such as peripheral European countries to emerging market (EM) giants such as Russia, China, and India. China and India, the two most populous in the world, have strong historical affinity for gold on the one hand and lacking gold reserves on the other (please see the historical gold holdings of central banks chart).

And with escalating discontent over America's sustained government deficits and trade deficits -- and thus with the dollar's reserve currency status and the dollar's commodity pricing dominance -- emanating from both net creditor nations and OPEC nations (http://www.bloomberg.com/news/2013-03-26/china-brazil-sign-currency-swap-agreement-for-30-billion.html, http://www.financialsense.com/contributors/dan-collins/rise-petro-yuan, http://english.peopledaily.com.cn/90778/8309983.html), gold, the only precious metal that is considered a central bank monetary reserve, has an arguably bright secular demand outlook. This is especially true given the strategic (long-lived) nature of gold purchases by leading emerging market nations. In other words, the gold that these countries accumulate will likely stay in their "central bank vaults" as a bulwark against sustained dollar depreciation and to ease future EM currency-based global trading, potentially removing large amounts of gold from an already tight gold market over time. Historically, the nation that has "had the gold" has also determined the terms of trade, a point not lost on either the United States or China -- or on Germany, for that matter, which is bringing its geographically diversified gold holdings back to its own shores.

Historical gold holdings of central banks in tons (166,000 tons of "above ground" gold)

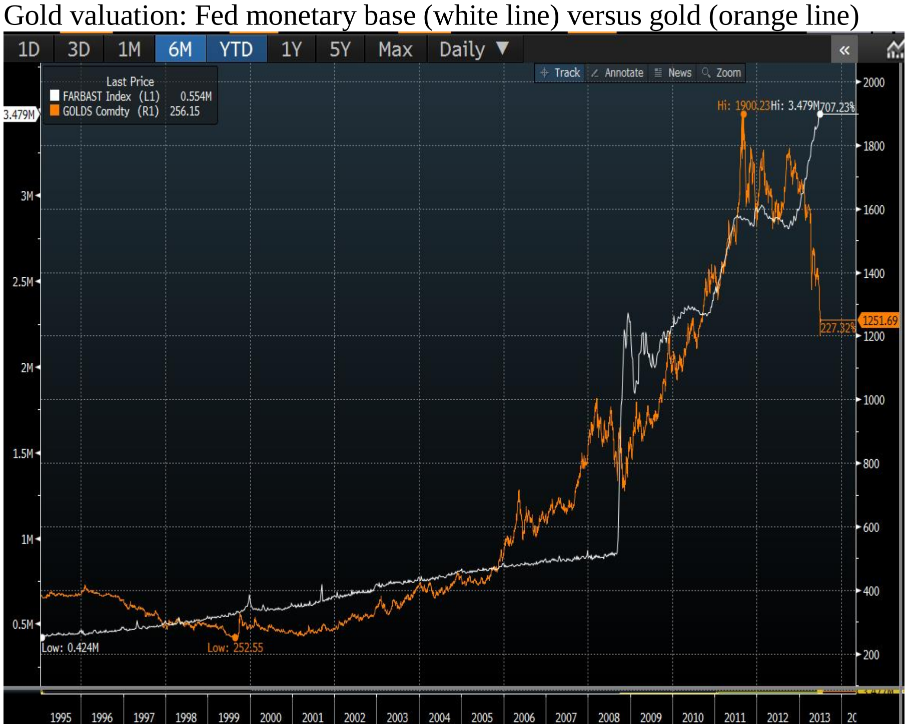


Sources: WGC, Datastream, Credit Suisse

Gold valuation:

How high can gold go? How much balance sheet expansion can central banks engage in? The gap between the gold price (orange) and the monetary base of the Fed (white) is viewed as the current gold price appreciation potential (back to $1,900 per troy ounce).

Gold valuation: Fed monetary base (white line) versus gold (orange line)



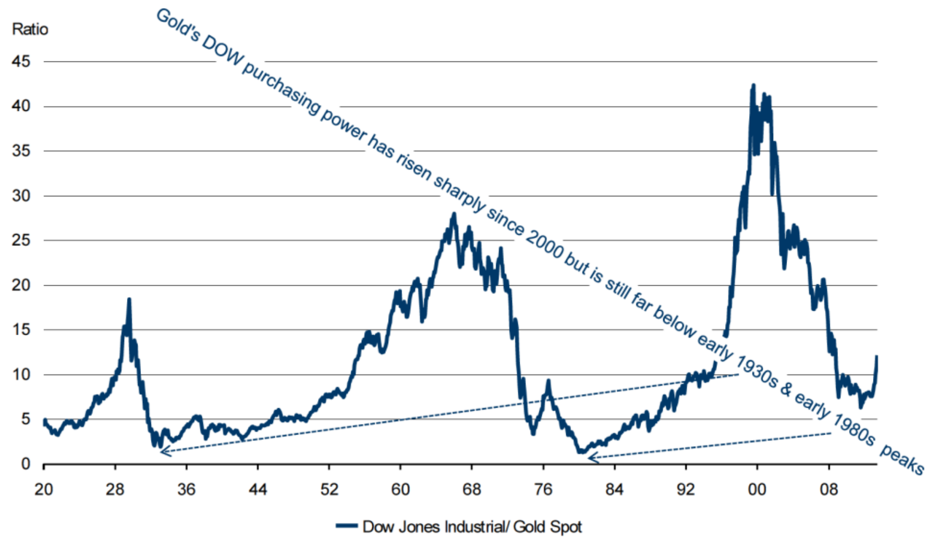
Farbast Index (white, LHS): Total assets of all US Federal Reserve banks

Golds Comdty (orange, RHS): $ gold spot price per oz.

Source: Bloomberg

Assuming we sustain the current "politically-driven" economic policy, gold also appears to have upwards potential as viewed from the historical "DJI valuation" perspective, i.e., gold stands poised to again outperform stocks:

Gold valuation: DJII/gold spot price (long-term)



Sources: Bloomberg, Credit Suisse

Risks:
Buyers of gold at current prices (in the mid-$1,200 range) are exposed to various risks, including, but not limited to:

- Pronounced volatility
- A sustained "technical" correction (further selling of gold based on the stout recent decline)
- Reinstitution of free market capital, productive growth furthering, "balanced budget" policies in the US
- A sharp and sustained cessation of US and global monetary base expansion (QE)
- A sustained rise in interest rates. Caveat: the yellow metal shrugged off the federal funds rate (interest rate) roller coaster between 2000 – 2013, as can be seen below:

Fed funds rate (white) versus gold price per Troy ounce (orange)

GOLDS Comdty (orange, LHS): $ gold spot price per oz.

FDTR Index (white, RHS): Fed funds rate

Source: Bloomberg

Conclusion:

In a day and age in which:

- Ever more interventionist policies are being pursued by the state on a global basis at fiscal, monetary, legislative, and regulatory levels
- The “too big to fail” doctrine is increasingly robust and the wealth of nations’ furthering “invisible hand of Adam Smith” and Schumpeter’s “creative destruction” are hindered
- The rule of law (individual property rights to ensure that the fruits of labor such as income, savings, financial assets, real estate, intellectual property, etc. remain one’s own) is increasingly under attack via the courts, the tax code or via various governmental agencies (USSC, IRS, FED, EPA, FDA, EC, ECB)
- Suboptimal growth/productivity, expanding redistributionism, unparalleled monetary base expansion, and per capita real income stagnation have become de facto government policy
- The risk of revisited a 1970s stagflation period, albeit a more virulent variety, keeps rising
- Gold is the only metal still held by central banks as a monetary reserve, thus is most strongly driven by "store of value" considerations of all precious metals; EM central banks have relatively low gold holdings
- Ca. 2,750 metric tons (88m troy oz.) are being mined p.a., meaning gold supplies have been expanding at 1.5 – 2.0% p.a., a fraction of roughly 25% p.a. expansion in the monetary base of leading central banks since 2008, with more QE on tap, ...

… a satellite portfolio position (5% - 10%) in the ultimate historical store of value, **physical gold** (not synthetic gold positions, which bring us back into the “paper world” and the very counterparty risks we seek to escape), should be considered, in this author’s view. This is all the more apt given the recent sharp correction in the price of gold. Alan Greenspan, in 1966, long before he became Fed chairman, summed up, perhaps best of all, the rationale for a portfolio allocation in gold in times such as today:

“In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold ... The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves. This is the shabby secret of the welfare statists’ tirades against gold. Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists’ antagonism toward the gold standard.”

Dan Kurz, blogger

Dan_34135@yahoo.com

My strategic allocation convictions:
The golden rules of client-centric investing are: capital preservation, purchasing power preservation, and the strategic attainment of a real yield (the reward for forgoing consumption).

Contrast this client mandate with today’s monetary policy, which is made for the benefit of debtors, not savers. This holds true for the short end and the long end of the yield curve. At the short end, numerous leading central banks have moved overnight intra-bank interest rates to zero. At the long end, the same institutions have increasingly resorted to “printing money” with which to purchase 10-year government bonds, artificially lowering yields available to investors while bloating central bank balance sheets, thereby creating substantial long-term monetary inflation and misallocation risks. Add to this the fact that G20 government debt/G20 GDP has surpassed 100% with rising structural, aging-based government deficits ahead of us, and investors are also staring rising solvency risks in the face. Last but not least, with current government bond yields into the nominal to zero percent range, those instruments’ durations have lengthened markedly, in extreme cases, to de facto “zero coupon bond” equivalence, thereby dramatically raising capital loss perspectives when benchmark interest rates rise.

In summary, then, today’s strategic fixed income investors must contend with historical yield deprivation and even negative real yields across the yield curve, on the one hand, while having to come to terms with expanding inflation, solvency, and capital loss risks on the other hand. Meanwhile, in the wake of an unprecedented (post WWII) deficit spending/QE-induced four-year earnings recovery, equity investors must contend with what increasingly looks like a recession-induced earnings compression ahead as well as its implications for current valuations. Longer-term, shareholders face anemic real GDP growth -- and thus anemic profit growth -- associated with having to unwind the debt mountains referenced above.

So much for the problem. What about transparent and liquid investment-grade diversification, yield deprivation relief, inflation protection, capital preservation, and real yield solutions (themes) in today’s investment landscape? I am convinced that I can help you identify some compelling, counterparty risk-free strategic asset allocation ideas via my investment depth and breadth and through my expertise in real or “scarcity assets,” balance sheet compositions, and all-important asset valuations (during my Credit Suisse CIO Office tenure, these themes achieved an equally-weighted outperformance of 68% relative to the MSCI ACWI).

Appendix

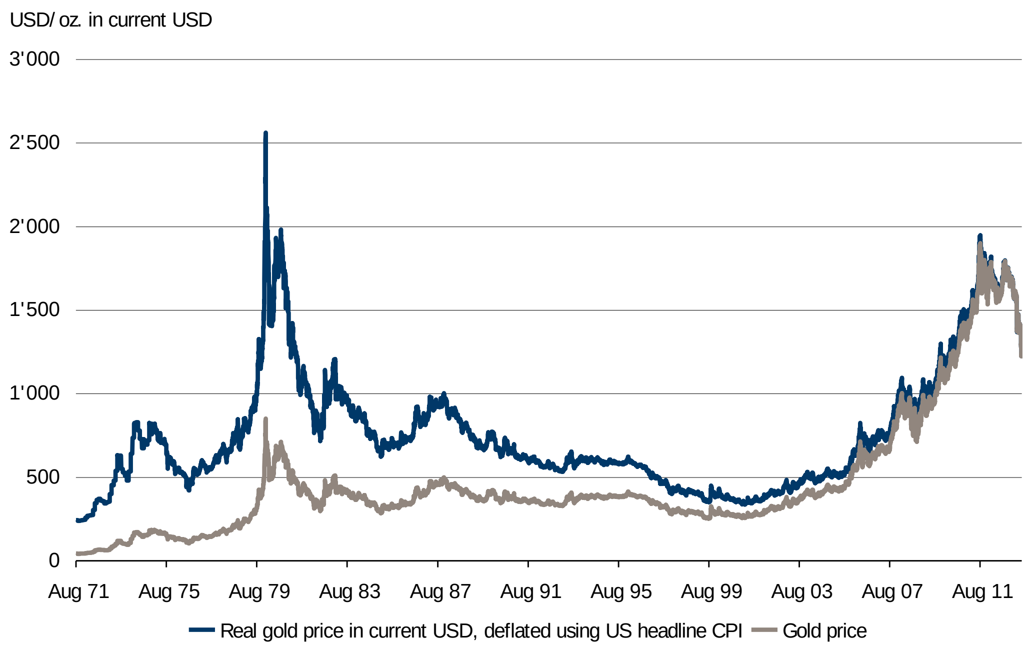
Gold attributes:

- Average concentration in earth's crust: 3.5 parts per billion or ppb, a fraction of silver's 73 ppb, uranium's 2,700 ppb or copper's 60,000 ppb
- The same value of gold can be stored in roughly 3% the space which silver would require
- Industrial uses include dentistry and electronics; gold has good corrosion resistance and conductor qualities
- Gold has been highly-valued since prehistoric times; earliest known coinage in 630 B.C.
- Gold is only metal still held by central banks as a monetary reserve, thus is most strongly driven by "store of value" considerations of all precious metals

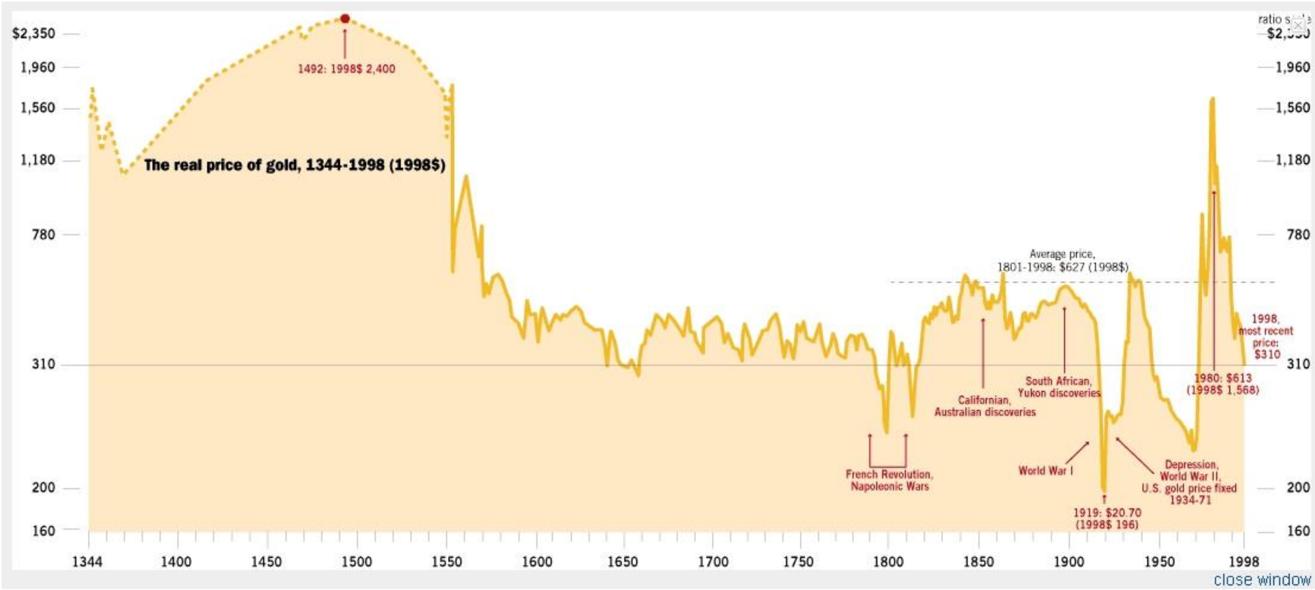
Gold extraction & supply (1MT = 32,150 Troy oz.) statistics:

- There are ca. 166K tons of gold above ground
- Below ground gold reserves estimated at 51K tons, or ca. 31% of all that's been mined
- South Africa has 50% of known un-mined gold (leading producers: China, Australia, US, South Africa, Russia, Peru)
- Ca. 2,750 metric tons (88.4m troy oz.) are being mined p.a., meaning gold supplies have been expanding at 1.5 – 2.0% p.a. or roughly in-line with real global GDP growth over 15 years

Nominal and real gold prices since the end of the gold standard



Sources: Bloomberg, Credit Suisse



http://www.google.ch/imgres?imgurl=http://fxmadness.com/wp-content/uploads/2009/09/long-term-gold.jpg&imgrefurl=http://fxmadness.com/2009/09/26/general/long-term-gold-silver-chart/&h=495&w=1109&sz=140&tbnid=u3S1fkvnrM7oIM:&tbnh=54&tbnw=120&prev=/search%3Fq%3Dlong-term%2Bgold%2Bprice%2Bchart%26tbm%3Disch%26tbo%3Du&zoom=1&q=long-term+gold+price+chart&usg=__8xRqj3t9GYDzwN3agA6Em1eOpKI=&docid=-5Rfq9fJ-_iJDM&sa=X&ei=66LaUbqvDLDo4QT1tYGIBg&ved=0CD4Q9QEwAQ&dur=79#imgdii=_