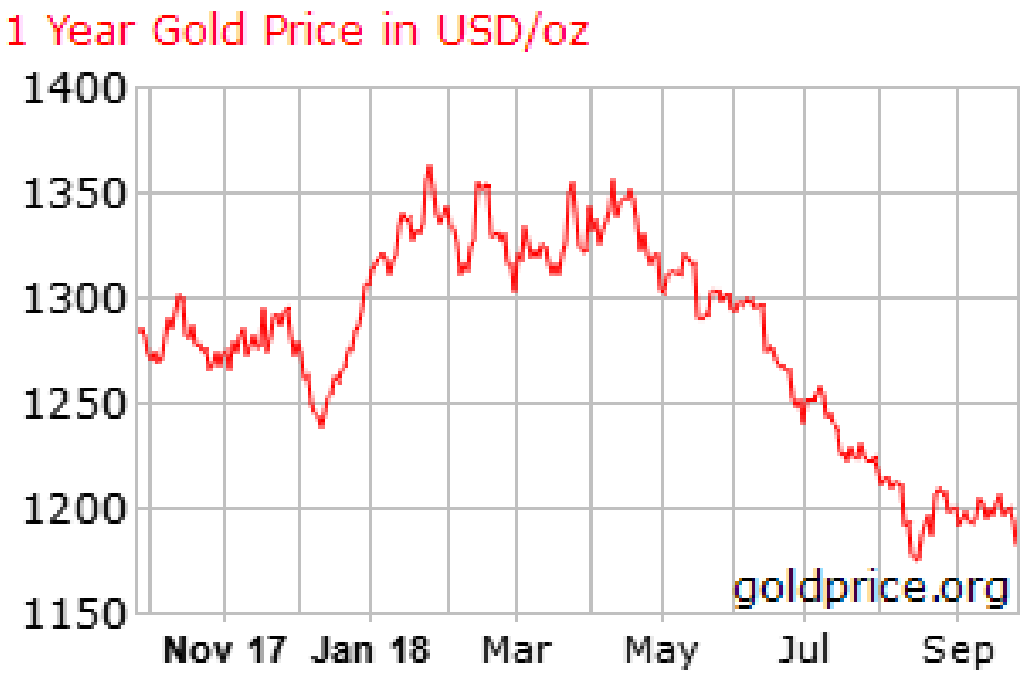
Why Gold is Approaching a Bottom

Recent months have proven challenging for the gold sector, with trading momentum definitely on the negative side as speculators have sided with the US dollar. These pillars of global financial markets move inversely proportionately to each other – i.e. when one's rising, the other falls – and vice versa. The graphic below represents gold's price performance over the past six months.



Nevertheless, the key fundamentals with respect to gold at present still ring true and support higher gold prices. **But why is this so?**

Well firstly, recent price gyrations are predominantly related to short-term trading positioning, especially as traders have deemed the US dollar as the go-to safe-haven of choice whilst the current trade imbroglio gets resolved. Inflation is already spiking, and trade tariffs and other factors will almost certainly accelerate the inflationary process. Furthermore, US national debt is the elephant in the room and the inconvenient truth that nobody wants to talk about - and the only way it's going to get smaller is if it's 'inflated' away.

In essence, the recent sell-off is overwhelmingly a transient phenomenon that's decoupled from any intermediate or long-term fundamentals, which potentially presents a compelling opportunity for investors.

Let's remind ourselves about gold's unique status and why it has been a staple of the world's economic systems for thousands of years. Gold is simultaneously both a commodity and a financial asset. Central banks around the world retain gold as part of their foreign currency reserves.

During 2018, as in past years, governments have continued to be net buyers of gold adding to official sector holdings. The two main accumulators of gold are China and Russia, whose gold stocks remain far below those of other leading nations like the USA and countries within the European Union.

Whilst the Chinese and Russian governments have done some light buying in the international gold market, the bulk of their reserve accumulation has come from their domestic production. China is the world's leading producer of the yellow metal, whilst Russia has considerable annual output.

Amongst all of this, I believe there are various factors that could set the stage for a gold price recovery over the coming weeks and months, which I will outline below.

Gold's Role Undiminished

Precious metals like gold and silver do best in times of elevated inflation, because of their abilities to hold value, protect against currency devaluation, and provide investors with a safe haven alternative to financial instruments like stocks, bonds, derivatives, and other fiat-based assets. After all, gold and silver are time tested, trusted commodities, that have served as stable forms of currency throughout time, for millennia. Whereas, "*all forms of fiat currencies eventually return to their intrinsic value, which is zero.*" – Voltaire, famous French enlightenment writer and philosopher.

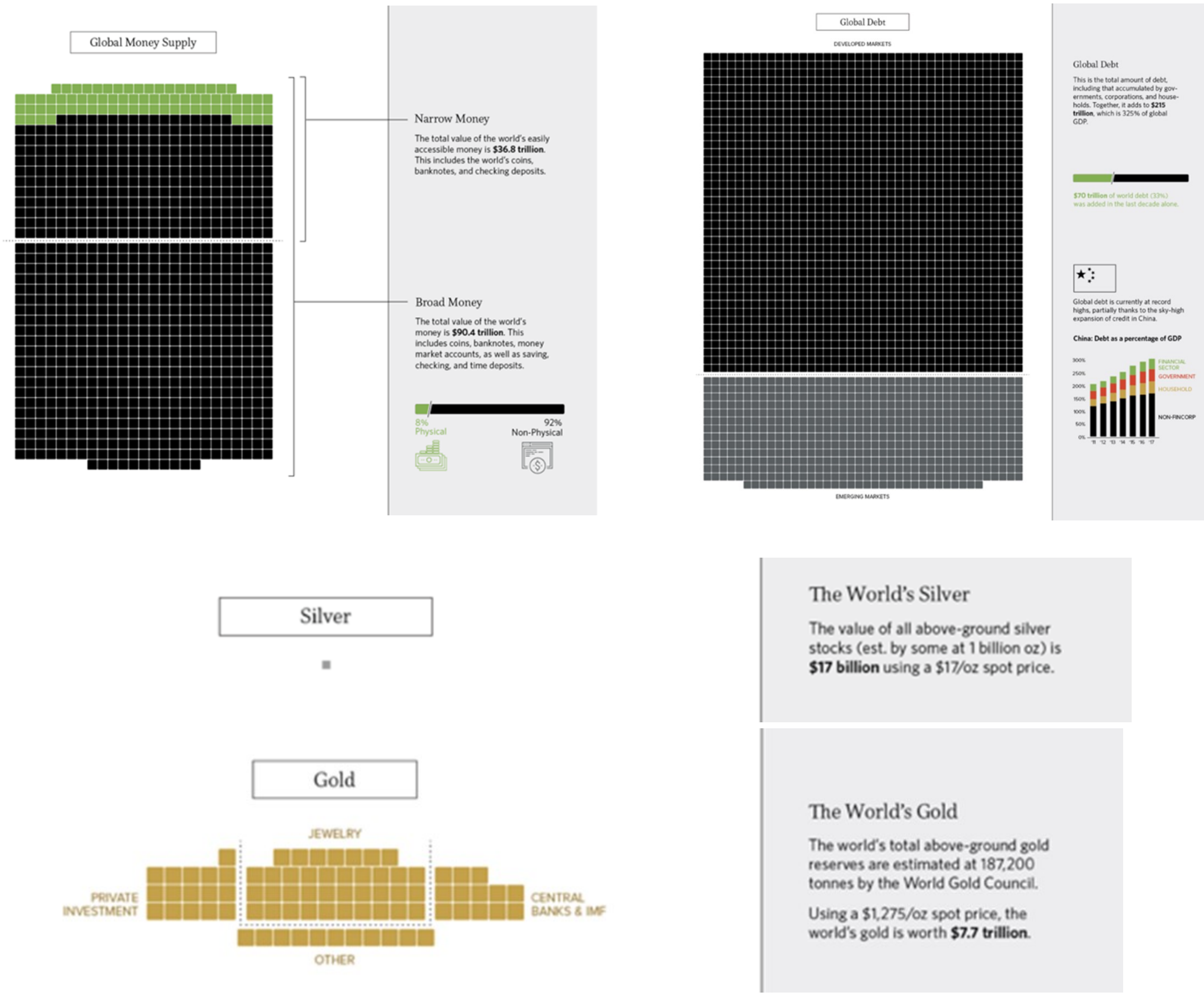
This is effectively true, since organizations such as the Federal Reserve, the European Central Bank, and most other central banks can essentially create money out of thin air, continuously inflating the money supply in perpetuity. In the modern age, this is done with little more effort than punching numbers on a computer screen. In fact, only about 8% of the world's "money" is physical cash, and the remaining 92% are basically just digits in a computer program.

Fiat money continuously loses its value through inflation, whereas gold and silver move in the opposite direction, and once confidence in a fiat currency begins to be impacted, the value of a currency can drop precipitously, which would produce an enormous surge in precious metals. This has occurred numerous times throughout history. Instances of hyperinflation are not just limited to poor Latin American and African countries. Hyperinflation-induced currency crises have struck about 55 times over the last century alone and have deeply affected economies of countries like France, Germany, China, and many others.

If you add up all the physical and digital cash in the world, also known as the M3 money supply, you would get an immense number of over $90 trillion. Moreover, the global debt market is even bigger, with an estimated $215 trillion. And if you consider the world's derivatives market you get an insane figure ranging from $544 trillion to about $1.2 quadrillion. Yes, that's an estimated upper range of $1,200,000,000,000,000 worth of derivatives floating around the world.

So, where do silver and gold factor in all of this? Well, all the silver in the world currently represents only about $15.5 billion worth of value at current price, with an estimated 1 billion ounces out there. And all the world's gold combined, an estimated 187,200 tons, represents a value of around $7.5 trillion at its current price. These are some of the world's most essential and valuable metals that are used widely in industry, jewellery, store of value, and for thousands of years were used as currencies. In fact, it was just very recently, fewer than 50 years ago that the world was "decoupled" from the gold standard.

All the gold and silver in the world currently represent only about 8% of the value that M3 fiat currencies have, and fewer than 1% if you consider all the debt and derivatives floating around the world.



Source: MarketWatch.com

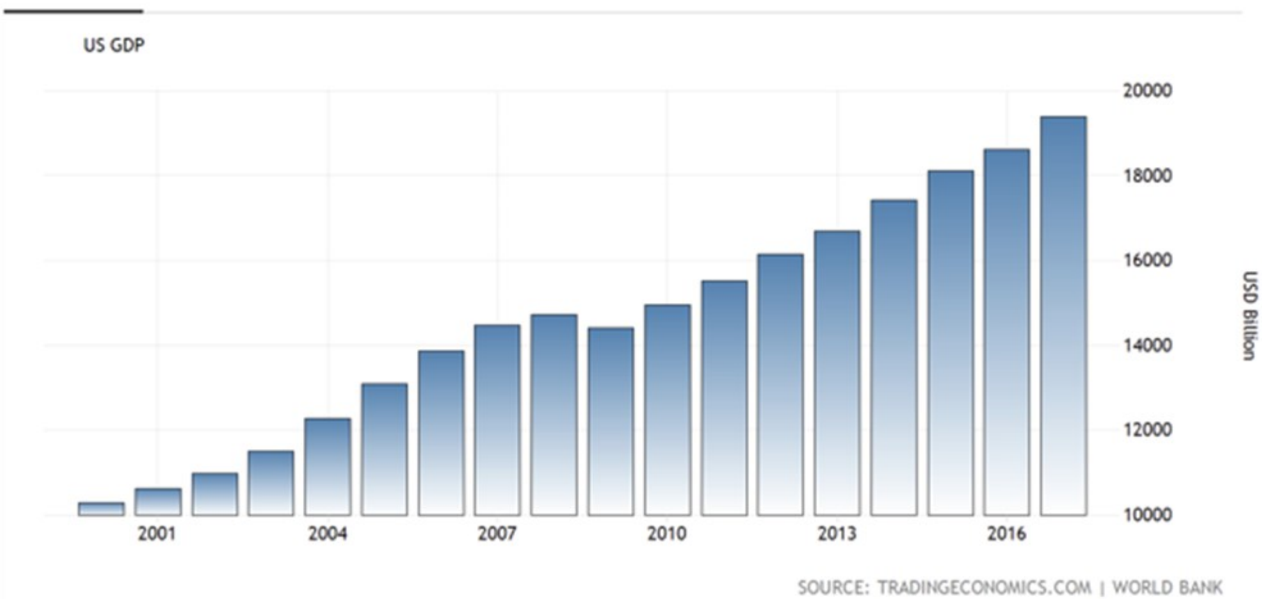
But why is this important for gold and silver prices going forward? Simply because there are far too many fiat-based "assets" in the world relative to the intrinsic, real assets like gold and silver. In addition, the number and "value"
associated with fiat-based assets continuously increases, thus so should the value of gold and silver. In fact, this trend has been intact for many years, and there is no reason to believe it is going to stop.

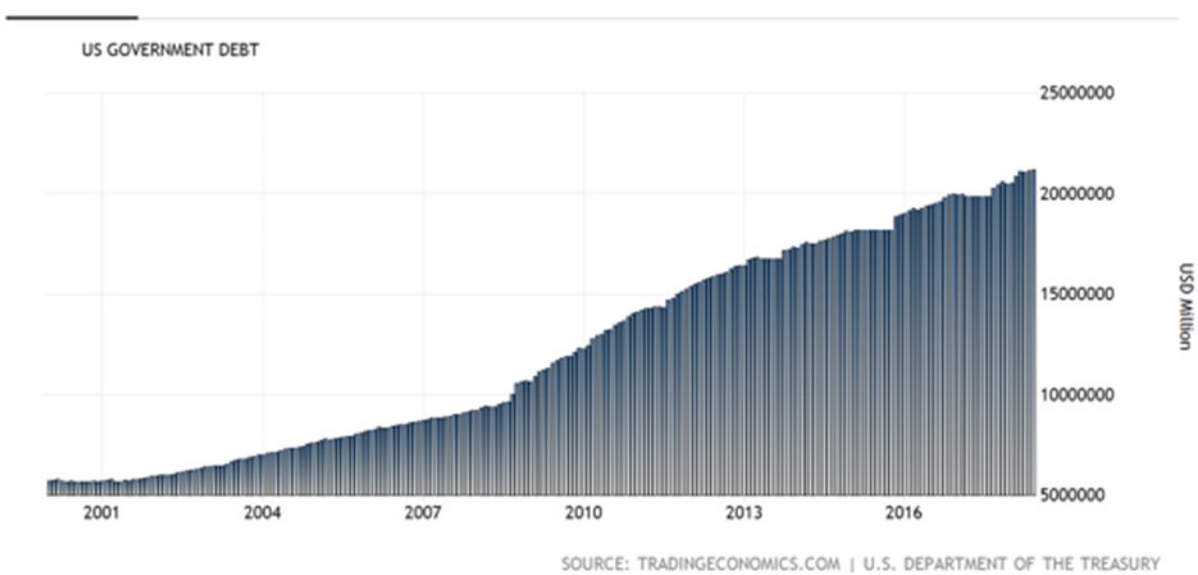
Gold Outperforms Dow More Than 10-Fold Since 1970

This may come as a surprise to many people, but the price of gold was very stable for many years - almost 150 years actually. From about the inception of the dollar in the late 1700's to 1932, the price of gold remained around $20 an ounce. In 1933, gold got repriced to about $35 an ounce, and once the world's monetary system became decoupled from gold in the early 1970s, the price began to rise drastically. Since then, the price has appreciated by about 3,400% to its current price of roughly $1,225 an ounce.
By comparison, the DJIA and the S&P 500 are up only about 315% and 385% in the same time frame.

The explanation for this wide difference lies in the perpetual rise in inflation, immense levels of fiat-based assets and derivatives, combined with the continuous degradation of the dollar and other currencies.
The bottom-line is that there is only so much gold and silver that can ever be mined, yet, fiat money can be inflated to infinity. Therefore, as global debt levels continue to rise, the inevitability of perpetual money inflation becomes inescapable.

The United States, as well as many other nations around the world, has enormous levels of debt.
There are many countries out there with significant, problematic debt loads, but for the sake of simplicity we will focus on the U.S. alone. The U.S. national debt currently towers at around $21.27 trillion, about 105% of GDP. Moreover, U.S.'s personal debt is now over $19 trillion, total debt recently eclipsed $70 trillion, and total U.S. unfunded liabilities are over $114 trillion now.





This a problem because since 2000, the U.S.'s GDP has expanded by roughly 112%, whilst over the same period the national debt has exploded higher by about 325%, personal debt has grown by 134%, and total debt has increased by 168%. It is clear that debt growth is significantly outpacing the growth of the economy.

In addition, since 2000, the M1 money supply (monetary base) has been increased by 505%, M2 money supply has grown by 193%, supply of U.S. treasuries has exploded by 596%, and derivatives have grown by 512%. These are drastic increases over the past 18 years and are indicative of substantial money manipulation designed to inflate the global monetary supply.

Therefore, it is not a coincidence that the price of gold has increased by nearly 400% since 2000. As more fiat-based financial assets flood worldwide markets to support the current financial status quo, gold and silver have risen. This trend is very likely to continue and should accelerate going forward.

The U.S.'s debt burden is essentially unsustainable, and the national debt will only get bigger with time. Right now, the Federal budget deficit is close to $800 billion. This means you can add about another $800 billion to the $21.27 trillion national debt in roughly one year from now. Moreover, Trump tax cuts, infrastructure spending, and other efforts to "grow the U.S. economy", will likely cause the Federal budget deficit to blow out to over $1 trillion in future fiscal years.

The kicker here is that debt doesn't come cheap, and the U.S. is required to pay interest to service its national debt. We know that the U.S. already pays about $500 billion annually just in interest to service the gargantuan national debt. But in this rising rate environment coupled with a continuously increasing debt load, the U.S. will pay more, much more.

Just by simply applying a 3% interest rate (which is very close to the current 10-year and an appropriate benchmark for national debt servicing), we arrive at an annual figure of about $640 billion. It seems clear that with the enormous Federal budget deficit, and the perpetual debt servicing, the national debt only has one way to go, and that's a lot higher.

Trade War Threat

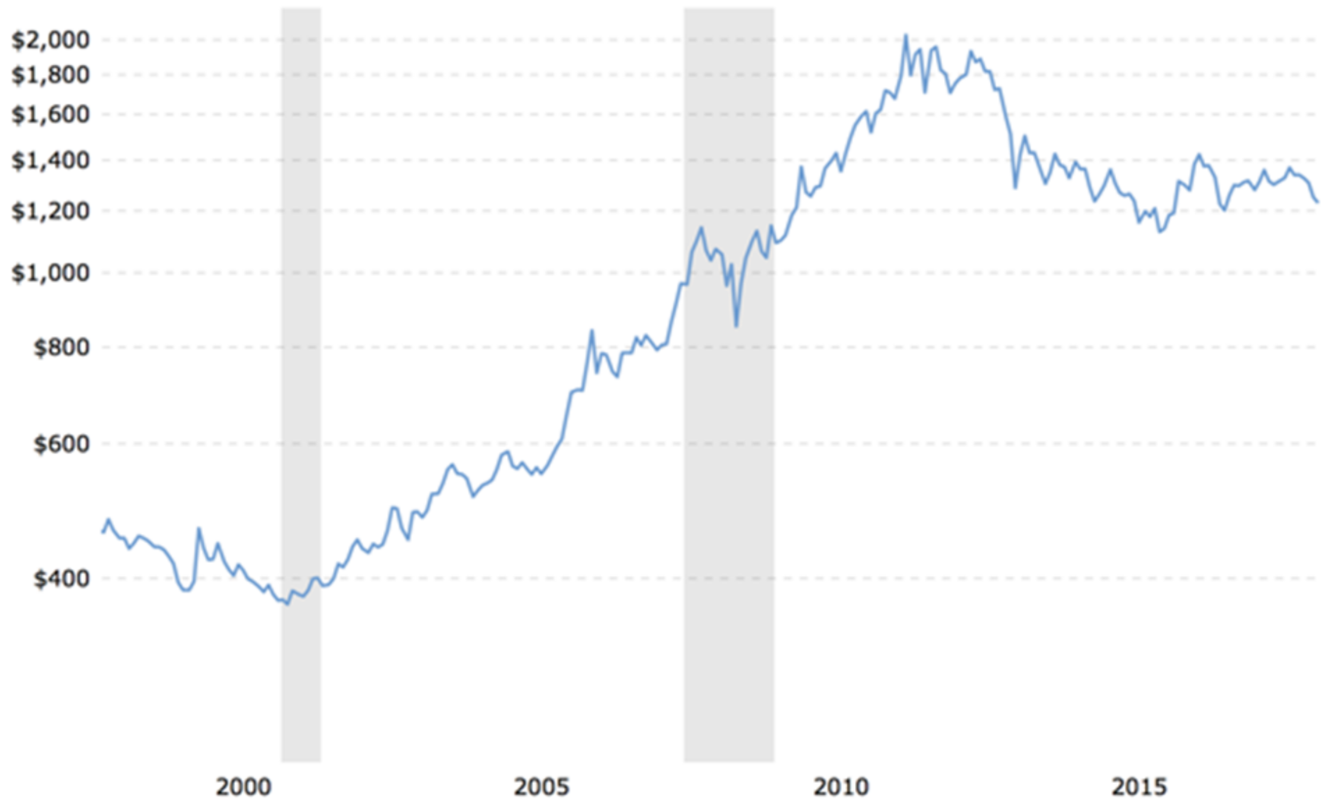
There is a lot of talk about the current trade tensions in the world, especially in regard to U.S. and China. In addition, gold and silver seemingly declined on news of further tariffs imposed on Chinese goods and vice versa. But are trade tariffs negative to the overall inflationary narrative? In fact, the opposite appears to be true.

For instance, the U.S. has now slapped tariffs on hundreds of billions of dollars worth of Chinese goods entering the U.S. each year. This means that the underlying goods will now cost more for U.S. consumers. In conjunction, new higher priced competing products coming in from other producers, domestic and foreign will also be more expensive.

Producers will also pay higher raw material prices for steel, aluminium, oil and so on. And companies facing higher tariffs will likely pass the bill to consumers. Similar developments are likely to ensue all over the world from retaliatory tariffs and so on. Both consumer and producer prices will go much higher due to trade tariffs, which are very beneficial for inflation, and supports much higher gold and silver prices. Historically, investors have used gold as an inflation hedge and the yellow metal has seen prices increase substantially when inflation rises above 3%.

Gold and Silver Trade Decoupled from Fundamentals

In the most recent bull cycle, gold and silver started going up substantially in the mid to late 2000s, and then exploded higher when the Fed took rates down to zero and started implementing QE. This bull cycle is just getting started, it began in the end of 2015, and prices will go substantially higher as inflation spikes, and should explode higher when the Fed engages in further monetary manipulation to make America's debt problems more "manageable" and/or attempt to avert or lessen the impact of future economic downturns.



Source: MacroTrends.com

I believe the current situation is analogous to where gold and silver were in the early 2000s. Prices were bouncing around in a sideways trajectory, much like they are right now. Then, around 2004-2005, a wave of inflation began to propel prices higher, much like the increasing tide of inflation we're seeing develop right now.

And then, through financial engineering, the Fed drastically increased the money and treasuries supply, and gold and silver skyrocketed. A second wave of something similar is coming down the line, only this time gold and silver are likely to grow substantially higher than they did during the past bull market cycle.

The World Gold Council (WGC) holds a similar view. It believes gold's current price presents an attractive entry point, as investors should expect macro trends to boost the yellow metal's relevance over the coming months. The WGC makes the case that three critical macroeconomic forces will drive gold's behaviour during the second half of 2018: positive but uneven global economic growth, trade wars, and rising inflation and an inverted yield curve.

Uncertain US Political Landscape

The US political scene remains divided like few times over recent generations. The upcoming mid-term elections will either provide President Trump with validation or put a giant roadblock in front of his initiatives for the next two years. While polls are leaning towards the opposition Democrats taking control of at least one house of Congress, we have learned that polls can be misleading. The level of the US stock market and economic growth would clearly favour the ruling party in an ordinary election; however, few things are normal in the world of American politics these days.

At the same time, the investigation of Russian collusion in the 2016 and other issues continues to weigh on the Trump administration. Moreover, calls for impeachment by Democrats and a vitriolic environment in Washington, continue to rise to unprecedented levels. Uncertainty over the election could cause volatility in markets in the lead-up to the November contests and gold could be a beneficiary.

Conclusion

I remain very bullish on gold and silver short, intermediate, and long term. Recent price gyrations appear to have nothing to do with long term fundamentals pertaining to gold and silver, but are likely the result of short-term trading, especially the positioning of the US dollar as the current safe-haven of choice. Thus, the recent sell-off will in time will come to be seen as a substantial buying opportunity. I anticipate gold will recover to trade between $1250 and $1350 over the next 12 months.

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