THINK PIECE
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Why Gold Lost Its Mojo

By

Ronald-Peter Stöferle

Ronni is Managing Partner of Incrementum AG. In 2007, whilst at the Erste Group, he published his first *In Gold We Trust* report, which has proceeded to become one of the benchmark publications on gold, money, and inflation. Adviser to Affinity Metals (AFF), Matterhorn Asset Management and on several boards including Tudor Gold Corp, Ronni has co-authored the international bestseller, "*Austrian School for Investors*", and in 2019, "*Die Nullzinsfalle*" (The Zero Interest Rate Trap).
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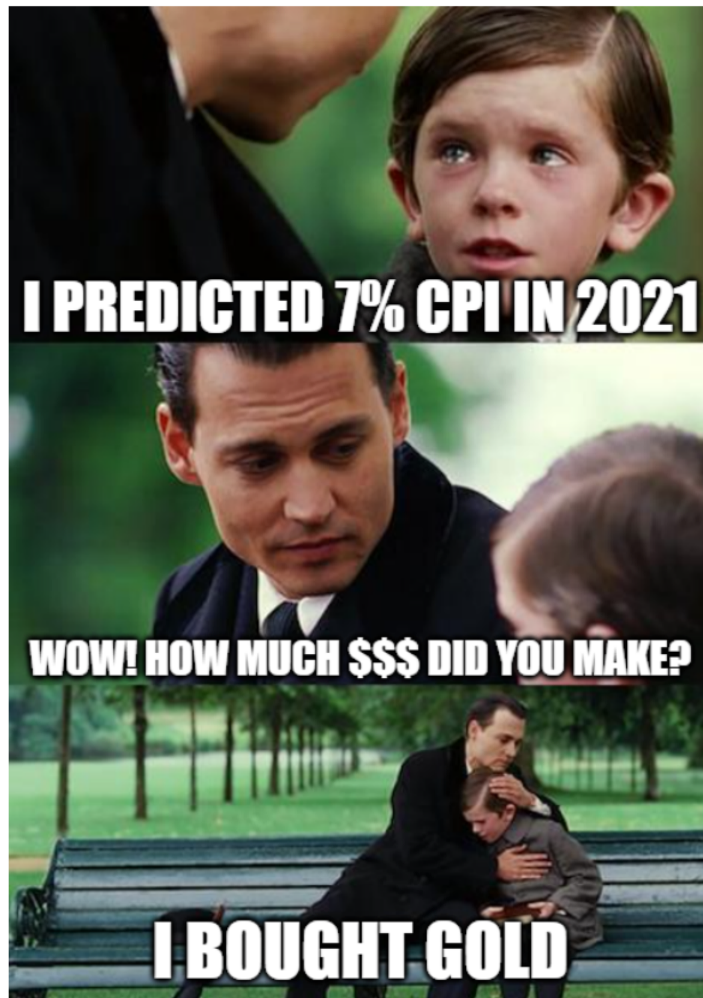
Raoul's Note:

Ronni is my go-to person to help comprehend the deep workings of the gold market and how the macro overlays the fundamentals. I really wanted Ronni to help us understand what is going on in gold and if there is still an opportunity ahead...

Why Gold Lost Its Mojo

Gold and the year 2021: one meme catches it all...



Your time is precious, and we won't beat around the bush: 2021 was disappointing for gold, especially as inflation rates have surged dramatically during the year, rising from 1.4 percent in January to 6.9 percent year-on-year in November.

The HICP for the eurozone recorded a meagre 0.9 percent increase in January, while in November it stood at 4.9 percent year-on-year. Still, in many currencies, gold struggled over the course of the year.

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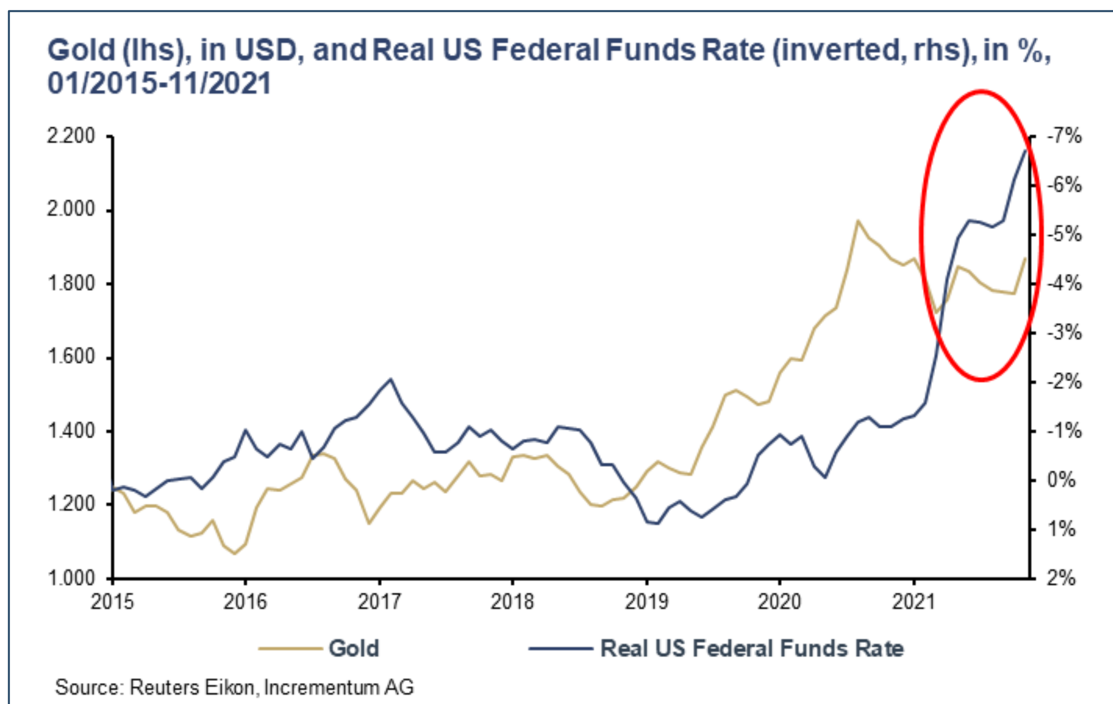
And in those currencies in which the gold price recorded a gain, the gain was small relative to the sharp rise in inflation...

Year	USD	EUR	GBP	AUD	CAD	CNY	JPY	CHF	INR	Average
2000	-5,3%	1,2%	2,4%	11,2%	-1,9%	-5,4%	5,8%	-4,2%	1,4%	**0,6%**
2001	2,4%	8,4%	5,3%	12,0%	8,8%	2,4%	18,0%	5,5%	5,8%	**7,6%**
2002	24,4%	5,5%	12,3%	13,2%	22,9%	24,4%	12,2%	3,5%	23,7%	**15,8%**
2003	19,6%	-0,2%	8,0%	-10,7%	-1,3%	19,6%	8,1%	7,4%	13,9%	**7,2%**
2004	5,6%	-2,0%	-1,7%	1,5%	-2,0%	5,6%	0,8%	-3,1%	0,1%	**0,5%**
2005	18,1%	35,2%	31,6%	25,9%	14,1%	15,1%	35,9%	36,3%	22,8%	**26,1%**
2006	23,0%	10,4%	8,1%	14,3%	23,3%	19,0%	24,2%	14,1%	20,7%	**17,5%**
2007	30,9%	18,4%	29,2%	18,0%	12,0%	22,5%	22,5%	21,8%	16,9%	**21,4%**
2008	5,4%	10,0%	43,0%	30,5%	28,7%	-1,5%	-14,2%	-0,8%	30,0%	**14,6%**
2009	24,8%	21,8%	13,0%	-1,6%	7,9%	24,8%	27,9%	21,1%	19,2%	**17,6%**
2010	29,5%	38,6%	34,2%	13,9%	22,8%	25,1%	13,2%	16,8%	24,8%	**24,3%**
2011	10,2%	13,8%	10,6%	9,9%	12,7%	5,2%	4,5%	10,7%	30,7%	**12,0%**
2012	7,1%	5,0%	2,4%	5,3%	4,2%	6,0%	20,7%	4,5%	11,1%	**7,4%**
2013	-28,0%	-30,9%	-29,4%	-16,1%	-23,0%	-30,1%	-12,6%	-29,8%	-19,1%	**-24,3%**
2014	-1,8%	11,6%	4,4%	7,2%	7,5%	0,7%	11,6%	9,4%	0,2%	**5,6%**
2015	-10,4%	-0,2%	-5,3%	0,6%	6,8%	-6,2%	-9,9%	-9,7%	-5,9%	**-4,4%**
2016	8,5%	12,1%	29,7%	9,4%	5,3%	16,1%	5,4%	10,3%	11,4%	**12,0%**
2017	13,1%	-0,9%	3,3%	4,6%	5,9%	6,0%	9,0%	8,3%	6,3%	**6,2%**
2018	-1,5%	3,0%	4,3%	9,0%	6,8%	4,1%	-4,2%	-0,8%	7,3%	**3,1%**
2019	18,3%	21,0%	13,8%	18,7%	12,6%	19,7%	17,2%	16,6%	21,3%	**17,7%**
2020	25,0%	14,7%	21,2%	14,1%	22,6%	17,2%	18,8%	14,3%	28,0%	**19,5%**
2021 YTD	-5,2%	3,0%	-2,1%	2,4%	-4,0%	-7,4%	4,4%	-1,1%	-1,4%	**-1,3%**
Average	**9,7%**	**9,1%**	**10,8%**	**8,8%**	**8,7%**	**8,3%**	**10,0%**	**6,9%**	**12,2%**	**9,4%**

Source: Reuters Eikon (as of December 17th 2021), goldprice.org, Incrementum AG

Record low and falling real interest rates should have been favourable to the gold price, since the opportunity costs of holding cash have been rising, as have the opportunity costs of bank deposits, given the low and sometimes even negative nominal interest rates for deposits.

In November 2021, the Real Fed Funds Rate even fell below the 1975 low of -5%. However, the gold price did not follow this historical decline in real interest rates, contrary to the solid negative correlation between the gold price and yields, but merely moved sideways...



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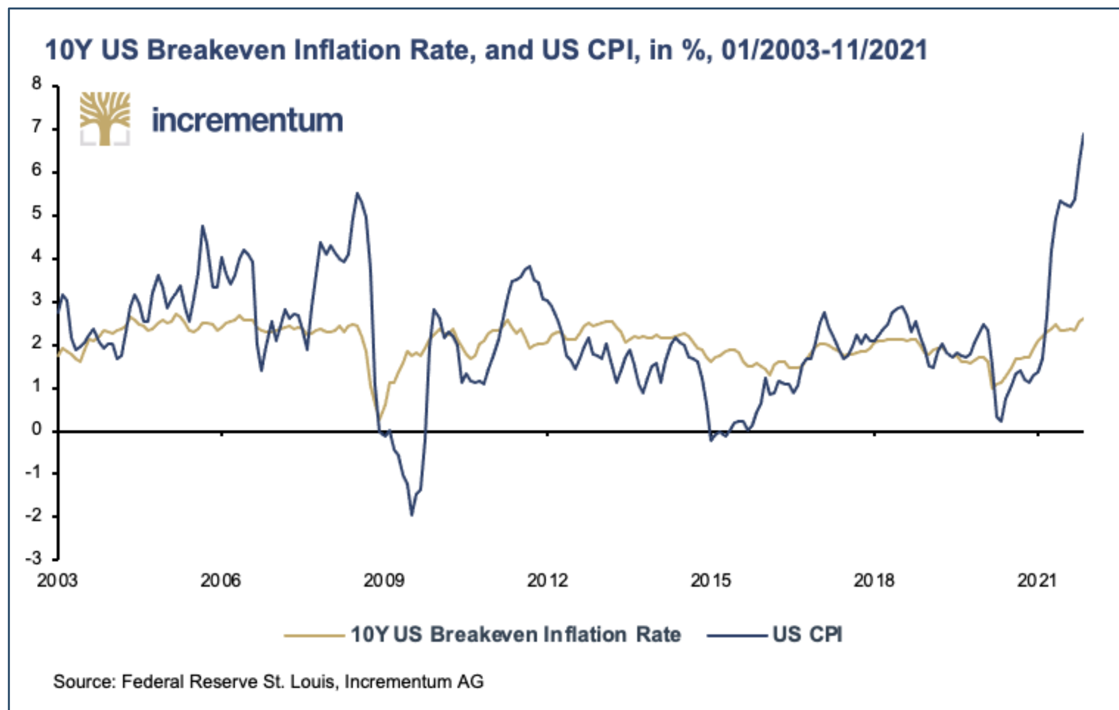
Has gold become irrelevant?

So, the question arises: has gold lost its central portfolio characteristic as an inflation hedge?

We do not think so. There are some good reasons for this year's disappointment.

1) After record gains in 2019 and 2020, gold had to take a deep breath: after two years of well-above-average gains of 18.9 percent and 24.6 percent, as well as a new all-time high in August 2020, gold had to consolidate. More so, as the huge 80 percent advance in gold from the August 2018 lows to the August 2020 top correctly signalled the 2021 surge in the CPI. Back in 2020, gold did exactly what it should do in a diversified portfolio. Gold was an excellent hedge against the multi-layered turmoil that hit the global economy because of the outbreak of the Covid-19 pandemic, with gold acting as a hedge against recession, stock market turbulence, rising inflation, and black swan events. Furthermore, gold demonstrated its ability to hedge against recessions, corroborating our analysis of this matter in the *In Gold We Trust* report 2019. To sum it up: Gold confirmed that it is the Virgil van Dijk of assets: always on hand when things get really hairy.

2) Long-term inflation expectations remain subdued: while inflation rates have picked up significantly, long-term expectations are still close to central banks' inflation targets. Global central bankers have been pounding the table that inflation will be *transitory*. Even though Jerome Powell recently revoked his assessment that the rise in inflation will be short-lived, the market still believes otherwise. In our opinion the market is most likely underestimating medium to long-term inflationary dynamics and at this point still is discounting a transitory inflationary environment.



Last year, we outlined our view of a structural change towards higher inflation in an, *In Gold We Trust* special titled, "*The Boy Who Cried Wolf: Is an Inflationary Decade Ahead?*". We have also made that case in numerous editions of our annual *In Gold We Trust* report. Ronald-Peter Stoeferle's keynote speech, "*The Monetary Tipping Point*", provides an update to this long-held contrarian view of ours, which is now becoming more and more mainstream.

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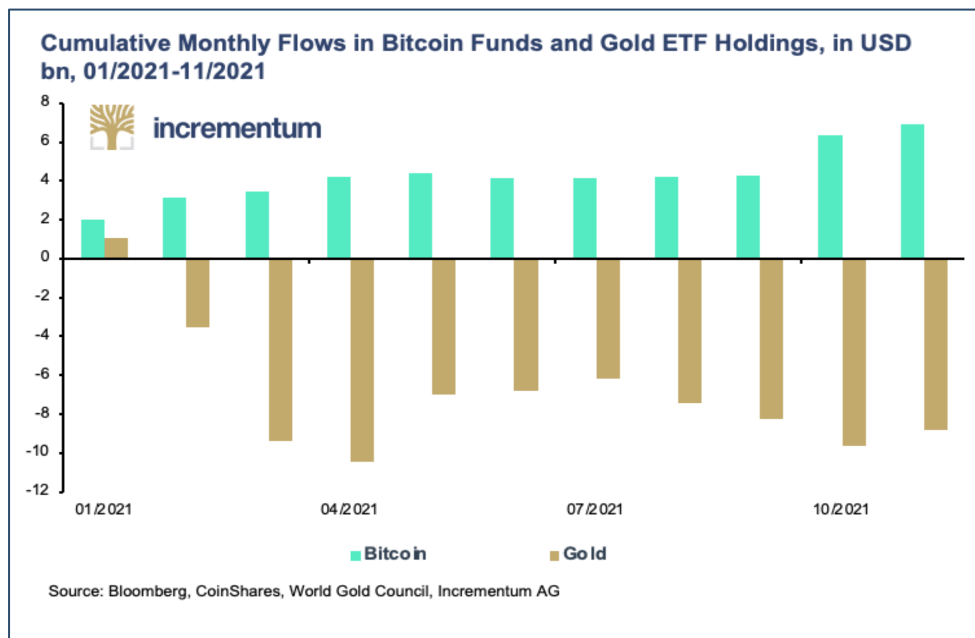
Record rises of producer prices around the globe support our view. Producer prices in the US are up 9.6 percent year-on-year, in China 12.9 percent, and in Germany a staggering 19.2 percent. Contrary to the mainstream view, inflation is not limited to energy prices, as more than 80 percent of CPI components have recorded an inflation of 2.5 percent or more. In addition, there are initial signs that the dreaded wage-price spiral has set in. Without doubt, base effects and pandemic-related one-off effects are currently driving inflation as well; but contrary to many statements from central bankers, even without these effects, inflation rates would still be well above target.

3) Crypto assets such as Bitcoin have attracted significant attention: in 2021 cryptocurrencies took a big step in the maturation process towards becoming a full-fledged asset class, as we discuss in our "*Bitcoin Chartbook 2022: Is This Halving Cycle Over?*", which was published mid-December 2021. At this point inflows into crypto products are significant. Bitcoin's market cap has reached roughly 10% of gold's market cap and cannot be ignored, even from the point of view of a pure gold investor. More and more traditional banks are offering services and products related to crypto assets; regulatory authorities are drafting or already implementing regulatory frameworks; and tax authorities are detailing the tax treatment of crypto assets. For crypto enthusiasts who jumped in early, these may be negative developments, but for the masses they are confidence-building signs.

   As a result of this maturation, Bitcoin ETFs saw inflows across the board in 2021, while US gold ETFs faced significant and sustained outflows.



When moving sideways is a success

Sometimes, a sideways movement is a success, as it was for gold in 2021. If you listen to the Nervous Nellies in the gold community, you might think that the gold price had collapsed by 50 percent or even more. However, when you widen the perspective, gold's performance over the past few months, which has fluctuated between USD 1,700 and USD 1,900 (see overleaf), seems like an interim breather, not the beginning of a bear market.

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Therefore, the sideways movement of gold should be interpreted in light of the fact that the gold price fended off further declines, defending its terrain despite several developments which were disadvantageous to gold.

- Tapering debate

  Market expectations were that the Federal Reserve's tapering would be the nail in the coffin for gold. It seems that gold agrees with bonds that the Fed's tightening will lead to market conditions that force additional money printing in the not-too-distant future. To put it differently, central banks will abandon the normalisation process when the inevitable consequences of even a slightly tighter monetary policy begin to play out on financial markets as well as in the real economy. We are quite certain that this will be the shortest and shallowest rate-hike campaign in the history of the Federal Reserve.

- USD appreciation

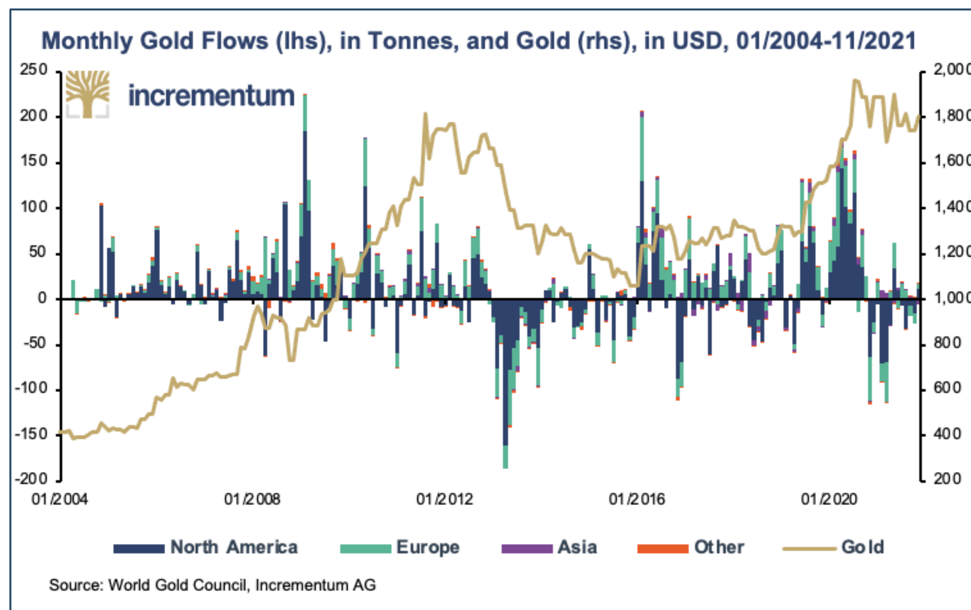
  Despite record-high inflation and money supply growth figures, as well as fiscal deficits of more than 10 percent of GDP in two consecutive fiscal years, the US Dollar has rallied since summer, as the Federal Reserve has taken the lead in tightening monetary policy from ultra-loose to loose. As a result, the US Dollar strengthened considerably, by more than 7 percent.

Can gold regain its mojo in 2022?

In 2022, gold should prove that there is life in the old dog yet.

- Investor demand

  Investor demand will tip the scales as it slowly but surely recovers from the dramatic setback caused by the Covid-19 pandemic. While investors in the US and UK continue to decrease their gold ETF holdings, demand from India, France, China, Hong Kong, Australia and Germany has been substantially positive in the course of 2021. Given the pro-cyclicality of investor demand, the slight upward trend of gold in recent months should generate more investor demand and could once more trigger a self-reinforcing upward spiral.



  Consumer demand appears to be on the verge of fully recovering from the sharp 23 percent drop in 2020. Germany and Austria, which have a strong fear of out-of-control inflation due to their respective traumatic historical (hyper)inflationary experiences, recorded twice as much consumer demand in 2020 as in 2019. This trend was confirmed in the first three quarters of 2021. In the US, consumer demand has also almost doubled in 2021 compared to 2019. China's consumer demand, the world's largest, has already overcome the massive slump of 2019 while India, which takes second place, is still well below the level of 2019 but significantly above the 2020 trough. All in all, Asia sets the tune as it now accounts for around 60 percent of global consumer demand.

- Central bank interest

  Central banks have remained net buyers of gold, despite the economic havoc caused by several Covid-19 waves and ensuing lockdowns. Nevertheless, net demand in 2020 was the lowest in ten years. In Q3/2020, net central bank demand was negative for the first time since Q4/2010. In 2021, net central bank demand recovered but is down a significant 20 percent from 2019 levels. The top buyers in the first three quarters of 2021 were diverse. In descending order, they were Thailand, Japan, India, Hungary, Brazil, Uzbekistan, Singapore, Kazakhstan, Mongolia, Cambodia and Poland. Poland, an EU member state, has confirmed its willingness to add another 100 tonnes to its gold reserves. This investment will boost Polish gold reserves by more than 40 percent. Ireland, a euro member state, has also increased its gold holdings for the first time in twelve years due to inflation fears.

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- Monetary policy will only tighten, from ultra-loose to loose

Several central banks have said farewell to their ultra-loose monetary policies. There is, however, no chance for central banks to raise interest rates significantly, as this course of action would endanger both the economic recovery and, most importantly, the financial viability of the highly indebted governments. In 2020, global public debt jumped by 19 percentage points to 99 percent of GDP, with global debt experiencing the largest surge in fifty years to 256 percent of GDP from 227 percent in 2019.

In the US, for example, the Congressional Budget Office (CBO) has calculated that even under a moderate increase in yields, interest service will rise from the current 1.4 percent of GDP to an unfinanceable 8.6 percent in 2051. In a further scenario considered by the CBO, which is still far short of extreme, interest service could reach 15.8 percent. So, financial repression – the regime of negative real interest rates – is here to stay.

Jerome Powell's announcement in mid-December 2021 that the Federal Reserve might raise interest rates three times in both 2022 and 2023, would translate into positive real rates only if inflation were to fall to no more than 1.5 percent. This prospect seems highly unrealistic.

More likely than a substantial increase of interest rates is that Austria will reach the final of the World Cup in Qatar at the end of this year, where it beats Germany 7–0.

- Stock-to-flow ratio (SFR) supports the case for gold – and Bitcoin

It's all about relative scarcity: M2 money supply growth has pulled back from a record high of 25 percent or more year-on-year but, with growth rates in the double digits, M2 growth is still well above the average growth rates of the last forty years. Compare these growth rates to the annual supply growth of gold and digital gold, i.e., Bitcoin, of 1.7 percent.

To put it differently, the stock of gold and Bitcoin is almost 60 times larger than the annual flow, that is, newly mined gold and bitcoins, which translate into a stock-to-flow ratio (SFR) of almost 60. In stark contrast, the SFR for M2 is currently less than 7, after a record low of slightly more than 5 in 2020. This huge difference between gold's SFR and that of the US Dollar – as well as those of all other fiat currencies – should support the gold price in the months and years to come...

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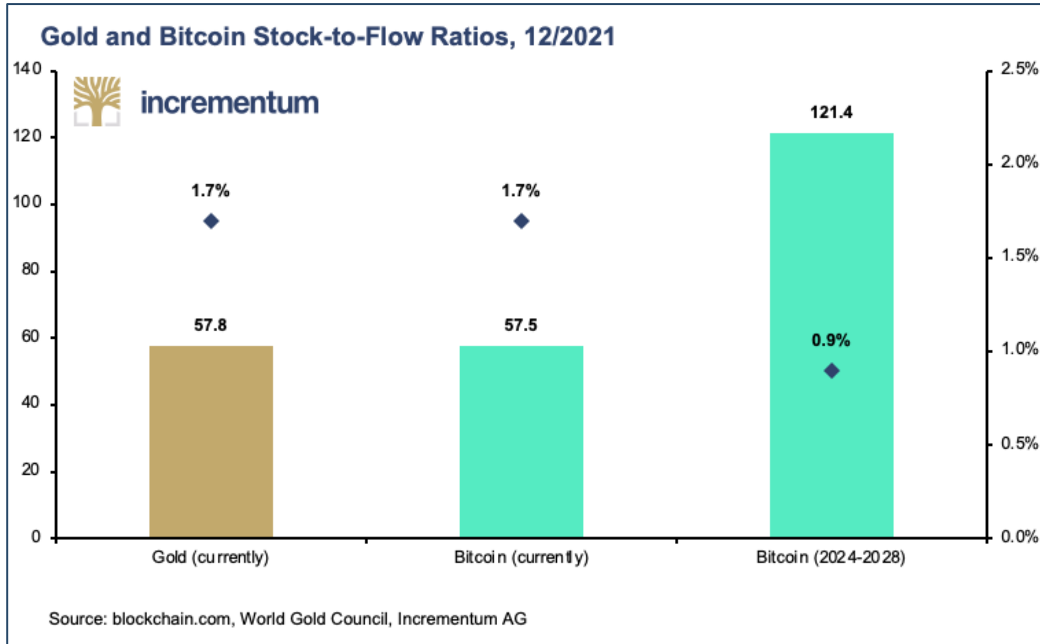
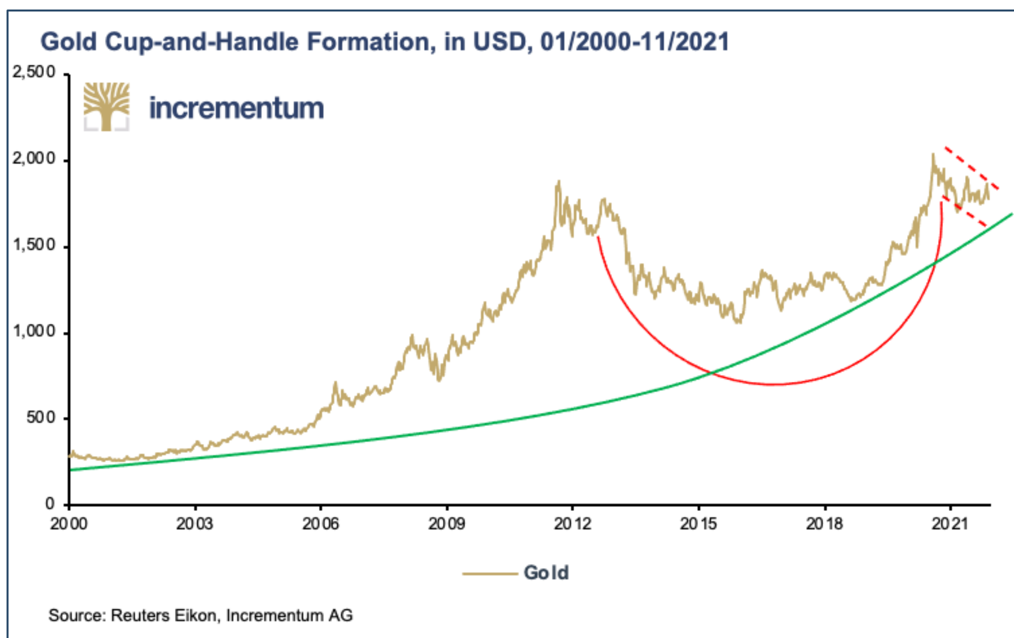


- Technical analysis supports bullish outlook

The long-term cup-handle formation, which could now soon be resolved, is particularly interesting.

The correction since August 2020 appears as the handle part of the formation. The price target can be estimated by measuring the distance from the right edge of the cup to the bottom of the cup and then extended further in the direction of the breakout area. Accordingly, the price target of the formation is around USD 2,700.



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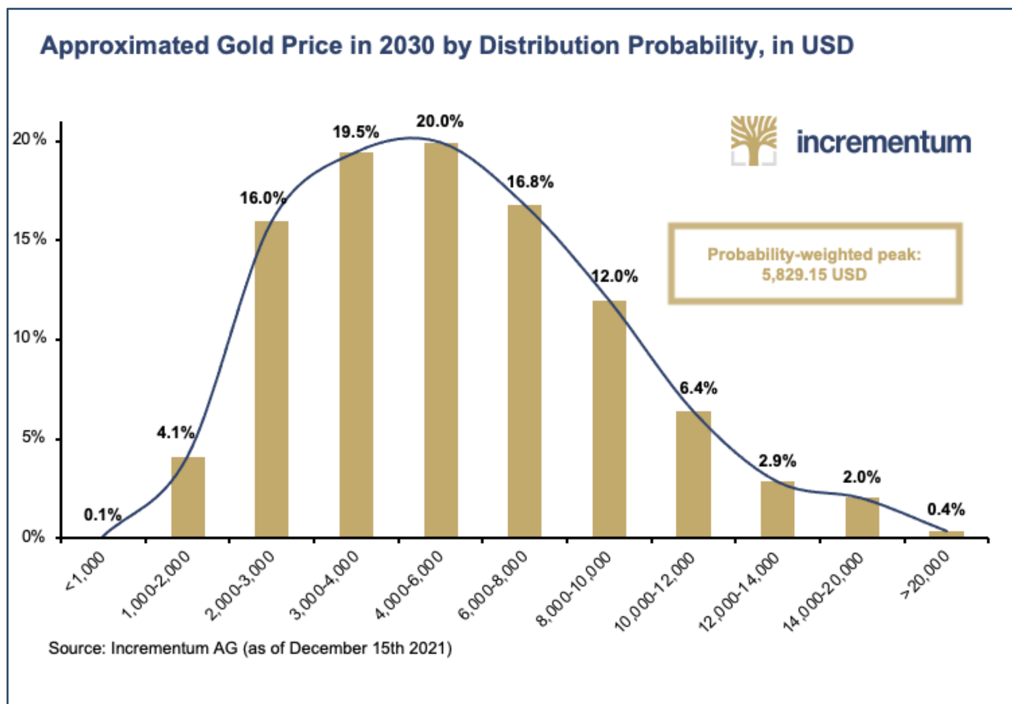
- The long-term perspective remains bullish

In our *In Gold We Trust* report 2020 we presented our proprietary valuation model. We use two parameters to calculate the gold price target, namely money supply developments and the implicit gold coverage ratio.

For the growth rate of the money supply in the coming decade we have drawn up three scenarios. We have used historical M2 growth rates from different decades – the inflationary 1970s, the disinflationary 1990s, and the 2000s – which experienced average growth rates of 9.7 percent, 3.9 percent, and 6.3 percent respectively. To each of these scenarios we assigned an estimate of their probability of occurrence: 15 percent for the first, inflationary scenario; 5 percent for the second, disinflationary scenario; and 80 percent for the "average" scenario represented by the 2000s.

The implicit gold coverage of a currency is calculated by valuing the central bank's gold reserves at the current gold price and relating them to the money supply.



If we now calculate a cumulative distribution function across all scenarios, the following picture emerges.

Our expectation for the gold price at the end of the decade is around USD 5,830, equalling to a CAGR of 15.8 percent. The distribution is clearly skewed to the right. This means that significantly higher prices are far more likely than lower ones. That our assumptions are quite realistic is corroborated by monetary developments since January 2020, which saw an annual growth rate of more than 17 percent.

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A word on mining stocks

So, gold's performance in 2021 was disappointing, but the performance of mining stocks was even more disappointing. In the last few years mining stocks failed to emancipate themselves from the gold price, as they were able to do in the long gold bull market that got underway at the beginning of the new millennium. Back then gold rose about 600 percent while the HUI posted a gain of 1,400 percent in less than twelve years.

However, the outlook for mining stocks is bright since, based on a wide range of indicators, mining stocks are inexpensive.

Mining Stocks (GDM) Are Inexpensive!

	S&P 500 Index	GDM Index
Price/Earnings	24.34	13.45
Price/Cash Flow	19.24	6.78
Price/EBITDA	14.82	5.89
Price/Sales	2.98	2.70
Price/Book	4.51	1.60
Ent. Value/EBIT	22.87	10.15
Ent. Value/EBITDA	16.58	6.37
Gross Margin	34.70%	41.49%
Operating Margin	14.50%	29.50%
Profit Margin	11.32%	19.10%
Return on Capital	8.44%	10.36%
Free Cash Flow Yield	3.36%	7.32%
Dividend Yield	1.38%	2.31%
Total Debt/Ent. Value	0.24	0.12
Total Debt/Total Equity	117.34	19.44
Total Debt/Total Assets	24.43	13.01
Net Debt/EBITDA	1.13	0.14

Moreover, there has been a spate of M&A activity recently, suggesting that the larger players see value in the smaller companies that own Tier 1 assets in safe jurisdictions. For example, Newcrest Mining acquired Pretium Resources at a 22% premium, and Kinross acquired Great Bear Resources at a 40% premium to Great Bear's 20-day VWAP.

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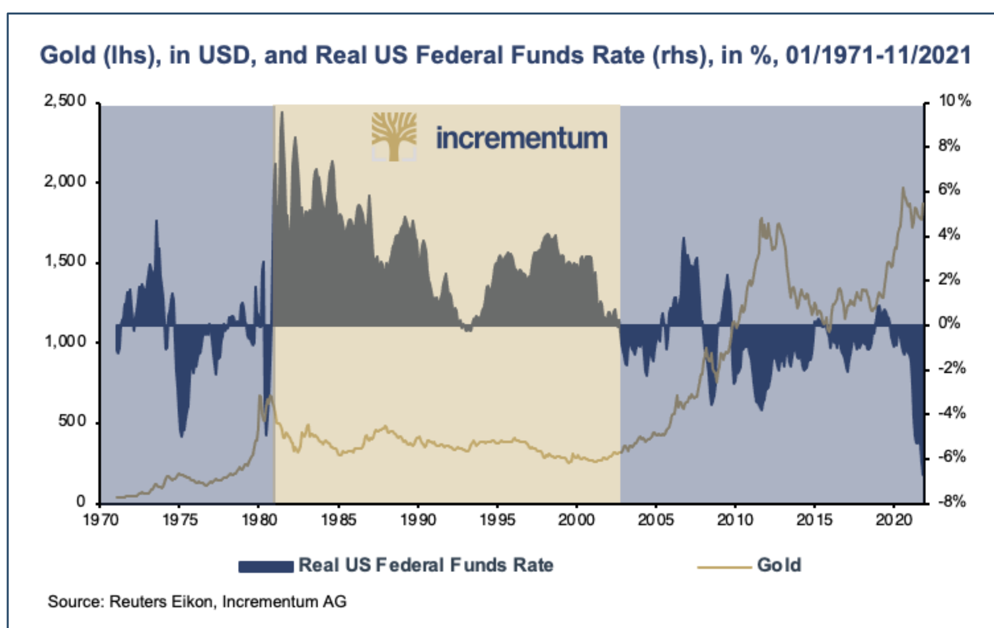
Conclusion

Wonderful one minute and rubbish the next – this emotional rollercoaster seems to be a characteristic of our times, and the public's view on gold is not an exception to the rule. In summer 2020, when gold marked a new all-time high above USD 2,000, gold was the asset par excellence. But just a few months later gold was considered an asset of the past. Neither of these emotional extremes does gold justice. Gold was, is, and will remain a solid defender in any investment portfolio, demonstrating its strength especially in times of economic turmoil. Gold displays its strength in the medium and long term; it is an insurance policy that will not disappoint policyholders. The case for gold remains more than solid.

In 2022, inflationary pressure will remain high as inflation has become a widespread phenomenon, supported by several fundamental changes – economically, politically, psychologically, and demographically. That does not mean that inflation rates will continue to rise but that the inflation level will remain elevated, i.e., (well) above central banks' inflation targets. In its most recent projection, the ECB has almost doubled its inflation forecast for 2022 to 3.2 percent, significantly higher than its symmetric 2 percent inflation target. And as long as the Covid-19 pandemic continues to affect daily life, further restrictions by governments to contain future Covid waves will create supply-side woes that fuel inflationary tendencies.

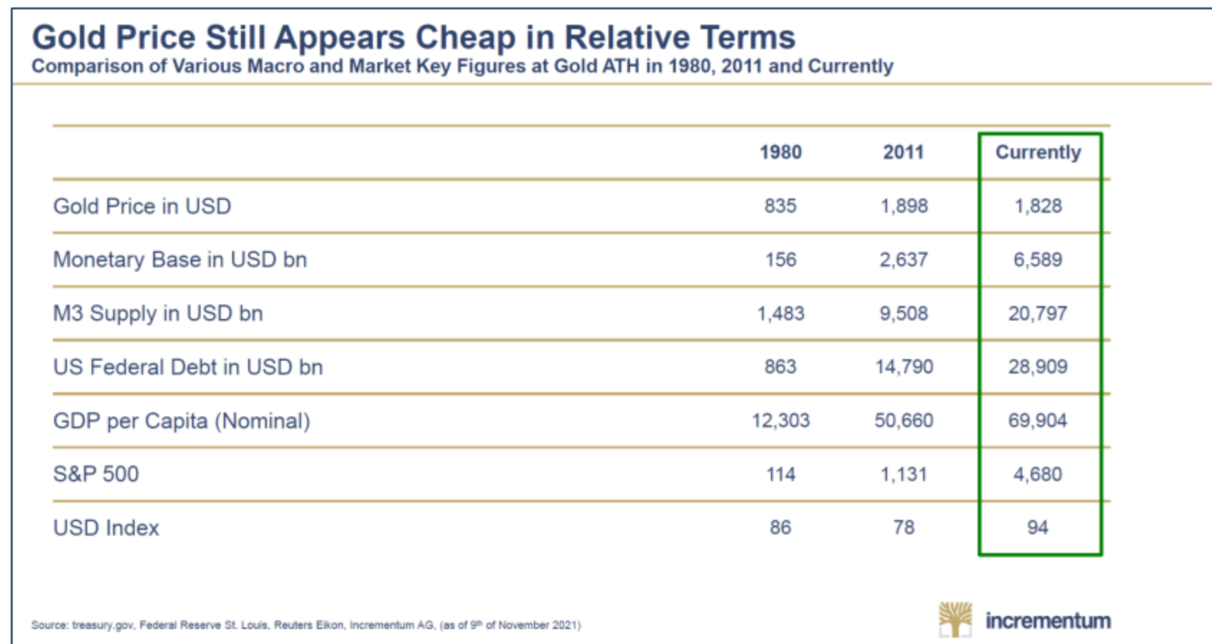
2022 will also turn into a turbulent year, not only because several central banks have announced that they will end their ultra-loose monetary policies soon, but also because stock markets all over the world are heavily inflated, with excessive money supply growth and government support programmes as the latest boosters. Only 2 percent of the time in history has the CAPE multiple been at today's 40x level or higher, and breadth has been lagging too, which is rarely an encouraging sign.

To bet against gold at this point is to bet that central bankers will actually be able to implement a less accommodative monetary policy and stay the course when, in response to tapering and rate hikes, markets plunge, interest rates rise, and the economy cools. Our take is that central banks will fail this test. As a result, real yields will remain in negative territory for much longer than even pessimists think. And as the following chart clearly shows, negative real yields are the foundation for every bull market in gold.



That gold is far from being an outdated asset was demonstrated by Palantir, a US data analytics software company, in August 2021. Palantir, a name taken from the fantasy novel *Lord of the Rings*, where *palantir* is a stone used for communication, bought USD 50mn in gold bars, probably as a hedge against black swan events that could significantly shake financial markets. The fact that Palantir is one of the best-connected companies in the world adds even more significance to this decision.

However, gold's potential lies not only in hedging against unforeseeable events. There is also a genuine investment case for gold, because compared to the all-time highs of 1980 and 2011, gold still appears cheap in relative terms. In fact, gold seems to be one of the very few undervalued assets out there at the moment.



Gold Price Still Appears Cheap in Relative Terms

Comparison of Various Macro and Market Key Figures at Gold ATH in 1980, 2011 and Currently

	1980	2011	Currently
Gold Price in USD	835	1,898	1,828
Monetary Base in USD bn	156	2,637	6,589
M3 Supply in USD bn	1,483	9,508	20,797
US Federal Debt in USD bn	863	14,790	28,909
GDP per Capita (Nominal)	12,303	50,660	69,904
S&P 500	114	1,131	4,680
USD Index	86	78	94

Source: treasury.gov, Federal Reserve St. Louis, Reuters Eikon, Incrementum AG, (as of 9th of November 2021)

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Two huge steps forward, one small step backward – that was gold’s rhythm over the last six years. If gold keeps this rhythm, 2022 and 2023 will indeed be golden years for gold.

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BACKGROUND

Raoul Pal has been publishing Global Macro Investor since January 2005 to provide original, high quality, quantifiable and easily readable research for the global macro investment community hedge funds, family offices, pension funds and sovereign wealth funds. It draws on his considerable thirty-two years of experience in advising hedge funds and managing a global macro hedge fund.

Global Macro Investor has one of the very best, proven track records of any research service in the industry, producing extremely positive returns in thirteen out of the last seventeen years.

Raoul Pal retired from managing client money at the age of 36 in 2004 and now lives in the tiny Caribbean Island of Little Cayman in the Cayman Islands.

He is also the founder of Real Vision Group a world-renowned financial and crypto media platform: **www.realvision.com**

Recently, in 2021, Raoul co-founded Exponential Age Asset Management: www.EXPAAM.com, which is a fund of hedge funds in the digital asset space.

Previously he co-managed the GLG Global Macro Fund in London for GLG Partners, one of the largest hedge fund groups in the world.

Raoul moved to GLG from Goldman Sachs where he co-managed the hedge fund sales business in Equities and Equity Derivatives in Europe. In this role, Raoul established strong relationships with many of the world's pre-eminent hedge funds, learning from their styles and experiences.

Other stop-off points on the way were NatWest Markets and HSBC, although he began his career by training traders in technical analysis.

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