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Remarks on Gold Markets
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Thank you Joe:
Ladies and Gentlemen:

I am delighted to participate in this forum on gold and gold cycles along with my fellow panelists so thank you Joe for organizing this session.

I have never been a gold bug but have followed it closely over the years as I have found the gold market to be somewhat mysterious, totally opaque and endlessly fascinating.

There are no reliable trading statistics for gold bullion and apart from Central Bank transactions, it is almost impossible to trace who is buying or selling.

There are gold markets in London, New York but also in Hong Kong, the Middle East, Singapore, Switzerland and India – and a host of unofficial gold markets around the world.

The jewelry industry worldwide is a big consumer of gold and a big player in the gold market along with

- Central Banks
- Gold mining companies
- Exchange Traded Gold Funds
- Private hoarders
- Hedge Funds
- Middle East investors and Swiss Banks
- Billionaires from China, the Middle East and around the world
- South American and South Asian dictators
- Money launderers

So what is gold?

In 1924 the famous Economist, John Maynard Keynes called "Gold – a Barberous Relic" and for the past few decades Warren Buffett derided gold saying it paid no dividends, paid no

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interest and was just a useless metal but, after all these years, the Sage of Omaha changed his mind and recently acquired a substantial stake in Barrick Gold for Berkshire Hathaway.

Is gold a currency, a commodity, a store of value?

The answer is all three but gold bullion is primarily a currency and a store of value and is a long term hedge against fiat paper money and inflation.

As an economic consultant in 1966 Alan Greenspan wrote

"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. Gold stands in the way of this insidious process". He said.

Don't measure the dollar against the Euro, or the Euro against the Yen, but measure all paper currencies against gold bullion because gold is the ultimate currency benchmark.

The trend in the price of gold reflects global confidence or lack thereof in a particular currency.

If gold is increasing in price in your currency it means there is a lack of confidence in your money and probably in your government and Central Bank as well.

If you live in Zimbabwe, Argentina or Turkey or any one of a few dozen similar countries, gold bullion has been a great currency to own and an incredibly good investment.

At banks and dealers around the world gold bullion should be traded off the foreign exchange desk rather than the commodity desk because that's what it is – a global currency.

As J.P. Morgan said in 1913 "gold is money and nothing more".

Gold bullion is the only currency which is freely tradable worldwide and which is unencumbered by vast quantities of sovereign debt and prior ranking obligations.

If you own U.S. or Canadian dollars or Euros or Yen, you rank behind all their sovereign debt, all their pension fund and long term social security obligations, which are massive.

Gold has none of these prior obligations. It is totally debt free and it owes it's allegiance to no country and to no Central Bank.

Gold bullion is the one investment and long term store of value which cannot be adversely impacted by corrupt corporate management or incompetent free spending politicians – each of which are in ample supply on a global basis.

<u>A Gold Primer</u>

The World Gold Council estimates, or maybe guesstimates is a better word, that the total amount of gold mined since the beginning of time is about 198,000 tonnes which would have a value of about $12.4 trillion at the current gold price of about $1,950 per ounce.

In theory, based on these numbers, you could say if gold was a corporate equity, the company would have a market cap of $12.4 trillion.

198,000 tonnes worth $12.4 trillion sounds like a lot of gold but then consider global debt of all kinds amounts to an estimated $257 trillion, global equities have an estimated market cap of about $90 trillion and who knows the value of global real estate.

So gold is, in fact, a very small but very key player in the global financial system – especially when you consider half of the gold is in jewellery and not readily tradeable.

Since gold is virtually indestructible, this means that almost all of the gold mined to date is still around in one form or another in jewellery, Central Banks or private vaults, dental work or wherever.

If all of this gold in the world was melted down into one cube, it would measure about 68 feet square.

Annual gold production is now estimated at about 3500 tonnes with a value of about $220B.

Gold production is an incredibly fragmented industry around the world. The two largest producers are Newmont Mining and Barrick Gold which combined produce about 360 tonnes annually or only about 10% of global production.

The five largest country producers are China, Russia, Australia, the U.S. and Canada.

There are literally hundreds of medium sized and very small boutique producers around the world.

WHO OWNS THE GOLD

While these are extremely rough approximations, the World Gold Council estimates the total above ground stock of gold was distributed roughly as follows at the end of last year.

Jewellery of all kinds	47%
Private Investment vaults	22%
Central Banks vaults	17%
Miscellaneous Categories	14%
	100%

And I say there is a lot of guesswork in these numbers.

Historical Price of Gold

Gold has been a long term store of value and protection against inflation for over 1,000 years but just looking at recent history, after the financial panic of 1893, the U.S. passed the Gold Standard Act in 1900.

This Act set the price of gold at $20.67 per ounce with the U.S. dollar fully convertible at that level.

During the Depression, the U.S. passed the Gold Reserve Act of 1934 and President

Roosevelt raised the price of gold from $20.67 to $35.00 an ounce. The U.S. dollar remained fully convertible and stayed so for the next 37 years.

In the late 1960s there was a growing loss of global confidence in the U.S. dollar caused by

- a concerning increase in the U.S. balance of payments deficit
- never ending spending on the Vietnam War and on President Johnson's great society programs
- an increasing U.S. government budget deficit

and

- early signs of rising inflation.

Some Central Banks, led by France, which held substantial U.S. dollars in their foreign exchange reserves, were losing confidence in the U.S. dollar and began to gradually convert their U.S. dollars into gold at the Federal Reserve gold window at the stated price of $35.00.

This gradually became a "run" on the U.S. gold reserve.

In light of this, the major Central Banks formed a gold pool to sell gold to hold down the price but eventually the gold pool was overwhelmed.

By 1970, as other Central Banks joined France in converting dollars for gold, President Nixon, to protect U.S. gold reserves, was forced to close the gold window which he did on August 13, 1971 when he directed the U.S. Treasury to suspend the convertibility of the U.S. dollar into gold.

The U.S. dollar dominated world trade at that time, as it does today, so with that single stroke the world transitioned from a hard U.S. dollar convertible into gold at a fixed price to a fiat U.S. paper dollar backed only by the full faith and credit of the U.S.

Fiat money is defined in the Oxford dictionary as inconvertible paper money made legal by Government decree. In other words, they can print and issue as much money as they want.

Henceforth, gold would trade freely on the open global market as an independent autonomous free standing currency beholden to no one.

This transition to fiat money was a huge turning point but most people do not realize the long term implications – some of which we are seeing now with the Federal Reserve, the Bank of England, the ECB and Bank of Japan printing hundreds of billions of fiat money - - - in aggregate many trillions of new paper money.

<u>Recent Gold Price Performance</u>

Steve Foerster, a professor of finance at the Ivey Business School has done some interesting work on how gold has performed relative to the U.S. S&P 500.

His work showed since 1970, when the gold window closed, adjusting for inflation, the S&P 500 has provided a real return after inflation of 7.2% annually compared to 4.5% for gold.

It's of interest that this outperformance of equities was due entirely to dividends paid. Of course, gold pays no dividends or interest.

Professor Foerster's work also shows it depends a lot on when you buy and when you sell.

If you consider the last five decades since 1970 independently, stocks outperformed in three of the decades but gold outperformed massively in two – in the 1970s with a real return of 23.6% and from 2000 to 2010 with a real return of 11.6%.

It's of note that the worst time to hold gold was the almost 20 year period from 1980 – 1999 when gold declined 70% and you received no dividends or interest.

It was a brutal bear market due primarily to Fed Chairman, Paul Volcker, who defeated inflation with incredible high interest rates and the impact was felt for two decades.

Since the current bull market commenced in mid-2015 with gold at $1,050 gold is up 86% and the S&P 500 76%.

HOW DO YOU VALUE GOLD

The answer is with difficulty.

Valuing gold is far more challenging than valuing a commodity like copper, nickel or oil and gas because with such commodities you can forecast production and make a reasonable estimate of industrial consumption and an estimate of whether there is likely to be a surplus or a shortage which would impact the price of that commodity.

With gold there is minimal industrial consumption and half goes into jewellery around the world which is impossible to trace or forecast. Gold will usually fluctuate up or down depending on global confidence in fiat paper money and in the international financial system.

Valuing gold is much harder than valuing a stock. With gold there is no yield, no P/E ratio, no price to sales ratio, no price to EBITDA or enterprise value so there is no historical benchmark guideline. Also, there is no comparable investment to benchmark against.

Gold just floats on a global sea of fiat paper money and investor sentiment and confidence.

When the price of gold goes up relative to a particular currency it probably reflects an anticipation of rising inflation in that country and also reflects a lack of confidence in that particular fiat paper money, that countries Central Bank and political backdrop.

Gold is the canary in the coal mine when it comes to inflation or instability in the global financial system.

Where To Now?

Looking ahead my own view is that the stage is set for higher gold prices over the coming decade. There is no point in forecasting a particular level or time frame because no one can be that precise.

The two primary determinants of the gold price is the prospect of future inflation and confidence, or lack thereof, in the U.S. dollar.

As a result of the great recession in 2008 and the recent pandemic and a generally slowing global economy many Central Banks have become more concerned about the risk of disinflation or deflation. This has been the case for a long time in Japan and now in Europe.

Accordingly, some Central Bank mandates have been broadened to include full employment and some have established a formal, or informal, inflation target generally around 2%.

In the U.S.,having generally failed to reach 2% inflation over the past many years, the Federal Reserve is now openly encouraging inflation with a new target of an <u>average</u> of 2% inflation over a number of years meaning they are comfortable perhaps with inflation, at say 3% or 4% for several years, to compensate for the many years under 2%. This is a slippery slope.

In effect, Central Banks have done a 180 and instead of fighting inflation are actually promoting it. Governments and Central Banks are far more afraid of deflation than inflation.

Stated differently, Central Banks, led by the Federal Reserve now have an official policy to devalue and debase their currency. This is an incredible and almost unbelievable sea change.

I am not sure why they want 2% inflation because at that rate you lose about 20% of your purchasing power in ten years and at 3% inflation you lose about 30%. Is that what we want?

It's often been said that there is no such thing as a little inflation and once started it's very difficult to control and the record would appear to bear this out.

There used to be a check on governments spending due to a strong desire to balance Government budgets but now borrowing is so easy and so cheap there is little interest in balancing budgets and the new guidelines of debt and/or debt servicing costs as a percent of GDP are totally meaningless due to record low interest rates.

In the U.S. government debt is climbing dramatically but total debt service costs are declining even faster as they roll over old high interest debt to the new rates.

We are now witnessing an epic global battle between deflation and inflation which in my view will take years to play out. At the moment deflation would appear to have the upper hand.

When you look at the big picture over the past 60 years, we have witnessed the formation of a giant global debt and credit bubble. In the last 30 years every time there was an economic slowdown or recession Central Banks lowered interest rates to encourage all sectors to borrow and spend to spur the economy – which they did with a vengeance.

It's hard to believe that the yield on 10 year U.S. treasuries peaked out slightly over 15% in 1980 and has declined to the current level of .68% – a decline of 95%.

Stated differently, the yield on 10 year U.S. treasuries has fallen in half four times since 1980, from 15% to 7 l/2% to 3 ¾% to 1.85% to the current level of .68%.

This has been an incredible boon to borrowers and debt has exploded.

It did not take long for governments, corporations and consumers alike to figure out when interest rates fall by half, they can borrow twice as much and when they fall by half again, they can borrow twice as much again.

Central banks now have both hands deep in the cookie jar.

The Institute of International Finance estimated total global debt at $257 trillion at the end of March this year and this would now would be very materially higher due to recent stimulus spending. This number is very similar to World Bank numbers.

It should be noted that since the global recession in 2007/08 global debt has been increasing far more rapidly than global GDP and obviously this is an unsustainable trend long term even with low rates.

The problem with a credit and debt bubble is you have to keep feeding the beast or it will collapse.

Even at current low rates $257 trillion of global debt is a powerful deflationary drag on the economy. Offsetting this is trillions of government stimulus spending in North America, Europe and Asia with indications of much more to come.

In my view it's an open question who will win the inflation/deflation battle. Central Banks have been trying to increase inflation for several years without success. Even with massive borrowing and spending – will the future be any different?

Nevertheless, Central Banks and governments can print as much money, liquidity and credit as they want and they have basically said they will do whatever it takes.

An interesting aspect to all of this is that 3500 tonnes of global annual gold production only increases the amount of gold in the world by less than 2% while the money supply and credit provided by the world's Central Banks is increasing multiple times faster which should provide a strong upward bias to gold prices over coming years.

We have no idea how all this debt issuance, quantitative easing and money printing will end but the record clearly shows that prolonged periods of super low interest rates encourages borrowing, risk taking and speculation all of which usually has a very unhappy ending.

There is now dramatically more leverage in the international financial system than there was ten or twenty years ago.

At a time like this we would now do well to heed the words of the famous Austrian school economist, Ludwig von Mises (1881 – 1937), who said:

"There is no means of avoiding the final collapse of a boom brought about by credit and debt expansion.

The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved".

So Joe that concludes my remarks and I turn the microphone over to you and I look forward to further discussion.