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Gold and Money

Dear friends,

My usual commentaries on gold focus on the metal's fundamental and technical profiles. Today, I'd like to get down to monetary basics. Let me begin by stating three facts that are often overlooked:

-Gold, indisputably, is money; it is highly liquid and accepted globally.

-Unlike all the other monies, it's been a medium of storing and exchanging wealth throughout history; it held that distinction at the beginning of monetary convention and does so today.

-Unlike other forms of money, gold, in its physical form, is not someone else's liability.

Now, having this out of the way, let's consider what's happened to gold and what's happened to paper money—during the past half century and so far this year. Each of these timeframes contains relevant information.

Then…

1971 is the year when Richard Nixon terminated the Smithsonian Agreement, which linked the U.S. dollar to gold, at a ratio of 35 paper dollars for each one troy ounce of the yellow metal. Abandoning the dollar's gold backing was an act of faith, literally: it gave the Federal Reserve the leeway to follow a course of prudence or, alternatively, abandon any commitment to discipline. From here on, the central bank could print dollar bills whenever the economy needed to be stimulated.

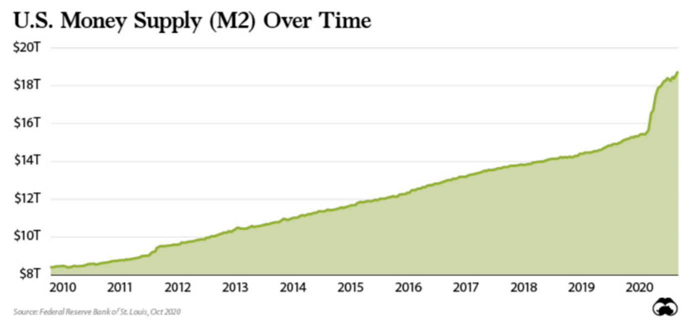
I was a young currency trader when this happened. I remember telling my peers and bosses that the dollar would now surely drop in value and that U.S. inflation would sky-rocket. My viewpoint was labelled naïve: not only was the U.S. the world's most powerful nation, but the Fed's actions were no more than a temporary measure. As soon as the economy took off, the central bank would resort to its usual discipline again.

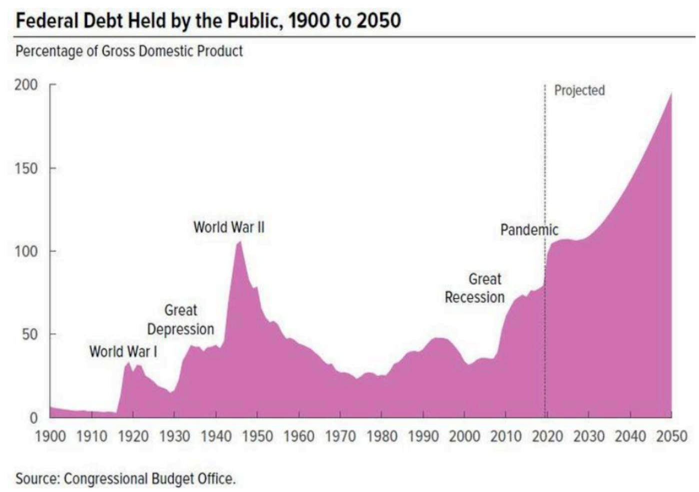
It took a bit longer than I had expected, but by the mid 1970s it was clear that the U.S. currency was a train wreck and inflation was rising. When Nixon abandoned the Smithsonian Agreement it took 4.3 Swiss francs to buy a dollar; by 1975 it took only 2.75. The price of gold had gone from $35 to $140, during the same period; the U.S. annual inflation had tripled from 4% to 12%. Yet, my pals at the foreign exchange desk were still not convinced, which compelled me to write a book on gold's merits. I thought the metal could go a lot further.

When I started writing my first book, *How To Invest In Gold**, sometime in late 1977, the gold price was around $175. When the book hit the shelves nearly two years later, it was close to $300; when the metal peaked in 1980 it changed hands at $850. That much about the explosion in gold prices which resulted from the termination of the Smithsonian Agreement—during the space of less than a decade, it appreciated by a factor of 25 times.

…and Now

Now, let me get back to the year-to-date. What the U.S. monetary authorities have done is even more dramatic than what Nixon did in 1971. The supply of money, which has essentially gone up for half a century, and which virtually doubled in the ten years following the 2008 economic setback, is now, as a result of the pandemic, going exponential. Debt, a logical corollary to abundant money is sky-rocketing alongside (see the U.S. Congressional Budget Office's projections). And, just as back in the 1970's, we're being told that it's only temporary and that all will be fine.





Personally, I don't pretend to have the tools to make accurate predictions—especially at a time when so many dynamics are unprecedented and so many systems are unsustainable—but there are things that strike me as odd. When the stock market keeps making new highs against an economic backdrop that reminds of the Great Depression, and when the bond market shrugs off unprecedented debt levels and historically low yields, I turn cautious. Given the valuations across different asset classes, that means I am extremely cautious on bonds and unusually defensive on stocks. In contrast, we have larger-than- usual positions in cash and gold.

Two Big Questions

The two questions I get asked more than any others are these:

> -What opportunity do I lose by holding a large cash position, and
>
> -How high do you think gold could go?

I imagine you'd agree with me that the economic and socio-political climate for both equities and fixed income is worse now than in it was pre-pandemic, i.e. at the beginning of the year. And yet, financial asset markets keep shrugging off challenges we could not have imagined just a short while ago. My firm belief: the loss of opportunity that results from sitting on a large cash reserve is very low.

**How To Invest In Gold,* McClelland & Stewart, Toronto and Follett Publishing Corporation, Chicago.

How high do I think gold could go? Outguessing the psychology of crowds is an impossible task, so let's instead take a look at relevant precedents. As I already explained, gold appreciated roughly twenty-five fold during the 1971–1980 period, moving from $35 to $852. The second great bull market in gold started in spring of 2001 and ended in fall of 2011; the metal rallied from $256 to $1900, an increase of 7.4 times.

What would happen if this time gold only tripled—in the face of the largest monetary expansion and debt escalation in modern history? From its bear market low in December 2015 around $1070, gold would reach a level of $3,210. If it appreciated in line with the 2001-2011 uptrend, it would end up at around $7,900. And if it equated the mega bull run of the 1970s, the bullion price would peak somewhere around $26,000.

I prefer to go step by step, articulating my next upside objective as we move along. My next target is $2,700, which I believe is attainable within a year. As I write this, we are at $1895.

As I've explored in previous commentaries, there are numerous reasons beyond money and debt creation that make gold a desirable asset. De-dollarization is one other key dynamic, geopolitical turmoil is another.

A Sustainable Uptrend

Here is something that gives me great comfort. Gold is up more than 20% so far this year, which means it's easily outperformed all major asset classes. Yet, its rise has been tempered by healthy bouts of profit taking, as our chart illustrates.

How long the metal's current corrective phase will continue is anyone's guess. We suspect that, during the ramp-up to the U.S. presidential election and the weeks beyond, volatility across all markets will remain high. That makes the current period attractive to initiate gold positions or add to them.

Our recommended portfolio allocation remains at 15%.

Best regards,

Peter Cavelti