The BOECKH INVESTMENT LETTER

SPECIAL REPORT
OCTOBER 5, 2011

Gold And The Credit Pyramid

Subscribers will be aware that we recently increased our gold weighting from 5-10% to 10-15%. We have become increasingly concerned that investment risks, both short and long term, appear to be rising. This reflects four major issues: 1) an extraordinary over-indebtedness in the rich world (OECD total public debt is over 96% of GDP in 2011); 2) the near-certainty of well below normal growth due to public and private deleveraging and the continuing long wave economic decline; 3) a seriously flawed international monetary system and eurozone structure; and 4) dysfunctional politics and profound lack of leadership in Europe, the U.S. and Japan.

As a result of these risks and a clear sense that no "solution" is in sight, risks have escalated to an unknown but substantial degree.[1]

Over thousands of years, gold has a track record of preserving wealth. With no central bank guaranteeing a fixed price since 1971, it has become extremely volatile and therefore is only suitable for those, apart from speculators, trying to preserve wealth over the long run.

Large numbers of investors are not comfortable with gold as it has no yield. They prefer to own business assets or shares thereof that will hopefully generate income and preserve wealth in the long run. This is particularly true of North Americans and others who have always lived in safe places and have had little or no experience with the

[1] See the Boeckh Investment Letter: *Asset Allocation September 2011* (Vol. 3.14 September 22, 2011).

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repeated disasters in Europe, Russia, the Middle East, India, Africa, China and other parts of the world. Many people in those countries owe their financial and physical survival to having gold. For that reason there is always a powerful underlying growth in demand when financial and geo-political fears are rising.

This report is to explain why we think gold is a useful hedge and an insurance policy against economic and financial conditions becoming significantly more destructive than most people are assuming. It is not our base case, but it is clear for anyone to see that serious trouble is brewing. You do not buy fire and life insurance assuming a worst case scenario, but to protect against risk.

The Inverted Credit Pyramid

It is hard to believe that at the beginning of this century, Peter Bernstein [2] posed the question whether the glorious history of gold had come to an end—a history in which gold was the center of the financial universe for thousands of years. He wrote this 30 years after the collapse of the Bretton Woods[3] agreement and after 20 years of a bear market in gold. The past 10 years have answered the question decisively. Gold has risen seven-fold, outperforming virtually every major asset class (see Charts 1 and 2). Moreover, significant central bank net purchases have put an end to speculation that gold would be officially demonetized.

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[2] Peter Bernstein, *The Power of Gold: The History of an Obsession* (John Wiley and Sons, Inc., 2000).

[3] The Bretton Woods monetary system lasted from the end of World War II to August 1971 when President Nixon floated the dollar and ended convertibility of the dollar into gold at $35/ounce. Other currencies were pegged to the dollar.

Chart 1

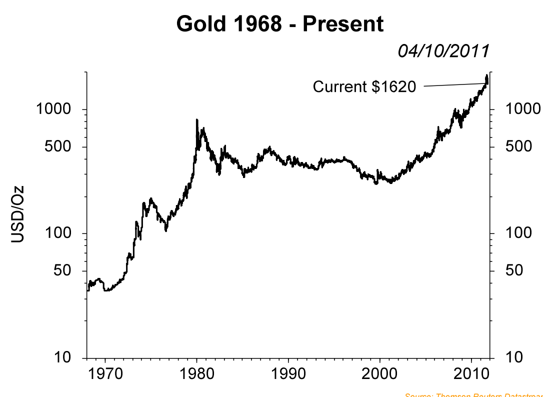
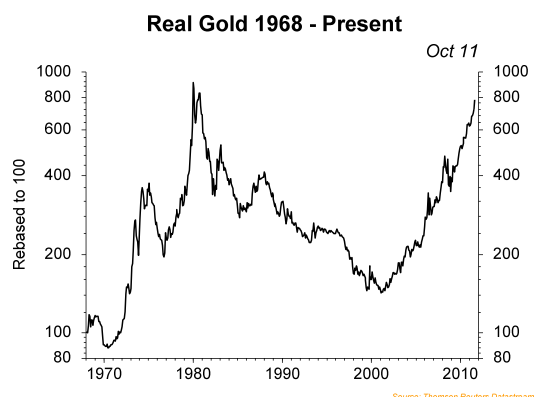


Chart 2



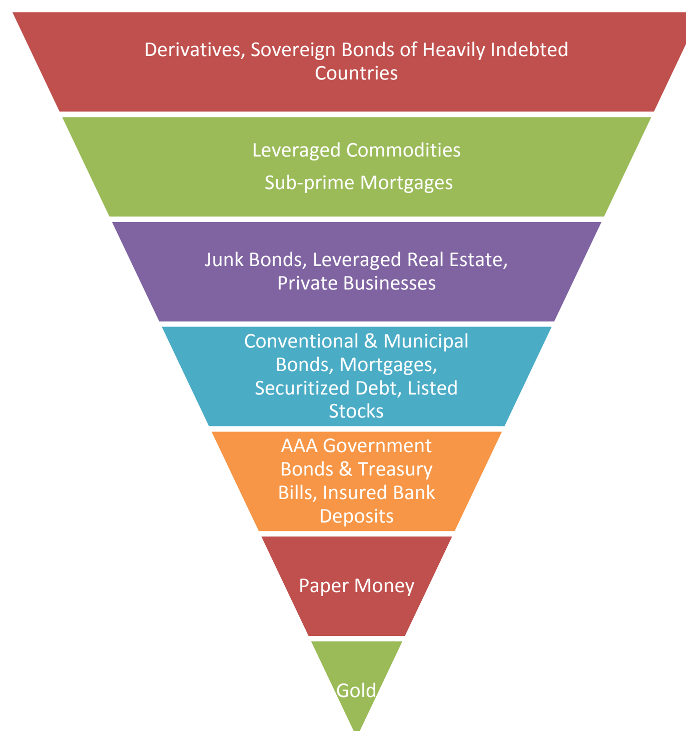
Well before the Bretton Woods international monetary system collapsed, it had become apparent that the U.S. and many other countries were ignoring the lessons of why monetary and fiscal discipline were important to long-term financial stability. Keynesian economic thinking became main stream after World War II and was soon to become perverted by politicians and policymakers. Increasingly, they focused on fine-tuning the economic cycle to remove risk, maximize employment and create vast entitlement programs, ignoring Keynes' own warning about the need to balance the budget over the normal course of the business cycle.

As the perception of risk declined, the private sector began an orgy of borrowing, aided and abetted by politicians, deregulation and entrepreneurial lenders. There developed a growing disregard for the need to save against the usual exigencies of life. Naturally, when savings decline, governments should save more (i.e. run surpluses) as an offset. When they don't, or even add to the savings shortfall by running deficits, then investment in plant, equipment and infrastructure must fall and/or the country runs bigger and bigger current account deficits. This means either borrowing from foreigners

or selling assets to foreigners to pay for living beyond one's means. The result is to undermine the long-term sustainability of the economy.

With unusual insight, John Exter[4] saw what was coming as early as the 1960s—credit inflation, monetary inflation, an end to the Bretton Woods international monetary system and ultimately deflation. He graphically illustrated his theory with the inverted pyramid of credit, depicted below.

The Inverted Pyramid



Gold is at the bottom of the pyramid and it supports everything above it—essentially paper claims that increase in risk depending on how high up they are in the pyramid. All paper is a form of credit, some involving more leverage and risk than others.

[4] John Exter was a Citibank Senior Vice President and international monetary adviser for the bank's International Banking Group and a Federal Reserve official before that.

For example, Federal Reserve notes are the visible portion of money, which is backed by Federal Reserve assets primarily in the form of government bonds. This is the first asset class above gold in the pyramid and is based on the credit quality of the government and Federal Reserve. Next is money in the form of deposits at commercial banks, which are highly leveraged institutions. Treasury bills, government bonds, corporate bonds, mortgages, listed stocks, etc. provide the ascending asset tranches in the pyramid. The location of each asset within the pyramid is subjective and varies depending on circumstance. For example, the quality of mortgage lending deteriorates in a housing bubble. The pyramid drawn here is just for illustrative purposes.

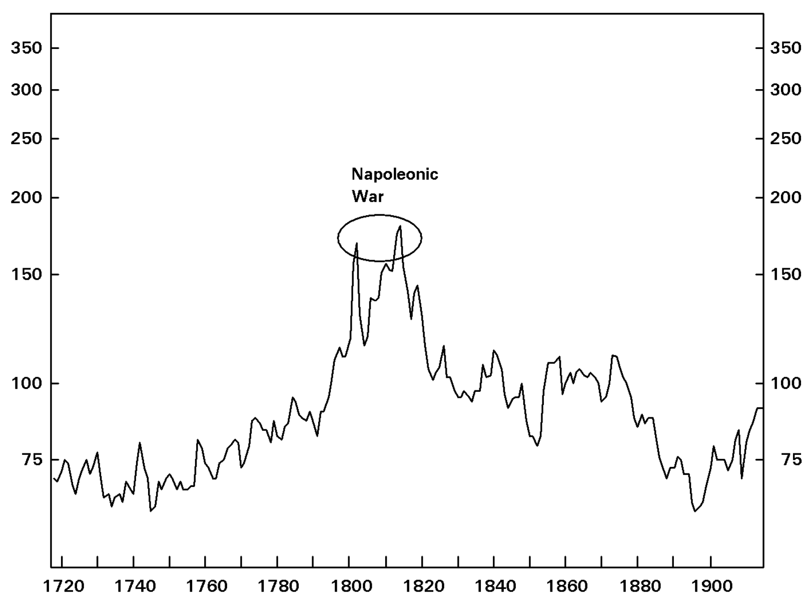
The point is that as the pyramid builds, the assets get riskier, the leverage greater. Near the top you could place sub-prime mortgages, derivatives, CDOs, CDSs, etc. In 2007-2008, credit derivatives totalled trillions of dollars.

In prosperous times, money moves up the pyramid, leverage increases and the pyramid becomes increasingly top-heavy and unstable as the base supporting it—physical gold—increases very slowly. At some point, the business cycle turns down, credit strains appear and risky assets become bad assets. As the quality and viability of assets is undermined, so too are debts which are collateralized by those assets. Money starts to flee the riskiest assets and moves back down the pyramid looking for safety. When this happens, it creates a self-feeding spiral which destabilizes the pyramid. The more top-heavy it becomes in the prosperous phase, the more it wobbles in the deleveraging phase. In extreme circumstances, the wobble starts to go out of control and money moves faster and deeper down the pyramid into the safest assets—government bills and bonds of the safest countries and ultimately gold.

In the event that the credit pyramid topples, it is possible that gold, which is the base of the pyramid, will become the preferred "safe asset" for millions of people. Safe, however, no longer means free from price fluctuation. Under the gold or gold exchange system, when the dollar (and earlier the pound sterling) was pegged to gold and freely convertible, price fluctuations in gold were not possible. Central banks were the backstop. They no longer are, so the price of gold fluctuates quite sharply from day to day and week to week as it attracts speculative capital and momentum investors. But over long periods of time, the purchasing power of gold has been remarkably stable. Over the roughly 200 years of the gold standard in the UK, prices were approximately the same at the end of the period as they were at the beginning (see Chart 3 below).

Chart 3

Stability of UK Prices under the Gold Standard, 1717—1914



Source: This chart appeared as Figure 11.5 in *The Great Reflation* (Wiley, 2010)

Will The Credit Pyramid Topple?

We have written frequently [5] on the global credit crisis, the seeming paralysis of policymakers, the dysfunctional eurozone, U.S. and Japanese political systems, the profound lack of leadership and continuing failure of governments to get ahead of the crisis curve. Fiscal and monetary policy are pretty well tapped out as instruments to effectively stimulate economies. The ongoing long wave economic decline in the rich countries and need for persistent deleveraging of private and public debts means that the over-indebted countries cannot rely on economic growth to escape debt traps.

Increasingly, investors have to face the reality that there is no solution to the current state of economic and financial affairs as described above. We are living in a very long-term workout situation with undercapitalized banks and over-indebted governments that markets are forcing to cut back on entitlements and other forms of spending. Entitlement promises were made when life expectancies were in the mid to late 60s. Now they are in the 80s. Populations are aging and entitlement commitments will eventually bankrupt most governments. Therefore, people will not receive what they have been promised.

In this environment, populations will become increasingly angry and restive. The credit pyramid will continue to wobble dangerously and there can be no assurance that it won't topple.

[5] See, for example, the Boeckh Investment Letter: *Crisis Without a Solution: Panic and Reality* (Vol. 3.13 September 15, 2011).

Why This Credit Pyramid is So Dangerous

The reason this credit crisis is so severe is because there has been no discipline in the monetary system for over 40 years. The Bretton Woods monetary system was based on the U.S. dollar being convertible into gold at $35/ounce and other major currencies were pegged to the dollar. Those currencies adjusted up or down when they became fundamentally misaligned with the dollar based on relative costs and balance of payments disequilibrium. Well before Bretton Woods collapsed and the dollar floated, the U.S. had given up on monetary discipline. The gold clause on convertibility and the discipline it was supposed to impose became a hindrance to monetary expansion.

Without such discipline, the U.S. and other countries have had 40 years of unbridled credit expansion and growing financial leverage to build by far, the greatest credit pyramid in history. In the past, even when there has been external discipline on the monetary system, generally provided by gold, sometimes by silver, credit can still grow excessively and financial crises did occur with regularity throughout history—"a hardy perennial" in the words of Charles Kindleberger[6]. But these credit-driven asset bubbles never proceeded too far because discipline would come into play, money would get tighter, interest rates would rise, the credit expansion would come to a halt and the bubble would burst before it was a threat to the entire global financial system. Some exceptions were the paper money inflations of the Mississippi bubble and the assignat inflation in France.

[6] Charles Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises*, rev. Ed. (New York: Basic Books, 1989).

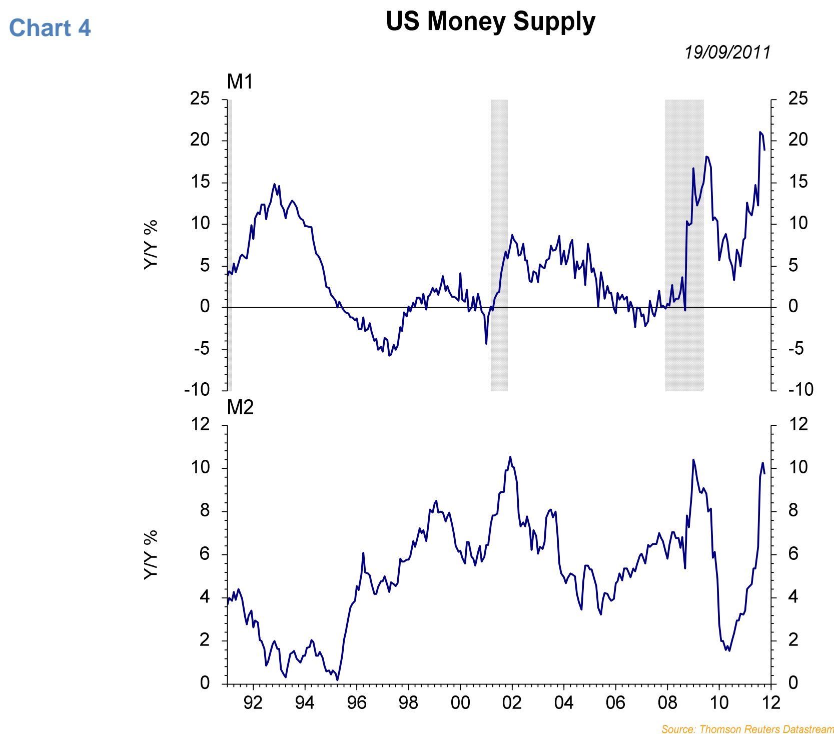
The 1920s credit bubble and subsequent bust also may seem like an exception. However, the 1914-1918 wartime financial and economic distortions were never fixed in the 1920s. There was a lack of discipline in the system because currencies were used in the reserves of countries for the first time to bypass the discipline of gold, and policy mistakes in the 1930s created an extended debt deflation spiral.

However, we must remember that the credit bubble then lasted only 10 years. The current one started 40 years ago and is far bigger. When the private credit bubble burst in 2007, the public sector tried to fill the hole by rapidly expanding its debt to offset the deflationary impact of private deleveraging. The result is that four years after the crisis started in 2007, the total of private and public debt in virtually every country in the world is as high, or higher, than it was then. This is why the world has been unable to find a "solution" to this crisis. There isn't one. All we have had so far are stopgap bailouts and massive fiscal deficits to keep the financial system and economy afloat. Not surprisingly, attempting to solve a debt problem with more debt, does not work.

The inverted pyramid remains just as big as in 2007. The only difference is that the names on the various layers of paper have changed. Greece, Portugal and Ireland, for example, have moved up to the top; sub-prime has moved down a bit because there is much less of it around. European bank paper has moved up. The physical base of gold at the bottom has remained roughly the same, although its value has risen sharply.

Money continues to race back down the pyramid into what people perceive are safer assets. These include gold and silver and so far, bank deposits in U.S. banks and U.S. government paper. This is why we have seen a sharp rise in the price of U.S.

government bonds, precious metals, huge inflows into gold and silver ETFs, and an enormous increase in U.S. money supply on both narrow and broad definitions as shown in Chart 4.



Supply and Demand Patterns for Gold

Understanding supply and demand for any asset is important but it is crucial to be aware of a few caveats. First, most commodity prices are determined by demand in the short run and supply in the long run. Bulls have to be aware that the latter has a nasty habit of rising with a lag following sharp price increases. Second, the price at any one time is that which is required to clear the market based on ex post (after the fact) supply and demand. The future price is determined by the gap between ex ante (before the fact) supply and demand which is not known in advance. When more people want to buy than sell, then obviously the price rises to clear the market. Third, gold is a

unique asset because it has both money properties and commodity properties and the line between the two is far from precise. Jewellery, the prime example, is used for decoration but also as a store of value in many parts of the world.

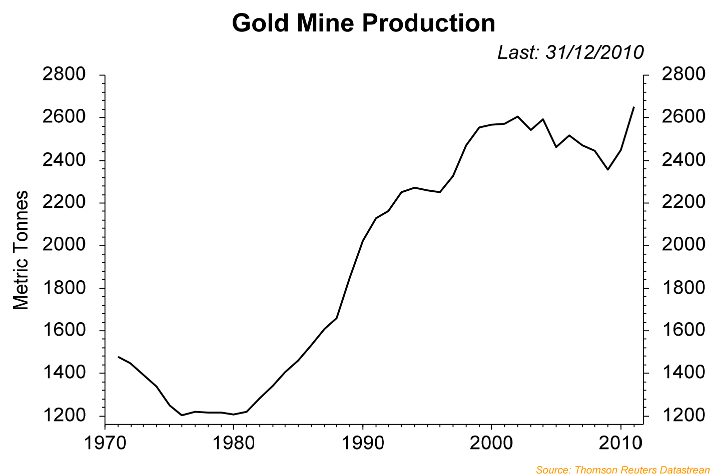
It is estimated by the World Gold Council that jewellery accounts for half of annual demand. Fourth, 165,000 tonnes of gold have been mined in the past, and the overwhelming majority is still in existence, held primarily above ground as jewellery or as coins and bullion by custodians. The rest is held below ground by central banks. Part of the stock of jewellery and gold bars comes back on the market each year as supply, the amount depending on price and liquidity concerns of holders. For example, Gaddafi reportedly sold a billion dollars worth of gold during the late stages of the Libyan revolution to pay his fighters. Interestingly, it was instantly absorbed by the market.

It is clear then that forecasts for the gold price based on past supply and demand trends should be taken with a grain of salt, as the available "inventory" dwarfs the annual production of 2,650 tonnes. While conventional supply from mines may not change much from year to year, the holders of existing gold can, if they wish, throw a huge supply on the market. That said, however, it is likely that supply and demand forces will be supportive of gold over time as long as the financial crisis remains in force and essentially out of control.

The key factors driving the surge in gold prices have obviously been from the demand side. The supply of new gold from mines has been relatively stable since the late 1990s with a downward drift until 2010. For the four years, 2000 through 2003, new

supply averaged about 2550 tonnes[7]. For the following six years, new supply averaged about 2380 tonnes. In 2010, gold production jumped about 10% to about 2650 tonnes (see chart 5). Gold production will likely rise slightly in the next few years as many new projects have been started and mothballed mines have been re-opened in response to higher prices. However, longer term, the supply will likely continue to decline as a result of lower grade production, increasing time requirements and impediments in bringing new, large scale projects online, and a lack of global exploration success in recent years.

Chart 5



Other supply and demand factors are also important for the trend in gold prices. In the 1980s and 1990s, central bank gold sales and forward hedging by gold mines added significantly to world supply. In particular, central bank sales implied possible official demonetization. Since 2000, these factors have reversed. Central banks are now large net buyers of gold on an increasing scale, implying that gold is being officially recognized as an important reserve asset. In particular, China and Russia have been quite aggressive in their purchases but still hold only 1.6% and 8.2% respectively of

[7] Metric tonnes. In Troy ounces the figure would be approximately 82 million ounces.

their foreign exchange reserves in gold. It is estimated that central banks will buy about 340 tonnes in 2011, about 13% of yearly production. Miners have run off their hedges, and are actually adding to net demand.

China and India continue to be prodigious buyers of gold jewellery, coin and bars. Their demand accounts for over 50% of world demand. Investment demand reflected in ETFs, futures, mutual funds, endowments (University of Texas put $1 billion into gold) continues to rise sharply, fed by fears of global financial instability and money printing. As prices rise under pressure of excess demand, gold recycling becomes important in clearing the market. In the last two years, recycling has averaged about 1,650 tonnes.

Those interested in detailed supply and demand analysis and statistics are referred to the excellent work of the World Gold Council and GFMS.

The bottom line is that supply and demand factors have been very supportive of gold prices and this is likely to continue so long as the world's financial situation is so fragile and uncertainty over the future remains so high. The two big caveats are: 1) deflations and recessions are generally not positive for gold; 2) a credible move to repair the world's credit structure and international monetary system without risking inflation would almost certainly knock gold down. The former is quite possible; the latter very unlikely.

Conclusion

The demand for gold in recent years, and particularly in recent months, has been driven by fears that the credit pyramid will collapse and that gold will be the ultimate refuge. As William Rees-Moggs said in 1974, "When the paper system collapses, the survivors will dig in the rubble and they will find gold".[8]

John Exter, anticipating the current crisis many years ago said,

> *"This will be a deflationary collapse rather than an inflationary blow-off because creditors in the debt pyramid will move down the pyramid out of the most illiquid debtors at the top of the pyramid... This explains why we are headed for deflation. Creditors will move out of debtors high in the debt pyramid as many of those debtors fail through defaults & bankruptcies... I went 100% position into gold...This will be an economic catastrophe on a scale never before seen in history. It will last for decades".*[9]

These are certainly extreme views and are well beyond where we believe we are on the spectrum of risk. However, it is clear that the fundamental risks of a severe credit crisis will continue for years. For that reason, we have recently recommended that investors move their gold allocation (which would include related assets such as gold shares) up from 5-10% to 10-15% on price weakness, such as we have seen in recent weeks.

We understand that many intelligent investors are not comfortable with the concept of holding gold and see it only as a speculative play requiring a "greater fool" to

[8] William Rees-Mogg, *The Reigning Error: The Crisis of World Inflation* (Kensington, UK: Hamish Hamilton Ltd., 1974).

[9] Interview with John Exter, Franklin Sanders, *The Moneychanger* (June 1991).

come along later to create hoped for capital gains. However, there is another way to look at gold, as we discussed above. It has endured as a store of value and protection against risk for thousands of years. But it will remain very volatile and therefore should be seen as a store of value only over the long run. Investors should avoid chasing gold and add to positions on significant price weakness.

Date: October 5, 2011

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