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# Gold and the Turning of the Monetary Tides



incrementum

Ronald-Peter Stoeferle  
& Mark J. Valek

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to our premium partners for supporting the  
*In Gold we Trust* report 2018



# Introduction

*“To study history means submitting to chaos and nevertheless retaining faith in order and meaning.”*

**Hermann Hesse**

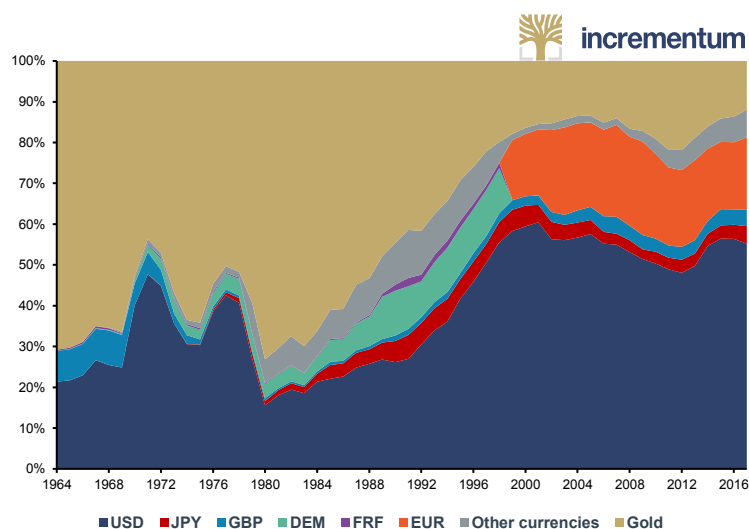
*“It costs only a few cents for the Bureau of Engraving and Printing to produce a \$100 bill, but other countries had to pony up \$100 of actual goods in order to obtain one.”*

**Barry Eichengreen**

**Much of what is currently happening right in front of our eyes provides evidence of an unfolding sea change in the global monetary order.** As the US Fed turns from monetary easing to monetary tightening, with uncertain outcomes for the global economy, investors’ trust in currencies issued by central banks is eroding. Blockchain technology has enabled a much-hyped boom in cryptocurrencies as investors seek alternatives to the US dollar, once perceived as an invulnerable safe haven. These shifting tides in the monetary system are coming to pass in different ways, at different velocities, and at different levels of visibility. On the cusp of fundamental change, it is particularly important not to lose sight of the forest for the trees.

**The global economic order was and is undoubtedly dominated by the US.** The US produces the world’s largest economic output<sup>1</sup>, enjoys far-reaching diplomatic clout, and is an uncontested military hegemon, all of which testifies to its global dominance. On the currency front, the global balance of power is embodied in the long-standing US dollar-centric global currency architecture, which critical observers have warily referred to as an “exorbitant privilege”<sup>2</sup>

## The US dollar as global reserve currency



Source: IMF, World Gold Council, Incrementum AG

**Confidence in the US dollar has evolved historically.** The status of the US as a free market economy with strong property rights and a robust rule of law, deep and highly liquid capital markets<sup>3</sup>, and a hard currency under the gold standard, have propelled the country to a global leadership position. Moreover, the fact that commodities are traded and settled in USD is of particular importance.

<sup>1</sup> In terms of nominal GDP expressed in USD.

<sup>2</sup> Valéry Giscard d'Estaing, one of the main architects of the euro, was critical of the hegemony of the US dollar even while the Bretton Woods system was still in place. See <https://en.wikipedia.org/>.

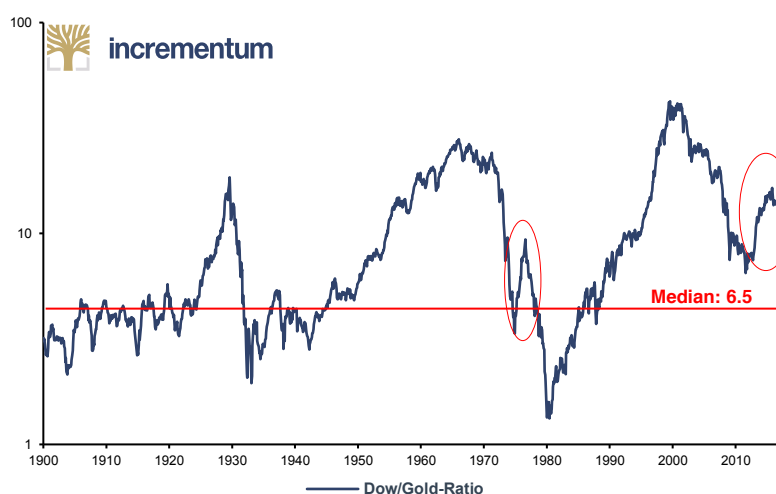
<sup>3</sup> For example, daily trading volume in US Treasuries alone amounts to more than USD 500bn.

*“We are in a world of irredeemable paper money – a state of affairs unprecedented in history.”*

**John Exter**

**However, faith in the US dollar-centric dispensation is not carved in stone.** One measure of international trust is the proportion of global currency reserves held in US dollars. So far, it remains relatively static, as central banks tend to be cautious and deliberate and are not exactly prone to shooting from the hip. As Alan Greenspan pointed out, the price of gold is a useful indicator of global confidence in the US dollar as a reserve currency.<sup>4</sup> Combined with the Dow Jones index one can calculate the well-known Dow/gold ratio which also serves as an indicator of the degree of confidence or distrust in the US-centric economic and monetary order.

#### Dow Jones/gold ratio as indicator of trust in the US-centric system



Sources: Bloomberg, Incrementum AG

*“In order to destroy the bourgeoisie, one has to wreak havoc on its monetary system.”*

**Lenin**

**By the end of the 1970s, confidence in the US monetary system had eroded substantially.** The Dow/gold ratio hit an all-time low of 1.29x in January 1980, well below its median of 6.5x. Due to the abysmal economic environment in the 1970s and the assumed strength of the Soviet Union, it was not entirely clear at the time whether the West would prevail in the struggle against communism. **To almost everybody’s vast surprise, by the early 1990s the US emerged as the only remaining superpower, apparently inviolable in every respect.** The US dollar index reached an all-time high around the 120 levels<sup>5</sup>; budget surpluses were rolling in; and by the turn of the millennium the Dow/gold ratio hit an all-time high.

Alas, prior to the Great Financial Crisis of 2007–2009 the Dow/gold ratio suggested that faith in US leadership had already begun to sag. The boom in equities and housing markets was driven by a major credit bubble; its eventual unwinding made clear that a high price had been paid for prolonging the “good times” of the 1990s by a few years. Contrary to the late 1990s, on this occasion the gold market sensed early on that something was amiss.

*“We did the right thing, I hope.”*

**Ben Bernanke**

**The Fed reacted decisively to the onslaught of the financial crisis.** While the ensuing years of money printing pushed nominal share prices up, the

<sup>4</sup> “Transcript of FOMC meeting”, May 18, 1993, p. 40

<sup>5</sup> As measured by the trade-weighted US Dollar Index, DXY.



reservations of market participants found expression in the performance of share prices relative to the gold price. Trust was finally fully restored to the markets in 2012 to 2013, after the ECB promised to intervene in the sovereign debt crisis in the euro area and the Fed announced that its monetary emergency measures would be tapered and eventually discontinued. Today, ten years after the crisis, the Dow/gold ratio seems to indicate that US economy is well on the way to regain its former strength.

Or so the story goes.

**We will challenge this widely held view in this year's *In Gold we Trust* report. We see numerous reasons to question the plausibility of this narrative.**

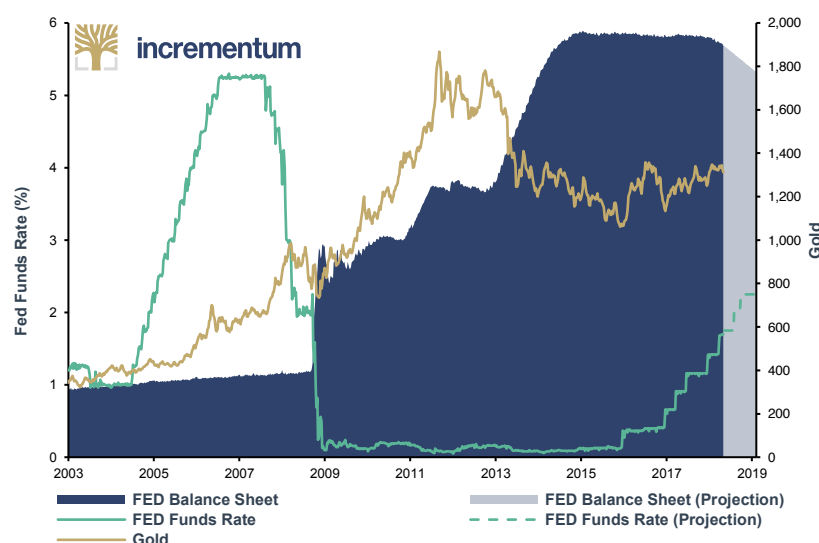
**For instance, there are continuing efforts to turn away from the US dollar.** We believe this trend is on the one hand a consequence of increasing geopolitical polarization and tensions, as exemplified by the West's confrontation with Russia, or more recently with Iran; while on the other hand, it is also a result of the ascendance of powerful emerging market economies such as China. **Even though this process is not yet obvious to everybody, in our view the tide is turning in regard to the global monetary architecture.**

*"I think the stock market is kind of a pathetic creature of the moment and of a Fed that is no longer there. In other words, the argument for the last 30 years is, the Fed is your friend. The Fed is now the mortal enemy of the speculators. And they just don't know it yet."*

**David Stockman**

**Also most relevant for the price of gold is the turning of the tide in terms of monetary policy.** We find it quite remarkable that the gold price (in USD terms) bottomed out exactly at the beginning of the current rate hike cycle. When it became clear in 2015 that administered US interest rates would soon be raised, many market participants and observers *sotto voce* predicted a precipitous slump in the gold price. In the same year, we pointed out to our readers that rising interest rates could actually prove to be positive for the gold price. Market developments in recent years are testifying to the fact that this assessment was correct.

#### Gold & Fed interest rate increases



Sources: Federal Reserve St. Louis, Incrementum AG



*“People vastly underestimated the power of QE. And they are in danger of doing the same with QT.”*

**Franz Lischka**

**In addition to hiking interest rates since late 2015, the Fed began reducing the size of its balance sheet starting in Q4 2017**, a process that has been dubbed “quantitative tightening” (QT). From our perspective, most market participants are currently massively underestimating the likely consequences of the QT process. The “everything bubble” which we discussed at length in last year’s *In Gold we Trust report*<sup>6</sup> is at grave risk of bursting as more and more liquidity is withdrawn. The monthly contraction in Fed assets is gradually ratcheted up and will reach USD 50bn per month from October 2018 onward. In total, the balance sheet is to be reduced by USD 420bn in 2018 and by USD 600bn in 2019. **However, we believe this monetary normalization plan is unlikely to survive a significant decline in even one, let alone several asset classes (equities, bonds, real estate).**

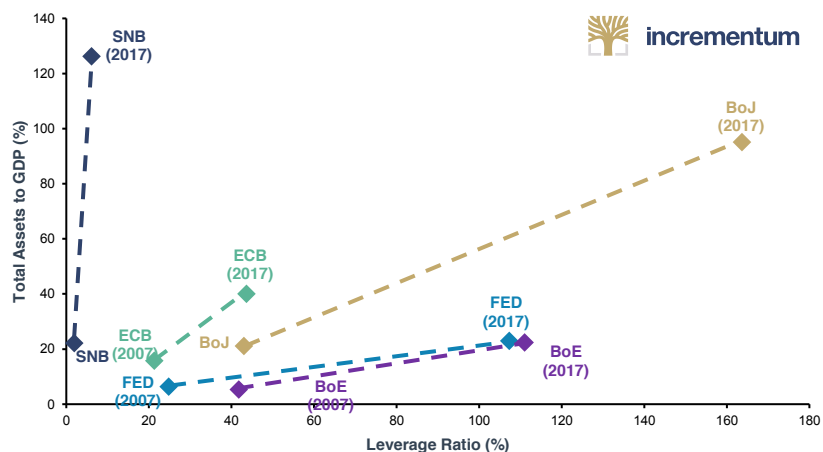


Courtesy of Hedgeye

**While the Fed is attempting a retreat from monetary accommodation, “monetary surrealism” remains alive and well elsewhere.** The QE programs of other major central banks continue, although the proponents of cautious disengagement have become more plentiful there as well. In fact, the ECB has already cut the monthly volume of its net asset purchases twice, and it is widely expected that they will be discontinued this autumn, to be replaced with mere reinvestment of funds the central bank receives for maturing bonds on its balance sheet. This U-turn is long overdue, as the balance sheets of many central banks increasingly resemble those of highly speculative hedge funds. The following chart illustrates that the Bank of Japan (BoJ) in particular is far ahead – in a negative sense – of other central banks in terms of its leverage ratio as well as with regard to the ratio of its balance sheet to GDP.

<sup>6</sup> See “Introduction”, pp. 4-10, and “White, grey, and black swans”, pp. 27-46, *In Gold we Trust report* 2017

### Expansion of central bank balance sheets: 2007 vs. 2017



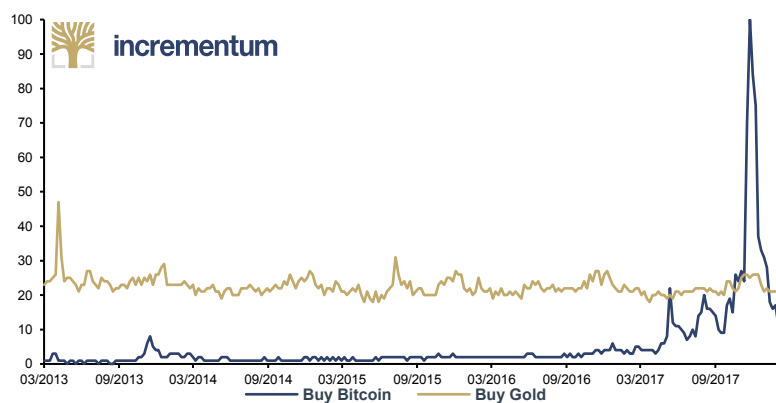
Sources: BoE, BoJ, ECB, Fed, SNB, Incrementum AG

*“The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust.”*

**Satoshi Nakamoto**

**One consequence of our seemingly ever more surreal monetary system is rapidly growing interest in cryptocurrencies.** By the close of 2017, when the bitcoin price set new all-time highs almost daily, even the mainstream media were practically tripping over each other with positive news reports proclaiming the investment merits of digital currencies. The hype over cryptocurrencies generated competition for media attention previously focused on gold - at least for a certain time period, as the following chart illustrates (one could almost read it as a measure comparing the volatility of cryptocurrencies with that of gold):

### Google queries for “buy Bitcoin” vs. “buy Gold”



Sources: Google Trends, Incrementum AG



*“Invest in things that have never happened before, hedge for regression to the mean, and plan for the unimaginable.”*

**John Burbank**

*“Our balance sheet is not intended to be an active tool for monetary policy in normal times. We therefore do not plan on making adjustments to our balance sheet normalization program.”*

**Janet Yellen,  
September 2017**

*“The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.”*

**Friedrich August von Hayek**

**We have been covering the topic of cryptocurrencies during the past three years.** Cryptocurrencies continue to gain traction and relevance, which is why we will once again focus some of our attention on the development of this sector in this year’s report.<sup>7</sup> **In particular, we will investigate at length in the extended version of this year’s *In Gold we Trust* report, whether cryptocurrencies and gold are friends or foes. The extended version is available at [www.ingoldwetrust.report](http://www.ingoldwetrust.report) for free.**

**What does the current mixture of multifarious trends imply for gold?** Despite rising interest rates, monetary policy normalization, and a still solidly performing stock market, gold held its ground last year. Admittedly, the gold price isn’t really going anywhere at the moment. **It is still dancing the cha-cha-cha – “one step forward, one step back, one step sideways”.**<sup>8</sup> Naturally everybody wonders how much longer this will continue.

**How will gold react when the recent headwinds turn into tailwinds?** What will happen to the gold price when equity markets stumble, the Fed feels compelled to halt or even reverse its monetary policy normalization program, serious inflation or recession worries begin to crop up, or the US dollar-centric currency regime itself is called into question? **Will gold then abandon the cha-cha-cha, find its stride, and take off like a scalded bat after the midnight quadrille?**<sup>9</sup>

**US monetary policy has to deliver now, that much is certain.** The Fed was the first central bank that attempted to overcome the financial crisis with a zero-interest-rate policy and QE. Central banks around the world eventually followed suit, embarking on a global experiment that made guinea pigs of us all. The Fed is also the first central bank to tighten the interest rate reins and reduce the size of its balance sheet. Market participants are complacent and their expectations that the Fed will fully implement policy normalization as envisaged are extremely high.

The current – albeit superficial – stability of financial markets depends on the faith of market participants in central banks, in their monetary philosophy, and thus ultimately in the maintenance of the US dollar-centric global monetary order. If the Fed fails in its normalization efforts and the US falls into recession – which is our expected scenario – a severe loss of confidence in central bank-administered monetary policy seems likely to ensue. **It is doubtful whether the global monetary architecture will be able to withstand such a profound loss of confidence unscathed.**

<sup>7</sup> We recommend that interested readers take a look at [www.cryptoresearch.report](http://www.cryptoresearch.report), a quarterly sister report of this publication.

<sup>8</sup> Quoted in: *“Wie lange tanzt das Gold noch Cha-Cha-Cha?”* (“How much longer will gold be dancing the cha-cha-cha?”), Die Presse, April 15, 2018

<sup>9</sup> This is a play on words referring to the “Fledermaus Quadrille” (“bat quadrille”), a.k.a the “midnight quadrille”, from the operetta *Revenge of the Bat* by Johann Strauss, a dance traditionally performed at the Vienna Opera Ball and other traditional Viennese balls. Thus we speak of a scalded bat rather than a scalded cat in this case. The dance ends with a gallop in one direction (in the case of gold one suspects the direction will be up).

See: <https://www.google.com/> and: <https://en.wikipedia.org/>





*"In Gold we Trust!"*

**Ronald-Peter Stoeferle &  
Mark J. Valek**

**With all this in mind, we have chosen the image of the turning of the tide as the leitmotif of this year's *In Gold we Trust* report.** As inhabitants of a land-locked country, a changing of the tide is a fascinating metaphor to us. We neither want to be dragged into the sea by the high tide nor do we want to be left high and dry by the low tide, so we will take a step back and once again take a critical look at the big picture and examine the gold sector with our multifaceted and sober-minded analytical approach. **We would like to invite you to join us on our annual journey and we hope you will enjoy reading our 12<sup>th</sup> *In Gold we Trust* report as much as we enjoyed writing it.**

*Yours truly,*

Two handwritten signatures in blue ink. The first signature is 'Ron Stoeferle' and the second is 'Mark J. Valek'.

**Ronald-Peter Stoeferle and Mark J. Valek**

# Quo Vadis, Aurum?

**At the outset of this report, let us assess our current position, as we always do.** We will take a critical look at the development of the gold price and analyze whether we are in the early stages of a new gold bull market – as described last year – or whether our fundamental assessment was flawed.

## The status quo of gold in a currency context

*“The decline of its currency is probably the worst fate that can befall a people. Even a lost war does not do as much direct damage as the ruin of one’s monetary system.”*

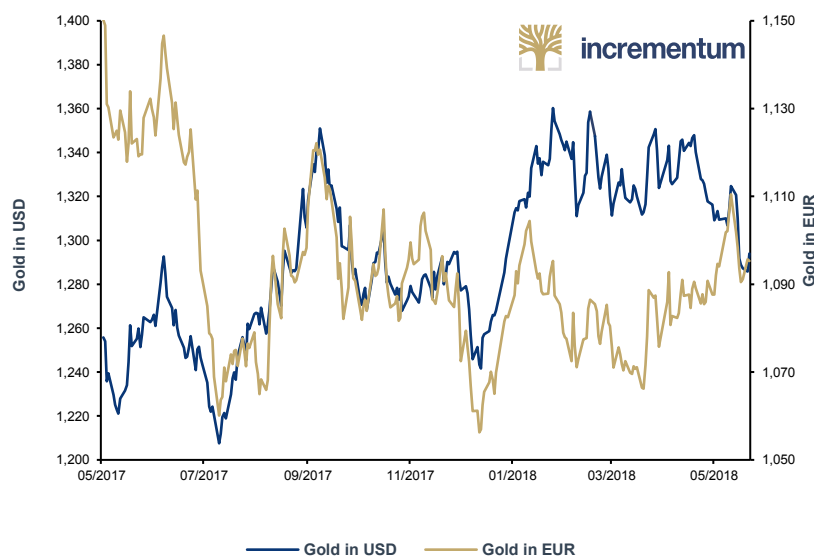
Argentarius, Vom Gelde (On Money)

*“So, the problem is not so much to see what nobody has yet seen, as to think what nobody has yet thought concerning that which everybody sees.”*

Arthur Schopenhauer

First, let us look at some performance data. During 2017 gold edged slowly higher, particularly in US dollars. In euro terms, the performance has not exactly been spectacular, with the gold price moving within a relatively narrow bandwidth of EUR 100. The relatively low volatility of the gold price has been one of its more outstanding aspects, falling to the lowest value in ten years.

### Gold in US dollars and euros since the last Gold Report



Sources: Federal Reserve St. Louis, Incrementum AG

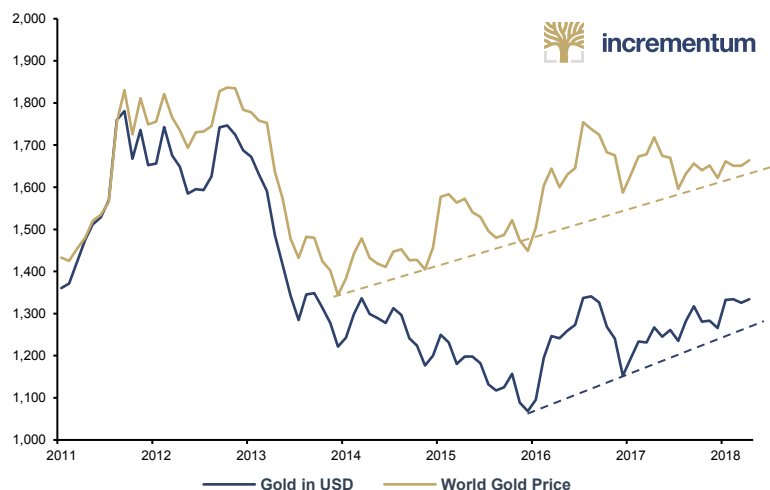
*“The risk of not owning gold is greater than the risk of owning gold.”*

Brent Johnson

**The following chart is one of the classics of every Gold Report. It shows the so-called “world gold price”.** Here, the gold price is depicted not in US dollars or euros but as the trade-weighted value of the US dollar. We find that the price is not far off its highs of 2011 to 2013 anymore. Moreover, the spread between the world gold price and the price in US dollars has narrowed since 2017.

After hitting its low in US dollars at the end of 2015, the gold price has recorded successively higher highs, which clearly supports our positive stance.

### World gold price vs. gold price in USD since 2011



Sources: Federal Reserve St. Louis, Incrementum AG

We now want to drill down further into the currency spectrum and look at the gold price in the most important currencies. **Overall, 2017 was clearly positive for gold across all major global currencies with the exception of the euro, where it incurred a slight loss of 1%.** The average performance in this secular bull market is still impressive. For example, the average annual performance from 2001 to 2018 has been +9.40%. **During this period, gold has outperformed practically every other asset class, and in particular every currency, despite intermittent, sometimes substantial corrections.** In the year to date, the development has been positive as well. Gold is up 0.34% on average.

### Gold performance since 2001 in various currencies (%)

	EUR	USD	GBP	AUD	CAD	CNY	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	12.10%	-1.50%	5.00%	7.70%	7.90%	1.20%	12.30%	9.90%	0.80%	6.16%
2015	-0.30%	-10.40%	-5.20%	0.40%	7.50%	-6.20%	-10.1%	-9.90%	-5.90%	-3.75%
2016	12.04%	8.50%	29.70%	10.10%	5.50%	16.50%	5.40%	10.40%	11.50%	12.27%
2017	-1.02%	13.64%	3.23%	4.64%	6.35%	6.42%	8.92%	8.13%	6.42%	6.30%
2018 ytd	0.70%	-1.10%	-0.50%	1.80%	0.70%	-2.90%	-2.60%	1.10%	5.90%	0.34%
Average	8.78%	10.39%	11.12%	7.70%	8.85%	8.41%	9.72%	7.02%	12.20%	9.40%

Sources: Federal Reserve St. Louis, Goldprice.org, Incrementum AG, data as of 23 May 2018

**Loyal readers know that, in our opinion, commodities are the antithesis of the US dollar.** The fluctuations of commodity prices and of the US dollar exhibit mutual dependencies, with the root causality lying more firmly with the US dollar than is generally suspected. This relationship can also be explained by the US dollar-centric currency regime (currently in crisis), which we will discuss in due course.

*“Diminution in the dollar’s value was so slow there seemed no cause for public alarm. It was like watching an ice cube melt. It happens, yet slowly.”*

**Jim Rickards**

**“Gold: The Story of Man’s 6000 Year Obsession”**

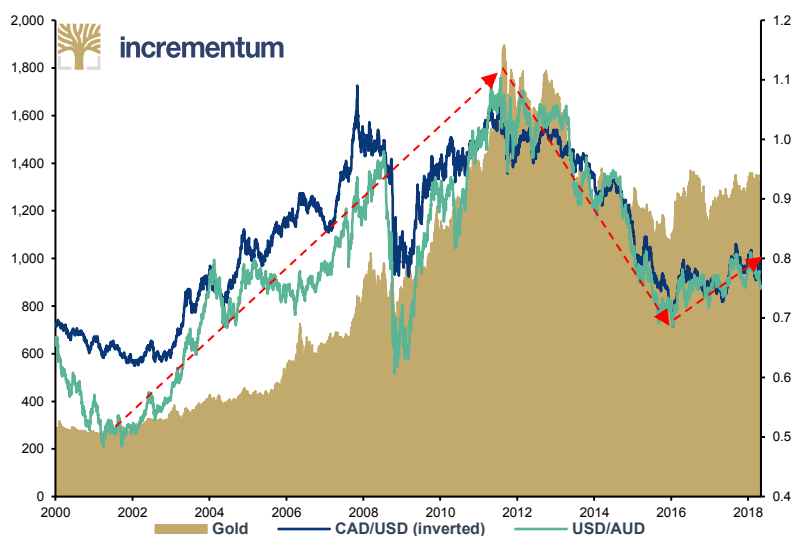
**When the US dollar depreciates against gold and commodities, its depreciation creates a global tendency toward rising prices.** The following chart highlights the interdependencies. It shows the negative correlation between the CRB Commodity Index (left scale) and the US Dollar Index (right scale, inverted). The rising moving average also illustrates that the CRB Index has established an uptrend.

**CRB Index and US Dollar Index (inverted axis) and 200-day moving average**



**The currency pairs AUD/USD and CAD/USD are regarded as commodity- and inflation-sensitive.** The following chart illustrates the high correlation between these commodity currencies and the gold price. Here, too, prices are rising vs. the USD since 2016.

### Canadian and Australian dollar (left scale) vs. gold (right scale)



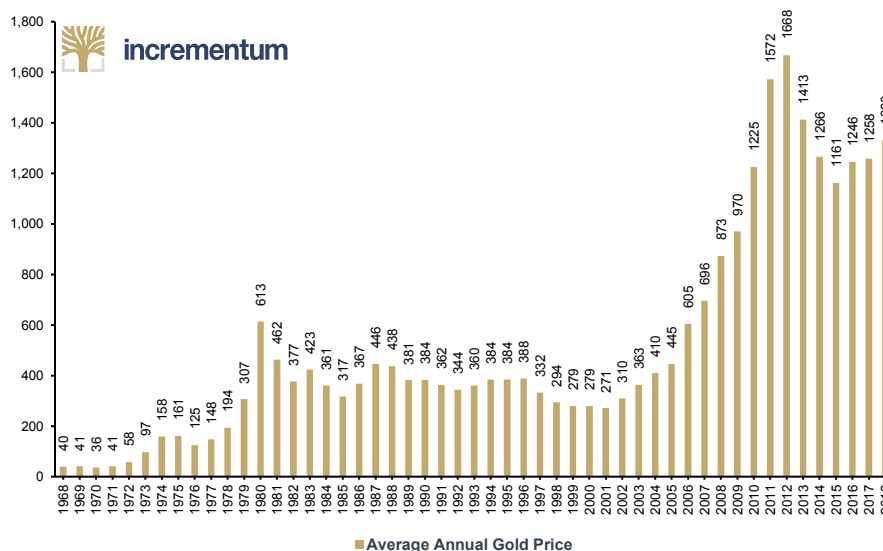
Sources: Federal Reserve St. Louis, Incrementum AG

*“The decline of the value of each dollar is in exact proportion to the gain in the number of them.”*

**Keith Weiner**

**But let us now go back even further in history.** Since 15 August 1971, the beginning of the new monetary era, gold has increased by an annualized 8% in US dollars. *Real* appreciation of currency gold vis-à-vis the US dollar has amounted to 4.5% per year on average. The long-term context puts the correction of the years 2013 to 2015 into perspective, as the following annual average price data shows. Also, the chart proves that the regular accumulation of gold can be recommended on the basis of the cost-average effect.

### Average annual gold price (USD)



Sources: Federal Reserve St. Louis, Incrementum AG

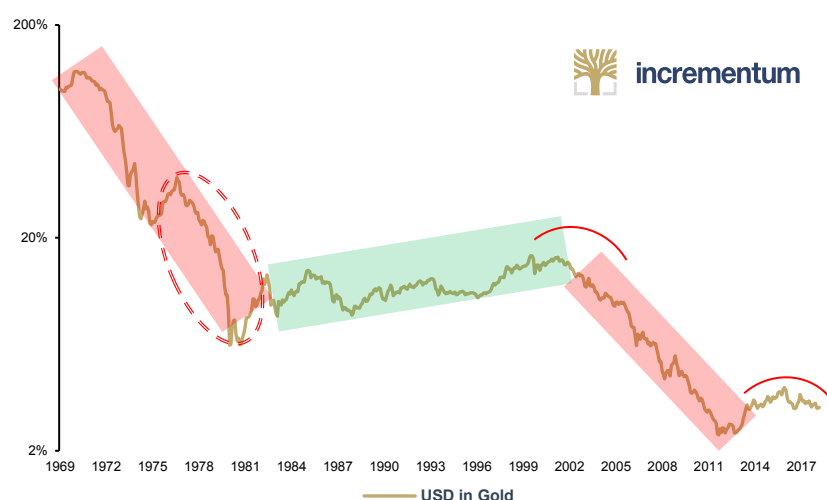
Changing one's perspective often triggers new findings. Rather than plotting the gold price in US dollars or euros, we now invert the relationship to show that the decline in the purchasing power of the US dollar, measured in terms of gold, occurs in long cycles.

*“Being right, but early in the call, is the same as being wrong.”*

**Howard Marks**

One can see that the ongoing depreciation is so far still significantly more moderate than it was in the 1970s. However, we have not yet seen the final trend acceleration that occurred in the 1970s (marked by a circle on the chart). The short-lived strength of the US dollar reminds us of the period 1974 to 1976, when during a disinflationary phase, gold was being sold off and the US dollar appreciated significantly. **In our opinion, the similarities of the current development to that mid-cycle correction are striking.**

#### Dollar in terms of gold: Are we at the end of the mid-cycle correction? (log-scale)



Sources: Federal Reserve St. Louis, Incrementum AG

*“Gold is scarce. It’s independent. It’s not anybody’s obligation. It’s not anybody’s liability. It’s not drawn on anybody. It doesn’t require anybody’s imprimatur to say whether it’s good, bad, or indifferent, or to refuse to pay. It is what it is, and it’s in your hand.”*

**Simon Mikhailovich**

**“Gold: The Story of Man’s 6000 Year Obsession”**

#### Let us now have a closer look at the US dollar and its most recent behavior.

We find the pronounced weakness of the greenback remarkable, given the positive expectations 18 months ago, when Donald Trump was being celebrated as a messiah who had fought the election campaign on the promise to “make America great again”.

#### In last year’s *In Gold we Trust* report we had already warned against regarding Trump as an economic miracle worker.

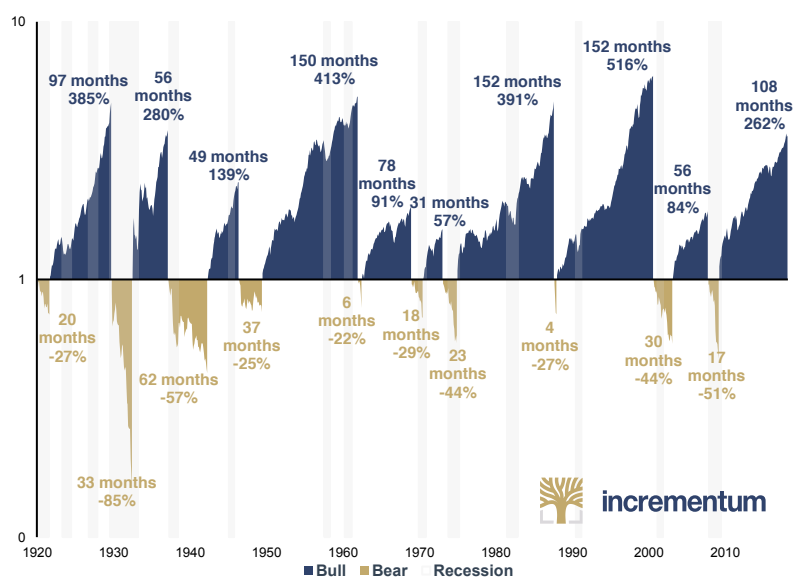
Even though the world has adjusted to his rather unconventional style of governing by Twitter, his politics remain somewhat erratic and volatile. The comparatively high gold affinity of his cabinet has also not manifested itself in day-to-day decision-making so far.<sup>10</sup>

To a certain extent, the US economy is still on the sunny side of the street: Consumer confidence is high; unemployment has fallen to its lowest level since 2001; the Fed is increasing rates and has started to curb its balance sheet (QT – quantitative tightening), while the equity market has been chasing high after high, short – and sometimes heavy – corrections notwithstanding. **At 108 months and an overall increase of 262%, the current stock bull market is one of the longest and strongest in US history.**

<sup>10</sup> See “The De-Dollarization: Good-bye Dollar, Hello Gold?”, *In Gold we Trust* report 2017, pp. 80-84



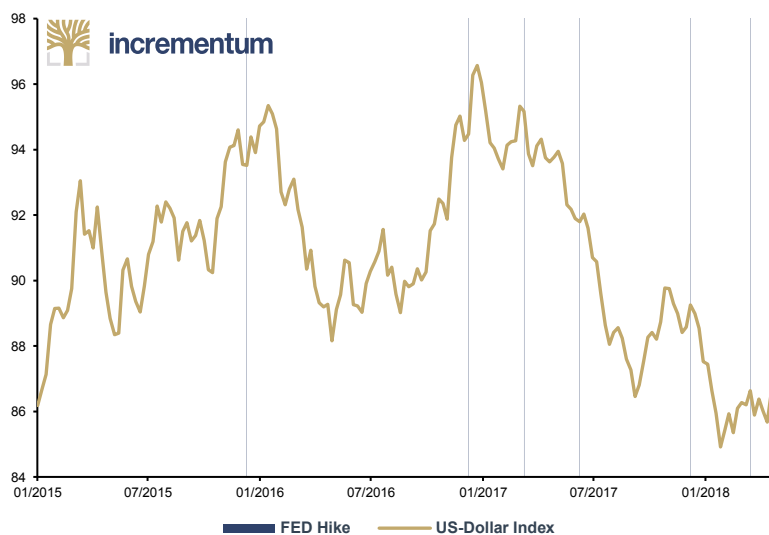
### S&P 500 Bull & Bear Markets



Sources: Robert Shiller, Incrementum AG

This confluence of factors should provide a positive environment for the US dollar. But, as the old trader's adage says, it's not the news that determines prices; it's the reaction to it. Thus the following chart is remarkable, because it illustrates the fact that the US dollar usually depreciates in the wake of interest rate hikes:

### Negative reaction of the US dollar to increases of the federal funds rate



Sources: Federal Reserve St. Louis, Incrementum AG

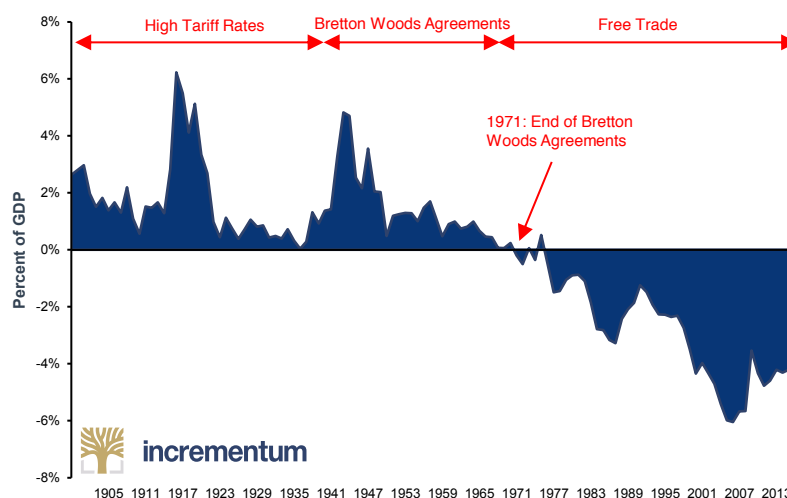
*"Out on the edge you see all kinds of things you can't see from the center. Big, undreamed-of things – the people on the edge see them first."*

**Kurt Vonnegut**

**Other vital US economic data suggests, however, that the situation is somewhat alarming.** The US trade deficit last year increased to USD 566bn, its highest value since 2008 – in a year, no less, when the weak US dollar should have actually reduced the gap.



### US Merchandise Trade Balance in percent of GDP



Sources: Federal Reserve St. Louis, US Census Bureau, Incrementum AG

In this context it comes as little surprise that the status of the US dollar as the classic safe-haven currency seems to be reversing.<sup>11</sup> The simultaneous correction of equities, bonds, and the US dollar at the end of January may offer a glimpse into the erosion of the currency's safe-haven status.

### Most recent phases of weakness of the USD and their consequences for gold and the S&P 500

Date	Dollar Index	Gold	S&P 500
6/7/2010 - 4/29/2011	-17.50%	26.28%	28.40%
3/10/2009 - 11/25/2009	-16.48%	27.78%	63.52%
3/19/2007 - 4/22/2008	-14.46%	40.68%	1.86%
12/20/2016 - 1/25/2018	-13.85%	20.01%	25.41%

Sources: Euro Pacific Capital, Incrementum AG

**The central question we are currently dealing with is this: What will happen to the US dollar if the current Goldilocks scenario is called into question, recession worries emerge, and the Fed is forced to reverse its tightening of monetary policy?**

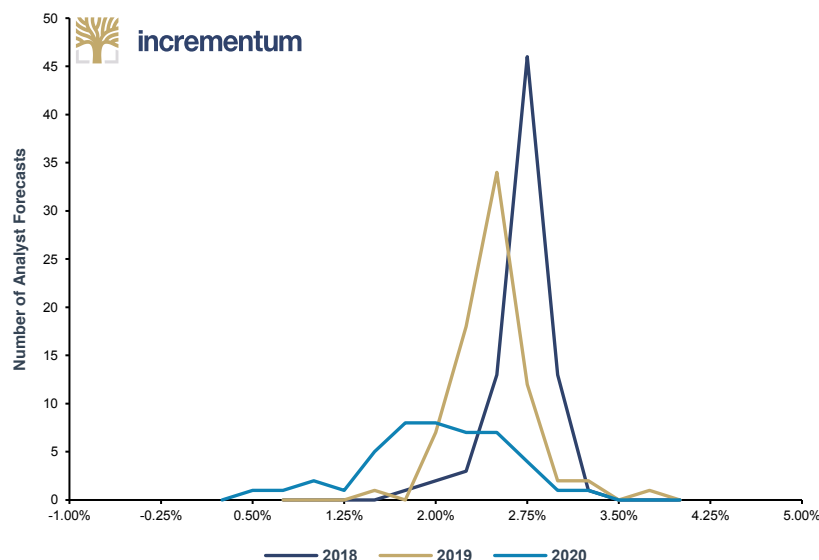
**In the past 100 years, the US economy has fallen into recession every six and a half years on average.** Now, more than ten years have passed, and yet the mainstream does not expect a recession in the foreseeable future. In view of this unbridled optimism, the potential for surprise seems to be clearly asymmetric. At the moment, a decline in US economic output seems as unlikely to most economists and market participants as Vin Diesel's coming home with an Oscar, or the national football team of Fiji's winning the World Cup.<sup>12</sup>

<sup>11</sup> See "Raising Rates Reflect Bigger Debt Not Faster Growth", Peter Schiff, Euro Pacific Capital Inc., February 5, 2018

<sup>12</sup> See "White, grey, and black swans", In Gold we Trust report 2017, p. 27

Of 78 analysts surveyed by Bloomberg, not even one is expecting US GDP to contract in 2018, 2019, or 2020.<sup>13</sup> The median of the expected growth rates for those three years falls in a bandwidth of 2.1% to 2.8%.

#### Unanimous analyst consensus: no recession in sight!



Sources: Bloomberg, Incrementum AG

*“The consequences of well-meaning (but not all-knowing) economists setting the cost of money are widespread, from the inflation in asset prices to encouraging companies to spend on projects they shouldn’t. But we really don’t know the second-, third-, and fourth derivatives of the consequences that command-control interest rates will bring. We know that most likely every market participant was forced to take on more risk in recent years, but we don’t know how much more because we don’t know the price of money.”*

**Vitaliy Katsenelson**

#### Contrary to all the optimistic forecasts, some facts currently suggest an increasingly recessionary tendency:

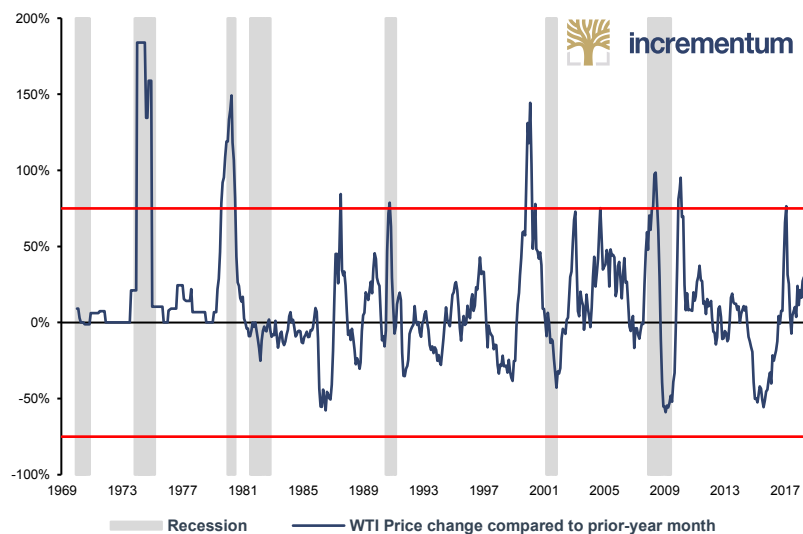
- Rising rates & QT
- Record high consumer confidence
- M&A boom
- Rising default rates
- Rising write-offs on credit card debt
- Weakening consumption rates
- Significantly flattening yield curve that could invert within a matter of months
- Strongly rising private and public debt ratios
- Sharp rise in oil prices

The following chart shows that the oil price (WTI) is currently almost 50% higher than 12 months ago. The question arises as to how far the global economy can cope with such price jumps without slipping into recession. The example of the US shows that oil price jumps quite often coincided with US recessions.<sup>14</sup>

<sup>13</sup> In 2007, NO analyst was expecting a recession either!

<sup>14</sup> See “Wellenreiter Frühausgabe”, May 15, 2018

### WTI price change (yoy) and recessions



Sources: Federal Reserve St. Louis, Incrementum AG

*“It is the preceding inflation that makes the depression phase necessary.”*

**Murray N. Rothbard**

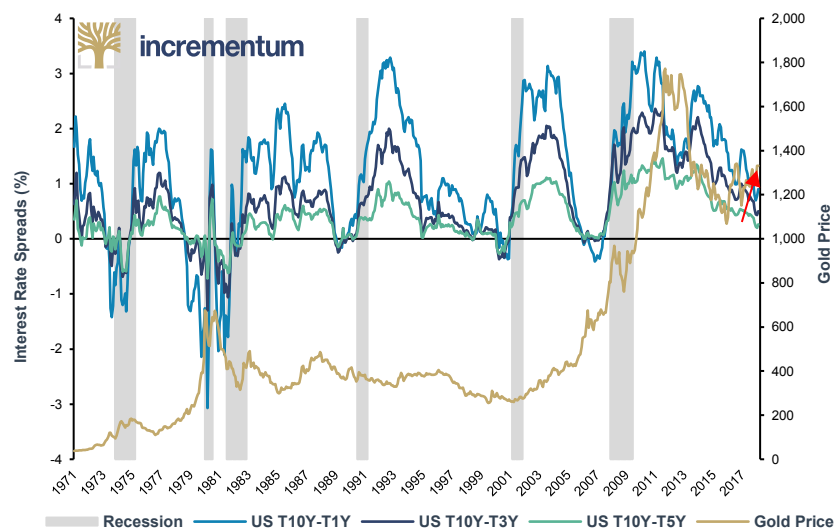
**Now it’s time to deal with the question of what effects a flattening yield curve has on gold. Recent research by the San Francisco Federal Reserve Bank shows that inverted yield curves have actually anticipated most recessions since the 1950s.<sup>15</sup>** In short, higher short-term rates anticipate recessions because they indicate a decreasing demand for short-term financial assets such as bonds and show that investors are actually expecting an economic downturn and are therefore moving their demand to long-term bonds, increasing their prices and lowering their yields as compared to those of short-term bonds. The decreasing demand for short-term bonds leads to an increase of the short-term interest rates.<sup>16</sup> **Flattening interest rate spreads have empirically anticipated downturns and the subsequent appreciation of gold, in particular since the Nixon shock of 1971.**

<sup>15</sup> For further detail on this study, see: <https://www.frbsf.org/>

<sup>16</sup> For a detailed explanation of this see: <https://mises.org/>



### Interest rate spreads for benchmark US Treasury constant maturities vs. gold price in USD: 1971-2018



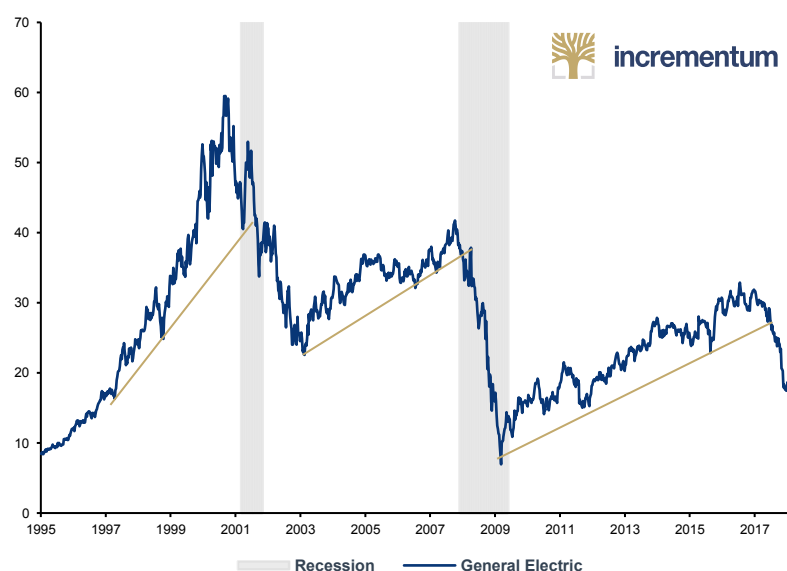
Sources: Federal Reserve St. Louis, Incrementum AG

*“In proportion as you give the state power to do things for you, you give it power to do things to you.”*

**Albert Jay Nock**

**Furthermore, the US equity market is showing initial cracks as well. We regard the General Electric share as representative when it comes to the “old economy” of the US.** The following chart illustrates that the broken upward trend of the GE share was a leading indicator of the last two recessions. But GE’s is not only the chart that provokes worries about the economy. Such high flyers and momentum stocks (which remind of us the infamous “Nifty Fifty”) like Tesla are also trading below their 50- and 200-day lines, and the FANG stocks look technically weak.

### General Electric share and recessions



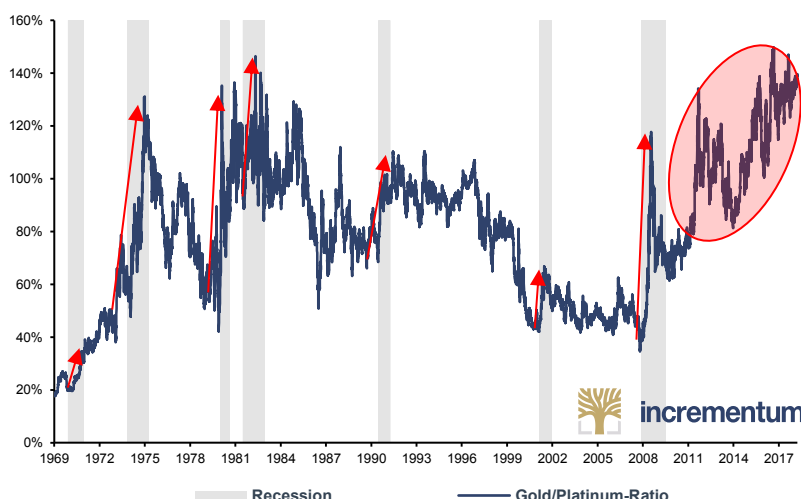
Sources: Yahoo Finance, Incrementum AG

*“Waiting too long to begin moving toward the neutral rate could risk a nasty surprise down the road—either too much inflation, financial instability, or both.”*

**Janet Yellen**

**The gold/platinum ratio may be another interesting recession indicator.** In the past, the ratio has generally ranged below 100%, with the exception of the unstable economic periods that often accompany recessions. In these phases, the gold price usually rises on the back of the metal’s reputation as a safe investment, while platinum, an industrial metal, faces a decline in demand. The current high gold/platinum ratio prompts the conclusion that the ratio is a sign of economic insecurity driven by monetary instability.

#### Gold/platinum ratio and recessions since 1969



Sources: Bloomberg, Federal Reserve St. Louis, Incrementum AG

*“This is why a simultaneous collapse in bond prices and the dollar could be so significant. It could show that rising interest rates do not reflect improved growth, as so many stock market bulls conveniently claim, but a loss of confidence in the dollar and the creditworthiness of the United States.”*

**Peter Schiff**

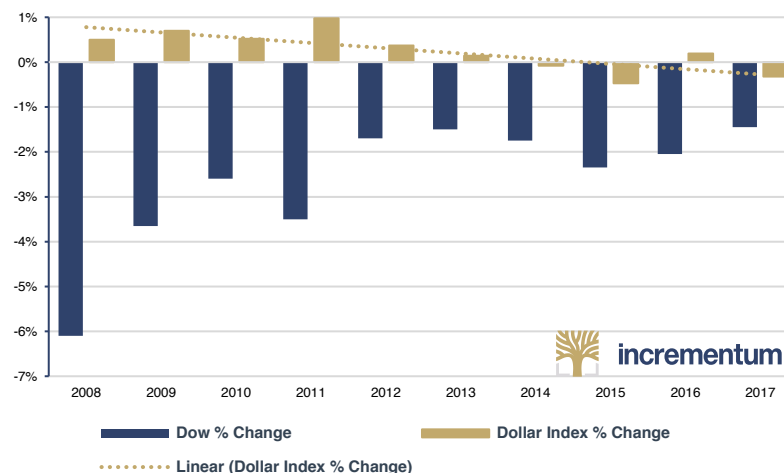
**But what will happen this time as clouds gather on the economic horizon? The two most recent recessions (2000 and 2008) led the Fed to cut its interest rates by 500bps.<sup>17</sup>** Now we are at 1.50-1.75%, which means that the potential for rate cuts is very limited, at least if negative interest rates are not broadly imposed.

**Looking at the average of the ten worst market days of every year in the five years from 2008 to 2012, we find that the US dollar tended to appreciate on days when the Dow Jones Index fell by at least 1%. On those days, the US dollar recorded gains in 80% of cases, rising by an average of 0.6%. However, this pattern has changed drastically in recent years. On average, the US dollar depreciated by about 0.3% on the ten worst market days each year from 2013 to 2017 and appreciated on only a quarter of those 50 days. It seems as if investors are calling less and less often on this particular safe haven.**

<sup>17</sup>The Fed cut its interest rates by an average of 5.5 percentage points in the nine recessions since the mid-1950s, a level that is impossible given the current low rates – unless negative rates are on the table.



### Average performance of the worst ten market days



Sources: Bloomberg, Euro Pacific Capital, Incrementum AG

**In view of the growing supply of US Treasuries, a further increase in yields does not seem unlikely.** For example, the Treasury Borrowing Advisory Committee expects government debt issues of USD 955bn for FY2018 (as compared to USD 519bn last year) and volumes beyond USD 1,000bn for FY2019 and FY2020. As a result of the most recent tax cuts, these numbers will probably have to be revised upwards.<sup>18</sup>

*“If we keep running deficits at this rate, we will need to think about what kind of debt burden we are going to leave for Keith Richards.”*

**Kevin Muir**

### The forecast of the Congressional Budget Office (CBO) for the US

**deficit in the coming ten years also looks worrying.** The CBO expects the budget deficit to rise until 2028. The annual deficit already exceeds USD 1bn every year. By comparison, the budget deficit of the entire Eurozone fell slightly short of USD 200bn in 2016.<sup>19</sup>

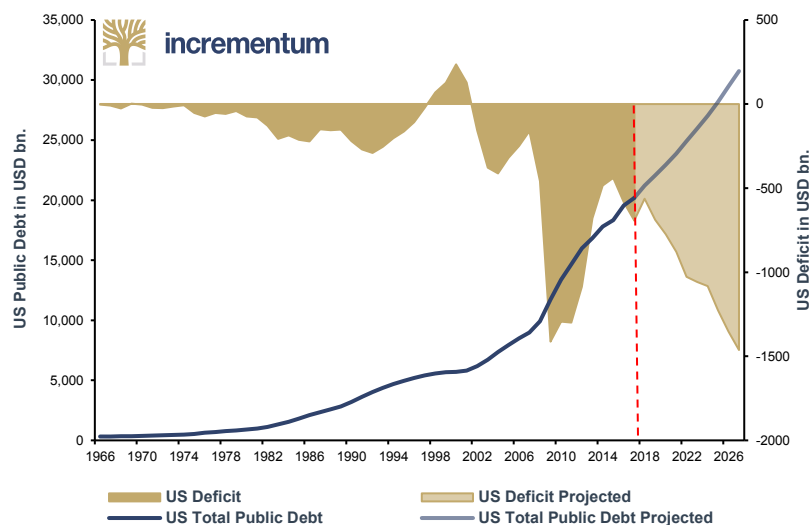
It is important to note that the CBO’s forecast hinges on very positive premises, not the least being that the CBO has based its model on non-recessionary years. Thus, from our point of view, the deficit will probably be significantly higher in the coming ten years than the CBO forecasts. The cumulative deficit for 2018 to 2028 amounts to USD 13,200bn.

<sup>18</sup> See “New Fiscal Worry: Too Much Short-Term Borrowing as Deficit Climbs”, *The Wall Street Journal*, January 31, 2018

<sup>19</sup> See “Öffentliches Defizit im Euroraum und in der EU28 bei 1,5% bzw. 1,7% des BIP”, Eurostat, April 24, 2018



### US government debt and deficits of the coming ten years



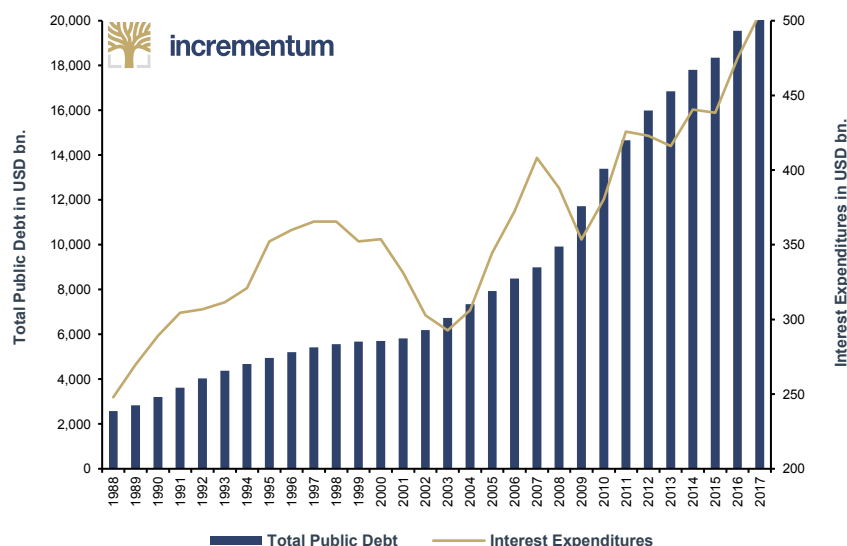
Sources: CBO, Federal Reserve St. Louis, Incrementum AG

*“Either the State ends public debt, or public debt will end the State.”*

**David Hume**

According to these forecasts, the deficit in 2028 will be larger than the one incurred in the crisis year of 2009 (USD 1,413bn) and will set a new record, at USD 1,526bn. As a result, US government debt outstanding also continues to rise rapidly. The total amount of US public debt is expected to reach USD 33,851bn in 2028, which will be tantamount to a six-fold increase within a decade. Moreover, it can be seen that interest service will reach a new record high of more than USD 500bn in 2018.

### US government debt (in USD bn, left scale) and annual interest payments (right scale)



Sources: Federal Reserve St. Louis, Incrementum AG

We have seen budget deficits of a similar magnitude only once before, in the period 2009 to 2012. **However, that was a phase when the Fed was absorbing almost USD 500bn worth of debt per year with its QE program. Now we**



*“Money is probably the most concentrated and pinpointed form and expression of trust in the societal-governmental order.”*

**Georg Simmel**

**are in QT mode, which makes the current situation considerably more delicate.**

### Conclusion

**We stick to our statement made last year, that gold is in the early stages of a new bull market.** The signs of a weak dollar accompanying that bull market are becoming more plentiful as we speak. We feel it is particularly worth noting the depreciation of the dollar within the context of trade wars. No surprise then that US Secretary of the Treasury Steven Mnuchin broke with the tradition of supporting a strong US dollar when he said in Davos, *“Obviously a weaker dollar is good for us as it relates to trade and opportunities.”*<sup>20</sup>

### US dollar cycles since 1973



Sources: 13d Research, Federal Reserve St. Louis, Incrementum AG

**But even among the gold bulls there are numerous supporters of a strong US dollar hypothesis, among them our esteemed colleague Brent Johnson<sup>21</sup>, whose words should in our opinion be heeded as well.** Our German colleague Professor Thorsten Polleit has summarized the (short-term) bullish case for the US dollar in his usual succinct and eloquent manner:

*“As long as the other big economic and currency areas of the world are in a stagnant mood, the scope of the Fed’s interest rate hikes seems to be limited. The Americans are unlikely to aim at an unwanted, interest-driven appreciation of the external value of the US dollar, which would be detrimental to the domestic economy and US company profits. They will therefore not be able to fully escape the depreciation policies that we have seen, for example, in Japan and the Eurozone and will instead have to go down the same road for a little while. The US dollar will not fulfill its role of safe haven, as investors would like it to do....”*

<sup>20</sup> See [“Trump Team at Davos Backs Weaker Dollar, Sharpens Trade War Talk”](#), Bloomberg, Januar 24, 2018

<sup>21</sup> We highly recommend [Brent Johnson’s presentation “Marvel”](#).

*At best, the US currency is a through street on investors' flight from the turmoil of the global uncovered paper money system, which the US currency will ultimately also have to face. But before the US dollar starts to fail, all other currencies that depend on the greenback will find themselves in trouble: The demise of the uncovered US dollar as foreign exchange benchmark is starting at the fringes and will corrode the system all the way to the core.”<sup>22</sup>*

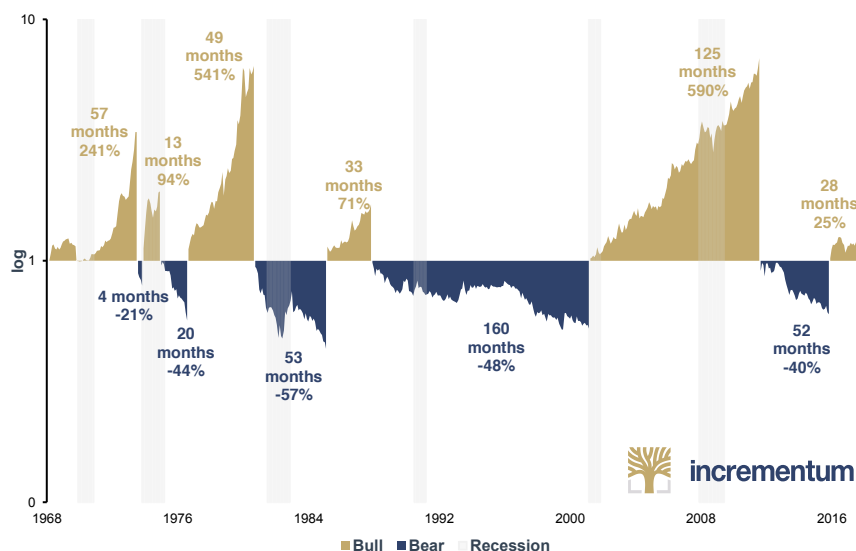
## Conclusion

*“You’ve got randomness, and you’ve got order. And right between them, you’ve got the phase transition.”*

John Beggs

**We will stick to our conviction that we are currently in the early stages of a new gold bull market**, which has been temporarily slowed down by the election of Donald Trump. The expectations of the political newcomer were clearly excessive – as we warned last year – and continue to harbor large potential for disappointment. As pointed out earlier, we can see significant upward potential, especially in the commodity markets, which now command extremely attractive valuations in a historical context, both in absolute and relative terms.

### Gold in bull and bear markets



Sources: Bloomberg, Incrementum AG

<sup>22</sup> "Degussa Marktreport", Professor Thorsten Polleit, May 27, 2016



*“The relevance of gold is not in its price but in its ownership. This is precisely important for those who wish to make a profit from gold by purchasing certificates, ETFs and the like. Participating in a price movement is not the same as owning an asset.”*

**Anthony Deden**

*“A woman is like beer. They look good, they smell good, and you’d step over your own mother just to get one!”*

**Homer Simpson**

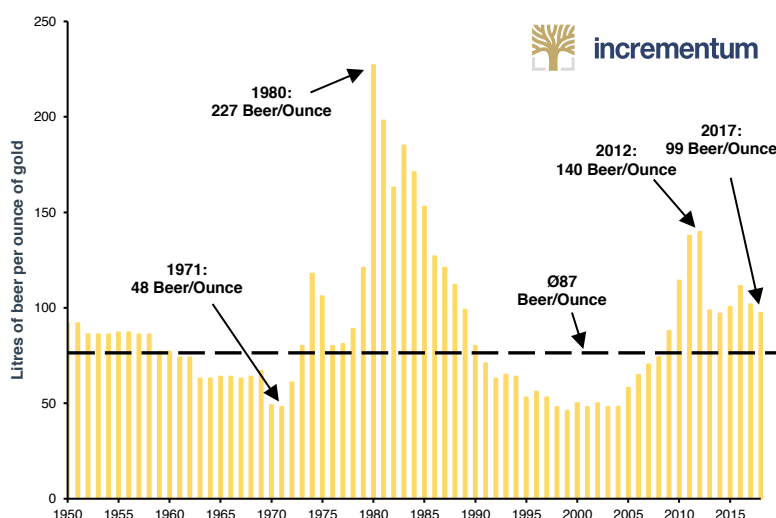
At the moment we are at the turning point towards a gold bull market. The macroeconomic and geopolitical factors support this tendency. **One of the things we notice across the bull markets of the past 50 years is that, even in its weakest period of increase, gold gained more than 70%. This record supports our optimism for future developments.**

From our point of view, stronger inflation tendencies or the abandoning of the rate-hike cycle in the US could trigger an increase in momentum of the gold price. **We regard these scenarios as realistic and will discuss them in detail in this report.**

**At the end of this round-up, we would like to revisit Oktoberfest in Munich – a dearly held tradition of ours.** No *In Gold we Trust* report would be complete without the gold/Oktoberfest beer ratio. How did that ratio fare in 2017?

In 2017, one liter of beer cost EUR 10.95. In 1950, a patron would have had to put only EUR 0.82 on the counter. This means that the price of beer at Oktoberfest has increased by an annual average of 3.9%. But how much beer does an ounce of gold buy you? In 2017, 99 liters. Relative to the historical average of 87 liters, the “beer purchase power” of gold remains well above the long-term mean.<sup>23</sup>

#### Gold/Oktoberfest beer ratio



Sources: www.HaaseEwert.de, Historical Archive Spaten-Löwenbräu, Incrementum AG

However, we are still far off the historic high of 227 liters of beer for one ounce of gold that was set in 1980. We do not regard this exalted level as completely unattainable. Of course, that does not mean that investors with an affinity for gold must step up their drinking game, even if the temptation of a good lager is in the same ballpark as the one for the shiny precious metal. It only means that less gold is needed this year to maintain a constant level of beer consumption.

<sup>23</sup> A price increase of 5-8% is forecast for 2018. The 11-euro threshold will probably be exceeded, especially as the City of Munich will significantly increase its turnover lease. As so often, these additional costs are passed on to consumers.

# The Portfolio Characteristics of Gold

**The analysis of the portfolio characteristics of gold is a regular feature of our annual *In Gold we Trust* reports.** We continue this tradition in this year's report as well, and provide interested readers with additional insights on the subject of "gold in a portfolio context".

The main focus of this year's report is an examination of gold in the "portfolios" of central banks. We consider the relevance of currency reserves for central banks, then discuss the significance of gold reserves in particular, and take a look at the trends, size, and distribution of official gold reserves held by central banks.

## The Role of Gold for Central Banks

*"If the dollar or any other currency would be universally accepted at all times, central banks would see no necessity to hold gold at all. The fact that they do so, shows that such currencies are not a universal replacement for gold."*

Alan Greenspan

*"The inevitable conclusion is that a true gold standard has so far been the only example of a satisfactory international monetary order, and no one has succeeded in finding a suitable replacement."*

Wilhelm Roepke

**Central banks are in a unique position in the modern fiat money system.** With their monetary policy interventions and the government-guaranteed currency monopoly, they influence global financial markets and the business cycle decisively. This is more than enough reason for us to analyze the behavior of these supposed stewards of the monetary system in detail. In the following section we take a look at "central bank portfolios" in order to shed light on the part gold plays in them.

We should begin by explaining what a "central bank portfolio" actually represents. Conceptually, the "portfolio" of a central bank comprises assets "backing" the money it has issued. Under a classical gold standard, 100% of the money certificates issued would be backed by gold. **Given that more than a century has passed since the classical gold standard was abolished and that following the suspension of the Bretton Woods system in 1971 the last tie between government money and gold was severed, it is quite interesting to see that gold continues to play a crucial role as a monetary reserve asset.**

The following table shows a simplified central bank balance sheet, modeled after the balance sheets of the German Bundesbank and the ECB.



## Central bank balance sheet: simplified illustration

### Assets

### Liabilities

<ul style="list-style-type: none"> <li>I. Gold and foreign exchange reserves</li> <li>II. Claims from monetary operations</li> <li>III. Other Receivables</li> <li>IV. Securities</li> <li>V. Other Assets</li> </ul>	<ul style="list-style-type: none"> <li>I. Banknotes in Circulation</li> <li>II. Deposits from Banks</li> <li>III. Capital and Reserves</li> <li>IV. Other Liabilities</li> </ul>
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Sources: ECB, Incrementum AG

*“It was not the gold standard that failed, but those to whose care it had been entrusted.”*

**Heinrich Rittershausen**

Currency reserves are part of the balance sheet line item “Gold and foreign exchange reserves” on the asset side. This line item comprises all kinds of currency reserves. While in the past gold reserves were held as backing for the banknotes issued by central banks, in our current monetary system, currency reserves have the following functions: They

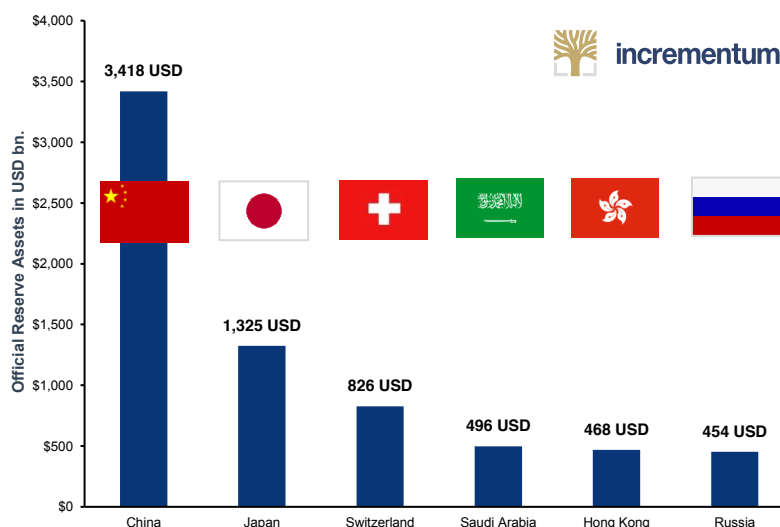
- Enable intervention in financial markets (particularly foreign exchange markets)
- Strengthen confidence in a currency
- Serve as a hedge or reserve in times of crisis.

Especially, hedging against crises and inspiring confidence in a currency are key features, as they signal stability and future planning security to other market participants.

## Comparison of Portfolios

Having looked at bank portfolios and their composition, we now take a closer look at the size of currency reserves. The following chart shows the size of the official currency reserves of the six nations holding the largest reserves.

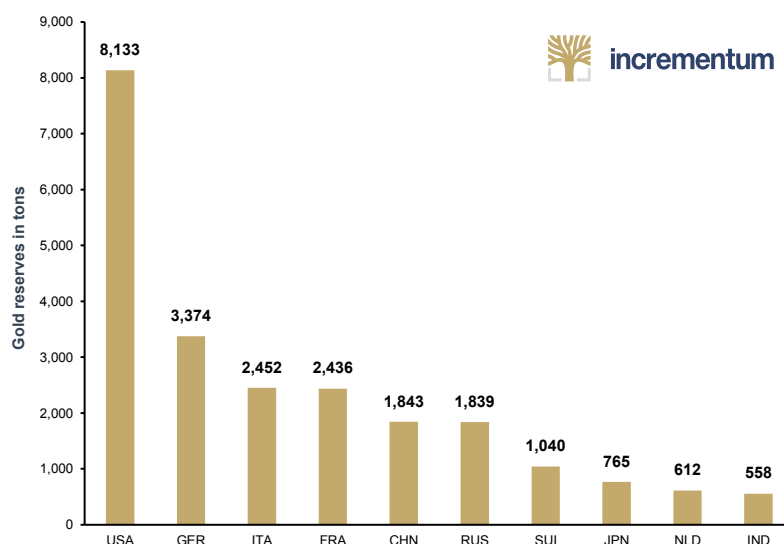
### Countries with the largest currency reserves (in USD bn)



Sources: IMF, Incrementum AG

It is interesting that apart from large economies such as China, Japan, or Russia, several rather small countries such as Switzerland, Saudi Arabia, and even Hong Kong are on the list of countries with the largest monetary reserves. Surprisingly, leading economies such as the US or Germany do not make the cut. We will discuss the reasons for this below. **A completely different picture emerges if we confine ourselves to comparing gold reserves.**

#### Countries with the largest gold reserves



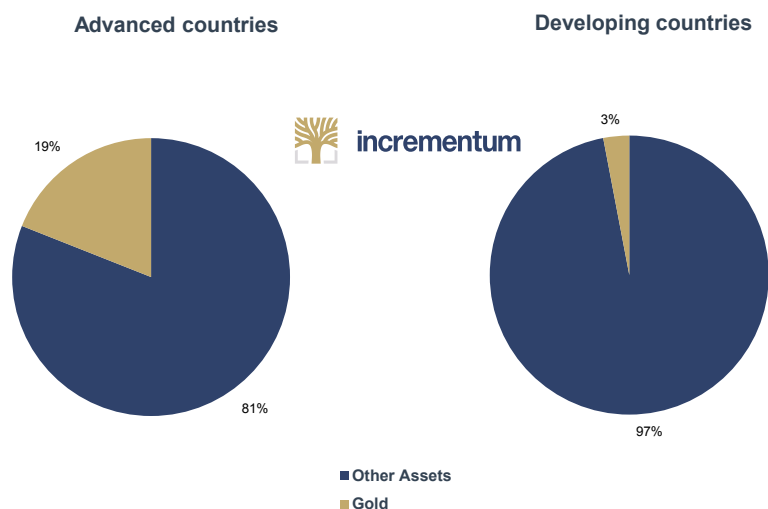
Sources: World Gold Council, Incrementum AG

*“Gold has been money for many thousands of years. Gold is mentioned repeatedly in the Bible. Every civilization and every government in history has treasured gold. (...) It’s been said that gold is built into man’s DNA. If you can’t accept the thesis that gold is the ultimate money, then you’re ‘out of it’ and in denial. And most likely, you will not understand the coming ‘big picture.’”*

**Richard Russell**

It can be seen that industrialized nations tend to have relatively large gold reserves at their disposal. Thus the US reports the largest gold reserves in the world but ranks far behind a plethora of nations – even small countries such as the Czech Republic and Thailand – in terms of foreign exchange reserves. It is the other way around with China, which holds the largest foreign exchange reserves in the world but is only in fifth place with respect to gold reserves. It is quite conspicuous that Western developed countries tend to hold significantly larger gold reserves than emerging-market nations that are still in the process of catching up economically. The following chart illustrates this situation.

## Share of gold in total currency reserves



Sources: World Gold Council, Incrementum AG

The proportion of total currency reserves consisting of gold holdings amounts to 19% among industrialized nations, which exceeds the 3% reported by emerging markets by a large margin. In light of this it is perhaps not too big a surprise that Kenneth Rogoff recommended in 2016 that emerging-market governments should massively expand their gold reserves.<sup>24</sup> This substantial difference is primarily attributable to (a) monetary history, (b) financial market-related factors, and c) monetary policy factors.

### a) Monetary History

Central banks of industrialized nations currently still have large gold reserves on their balance sheets, which were either accumulated via export surpluses in the Bretton Woods era (e.g. in the case of Germany) or can be traced back to the former gold backing of banknotes issued under the classical gold standard. The economic ascendance of emerging-market economies and the export surpluses often associated with them started only in the late 20<sup>th</sup> century, though, long after the reign of “King Dollar” had begun.

In a de facto dollar-based global monetary order, it makes sense to hold the currency most widely accepted in international trade as a reserve and a hedge against crises. It is particularly important for large commodity importers such as China or Japan to hold dollar-denominated foreign exchange reserves as long as most commodities are still traded in USD. Hence emerging markets accumulated ever larger amounts of dollar reserves from the 1980s until well into the new millennium. The outlook of central bankers in Southeast Asia was shaped by the financial crisis of 1997, which provided them with a strong motive to focus on the acquisition of dollar reserves.

*“(…) if the gold standard were in place today we would not have reached the situation in which we now find ourselves.”*

**Alan Greenspan**

<sup>24</sup> “Emerging Markets Should Go for the Gold”, Kenneth Rogoff, Project-Syndicate.org



#### b) Financial market-related factors

A sine qua non for a reserve currency is that a sufficient number of top-rated and highly liquid investment instruments are denominated in it and are tradable in financial markets. According to received financial market wisdom, US Treasury bonds continue to be seen as risk-free instruments and enjoy enormous liquidity. Moreover, central banks are inclined to invest their reserves in fixed-income instruments, at least in times of positive real yields.

#### c) Monetary policy factors

Beyond the two reasons cited above, central banks hold currency reserves in order to be able to intervene in foreign exchange markets. The SNB has stood out in this respect in recent years, as it attempted – ultimately without success – to artificially devalue the Swiss franc by pegging it to the euro. The manipulation of exchange rates is also associated with the political debates over “exorbitant” trade surpluses and deficits. The issue received its fair share of international attention well before Donald Trump took it up and imposed a number of initial protectionist measures.

Institutions such as the IMF and the European Commission regularly admonish countries that post trade surpluses in excess of 6% of GDP. Trump’s rushing ahead rather aggressively and imposing punitive tariffs is a new wrinkle, which rightly raises concerns that his actions could trigger a global tit-for-tat protectionist spiral.

*“Bullion doesn’t pay interest or dividends, nor does it grow or expand by itself. That’s the price you pay for tranquility.”*

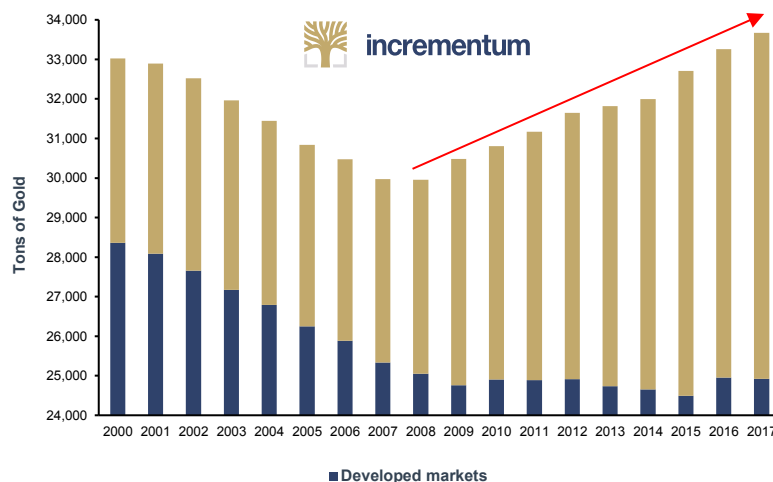
**Pierre Lassonde**

Another monetary policy-related reason for holding currency reserves is the fact that they boost the public’s confidence in a nation’s currency. If a central bank holds large currency reserves, it signals that it has the financial wherewithal to impose unconventional measures. This applies particularly to relatively “young” currencies. Established currencies such as the euro or the US dollar have a significant advantage in this respect due to their international standing.

#### Is gold the admission ticket to negotiations over a new global monetary order?

Although industrial nations historically hold the largest gold reserves, a change in trend is discernible in emerging markets. Gold is becoming an increasingly important component of the official currency reserves of these countries.

### Trend in official gold reserves



Sources: IMF-IFS, World Gold Council, Incrementum AG

*"I never said the central bank is independent!"*

**Alan Greenspan**

**As the chart above shows, the financial crisis of 2008 marked a turning point.** While the gold reserves of central banks steadily declined until 2008, they have been rising ever since. Even more remarkable is the fact that the entire increase is due to gold reserve accumulation by emerging-market central banks. While gold reserves held by developed countries have fluctuated around the 25,000-ton level, gold reserves of emerging markets have increased consistently since reaching a low in 2006. From a total of 4,596 tons in 2006 they rose to 8,755 tons in 2017. This is a quite stunning 90.82% increase. In recent years the central banks of emerging-market economies were very important investors at the margin.

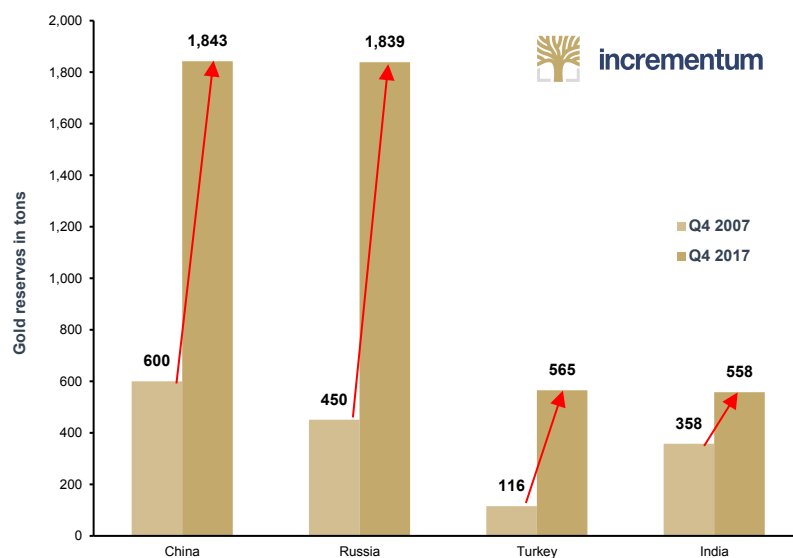
*"Diplomacy is the art of telling people to go to hell in such a way that they ask for directions."*

**Winston Churchill**

**The increase in gold reserves should be seen as strong evidence of growing distrust in the dominance of the US dollar and the global monetary and credit system associated with it.** Apart from economic interests, geopolitical interests and power aspirations play a very important part in this context as well. In recent years the governments of countries such as China, Russia, Iran, and even Turkey have frequently and more or less openly questioned the US-dominated global economic order. Their distrust is reflected in the steady expansion of their gold reserves. The following chart illustrates this by showing the change in gold reserves held by China,<sup>25</sup> Russia, India, and Turkey over the past decade:

<sup>25</sup> We actually assume that China's gold reserves are significantly higher than officially reported. For the reasons for this assumption, see the section "[China and the Importance of Gold](#)" in the *In Gold we Trust* report 2014.

### History of gold reserves



Sources: World Gold Council, Incrementum AG

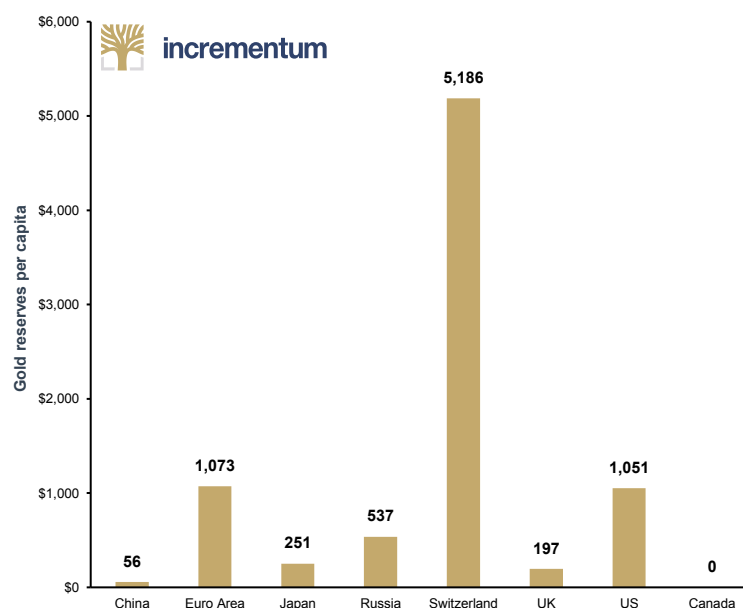
*“America is losing its status as the world’s hegemonic power – just as Britain did before it.”*

**Stanley Fischer**

**China, Russia, and Turkey in particular have boosted their central bank gold holdings substantially since 2007, namely by 307% (China), 408% (Russia), and 486% (Turkey).** In Q4 2007 China, Russia, Turkey, and India together held 1,524 tons of gold, which represented just 5.1% of total official gold reserves at the time. In Q4 2017 their combined reserves amounted to 4,804 tons, or 14.3% of total official gold reserves.

As absolute numbers sometimes tell us very little about the actual dissemination of gold in an economy, we will take a look at a few relative numbers. The next chart shows official gold reserves per capita:

### Central bank gold reserves per capita (in USD)



Sources: Santiago Capital, Statista, Incrementum AG

*“If the United States would take this first step towards linking the dollar to gold, it would send a signal of America’s commitment to restoring the integrity of the dollar as a meaningful unit of account and reliable store of value.”*

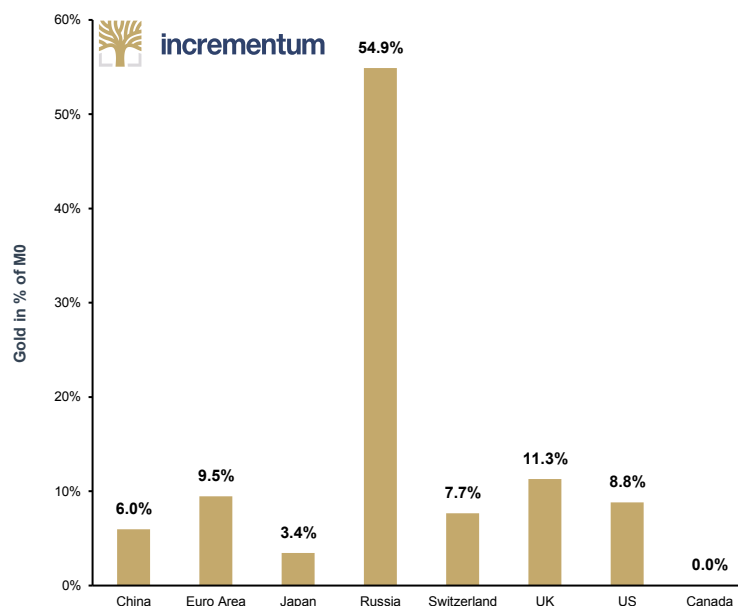
**Judy Shelton**

**In this comparison Switzerland is a clear standout with a formidable level of USD 5,186 per inhabitant.** Gold reserves per capita in the Eurozone of USD 1,073 and in the US of USD 1,051 are also relatively high compared to those of other countries. It is remarkable that the central bank of Canada, a country that was actually the fifth-largest global gold producer in 2015, holds no gold reserves at all.

A disadvantage of looking at per capita gold reserves is that – as is the case with the Swiss franc – the monetary asset or currency is not only used by national residents, there is a demand for it in other countries as well, whether due to its high liquidity or its perceived suitability as a store of value.

Another very interesting indicator is the extent to which the monetary aggregate Mo is covered by gold reserves on the books of central banks. The next chart shows the percentage of legal tender and bank reserves covered by official gold reserves:

### Central bank gold reserves as a percentage of M0



Sources: Santiago Capital, Statista, Incrementum AG

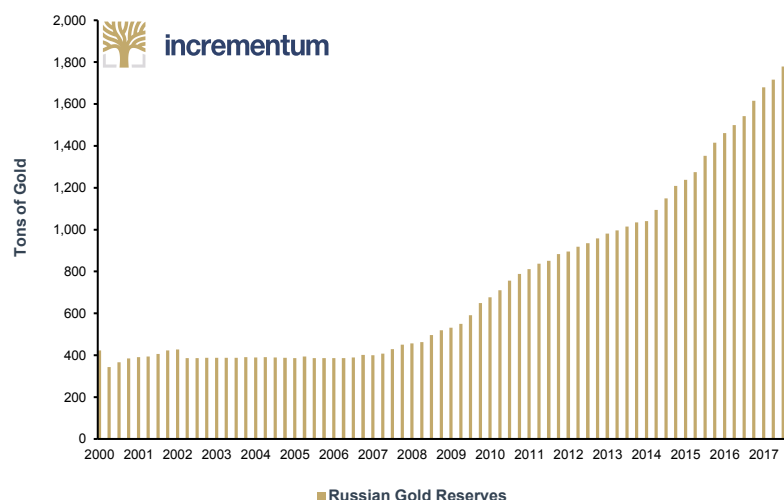
*“While I live I will never resort to irredeemable paper.”*

**Napoleon Bonaparte**

A look at the most important currency areas reveals several surprises. The monetary base of the Russian ruble has by far the highest gold coverage ratio at almost 55%. The fact that the British pound follows in second place with a coverage ratio of 11.3% is somewhat surprising as well, considering that the BoE sold half of its gold reserves at the turn of the millennium.

Generally, though, in most currency areas only a tiny fraction of even the smallest monetary aggregate, Mo, is actually covered by official gold reserves. Thus the value of legal tender rests largely on the fact that it can be used in transactions. On the other hand, the example of Russia shows that the degree of gold cover of the monetary base is by no means carved in stone. **A lot can be achieved if monetary authorities have the required political will, as the recent history of Russia’s gold reserves reveals:**

### Russian gold reserves (tons)



Sources: Bloomberg, World Gold Council, Incrementum AG

*“Gold is the sovereign of all sovereigns.”*

**Democritus**

While official gold reserves initially remained by and large constant after the fall of the Soviet Union until 2006, they have been in a steady uptrend since then. The accumulation of reserves has accelerated significantly since the beginning of the Ukraine crisis in 2014, in the wake of which Western countries imposed economic and financial sanctions on Russia.

## Conclusion

*“Put not your trust in money, but put your money in trust.”*

Oliver Wendell Holmes

*“Gold is simply permanent units of energy, labour, and time. Gold emanates from the canceling of those 3 but then forever represents them.”*

**Roy Sebag**

**Over the past several years, confidence in the US-dominated monetary and world order has dwindled.** Central bankers across the world appear to have taken the motto of our report to heart and are expressing their steadily growing trust in gold. The surge in official gold reserves since 2008 provides ample evidence for this conclusion. For the time being, the West retains its dominant position in the global monetary system, not least due to its large gold reserves. However, this dominance is questioned ever more frequently.

While official gold reserves of developed countries have, for the most part, remained stagnant since 2007, the central banks of China, Russia, Turkey, and India in particular have boosted their gold holdings significantly. We believe this trend is set to continue in the near term. In line with the increasing shift of global economic output from West to East, gold appears to be moving from West to East as well, at least in terms of relative shares of official gold reserves.

*“The time has come to establish the international monetary system on an unquestionable basis that does not bear the stamp of any country in particular. On what basis? It is hard to imagine that it could be any other standard than gold.”*

**Charles de Gaulle**

*“In extremis gold is always accepted.”*

**Alan Greenspan**

**From the perspective of central banks, gold has not lost its importance as an anchor. On the contrary, as in previous centuries, gold remains indispensable for inspiring confidence in a currency and serves as a guarantor of its stability. The gold reserves on the balance sheets of central banks may well become poker chips in future negotiations over a new global monetary order.** Those with a few golden aces in the hole will undoubtedly enjoy an advantage. Investors should therefore keep a close eye on the announcements, plans, and activities of central banks in this context.

**The proportion of gold in the currency reserves held by central banks may be a useful reference for private investors pondering what gold weighting would be suitable for their own portfolios.** This idea is based on the quite interesting fact that the gold reserves held by the central banks of developed nations amount to 19% of their total currency reserves, which approaches the 25% gold allocation recommended for the Permanent Portfolio.<sup>26</sup>

In the following, we have summarized some important key figures regarding the significance of central banks' gold reserves for the most important currency areas.

	Gold reserves/capita	Gold in % of GDP	Gold in % of M0	Gold in % of M2	Gold in % of all reserves
China	55.75 USD	0.64%	5.98%	0.28%	2.25%
Euro Area	1,072.76 USD	3.28%	9.48%	2.65%	42.64%
Japan	251.40 USD	0.65%	3.45%	0.34%	2.41%
Canada	0.00 USD	0.00%	0.00%	0.00%	0.00%
Russia	537.40 USD	5.28%	54.91%	10.78%	17.09%
Switzerland	5,185.90 USD	6.58%	7.67%	4.21%	5.25%
UK	197.11 USD	0.50%	11.30%	0.39%	6.88%
USA	1,051.17 USD	1.76%	8.82%	2.45%	8.80%
Total	541.42 USD	2.48%	11.96%	1.83%	13.73%

Sources: IMF, Santiago Capital, Statista, World Gold Council, Incrementum AG

<sup>26</sup> A comprehensive overview of the "Permanent Portfolio" can be found in our book *Austrian School for Investors*, in the section "The Permanent Portfolio".





# Conclusion

*“Come gather ’round people  
Wherever you roam  
And admit that the waters  
Around you have grown  
And accept it that soon  
You’ll be drenched to the bone.  
If your time to you  
Is worth savin’  
Then you better start swimmin’  
Or you’ll sink like a stone  
For the times they are a-changin’.”*

Bob Dylan

*“People today are still living off  
the table scraps of the sixties.  
They are still being passed  
around – the music and the  
ideas.”*

**Bob Dylan**

“The Tides They Are a-Changin’”: This slightly adjusted title of Bob Dylan’s famous song is a fitting opening to our summary of this year’s *In Gold we Trust* report. Quantitative tightening, de-dollarization, and cryptocurrencies seem to be echoing the strains of R.E.M.’s “It’s the End of the World as We Know It”. Whether we find this changing of the tide good or bad is of no relevance to the phenomenon itself. What is unfolding will affect our lives either way. But the better we brace ourselves for these fundamental changes, the more we will be able to benefit from them.

The key findings of this year’s *In Gold we Trust* report may be summarized in terms of the following three changings of the tide:

## Change of the tide in monetary policy

The reversal from QE to QT has provoked remarkably little attention in public discourse. However, the consequences of this monetary U-turn could be dire, because the monetary amphetamine that prevented a relapse into crisis in the post-Lehman era has come with numerous side effects.

*“Emancipate yourselves from  
mental slavery,  
None but ourselves can free our  
minds.”*

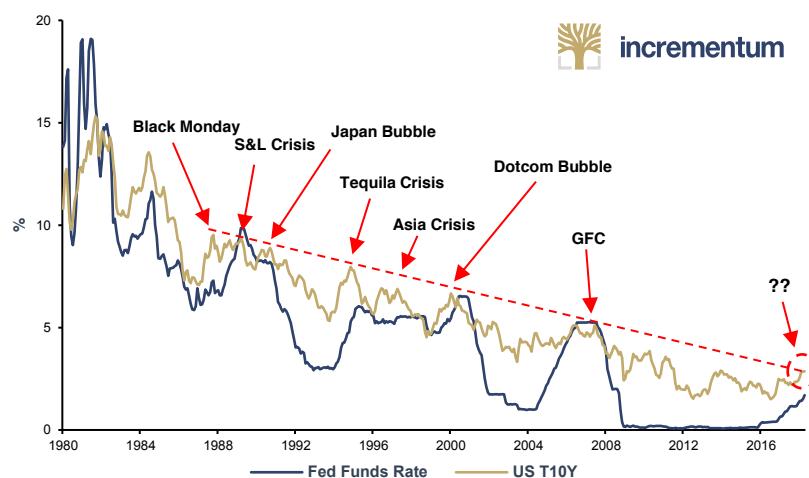
**Bob Marley,  
“Redemption Song”**

**On the one hand, the monetary medicine has effected a *da capo* of global debt excesses.** In theory, Mario Draghi’s “Whatever it takes” policy should have bought Southern European countries time for structural reforms and debt reduction. In reality, near-zero and subzero interest rates acted as an incentive to accumulate more debt. **On the other hand, investors have grown familiar with today’s allegedly less risky capital market environment and have fallen in love with it.** Now the first dark clouds are gathering on the (interest) horizon. Not only the Fed but also the ECB is slowly but surely leaning into the monetary turn.<sup>27</sup> (although with a substantial time lag).

<sup>27</sup> Jan Smets, a member of the ECB Council, has announced a possible date for euro QExit. After the rotational Council meeting at the end of July, the ECB could actually perform a gradual exit from the bond purchase programme. See <https://www.wsj.com/>



### Federal funds rate & UST 10Y



Sources: Federal Reserve St. Louis

### Change of the tide in the global monetary order

De-dollarization and the reshaping of a unipolar world monetary regime into a multipolar one continue. Admittedly, these transitions are occurring in small (and sometimes hardly recognizable) steps; but the trend is clear.

*“The future’s in the air  
I can feel it everywhere  
Blowing with the wind of  
change.”*

**The Scorpions,  
“Wind of Change”**

*“When it is time for us to sell, or  
even to stop buying, the response  
could be quite strong; there is  
every reason to expect a strong  
response...”*

**Jay Powell**

*“I am not in danger. I am the  
danger!”*

**Walter White,  
Breaking Bad**

The process comes with geopolitical polarization and rhetoric that promotes divisiveness above unification. This tendency reached a new peak with Donald Trump’s election. Those European politicians in particular who do not conceal their deeply rooted feelings of antipathy toward the property tycoon in the White House are trying to seize the geopolitical moment to escape the shackles imposed by the US at least by a bit. Demands for an EU army are testament to this emancipation movement (as was the establishment of the euro a generation ago).

**Intensifying trade conflict is going hand in hand with the currency war, which was declared a while ago.** Even though the trade war is still being fought with blanks, the increasingly martial rhetoric and the rising degree of irrationality inherent in trade policy decision-making have added to economic and political uncertainty. While the measures taken so far have affected only a very small portion of the economy, the importance of the measures as symbolic political acts cannot be underestimated. <sup>28</sup> For the US, the gradual loss of currency hegemony could have far-reaching consequences. Falling demand for the US dollar and Treasuries could fuel both inflation and interest rates.

It remains to be seen what effects the debt problem will have on the changing of the tide in foreign exchange policy, especially since no one can do away with the hard truth that one party’s receivable is the other party’s liability. Whoever suggests the culling of nominal debt has to be aware of the fact that financial assets have to be written off at the same time and in the same amount as counterparty liabilities. The geopolitical powder keg that such a debt jubilee would set off needs no detailed explanation.

<sup>28</sup> At this point, we would like to refer to our Advisory Board member Jim Rickards, who has repeatedly alerted us to the sequence “currency war – trade war – shooting war”.

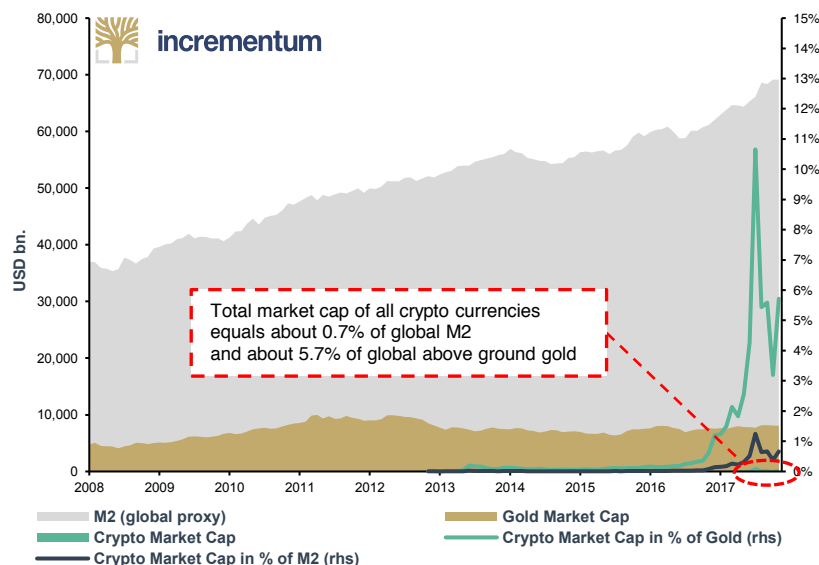
*“Sometimes things happen in an instant that would not have seemed imaginable within a year.”*

**Emperor Ferdinand I**

### Change of the tide in technology

We have experienced a swift technological shift of epic proportions. More and more financial transactions are being executed via smartphone and the internet. The advent of cryptocurrencies has led to further acceleration of the digitalization of money. Fascinatingly, the emergence of these new technologies has set off a Hayekian competition that is attracting human and financial capital keen on innovation.

### M2, gold and crypto-market cap in USD bn and in % of M2



Sources: Bloomberg, coinmarket.com, Incrementum AG

*“Our times are not special. They are only presented as something special because it is the present. Fear of the future is an inherent part of the human condition.”*

**Robert Rethfeld**

With regard to cryptocurrencies, we are convinced of two truths: (1) Cryptocurrencies and especially the underlying decentralized ledger technologies will fundamentally change business and possibly the reality of the global monetary order,<sup>29</sup> and (2), gold and cryptocurrencies are friends, not foes. In fact, a collaborative approach would play to the strengths of both. The first gold-based cryptocurrencies are underway as we speak.

**Each of these three tidal changes holds the potential of inflicting fundamental transformation on the world. But what does this turning of the tide, the first signs of which we are now seeing, mean for the price of gold?**

*“I think people expect too much from gold.”*

**Adrian Day**

A glance at the status quo on the financial markets shows the headwinds that gold currently faces:

- Equities are still in a bull market and are trading close to their all-time highs.
- Volatility remains relatively low.
- Real estate (aka “concrete gold”) is regarded as the *asset sans alternative* in many places.
- Robust economic growth

<sup>29</sup> The Marshall Islands passed a law on the introduction of a cryptocurrency in February 2018. The SOV will be legal tender at eye level with the US dollar (currently the only legal tender): See <https://www.cnn.com/>. Venezuela started circulating a governmentally sanctioned cryptocurrency, the Petro or Petromoneda, in February 2018.

- (Official) Price inflation remains relatively low.
- US interest rates are rising.
- Central banks are becoming more hawkish – QT instead of QE.
- Cryptocurrencies are stealing the limelight from gold.

Mulling over this list, we were reminded of a statement by our esteemed colleague Adrian Day: *“People expect too much from gold! Whatever scenario you’re in, everyone expects gold to react more than it does. But when you think about what gold has done, I think it has done very well this year.”*<sup>30</sup> **In other words, gold aficionados should not fall prey to the mistake of expecting excessive price gains as long as those headwinds prevail.**

*“So, while there are no obvious triggers for historically high global asset valuations to correct, while they remain this high there is always a risk of a sudden correction that could be destabilising to a financial system and global economy that seems to require such elevated asset prices.”*

**Jim Reid**

**We also have to point out in this summary a new aspect of the financial markets, one that might turn into a blessing for gold.** What distinguishes the current phase decidedly from the runup to earlier big stock exchange crashes (1929, 1987, 2000, 2008) is the simultaneously high valuations of stocks *and* bonds. Previously, bonds would help contain any losses on the stock exchanges due to the negative correlation of these asset classes. However, bond valuations have climbed into extremely thin air at this point. From a purely mathematical perspective, bond prices will hardly be able to post any further gains unless the Federal Reserve takes a dramatic step towards negative interest rates. **A fantastic piece by Deutsche Bank recently showed that an equally weighted index of shares and bonds is currently trading at the highest level since 1800 (!).** Sooner or later the financial markets will have to bow to the law of gravity and embark on the return trip to the mean. – which could catch many portfolios on the wrong foot.<sup>31</sup>

So what happens if both shares and bonds dive in a bear market? What will be the safe haven, now that the traditional pattern of negative correlation has changed? Will it be cash, property, Bitcoin, or – yet again – gold? **We are convinced that in such a scenario, gold will be among the biggest beneficiaries.**

*“The only permanent truth in finance is that people will get bullish at the top and bearish at the bottom.”*

**Jim Grant**

**Our discussion has shown that gold should benefit from a dynamic environment of fundamental change. But what about the short- and medium-term outlook for gold?** Last year we established several scenarios for the gold price that were in tune with the momentum of GDP growth and the further development of US monetary policy. The time horizon we used was the term of office of the current US administration (2017-2021), by the end of which period the Fed expects monetary normalization to have been achieved.

<sup>30</sup> “People expect too much from gold”, Kitco.com interview with Adrian Day

<sup>31</sup> “Long-Term Asset Return Study. The Next Financial Crisis”, Jim Reid, Deutsche Bank Research, 18 September 2017



Term period dominated by	Growth	Monetary normalization	Gold price in USD
<b>Scenario A: Genuine boom</b>	Real growth > 3% p.a.	Success; Real interest rates >1.5%	<b>700–1,000</b>
<b>Scenario B: Muddling through</b>	Growth & inflation 1.5-3% p.a.	Still not fully successful	<b>1,000–1,400</b>
<b>Scenario C: Inflationary boom</b>	Growth & inflation > 3% p.a.	Still not fully successful	<b>1,400–2,300</b>
<b>Scenario D: Adverse scenario</b>	Stagnation / contraction <1.5%	Stoppage & reversal of monetary policy	<b>1,800–5,000</b>

Source: Incrementum AG

*“No one can possibly know what is about to happen: it is happening, each time, for the first time, for the only time.”*

**James A. Baldwin**

**The path of the gold price has so far moved in the range of scenarios B and C.** The actual growth and inflation figures reflect this path rather well. The crucial issue will be whether the feat of the monetary normalization is successful and whether scenario B or C will prevail in the coming years. A recession is overdue; the changing of the tide in monetary policy could trigger one in the coming 6 to 24 months.<sup>32</sup>

**How does the gold price perform in recessions? Short answer: Very well!** On the one hand investors are looking for safe havens in times of crisis, and gold is the classical safe haven asset; on the other hand many investors will anticipate monetary and fiscal stimulus and buy gold for inflation protection.

#### Gold performance during US recessions

Decade	Gold Start (USD/oz)	Gold End (USD/oz)	Change (%)
11/1973 – 03/1975	100	178	78.0
01/1980 – 07/1980	512	614	20.0
07/1981 – 11/1982	422	436	3.3
07/1990 – 03/1991	352	356	1.0
03/2001 – 11/2001	266	275	3.5
12/2007 – 06/2009	783	930	18.8
Mean			20.8

Sources: Deutsche Bank, Incrementum AG

**We have also distilled these additional key findings from this year’s journey through the world of gold, which we analyze in depth in the extended version of this year’s *In Gold we Trust* report, available for free at [www.ingoldwetrust.report](http://www.ingoldwetrust.report):**

- **Technical analysis gives us a positive outlook on the gold price.** The risk/reward profile of gold seems extremely attractive, and the profile for silver may be even better. The weekday seasonality of gold has been remarkable, with Friday being the best day and Tuesday the worst for the gold price.
- **We also see an excellent reward/risk profile for the mining sector.** On the basis of our premise that gold has now re-entered a bull market, we expect the gold/silver ratio to fall in the medium term. In this scenario, we should see outstanding investment opportunities for silver mines in particular.

*“Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”*

**Warren Buffett**

<sup>32</sup> Dr. Lacy Hunt just pointed out that since the early 1900s, money supply (M2) decelerated prior to 17 of the 21 recessions. In the first quarter of 2018, M2 growth decelerated to just above a 2% annual rate. Year-over-year M2 growth slowed to just 3.9% versus the 6.6% long-term average growth. Additionally, bank credit growth declined 0.6% at an annual rate. (See: *Hoisington Quarterly Review and Outlook*, First Quarter 2018.)



In our investment process, we remain focused on developers and emerging producers.

- **So as not to be caught on the wrong foot, we have analyzed a vast array of different potential crisis triggers.** One of our general conclusions is that gold's performance exhibits an inverse relationship to the monetary system's perceived soundness and thus offers effective protection against inflation and crises, not the least in situations whose details are not predictable.<sup>33</sup>
- **We have always put gold under scrutiny from a portfolio perspective.** This year, we focus on the importance of gold reserves for central banks. Remarkably, since the financial crisis in 2008, not only has the trend towards the reduction of gold reserves been stopped, but the central banks have actually reversed the trend and boosted their reserves drastically. The central banks of China, Russia, India, and Turkey – i.e. emerging economies across the board – have increased their gold reserves, sometimes by a significant extent. This renaissance of gold is also testament to the declining trust in the US-centric monetary and global political regime.
- As far as the struggle between inflationary and deflationary forces is concerned, we can see that inflation has gained in strength over the past year. **Our Incrementum Inflation Signal has also indicated rising inflationary tendencies since September 2017.**

*"A friend asked me to choose one investment that I would want to leave to my great-great-grandchildren. I immediately answered that it would be gold coins. The reason I explained is as follows – corporations can disappear, stocks can collapse, governments can change and they can fall, booms and recessions come and go – but gold is intrinsic money, and no man or nation has ever doubted its value. And they never will."*

**Richard Russell**

**The central point is this: The global boom, fueled by ultra-low interest rates and the never-ending expansion of the money supply and credit, is on shaky ground.** The likelihood of the boom turning into a bust is high – much higher than the mainstream expects.

**We therefore anticipate a significant global economic dislocation with a substantial effect on the gold price in the coming years.** As always, we will monitor these events, analyze them in detail, and comment on them regularly. Gold will definitely contribute to staking out a comfort zone in the turmoil of the tidal changes that we have discussed.

[www.ingoldwetrust.report](http://www.ingoldwetrust.report)

<sup>33</sup> See "Gold in the context of portfolio diversification", *In Gold we Trust* report 2016, pp. 100-107



## About us

### Ronald-Peter Stoeferle, CMT



Ronnie is managing partner of Incrementum AG and responsible for Research and Portfolio Management.

He studied business administration and finance in the USA and at the Vienna University of Economics and Business Administration, and also gained work experience at the trading desk of a bank during his studies. Upon graduation he joined the research department of Erste Group, where he published his first *In Gold we Trust* report in 2007. Over the years, the Gold Report has proceeded to become one of the benchmark publications on gold, money, and inflation.

Since 2013 he has held the position as reader at scholarium in Vienna, and he also speaks at Wiener Börse Akademie (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the international bestseller *"Austrian School for Investors"*. In 2018 he will publish *"Die Nullzinsfalle" (The Zero Interest Rate Trap)*. Moreover, he is an advisor for Tudor Gold Corp. (TUD), a significant explorer in British Columbia's Golden Triangle.

### Mark J. Valek, CAIA



Mark is a partner of Incrementum AG and responsible for Portfolio Management and Research.

While working full-time, Mark studied business administration at the Vienna University of Business Administration and has continuously worked in financial markets and asset management since 1999. Prior to the establishment of Incrementum AG, he was with Raiffeisen Capital Management for ten years, most recently as fund manager in the area of inflation protection and alternative investments. He gained entrepreneurial experience as co-founder of philoro Edelmetalle GmbH.

Since 2013 he has held the position as reader at scholarium in Vienna, and he also speaks at Wiener Börse Akademie (i.e. the Vienna Stock Exchange Academy). In 2014, he co-authored the book *"Austrian School for Investors"* and will publish *"Die Nullzinsfalle" (The Zero Interest Rate Trap)* in 2018.



## Incrementum AG



**Incrementum AG is an independent investment and asset management company based in Liechtenstein.** Independence and self-reliance are the cornerstones of our philosophy, which is why the four managing partners own 100% of the company. Prior to setting up Incrementum, we all worked in the investment and finance industry for years in places like Frankfurt, Madrid, Toronto, Geneva, Zurich, and Vienna.

We are very concerned about the economic developments in recent years, especially with respect to the global rise in debt and extreme monetary measures taken by central banks. We are reluctant to believe that the basis of today's economy, i.e. the uncovered credit money system, is sustainable. This means that particularly when it comes to investments, acting parties should look beyond the horizon of the current monetary system. Our clients appreciate the unbiased illustration and communication of our publications. **Our goal is to offer solid and innovative investment solutions that do justice to the opportunities and risks of today's prevalent complex and fragile environment.**

[www.incrementum.li](http://www.incrementum.li)

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