Incrementum
Liechtenstein

In Gold we Trust 2014 – *Extended Version*

We are currently on a journey to the outer reaches of the monetary universe. We believe that the monetary experiments currently underway will have numerous unintended consequences, the extent of which is difficult to gauge today. **Gold, as the antagonist of unbacked paper currencies, remains an excellent hedge against rising price inflation and worst case scenarios.**

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All prices are closing prices as of June, 20th 2014

Monetary policy does not work like a scalpel, but like a sledgehammer. The tug-of-war between a deflationary debt liquidation and politically-induced price inflation is well and alive. Last year we coined the term **"monetary tectonics"** which describes the battle between these powerful forces.

In our opinion, it is by no means certain that inflationary forces will win the race. However, socio-economic incentives and high indebtedness clearly suggest that in case of doubt, higher inflation rates will be tolerated. **Should the inflation trend reverse, there would be excellent opportunities in inflation sensitive assets like gold, silver and mining equities.**

In the course of last year's price collapse, a lot of technical damage was inflicted. **The past months have seen a significant decline in speculative activity in the sector**. The majority of bulls appear to have thrown in the towel. We like the fact that the consensus considers the gold bull market over. **Gold is now a contrarian investment.**

The migration of gold demand from West to East is continuing. The growing importance of Asia's middle class for gold demand is widely underestimated. Assuming that incomes in China and India will continue to rise, gold will inevitably be one of the beneficiaries of this "love trade".

Gold stocks clearly exhibit a highly asymmetric risk-reward profile at present. In the wake of the correction, mining companies have reset their priorities - profitability, capital spending discipline and shareholder value have replaced the maximization of production. Moreover, there is no other sector that investors view with similarly pronounced scepticism.

From a technical perspective, our assumption is that the gold price is near the end of its long consolidation period. The clearly positive CoT data and the recent revival of gold mining shares all suggest as much. **We are therefore convinced that the technical picture has been repaired and that a stable bottom has formed.**

Our 12-month price target is the USD 1,500 level. Longer-term, we expect that a parabolic trend acceleration phase still lies ahead. **In the course of this event, our long-term target of USD 2,300 should be reached at the end of the cycle.**

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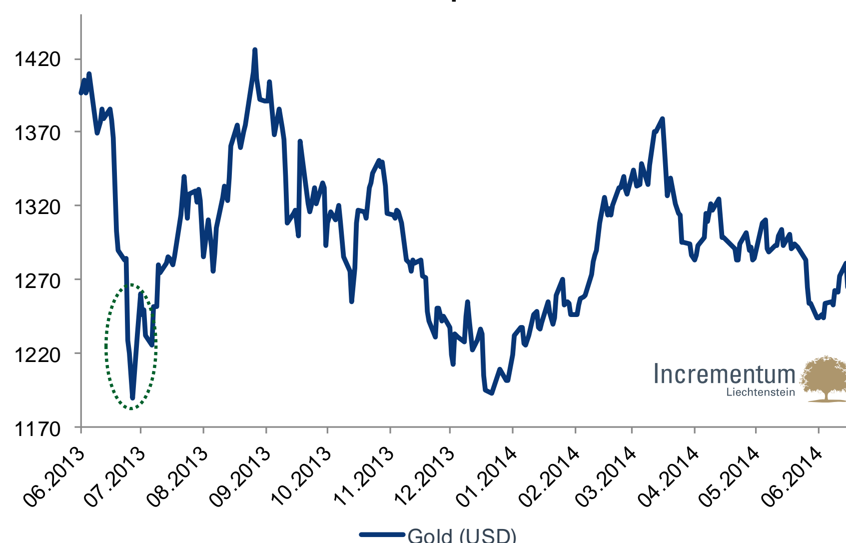
1. INTRODUCTION

The last gold bulls appear to have thrown in the towel

Our last gold report was published on 27 June 2013, just as the anxiety over the metal's declining price trend reached its peak. In hindsight, this date turned out to coincide with a multi-year low. Last year, we came to the conclusion that massive technical damage had been inflicted and that it would take some time to repair the technical picture.

That forecast has turned out to be correct, even though the counter-trend move we expected turned out to be significantly weaker than thought. **Recent months show clearly that many speculators have given up on the sector.** A majority of bulls appear to have thrown in the towel. Volatility and market participant interest have decreased significantly in the last year.

Gold in USD since the last Gold Report



Source: Federal Reserve St. Louis, Incrementum AG

"So we did the right thing. I hope."
Ben Bernanke in his farewell speech

With their monetary interventions, central banks have entered *terra incognita*. Monetary policy doesn't work like a scalpel, but like a sledgehammer.[1] Superficially, extreme monetary policy stimulus has calmed financial markets overall. The results, in terms of the real economy by contrast, continue to lag behind expectations. The often invoked 'self-sustaining recovery' is rather modest in many regions and is not 'self-sustaining' anywhere so far. It will probably still take months or years before the full extent of the collateral damage from these monetary measures will become visible. In our opinion, these will be predominantly negative. Interventions always result in keeping existing misallocations afloat, while new ones are added to them.

"*The crisis was yesterday*" seems to be the consensus

The current "lowflation" environment that still prevails, which is characterized by low price inflation and growth figures that largely remain below expectations, has turned out to be a Land of Cockaigne for stock market investors. As long as stimulus does not show up in inflation data, market participants don't fear a drying up of the monetary aphrodisiac. Among investors, the prevailing sentiment is "the crisis was

[1] "The Lords of Finance", Liaquat Ahamed

yesterday", and the "Yellen Put" is considered an integral feature of asset allocation decisions in many portfolios. **The longer the low interest rate environment continues, the more investors will be pushed toward excessive risk tolerance.**

"It is a crazy world: the big central banks are suspending the market. Market participants are altering their behavior, and let themselves be guided solely by the central banks – and vice versa."
Jürgen Stark, former ECB chief economist

What is already clearly recognizable is that these massive market interventions marked a regime change: while before 2008, a balance between economic growth and moderate price inflation were the focus of central bank efforts, central bankers have in the meantime mutated into slaves of the financial markets. **The continual artifices of banking and currency policy appear to have now become a necessity, so as to prolong the continued existence of the fiat debt money system.**

As readers of our annual report know, we analyze gold primarily as a monetary asset and not as an industrial commodity. In our eighth "In Gold We Trust" report, we want to once again take a sober look at the big picture and perform a holistic analysis of the gold sector.

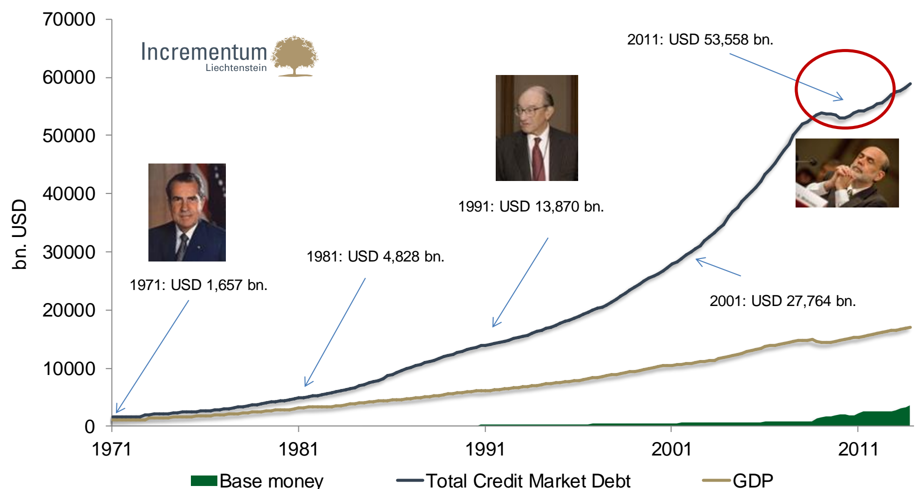
2. ASSESSMENT OF THE MONETARY CLIMATE

a.) 1971: Monetary Paradigm Change

"The monetary system is the lifeblood of the economy, and therefore, artificial tampering with money, credit, and interest rates will affect the entire structure of the economy. When the credit bubble pops Austrian theory implies that it will have widespread fallout as the malinvestments are cleared."
Seth Daniels

The virtualization/dematerialization of the monetary system at the beginning of the 1970s unleashed monetary policy and enabled disproportional growth of credit and debt. Economic activity based on savings and real investment was replaced by a credit-induced growth mania. In today's debt money system, credit-induced growth is mainly "created" by pumping additional money into the economy through an increase in lending by the banking system or by an increase in government debt.[2] The superficial stability of financial markets now depends to a large extent on ceaseless monetary inflation. **Since commercial banks are currently not contributing sufficiently to credit expansion, this has to be compensated by unconventional central bank monetary policy measures.**

GDP, total credit market debt and monetary base since 1971



Source: Federal Reserve St. Louis, Incrementum AG

***"Monetary tectonic"* gains in importance**

This debt-induced growth is strikingly demonstrated in the above chart. "Total credit market debt owed" in the US has risen 35-fold since 1971, the monetary base 54-fold and GDP only 14-fold. The visible dip in debt expansion since 2008 had to be compensated by the Fed's major expansion of the monetary base. **Last year, we introduced the term 'monetary tectonics' to designate this situation, which describes the interaction between credit deflation and central bank-induced inflation.**

Since 2009, "gentle deleveraging"; but level of indebtedness still unhealthily high

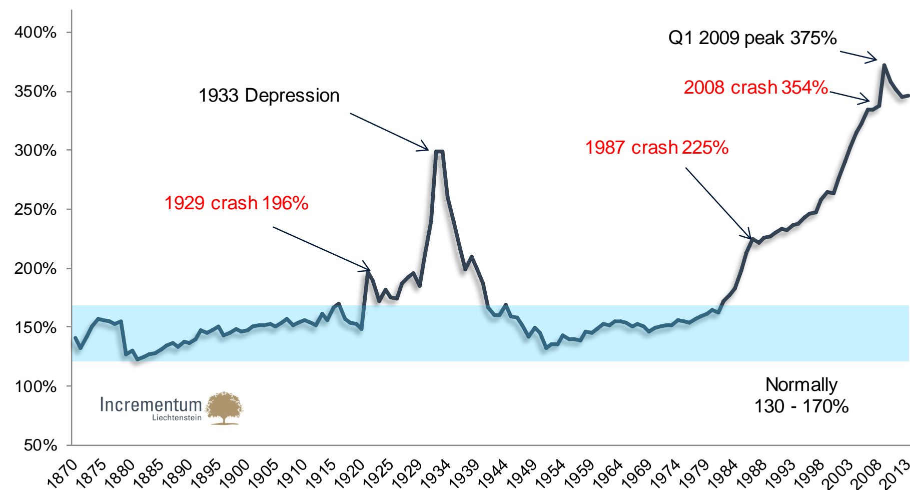
The ratio of total credit market debt to GDP in the US has stood at around 150% for much of its recent history. Historically there are only two important exceptions: the 1920s ("roaring twenties"), during which a large credit expansion laid the foundation for the stock market crash and the Great Depression; and the current period, which originated in the 1970s.

[2] In this context we want to point to the ever more frequently discussed policy of "NGDP targeting", which entails monetary policy pursuing an explicit nominal GDP growth target.

„To prevent busts, one must stop booms from happening in the first place by taking away the punchbowl of credit well before the party has gotten out of hand. So wisdom consists in consciously renouncing immoderate greatness."
William Ophuls, Immoderate Greatness

In contrast to October 1929, additional growth in economy-wide debt was fostered after the stock market crash of 1987, among other things by Alan Greenspan's loose monetary policy. At the end of 2008, the ratio reached 375%, an all-time high. Since then there has been gentle deleveraging, the ratio remains however at an unnaturally high level and in "uncharted territory".

Total US Credit Market Debt as a % of GDP

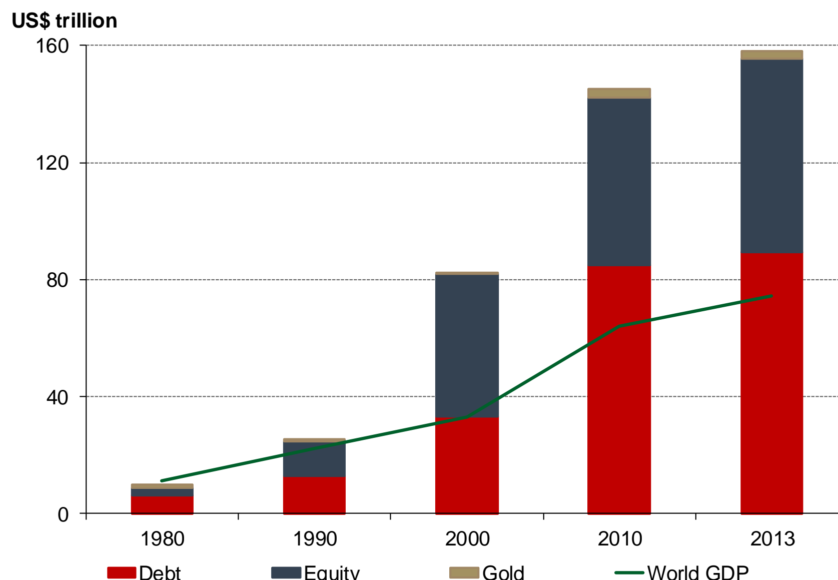


Source: Dr. David Evans, sciencespeak.com

"It should promise that monetary policy will not remove the punch bowl but allow the party to continue until very late in the evening to ensure that everyone has a good time."
Charles Plosser
President of the Federal Reserve Philadelphia

The significant bubble in paper assets relative to hard assets is illustrated in the next chart. In spite of substantial volatility, global financial wealth has doubled since 2000 alone. **The growth stems primarily from the bond markets.** Between 2000 and 2013, the value of outstanding debt securities has almost tripled (from USD 33 trillion to USD 100 trillion). Over the same period, the total capitalization of stock markets has increased by a mere 35% (from USD 49 trillion to USD 66 trillion). The share of gold can also be seen. While it has grown considerably since 2000, it nevertheless remains at an extremely low level.

Global financial assets are increasing faster than ever



Source: BIS, Thomson Reuters GFMS, World Bank, World Federation of Exchanges, World Gold Council

b.) The status quo

„Crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought."
Rudi Dornbusch

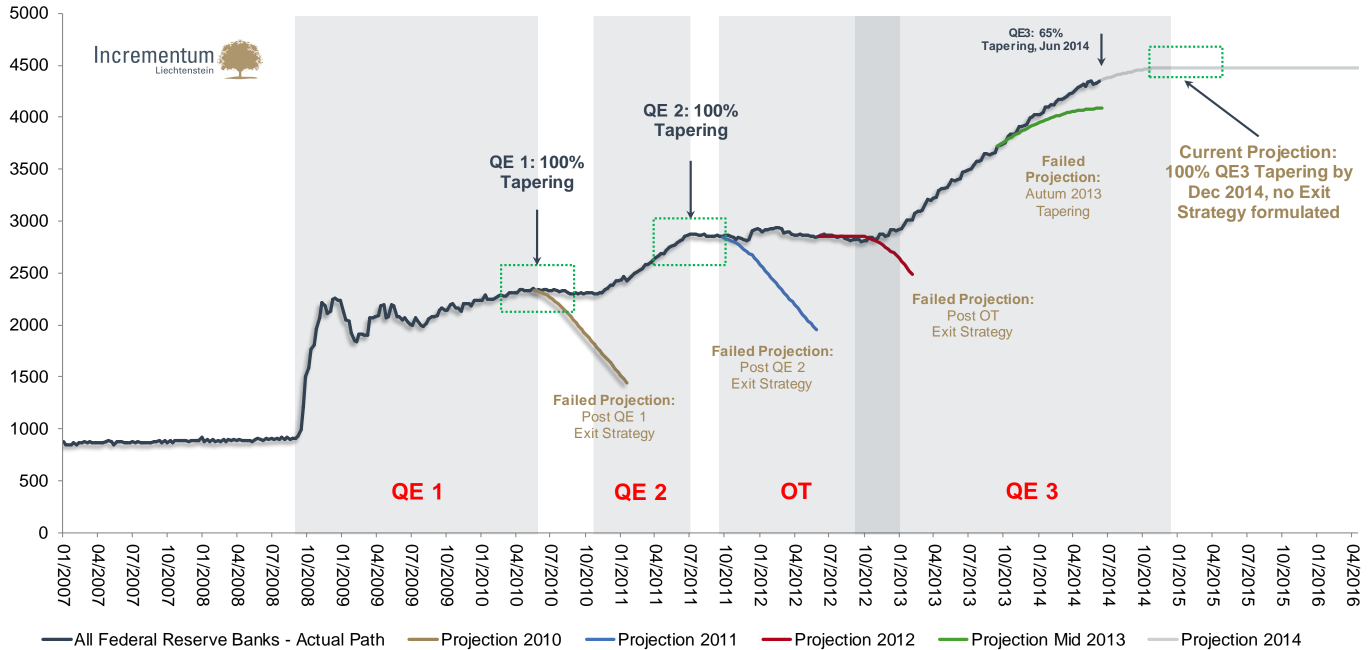
Market participants are currently watching the Federal Reserve's repeated attempts to exit its unconventional monetary policy with eagle eyes. Over the past five years, two such attempts have failed already. At the end of both QE1 and QE2, massive dislocations in financial markets ensued almost immediately. In the current third attempt at an exit, the Federal Reserve is attempting a 'softer exit' from its money printing.

„Things often look better when one is under the influence of free-flowing liquidity."
Richard Fisher

Economist Stephanie Pomboy suspects that 'tapering' is the central bank's attempt to temporarily slow down the above mentioned bubble in paper wealth.[3] This thesis is supported by a number of comments by long-serving Fed members, who are apparently a bit worried by the decline in risk perceptions on the part of investors. The arguably most amusing comparison in this context was provided by FOMC member Richard Fisher in January 2014: he pointed to the fact that under the influence of alcohol, things tend to look more alluring than they really are and offered by way of comparison that QE had a similar effect on investors. **Due to artificially low interest rates, they see risk assets through "beer goggles".**[4]

[3] http://www.youtube.com/watch?v=1mVM3_8nYq0
[4] http://www.dallasfed.org/news/speeches/fisher/2014/fs140114.cfm

Fed balance sheet vs. expectations



Source: Federal Reserve St. Louis, Incrementum AG

Tapering = Tightening

We believe that so-called 'tapering', i.e., the slow exit from 'QE', will once again have a significant impact on capital markets.[5] Should the attempt be made to actually reduce the amount of money created hitherto as well, a severe recession would undoubtedly ensue. The exit debate is in our opinion merely verbal hygiene. **For a system that – as a result of the rapidly declining marginal utility of every additional monetary unit that is created – requires a steady increase in monetary stimulus, the 'tapering' currently underway definitely amounts to 'tightening'.**

„If you are not confused about the economy, you don't understand it very well.“
Charlie Munger

The knee-jerk reaction to a fading of the effects of short term stimulative monetary policy is once again going to be the application of even stronger 'monetary ecstasy' in the future. We believe, contrary to the majority of market participants, that 'QE' is not simply going to be stopped, but will probably be continued in the long run, or be replaced by other, possibly stronger monetary drugs, such as negative interest rates. The ECB already successfully demonstrated this option in June. Central banks are facing the difficult choice between further artificial bubble blowing, and a painful economic adjustment. **Based on recent history, we believe that when in doubt, the former method will clearly be preferred.**

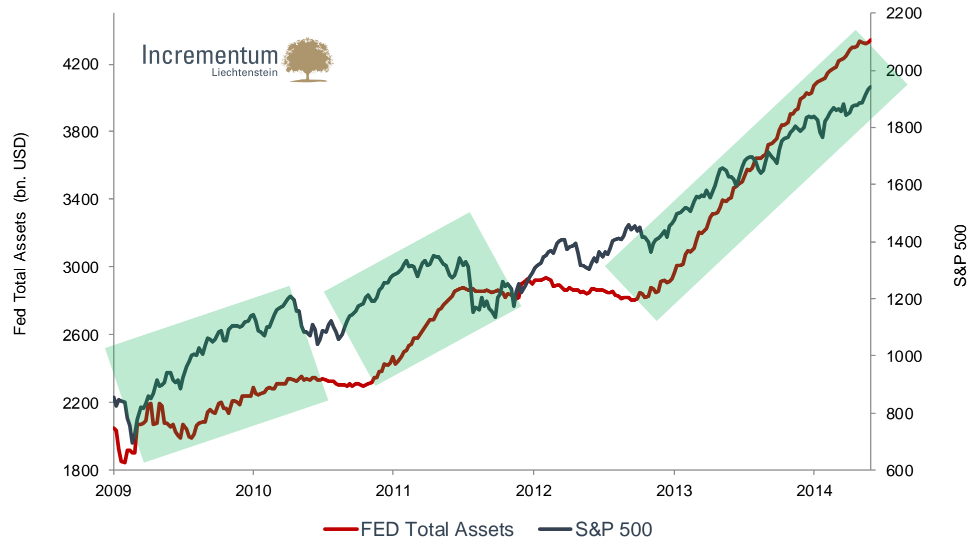
"There was a time, not that long ago actually, when it was the economy that drove asset prices like equity and real estate valuations. But today, the causation is viewed, even in policy circles, as running in the opposite direction. It is asset prices that now drive the economy.“
Dave Rosenberg

The decisive factor affecting financial markets thus remains (unfortunately) the anticipation of central bank actions. In order to stimulate the economy from the demand side, the Fed is once again – just as in the last US business cycle – betting on the so-called "wealth effect". It is not least this phenomenon that worsens the dependence of a consumption-oriented economy on ever more expansive monetary policy. Should the market values of once again artificially inflated financial assets decline, consumer demand is apt to decrease all the more, raising the danger of recession. The incentive to counteract this with even more

[5] The term is by the way borrowed from sports science, and describes the reduction in training prior to activities tasking endurance (e.g. during a competition)

expansive monetary policy is hence quite pronounced. **The extremely tight correlation between the growth of the Federal Reserve's balance sheet and the trend of the S&P 500 can be discerned in the next chart**.

Balance sheet Federal Reserve vs. S&P 500

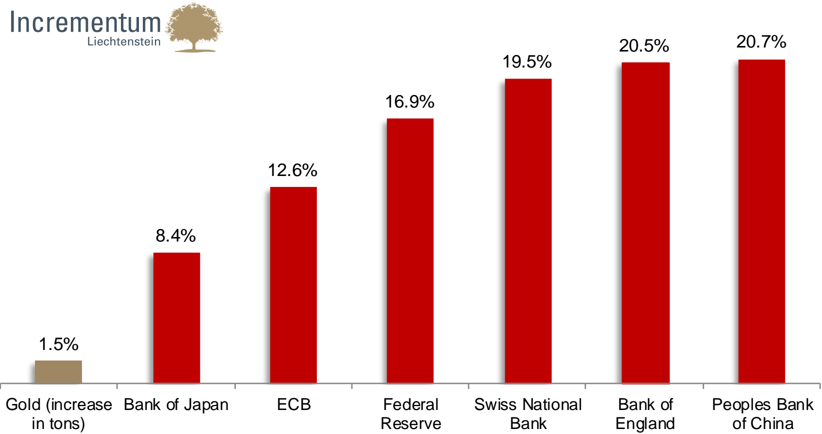


Source: Incrementum AG, Federal Reserve St. Louis

The following chart shows the annual growth rates of central bank balance sheets since 2002. The Bank of Japan has pursued a comparatively restrictive monetary policy, which is, however, changing rapidly now due to 'Abenomics'. The ECB was also restrictive, at least on a relative basis, with an annual rate of inflation of 'only' 12.6%. Inflationary world champion remains the People's Bank of China, closely followed by the Bank of England. By way of comparison, the global supply of gold grew by a mere 1.48% per year. This underscores the relative scarcity of gold compared to fiat currencies that can be inflated at will. **Due to monetary excess and the global devaluation competition of recent years, we expect that the exchange rate between gold and paper will continue to rise.**[6]

[6] If one – similar to us – views gold as a monetary asset and not as a commodity, one must speak of gold's exchange rate so as to be consistent.

Annualized rate of change of central bank balance sheets vs. annual growth in gold supply (2002-2014)



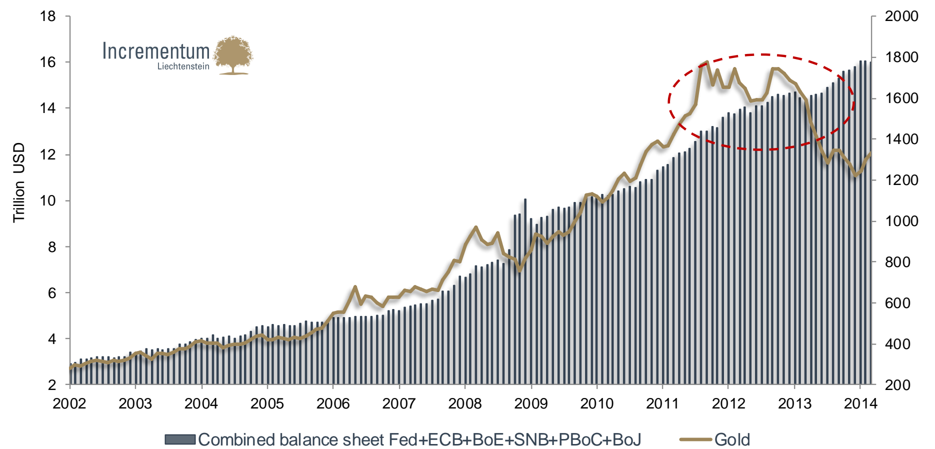
Source: Datastream, Bloomberg, Incrementum AG

Divergence between the growth in the money supply and the gold price

The following chart shows the divergence between money supply growth and the trend in the gold price that has been underway since 2011. It shows the combined balance sheet totals of Federal Reserve, ECB, Bank of England, People's Bank of China and Bank of Japan. **Whenever the money supply grows at a faster pace than the supply of physical gold, the gold price should rise and vice versa.** The chart shows us that either the gold price has corrected too much, or that central bank balance sheets will stagnate, resp. decline, in the future. Anyone familiar with economic history knows how few precedents of sustained reductions in central bank balance sheets exist.

"Every dollar printed is a government tax on cash balances."
Frank Hollenbeck

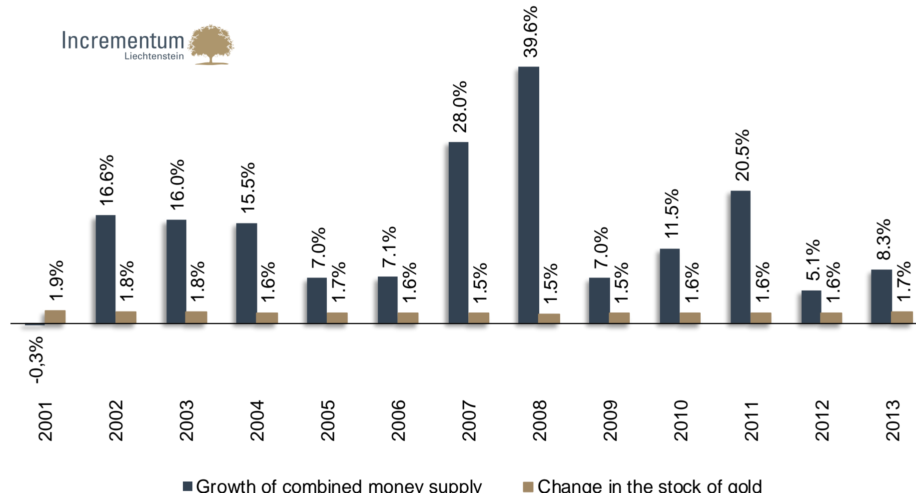
Combined balance sheet totals Fed+ECB+BoE+SNB+PBoC+BoJ in USD trillion (2002-2014)



Source: Bloomberg, Datastream, Incrementum AG

The following chart compares the annual rate of change of the money supply in the US, the euro zone, China and Japan with the annual change in the stock of gold.

Comparison: Growth of combined money supply Fed, ECB, PBoC and Bank of Japan vs. change in the stock of gold



Source: Ned Davis Research, U.S. Geological Survey, Incrementum AG

"Gold is an expression of the world's distrust of the way our central bankers conduct their affairs."
James Grant

"As we look back throughout history, it quickly becomes obvious that Christopher Columbus was the world's first modern central banker. He left without knowing where he was going, when he arrived he did not know where he was, and he did it all with other people's money."
Charles Gave

Apart from inflating central bank balance sheets, many additional potentially inflationary measures have been taken recently, including **liquidity swap agreements.** Simply put, central banks thereby create unlimited credit lines with each other. In October 2013, the Bank of England, the Bank of Japan, the ECB, the Federal Reserve, the Swiss National Bank and the Bank of Canada signed an agreement which transformed the hitherto temporally limited 'crisis' swap agreements into permanent ones. This is especially relevant for the dollar liabilities of banks outside of the US. Banks can thus borrow US dollars directly from the ECB, BoJ, SNB, etc., and the respective central banks swap their own currencies with the Fed. This ensures that there is guaranteed and *de facto* unlimited dollar liquidity. **This results in an increasing convergence of monetary policy, with central banks losing sovereignty over the domestic money supply**, since they must make any amount demanded by foreign commercial banks available. **According to Thorsten Polleit, currency sovereignty is thereby *de facto* rescinded.**[7]

[7] see: „Grenzüberschreitendes Geldvermehren", ("Cross-border Money Multiplication"), Dr. Thorsten Polleit, Rottmeyer.de

c.) Reasons for the recent correction in the gold price

The price trend in gold was clearly negative in 2013. Since the beginning of the new year, things have however changed, and the trend has been positive in nearly every currency. Since the beginning of the bull market, the average annual advance is 10.88%. This is roughly in line with the monetary inflation shown in the preceding charts.

Gold's performance in various currencies since 2001 (%)

	EUR	USD	GBP	AUD	CAD	Yuan	JPY	CHF	INR	Average
2001	8.10%	2.50%	5.40%	11.30%	8.80%	2.50%	17.40%	5.00%	5.80%	**7.42%**
2002	5.90%	24.70%	12.70%	13.50%	23.70%	24.80%	13.00%	3.90%	24.00%	**16.24%**
2003	-0.50%	19.60%	7.90%	-10.50%	-2.20%	19.50%	7.90%	7.00%	13.50%	**6.91%**
2004	-2.10%	5.20%	-2.00%	1.40%	-2.00%	5.20%	0.90%	-3.00%	0.90%	**0.50%**
2005	35.10%	18.20%	31.80%	25.60%	14.50%	15.20%	35.70%	36.20%	22.80%	**26.12%**
2006	10.20%	22.80%	7.80%	14.40%	22.80%	18.80%	24.00%	13.90%	20.58%	**17.24%**
2007	18.80%	31.40%	29.70%	18.10%	11.50%	22.90%	23.40%	22.10%	17.40%	**21.70%**
2008	11.00%	5.80%	43.70%	33.00%	31.10%	-1.00%	-14.00%	-0.30%	30.50%	**15.53%**
2009	20.50%	23.90%	12.10%	-3.60%	5.90%	24.00%	27.10%	20.30%	18.40%	**16.51%**
2010	39.20%	29.80%	36.30%	15.10%	24.30%	25.30%	13.90%	17.40%	25.30%	**25.18%**
2011	12.70%	10.20%	9.20%	8.80%	11.90%	3.30%	3.90%	10.20%	30.40%	**11.18%**
2012	6.80%	7.00%	2.20%	5.40%	4.30%	6.20%	20.70%	4.20%	10.30%	**7.46%**
2013	-31.20%	-23.20%	-28.80%	-18.50%	-23.30%	-30.30%	-12.80%	-30.20%	-19.00%	**-24.14%**
2014 ytd	**6.70%**	**5.00%**	**2.50%**	**0.20%**	**7.20%**	**8.10%**	**1.70%**	**6.10%**	**2.40%**	**4.43%**
Mean	**10.09%**	**13.06%**	**12.18%**	**8.16%**	**9.89%**	**10.32%**	**11.63%**	**8.06%**	**14.51%**	**10.88%**
Median	**9.15%**	**14.20%**	**8.55%**	**10.05%**	**10.15%**	**11.65%**	**13.45%**	**6.55%**	**17.90%**	**11.29%**

Source: James Turk, Goldmoney.com, Incrementum AG

“*Gold always does what it should do… it just never does it when we think it should.*”
Richard Russell

Since the publication of our last report on 27 June 2013, the trend has been patchy. To be fair, given that our price target of USD 1,480 was clearly not reached, we have to exercise some self-criticism. We therefore want to analyze below what the reasons for the weaker than expected gold price trend were.

In our opinion, the following factors are, resp. were, decisive for the weak trend:

- **strong disinflationary tendencies**
- **rising real interest rates**
- **partly declining money supply** (esp. ECB), resp. slowing momentum of money supply growth (tapering by the Federal Reserve)
- **rising opportunity costs** due to the rally in stock markets
- **ETFs**[8]**:** strong outflows of approx. 900 tons last year. The exodus has however slowed markedly, in February the first net inflows since 2012 were recorded.
- **tightening credit spreads**
- **analyst opinions** turning increasingly negative (among others Goldman Sachs, Credit Suisse, Société Générale,...)

Consensus sees gold bull market as over: gold is now a contrarian investment by

Even though consensus now assumes that gold's bull market is over, we believe that the fundamental case remains intact more than ever. In our last gold report we already mentioned the similarities to the 1974-1976 “mid-cycle correction”. The period is similar to the current one, especially

[8] ETF sales were a consequence rather than a cause of the price decline.

due to significant disinflation, rising real interest rates and extremely high pessimism with respect to the future gold price trend.

"Mid-cycle correction" 1974-1976 vs. current correction (since 2011)

Source: Datastream, Incrementum AG, Erste Group Research

In the meantime, it appears as though – analogous to the situation in 1976 – sentiment towards gold has tilted toward pessimism. An excerpt from the New York Times from 29 August 1976[9] strikingly confirms the similarities to the current situation:

"*Two years ago gold bugs ran wild as the price of gold rose nearly six times. But since cresting two years ago it has steadily declined, almost by half, putting the gold bugs in flight. The most recent advisory from a leading Wall Street firm suggests that the price will continue to drift downward, and may ultimately settle 40% below current levels…*

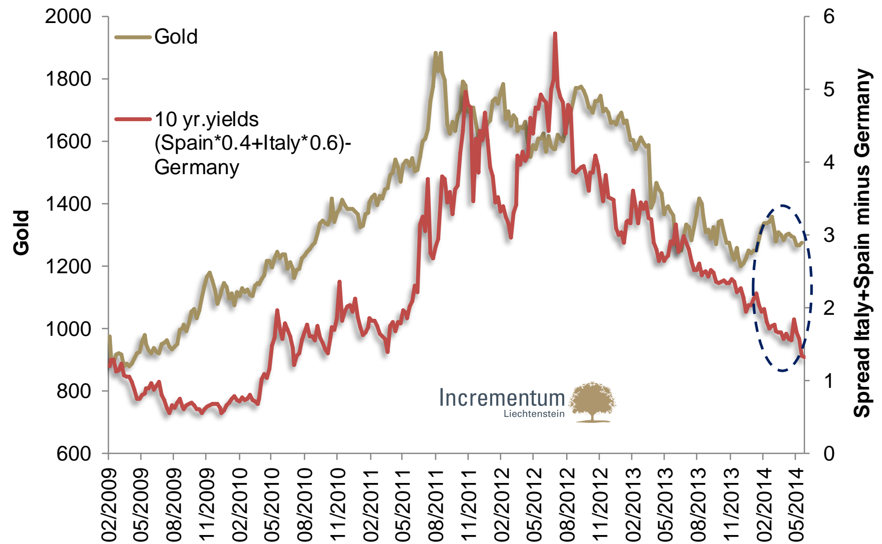
…The sharply reduced rates of inflation combined with resurgence of other, more economically productive investments, such as stocks, real estate, and bank savings have combined to eliminate gold's allure….

…Although the American economy has reduced its rapid rate of recovery, it is still on a firm expansionary course. The fear that dominated two years ago has largely vanished, replaced by a recovery that has turned the gold speculators' dreams into a nightmare."

The next chart shows that the gold price is definitely suffering from the (temporary) return of confidence in the euro area as well. The spread between Italian and Spanish to German government bond yields has been declining significantly for many months and is currently at the lowest level since 2011. **This signals that tail risks in the euro zone have recently been priced out.** Interestingly, however, the gold price is exhibiting a small degree of divergence since the beginning of 2014 and may therefore be giving advance warning of rising nervousness in the euro zone.

[9] i.e., only a few days after the trough of the correction

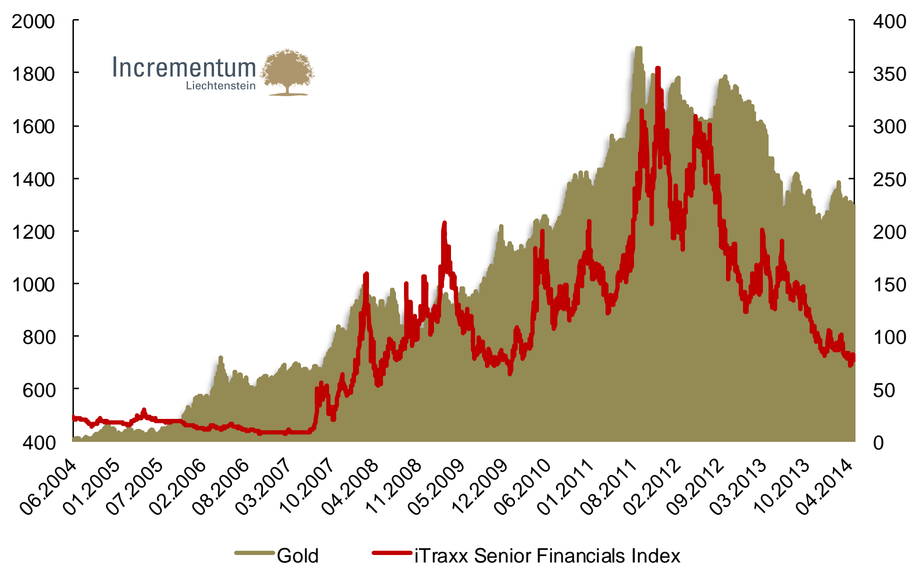
Yield spread between Italy+Spain vs. Germany vs. the price of gold



Source: Erste Group Research, Incrementum AG, Datastream

The following chart illustrates the extremely strong correlation between the gold price and CDS spreads. The confidence of financial market participants with respect to the stability of financial institutions is almost back to pre-crisis levels.

Gold (lhs. scale) vs. iTraxx Senior Financials Index (rhs. scale)



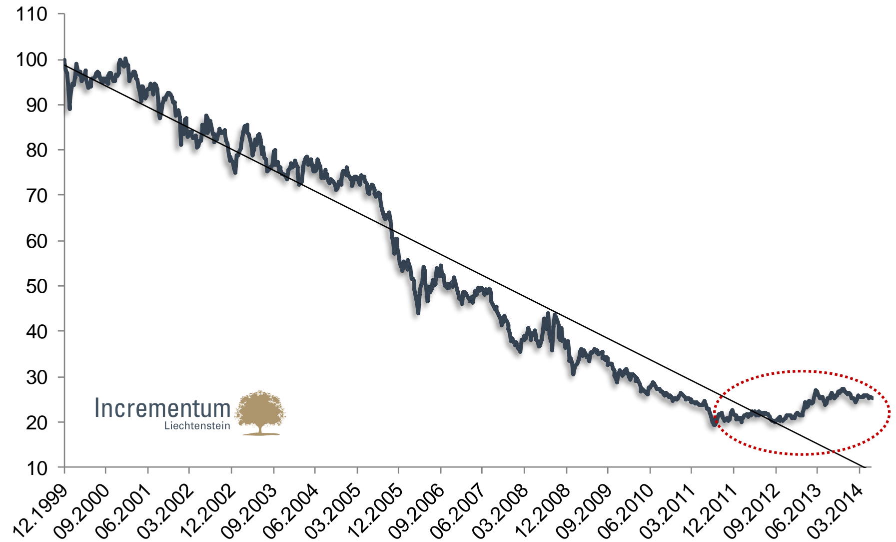
Source: Erste Group Research, Incrementum AG, Bloomberg

"100 years ago, the dollar was worth 1555mg of gold. Today, it is worth about 25mg. The long-term price target is 0."
Dr. Keith Weiner

The long-term downtrend of most currencies relative to gold can be seen in the following chart. The downtrend in the equal-weighted basket of currencies[10] has however flattened out recently and broken through a downtrend line.

[10] The basket consists of: US dollar, euro, Swiss franc, Japanese yen, renminbi, Indian rupee, British pound, Canadian dollar and Australian dollar

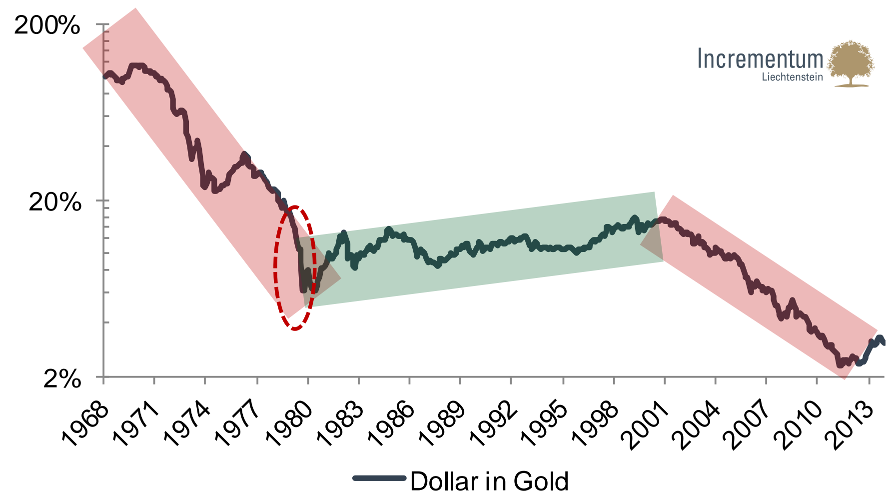
Basket of currencies measured in gold terms: long-term downtrend intact, however currently bottoming out?



Source: Datastream, Incrementum AG

As a longer-term perspective shows, the decline in the dollar's purchasing power versus gold is subject to long-term cycles. The current devaluation period is actually markedly more moderate than that of the 1970s. The final trend acceleration phase analogous to that of the 1970s, which is highlighted by a dotted circle, hasn't taken place yet. Time-wise, the current period is roughly congruent with the final devaluation phase.

Dollar value in gold (logarithmic scale)



Source: Federal Reserve St. Louis, Incrementum AG

3. GOLD AND INFLATION

The rate of change of price inflation and real interest rates play a decisive role for the gold price trend. We therefore want to focus on the topics of inflation and deflation at this juncture.

a.) Systemic inflation addiction

"The most important thing one must understand is that inflation isn't an act of God, it is no natural catastrophe, and no illness. Inflation is a political strategy."
Ludwig von Mises

The term ***inflation*** is usually employed as synonymous with the rate of increase in consumer prices. However, this perspective is actually far too narrow. In order to understand the phenomenon of monetary debasement we believe it makes sense to differentiate between **inflation and increasing prices (or price inflation)**. The causal connection between a rising money supply (inflation) and higher prices (price inflation) is barely disputed by economists, however, the actual concatenation of cause and effect often gets lost in linguistic usage.

The prevailing monetary order has emerged as the result of a step-by-step transformation of a gold-backed currency into a debt-backed currency. **Money is nowadays either created by the extension of new loans by commercial banks or by the central bank increasing its balance sheet (through the purchase of debt securities).**

As a direct consequence of this, the market economy has gradually been transformed into a system of 'creditism'.[11] The real economy has become dependent on an uninterrupted expansion of the supply of credit and money (i.e., inflationism). The result of this is both today's "growth mania" as well as the "inflation mania".

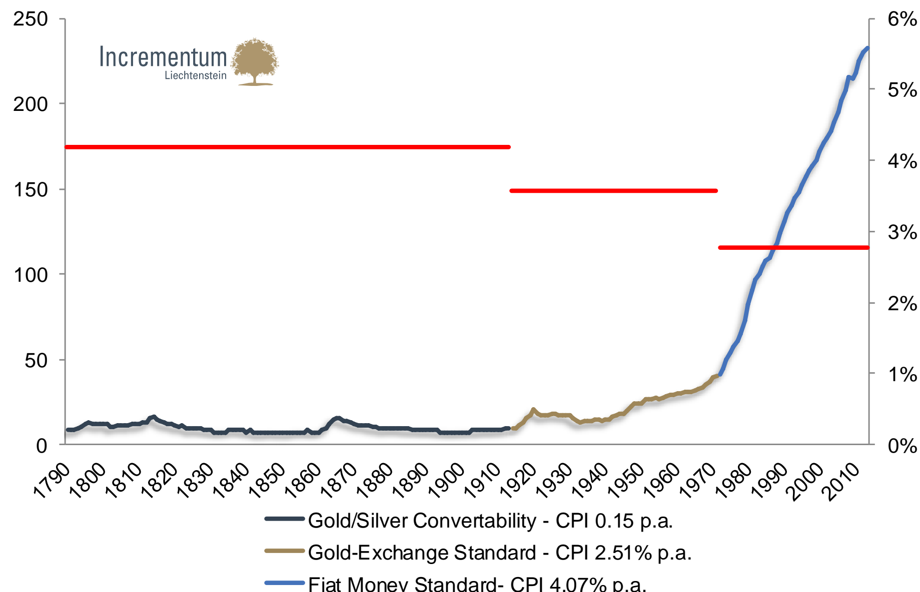
The ECB defines price stability as an annual loss of money's purchasing power (as measured by CPI) of close to two percent. It appears fundamentally paradoxical to define a state of stability by means of an exponential function that quadruples every 70 years. According to the prevailing orthodoxy, a truly stable price level (i.e., about 0% price inflation) is disadvantageous because the economy allegedly cannot prosper under such circumstances. **This assertion is historically clearly proved wrong.**

The truth is rather that **the monetary regime sets the inflation paradigm**. The United States provides us with instructive long-term data which support this thesis. The chart below shows annualized real growth (marked with a red line – right hand side scale) and the consumer price index. The different color markings divide the time period shown into three different monetary phases:

- before 1913: gold (and silver) serve exclusively as the monetary base[12]
- 1914-1971: partial gold backing prescribed
- from 1971: no gold backing necessary (fiat money/debt money)

[11] see „Österreichische Schule für Anleger" („Austrian School for Investors"), Taghizadegan, Stöferle, Valek
[12] In this time period gold convertibility was temporarily suspended on two occasions, was however restored again within a few years in both cases.

Trend in consumer prices and average real growth rates under different monetary regimes



Source: measuringworth.com, Incrementum AG

"All that deflation does is shatter the illusion of prosperity created by monetary pumping."
Frank Shostak

Until the end of the classical gold standard (1913), the absence of continuous price inflation was not detrimental to growth – on the contrary. Average real growth rates have declined both with the changeover to the gold exchange standard, respectively to today's debt based fiat money system. From this one could deduce that the more consistent the gold backing, the lower long-term inflation and the higher real economic growth will be.[13]

b.) Deflation from the perspective of the Austrian School of Economics

"Falling prices or price deflation are not the cause of economic and financial crises, but their consequence and simultaneously their cure"
Roland Baader

The "deflation specter", the great "deflation trap" as well as the "catastrophic deflation spiral" have recently been ubiquitous in the media, there was so to speak almost a hyperinflation of commentary on deflation. The scaremongering over falling prices appears somewhat baffling though; after all, the majority of consumers are happy with falling prices. This has been evident for years with respect to technology, such as smart phones or television sets, or the likes of long-distance travel. From the perspective of the Austrian School deflation is an increase in money's quality and a decrease in its quantity. It implies a partial realignment of relative prices, which have been distorted during the boom phase.

Professor Jörg Guido Hülsmann explains that the harmfulness of price deflation is one of the sanctified dogmas of today's monetary policy. Theoretical or empirical proof supporting this idea is however either weak or

[13] **Comment:** It is understandable that the gold standard is criticized as rigid and inflexible in the context of by now extremely over-regulated and centrally planned monetary system. The monetary basis cannot be inflated at will, a fractionally reserved banking system that collapses after an artificial credit boom cannot be 'reflated' under a gold-backed currency. Ludwig von Mises has already a century ago warned of the wide-ranging consequences of the fractionally reserved banking system (see: "The Theory of Money and Credit", 1912)

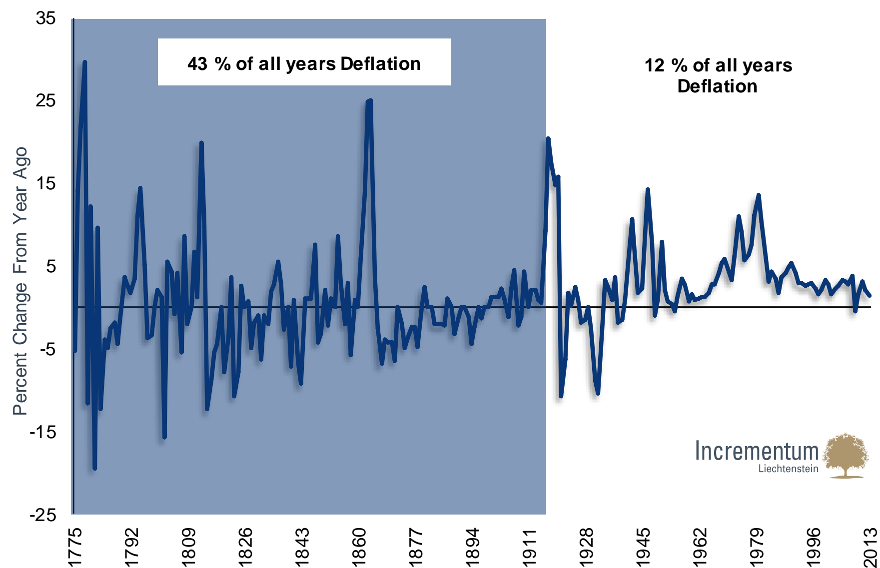
"Scratch an inflationist and you will find a debtor under the skin. Scratch a deflationist, and you will find a creditor."
Arthur Salz

entirely absent. Price deflation always means an unloved drastic treatment. This is mainly due to the fact that in the course of growing indebtedness, a significant redistribution of wealth takes place. **That there exists no empirical connection between deflation and depression, apart from the exception of the Great Depression, is also confirmed by a comprehensive historical study conducted by the Federal Reserve[14]:**

"Our main finding is that the only episode in which we find evidence of a link between deflation and depression is the Great Depression (1929-34). We find virtually no evidence of such a link in any other period…. ***What is striking is that nearly 90% of the episodes with deflation did not have depression. In a broad historical context, beyond the Great Depression, the notion that deflation and depression are linked virtually disappears."***

The next chart shows that up until the founding of the Federal Reserve, deflationary and inflationary periods alternated. Since 1913 and especially since the Bretton Woods agreement, this has however changed dramatically: in only 12% of all years was there price deflation on an annualized basis.

Since 1913, price deflation is no longer in fashion: CPI y-o-y since 1775



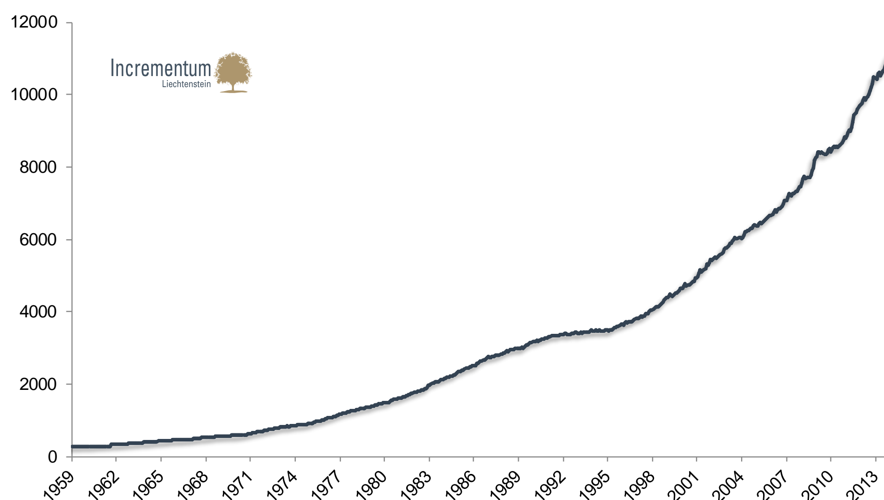
Source: Professor Robert Sahr, Measuringworth.com, Incrementum AG

"Due to high debts – and only due to high debts – falling prices become a societal and political ordeal"
Jörg Guido Hülsmann

In today's highly leveraged fractionally reserved fiat money system a pronounced credit deflation would have harrowing consequences for the real economy. The withdrawal symptoms of a debt liquidation are all the worse the more pronounced the dependency on credit is. Should there be an unchecked reversal of credit expansion, a significant money supply deflation would be fatal for large parts of the banking system. **Permanent expansion of the money and credit supply thus becomes an end onto itself for the debt money system.**

[14] See „Deflation and Depression: Is There an Empirical Link?" Federal Reserve Bank of Minneapolis, Andrew Atkeson and Patrick Kehoe, January 2004. The study evaluates data from 17 countries over a time period of 100 years

Money supply M2 (USD bn.)



Source: Federal Reserve St. Louis, Incrementum AG

This is the real reason why deflation is nowadays the nemesis of every central banker. The goal of every organism, every human being and every bureaucracy is to maximize its own chances of survival. From that perspective, deflation represents an existential threat to the current monetary system, which has to be fought *by all means*. In order to conceal the inherent instability of the credit system, extremely expansive central bank policy will continue to compensate for ongoing credit deflation (deleveraging). **In our opinion, this is a balancing act on a knife's edge.**

c.) The quantity theory of money

"Inflation is always and everywhere a monetary phenomenon."
Milton Friedman

Not only the Austrian School of Economics regards inflation as a monetary phenomenon: the view of the "Chicago School" is much more widely known. Milton Friedman is the most important proponent of the neo-quantity theory of money. **The quantity theory of money correlates the money supply with the price level and transactions in goods and services,** which can as a simplification be assumed to consist of nominal GDP. Based on nominal economic output and a predefined money supply, the so-called velocity of money can be calculated. If one furthermore takes into account that the broad money supply (e.g. M2) in a fractionally reserved banking system is the result of a multiplication process, one can draw up the following two equations:

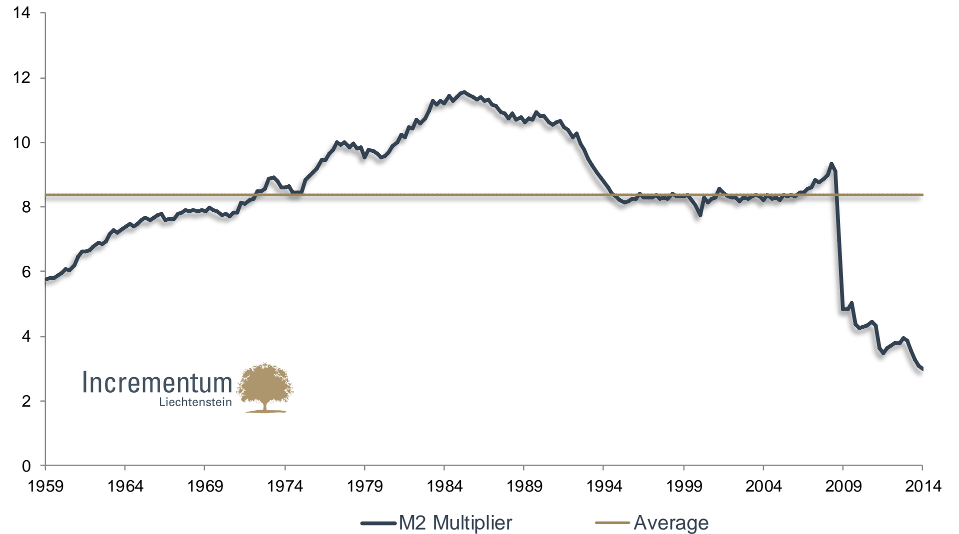
broad money supply * velocity of circulation = nominal GDP
(quantity theory)

and

central bank credit * money multiplier = broad money supply (e.g. M2)

Since the outbreak of the financial crisis in 2008 both the money multiplier and the velocity of circulation have massively decreased. From a monetarist perspective, the decrease in these variables is mainly responsible for the fact that in spite of central bank interventions, no strong growth of the broad money supply and consequently no large price increases have so far taken place.

Money multiplier since 1959



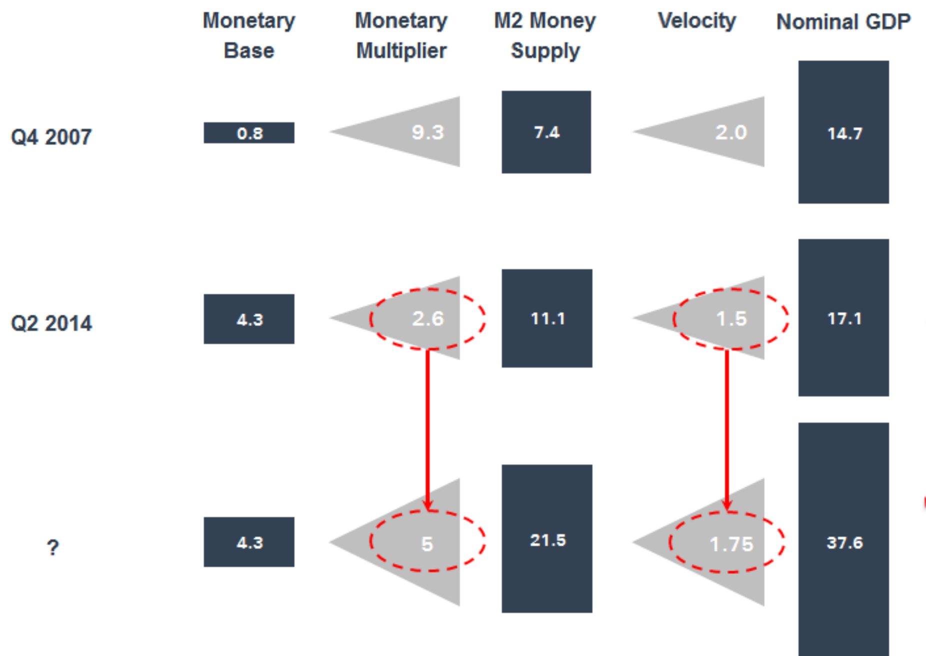
Source: Federal Reserve St. Louis, Incrementum AG

Should credit expansion by commercial banks (for example due to the implementation of steeply negative interest rates) move the money multiplier back toward its historical mean and /or velocity increase as well, a significant increase in nominal GDP would result.

Central bank money is often called 'high powered money", because it can be multiplied by the fractionally reserved banking system

The following illustration shows how large the potential for inflation is which has been "stored up" due to the generous supply of central bank liquidity. To this end we employ the above described logic of the monetarist perspective and assume that that the money multiplier and the velocity of circulation normalize.

Money multiplier and velocity of circulation



Source: Federal Reserve St. Louis, Incrementum AG

"Debt-to-GDP ratios are calculated in nominal rather than real terms. Nominal debt needs to be repaid with nominal growth in income. Nominal growth equals real growth plus inflation. Since real growth is anemic, the central banks must cause inflation to have any hope of increasing nominal growth and reducing these debt-to-GDP ratios."
Jim Rickards

The increase in the broad money supply combined with greater velocity results inevitably in greater nominal GDP. In the schematically outlined case above, GDP would increase by approximately 120%. **Nominal GDP growth consists of real growth and the rise in the price level.** It stands to reason that in this scenario the by far greatest part of the nominal increase would be due to a higher level of prices. Should the two variables "money multiplier" and "velocity of circulation" regain their pre-crisis levels, a large increase in GDP would result.

The Austrian School generally views quantitative models with great scepticism, especially if the parameters are aggregated to a large degree. Determining the "correct" money supply – which represents a major input of the quantity theory – is a difficult task in a fractionally reserved banking system. Even central banks employ different conventions for calculating money supply aggregates. Austrian economists consider primarily the behavior of acting individuals and speak in this context about a demand for cash balances. Austrians refer to a rising or falling demand for money (hoarding/dehoarding), which correlates conceptually with the velocity of circulation in the monetarist terminology.

Increasing acceptance of price inflation

„To me, a wise and humane policy is occasionally to let inflation rise even when inflation is running above target."
Janet Yellen

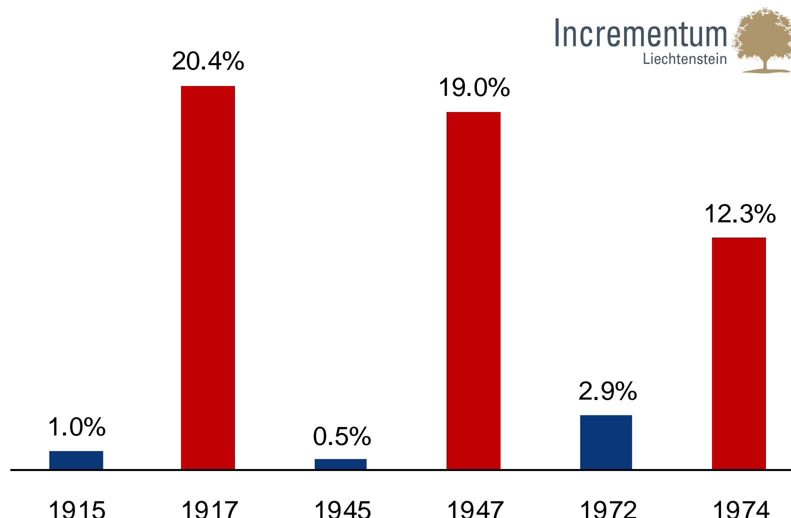
In the meantime there is increasing clamor in favor of pronounced inflation as the only viable solution for lowering debt ratios. In order to bring the ratio of total debt and economic output back to a sustainable level, nominal GDP growth needs to exceed debt growth. Since nominal growth consists of real growth plus price inflation, higher nominal growth can be induced by an increase in price inflation.

"…inflation can gain substantial momentum before the general public notices it. It was not until 1974, nine years into an inflationary cycle, that inflation became a potent political issue and prominent public policy concern. This lag in momentum and perception is the essence of money illusion."
Jim Rickards

At the end of 2008, Kenneth Rogoff, former chief economist of the IMF, already wrote in the Central Banking Journal that a higher rate of price inflation of 5% to 6% would be healthier in coming years than deflation amounting to 2% to 3%. Extraordinary times require extraordinary measures according to Rogoff. Only inflation remains as an "exit strategy". Similarly, the (unfortunately) influential Nobel laureate Paul Krugman is a proponent of higher inflation targets. His argument is that a too low inflation target provides European central bankers with a pretext not to take additional monetary stimulus measures. He calls this the "self-satisfaction trap".

History teaches us: neither mainstream economists nor central bankers have any control over the specific characteristics of inflation dynamics. The failure of attempting to regulate the level of price inflation like a thermostat is testament to hubris, a lack of judgment, and naiveté. **This pretence of knowledge is dangerous and is in the end going to fail. Waves of price inflation occur unexpectedly and in relatively short time periods.** As the following chart shows, this is confirmed by numerous historical episodes.

The dynamics of inflation: within a mere two years dramatic increases in price inflation are possible



Source: Federal Reserve St. Louis, Incrementum AG

d.) Monetary Tectonics: The interaction between inflation and deflation

„Since inflation favors the government and deflation favors the worker, governments always favor inflation"
Jim Rickards

The power struggle between market-cleansing natural deflation and politically-induced inflation continued throughout the last year. Inflationary measures taken by central banks have so far compensated for the deflationary trends emanating from the commercial banking sector and have created a superficial stability with respect to price inflation, even though the pendulum has swung increasingly toward disinflation in the past 12 months.

According to Austrian Business Cycle Theory, the prices of capital goods (= asset price inflation) are the first to increase in an inflationary process, while consumer price inflation only sets in at a later stage. The currently ongoing asset price inflation can be discerned in many areas, thus prices for antiques, luxury goods, expensive wines, collector's cars and of course real estate and stocks have increased substantially. **For the transmission of monetary inflation into pronounced consumer price inflation, rising commodity prices are of decisive importance.** An environment of significantly rising commodity prices (in domestic currency) is the main precondition for a significant increase in consumer price inflation rates.

Currently various potentially inflationary as well as deflationary forces are offsetting each other. We have listed the most important influence factors below:

Deflationary forces:

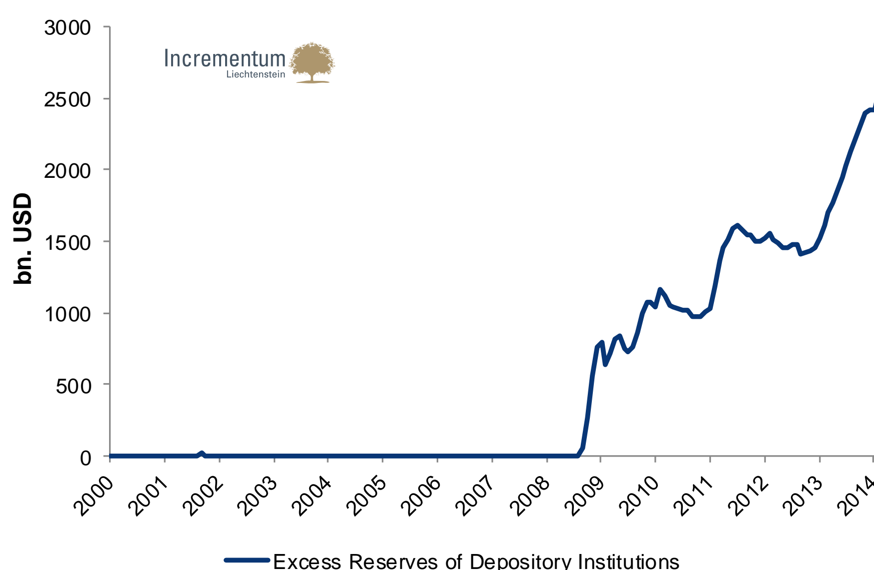
- shrinking balance sheets: undercapitalized banks continue to be restrictive with respect to extension of credit
- deleveraging: over-indebted consumers are reducing their debt burdens
- regulations: Basel III
- currently low money multiplier and velocity of circulation[15]
- productivity increases
- debt restructuring (Greece, Cyprus)

Inflationary forces:

- zero interest rate policy
- communication policy (forward guidance)
- Operation Twist
- quantitative easing
- devaluation of currencies (currency war)
- eligibility criteria for collateral
- penalty rates (negative interest rates for banks)

So far the effort to get more money into circulation via credit expansion has at least partly failed. Demand for credit continues to be low. Bank reserves newly created by quantitative easing are parked as excess reserves with the central bank for now. QE nevertheless is not without consequences: the market-distorting effects of low long-term interest rates must not be underestimated. The already mentioned spectacular inflation of asset prices is merely a side effect of QE.

Excess Reserves (bn. USD)



Source: Federal Reserve St. Louis, Incrementum AG

An excellent indicator for the interaction between inflation and deflation is the gold/silver ratio. The economic background is plausible: silver has the characteristics of a hybrid, as there is monetary demand for it on the one hand and industrial demand on the other. The possible

[15] The Austrian School correctly speaks about the "demand for money" in this context

applications for silver are quite diverse, e.g. in medical technology, in batteries and chemical catalysts, solar panels, etc. It is often used in "early cycle" industries, which means that it can provide reliable "economic forecasts" and tends to provide accurate signals of rising inflationary trends. Industrial use of gold is however scant, the demand for it is foremost of a monetary nature. In addition, gold benefits not only from rising inflation rates but also from deflationary episodes. **One could therefore also refer to the gold-silver ratio as the "deflation/reflation" ratio.[16].**

The ratio remains currently in an uptrend, i.e., the relative weakness of silver continues. Moreover, one can see that the gold rally earlier this year was not confirmed by silver. This suggests that the move in the gold price could mainly be explained as a political premium due to the Ukraine crisis.

Gold/silver ratio about to reverse?

According to our statistical evaluations, the probability of a sustainable gold price rally is significantly diminished when the gold/silver ratio is rising at the same time. **The current situation in the gold/silver ratio is therefore monitored carefully by us, as we could be very close to a reversal of the ratio.**

Gold/silver ratio since 1971 (circles indicate disinflationary periods)

Source: Bloomberg, Incrementum AG

Excursus: Incrementum Inflation-Signal

Proprietary inflation seismograph signals rising inflation

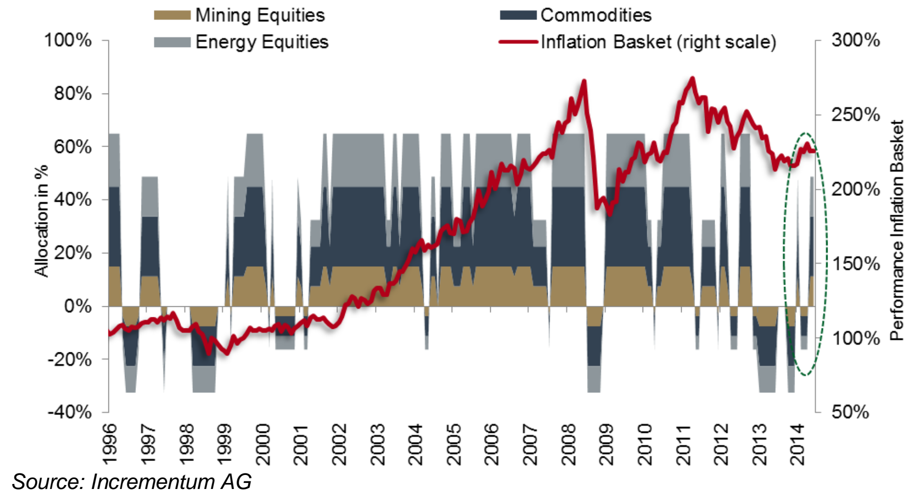
As we have already elaborated on, we are convinced that inflation is definitely a monetary phenomenon. Because of the dynamics of "monetary tectonics", inflationary and deflationary phases can alternate. **To measure how much monetary inflation actually reaches the real economy, we utilize a number of market-based indicators** - a combination of various quantitative factors including the Gold-Silver Ratio - which result in a proprietary signal. This method of measurement can be compared to a "monetary seismograph", which we refer to as the **"Incrementum Inflation Signal"**.

In the fund we manage, our Incrementum Inflation Signal gauges the inflation trend and we position the fund accordingly.

[16] See "Why we are optimistic about silver vs. gold and non-U.S. EPS?", Barry Bannister, Stifel Nicolaus

Historically, we observed periods of between 6 and 24 months during which disinflationary forces were dominant. These phases were particularly painful for the holders of inflation sensitive assets. Right now it looks as though we could be moving towards the end of such a phase. **Our inflation seismograph has triggered a "rising inflation signal" in mid June.**

Incrementum Inflation-Signal



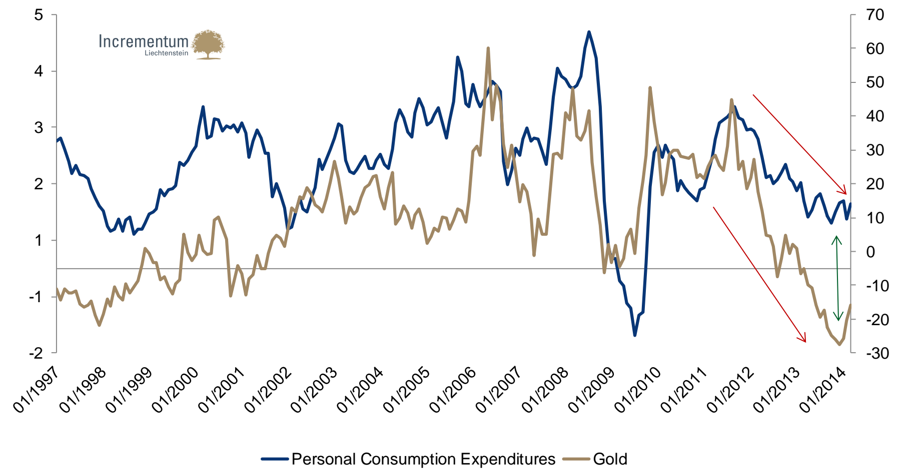
Source: Incrementum AG

e.) The gold price and the rate of price inflation

Gold is often called a hedge against inflation. This is not entirely correct. Last year we showed quantitatively that it is not so much the absolute rate of inflation that is relevant for the gold price, but rather the rate of change of inflation. Rising inflation rates generally mean that the environment for the gold price is positive, while falling rates of inflation (=disinflation) indicate the environment is negative. This can also be discerned in the following charts. Since autumn of 2011, the trend of the PCE index[17] is clearly declining, however, it currently seems to be stabilizing.

[17] Personal Consumption Expenditure Index, an inflation measure regarded as essential by the Fed, as the core inflation rate is derived from it.

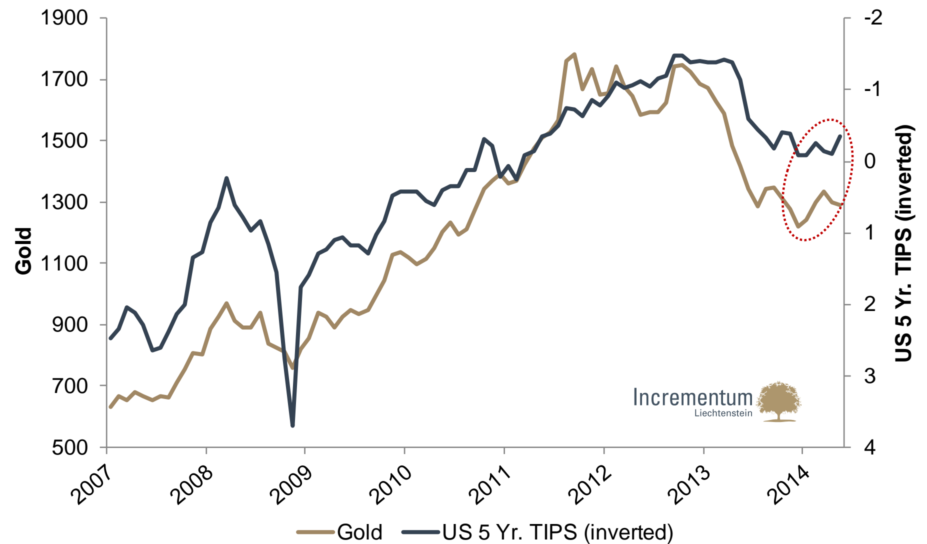
Price inflation and the gold price (rate of change in %)



Source: Federal Reserve St. Louis, Incrementum AG

Inflation-protected securities also show that rising price inflation has been 'priced out' since 2011. **However, over the past few weeks, TIPS seem to be factoring in rising inflation again. This was also confirmed by the action in the gold price.**

Gold price vs. 5yr. TIPS yield (inverted)



Source: Federal Reserve St. Louis, Incrementum AG

Alternative inflation measures already show rising price inflation rates

An alternative method of measuring the rate of price inflation is provided by the Billion Prices Project of the MIT. The goal of the project is to measure inflation trends more quickly and accurately than traditional price indexes. The price changes of five million goods in 70 countries are recorded daily with the help of software. For the US, the consumer price index "MIT Daily Index" is calculated, which has proved to be a leading indicator at every CPI turning point since 2009. **As the following chart shows, the index is currently diverging from CPI and has recently been trending upward.**

Billion Prices Index vs. CPI (y/y rate of change in %)

Source: State Street Price Stats, WSJ.com

Stocks and inflation-protected bonds provide only a very limited inflation protection

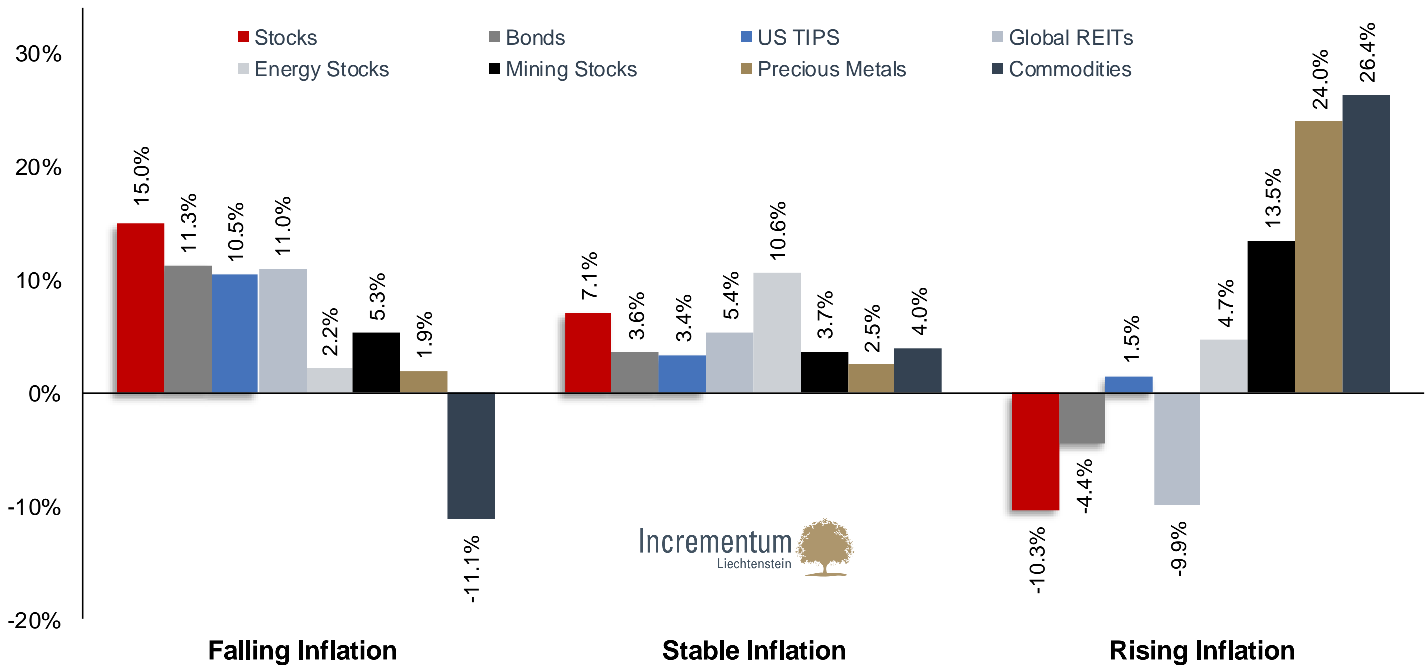
We believe that the inflation outlook currently represents one of the most important macroeconomic data points for the financial markets. As soon as market participants take rising price inflation seriously, market sentiment could change significantly. The current expectation that "*if in doubt, there will be further measures taken by central banks*" would be increasingly questioned if inflation expectations were to rise.

Based on this, we now want to discuss the characteristics of different asset classes in different inflation regimes. Apart from precious metals, inflation-indexed bonds are often cited as inflation hedges. Many investors don't realize, however, that **the inflation-protection feature only kicks in at maturity**. During their term, such bonds exhibit considerable sensitivity to changes in nominal interest rates. This is not an unimportant factor in portfolio construction. Especially long-term inflation-protected securities often face headwinds during times of rising inflationary trends, as these times are occasionally accompanied by rising nominal interest rates. If this asset class is added to a portfolio to hedge against inflation, it is possible that there will be severe disappointment in some years.

Gold, energy and commodities are highly inflation-sensitive

The following chart clearly shows that both stocks and bonds are among the losers in an environment of rising inflation rates. Even though stocks are often numbered among inflation hedges due to their real value characteristics, this is historically not quite clear. Numerous studies show that stock prices and inflation are negatively correlated. This means that an increase in price inflation normally has a negative effect on stock prices. Naturally, the effect clearly depends on the industry. **This is an important reason why gold and commodity stocks have attractive characteristics in terms of prudent portfolio diversification.**

Performance of different asset classes in different inflation regimes

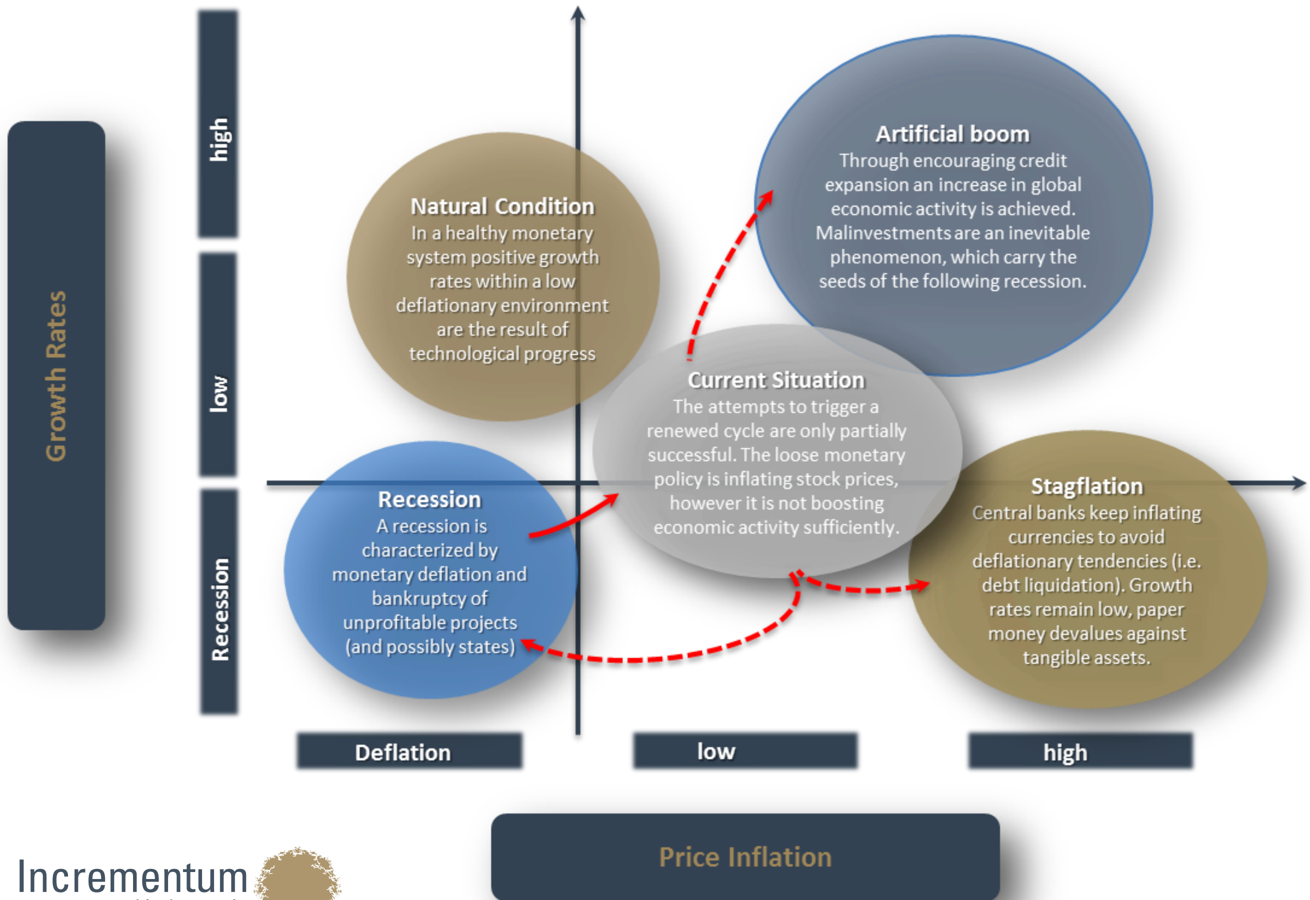


Source: Wellington Asset Management, Incrementum AG

f.) Future growth and inflation scenarios

The following illustration serves to place the current economic situation in an inflation matrix and to explicate possible developments. It shows possible future scenarios based on different growth and inflation rates.

Stagflation, artificial boom or recession?



Source: „Österreichische Schule für Anleger“, Taghizadegan, Stöferle und Valek

Mainstream economists held stagflation to be impossible

A scenario that has a destructive effect from an economic, political and social perspective is stagflation. The term designates an economic situation that is marked by economic stagnation (falling growth and high unemployment) combined with high inflation (rising prices). The term was coined during the economic crisis of the 1970s, when the US went through a period of rising inflation rates in concert with an economic recession. This state of affairs had previously been held to be impossible by mainstream economists.

However, stagflation could be observed for the first time in the US and the UK in the 1960s already. In the 1960s the Federal Reserve believed that there was a stable inverse correlation between unemployment and inflation. The goal of the Fed's monetary policy was to stimulate demand for goods and services and keep unemployment low. The only trade-off in the eyes of economists at the time was a rising inflation rate (at a controllable extent).

Asset classes in a stagflation environment: Stocks and bonds bad, gold and commodities good

The wage-price spiral set into motion by high inflation (which is a process of adjustment between wage increases and rising prices on the part of households and corporations) was however not the trigger of the momentous stagflation of the 1970s. Prices began to rise dramatically in the subsequent decade. The transition also had grave effects on the capital markets as well as investors' real returns. **Due to the monetary inflation of the 1970s (and the subsequent rise in prices), the decade delivered well below average bond and stock returns, whereas commodities and precious metals rallied.**

„The next major theme is stagflation — this will be the legacy of the Bernanke regime. You cannot keep real short-term rates negative for this long in the face of even modestly positive real economic growth without generating financial excesses today and inflationary pressures in the future.“
Dave Rosenberg

According to mainstream economics, stagflation is generally triggered by supply shocks (price shocks), which influence the general level of prices due to rising cost pressures. Entrepreneurs are driven to raise their sales prices on the back of higher input costs (energy prices). With total demand unchanged, a decline in revenues ensues, which ultimately leads to a decline in production and accordingly the dismissal of employees. In Keynesian economic theory, the Phillips curve postulates that there is a proportional relationship between economic growth (resp. unemployment) and inflation.[18]

A closer examination of the current situation reveals signs of the beginnings of a stagflation period. Japan's economic history may be a harbinger with respect to future developments in terms of stagnating growth. This case demonstrates that the Keynesian fiscal policy implemented in the past was unable to counter sustained economic stagnation. Instead Japan's government amassed an enormous debt load. In light of the lack of success, it is now attempted with typical Keynesian logic[19] to cast out the devils by Beelzebub, by enacting even greater stimulus programs in the framework of “Abenomics” - supported by loose monetary policy.

g.) Conclusion: inflation vs. deflation

“Acquiring gold is not an investment. It is a conscious decision to REFRAIN from investing until an honest monetary regime makes rational calculation of relative asset prices possible.”
Andreas Acavalos

The monetary experiments currently underway resemble a walk on a knife's edge. A low rate of inflation can be driven up by brute force through decisive central bank action. Whether the flood of liquidity that is currently put at the banking system's disposal can really be removed in time is more than questionable. In a worst-case scenario, a loss of confidence in the currency may occur that can no longer be reversed. It was said in the 1920s that central bankers were like ships captains who not only refused to learn the basic rules of navigation, but even asserted that they were superfluous. At the moment the impression is that central bankers are attempting to cross the Pacific using a map of the Atlantic.[20]

“Deflation is every central bank’s nemesis because it is difficult to reverse, impossible to tax, and makes sovereign debt unpayable by increasing the real value of debt.”
Jim Rickards

From our perspective it cannot be stated a priori whether inflationary forces will prevail in this power struggle. However, due to existing socio-economic incentive structures, when in doubt, higher price inflation will definitely be preferred over a deflationary adjustment. However, disinflationary forces should not be underestimated. The southern European banking system has not yet been sufficiently recapitalized in the wake of the

[18] According to this curve, inflation rises when unemployment is low, while it decreases under high unemployment. Full employment goes hand in hand with high economic growth. A higher rate of inflation thus leads to higher economic growth. Stagflation is by definition impossible.
[19] Allegedly it is not the Keynesian approach that is wrong, but only the implementation is lacking.
[20] see „Keine Dogmen“ („No dogmas“), Philipp Vorndran, Flossbach von Storch News, October 2013

credit bust and is very reluctant to extend new loans. **The preceding credit boom has left a palpable deflationary echo behind.**

It cannot be ruled out that deflationary effects will intermittently prevail, e.g. due to another banking crisis or a government bankruptcy. A temporary deflationary episode similar to that of 2008, on the road to greater inflation, could well be a realistic scenario.

Since the autumn of 2011, when inflation rates in the US stood at an annual rate of change of more than 4%, we have seen a strong disinflation trend. Since the inflation rate has in the meantime fallen significantly below the official 2-2.5% target, and the trend continues to point down, the Federal Reserve and the ECB have leeway to take countermeasures against the disinflation trend. **Should the trend of price inflation reverse, excellent opportunities in inflation-proof investments would present themselves.**

"At first, the pendulum was swinging towards infinite interest, threatening the dollar with hyperinflation. Right now the pendulum is swinging to the other extreme, to zero interest, spelling hyper-deflation. This is just as damaging to producers as the swing towards infinite interest was in the early 1980's. It is impossible to predict whether one or the other extreme in the swinging of the wrecking ball will bring about the world economy's collapse. Hyperinflation and hyper-deflation are just two different forms of the same phenomenon: credit collapse. Arguing which of the two forms will dominate is futile: it blurs the focus of inquiry and frustrates efforts to avoid disaster."[21]

Prof. Antal Fekete

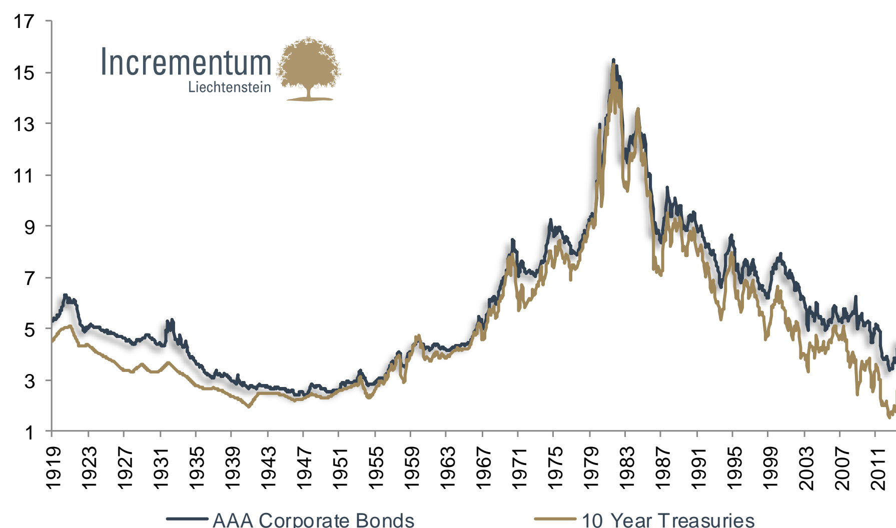
[21] "Monetary Economics 101: The Real Bills Doctrine of Adam Smith. Lecture 10: The Revolt of Quality", Prof. Antal Fekete

4. THE CONSEQUENCES OF GLOBAL ZERO INTEREST RATE POLICY

In many countries yields are at all time lows

Bond prices in practically all industrialized nations are near all-time highs. Never before have interest rates been this low on a global basis. **If one examines these events more closely, it becomes clear that the underlying problems cannot be solved by global zero interest rate policy, but that the natural selection process of the market is instead being undermined.**

Yields of 10yr. US treasury notes and AAA corporate bonds since 1919



Source: Federal Reserve St. Louis, Prof. Robert Shiller, Incrementum AG

„Interest rates are the heart, soul and life of the free enterprise system“
Michael Gayed

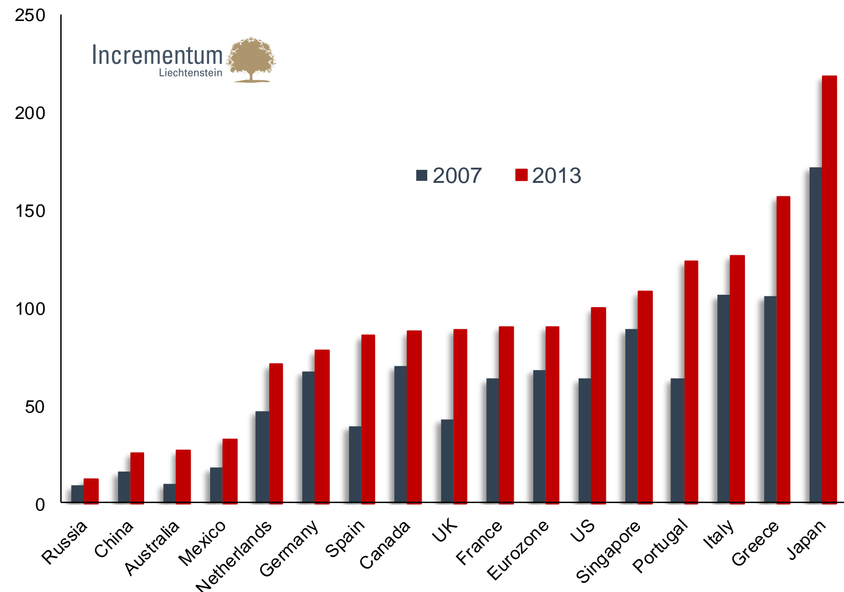
Michael von Prollius said that the key to avoid booms and busts was *“to let interest rates tell the truth about time”.*[22] This truth is however veiled and distorted at the moment. Governments, financial institutions, entrepreneurs and consumers that are acting in an uneconomic manner are thus kept artificially afloat. As a result, instead of them being punished for their errors, these errors are perpetuated. Protraction of this process of selection leads to a structural weakening of the economy, and a concomitant increase in the system's fragility.

Declining interest rate levels make a gradual increase in public debt possible

As a consequence of structurally too low interest rate levels, a *“culture of instant gratification”*[23] is fostered, which is characterized by the fact that consumption is not financed with savings, but by taking on debt. This debt-based life goes hand in hand with rising time preferences and undermines the sustainability of responsible economic activity. Declining interest rate levels make a gradual increase in public indebtedness possible, while the interest burden (as a share of government spending) does not grow.

[22] see „Geldsozialismus“ („Money Socialism“), Roland Baader
[23] see „Wenn Menschen zu Ratten werden“ („When men become rats“), Linus Huber

Comparison of indebtedness, 2007 vs. 2013



Source: Tradingeconomics.com, Incrementum AG

Large hikes in base rates now impossible

Without negative real interest rates, the steadily growing mountains of debt would long ago have ceased to be sustainable. Central banks are increasingly prisoners of the policy of over-indebtedness. This was even remarked upon by the IMF in a stability report.[24] It was criticized that the reversal of unconventional monetary policy was not accompanied by appropriate preparations on the political level in favor of normal and self-sustaining growth. It is probably already impossible to achieve a normalization of monetary policy without triggering major dislocations in the financial markets. **Raising base rates would destabilize the entire financial system.**

Low interest rate policy has the following grave consequences:

– Normally conservative investors are increasingly under **duress** and due to the outlook for interest rates remaining low for a long time, are taking on excessive risk. This leads to capital misallocation and the formation of bubbles.

– The sweet poison of low interest rates and easy money therefore leads to massive **asset price inflation (stocks, art, real estate)**

– Through carry trades, interest rates that are structurally too low in the industrialized nations lead to asset bubbles and contagion effects in emerging markets

– a **structural weakening of financial markets**, as reckless behavior of market participants is fostered (moral hazard)

– a change in **human behavior patterns**, due to continually declining purchasing power. While thrift is slowly but surely transmogrified into a relic of the past, taking on debt becomes rational.

– The **acquisition of personal wealth** becomes gradually more difficult.

[24] „Global Financial Stability Report“, IMF, April 2014

- The importance of money **as a medium of exchange and a unit of account** increases in importance relative to its role as a **store of value**.[25]
- Incentives for fiscal probity decline. Central banks have bought time for governments. Large deficits appear less problematic, there is no incentive to implement reform, resp. consolidate public finances in a sustainable manner.
- The emergence of **zombie-banks and zombie-companies**. Very low interest rates prevent the healthy process of creative destruction. Zero interest rate policy makes it possible for companies with low profitability to survive, similar to Japan in the 1990s. Banks are enabled to nigh endlessly roll over potentially delinquent loans and consequently lower their write-offs.
- **Unjust redistribution (Cantillon effect):** the effect describes the fact that newly created money is neither uniformly nor simultaneously distributed in the population. Monetary expansion is therefore never neutral. There is a permanent transfer of wealth from later to earlier receivers of new money.[26]

Moreover, permanent inflation also has a negative effect on the quality of production. This can e.g. be observed in the deterioration of the construction business. According to Professor Hülsmann, a great many roads and buildings in countries that suffer from incessant inflation need to be continually repaired.[27]

Socio-cultural implications of zero interest policy

Global zero interest rate policy does not only have economic consequences. In his fascinating book "The Ethics of Money Production", Professor Hülsmann describes how social behavior patterns change on account of inflation. Financial questions begin to play an ever bigger role in life. Inflation, which Hülsmann similar to all Austrian economists defines as an increase in the money supply, makes society increasingly materialistic.[28] According to Thomas Woods, the ethical aspects are especially pronounced among young people. *"They learn to live in the present, and scorn those who want to teach them old-fashioned morals and thrift".* The low interest rate structure fosters short-term consumption to the detriment of long-term investment for future generations.[29]

"*When you devalue money, you devalue trust.*"
Dylan Grice

In addition, the trust between creditors and borrowers tends to fray. "Credo" is a Latin word meaning "I believe". The English term "credit" is derived from it. Debt and credit always rest to a certain degree upon confidence and the belief that one will be repaid (incl. adequate interest). In financial markets, confidence is expressed by the risk premiums embedded in yields. The less trustworthy a borrower, the higher the yield a creditor will demand.[30] However, if there are interventions, fragility of confidence is

[25] see: „Ein Staatsgeldsystem lädt Regierungen immer zum Betrug ein" („A state-controlled monetary system is always an invitation to fraud"), Hubert Milz, Ludwig von Mises Institute Germany
[26] see: „Cantillon effect describes unequal distribution of newly created money", In Gold We Trust 2013
[27] "The Ethics of Money Production", Jörg Guido Hülsmann
[28] "The Ethics of Money Production ", Jörg Guido Hülsmann
[29] "Money and Morality: the Christian Moral Tradition and the Best Monetary Regime ", seen in: Hülsmann „The Ethics of Money Production"
[30] Ownership of gold by contrast is pure property without any associated liability. This explains also why it pays no interest: there is no counterparty risk.

fostered.[31] Credit is after all "*suspicion asleep*". The point at which confidence collapses and creditors lose their faith in creditworthiness, can therefore not be predicted with certainty. **We are convinced that gold represents a sensible hedge for such a crisis of confidence.**

a.) An illustration of the relationship between capital and consumer goods production – distortion of the capital structure

"Saving is the indispensable precondition for investment. There simply exists no investment that is not financed out of savings"
Prof. Jörg Guido Hülsmann

The Austrian School has recognized that in a free monetary system, interest rates represent the ratio between the supply of savings and the demand for savings for purposes of investment. They express the price of today's money in terms of future money. In our unbacked, monopolistic monetary system, this relationship is distorted. The prevailing level of interest rates suggests that the supply of savings is far greater than it is in reality. This is disastrous, as interest rates guide the formation of the capital stock, which allows productivity and real incomes to increase in the long-term. Interest rates signal the availability of real resources for investment, resp., which investment projects are actually *not* viable, as the scarcity of resources makes it impossible to realize all investment projects.[32]

Interest rates are an indispensable compass

The interest rate is thus the ultimate key datum of the economy. It aligns people's time preferences and is therefore an ***indispensable compass*** for all market participants. According to Roland Baader, the most precious resource of human beings is their lifetime. The natural interest rate represents the decisive link between lifetime and scarcity.

Ratio of capital vs. consumer goods production at a dangerously high level

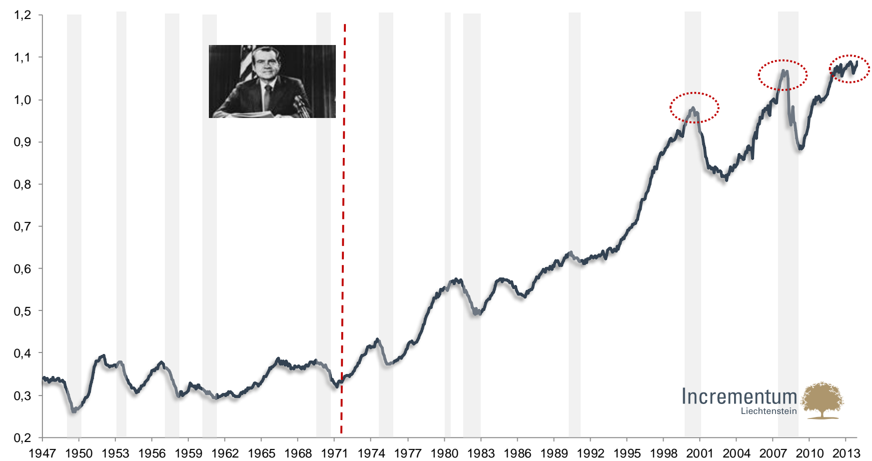
The ratio between the production of capital goods vs. consumer goods represents an excellent illustration of the extent to which the economy is distorted. According to the Austrian Business Cycle Theory (ABCT), low savings rates and a large expansion of the money supply always lead to a lengthening of the production structure that cannot be sustained in the long-term, unless it is backed by an increase in the volume of savings. Activity in the higher stages of the capital structure (capital goods) increases to the detriment of the lower stages (consumer goods) of the production structure.

"Let's be clear. We've intentionally blown the biggest government bond bubble in history. We need to be vigilant to the consequences of that bubble deflating more quickly than we might otherwise have wanted."
Andy Haldane, Bank of England director of financial stability

This can be seen in the following chart. **An increase in the ratio points to a shift in capital structure investment from lower to higher stages.** This phenomenon is a symptom of a credit-induced boom. The chart shows that recessions generally follow periods during which the production of capital goods increases excessively. The production structure is then realigned with the true consumption and savings preferences of market actors. However, since the reaction of monetary authorities to recessions is usually not long in coming, a complete reallocation of the previously misallocated capital fails to take place. One can furthermore see that the ratio remained in a sideways channel prior to the repeal of the Bretton Woods agreement in 1971 and began to enter a strong uptrend only after the dollar's tie to gold was severed. **Currently, the production of capital goods exceeds the production of consumer goods for only the second time in history. The first time this happened was in 2007, shortly before the beginning of the financial crisis.**

[31] see „Memo to Central Banks: You're debasing more than our currency", Dylan Grice
[32] see. „Was der unbegrenzte Ankauf von Staatsanleihen durch die EZB wirklich bedeutet" ("What the unlimited purchase of government bonds by the ECB really means"), Dr. Thorsten Polleitt, Rott&Meyer

Ratio of capital vs. consumer goods production (gray areas indicate US recessions)



Source: Federal Reserve St. Louis, Incrementum AG, acting-man.com

Conclusion

The desperate avoidance of creative destruction is going to have long-term negative consequences for systemic economic stability. **The seeds of the next crisis have already been sown as a result of the policy of low interest rates and monetary stimulus.**

b.) Beneficiaries and victims of the zero interest rate policy

Cui bono?

In a study well worth reading[33], McKinsey has identified the beneficiaries and victims of low interest rate policies. The study finds that governments and big corporations are the main beneficiaries, since they hold a much larger portion of interest-bearing liabilities than interest-bearing assets, and their interest costs decline significantly.

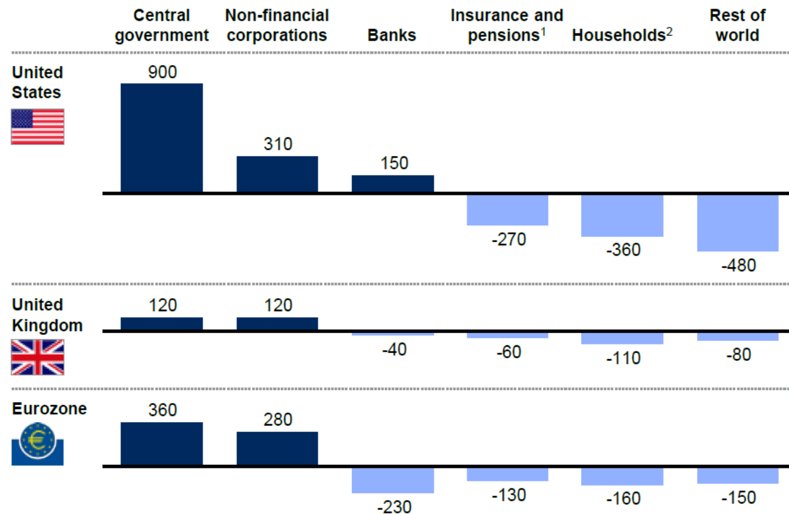
In the US, the average interest rate of all outstanding bonds declined from 4.8% in 2007 to 2.4% in 2012, in the UK from 5.1% to 3.2% and in the euro zone from 4.5% on average to 3.3%. Between 2007 and 2012, the governments of the US, the UK and the euro area were as a result able to save USD 1.6 trillion in expenses. This was due to lower debt service costs on the one hand, and increasing profits of central banks on the other.[34]

Zero interest rate policy endangers insurance companies and their policyholders

Institutional investors such as pension funds and life insurance companies (and their policyholders) are by contrast among the biggest losers of the easy money policy. The yields on most government bonds have fallen well below guaranteed interest rates in the meantime. In Germany, the guaranteed rate is currently 1.75%, while the yield of a 10-year government note is 1.33%[35]. As soon as higher yielding bonds mature,

[33] see McKinsey Global Institute , „QE and ultra-low interest rates: distributional effects and risks", November 2013
[34] The Federal reserve's remittances to the treasury between 2009 and 2012 amounted to USD 291 bn. in total.
[35] 16 June 2014

reinvestment takes place at lower yields. **The longer this discrepancy lasts, the more many insurance companies' survival is under threat according to the McKinsey study.**



Source: McKinsey Global Institute

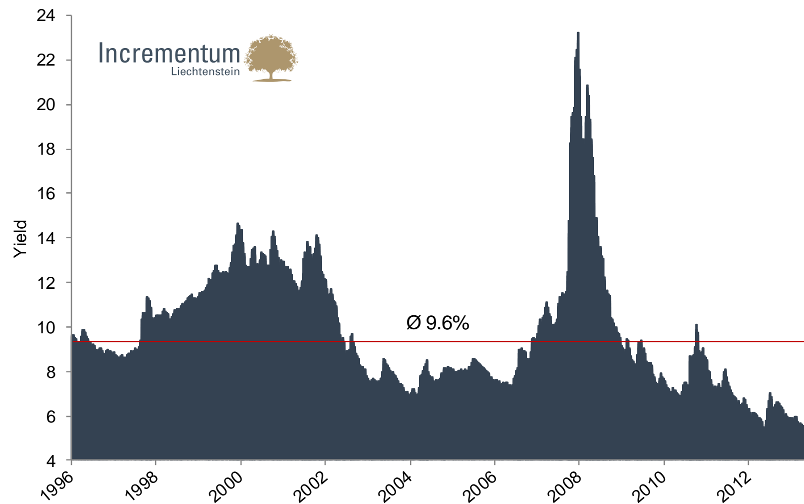
"***The money rate can, indeed, be kept artificially low only by continuous new injections of currency or bank credit in place of real savings. This can create the illusion of more capital just as the addition of water can create the illusion of more milk. But it is a policy of continuous inflation. It is obviously a process involving cumulative danger.***"
Henry Hazlitt

In view of the ongoing low interest rate policy, investors are forced to take on ever greater risks in their search for yield. This hunger for yield is in the meantime producing rather disturbing effects. While investment in government bonds was preferred in the past, the 'yield caravan' soon proceeded toward corporate bonds, then to medium grade bonds, and now toward junk bonds and frontier market bonds.[36]

According to a study by Bank of America[37], 50% of all government debt securities currently trade at yields below one percent. As a result, yield chasing leads to irrational exuberance in risk assets. This can be discerned in the following chart. The yield of the US High Yield Index declined to 5.2%, which is significantly below the long-term average of 9.6%. **Only a few years ago, a yield of 5% on US treasuries was considered low.**

[36] The term frontier market is commonly used to describe markets of the smaller and less accessible, but still „investable", countries of the developing world. Examples are Bangladesh, Botswana, Kenya, Sri Lanka, Vietnam, Algeria, Tunesia or Colombia.
[37] see "Yield Chasers United sets new records as well", Acting-man.com

Yield of US High Yield Index since 1996



Source: Federal Reserve St. Louis, Incrementum AG

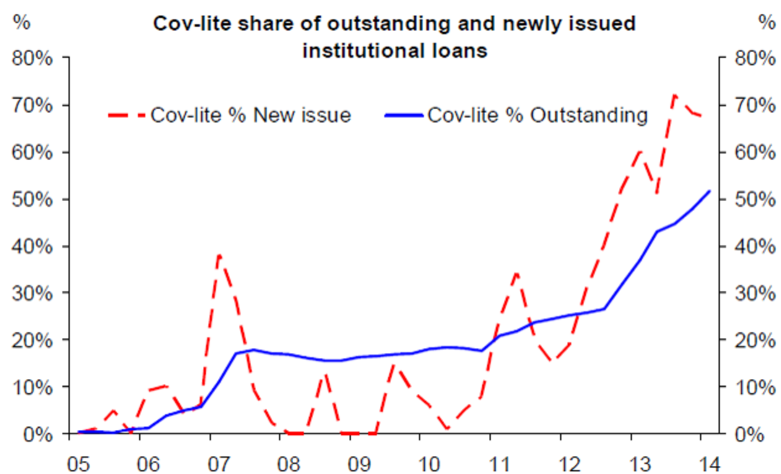
The bond mania reminds us of irrational exuberance in the NASDAQ at the end of the 1990s

Even nations that are far from paragons of stability have been able to issue bonds without a problem of late. Zambia recorded demand amounting to USD 12bn for a 10-year bond yielding 5.4% - the issue was 15 times oversubscribed. Even Rwanda had no problem finding financing at 6.875% and saw its issue 8 times oversubscribed. Pakistan issued its first bond since 2007 and received USD 1bn at 8.25%. This issue is the equivalent of 5% of annual government revenue. **These record prices and massive oversubscriptions remind one of the excesses in Germany's "Neuer Markt" or in the NASDAQ at the end of the 1990s.**

"Cov-lites are pretty dangerous pieces of paper for those who advance the loan."
Jon Moulton

"Covenant light" loans (Cov-lite for short) are the equivalent of sub-prime loans on the corporate loan market. The term describes bonds in the highest risk segment with especially lenient covenants, in which the creditor largely waives all the usual safeguards. The majority of these loans are used for takeovers (primarily LBOs) or the refinancing of old loans. The Financial Times called this type of bond *"the financial equivalent to bungee jumping, only without a second safety belt."* In 2013, USD 238bn in new Cov-Lite loans were issued, a volume that exceeded the previous peak achieved in 2007.

"Ongoing monetary accommodation is blunting its own effectiveness… ever more money will have to be injected ever faster for the central banks to keep achieving their near-term policy goals, which are to obstruct any liquidations of capital misallocations and excess debt."
Detlev Schlichter



Source: Torsten Slok, DB Global Markets Research

Conclusion

The longer the zero interest rate period lasts, the higher the risks investors who have defined return requirements are forced to take. Normally, lower yields would have to go hand in hand with a commensurate decline in risks. That is currently a highly dubious notion, especially in light of the vast increase in public debt worldwide.[38]

"*The artificial prosperity cannot last because the lowering of the rate of interest, purely technical as it was and not corresponding to the real state of the market data, has misled entrepreneurial calculations. It has created the illusion that certain projects offer the chances of profitability when, in fact, the available supply of factors of production was not sufficient for their execution. Deluded by false reckoning, businessmen have expanded their activities beyond the limits drawn by the state of society's wealth. They have underrated the degree of the scarcity of factors of production and overtaxed their capacity to produce. In short: they have squandered scarce capital goods by malinvestment.*"
Ludwig von Mises, On the Manipulation of Money and Credit

c.) How zero interest rate policy affects systemic fragility

***"When risk is separated from gain, the system is doomed"* Charles Hugh-Smith**

Risk is an ever-present feature of life. It cannot be avoided or prevented; it can only be temporarily suppressed. The superficial veiling of risks therefore also leads only to superficial stability[39]. If systems are robbed of their natural volatility[40], this leads at some point to much greater, cascading volatility and increasing fragility of the system at some point in the future.[41]

"Prices tell us what we have to do – and often that is different from what we intended to do"
F.A. Hayek

Central banks are currently attempting to prevent the natural cycle from unfolding. This is akin to attempting to take responsibility for the seasons of the year and trying to keep temperatures at a constant 21 degrees Celsius. If one suppresses variation in a natural system, one ultimately blows up the entire system. According to Nassim Taleb, the error is in believing that complex systems work like machines. **The result is the assumption that something akin to the user manual for a washing machine can be employed everywhere else as well.[42]**

"To confuse masking risk with the elimination risk is the acme of hubris and the perfect setup for disaster."
Charles Hugh-Smith

However, stability without volatility is impossible. In the course of "combating crises", we make social and economic systems increasingly fragile, by denying them stressors and randomness, putting them in the Procrustean bed[43] of cushy and comfortable - but ultimately harmful – modernity. Niall Ferguson has already explained that systems can operate in a stable manner for long periods of time, making it appear as though they

[38] Comment: Even the Fed realizes by now what the implications of zero interest rate policy are, see: „Ultra Easy Monetary Policy and the Law of Unintended Consequences", Federal Reserve Bank of Dallas, Working Paper No. 126, William R. White, August 2012
[39] see "When Risk is Separated From Gain, The System is Doomed", Charles Hugh-Smith
[40] The term 'volatility' comes from the Latin word 'volare' ('to fly')
[41] Suppressed volatility is moreover underestimated by quantitative risk models (value at risk, etc.)
[42] „Im philosophischen Basislager", Schweizer Monat
[43] **"**Procrustes was an inn-keeper in Greek mythology who, in order to make the travelers fit in his bed, cut the limbs of those who were too tall and stretched those who were too short. But he had the bed fitting the visitor with total perfection.", Nassim Taleb, "Antifragile"

were in equilibrium, while they are in reality permanently adapting.[44] At some unpredictable point in time, a critical phase begins, in which even a tiny trigger can lead the system away from apparent equilibrium to a transition phase and crisis. **Even a small shock can therefore lead to disproportionately large – and sometimes fatal – consequences.**

We believe therefore that the intellectual "monoculture" of central bankers[45] will have numerous unintended consequences, the extent of which is difficult to judge from today's perspective. Their reaction to the current crisis already feeds the next one. **Gold as the antagonist of unbacked paper currencies remains an excellent hedge against worst case scenarios.**

5. IS EUROPE AT RISK OF A JAPANESE SCENARIO?

„I am not sure advanced economies in general will find it easy to get out of their current predicament without creditors acknowledging further likely losses, a significant writing down of asset values, and recapitalisation of their financial systems."
Mervyn King, former Governor Bank of England

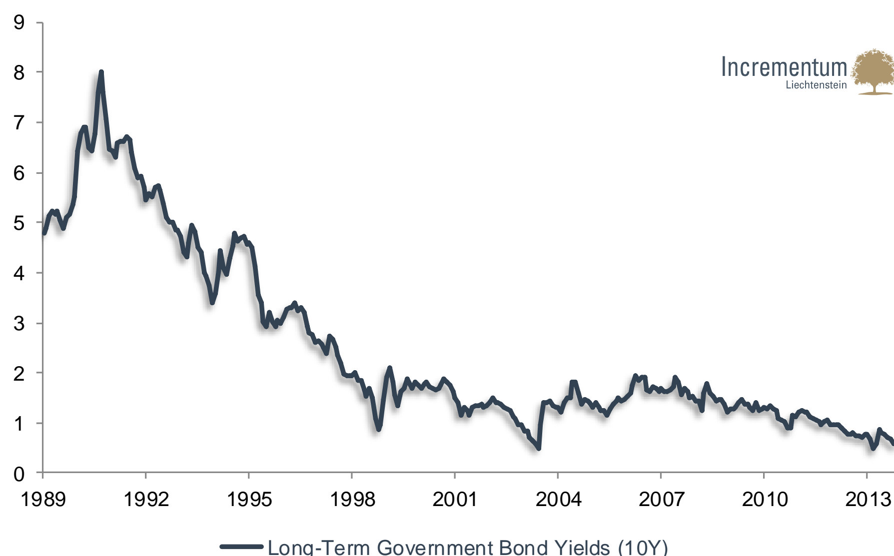
With respect to monetary debauchery, Japan has certainly been the forerunner in recent years.[46] Japan was the first major industrialized nation to experience the bursting of a massive real estate and credit bubble in 1990. It was the first country to introduce a zero interest rate policy in reaction to the deflationary consequences, and where modern-day "quantitative easing" celebrated its sad premiere. The unintended consequences of the zero interest rate policy are especially glaring in Japan. Among these are the growing interdependence between fiscal and monetary policy, and the erosion of the allocative and signalling function of interest rates. This leads to ever larger waves of speculative excesses followed by macro-economic rescue operations and ultimately the **subtle nationalization of the financial and economic system.**[47]

Due to the zero interest rate policy in existence for 17 years already, the government has by now refinanced its entire debt burden at extremely low interest rates. Despite these favorable financing conditions, debt servicing now amounts to 25% of tax revenue. A rise in the average interest rate of a mere three percentage points would swallow the government's entire revenue. **This alone illustrates that higher interest rate levels cannot possibly be reconciled with the fiscal situation. We refer to this economic policy impasse as the *"Keynesian endgame".***

The most recent policy effort – referred to as 'Abenomics', after Japan's prime minister Shinzo Abe – would be called the final "all-in" in a poker game. **In our opinion, this monetary gamble is going to have grave consequences, which won't remain confined to Japan.**

Yield, 10yr. JGB

[44] "America, the fragile empire", Niall Ferguson, Los Angeles Times
[45] Both Ben Bernanke and Mario Draghi and numerous other important central bankers have studied at the MIT. A highly experimental approach to monetary policy unites them. The clash between theory and reality is however often quite different from that simulated in the laboratory. The policy of central bankers is moreover "rule reactive", i.e., it is similar to a driver who drives forward while staring into the rear-view mirror. In the 2008 FOMC protocols it can be seen that the highly decorated economists were barely aware of the coming problems. It is strikingly demonstrated that bureaucrats are no good at economic forecasting. If they were making good forecasts, they would be working in the private economy, instead of being bureaucrats.
[46] see. "Are central bankers losing control?", Detlev Schlichter
[47] see „Die Japanischen Lehren für die europäische Krise" (Japanese lessons for the European crisis), Prof. Gunther Schnabl, Universität Leipzig



Source: Federal Reserve St. Louis, Incrementum AG

Numerous similarities between developments in Japan and Europe

Even though there are significant differences between Europe and Japan – such as the heterogeneity of national interests – Europe nevertheless follows a similar path as Japan in terms of economic decisions. Interest rates are close to zero, banks and large corporations are surreptitiously subsidized, and risks are offloaded onto the central bank, while government debt rises unceasingly. According to the Bank for International Settlements, Western industrialized nations are repeating the mistakes that Japan's government made. **However, with a difference - central banks themselves are in danger of becoming zombie-banks.**[48]

Japan at a monetary dead end

The road into the low interest rate and debt trap era is the result of many small steps taken to resolve the crisis, and may look sensible considered individually. If Europe wants to learn from this experience, there would soon have to be an exit from the expansive monetary policy, a flexibilization of labor markets, as well as a convincing fiscal consolidation.[49] This would entail a painful adjustment process, however, it is the only way back to a path of growth that is sustainable in the long term. Otherwise, a gradual decline of prosperity and ever greater pressure on social institutions would follow, similar to Japan.[50]

Numerous similarities between developments in Japan and Europe

Japan's mentality of thrift appears to exhibit certain similarities with parts of Europe. The aging population has strong confidence in the sustainability of the value of domestic government bonds, the proceeds of which were however in the meantime used for not overly sensible crude Keynesian stimulus programs. These are so to speak the counterpart to domestic savings, which have been channeled through the Post Bank and pension funds. In spite of low interest rates, bank deposits and government bonds have provided significant gains in purchasing power in real terms in recent years, not least due to the often-cited price deflation.

[48] Bank for International Settlements, 82nd Annual Report, June 2012
[49] we would be remiss not to mention here that especially in Southern Europe, partly quote painful structural reforms have been set into motion, which have been forced on these countries. One could thus make the argument that a somewhat weaker form of Keynesian policy has been pursued in Europe compared to Japan, which has however provoked vociferous complaints by many mainstream economists.
[50] see „Die Japanischen Lehren für die europäische Krise" (Japanese lessons for the European crisis), Prof. Gunther Schnabl, Universität Leipzig

However, should we see a sustainable increase in price inflation expectations in the course of the reflation program, it must be assumed that bank deposits will be gradually withdrawn and redirected into alternative investments. Japan's gold demand, which already tripled last year from a very low level, could increase significantly.[51] **In the meantime, the gold price in terms of the Japanese yen is trading only slightly below it's all time high.**

Gold price in JPY

Source: Federal Reserve St. Louis, Incrementum AG

[51] see „Gold Demand in Japan Tripled Amid Abenomics as Prices Slumped", Bloomberg.com

6. THE EXTRAORDINARY PORTFOLIO CHARACTERISTICS OF GOLD[52]

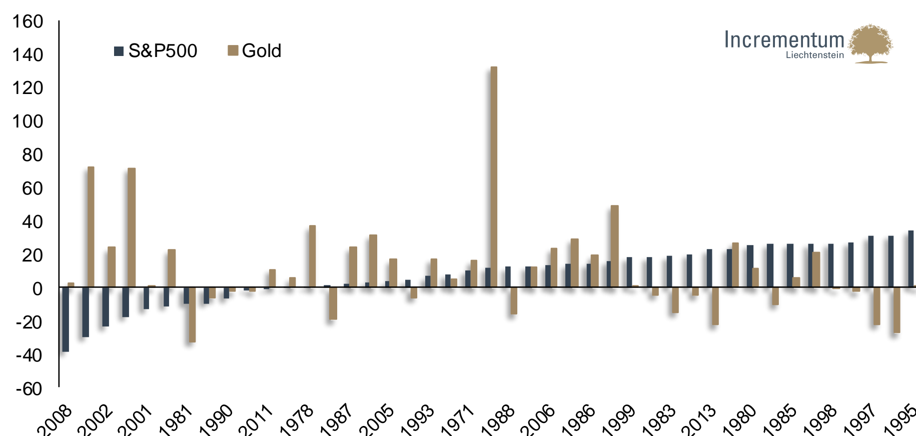
"Only a desperate gambler stakes everything on a single card."
Friedrich von Schiller

As we have already stated in previous reports, we are firmly convinced that gold is a sensible addition to portfolios due to its unique characteristics. Below the important advantages are summarized again:

- **increased portfolio diversification**: gold's correlation with other assets is on average 0.1[53]
- **effective hedge against tail risk events**[54]
- **highly liquid asset:** the daily liquidity is significantly higher than that of German Bunds, UK Gilts, US agencies and the most liquid stocks
- **portfolio hedge in times of rising inflation rates** as well as during strong deflationary periods (but not in disinflation)[55]
- **dollar hedge**: gold has a correlation of -0.5 with the US dollar and correlates negatively with most other currencies.

Numerous studies prove that adding gold lowers the volatility of a portfolio and hence improves statistical portfolio characteristics. This is also shown in the following chart. The annual performances of the S&P 500 are sorted from left (weakest year) to right (strongest year) and contrasted with the respective performance of gold. One can see that during the S&P's six worst losing years, gold clearly outperformed not only on a relative, but also on an absolute basis. **This confirms its usefulness as a portfolio hedge. On the other hand, it can be seen that rally phases in the US stock market are usually not a positive environment for the gold price. From this perspective, it is plausible that the continuation of gold's bull market will coincide with the end of the rally in the stock market.**

Comparison annual performance Gold vs. S&P

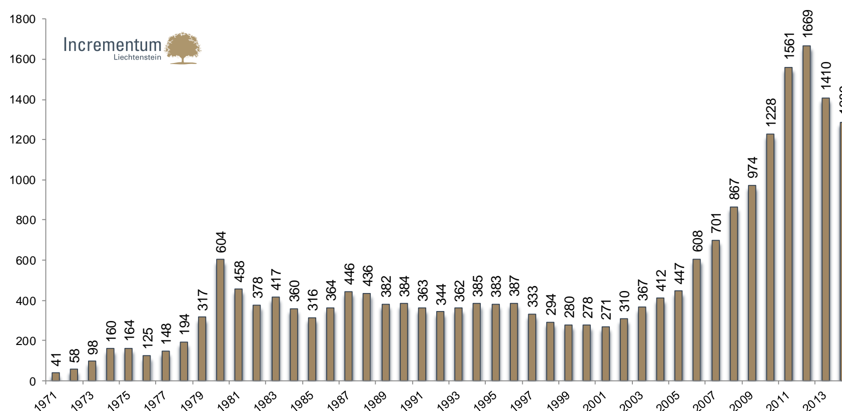


Source: Federal Reserve St. Louis, Incrementum AG

[52] we have already discussed the portfolio characteristics of gold in great detail in our previous gold reports, see "The extraordinary portfolio characteristics of gold" - Gold Report 2013, "Gold as a stabilizing portfolio component" - Gold Report 2012, as well as "Gold as a Portfolio Hedge" - Gold Report 2011
[53] see "Gold: a commodity like no other", World Gold Council
[54] see "Gold: hedging against tail risk", World Gold Council
[55] see "The impact of inflation and deflation on the case for gold", Oxford Economics

Since 15 August 1971 – the beginning of the new monetary era – the annual rate of increase in the gold price amounts to 8.25%. In real terms, gold appreciates on average by 4.3% per year against the dollar. The current correction is put into perspective in a longer term context, as can be seen from the following chart of average annual prices.

Average annual gold price



Source: Incrementum AG, Datastream

Fungibility as a crucial advantage of gold

High marketability is an important characteristic of gold. The easier a good can be converted, the more pronounced its "moneyness" is. Carl Menger already developed the theory of marketability or saleability in the 19th century. According to this theory, gold has prevailed in a long term evolutionary process, because its marketability was higher than that of any other good. **Gold and silver didn't attain their monetary status due to their alleged scarcity, but rather due to their superior marketability.**[56]

There is a significant difference between gold and other stores of value such as real estate, diamonds or works of art: a van Gogh painting, an expensive Bordeaux wine, or real estate are not easy to sell quickly at an acceptable price during a crisis. The fungibility of gold is therefore an important distinguishing feature. **This feature is one reason why central banks continue to hold gold as major currency reserve, but not real estate, works of art or commodities.**

Gold is pure ownership and has no counterparty risk

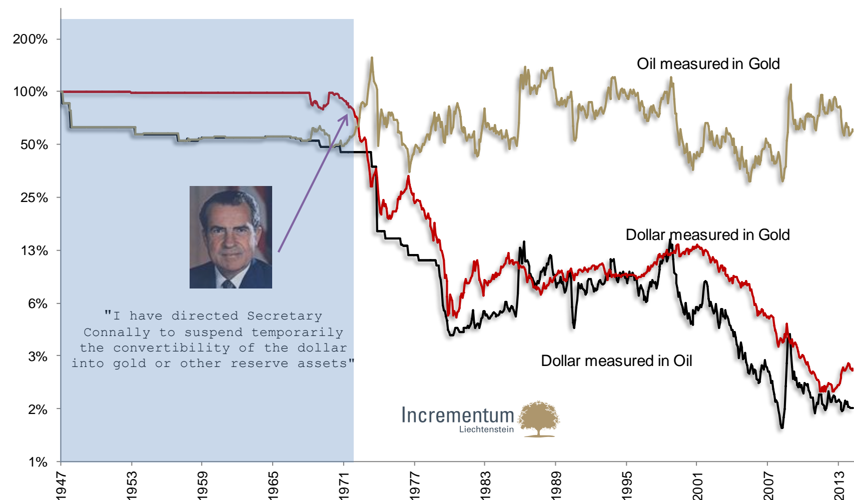
In addition to these features, gold as an asset class has the qualitative characteristic of representing a debt-free asset and therefore, contrary to bonds and bank deposits, inherently harbors no counterparty risk. **Gold is pure property. The market of paper assets by contrast consists of numerous promises issued by a variety of counterparties.** In periods of (supposed) safety, the attractiveness of an asset without counterparty risk is valued less highly. Once worries about potential default risks increase (deflationary environment), this characteristic of gold will be valued more highly again.

This is also a reason why we are critical with respect to ETFs. Gold held in ETFs may have certain advantages during quiet times (low bid/ask spread, high liquidity), however, in rough waters the claim to gold provided by an ETF does not have the safety characteristics that can be ascribed to physical gold. In such periods, the faith that the ETF's administrator will fulfil his conversion duties may well falter.

[56] see „Critique of Mainstream Austrian Economics", Prof. Antal Fekete

Every portfolio consists broadly speaking of two parts: liquidity and investments. Gold clearly belongs to the former category, and should therefore be compared primarily to other currencies. Even if a comparison in terms of purchasing power currently appears negative short term, the situation is clearly positive from a medium to long-term perspective. One ounce of gold still buys the same amount of crude oil today as in 1947. This fact, combined with the rapidly declining purchasing power of the US dollar in terms of oil and gold, is starkly illustrated by the following chart.

Purchasing power of USD in terms of gold and crude oil vs. purchasing power of gold in terms of crude oil



Source: Federal Reserve St. Louis, Incrementum AG

Another important characteristic should be mentioned as well: paper money can only render the services of money, while commodity money renders both monetary and non-monetary services. **It follows that the prices paid for paper money can shrink to zero, while the price for a commodity money must always remain in positive territory.**

a.) The opportunity cost of holding gold

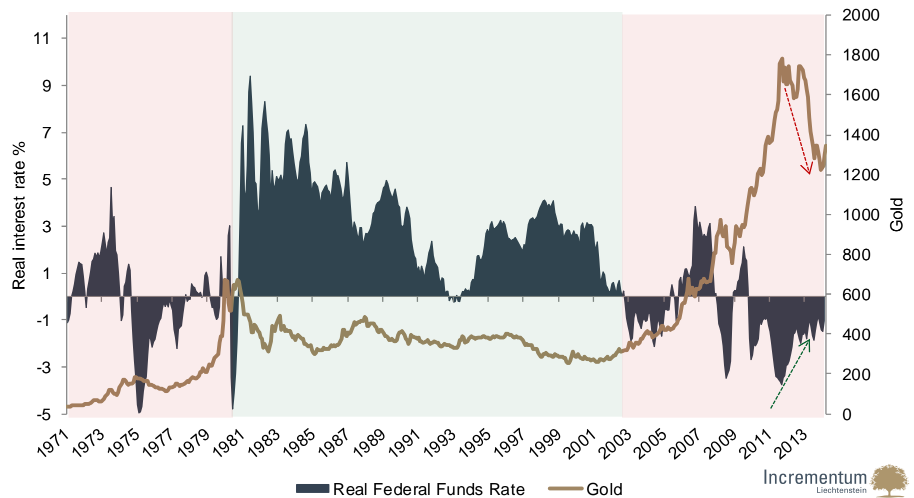
„Gold still represents the ultimate form of payment in the world. Fiat money, in extremis, is accepted by nobody. Gold is always accepted."
Alan Greenspan

There are a number of reasons to hold gold, to buy or to sell it. It is used for jewellery, as a currency reserve, for works of art, as well as in technological applications. Similarly varied are therefore also the respective time horizons, which range from the short term speculation of a trader to monetary insurance spanning several generations. These decisions are not transparent, but depend on opportunities that compete with each other over the course of time.

Opportunity costs are therefore essential for the gold price. What are the competing economic opportunities and risks which one accepts by holding gold? Real interest rates, growth rates of monetary aggregates, volume and quality of debt, political risks as well as the attractiveness of other asset classes are the most important determinants of opportunity costs. All market participants employ different filters and have different thoughts and time preferences, all of which influence price determination.

The following chart shows real interest rates and the gold price. It can be clearly seen that in the 1970s and since 2002, a predominantly negative level of real interest rates prevailed, which created a positive environment for gold.

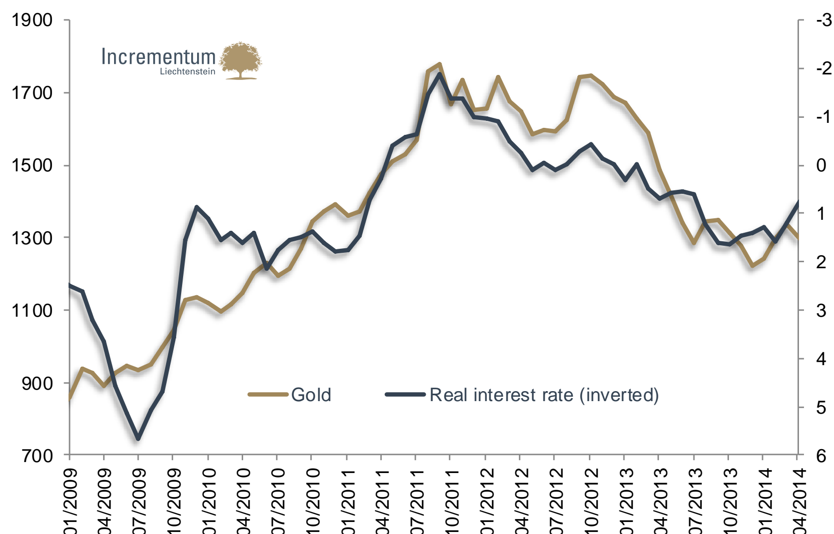
Real interest rates vs. the gold price since 1971



Source: Federal Reserve St. Louis, Incrementum AG

A shorter term consideration of real interest rates reveals that the period since 2011 was marked by rising real interest rates, which was in turn reflected by a falling gold price.

Gold vs. real interest rates (inverted)



Source: Federal Reserve St. Louis, Incrementum AG

A negative long term gold price trend would therefore have to go hand in hand with rising, resp. continually positive real interest rates. Due to the level of debt that has been reached in the meantime – on the part of industrialized nation governments, corporations and households – this is in our opinion difficult to imagine.

b.) Negative GOFO rates: beginning of the next rally phase?

GOFO = LIBOR (USD) minus Gold-Lease Rate

An important indicator for the gold market's structure is the so-called GOFO rate. The abbreviation stands for "Gold Offered Forward Rate" and designates the interest rate at which institutional gold holders (mainly central banks) can lend out their gold. Since gold doesn't generate a yield, this rate is usually positive, i.e., central banks pay investors who want to borrow gold a compensation for the dollars they receive in exchange for gold. The gold lender in the meantime invests the amount he is credited with at the going LIBOR[57] rate.

Extreme anomaly – GOFO mostly negative since July 2013

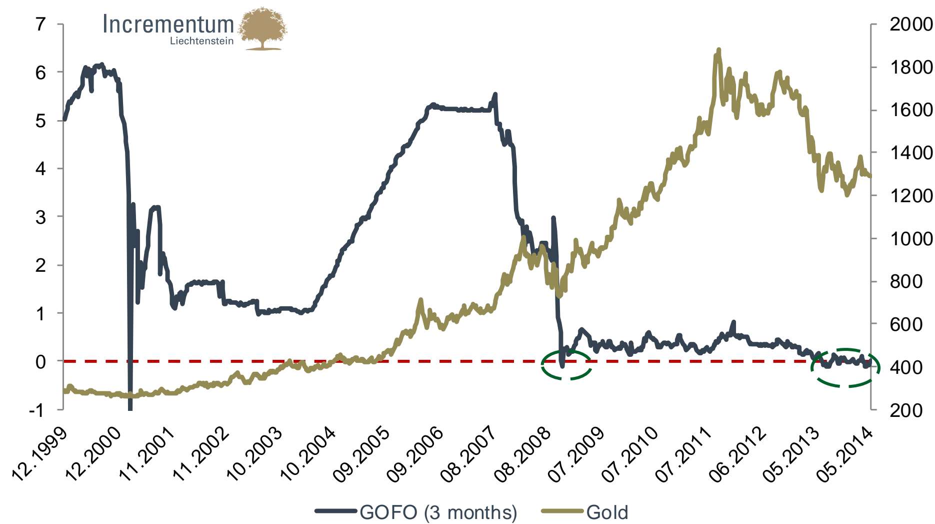
What do negative GOFO rates mean? A unique phenomenon (since July 2013) are GOFO rates that remain negative over extended time periods.[58] Between January 1989 and July 2013, there were only seven trading days during which the GOFO rate was in negative territory. This represents just 0.117% of all trading days. On 8 July 2013, the GOFO rate turned negative again for the first time since 24 November 2008. Since then, negative GOFO rates are no longer the exception, but the norm. In more than 60% of all trading days, the 1-month GOFO rate was below zero.[59]

This implies that banks and investors are prepared to pay penalty rates in order to be able to have command over gold in the here and now. This is

[57] LIBOR is the average interest rate (London price fixing) at which banks lend dollars to each other. LIBOR is an important yardstick for other interest rates worldwide, such as e.g. mortgage and credit card interest rates. Last year it became known that LIBOR had been manipulated by a number of banks for many years.
[58] Especially in 1 and 3 month GOFO
[59] see „Another Review of GOFO and Gold Price", TF Metals Report

testament to an apparently very tense market situation as a result of extraordinarily strong demand for physical gold. **As the following chart shows, negative GOFO rates often presage rising gold prices.**

3 month GOFO (left hand scale) vs. gold (right hand scale)



Source: Bloomberg, Incrementum AG

7. THE STOCK-TO-FLOW RATIO AS THE MOST SIGNIFICANT REASON FOR GOLD'S MONETARY IMPORTANCE

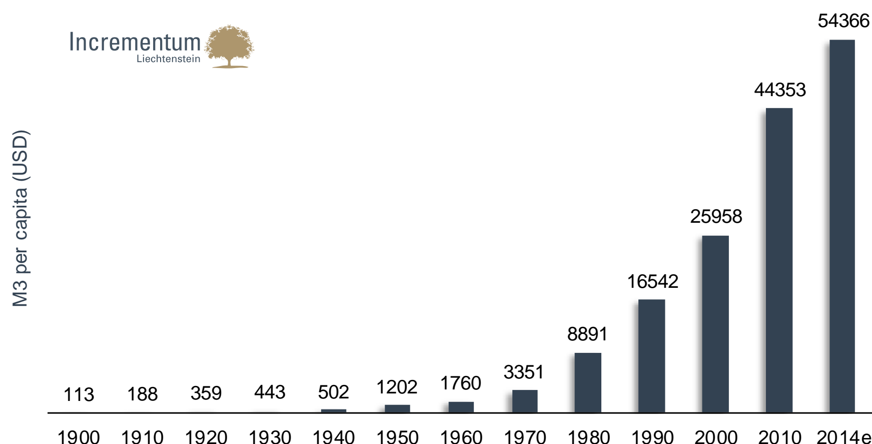
"If a good is to remain money, the public must remain convinced that there won't be a sudden and unstoppable increase in its supply"
Ludwig von Mises

Ludwig von Mises always held the opinion that gold is a good like any other. It differs only in terms of one important characteristic: money is the generally accepted medium of exchange, because it is the most liquid good. According to Mises, its role as a medium of exchange is therefore its crucial characteristic, while its function as a store of value and unit of account are only subsidiary features. This implies also that a rising money supply must lower the exchange value of money.[60]

Supply and demand thus determine not only the prices of goods and services, but also the price of money, resp. its purchasing power. Confidence in the current and future purchasing power of money depends decisively on how much money is in existence currently, but also on expectations regarding the future supply of money. The more money is supplied – relative to the goods and services offered – the more its value declines.

This can also be seen in the following chart. In 1913 the population of the US stood at 97 million people. The money supply M3 at the time amounted to approximately USD 20 billion, i.e., USD 210 per capita. Currently the population stands at 317 million people, while the money supply M3 has risen to USD 17.26 trillion.[61] The per capita supply of money thus amounts to USD 54,366.

M3 per capita since 1900 (USD)

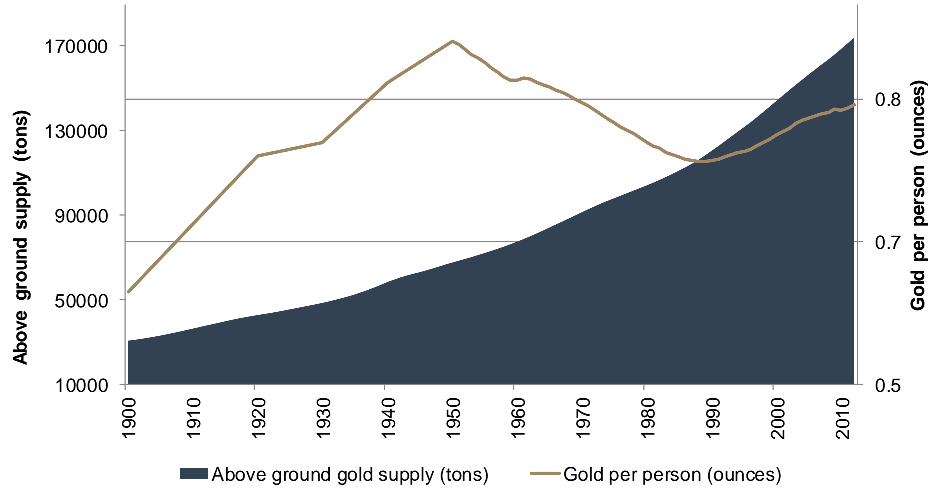


Source: US Census, US Geological Survey, Wikipedia, Incrementum AG

The next chart illustrates that the global stock of gold per capita since the beginning of the 20th century is fluctuating in a fairly tight range of 0.6 to 0.85 ounces. This is remarkable, as the global population has exploded from 1.65bn people in 1900 to some 7bn people today.

[60] see "Die wahre Lehre vom Geld" („The true science of money"), Dr. Thorsten Polleit, Liberales Institut
[61] source: www.nowandfutures.com

Gold stock in tons vs. gold per capita (ounces) since 1900



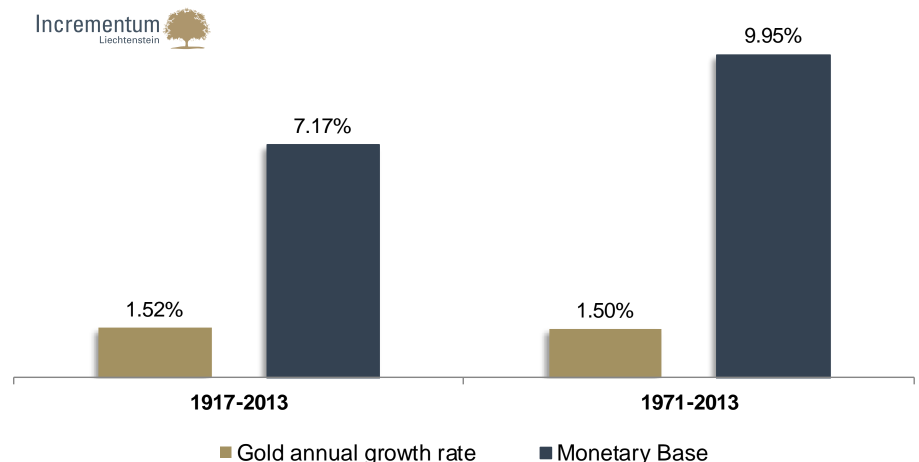
Source: Myrmikan Capital, Incrementum AG

"It's all about relative supply curves – the supply curve for bullion is far more inelastic than is the case for paper money. It really is that simple."
Dave Rosenberg

The gold supply curve only changes marginally. Scrap supply can be volatile, while mine production is highly inelastic. If one compares this to the supply curve of paper currencies, this is one of gold's major advantages: governments can print currency at will. There is no difference between the (digital) costs of printing a 100 euro note or a 10 euro note. There is, however, a substantial difference between producing 100 ounces or 10 ounces of gold. The former takes exactly 10 times the effort.

The following chart illustrates this "***relative scarcity***". The average annual growth rate (CAGR) of the US monetary base between 1917 and 2013 amounted to 7.17%. The supply of gold by contrast only increased by 1.52% per year. If one looks at the rate of change since the beginning of the new monetary era – i.e., since the end of the Bretton Woods agreement – the growth rate of base money is actually significantly higher at 9.95%. The gold supply by comparison grew only by 1.5% per year in the same time period. **This relative scarcity is the main advantage of gold compared to fiat currencies.**

Annualized rate of change: gold vs. monetary base, 1917-2013 and 1971-2013



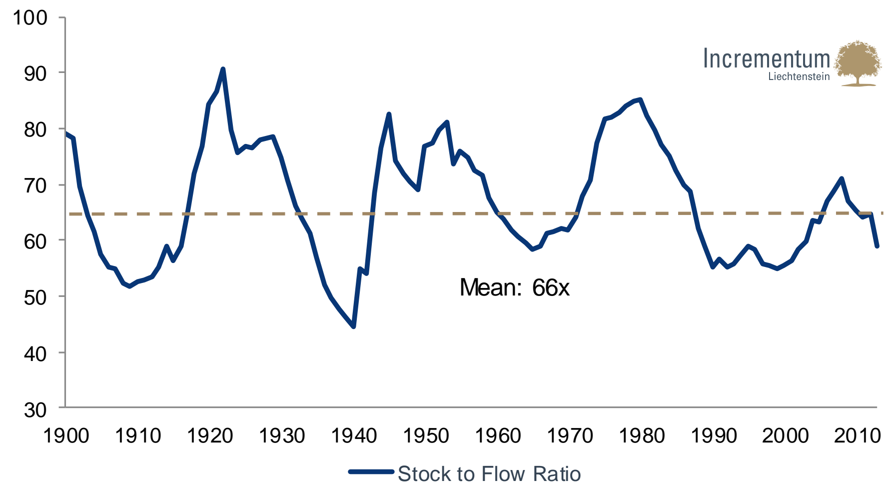
Source: Federal Reserve St. Louis, Incrementum AG

Gold is the money of kings; silver is the money of gentlemen; barter is the money of peasants; but debt is the money of slaves

We have already discussed the crucial importance of the stock-to-flow ratio in our previous reports. Simply put, the ratio means that in the case of gold and silver – as opposed to other commodities – there is a major discrepancy between annual production and the total available supply (= high stock-to-flow ratio). As we stated last year, we believe that the permanently high stock-to-flow ratio represents one of gold's (and silver's) most important characteristics. The total amount of gold amounts to approximately 177,000 tons. This is the stock. Annual mine production amounted to roughly 3,000 tons in 2013 – this is the flow. If one divides the total gold mined by annual production, one arrives at a stock-to-flow ratio of approximately 59 years. **The ratio expresses the number of years it would take to double the total stock of gold at the current rate of production.**

The following chart shows the trend of the ratio since 1900. One can see that it fluctuates akin to a sine curve around a mean value of 66.

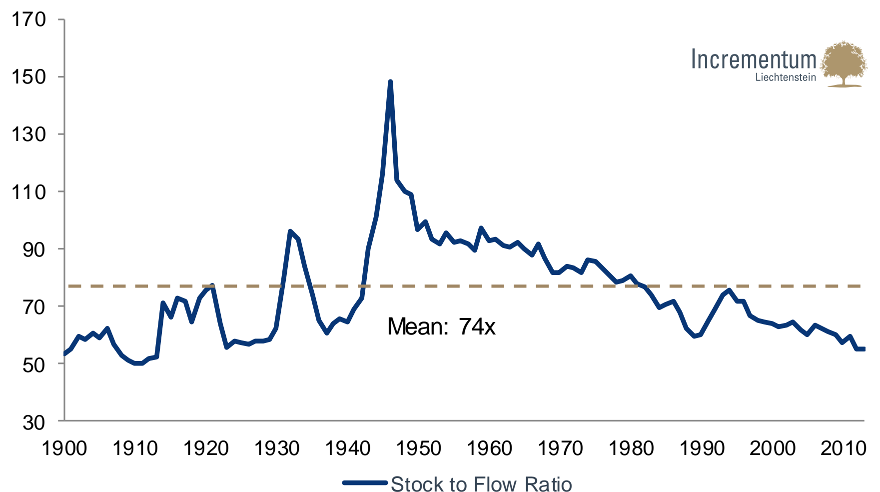
Gold: stock-to-flow ratio since 1900



Source: US Geological Survey, Incrementum AG

Silver's stock-to-flow ratio by contrast shows a definite long-term trend. Until 1951 it rose, and has been falling ever since.

Silver: stock-to-flow ratio since 1900



Source: US Geological Survey, Incrementum AG

The monetary suitability of gold, silver and the US dollar

In order to quantify monetary serviceableness, we have determined three sensible values based on the stock-to-flow ratio for gold, silver and the US dollar which are shown in the following table:

the average absolute height of the StFR

- the **higher**, the better the suitability as money
- shows how high the annual growth in supply usually is

the difference between the highest and lowest value of the StFR

- the **lower** the better the suitability as money
- shows what one must expect in terms of extreme outliers in the StFR in the long term (soundness – reliability – manipulability)

the Median of the annual rate of change of the StFR

- the **lower**, the better the suitability as money
- shows how large the short term fluctuations in the StFR are on average

Stock-to-flow Ratio (1900-2013)	Mean	Difference between extreme values	Median yoy-Change (%)
Gold	67.1	**46.8**	**3.1**
Silver	**74.3**	98.1	3.2
US-Dollar (M3)	37.1	3362.3	30.6

As the above comparison shows, the US dollar as a representative of fiat currencies has the worst values on terms of all three criteria. **Especially the last two figures illustrate quite starkly why the dollar is not suitable to function as stable money.** Gold by comparison proves superior in two cases, and is only bettered by silver in terms of the mean value. This confirms once again that gold is the primary monetary metal.

a.) The great fallacy of „high gold demand“

Since gold is not a consumption good, the tacit assumptions employed by nearly all gold analysts are not applicable. This has major implications regarding the validity of the bulk of mainstream gold analysis and will be discussed in more detail at this juncture.[62]

Fundamental misconceptions of many gold analysts

Why is it decisive that gold is not a consumption good? For one thing the supply of and demand for gold is not necessarily separable on an interpersonal level. Every gold owner can at any time enter the market as a seller, but also as a buyer. That may sound trivial, but it is a major difference to consumer goods, which are used up. One cannot usually expect that a market participant who buys a consumer good does so in the manner of a speculator based on certain expectations about future prices.

Consequently, there are usually largely separate groups of people involved in the buying or selling of specific consumer goods - producers sell them,

[62] We want to recommend the work of Robert Blumen on this topic, especially “Does Gold Mining Matter?”, “The Myth of the Gold Supply Deficit” and „What is key for the price formation of gold“.

consumers buy them.[63] Moreover, by consuming consumer goods, consumers deprive them of their function and need to acquire the goods concerned anew if they want to have the function at their disposal again.

Exclusive focus on 'gold demand' is misleading

What does this mean for the price determination of gold? The majority of gold analysts regard demand as the sole decisive influence on price determination and thus assumes that the decision of gold owners whether to sell their gold is solely determined by demand. Once a market participant has decided to buy an ounce of gold and agrees with a seller on the price, gold analysts determine gold demand based on the fact that a transaction has taken place. If this happens more often than in a previous time period, demand is said to have increased.

"The main error in this thinking is that demand is not a quantity. Demand is the willingness of buyers to offer more money in exchange for a good at a range of prices."

Robert Blumen

Should more trades have been recorded, many analysts conclude that due to "*higher demand for gold*" its price must rise. Is this even a valid conclusion? No, all that has happened is that the number of trades has increased. Whether this is due to a change in supply or demand cannot be stated. Such a statement would, however, be valid in the consumer goods area. If a supermarket always has a good available at a constant price over two similar time periods and sells more of it in the second than in the first time period, one can conclude from the statistically ascertainable sales figures that demand has increased.

Let us assume that as a result of a certain event, the preferences of market participants shift toward gold. Demand increases significantly in that case, but there doesn't even have to be a trade, because the supply side also exhibits a stronger preference for holding gold, if for instance a currency reform is feared. As a result, there doesn't even have to be a higher gold price evident, despite a massive increase in demand, if no one wants to sell their gold and no trade is recorded that would reflect the current market price.

Miners are price takers and have minimal impact on price formation

The other confusing aspect of the gold price is that the supply is also not a number. Supply, like demand, is the willingness of buyers to offer a quantity of gold at a range of prices. Nearly all gold supply, in this sense, is an expression of the reservation demand for gold by the people who own it. **The only exception to this are miners who are price takers. Because mine supply is so small compared to the existing gold, miners have minimal impact on price.** They are for the most part price takers who sell at a price determined by the reservation demand of everyone else who owns gold.

The reason why people aren't spending all their money today is that they exercise a reservation demand for money, expecting it to have greater usefulness to them in the future. Reservation demand is therefore essential for price determination. Due to gold's monetary importance it is therefore also decisive in gold's case who values it more highly: the new, incremental buyer, or the existing owner. The majority of gold analysts however concern themselves exclusively with "exchange demand" and therefore assume that the gold price can be predicted with a trivial consumption model. If one wants to quantify demand in this way, one must rely on the only available data in the form of the number of trades at specific prices. **We believe that this can lead to significantly erroneous conclusions in the case of**

[63] Merchants are excluded from this observation, since they fulfill an entirely different function and play no role in our analysis. They increase the marketability of a good in exchange for an agio. Their motivation is however neither consumption nor holding of the good.

gold. The amount demanded and supplied must always balance at whatever price is determined in the market. Focusing on such quantities can however give us no information about past or future prices.

Conclusion

"*Gold is the inverse of paper, unlimited to the upside, limited to the downside. It's not the total stock of gold that matters, but the flow from those that already hold it"*
FOFOA

Every holder of gold is automatically on the supply side, since he is at any time a potential seller of gold. There will always be a price or a combination of prices and circumstances that will lead market participants to sell their gold. For some this will only be at a significantly higher price level, for others however also at a markedly lower price level (for instance due to a deflationary collapse). **The decision *not* to sell gold at the current price level is therefore just as important as the decision to buy gold.**

8. GOLD AND THE INTERNATIONAL FINANCIAL ORDER

„The Gold Standard is the best ‚Governor' that can be devised for a world that is still human rather than divine."
Montagu Norman, former Governor of the Bank of England

The classical gold standard experienced its heyday at the time of classical liberalism. World War I put a sudden end to this era. Even though it is often asserted that the gold standard "failed", this is simply incorrect. It was rather that the planned government expenditures were not possible due to the restrictions imposed by the gold standard. **In our opinion it is certainly no coincidence that the 20th century, which exhibited such pronounced enmity toward gold, was also the century during which most hyperinflation episodes took place.**

Why then, is gold the unmentionable four letter word of economics? The answer is threefold; A misunderstanding of the role of money; a misreading of history; and finally, visceral revulsion to the notion that a metal can do a better job guiding monetary policy than a gaggle of finance ministers, central bankers and well-degreed economists."
Malcolm Forbes

Ludwig von Mises recognized in 1923 already that a currency reform in the form of a rejection of fiat money can never pose a technical problem. The primary necessity according to Mises, is a renunciation of inflationary policy. This is only possible if politics fully renounces the ideological commitment to imperialist, militarist, protectionist, statist and especially socialist ideas.[64]

As already discussed in previous years, we are convinced that the remonetization of gold is already underway. Even in the traditional financial system, support for this idea is increasingly voiced. For instance, OMFIF[65], a global think tank of central banks and sovereign wealth funds, argued in a sensational report in favor of the remonetization of gold.[66] Gold is once again to play a major role in the global monetary system. Due to its history, gold is predestined to rebuild and maintain trust and stability in international monetary relations. Gold would be mutually beneficial for all countries as an anchor for currencies and could end the currently escalating currency wars. **The report illustrates strikingly that fundamental changes in the monetary order are already discussed at the highest levels.**

The call for proper audits, resp. repatriation of central bank gold reserves becomes louder

The number of initiatives with respect to repatriation resp. thorough audits of government gold reserves continues to increase. We are convinced that the desire for transparency reflects the increasing interest of citizens in national gold reserves. Initiatives demanding repatriation or an orderly audit of national gold reserves have sprung up in Switzerland, the UK, Finland, Australia, Poland, Mexico, the Netherlands and Romania. In Austria, the Court of Auditors has audited the gold reserves stored in London, as 80% of Austria's gold reserves are stored with the Bank of England. In Germany, the repatriation of gold reserves has been somewhat tepid. Last year, only 37 tons were shipped to Frankfurt from Paris and New York. However, even if 700 tons are actually delivered by 2020, about half of the gold reserves would still be stored abroad. That the repatriation of 700 tons of gold supposedly takes seven years seems astonishing. Germany's Bundesbank justified this by pointing to the signalling effect in times of crisis, as well as the complicated logistics in terms of securing transport and creating storage space.[67]

Numerous additional examples show that the trend toward remonetization is gaining momentum. Especially in the US, calls for gold backing resp. acceptance of gold as an official means of payment are

[64] "Stabilization of the Monetary Unit—From the Viewpoint of Theory", Ludwig von Mises
[65] Official Monetary and Financial Institutions Forum
[66] „Gold, the Renminbi and the multi-currency reserve system", OMFIF, January 2013
[67] see „Viele misstrauen immer noch der Bundesbank: Ist das ganze Gold weg" („Many still distrust the Bundesbank: is all the gold gone?"), Dimitri Speck

becoming louder. After Utah declared both gold and silver official means of payment, similar plans are now pursued in numerous other states. In Texas the sales tax on gold, silver and platinum coins was recently repealed. The reasoning, which was accepted, was that gold and silver represent official means of payment, and thus may not be taxed. Similar legal reforms are currently under discussion in several other states.

"We should put our faith in gold rather than in power-hungry men. It has neither their weaknesses, nor bad intentions. It was, is and will remain the money of freedom"

Roland Baader

The biggest political obstacle to a formal re-entry of gold into the international financial order is currently represented by the statutes of the IMF. In the late 1970s, gold was banned from the "general exchange arrangements". As a result, member nations were prohibited from carrying out international transactions in gold.[68]

We are convinced that the remonetization of gold will not occur at a specific point in time, but will instead be a gradual, long term process - a process that was set in motion some time ago and is gaining momentum at present. The role of gold will be greatest during a transition period from the dollar standard to a multi-currency system or a new global reserve currency. This would probably be accompanied by rising volatility in currency and commodity markets, while the market probes for a new equilibrium. It is thinkable that, due to rising commodity prices, confidence in the paper dollar will fall dramatically. **As a glance at the history books shows, gold was always needed to create fresh confidence in a currency.**[69]

a.) Good-bye, exorbitant privilege[70]

The Golden Rule: He who has the Gold makes the rules.

Especially since the beginning of the crisis in the Ukraine, voices in favor of emancipation from the dollar standard can be heard. Among others is Vladimir Putin's economic adviser Sergey Glazyev, who voiced the opinion that Russia could simply circumvent all US sanctions by getting rid of its dollar reserves and establishing its own payments system. [71] The state-owned oil company Gazprom Neft is possibly preparing to switch its delivery agreements from dollars to euro. According to the company, 95% of its customers are prepared to oblige.[72]

Russia's stance with regard to the dollar's hegemony is trenchantly summarized in the following quote by Vladimir Putin:

"The United States are currently living above their means and are simply shifting some of their problems to the global economy. Through the monopoly of the dollar, they are living like parasites off the global economy. If a systemic malfunction occurs in the US, this would affect all others as well. Countries like Russian and China hold a significant part of their reserves in the form of US treasuries. ***There should therefore also be other reserve currencies."***[73]

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[68] see http://www.imf.org/External/Pubs/FT/AA/index.htm#art4
[69] see „The Big Reset", Willem Middelkoop
[70] The term used by former French finance minister Giscard d'Estaing in the 1960s, in describing the US privilege of issuing the global reserve currency.
[71] see "Putin Advisor Threatens With Dumping US Treasurys, Abandoning Dollar If US Proceeds With Sanctions", Zerohedge.com
[72] see "Gazprom macht sich unabhängig vom Petro-Dollar" („Gazprom makes itself independent from the Petro-dollar"), Deutsche Wirtschafts Nachrichten
[73] see "Putin says U.S. is "parasite" on global economy", Reuters

Alexey Moiseyev, Russia's deputy minister of finance, mentioned in an interview with the broadcaster Russia 24, that there exists a "**currency switch executive order**" which allows the president to decree what percentage of their trade companies must settle in rubles. It would be possible to raise this percentage to 100% overnight. China and Iran were quoted by Politonline.ru as stating that they are ready to support Russia in this effort.

Many countries want to get rid of the slavish ties to the dollar

High level institutional circles are also calling ever more loudly for a new global currency. Thus Yifu Lin, the IMF's former chief economist for example proposed to replace the US dollar with a single global currency: "*The dominance of the greenback is the root cause of global financial and economic crises. The solution to this is to replace the national currency with a global currency*."[74]

The liberation from the US dollar is gaining ever more momentum is confirmed by numerous additional examples:

- **in reaction to Western sanctions, Russia's central bank sold 20.5% of its US treasury bonds in March alone.** Since March of last year, its stock of US treasuries has been lowered from USD 155 bn. to USD 100 bn.

- **the recent gas agreement between Russia and China is an important milestone in the strategic energy cooperation between the two countries.** Until 2020, Russia will export 38 bn cubic meters of gas to China per year, after which the deliveries will be gradually increased to twice that amount. The precise value of the transaction is not known, but reports speak of up to USD 500 bn. **For now, billing will take place in USD, however, the agreement can be changed to yuan or rubles at any time, after which the US dollar would no longer be needed.** 48 additional economic agreements were signed in addition to this deal. The level of trade between the two nations is forecast to double over the next five years to USD 200 bn.

- in October 2013, the ECB and the People's Bank of China concluded a bilateral currency swap agreement amounting to 350 bn. yuan and 45 bn. euro: the ECB can henceforth provide yuan loans to euro area banks and the PBoC can offer euro loans to Chinese banks.

- **China's central bank president would also prefer to see a "*strong sovereign reserve currency*" to replace the US dollar.** In a study published on the PBoC's web site, it is stated that an international reserve currency "*free of the interests of individual nations*" which is able to "*remain permanently stable*" would be a blessing for the financial system.[75]

- **OMFIF recommends that gold should become part of the IMF's special drawing rights.** Apart from gold, the "R-currencies" should also receive higher status in the international monetary order and be added to the SDR basket.

[74] see "Replace dollar with super currency: economist", ChinaDaily USA

- The IMF has recently added the Australian and Canadian dollar to the list of official reserve currencies. With this move, the list of official reserve currencies has increased to seven.

- **The Eurasian Economic Union wants to create a common free trade area and become a counterweight to the European Union.** A common currency called "Altyn" is planned to be issued within the next five years. The name is from the Tartar language and means "gold".

- **The BRICS nations also want to become more independent in terms of currency policy.** The five nations are working intensively on the creation of their own development bank, whose primary purpose would be the financing of infrastructure projects. The creation of a monetary fund is also planned.

- **The Shanghai Cooperation Organization (SCO) and the Gulf Cooperation Council are additional organizations working to intensify economic cooperation with the intention of achieving a decoupling from the dollar**. The SCO promotes infrastructure programs and the geo-strategic interests of Asia. Its agendas far exceed mere free trade zones; it increasingly pursues monetary system related initiatives as well as military strategic goals.

Conclusion

The congruent interests of the above associations regarding major changes to the monetary system should give Western nations pause, especially given Russia and China's significant intensification of activities in recent months.

b.) China and the importance of gold

"No asset is safe now. The only choice to hedge risks is to hold hard currency - gold."
Zhang Jianhua, People's Bank of China

China has recently taken numerous important steps toward emancipation from the dollar-centric worldview. While France was the most important critic of dollar hegemony in the 1960s (prior to the collapse of Bretton Woods), it appears that China is now taking on this role. We assume that a speedy transformation of the renminbi to a reliable, stable and globally traded currency is one the top priorities of China's leadership.[76]

„Gold goes where the money is, and it came to the United States between World Wars I and II, and it was transferred to Europe in the post war period. It then went to Japan and to the Middle East inthe 1970s and 1980s and currently it is going to China and also to India."
James Steel

Although China has in the meantime become the second-largest economy in the world, and has amassed almost USD 4 trillion in foreign exchange reserves, the renminbi does not yet live up to the economic status that has been achieved. As an initial step, China is trying to strengthen its domestic currency's role as a trading currency. The renminbi's economic integration and convertibility is gradually extended by means of bilateral trade and clearing agreements. **Many of the measures which we have discussed in previous years as well are already crowned by success**. According to a report of the Society of Worldwide Interbank Financial Telecommunication (SWIFT), the renminbi has already replaced the euro from 2nd place among the currencies most widely used in trade. Currently the renminbi's global market share amounts to 8.6%. Although the dollar continues to represent the lion's share at 80%, the

[76] Whereby one should clearly differentiate between a *reserve* and a *trade* currency

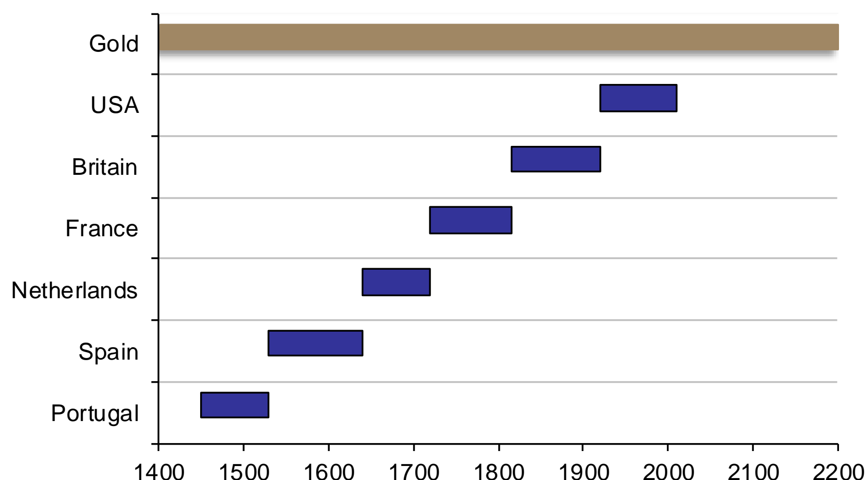
renminbi's importance is growing rapidly. In January 2012, its global share was only at 1.9%. In less than two years, its acceptance has grown by a factor of five.

Gold backing of the renminbi would substantially increase international acceptance

The continued rise of the renminbi in the international monetary structure is however dependent on the currency advancing to the status of a local and international reserve currency. Apart from a strong exchange rate, this also requires a free money market and a liquid bond market. We believe that gold will also be a pillar of China's strategy. Euro and dollar would probably not be reserve currencies today if not for the fact that several thousand tons of gold are standing behind them. Thus the once enormous gold reserves of the United States were – apart from the country's military superiority – a major reason why the US dollar was crowned the global reserve currency.

Despite the explosive ascension of China, one shouldn't get carried away and expect an imminent replacement of the US dollar by the renminbi. Change in the currency system is as a rule a long term process, thus the transition from the British pound to the US dollar took several decades.

International reserve currencies since 1400

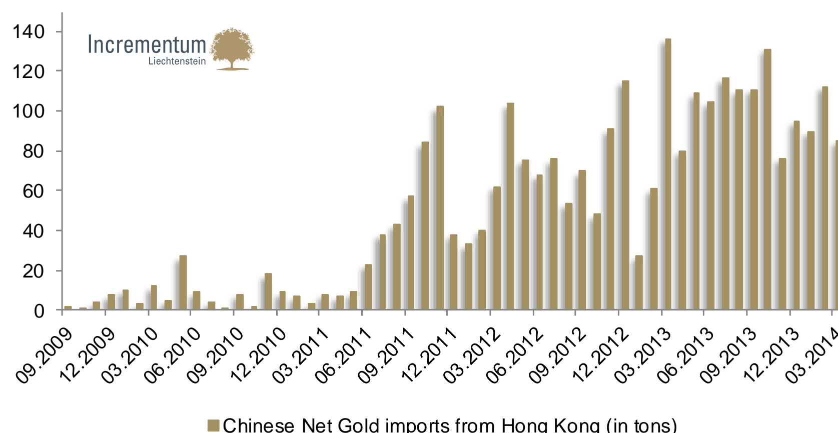


Source: JP Morgan – Eye on the Market, Erste Group Research, Incrementum AG

Does China hold 4,000 to 6,000 tons and hence the second largest gold reserves in the world?

According to the World Gold Council, China's central bank has <u>officially</u> not bought any gold since 2009. We believe, however, that the PBoC is gradually expanding its gold reserves and has far higher reserves at its disposal than the officially reported 1,054 tons. We believe it is realistic to assume that China currently holds 4,000 to 6,000 tons of gold and with that has the second largest gold reserves in the world. A gold-backed renminbi would increase its international acceptability in one fell swoop. **We nevertheless don't believe that China's central bank is planning to introduce a gold standard**, as this would deprive it of a large part of its monetary policy flexibility, which it currently makes quite active use of. **We rather believe that China is increasing its gold reserves in order to build up a hedge against its enormous dollar reserves.**

China's net gold imports from Hong Kong (in tons)



Source: Koos Jansen – "In Gold we Trust Blog", Incrementum AG

c.) The International Monetary Fund and Special Drawing Rights

"The test of central bank status is not the name but the purpose. A central bank has three primary roles: it employs leverage, it makes loans, and it creates money. Its ability to perform these functions allows it to act as a lender of last resort in a crisis. Since 2008, the IMF has been doing all three in a rapidly expanding way."
Jim Rickards

The sesquipedalian term 'special drawing rights' (SDR) designates a currency unit introduced by the IMF, which isn't traded on foreign exchange markets. Currently, the units consist of 41.9% USD, 37.4% euro, 9.4% JPY and 11.3% pound sterling. Aside from the function as a currency unit, the IMF can actually issue SDRs. However, this has so far not **yet** happened to any significant extent. SDRs were last created in 2009 to the tune of USD 188.6 bn. That was approximately equivalent to USD 282 bn. What isn't widely known is that special drawing rights are already used in many places. For instance, they are employed as a unit of account in international guarantee claims, in air transport, shipping, and in the event of oil-related accidents on the high seas.

In a study well worth reading[77], the IMF makes critical remarks regarding the dollar's dominance and stresses the importance of SDRs: *"The current system has serious imperfections that feed and facilitate policies—of reserves accumulation and reserves creation—that are ultimately unsustainable and, until they are reversed, expose the system to risks and shocks that a reformed system could minimize."* In order to solve this problem, the IMF proposes the establishment of a global reserve currency, which would "i*n principle only be an extended SDR, which could however have regular or economic cycle dependent issuance adjusted to the size of reserve accumulation. Such a system could contribute to global stability, economic strength and global equality"*

"The SDR's mix of opacity and unaccountability permits global monetary elites to solve sovereign debt problems using an inflationary medium, which in turn allows individual governments to deny political responsibility."
Jim Rickards

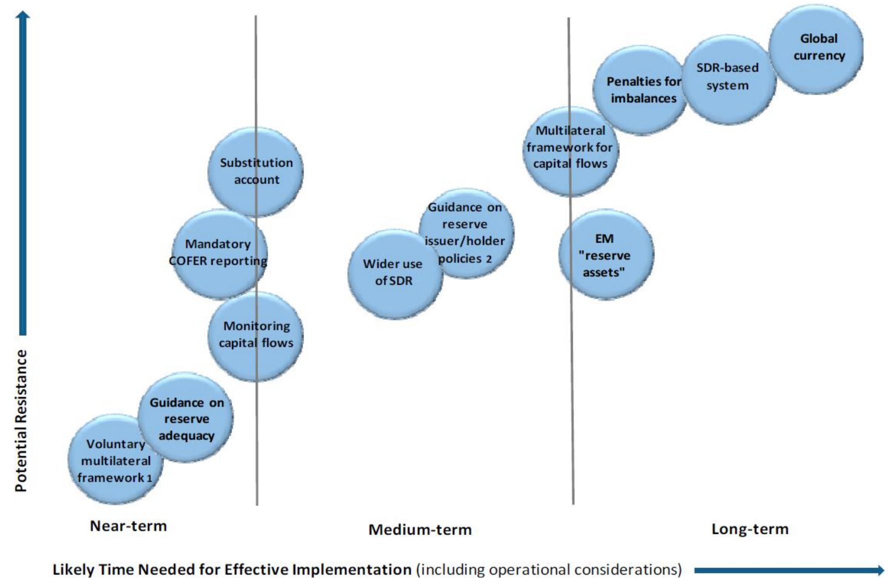
The IMF makes no bones about its ambition to replace the dollar with SDRs. A multi-stage plan was presented in the form of a study, which discusses how to position SDRs as a global reserve currency.[78] The IMF recommends increasing SDR liquidity by means of corporations such as IBM or Volkswagen issuing bonds denominated in SDRs. Sovereign wealth funds should buy such bonds for reasons of foreign exchange diversification. The study recommends that the SDR bond market should

[77] see "Reserve Accumulation and International Monetary Stability", International Monetary Fund
[78] "Enhancing International Monetary Stability – A Role for the SDR?", IMF, 2011

replicate the US Treasury bond market as precisely as possible.[79] **That the establishment of a global currency is an explicit goal of the IMF can be seen in the following chart:**

"Until 1971 the Dollar was an IOU (I owe you) Gold. Now the Dollar is an IOU nothing. The SDR is a who owes you nothing".
Peter Millar

The IMF's Roadmap to a Global Currency



Source: IMF, Reserve Accumulation and International Monetary Stability

The Economist magazine predicted already in 1988 that there would be a common global currency by 2018. In the wake of the crash of 1987, the idea of a common currency by the name of "Phoenix" was considered, which would so to speak rise from the ashes. The IMF was supped to become the new central bank and issue a global reserve currency.

Economist Cover, 9 June 1988

Source: Britanniaradio.com

[79] see „The Death of Money", p. 212, James G. Rickards

Conclusion

"The agreed changes in IMF governing structure are important in achieving a sense of political legitimacy for its governing structure and decision-making…
A new Bretton Woods conference? We are long ways from that. But surely events have raised, whether we want to admit it or not, some fundamental questions that have been ignored for decades."
Paul Volcker

The next big crisis could lead to a realignment of the global monetary order. Most of the proposals concerning the use of special drawing rights appear not very sensible from an "Austrian" perspective, as a global institutionalized fiat money cannot avoid the system-immanent problems of the debt money system as such. Special drawing rights are derivatives of derivatives, insofar it seems doubtful whether such an instrument would generate much confidence. One should nevertheless not underestimate the political will behind such proposals. An expansion of special drawing rights and the transformation of the IMF into a global central bank would not only agree with the mentality of the central economic planners in both East and West, but would from their perspective also have the advantage that governments could continue to finance various projects via a hidden inflation tax. The tongue twister "special drawing right" moreover sounds a lot more pleasant than the term "currency reform" and yet could amount to one arriving through the back door. It would also be politically attractive because in the event of rapidly rising inflation, no one could really be made responsible, as the IMF is similarly intangible to most people as terms such as QE, LTRO or OMT.[80]

[80] see "Österreichische Schule für Anleger" (Austrian School of Economics for Investors), Taghizadegan, Stöferle und Valek

9. THE MIGRATION OF GOLD DEMAND FROM WEST TO EAST

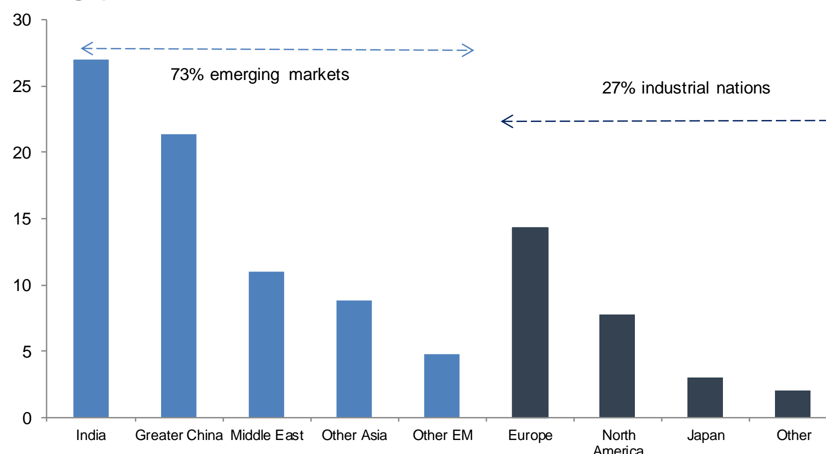
The steady migration of gold from West to East continues unabated

Gold moves from those countries in which capital is consumed to those in which it is accumulated. The Romans already noticed this 2000 years ago, when Chinese and Indians would only accept gold in exchange for spices and silk instead of Roman goods. We believe it is quite likely that gold is increasingly being hoarded and its circulation is declining, as it is increasingly held in "strong hands."[81]

***"Chindia"* by now accounts for 62% of physical demand**

The bulk of gold demand now comes from emerging markets. According to the World Gold Council, demand from emerging markets amounted to more than 70% of total demand in the past 5 years. "*Chindia*" alone was responsible for 62% of total demand last year. The decline in India's demand has in the recent past been (more than) compensated by China's demand. The change in India's government will have a positive effect on gold demand, as import restrictions are likely to be loosened.

Gold demand by emerging markets and industrialized nations (5 year average) in %

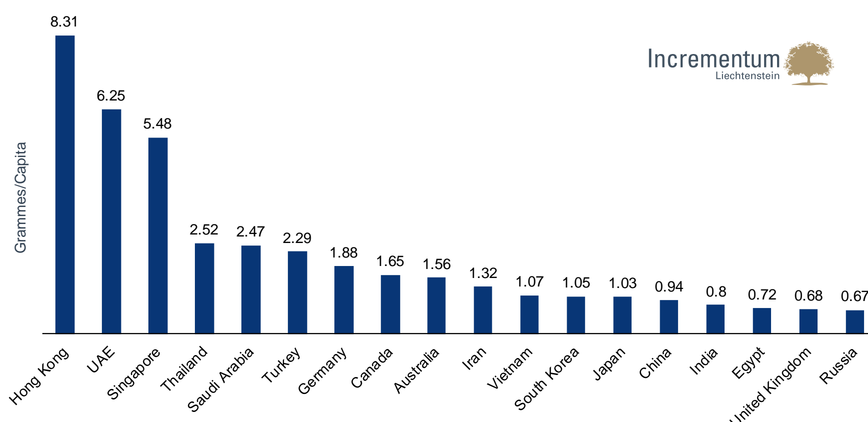


Source: Thomson Reuters GFMS, World Gold Council, Incrementum AG

If one looks at per capita demand last year, one can also see that numerous emerging markets are among the top 20 gold buyers. This is especially astonishing considering their significantly lower purchasing power.

[81] see „The Long Monetary March", Myrmikan Update, 23 September, 2013

Per capita demand in grammes



Source: GFMS, Thomson Reuters

China's jewelry demand by now amounts to 30% of global jewellery demand. In recent years, investment demand has significantly increased as well. The main reason is probably fear of a creeping devaluation of savings. This is the understandable result of a policy of financial repression and negative real interest rates pursued over many years. **The following factors will affect Asian gold demand in the long term:**[82]

- **rising incomes:** Ernst & Young forecasts in a study that the number of persons belonging to China's middle class will increase to 500 million by 2020. In India, the middle class will number 267 million already in 2016 according to Economic Times. By 2030, 64% of the global middle class will live in Asia.
- **Savings deposits:** Almost one third of disposable income is saved in China. Currently savings deposits amount to USD 7.5 trillion
- **Urbanization and transformation from an agrarian society into an industrialized nation**
- **Inflation fears:** China experienced hyperinflation from 1937 to 1949, an event that remains in the monetary DNA of the Chinese. Moreover, there is great scepticism (justifiably so) with respect to official inflation data.
- **A lack of investment alternatives:** disappointing performance of China's stock market (see next chart).

[82] see "China's gold market: progress and prospect", World Gold Council

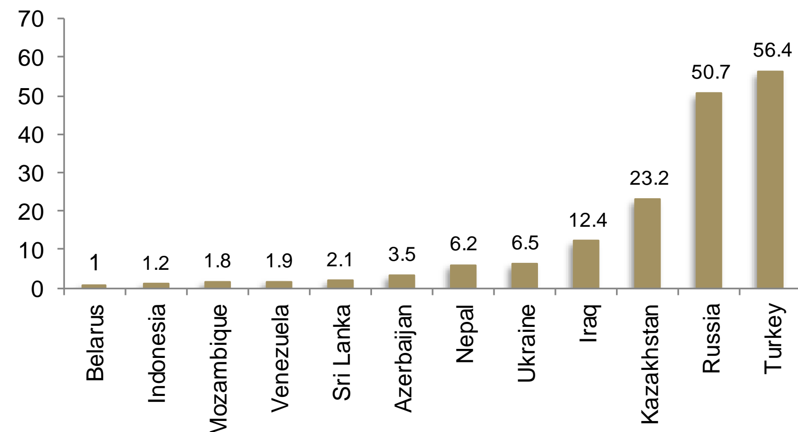
Shanghai Composite vs. gold in yuan

Source: Datastream, Incrementum AG

"The more gold a country has, the more sovereignty it will have if there's a cataclysm with the dollar, the euro, the pound or any other reserve currency."
Evgeny Fedorov

Official central bank purchases amounted to 409 tons last year, 135 tons less than in the previous year. The biggest buyers were once again Turkey and Russia. Developing countries are generally not only exhibiting more confidence with respect to their own economic and political power, but also more distrust with respect to established reserve currencies. This is demonstrated by the rising gold purchases of their central banks.

Central bank purchases since June 2013 in tons



Source: World Gold Council

While the central banks of developing countries continue to be net buyers, Western central banks have at least suspended their sales programs. Recently the central banks of the euro area, the ECB, the SNB and the Swedish Riksbank signed a new gold agreement and agreed "not to engage in any significant gold sales" over the coming five years. The fourth such agreement doesn't include an upper limit for gold sales for the first time, as was still usual in the past agreements. Central banks continue to demonstrate a commitment to gold's importance in the modern currency system: "*Gold remains an important element of global currency reserves*" and "*the signatories to the agreement will continue to coordinate their gold transactions in order to avoid market dislocations*".

Conclusion

“Love trade” will gain in importance

The growing importance of Asia's middle class for gold demand is in our opinion widely underestimated. People in the majority of developing countries have a much stronger affinity to gold than those in industrialized nations. This traditionally high gold affinity combined with rising prosperity is going to support demand in the long term. **If one assumes that incomes in China and India will continue to rise, while real interest rates will remain negative, resp. low, one must inevitably recognize that gold will be a beneficiary of these trends (“love trade”).**

10. THERE ARE NO MARKETS ANYMORE, JUST INTERVENTIONS[83]

Free price determination is a thing of the past

There is a fine line between intervention (mainly governmental, resp. political interference) and manipulation (in the negative sense of "exertion of influence"). That central banks intervene heavily in terms of bond yields (Operation Twist, quantitative easing) and currencies (Swiss franc, Japanese yen), is official and legitimized. Even Jean Claude Juncker confirmed recently that if he were nominated for the position of president of the European Commission, he would table a proposal that European finance ministers should "*issue mandatory guidelines for the exchange rate*", should the currency become too strong. **Free price determination is therefore a thing of the past in many areas.**

It is obvious that a rising gold price signals a decline in confidence in the financial and monetary system. That neither central banks nor governments have an interest in that is self-evident. In that sense, incentives for "price management" clearly exist and are plausible. It would therefore be naïve to rule out that there is intervention in the gold market. Circumstantial evidence is provided by quotes from high-ranking protagonists:

"*……Joint intervention in gold sales to prevent a steep rise in the price of gold, however, was not undertaken. That was a mistake"*
Paul Volcker, former Fed chairman

The following statement is especially remarkable, as the gold price is referred to as the thermometer of the financial system, and the possibility of gold sales is explicitly mooted:

"*If we are dealing with psychology, then the thermometers one uses to measure it have an effect. I was raising the question on the side with Governor Mullins of what would happen if the Treasury sold a little gold in this market. There's an interesting question here because if the gold price broke in that context, the thermometer would not be just a measuring tool. It would basically affect the underlying psychology."*
Alan Greenspan, former Fed chairman

Quite a lot of empirical evidence for gold price manipulation

While allegations of manipulation have always been categorized as conspiracy theories, quite a bit of sound evidence has emerged in recent years that clearly suggests a suppression of gold and silver prices is being pursued. Rosa Abrantes-Metz, professor at New York University, has presented a study together with Albert Metz, managing director at Moody's, in which they prove that the banks involved in the London Price Fixing are manipulating the gold price. The extent of this manipulative behavior is said to be worrisome. **Metz already caused quite a sensation in 2012, when she started the ball rolling with respect to the LIBOR manipulation scandal.**

„Many conspiracy theories have later turned out to be conspiracy facts."
Kevin Maher

A much more comprehensive study regarding manipulation was published by author and fund manager Dimitri Speck. [84] In his meticulously detailed work, he diagnosed with the aid of statistical methods that a new era began in the gold market on 5 August 1993. On that day, price manipulation is said to have started. **The following chart shows the**

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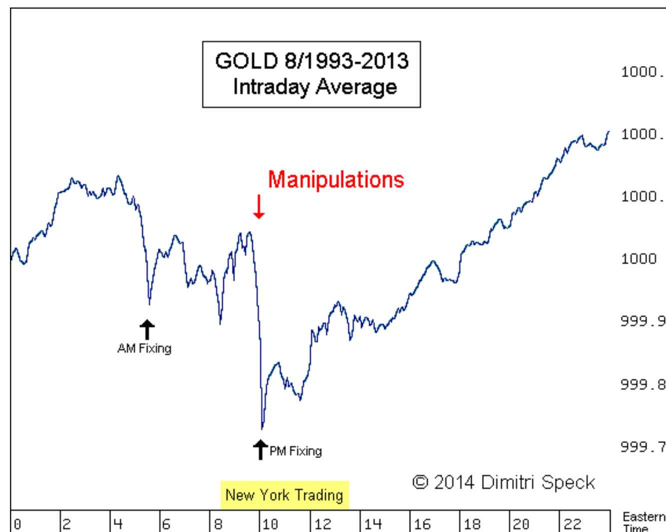
[83] Chris Powell
[84] see „The Gold Cartel", Dimitri Speck

average daily price movement since 1993. One can clearly see that prices decline conspicuously hard and fast at the time of the afternoon fixing.



Source: Dimitri Speck

"I see signs of manipulation in gold through the action of "paper gold" on the COMEX. Occasionally we see huge masses of futures being dumped in a matter of minutes on the thinly traded COMEX. All this in an effort to keep the price of gold down. Eventually, gold will reach its rightful level. So to coin a phrase, You can't keep a good currency down."
Richard Russell

The somewhat anachronistic practice of the gold fixing, which took place for the first time in 1919 in the wood-paneled offices of N.M. Rothschild & Sons in London, will likely soon become a thing of the past. After the suspicion that the participants in the fixing have abused their privileged position has been confirmed, a wave of lawsuits[85] is now rolling in against the banks participating in the gold fixing. Since it became known in November of last year that the German financial supervisor BaFin and the British supervisory authority FCA are investigating the manipulation allegations, criticism regarding price determination continues to be voiced. It appears as though the days of the fixing are slowly but surely numbered. A harbinger could be the fate of the silver fixing, which will be discontinued in August of 2014 after 117 years.

11. STRUCTURAL OVER-INDEBTEDNESS ARGUES FOR FURTHER UPWARD REVALUATION OF GOLD

"On the basis of the growing debt spiral, growth improves only quantitatively, but not qualitatively"
Rahim Taghizagedan

Economists and politicians continue to attempt to lower high debt relative to economic output (debt/GDP), resp. stop its further growth. **We think the ratio between the size of the public debt and gross domestic product[86] is not very meaningful. The uselessness of this data can for instance be seen from the fact that the calculation of GDP has recently been changed.** An increase in GDP must – *ceteris paribus* – lower indebtedness relative to GDP.[87] This happened in the US, where GDP was reported to be 3% higher than previously overnight, by suddenly including intangible values such as licensing fees and R&D spending in the calculation. As a

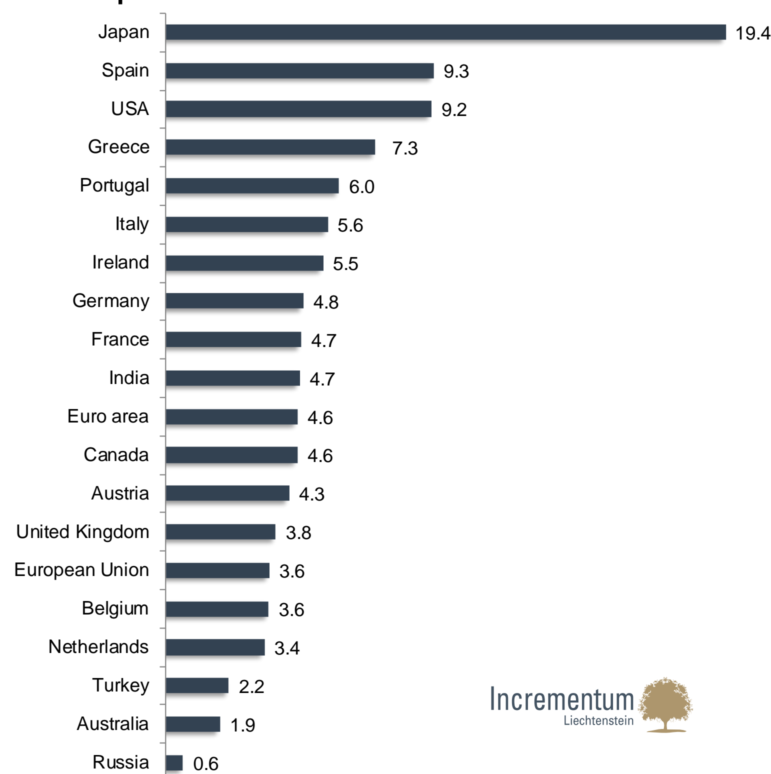
[85] Barclay's has already been sentenced to pay a fine of USD 44 million. The FCA charges the bank with having failed between 2004 and 2013 to "properly handle conflicts of interest", the fine however only referred to a specific instance of the gold fixing, namely on 28 June 2012.
[86] Whereby the concept of GDP must be viewed critically from an Austrian perspective. A critical review of this purported yardstick of an economy's prosperity would however be beyond the scope of this report. See however e.g. "GDP, Damaged Goods", Asianomics, 17 Mar 2009 for a critique from an Austrian perspective.
[87] see „The Mirage of Economic ‚Growth', or Kicking Rogoff While He's Down", Acting-man.com

"The natural remedies, if the credit-sickness be far advanced, will always include a redistribution of wealth: the further it is postponed, the more violent it will be. Every collapse of a credit expansion is a bankruptcy, and the magnitude of the bankruptcy will be proportionate to the magnitude of the debt debauch. In bankruptcies, creditors must suffer."
Freeman Tilden, A World In Debt

result, USD 470 bn. were pulled out of the statistics hat. This is roughly equivalent to the economic output of Belgium.[88]

We believe the ratio of public debt to government revenue is far more informative. In Japan, public debt stands at 19 times annual tax revenue. By changing the denominator one can also see how an increase in interest rates would affect the calculation. If, for instance, the public debt is equivalent to 10 times revenues, an increase in average financing costs by 1 percent implies that tax revenues would need to rise by 10%. The chart thus indicates how far advanced the "Keynesian endgame" already is.[89]

Ratio of public debt to tax revenues as of the end of 2012



Source: World Bank, Incrementum AG

Furthermore, the debate tends to be focused solely on explicit, directly visible debt. This present and past-oriented focus, however, shows only one side of the coin, while future fiscal and demographic trends are completely hidden.

The so-called sustainability gap takes this problem into account, as it consists of both the already reported explicit government debt of today, and adds implicit debt. Implicit debt is the *difference between all the future services and entitlements, which according to currently applicable law must still be paid to all generations living today, as well as future generations.* **In other words, the sustainability gap shows how big a reserve is needed**

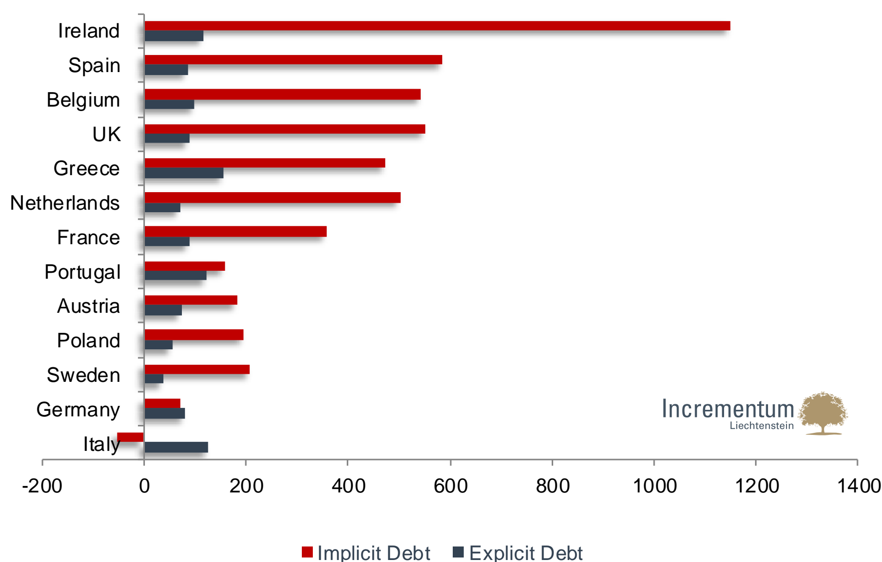
[88] Comment: Since 2014, Italy also includes the income of the drug trade, prostitution and cigarette smuggling in its GDP calculation. The size of these illegal businesses is calculated with a model, and is said to amount up to 21% of economic output. In Austria the "shadow economy" has been included in GDP calculations since 2009 already. In 2012, the contribution to GDP was EUR 890 m.
[89] see „The Critical Chart in Sovereign Debt Analysis", Greshams-Law.com

in order to continue to finance today's level of services in the future. These hidden debts consist mainly of those services that the government owes to its citizens and the working population in the form of retirement payments, care services or health insurance.[90]

"What the government spends more, the public spends less. Public works are not accomplished by the miraculous power of a magic wand. They are paid for by funds taken away from the citizens."
Ludwig von Mises

The following chart shows the sustainability ranking of the most important European nations. Two things are especially conspicuous: since implicit debt is significantly higher than explicit debt, the traditional, past-oriented debt perspective paints a far too optimistic picture.[91] Due to demographic trends, expenditure on health, retirement and care is going to markedly increase in practically all industrialized nations. In addition, the number of people of working age, who bear the bulk of social security contributions and the tax burden, is concurrently falling. A further increase in government debt is thus impossible in practice without a massive consolidation effort. According to the think tank "Stiftung Marktwirtschaft", a scissor-like divergence of public expenditures and revenues threatens as a consequence.

Implicit vs. explicit debt of a number of European countries[92]

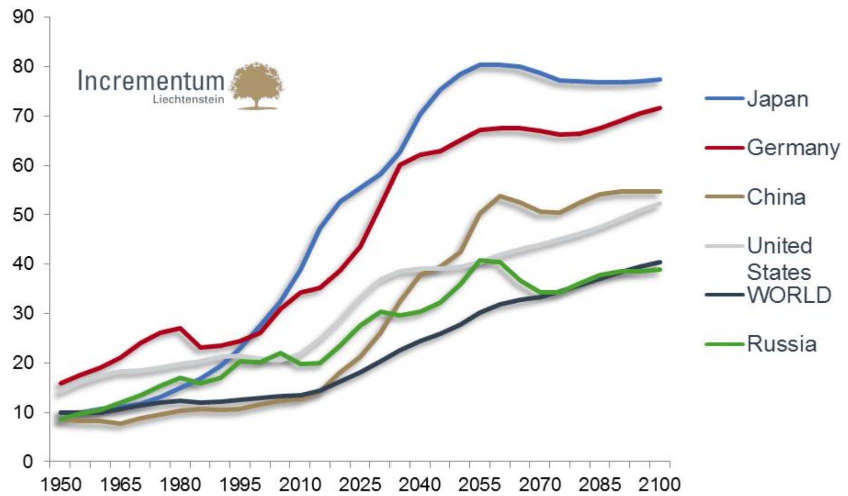


Source: Stiftung Marktwirtschaft

With regard to inflation and deflation, demographic trends should not be ignored. The old age dependency ratio illustrates the ratio between retirees (older than 65 years) and the working age population (20-64 years). Once the baby-boom generation retires over the coming 10 to 15 years, the ratio is going to gradually increase in all industrialized nations.[93] In Japan, the ratio is forecast to reach approximately 80 in 2055. This implies that 100 people of working age will provide for 80 retirees. This state of affairs is anything but sustainable.

Old age dependency ratio 1950 to 2100e

[90] see http://en.wikipedia.org/wiki/Generational_accounting
[91] see Stiftung Marktwirtschaft, Generationenbilanz
[92] Comment: while Luxemburg's high implicit debt is mainly due to an extremely generous pension system, Italy even has an implicit surplus, as the share of GDP of age-dependent expenses is barely going to rise in the long-term. Italy has moreover a clear primary surplus, i.e., a budget surplus excluding debt service costs.
[93] the US and Russia are exceptions, the former due to immigration and high birth rates, the latter due to declining life expectancy



Source: United Nations World Population Prospects

Based on demographic trends it is obvious that the bulk of government-run retirement systems will collapse without exorbitant government subsidies. **If more and more resources need to be shifted toward securing pensions, this will definitely have an effect on consumption and credit growth and represent a deflationary overhang.**[94]

a.) Wealth taxes and financial repression as a solution to over-indebtedness?

"There is only one way to kill capitalism - by taxes, taxes, and more taxes."
Karl Marx

In our last gold report, we already extensively discussed the topic of financial repression. Financial repression always consists of a combination of different measures, which lead to a significant narrowing of the universe of investable assets for investors. Money which in a more liberal investment environment would have flowed into other asset classes, is channeled in a different direction. The goal of financial repression is an indirect reduction of government debt by means of the targeted manipulation of the cost of government debt, most of the time accompanied by steady inflation. **Financial repression is ultimately a government-imposed transfer of wealth.**

A preferably "quiet debt reduction" is supposed to be achieved by the following measures:

- direct or indirect capping of interest rates (especially on government bonds)
- measures such as forcing domestic investors to invest in domestic capital markets, such as capital controls and regulations forcing institutional investors to hold portfolios with a "home bias"
- taxes that make alternative investments more expensive (e.g. transaction taxes)
- measures that imply a direct or indirect influence of government on financial institutions (macro-prudential regulation)

[94] see Wellenreiter-Invest „Deflationäre Vollbeschäftigung" (Deflationary full employment), Robert Rethfeld

– negative deposit interest rates, which increase the incentive for banks to invest in relatively risk-free assets. Banks are thus encouraged to monetize government debt – something that can rightly be called an inflation policy.

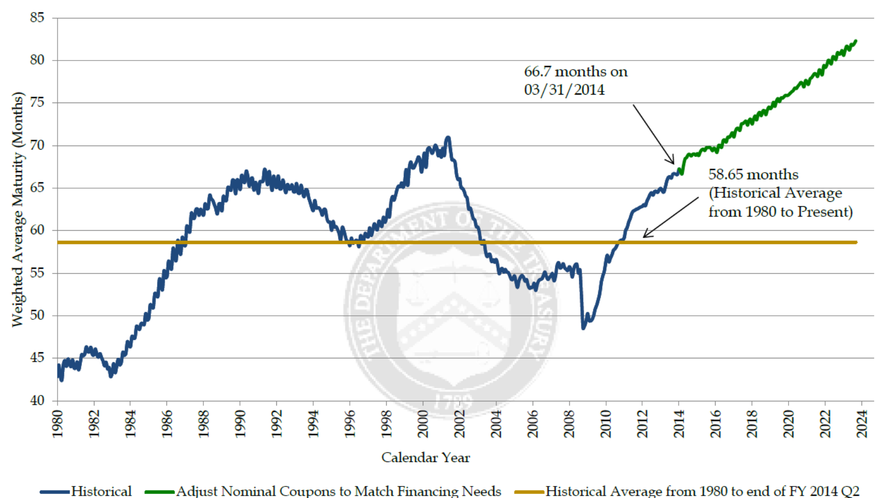
"If a policy is pursued over a long period which postpones and delays necessary movements, the result must be that what ought to have been a gradual process of change becomes in the end a problem of the necessity of mass transfers within a short period."
Friedrich August von Hayek

One of the most important goals of financial repression is to hold nominal interest rates below the rate of price inflation. This lowers the government's interest expenses and contributes to a reduction in the real value of the debt burden. Finders keepers, losers weepers: **Worldwide savers thus lose approx. EUR 100 bn. per year. Savings are, however, extremely important for capital formation and future growth, especially in times of crisis.**

The post-war period in the US is often cited as the standard example for the "history of success" of financial repression. At the time, liquid bonds with short maturities were exchanged for illiquid long-term bonds. One can see a parallel to the present in this, as the increase of maturities of outstanding bonds is a major component of financial repression.[95] This can also be seen in the following charts.

Debts can never erase debts. Debts erase wealth, or wealth erases debts.

Weighted average maturity in years



Source: U.S. Treasury Office of Debt Management, Fiscal Year 2014 Q2 Report

"The decline of the value of each dollar is in exact proportion to the gain in the number of them."
Keith Weiner

The maturity profile of the Fed's balance sheet has been dramatically expanded in recent years. Obviously, an increase of a bond portfolio's maturity profile vastly increases its interest rate sensitivity. Should interest rates increase quickly, exorbitant accounting losses would immediately accrue to central banks and their equity capital would turn negative.

Specific examples of repression measures imposed over the last year:

– **Federal Reserve officials are already discussing whether regulators should impose exit fees on bond funds to avert a potential run by investors.** This underlines their concern about the

[95] An important role in the debt reduction at the time was however played by a growth-oriented economic policy, which began after the war. This was made possible by a structural shrinking of government and thus a significant freeing up of resources for the private sector.

vulnerability of the USD 10 trillion corporate bond markets.[96]

- retroactively to 1 February, **Italy taxes incoming cross-border money transfers at a rate of 20%.** Only if one can prove that one has not engaged in money laundering does one get one's money back. The onus of proof is thus with taxpayers.
- **In Poland, a radical step was taken.** In order to lower the debt-to-GDP ratio by 8 percentage points, the expropriation of private pension funds was enacted. The background is that upon reaching a debt-to-GDP ratio of 55%, consolidation measures are automatically implemented. By expropriating AXA, ING and Generali, the debt-to-GDP ratio was lowered by 8 percent. According to finance minister Jacek, this creates the potential for the government to run up additional debt.

A revenue source for government that is currently one of the most popular debates, consists of more direct measures, including compulsory levies on all savings, securities and/or real estate. This debate has intensified following a publication by the IMF, an excerpt of which we provide below:

"The sharp deterioration of the public finances in many countries has revived interest in a "capital levy" - a one-off tax on private wealth - as an exceptional measure to restore debt sustainability. The appeal is that such a tax, if it is implemented before avoidance is possible and there is a belief that it will never be repeated, does not distort behavior (and may be seen by some as fair)."[97]

Germany's Bundesbank jumped on the bandwagon as well and said:

"With this special context in mind, the following outlines the various aspects of a one-off levy on domestic private net wealth, in other words, a levy on assets after liabilities have been deducted. From a macroeconomic perspective, a capital levy – and even more so a permanent tax on wealth – is, in principle, beset with considerable problems, and the necessary administrative outlay involved as well as the associated risks for an economy's growth path are high. In the exceptional situation of a looming sovereign default, however, a one-off capital levy could prove more favorable than the other available alternatives......If the levy is referenced to wealth accumulated in the past and it is believed that it will never be repeated again, it is difficult for taxpayers to evade it in the short term, and its detrimental impact on employment and saving incentives will be limited – unlike that of a permanent tax on wealth."[98]

"Capital will always go where it's welcome and stay where it's well treated."
Wriston's Law of Capital

US economist Barry Eichengreen outlined already in a 1989 study entitled "The Capital levy in Theory and Practice" how such a compulsory levy must be implemented to be successful: without political debate, fast and above all the surprise factor is essential. Otherwise, capital flees across the border or into different asset classes.

[96] see „Fed looks at exit fees on bond funds", Ft.com
[97] "Fiscal Monitor. Taxing Times", International Monetary Fund, October 2013, p. 49
[98] "A one-off capital levy:a suitable instrument for solving national solvency crises within the current EMU framework?" Monthly Report, January 2013, German Bundesbank

"Either the State ends public debt, or public debt will end the State"
David Hume

The road toward wealth taxes is thus already being paved. Even though the compulsory levy is often called a "millionaire's tax", caution is advisable. Such a levy on wealth would have massive effects on saving behavior and thus also long term negative consequences for capital formation. The capital structure will be distorted and capital accumulation will become more difficult. When in the past, savings were invested in the capital markets, other ways will now be sought in order to evade the levy. **Since these new ways will only be sought as a result of the new wealth tax, they represent more inefficient forms of capital formation, as they would otherwise already have been used previously.**[99]

Conclusion

We expect that financial repression as well as wealth taxes in various facets will increasingly gain in importance in coming years. We believe this to be a disastrous strategy, as the redistribution will merely buy time, while the structural problems remain unsolved.

[99] see „Österreichische Schule für Anleger" („Austrian School for Investors"), Taghizadegan, Stöferle, Valek

12. APPROACHES TO EVALUATING THE GOLD PRICE

"Value does not exist outside the consciousness of men."
Carl Menger

In a science like physics, there is 100% precision. We know for instance how the velocity of falling items or the freezing point of water can be calculated. Such constants do not exist in economics, as the data continually change. Economics is about human action and its consequences. **This perspective is a characteristic of the Austrian School, which largely eschews econometric explanatory models.**

According to Carl Menger, the founder of the Austrian School of Economics, the value of a good is determined by the expected marginal utility the good has to a valuing individual. The value of a good or service is therefore not an objectively measurable magnitude, but is always the result of a subjective act of valuation. Since there are as many different scales of preferences as there are human beings (and because every scale of valuations is also continually subject to change), it is impossible to ascertain the value of a good or service in an objective manner. **It is therefore impossible to calculate a "fair value" for gold.**

a.) Quantitative valuation model: Scenario analysis

„***In an ideal state of society perhaps the intrinsic quality of money might entirely disappear and be replaced by the value derived from the control of the state. But for that to occur the control of the state would need to be perfect in authority and god-like in intelligence.***"
Aristoteles

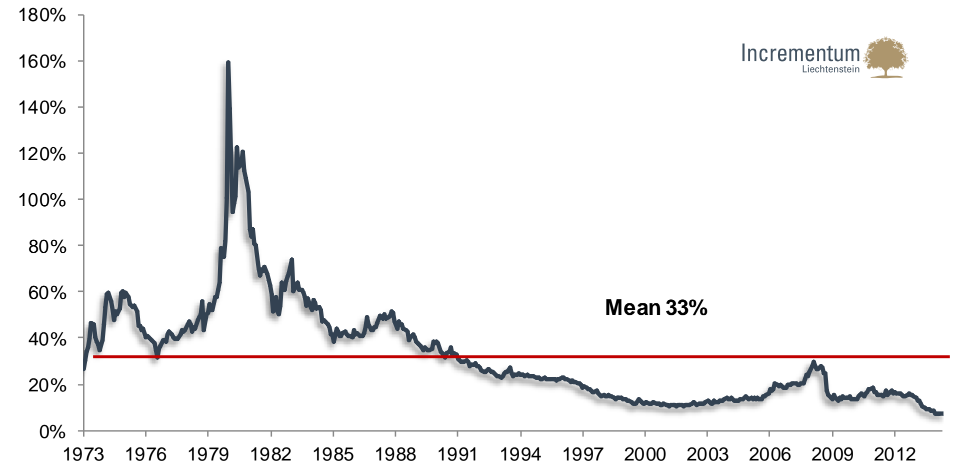
Even though we are convinced that every act of valuation on the part of individuals is distinct and subjective and that therefore no objectively ascertainable "fair price" exists, for the first time last year, we published a long term valuation model for the development of the gold price.

Although gold is not officially part of the international monetary architecture, it continues to play an important role as a currency reserve asset. As already mentioned in previous sections of this report, gold's relative position has tended to gain in importance for several years at a time. The most striking manifestation of this is the fact that central banks have once again become net buyers of the precious metal. We continuously monitor two parameters in this context in order to quantify the degree of gold's monetization:

1. the **future development of the central bank's balance sheet**
2. the **future implied balance sheet coverage** in terms of gold

Since the end of the gold standard, no explicit gold coverage ratio is required for central banks anymore. However, based on the market price and gold reserves, an implied gold coverage ratio can be calculated. A fundamental premise of our model is that an increase in the rate of expansion of central bank balance sheets will trigger higher market prices for gold in the long term (probably due to rising price inflation). The "*degree of monetization*" of gold rises in times of waning confidence and falls in times of growing confidence in paper money.

Gold coverage ratio of monetary base in %



Source: Incrementum AG, Federal Reserve St. Louis

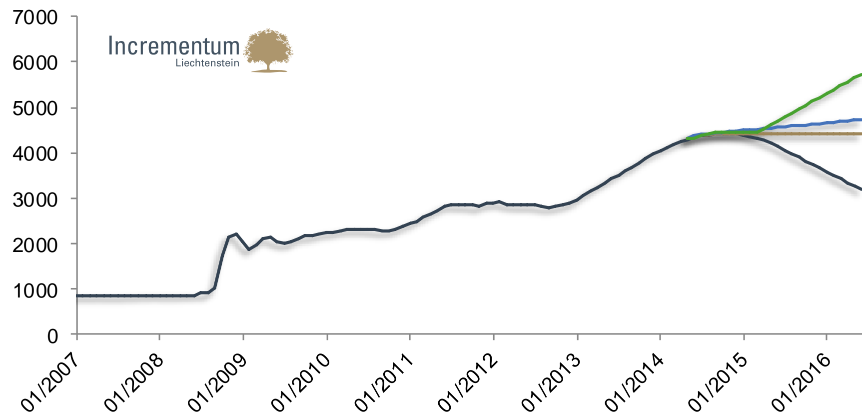
Monetization degree of gold relative to the dollar at an all-time low

The degree of gold's monetization relative to the monetary base currently stands at 8%, which represents an all-time low. Confidence in US monetary policy is therefore very high. Very few market participants regard price inflation as an imminent danger.

Last year, we developed four scenarios for the future trend of the US central bank balance sheet over a 24-month time horizon.[100] We have adjusted these scenarios this year to reflect the developments that have taken place since then and have tabulated new assumptions for the probabilities of occurrence over the coming 24 months.

Scenario	Probability 06/2013	Probability 06/2014
QE ends with exit	**25%**	**5%**
QE ends without exit	**30%**	**70%**
QE doesn't end	**30%**	**10%**
QE accelerates/is renewed	**15%**	**15%**

4 scenarios for the development of the Federal Reserve's balance sheet



Source: Incrementum AG

[100] We want to point out that these assumptions diverge clearly from the opinions of Erste Group Research

Currently, it appears as though QE3 will be discontinued by year-end. However, the probability that the size of the central bank's balance sheet will contract anytime soon has decreased dramatically. **High-ranking US central bankers have only recently admitted for the first time that the central bank's balance sheet will not be contracted for many years.**[101]

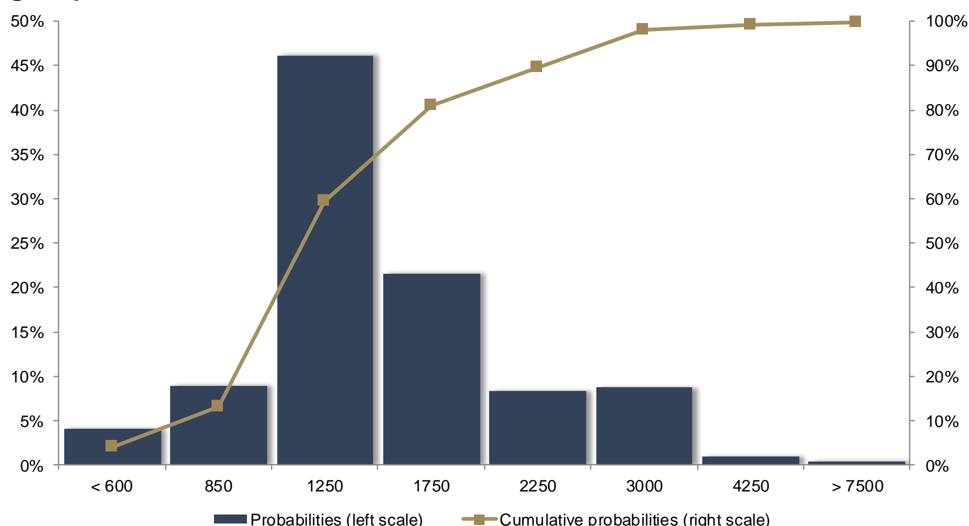
A more asymmetrical picture than last year

As a result, we see a more asymmetrical picture with respect to the future development of central banks' balance sheets compared to last year. The most likely scenario at this stage is clearly that the current "tapering" exercise will end by October or December 2014 and that the central bank balance sheet will be held at a stable level thereafter. We have therefore retained scenarios 3 and 4 with a low probability of occurrence, as the central bank continues with the data-dependent evaluation of its unconventional monetary policy measures. A renewed expansion of QE would, however, be a surprise for the great majority of market participants at this juncture, and would be highly likely to cause a reaction in the gold market. This, in turn, would have an impact on the balance sheet's implied gold coverage ratio. **Even if calculated with a low probability of occurrence, this has a notable effect in terms of a risk premium relative to the current gold price.**

Long-term expected value of USD 1,515

Based on the weighted probabilities, the model's calculation arrives at a long-term expected gold price of USD 1,515 per ounce. This estimate is significantly more conservative than that of last year, due to the fact that from today's perspective, the end of the current QE program has become more likely. One year ago, this probability was still markedly lower. However, as the following chart shows, the distribution remains significantly positively skewed. Therefore, should there be a deviation from the currently widely expected path towards stabilization of the central banks' balance sheet, significant upside potential for the gold price would result.

Calculated probability distribution of all scenarios and the associated gold price



Source: Incrementum AG

[101] see http://www.bloomberg.com/news/2014-06-11/fed-prepares-to-keep-super-sized-balance-sheet-for-years-to-come.html

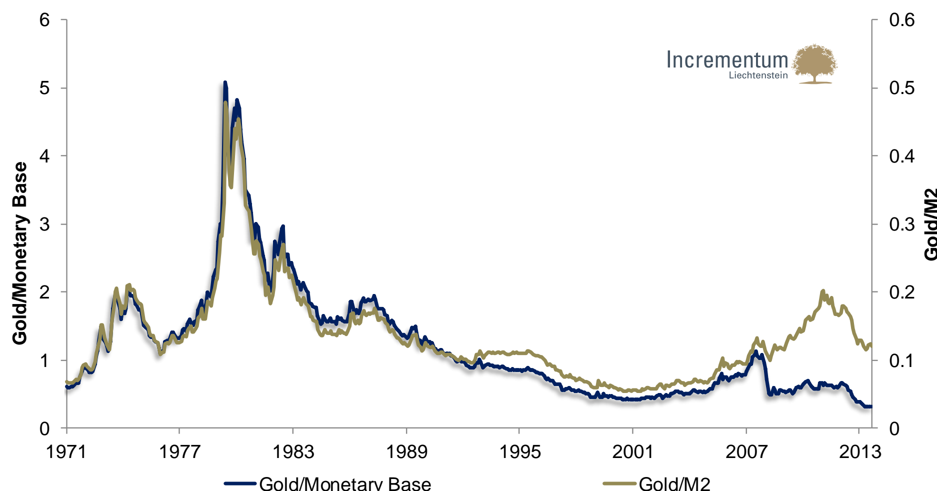
b.) Relative valuation based on ratio analysis

In addition to our monetary valuation model, we want to analyze gold's under- or overvaluation relative to other asset classes. Ratio analysis is a simple and extremely useful form of technical analysis. By dividing one price by another, a ratio results, which is charted as a line. Since we have used gold as the numerator (e.g. gold/stocks), a rising ratio means growing relative strength of gold versus the denominator.

1) Gold vs. monetary aggregates

As the following ratio chart shows, gold remains 'cheap' relative to both the monetary base as well as the money supply aggregate M2, and is well below the long-term average. As we have mentioned before already, relative to the monetary base gold is actually trading at new all-time lows.

Gold vs. monetary aggregates: monetary base (left hand scale) and M2 (right hand scale)



Source: Incrementum AG, Federal Reserve St. Louis

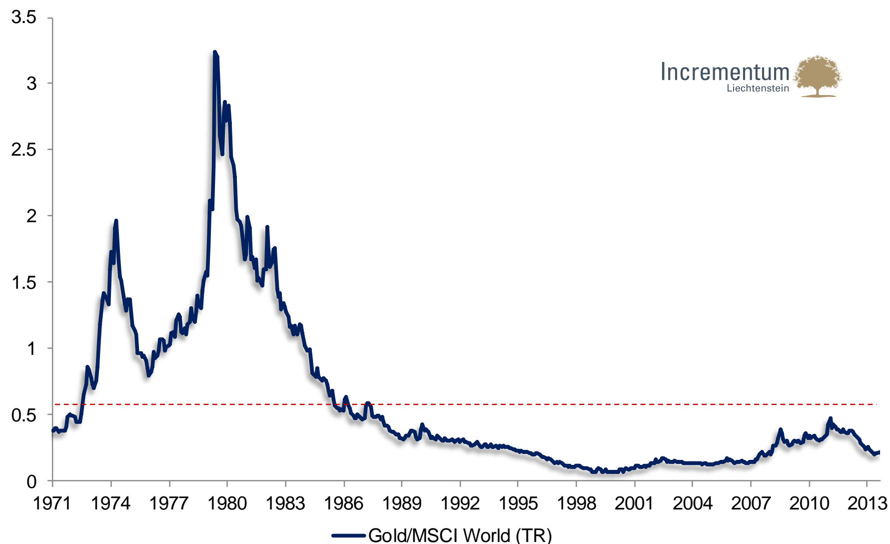
2) Gold vs. stocks

Gold undervalued relative to MSCI US and MSCI World

In a comparison to global stocks[102], one can also see that gold is undervalued on a relative basis. The ratio of gold to the MSCI World index of currently 0.20 is below its long-term mean of 0.6 and well below the all-time high of 3.4. Similar relative undervaluation is evident in comparisons to the DAX, DJIA and MSCI Europe.

[102] MSCI World Total Return Index, i.e.; incl. reinvested dividends

Gold vs. MSCI World

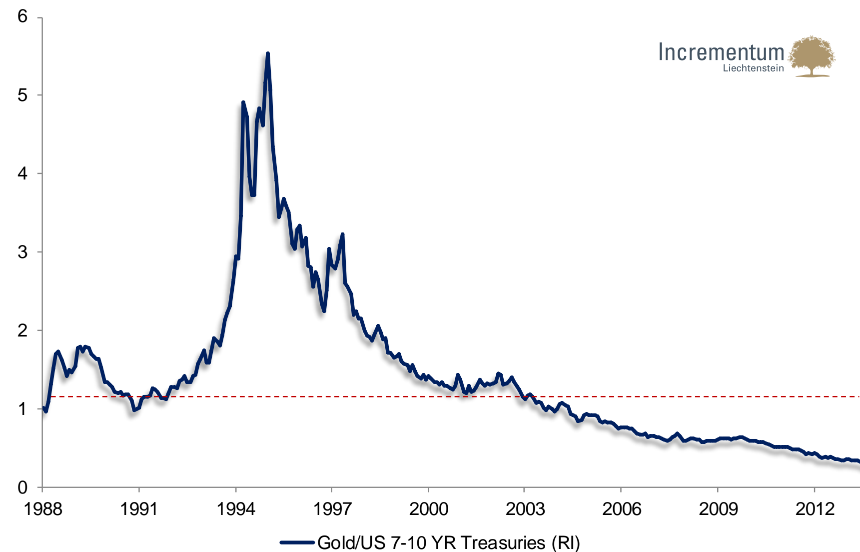


Source: Incrementum AG, Federal Reserve St. Louis

3) Gold vs. bonds

If one compares the gold price to bond indexes (total return), there is also no evidence of an overvaluation of gold. Relative to US treasury bonds, gold currently trades well below the long-term average. Similar results are obtained in comparisons to corporate bonds.[103]

Gold vs. BOFA ML 7-10YR Treasury



Source: Incrementum AG, Federal Reserve St. Louis

[103] BOFA ML US CORP MASTERS Total Return

Gold undervalued vs. high yield bonds and crude oil

Below, we show additional ratios of gold and a selection of "real assets" and bonds. One can see that the gold price is above the long-term average relative to US real estate, silver, copper and the commodities index CCI. Relative to crude oil and high yield bonds, gold appears undervalued.

Ratio	Current Ratio	Long-term Average	Low	High	Gold relatively expensive?
Gold/Silver	62x	56x	14x	99x	Yes
Gold/Oil (Brent)	11.5x	15x	6.5x	39x	No
Gold/CCI[104]	2.46x	1.6x	0.6x	3.2x	Yes
Gold/Fine Wine[105]	5.01x	4.9x	1.5x	15.1	Fair
Gold/Sotheby's[106]	32.5x	29.2x	4.2x	54.3x	Fair
Gold/High Yields[107]	1.21x	1.7x	0.69x	4.5x	No
Gold/Housing[108]	0.005x	0.0035x	0.0014x	0.0095x	Yes
Gold/Copper[109]	4.1x	3.6x	0.84x	25x	Yes

Source: Incrementum AG, Datastream, Liv-ex, Federal Reserve St. Louis

"Fine art behaves the way gold would behave if central banks didn't manipulate it."
Jim Rickards

Conclusion

The long-term comparison of gold to other asset classes therefore paints a very positive picture. Both in relation to monetary aggregates, as well as to traditional asset classes (stocks and bonds), gold is below the long-term averages. Compared to a selection of "real assets" a number of ratios are above the mean, but remain far from extreme values.

[104] Continuous Commodity Index
[105] Liv-ex Fine Wine Investables Index since January 1988
[106] We regard the stock of Sotheby's as a proxy for the art market
[107] BOFA ML US High Yield Masters Total Return, ab 1986
[108] US Average Existing Home Price, Single-family & Condo
[109] Copper Cathode C/LB

13. GOLD MINING STOCKS

a.) Stock-to-flow: the special anomaly of gold stocks

„*The cure for low prices is low prices*“ is not applicable to Gold!

Attentive readers of our reports are by now well versed with the concept of the stock-to-flow ratio. This year, we have once again emphasized this extraordinary characteristic of these monetary precious metals. Due to this characteristic, gold and silver represent monetary or investment assets. **It is important to us at this juncture to bring this special characteristic into context with gold stocks.**

High stock-to-flow ratio also has consequences for gold producers

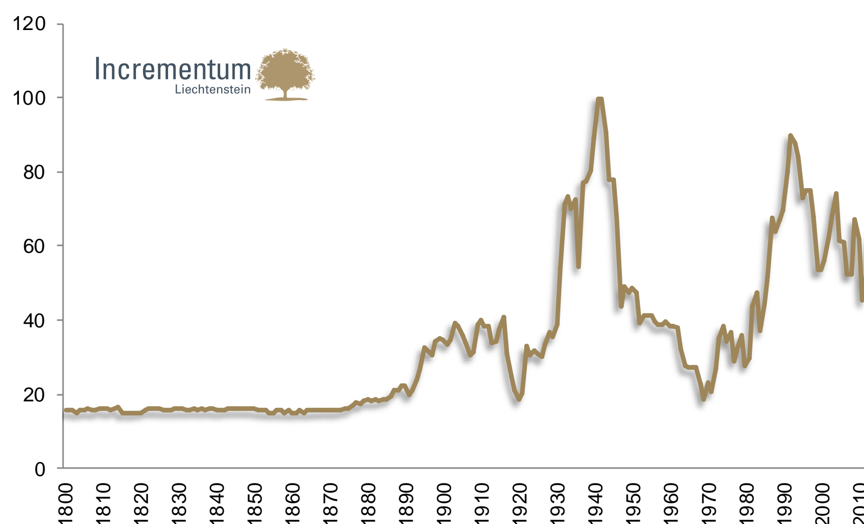
Gold is quite unlike consumable commodities (i.e., also from precious metals like platinum and palladium) in that the bulk of the amount mined is hoarded and not consumed. The total amount of gold hoarded is kept in the form of coins, bars, and some indirectly in fabricated form including jewelry and works of art. **The large stocks held in reserve are like a giant “warehouse” and one consequence of this is that long periods of excess supply are possible.**

Production costs do not represent a lower limit for the gold price

Under certain circumstances, the price can fall well below the cost of production, should industrial demand be supplied from existing stocks. ***It is often asserted that the price of gold cannot fall below the cost of production*. This often-cited argument regarding a natural lower price limit is not applicable in gold's case.**

This is also an important difference to all other commodity producers. The demonetization of a metal results typically in a decline in stocks held in reserve. One example for this is the transition from the bi-metallic standard to the gold standard. Silver was demonetized, and the monetary stock was released in subsequent decades for industrial purposes. The loss of monetary demand had a corresponding negative effect on prices. **This can be seen in the gold/silver ratio.**

Gold/silver ratio since 1800

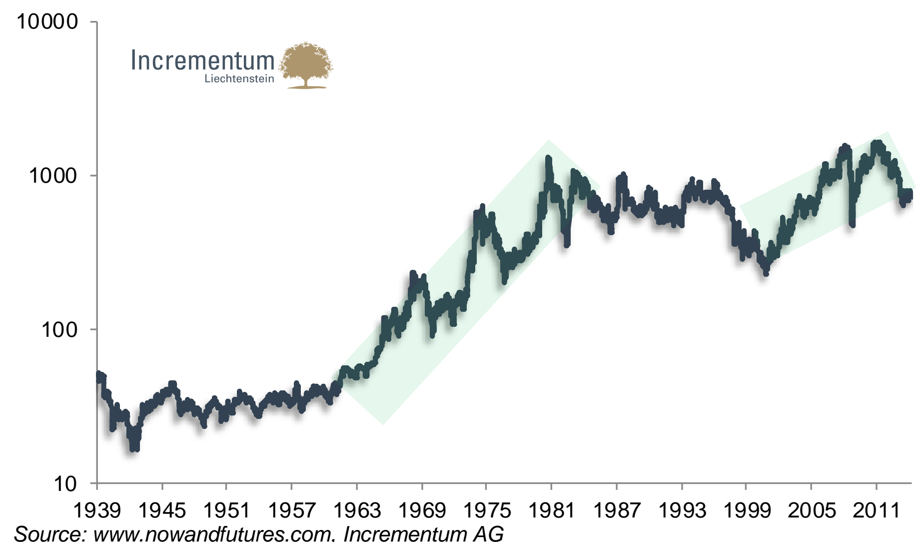


Source: Measuringworth.com, Incrementum AG

Remonetization, on the other hand, leads to a massive structural demand imbalance. For instance, if a paradigm shift in monetary policy

occurs in a fiat money system after decades of stable monetary policy, massive monetary demand for gold and silver can ensue. The 1970s provided a good example of this. In such a case, the price will rise significantly above production costs and gold mining stocks can rally for many years.

Barron's gold mining index since 1939 (log scale)



Source: www.nowandfutures.com, Incrementum AG

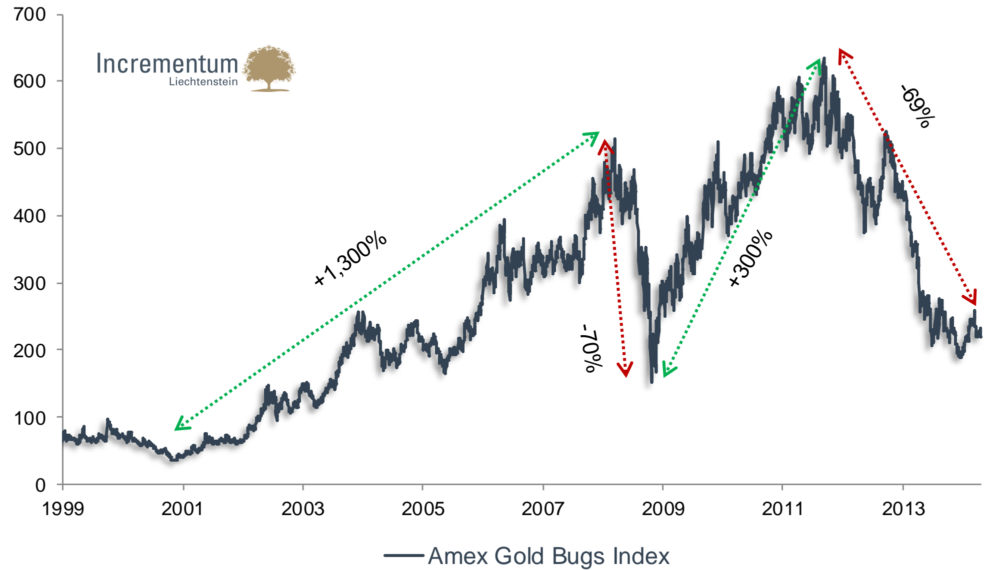
This monetary commodity anomaly therefore also leads to anomalies with respect to their producers. Such a super-cycle is in our opinion triggered first and foremost through long-term changes in the financial order. **For mining companies and investors in mining companies this has the following important consequences:**

- Historically, bull and bear markets of above average length can be detected in gold stocks
- the super cycle is triggered by fundamental changes in the monetary framework
- trends that are sustained over the long-term tend to affect corporate governance
- after extended boom periods, structurally high margins often lead to a sub-optimal handling of corporate resources
- extended periods of depression bring about massive consolidation in the sector and the remaining companies are forced to operate extremely efficiently
- for investors the most interesting entry points are offered after years of consolidation
- **the extraordinarily strong top-down influence of monetary policy-related events on this asset class argues for *active timing of investment in mining stocks***

The following chart illustrates that gold stocks are anything but "buy and hold" investments and must be actively managed. This is also confirmed by the saying: "*Market and sector forces together typically cause 80% of the price movement in a stock. That means the company fundamentals usually account for less than 20% of a stock's price*

movement. This is the reason a company's stock price sometimes seems to move independently of the fundamentals".[110]

Amex Gold Bugs Index: bull and bear market cycles since 1999



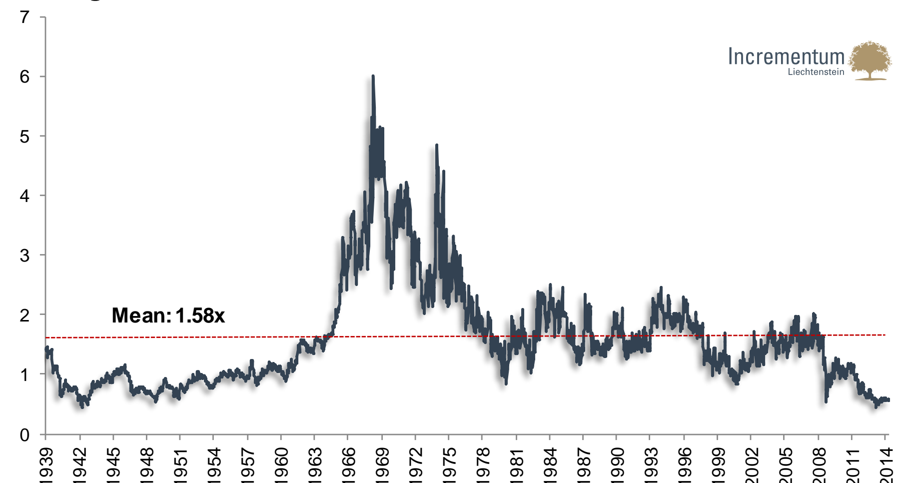
Source: Datastream, Incrementum AG

b.) Are gold mining stocks a historically rare contrarian investment opportunity after the sell-off?

Gold stocks relative to gold at the lowest level in more than 70 years

While the gold price delivered a disappointing performance last year, gold stocks' performance was a disaster. The extent of the underperformance is best illustrated by way of a long-term comparison. The oldest available gold stock index, the Barron's Gold Mining Index (BGMI) is currently at the lowest level relative to gold in more than 70 years.

BGMI/gold ratio at lowest level since 1942

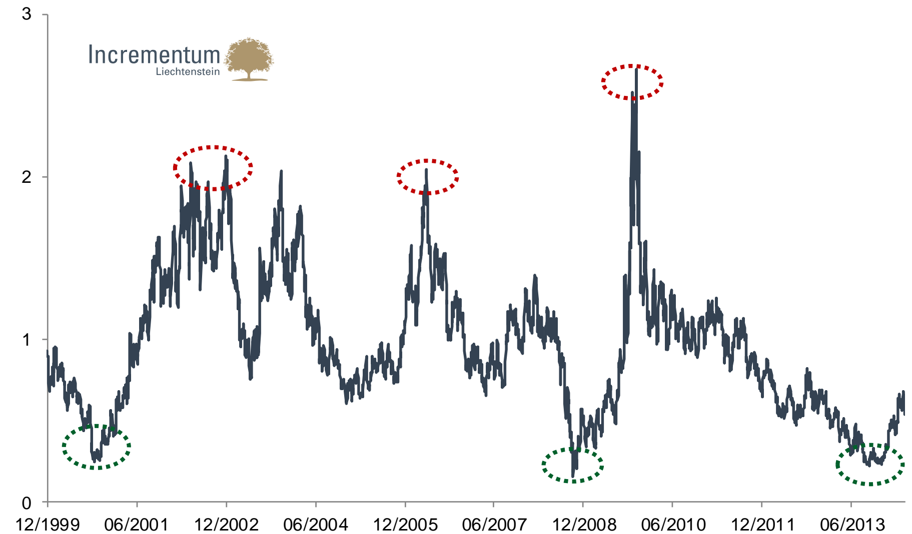


Source: Nick Laird, Sharelynx.com, Barrons, Incrementum AG

[110] "The Latent Statistical Structure of Securities Price Changes" Benjamin F. King

The following chart shows how deeply oversold the gold mining sector currently is. In the summer of 2013, the 12 month oscillator indicated an extremely oversold condition, which has occurred only twice before in the bull market to date. **On both occasions it was the starting point of large rallies in gold mining stocks.**

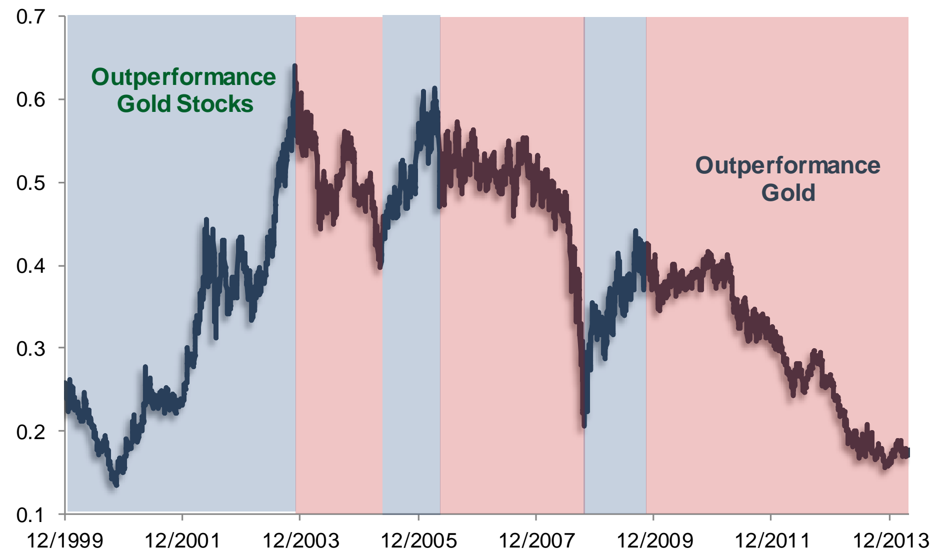
HUI Index: 12 month oscillator (y/y change)



Source: Bloomberg, Incrementum AG

Relative to the gold price, the gold shares in the Gold Bugs Index are at their lowest level since 2000. The blue periods depict the phases during which gold stocks are outperforming gold; the red periods are those in which gold's relative performance was better. One can see that the current period has so far been the longest period of under-performance of gold mining stocks since the beginning of the bull market.

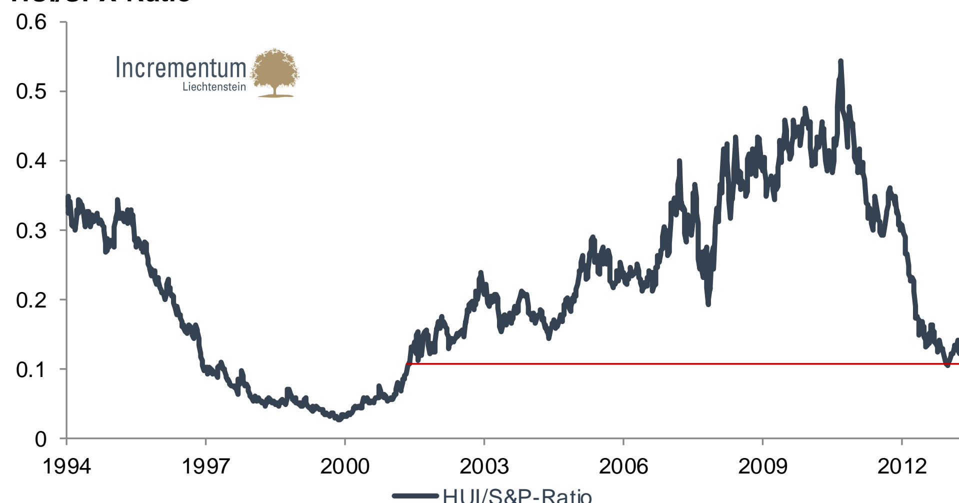
HUI/gold ratio since 1999



Source: Bloomberg, Incrementum AG

The sector continues to be subject to a lot of scepticism. This can also be seen in the ratio of the HUI index to the S&P 500. Currently the ratio is at the lowest level since 2001.

HUI/SPX-Ratio



Source: Datastream, Incrementum AG

c.) Creative destruction: does an about-face for the sector lie ahead?

Gold production per share fell by 9% annually

Gold stocks have failed to deliver the expected leverage to gold in recent years. It appears that mining stocks are being punished by investors for the mistakes made in previous years. Apart from cost inflation, the main reasons for this were sub-optimal capital allocation and the investment alternative offered by gold ETFs backed by bullion, but above all, the extrapolation of an ongoing upward trend in the gold price.[111] In the course of the bull market, the industry used ever higher price assumptions in order to include previously unprofitable ounces into its mine plans. As a result, the life of mines was increased and production expanded.[112] A large part of the expansion however consisted of high-priced ounces. Moreover, increasingly demanding and complex projects were tackled and highly dilutive takeovers were undertaken. In combination with steadily rising labor and input costs, as well as rising tax rates, the result was a decline in operating cash flows.

Continual extrapolation of rising gold prices was disastrous for the mining industry

Costs increased by an average of 11% per year from 2000. **In an environment of rising gold prices, this didn't pose a problem, production could be expanded "at any cost". However, the expansion was driven mainly by the issuance of new shares.** According to US Global, gold production of the 80 largest producers grew by 14% since 2008, while production per share actually fell by 9% per year.[113] As a result, the industry produced barely any free cash flow in 2012 (with the gold price averaging USD 1,670), while indebtedness had risen markedly.[114]

[111] see „Gold: Beta's back", Catherine Raw, BlackRock, Mining Journal.com
[112] Gold production rose by 24% between 2008 and 2013
[113] see „Time to Mine for Gold Mining Opportunities?", U.S. Global Investors
[114] see "Gold: Beta's back", Catherine Raw, BlackRock, Mining Journal.com

The sharp correction in the gold price abruptly revealed that numerous projects, which had been profitable at USD 1,600, were suddenly unprofitable. Additional development projects are not only a waste of money at current price levels, but would even threaten the existence of a company should the gold price remain at current levels (or a lower) for an extended time period.

In the course of the correction it could also be seen to what extent the gold price itself influences costs (both to the upside and the downside).

Many input costs are a derivative of the gold price

Numerous costs are direct derivatives of the gold price (such as royalties, input factors such as e.g. drilling costs, taxes, wages for skilled workers, etc.). Considering this, we think David Baker's proposal that gold producers should keep their accounts in gold terms and pay out a fixed percentage of their production to shareholders sounds very interesting. This would have numerous advantages, such as e.g. higher transparency and comparability within the sector, imposing the highest possible discipline on management in the context of M&A activities, etc.[115]

We continue to believe that falling mining costs are a realistic prospect

In our last gold report, we already pointed out that we were sceptical with respect to the mantra of "forever rising production costs" and are forecasting an end to rising costs, resp. even a deflation of mining costs. This was clearly proven correct in the course of the past year. Due to anaemic economic growth and a strong decline in commodity prices, numerous input costs stopped rising, resp. even fell. Thus prices for industrial tires, explosives, as well as wage costs have declined strongly in the course of the current brutal market adjustment. **We are of the opinion that the sharp correction in the gold price was a wake-up call for the industry.**

There were recently numerous positive changes in the sector:

- CEOs were replaced at nearly 30 companies, including the likes of Barrick Gold and Newmont Mining
- **cost discipline**: radical improvements in productivity, personnel reductions, new agreements with suppliers, etc. have led to lower operating and capital costs. According to Black Rock, all-in costs fell from USD 1,200 at the end of 2012 to USD 1,190 in Q4 2013. This implies a reversal of a 10-year long upward trend in costs
- **cost transparency:** among others, Yamana, Barrick Gold and Goldcorp will from now on publish their "all-in continuing cash costs"
- numerous exploration and development projects were sold or put on hold
- renewed focus on "higher return ounces". The reserve grade at the largest producers rose by 12% to 1.11 g/t
- balance sheets were strengthened through the issuance of shares or debt conversions
- numerous commitments to dividend growth and shareholder value

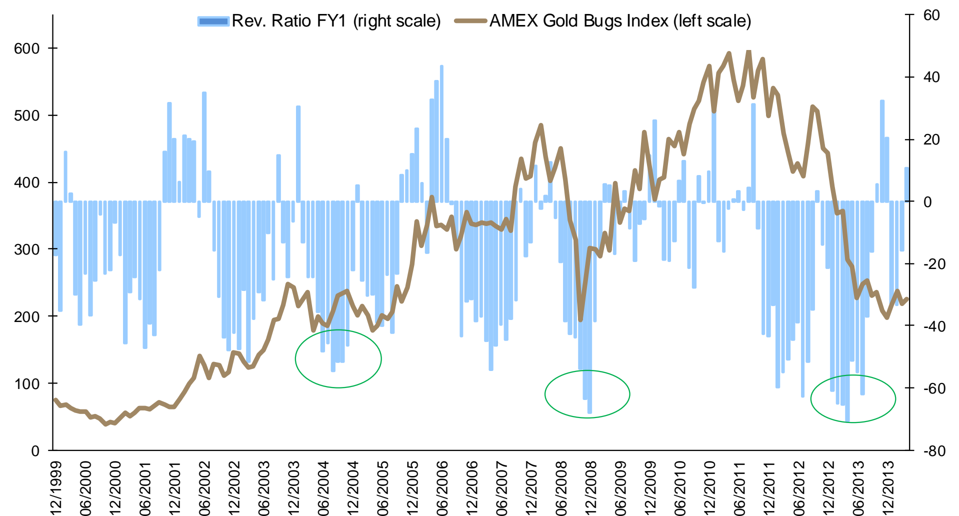
The result is a clear improvement in operating performance and a higher beta for the sector.

Revision ratio signals maximum pessimism on gold stocks

[115] see "Getting Closer to our Gold", "Defining a New Identity and Restoring the Appeal of Gold Shares", "Issues Facing Junior Gold Companies & Introducing the Production Linked Dividend Model", David Baker, Baker Steel Capital Managers

Gold stocks have declined by almost 70% from their highs. Sell-side analysts are – in usual pro-cyclical fashion – collectively issuing downgrades of earnings estimates. This classical herd behavior is often a reliable buy signal. If one compares earnings revisions with the price history of the Gold Bugs Index (golden line and left hand scale), one can see that earnings revisions reached a new nadir in June of last year. Historically, the point in time when pessimism was at its peak, often provided reliable entry signals.

Revision ratio for gold stocks



Source: JCF Factset, Erste Group Research

Conclusion on gold stocks[116]

"Gold will continue to vanish into private hoards against the day that even no metallic money will be had or seen any more. When the paper money is finally abolished, Gresham's Law will cause the market to reject all substitutes for wealth. Only metallic money, valid claims on metal, warehouse receipts for goods, or real bills will have purchasing power or command assets. Gold mines will once again be viewed as mini-central banks"
Daniel Oliver, Myrmikan Capital

The industry is currently experiencing changing tides. Such an amount of creative destruction within a sector is quite normal and healthy. It appears as though the industry is currently in the process of setting new priorities. Profitability, capital discipline, and stable cash flows per ounce are winning over the maximization of gold production. We believe this renewed commitment to cost transparency, greater financial discipline and shareholder value to be an important – if somewhat belated - move by the industry. Whether this new focus is pure lip service or not will become evident in the coming quarters. **Since the massive write-downs and charges were one-off measures, massive upside leverage could follow. We therefore believe that gold stocks exhibit a highly asymmetrical risk-reward ratio at the moment.**

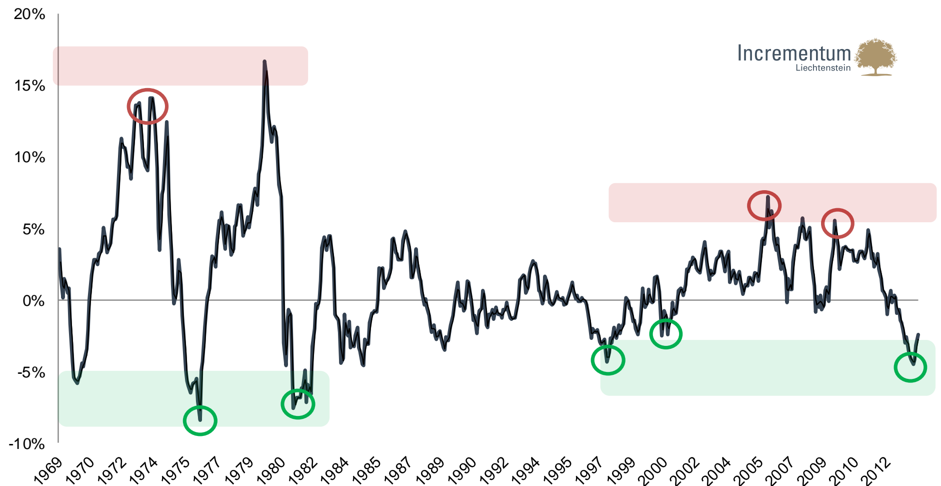
[116] as already mentioned last year, we regard gold as a currency, and thus gold ownership as a *form of saving*, while we see gold stocks as *investments*

14. TECHNICAL ANALYSIS: BOTTOMING PHASE ALMOST COMPLETE

1 year oscillator: Gold massively oversold at the moment

When the gold price reached its intra-day all time high of USD 1,920, the price was three standard deviations above the 40-day moving average. It was therefore extremely overbought. The oscillator shown in the following chart shows that gold is currently extremely oversold. The current corrective phase is the third largest sell-off since 1971. One can also see that the current bull market is characterized by a lot less volatility than that of the 1970s. **This could be an indication that the trend acceleration phase still lies ahead.**

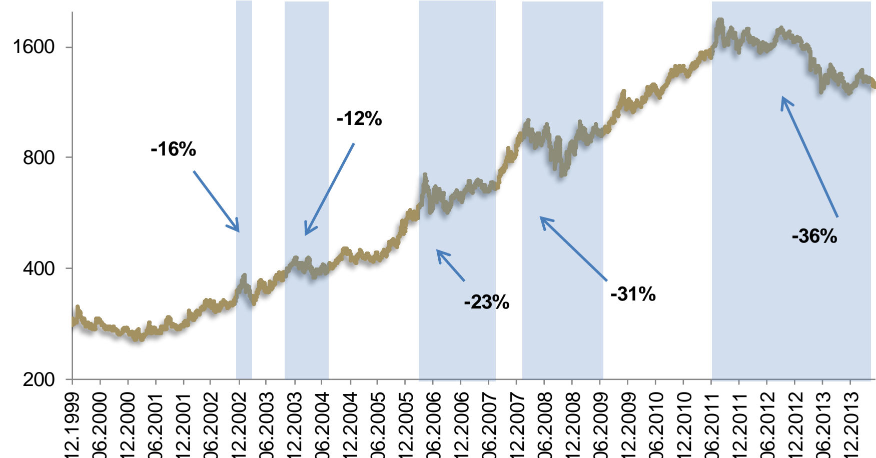
Oversold/Overbought-indicator (1 year oscillator)



Source: Incrementum AG, Datastream

As the following chart shows, the current correction is roughly equal in percentage terms to the correction of 2008. The duration is, however, clearly above average.

Correction phases since the beginning of the bull market (log scale)



Source: Incrementum AG, Datastream

A longer-term look at bear markets[117] shows that the current correction is still below average. The average price decline of the previous six bear markets was 43%.

Peak to Trough	Months	Change %
12/30/74 to 08/30/76	20.3	-47%
01/21/80 to 06/21/82	29.4	-65%
02/16/83 to 02/25/85	24.7	-44%
12/14/87 to 03/10/93	63.8	-35%
02/07/96 to 08/27/99	43.2	-39%
03/17/08 to 10/24/08	7.4	-30%
09/05/11 to 06/28/13	**21.8**	**-36%**

Source: Century Management, Incrementum AG

Be fearful when others are greedy, and be greedy when others are fearful

We consider the fact that sentiment is currently at the most negative level since the beginning of the bull market as clearly positive. In view of sentiment indicators such as Market Vane, the Hulbert Survey or Rydex precious metals cash flow, it can clearly be seen that there is currently anything but excessive euphoria in the gold market.

Public Opinion Index

Source: Sentimentrader.com

According to the Merrill Lynch "Global Fund Manager Survey", only 4% of all fund managers currently regard gold as overvalued. This is the lowest value since mid-2012.

[117] Defined as 25% decline in price, measured from high to low

Percentage of fund managers who regard gold as overvalued

Source: Bank of America Merrill Lynch, Wellenreiter Invest

That gold is subject to pronounced seasonality is something we have already discussed in detail in previous reports. **June is traditionally a good time to buy. In the second half of the year upward momentum is clearly at its highest. September is traditionally the strongest month.**

Seasonality Gold & Silver (1971-2013)

Source: seasonax

The commitments of traders report (CoT)[118] **at the moment also displays - from a contrarian perspective - a positive technical setup.** While positioning by 'smart money' traders (commercial hedgers) hasn't yet

[118] The weekly report issued by the Commodity Futures Trading Commission shows the positions of commercial traders, large speculators and small speculators. Commercials are often called the "smart money" and act in anti-cyclical fashion. The most valuable information is provided by the CoT report at extremes. Large speculators are hedge funds and other institutional investors and act in a highly pro-cyclical fashion. Extremes in positioning can most of the time be interpreted as reliable contra-indicators. Small speculators are also most of the time trend followers and are held to represent the "dumb money".

reached the extremes seen at the last price low, one can nevertheless conclude from the data that there is extreme relative strength. Commercials have sharply reduced their gross short positions. This means that the largest, best funded and best informed traders have positioned themselves for higher gold prices.

CoT setup is a recipe for a pronounced rally

The bullish picture in gold positioning is underscored by the extreme positioning of producers in silver futures, which currently clearly limits the potential for additional corrective price action. It is especially noteworthy that JP Morgan has massively covered and reduced its short positions in silver considerably, which argues for an imminent medium-term rally. All in all we observe CoT positioning data that look similar to those of many previous bottoming periods. I**n our opinion, this signals an attractive counter-cyclical entry point. The current structure of the futures markets is a recipe for a pronounced rally.**

Source: www.BlaschzokResearch.de

Conclusion

Opportunities outweigh the risks

The support zone between USD 1,250 and USD 1,270 has by now been successfully tested several times. **We believe based on futures market positioning data, negative sentiment and gradually improving seasonal tendencies, that the opportunities plainly outweigh the risks.** In the short-term, the significant relative strength in silver and mining stocks clearly gives us cause for optimism as well. As a result, we expect higher prices in coming months. The USD 1,530 level should represent a massive resistance level on the upside, based on the principle that *"support becomes resistance, resistance becomes support".*

15. CONCLUSION

Fundamental arguments in favor of gold are more convincing than ever

A glance at the (monetary) history books leads us to a clear conclusion: the fundamental arguments in favor of gold are more convincing than ever. The efficacy of monetary policy measures becomes ever more questionable, risks are rising. Mohamed El-Erian compares the behavior of central bankers to that of a pharmaceutical company that forces the market to take a medication that has never before been clinically tested. Investors should not only focus on the near-term successes of the treatment, but also consider the long-term side effects.[119]

Central bankers searching for the monetary perpetuum mobile

In the middle of the 19th century, the laws of thermodynamics provided the formal foundation for the understanding that it is impossible to create energy out of nothing. Analogous to this, central banks and governments are currently trying to create an increase in prosperity out of nothing. Such a monetary perpetuum mobile would be quite desirable for humankind, however, historically such attempts have at best led to a brief sugar high followed by a major hangover.

Japan's Abenomics program is in our opinion emblematic for the "Keynesian endgame" currently underway. It is a final desperate attempt to keep a debt dynamic going that must sooner or later collapse. **We also see Japan as a harbinger of what the West will soon face as well. A painless way out of this situation is by now unthinkable.**

"Confidence in central bankers' ability to learn from past inflation is as likely to be misplaced as it was in their ability to learn from past credit booms. Gold remains the cleanest insurance against such overconfidence"
Dylan Grice

If one wants to understand the future, one must look at the past. Future problems are always rooted in the crises of the past. The West is still at the beginning of its great paper money experiment - 43 years is not a long time period for a monetary order. The Austrian School of Economics not only poses the correct questions in this context, it also provides the correct answers. The root of the calamity is the unbacked, government-regulated monetary system. Together with a growing number of economists, we are convinced that the global monetary system needs an anchor again. Gold can play an important role in this context. Change will not come overnight through a central institution, but is rather a long-term process that has already begun.

"The crux of the problem in the global financial system today is not money but debt"
Jim Rickards

Our outlook for the gold price clearly remains optimistic. The ongoing consolidation that began in the late summer of 2011 with the all-time high is important for the bull market's health. **The nominal gold price may appear to be still high, but relative to the monetary base it is actually at an all-time low.** In our opinion, this is a temporary anomaly, which we regard as an excellent entry opportunity. We have demonstrated that gold remains attractively priced relative to stocks and bonds, but also relative to a number of hard assets. **Hence, the gold bubble argument often promoted by pessimists is refuted as well.**

"Inflation is a more fundamental danger than speculative investment. Some countries seem to be in the unusual situation where they are trying to create inflation. They will come to regret that."
Paul Volcker

For the global economy, the question whether the tug-of-war between the "tectonic plates" of inflation and deflation will be decided in favor of one or the other will be very important. One thing is certain, the pressure that has been built up between them is becoming ever stronger. **It is in our opinion by no means certain that inflationary forces will prevail.** However, the socio-economic incentive structures and all-encompassing high indebtedness clearly suggest that in case of doubt,

[119] "EL-ERIAN: The Central Bank 'Pharmaceutical Company' Has Brought An Untested Medicine To The Market", businessinsider.com

higher inflation rates will be tolerated. **The political calculation is simple: there are few creditors and many debtors**. **True reform is politically unpalatable, as "austerity" is certain to lose elections. Inevitably, politicians will choose inflation.**

Gold stocks' risk-reward profile is highly asymmetric

We are convinced that gold stocks' risk-reward profile is highly asymmetric, i.e., the downside seems limited relative to the potential upside. Creative destruction in the sector is normal and healthy in the long-term. In the course of the market adjustment, mining companies are resetting their priorities: profitability, capital spending discipline and shareholder value have replaced maximization of production. Moreover, there is currently no other sector that meets with more scepticism from investors.

"Sell economic ignorance; buy gold"
Tim Price

From a technical perspective, our assumption is that the gold price is near the end of its long consolidation period. The clearly positive CoT data, negative sentiment and not least the recent revival in gold mining shares all point in the same direction.

We are therefore convinced that the technical picture has been repaired and that a stable bottom has formed. Our 12-month price target is the USD 1,500 level.

„By failing to prepare, you are preparing to fail."
Benjamin Franklin

In the long-term, we expect that a parabolic trend acceleration phase still lies ahead. In the course of this event, our long-term target of USD 2,300 should be reached at the end of the cycle.

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