In Gold we Trust 2015 – *Extended Version*

After the barely averted implosion of the financial system in autumn of 2008, we are now in the seventh year of world-wide central bank experimentation. We have all become guinea pigs of an unprecedented attempt at re-inflation, the outcome of which remains uncertain. Questionable monetary policy ventures like quantitative easing and negative interest rates are a **direct consequence of a systemic addiction to inflation**.

Authors:

Ronald-Peter Stoeferle, CMT
rps@incrementum.li
Twitter @RonStoeferle

Mark J. Valek, CAIA
mjv@incrementum.li
Twitter @MarkValek

All prices are closing prices as of June, 19th 2015

The global financial architecture remains in a fragile state. Disinflationary forces have dominated since 2011. The systemic instability between inflation and deflation – **monetary tectonics – culminated in a "disinflationary earthquake" in the second half of 2014, as all industrial commodities and every paper currency lost enormous ground against the US dollar.**

Widespread, chronic over-indebtedness is ratcheting up the pressure on monetary authorities to break the deflationary trend and finally generate rising price inflation rates. **Gold has always been the best hedge against excessive inflationary efforts.**

We are convinced that we are now close to a decisive fork in the road: the disinflationary trend will (have to) be broken. Rising price inflation rates are possible both in conjunction with a revival in economic activity and in a stagflationary environment. **In both cases, inflation-sensitive investments including gold and gold mining stocks will benefit.**

The majority of market participants have gradually abandoned all concerns over inflation in recent years. This is reflected in exceptionally low inflation expectations and the composition of investment portfolios. **The exit from the current "low-flation" phase could prove to be the "pain-trade" for most investors.**

From a technical perspective, the picture is not unequivocal. The downtrend hasn't been broken yet. However, pronounced negative sentiment indicates resignation among gold bulls. **We believe a final sell-off is possible**. During such a sell-off, the support at USD 1,140 could be tested. **A reversal following such a test would be a reliable indication of a primary trend change in the gold market**.

Based on the "big picture" analysis that is packed into this report, we see no reason for a change of course: ***In gold we (still) trust***. **We are firmly convinced that gold remains in a secular bull market that is close to making a comeback.**

We expect to see a final trend acceleration at the end of the cycle. We thus decided to set a time horizon of three years – June 2018 – for our long-term price target of USD 2,300 to be reached.

Table of contents

We would like to express our profound gratitude to our premium partners for supporting the "In Gold we Trust" report 2015

philoro EDELMETALLE

MÜNZE ÖSTERREICH

ABX Allocated Bullion Exchange

LPM GROUP

ÖGUSSA

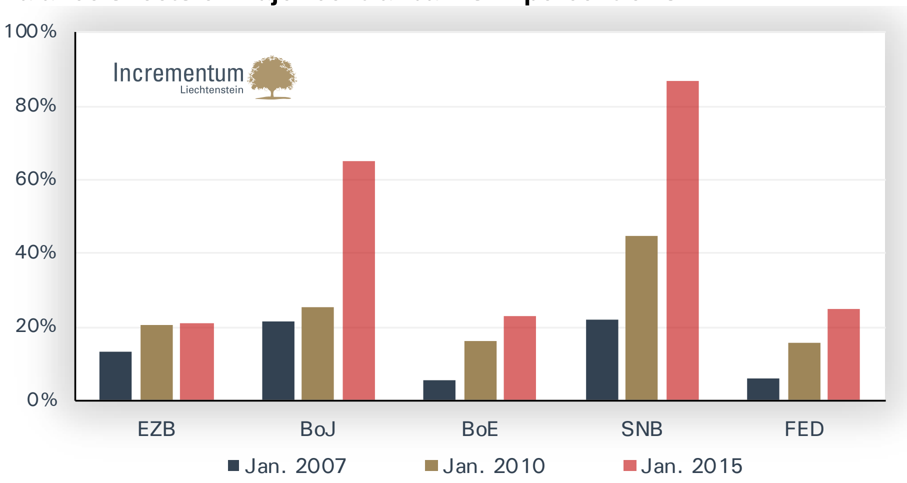
TOCQUEVILLE

1. INTRODUCTION

"Unconventional monetary policy" is now a standard procedure of central bankers

Since the narrowly averted implosion of the financial system in the fall of 2008, we are now in the 7th year of global monetary policy experimentation. Although the Federal Reserve stopped its "quantitative easing"[1] program last year, other central banks are now stepping into the breach. **On a global level, central banks will create more irredeemable money this year than ever before**.

Balance sheets of major central banks in percent of GDP



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

"What is seen as the evil of economic depression, is the materialization of the consequences of the artificial boom caused by credit expansion."
Ludwig von Mises

With the introduction of negative interest rates in what are supposedly hard currency areas, monetary policy has set yet another, hitherto unthinkable record. **This attack on the cultural heritage of money, which is justified with the goal of creating greater general prosperity, is clearly in conflict with any sort of economic common sense.** These policies are thus also contrary to our fundamental economic convictions, which are rooted in the Austrian School of Economics.

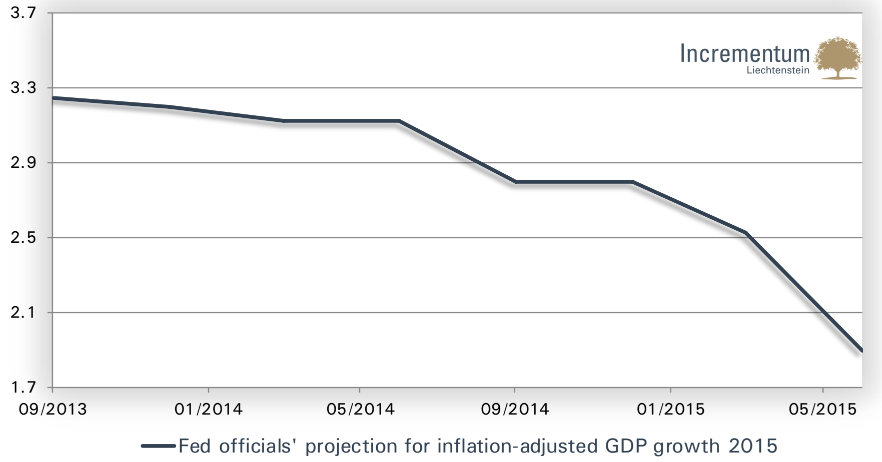
The promised self-sustaining recovery by means of magical monetary policy elixirs is again conspicuously absent this year - the situation is increasingly reminiscent of the comedy "Groundhog Day". It is noteworthy that the annual déjà-vu in terms of growth disappointments hasn't yet resulted in market participants recognizing that the nature of the crisis isn't cyclical, but systemic.

Growth expectations keep disappointing

It is therefore all the more astonishing that the loose monetary policy that has been practiced for seven years running now, is being copied everywhere. This is a case of a theory attracting all the more support the less it is able to withstand empirical testing. Thus economic output in the US declined by 0.7% in the first quarter vs. the same quarter of the previous year. **As can be seen in the following chart, growth expectations continue to disappoint.**

[1] The term "quantitative easing" in our opinion represents a euphemism that is strongly downplaying what in effect amounts to running the (digital) printing press.

Gradually decreasing growth expectations[2]



Sources: Bloomberg.com, Federal Reserve, Incrementum AG

Regular readers of this gold report, which has been published for the past nine years, already know that we believe that the examination of the current monetary system is central to any profound analysis of the gold market. In recent issues, we have in this context extensively discussed the struggle between deflationary and inflationary forces. **This conflict, which we have dubbed "monetary tectonics", is very important for investors.**

Monetary tectonics: disinflationary forces overwhelming in 2014

In said struggle, disinflationary forces have clearly had the upper hand since 2011. In the past 12 months, we were able to observe a textbook example of systemic instability – i.e., of monetary tectonics in action. The price of crude oil declined by more than half within just seven months. Many analysts have attributed this solely to underlying supply and demand factors, which is in our opinion a deficient explanation. All industrial commodities, as well as every paper currency, have lost enormous ground against the US dollar over the same time period. **In our current dollar-centric monetary system, this concurrent devaluation of all commodities is a disinflationary earthquake.**

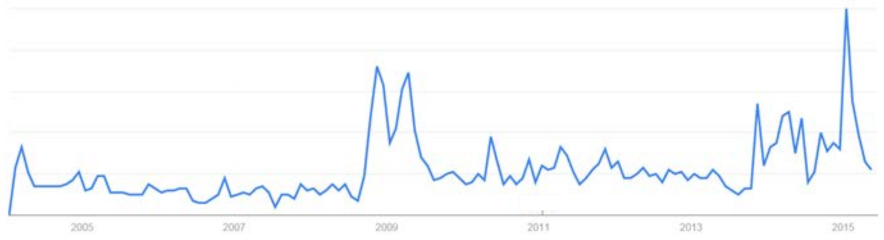
Excessive deflation phobia: the gold investors' best friend

As a consequence, the trend of slowing price inflation rates accelerated further and culminated in a bout of scaremongering propaganda in the media about the allegedly acute threat of falling consumer prices. Even in Germany, traditionally a stronghold of inflation concerns[3], a never before seen fear of deflation began to spread in early 2015. This successfully paved the way for a quantitative easing experiment amounting to EUR 1.14 trillion[4]. **As can be seen on the chart below, Germany-wide searches for the term "deflation" exceeded even the peak recorded in 2008.**

---

[2] Midpoint of central tendency amoing Fed officials' forecasts
[3] **The German Allensbach Institute ("Institut für Demoskopie Allensbach") has asked German citizens about their fears: Only the fear of becoming dependent on care is greater than the fear of inflation. Inflation scares Germans even more than illnesses like cancer, terror attacks, or unemployment!** (seen in: "Die große Geldschmelze", Hanno Beck und Aloys Prinz, p.170)
[4] The German term for "trillion" (i.e., "Billion") didn't even exist in the German language before the hyperinflation of the Weimar Republic in the early 1920s. For central banks it has however by now become the most important magnitude in monetary policy. Nikolaus Jilch, Die Presse

Google trends: Germany-wide searches for the term "deflation"



Source: www.google.de

"People are complaining about inflation, but they delightfully support political measures which can only be realized with the help of inflation"
Ludwig von Mises

In our last report, we wrote: ***"Should the inflation trend reverse, excellent opportunities in inflation-sensitive investments such as gold and gold stocks will emerge."*** Since then, the gold price has been able to hold up quite well despite the disinflationary tsunami; other inflation-sensitive assets – as was to be expected in such an environment – were sold heavily. From today's perspective, the portents for a turning point in the inflation trend have changed dramatically, *inter alia* because commodities are trading at much lower price levels in the meantime and base effects will affect price inflation rates even if commodity prices should stagnate.

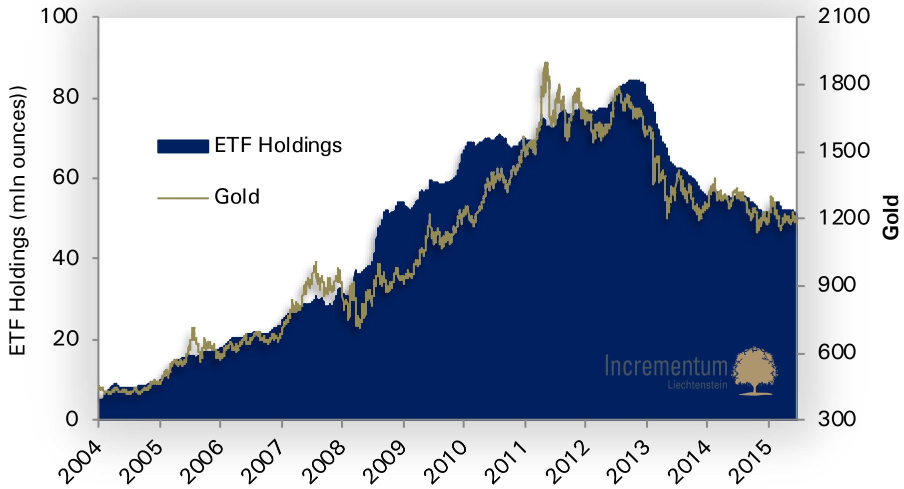
„The collapse of 2008 was ugly, until central banks put it on pause. They agreed to an unfathomable price in their Faustian deal with the devil. When the collapse resumes, it will make 2008 look like a dress rehearsal."
Dr. Keith Weiner

Considering how recent the monetary near-death experience of 2008 is, it is astonishing how quickly a "this time it's different" mentality has returned.[5] Since much of the speculation in the gold sector has evaporated in recent years – which can be seen in the large decline in ETF holdings – it now appears as though practically all market participants have lost faith in gold.[6] Similar to how many a *bon vivant* on his deathbed – this is to say, at that moment when his familiar world threatens to be obliterated – seeks his last refuge in God, a great many people became devoted disciples of gold during the last financial crisis, when the threat of systemic collapse loomed.

Since this danger seems to have been averted for the time being due to the life-supporting measures taken by central banks, gold is no longer seen as a necessity by these "disciples in extremity". **In this environment, a positive assessment of gold strikes many market participants as anachronistic, almost pitiable**.

[5] Thus the "financial stress index" published by the Federal Reserve Bank of St. Louis currently stands at minus 1, and with that at a similarly low level as in 2007.
[6] After strong outflows of nearly 900 tons in 2013 the exodus appears to have ended. For the first time since Q4 2012 net inflows into gold ETFs were recorded in Q1 2015.

Total ETF volume (in millions of ounces) vs. gold price



Sources: Bloomberg, Incrementum AG

The declining interest in gold is also reflected in the strong reduction of gold price volatility. The current market phase reminds us of a German saying that could be loosely translated as "tranquillity breeds strength" which is also applicable to financial markets.[7] Times of tranquillity are times in which strength is gathered prior to the emergence of a strong trend.[8] **Even though we did not expect such a long-lasting corrective phase, we definitely do not share the opinion of many analysts that a new secular gold bear market has begun in 2011.**

"The illusion of central bank control is in full force."
Dylan Grice

What is the reason for our unbroken confidence in gold? Our predilection for gold is primarily based on our understanding of monetary history. At the moment, it appears as though faith in the omnipotence and infallibility of central banks is at an all-time high. This goes hand in hand with new record highs in stocks and especially government bonds. According to Jim Grant, who describes **the price of gold as reciprocal of the credibility of central banks**, this is inter alia a likely explanation for the somewhat directionless performance of the yellow metal. Should the omnipotence of central banks be questioned by the markets, it could cause a fundamental change in perceptions and help gold regain its former respect and reach new heights.

"Time is the best teacher, but unfortunately, it kills all of its students."
Robin Williams

In addition, our analysis is reinforced by a comparison of the current situation with that of the last great bull market of the 1970s and how it ended. There is a fundamental difference: **back then, the Fed tried *to end* the trend of rising price inflation with restrictive monetary policy, today central bankers around the world are trying their best *to create* accelerating price inflation.** The stronger the systemic desire for rising prices becomes, the more creative and radical the actions of policymakers become in order to attain this goal.

[7] Even though this may try the patience of market participants used to the frantic short-termism of market events.
[8] See "Der Wellenreiter", Wellenreiter Invest, May 18 2015

"I do not hesitate to say that although the prices of many products of the farm have gone up […], I am not satisfied. ***It is definitely a part of our policy to increase the rise*** *and to extend it to those products that have as yet felt no benefit.* ***If we cannot do this one way, we will do it another. But do it we will****."*[9]

US president Franklin D. Roosevelt, October 23, 1933[10]

The constantly applied artifices of banking and currency policy have in the meantime become a necessity in order to artificially lengthen the lifespan of the fiat debt money system. Due to the latent potential of extreme money supply inflation, not just infinite credit growth, but also the associated rapid, sharp contractions thereof, it no longer represents a sound basis for the economy, but rather evokes connotations of an earthquake-prone region, in which a tectonic plate fault permanently threatens the achievements of civilization. **As a result, the economy has in the meantime degenerated into a political construct, in which the principal objective consists of anticipating exogenous interventions as well as possible and exploiting them for oneself.[11]**

It seems strange to us that after seven years of unconventional central bank policy, there is no debate as to whether these measures have any effect at all, resp. whether the situation wouldn't actually be better without QE.[12] The narrative of rising asset prices and a relatively painless way to supposedly sustainable growth is barely questioned.

"There are no limits to our policy tools...to completely overcome the chronic disease of deflation, you need to take all your medicine. Halfbaked medical treatment will only worsen the symptoms."
Haruhiko Kuroda,
Governor of the Bank of Japan

Unconventional monetary policy is justified by an emergency situation and is only temporary. Or is it not? How simple is the often-promised return to "monetary normality" really? In this context, Japan is an example that proponents of monetary policy experiments would rather not look at too closely. The country is a "model student" of highly aggressive monetary policy.[13] Zero interest rate policy has been de facto in place there for almost 18 years. Every attempt to hike rates came to grief within a few quarters and had to be rescinded again in embarrassment.

Japan thus demonstrates that the monetary policy measures held to bring salvation for many years already have failed, and an exit remains out of sight. Due to the zero interest rate policy, the government was able to amass such a huge amount of debt that a significant increase in interest rates has become illusory for good. If one asks Western monetary policymakers why the prescribed medicine has failed to have a sustainable effect in the land of the rising sun over the past two decades, the cynical explanation is that not enough of it has been taken.

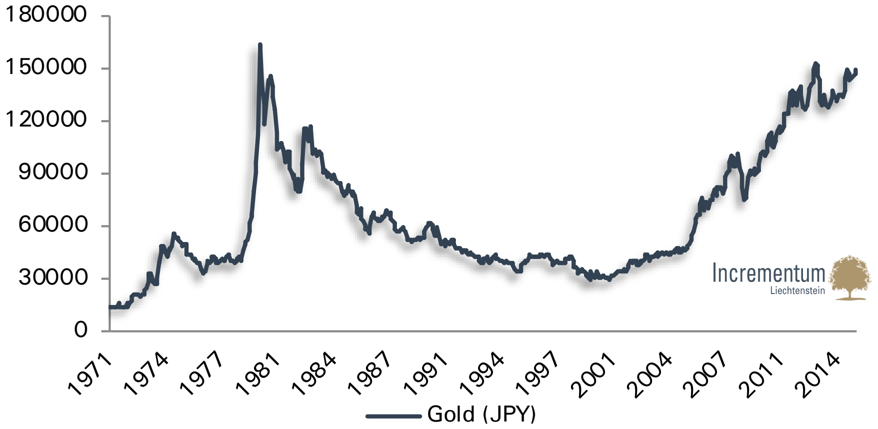
"There is a significant risk that this is going to end badly because the Bank of Japan is funding 40pc of all government spending. This could end in high inflation, perhaps even hyperinflation."
William White, former BIS Chief Economist

Should inflation expectations rise sustainably in the course of the aggressive reflation program, it has to be assumed that bank deposits will be withdrawn step by step and shifted into alternative investments. Japan's gold demand, which has already tripled last year from a very low level,

[9] See https://www.youtube.com/watch?v=kTe4paRPEM4 – FDR promises in a speech to turn around the deflationary forces by all means available, which he managed to do a few months later by revaluing gold by nearly 70% against the US dollar.
[10] Note: during the Great Depression in the 1930s a reversal in the deflationary trend could ultimately only be achieved by revaluing the gold price from USD 20 to USD 35.
[11] See "The Big Picture", Ritholtz.com
[12] We want to point to our explications further below here, resp. Frédéric Bastiat's essay "What is seen and what is not seen".
[13] See "In Gold We Trust 2014", chapter "Is Europe threatened by a Japanese scenario?" p. 41-43

increased significantly. **It is no coincidence that gold in yen terms is trading only slightly below its all time high. We are convinced that the gold price in yen terms will continue to rally significantly in the years to come.**

Gold price in JPY



Sources: Federal Reserve St. Louis, Incrementum AG

"The biggest bubble out there is central bank credibility. If Draghi was a stock he'd be on a P/E of 200! Yellen's on 100. When that bubble pops, all hell will break loose again, and there you really just want to be in cash."
Gerard Minack

The sweet, contagious poison of currency devaluation has now – after Japan – also spread to the euro area. The expectation of a European dose of monetary aphrodisiacs has on the one hand led to a sharp decline in the euro's exchange rate (from USD 1.40 to USD 1.04), as well as to a rally in European stock markets and a (final?) once-in-a-century rally in government bonds. We find this reminiscent of a classical crack-up boom. It gives us pause that the temporary, weak economic recovery resulting from the devalued currency tends to be lauded and is barely criticized. **If the debasement of a currency could promote wealth and prosperity, Zimbabwe and Venezuela would have to be at the top of the world's economic rankings and Switzerland at the bottom. As is well known, the exact opposite is actually the case.**

"If you don't own gold, you know neither history nor economics."
Ray Dalio

Readers of our annual report know that we analyze gold primarily as a monetary asset and not as a commodity. In our ninth "In Gold we Trust" report, we will therefore once again take a sober look at the big picture and analyze the gold sector in a holistic manner. We can already pre-empt the conclusion at this juncture: **The competitive position of gold relative to paper money and other asset classes has improved considerably in recent months.**

2. WHERE THINGS STAND

"Every dollar printed is a government tax on cash balances."
Frank Hollenbeck

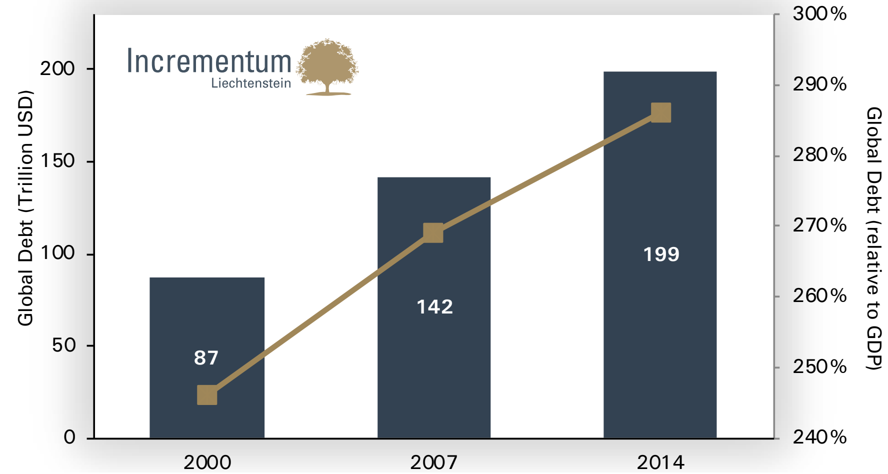
The bear market in the gold price has lasted four years already. *Chrysophiles,* i.e., friends of gold, didn't have much to laugh about in this time period. In 2011, our long term gold price target of USD 2,300 per ounce, which we formulated in 2007, appeared conservative, indeed almost pessimistic compared to the targets of other houses. We have however maintained this long term target in spite of falling prices, even though mainstream analysts have since then competed in undercutting each other with ever lower price targets. At the beginning of our report we therefore want to provide orientation by looking at where things stand, and by critically assessing whether our diagnosis has been wrong, or whether a structural change in the market climate can in the meantime be discerned.

a) Status quo

As a market-chosen medium of exchange, gold is the antithesis to paper money. Debts are claims on future paper money payments. **A brief glance at the overall debt situation already reveals that the foundations of the global economy haven't become more sound, but rather more fragile in recent years.**

"History shows that once an enormous debt has been incurred by a nation, there are only two ways to solve it: one is simply to declare bankruptcy – repudiate the debt. The other is to inflate the currency and thus to destroy the wealth of the ordinary citizen."
Adam Smith

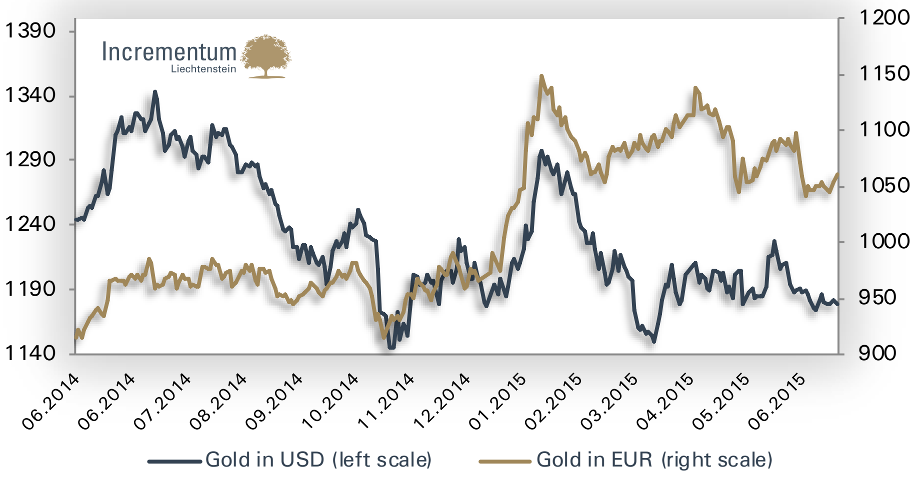
Total global debt in billions of US dollars (left hand scale) and in % of economic output (right hand scale)



Source: McKinsey

What is in our opinion quite remarkable is the current divergence between the actual gold price performance and the largely negative perception of many market participants. The reason for this is probably that attention is primarily paid to the gold price in USD terms. While gold moved sideways in dollar terms last year, the bull market resumed or continued in nearly every other currency.

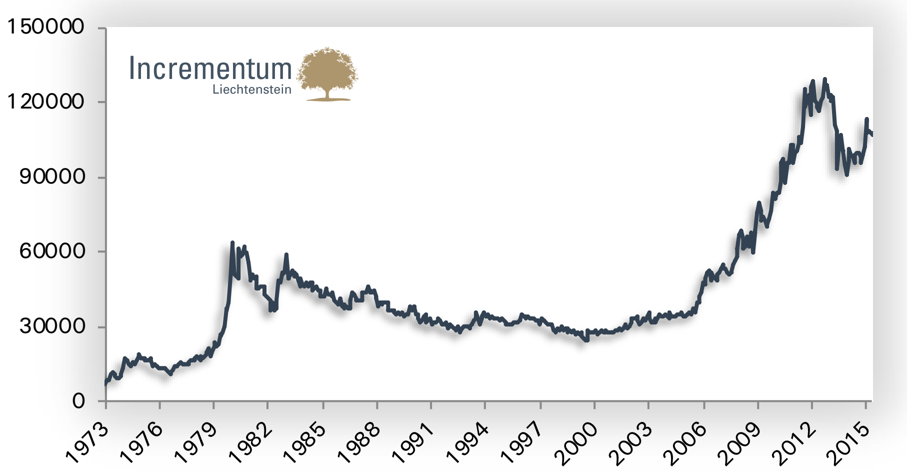
Gold in USD and EUR since the last Gold Report



Sources: Federal Reserve St. Louis, Incrementum AG

The following chart shows the global gold price. This chart expresses the gold price not in US dollars, but in the trade-weighted external exchange value of the dollar. It appears as though the correction has ended and the gold price has entered a new uptrend in the autumn of 2014.

Global gold price back in an uptrend since autumn 2014



Sources: Federal Reserve St. Louis, Incrementum AG

The prevailing divergence between perception and actual price performance can also be discerned in the table below. Last year, gold exhibited a negative performance solely in dollar terms. With a decline of 1.5% the loss was however quite moderate in the face of a historic dollar rally. One can also see that in euro terms a gain of 12.10% and in yen terms a gain of 12.30% was achieved. On average, the performance in the currencies under consideration here amounted to a solid 6.16%. **Since the beginning of the year 2015, gold has done very well, too.**

Gold price performance in various currencies since 2001

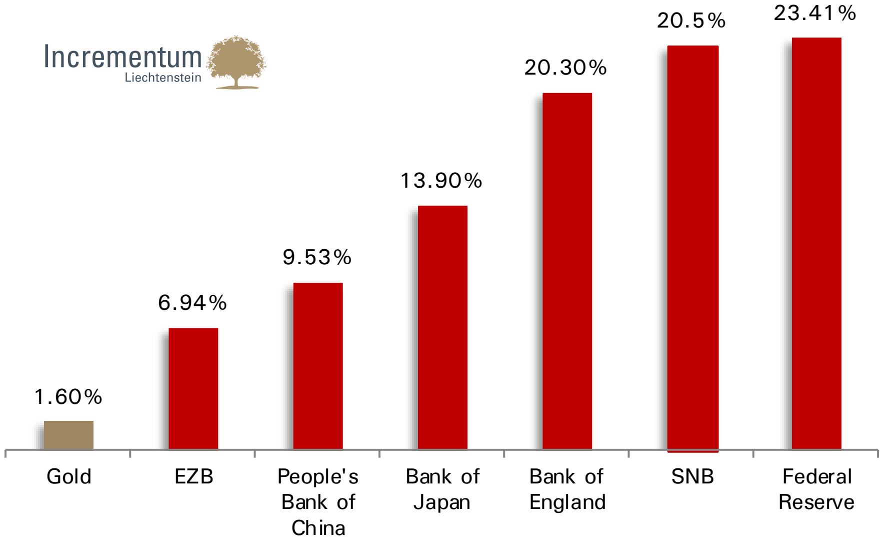
	EUR	USD	GBP	AUD	CAD	CNY	JPY	CHF	INR	ø
2001	8.10%	2.50%	5.40%	11.30%	8.80%	2.50%	17.40%	5.00%	5.80%	**7.42%**
2002	5.90%	24.70%	12.70%	13.50%	23.70%	24.80%	13.00%	3.90%	24.00%	**16.24%**
2003	-0.50%	19.60%	7.90%	-10.50%	-2.20%	19.50%	7.90%	7.00%	13.50%	**6.91%**
2004	-2.10%	5.20%	-2.00%	1.40%	-2.00%	5.20%	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 YTD	8.02%	1.53%	-0.50%	6.70%	7.40%	1.50%	3.80%	-6.20%	2.00%	**2.69%**
Average	**10.31%**	**11.86%**	**11.50%**	**8.56%**	**9.77%**	**9.27%**	**11.81%**	**7.36%**	**13.57%**	**10.45%**

Sources: Incrementum AG, Goldprice.org

"It is the nature of inflation to give birth to a thousand illusions."
Henry Hazlitt

The next chart depicts the annual growth rate of central bank balance sheets since 2008. It can clearly be seen that the ECB has pursued a comparatively restrictive monetary policy since 2008 – which is however changing radically now with the implementation of "QE". China's central bank was likewise somewhat restrictive, at least on a relative basis, with an annual inflation of "only" 9.5%. The most aggressive inflationary policy since 2008 has been pursued by the Federal Reserve, closely followed by the Swiss National Bank. By comparison, the stock of gold has grown by only 1.6% per year. This clearly underscores the relative scarcity of gold versus fiat currencies.

Annualized rate of change of central bank balance sheets vs. annual change in the stock of gold (2008-2015)



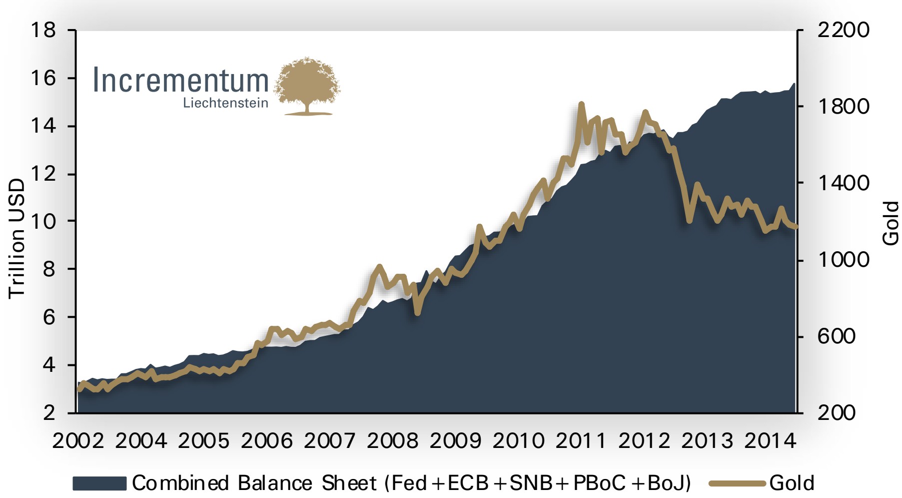
Sources: Datastream, Bloomberg, Incrementum AG

"It is essential to move away from debt as the main engine of growth."
BIS, Annual Report

The following chart shows that since 2011, the trend in money supply growth rates and the gold price are diverging. The money supply is measured by combining the balance sheet totals of Federal Reserve, ECB, SNB, People's Bank of China and the Bank of Japan. **When money supply growth exhibits a greater momentum than the growth in the physical stock of gold, the gold price should rise and vice versa.** The divergence evident in the chart therefore either points to the fact that the gold price correction has gone too far, or that central bank balance sheets will stagnate, resp. decline in the future. **Anyone who has studied economic history knows how few precedents of sustained declines in central**

bank balance sheets have occurred to date. Consequently, it is to be expected that the gold price will correct the divergence by rallying.

Combined balance sheet totals Fed+ECB+SNB+PBoC+BoJ in USD billion (2002-2015)



Sources: Bloomberg, Datastream, Incrementum AG

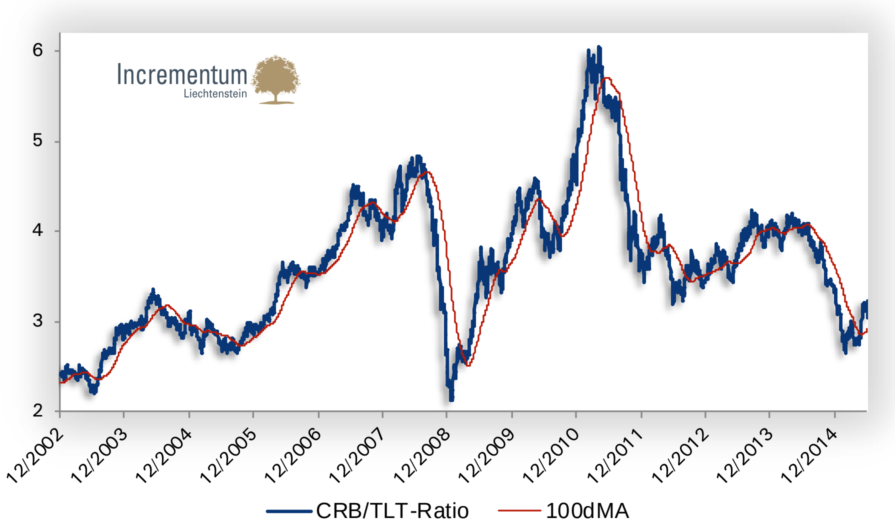
"The time is coming (when) global financial markets stop focusing on how much more medicine they will get (QEs) and instead focus on the fact that it does not work."
Russell Napier

As we discussed in great detail last year[14], the *trend* of the rate of change in price inflation is a decisive factor for the gold price. Since the end of 2011, disinflationary forces have had the upper hand. In the wake of a disinflationary earthquake we have experienced over the past 12 months, inflation-sensitive asset classes have been sold heavily. In the meantime, the situation appears to be slowly changing again. The following chart shows the ratio between the CRB Index (proxy for commodities) and TLT (an ETF representative of long-term US treasury bonds).

Is a change in trend in the works? Currently it can be seen that commodities are for the first time in a long time exhibiting relative strength versus bonds again, and the ratio has risen above its 100-day moving average.

[14] See: "In Gold we Trust" 2014, p. 16-32

CRB/TLT ratio and 100-day moving average

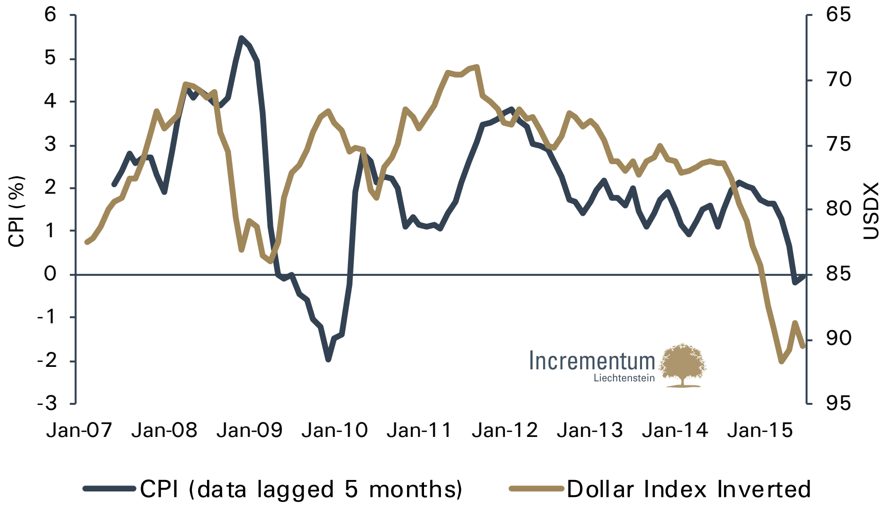


Sources: Bloomberg, Incrementum AG

Strong Dollar = Deflationary in US-Dollar centric monetary system

The strong performance of the US dollar naturally exerts a dampening effect on price inflation in the US. This can be seen in the following chart. One can observe a time lag of approximately five months. Currently this indicates that the recent bout of weakness in the dollar should increasingly be reflected in the form of rising price inflation over the coming months.

CPI vs. dollar index: Strong dollar has a deflationary effect

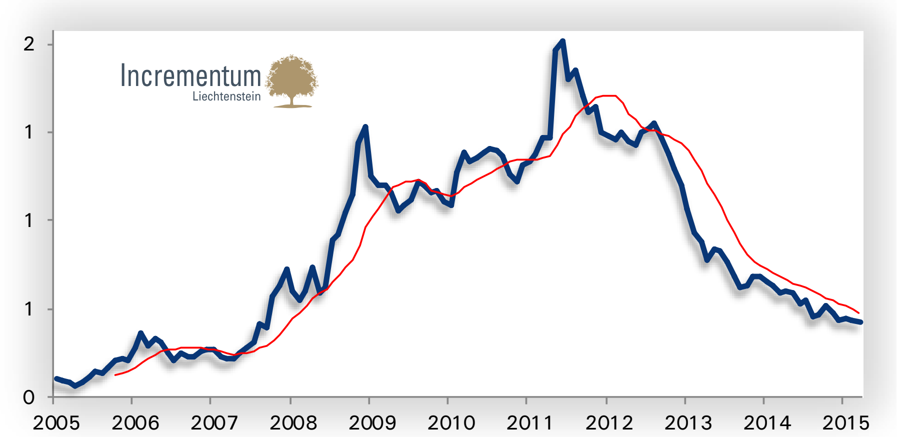


Sources: Federal Reserve St. Louis, Incrementum AG

Disinflation helping stocks, hurting gold

If one compares gold to stocks, it can be seen that gold exhibited relative weakness versus US stocks since the autumn of 2011. However, it appears now that the intensity of the trend is decreasing and the ratio is forming a bottom. Moreover, it is evident that strong deviations from the moving average overlaid in red (such as e.g. in 2011, when the spread amounted to nearly 20%) represent a reliable signal that relative performance has been excessive.

Gold/S&P500-Ratio (monthly)



Sources: Federal Reserve St. Louis, Incrementum AG

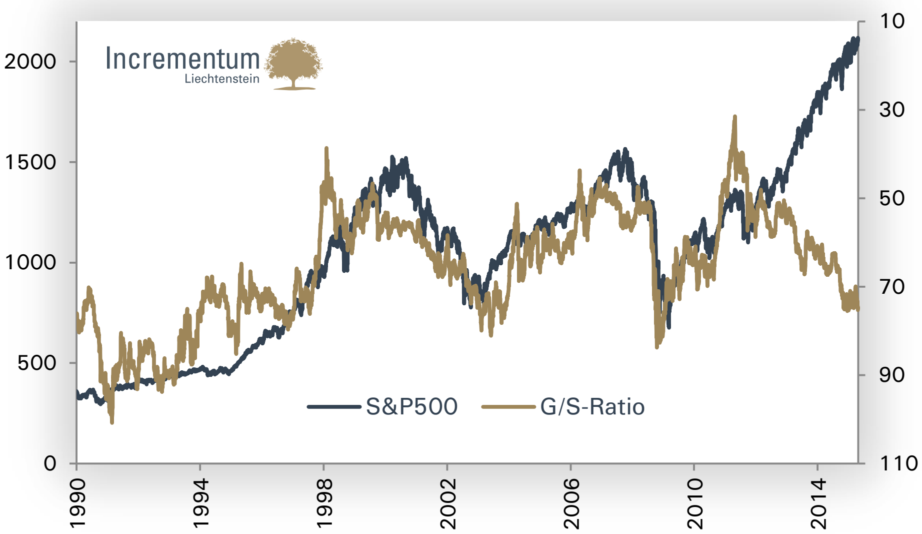
2011 turning point of inflation trend was crucial for investments!

Looking at things from the perspective of price inflation momentum is also highly interesting in this context. Disinflationary forces have provided an enormous tailwind to financial assets since 2011, which is especially obvious in relation to the gold-silver ratio. Thus, there has been an astonishing synchronization since the beginning of the 1990s: a rising stock market most often coincides with a declining gold-silver ratio, i.e. with silver outperforming gold.

Gold-Silver ratio not in sync with equity markets

One possibility to explain this phenomenon is that in previous economic cycles, re-inflation was accomplished with conventional monetary policy and thus credit expansion by commercial banks. This affects the real economy more quickly and fosters consumer price inflation. This time, re-inflation was attempted by means of central bank securities purchases, which led specifically to price increases in investment assets, but wasn't able to spur consumer price inflation.

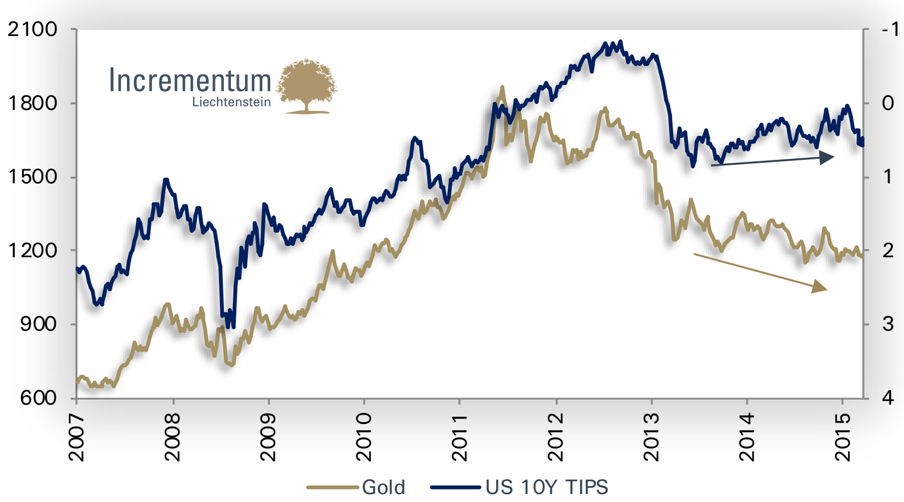
S&P 500 (left hand scale) vs. gold-silver ratio (right hand scale, inverted)



Sources: Bloomberg, Incrementum AG

If one compares the gold price to real yields of 10 year TIPS, one can see that the latter have lately begun to price in slightly declining real yields again, even if the lows in real yields haven't been reached. Declining yields or rising price inflation rates would accelerate this trend again.

Gold (left hand scale) vs. 10 year TIPS (right hand scale, inverted)



Sources: Federal Reserve St. Louis, Incrementum AG

"The causes of all panics, crashes and depressions can be summed up in only four words: the misuse of credit."
Ludwig von Mises

Differentiating between a bull market and a bubble evidently presents difficulties to many market participants and observers. In the past years, one has often read about an allegedly "crowded trade" in gold. However, are these Cassandra calls really justified? If one looks at the facts, the scaremongering is soon put into perspective. **Comparing the market capitalization of gold and silver with that of other asset classes, it becomes clear how underrepresented the precious metals sector is.**

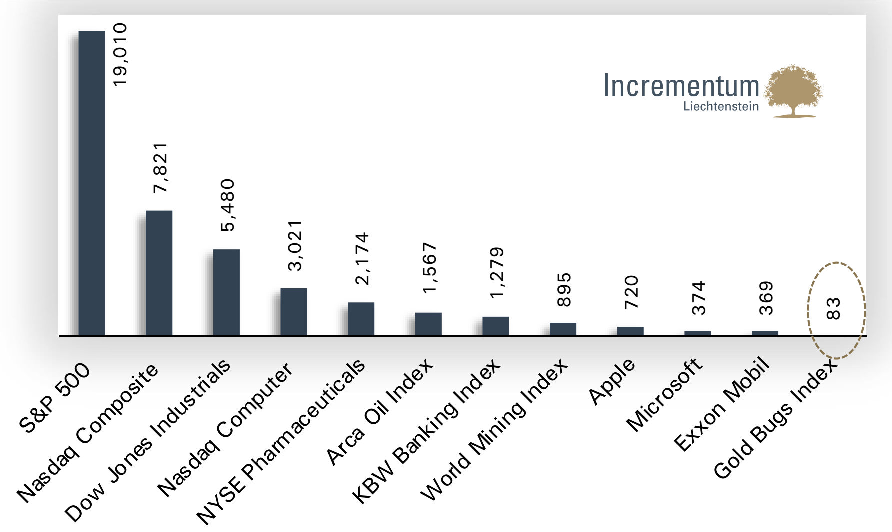
The global financial system edifice: how gold and silver are valued compared to other asset classes (in USD bn)

	USD bn.
Total global debt	199,000
Total global bond market capitalization	139,000
Money supply (World Bank 2013)	94,913
Total global equity market capitalization (June 2015)	73,022
US-private real estate holdings (2014)	23,538
Market capitalization of total above ground gold (2014)	6,998
Market capitalization of private and central bank gold holdings	2,598
Total market capitalization of all silver ever mined(2014)	846
Market capitalization of Apple (June 2015)	740
Total market capitalization of all silver ever mined excl. consumption	427
Total gold mined 2014	118
Total market capitalization of largest 16 gold miner (HUI)	83
Total silver inventory 2014	39
Total silver mined 2014	14

Sources: Silberjunge.de, Bloomberg, Reuters, BIS, World Federation of Exchanges, CPM,WGC (Silver: USD 16.05, Gold: USD 1,182)

A glance at the market capitalization of gold mining companies shows a similar valuation discrepancy. Currently the Gold Bugs Index, which includes the 16 largest unhedged gold producers, is valued at a mere USD 80 billion. Compared to the S&P 500, this market capitalization is tiny, it amounts to a mere 0.4% of the index.[15] **The market capitalization of Apple alone is almost 820% higher than that of all components of the Gold Bugs Index combined.[16]**

Market capitalization of US indexes, individual stocks and gold stocks compared (USD bn)

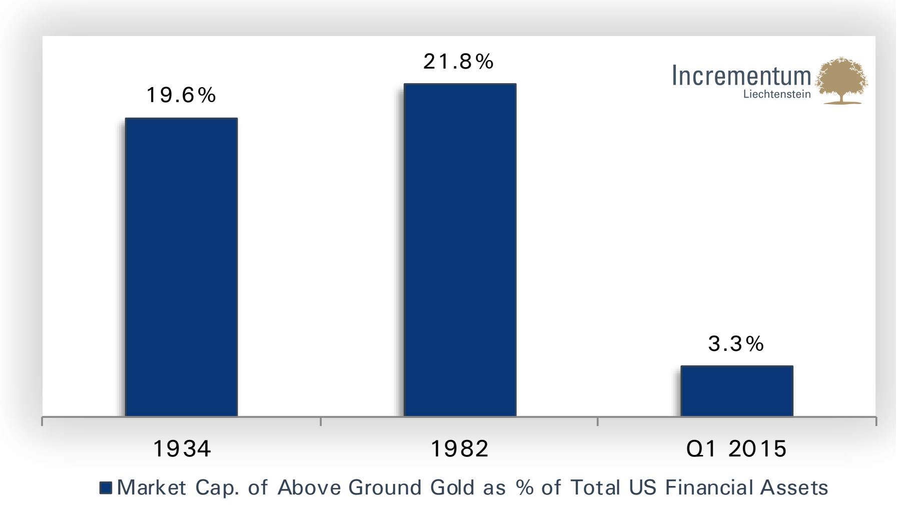


Sources: Bloomberg, Incrementum AG

A historical comparison between the value of the global stock of gold and US financial assets also confirms this assumption. Currently, the value of all gold ever mined – i.e., approx. 180,000 tons – amounts to only 3.3% of the value of all outstanding US financial assets. **In 1934, the existing gold stock at the time amounted to 19.6% of the value of all US financial assets, and in 1980 to 21.8%.**

[15] As of May 20
[16] Indeed Apples cash pile, which currently sits at approximately USD 194 bn., would be enough to buy outright, every gold mining company in the HUI Gold Bugs more than twice over.

Market capitalization of the global stock of above ground gold in % of the value of all outstanding US financial assets[17]



Sources: Tocqueville Asset Management

b) Reasons for the current correction in the gold price

"Gold always does what it should do… it just never does it when we think it should."
Richard Russell

Since the publication of our last report on June 24, 2014, gold price performance has been mediocre, in USD terms at least. As our price target of USD 1,500 was clearly missed, we have to admit that we were wrong and have to engage in self-criticism. **Freely paraphrasing Nassim Taleb, the failure of a forecast to materialize is not necessarily a proof of its incorrectness, but only of its failure to materialize**. We analyze below the reasons that led to the gold price trend being weaker than we had expected.

In our opinion, the decisive factors for the weak trend are, resp. were, the following:

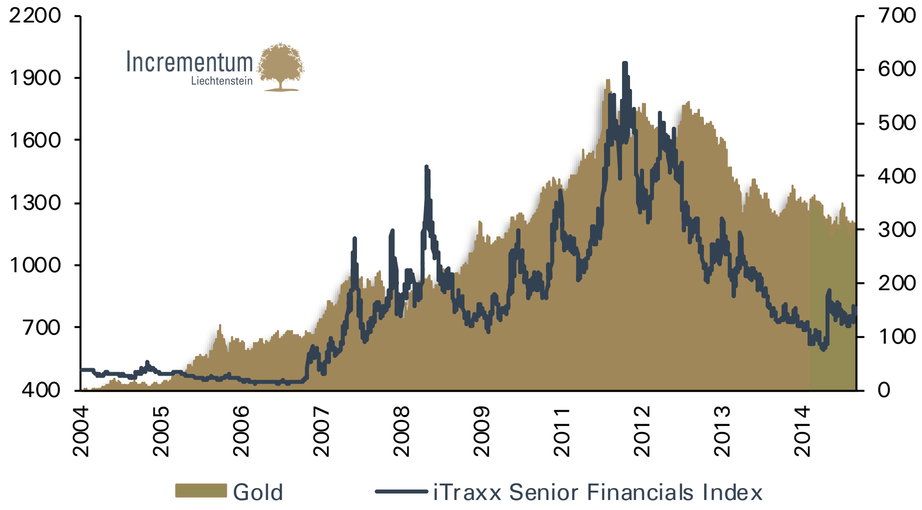
- **Strong disinflationary trends and the associated increase in real interest rates**[18]
- **Partly declining money supply growth rates,** resp. slowing momentum in the increase of the money supply (due to tapering by the Federal Reserve)
- **Rising opportunity costs** as a result of the rally in stock markets
- **Tightening credit spreads**
- Analyst estimates were revised lower (inter alia by Goldman Sachs, Credit Suisse, Société Générale,...)
- **Flattening of the US yield curve** due to rising expectations of a Fed rate hike
- **Continued strong faith in the ability of central banks** to keep things under control

[17] Ratios are based on US total financial assets of ~ USD 205 trillion and market value of above ground gold of USD 6.7 trillion as of 3/31/15.
[18] Whereby it should be pointed out that real interest rates of course remain in negative territory.

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
Mark Twain

The next chart illustrates the correlation between the gold price and CDS spreads of financial institutions (insurance premiums for default risk). The confidence of market participants in the stability of financial institutions is almost back at pre-crisis levels. Recently, CDS spreads have however jumped to higher levels again, and could therefore signal that a renewed period of declining confidence and associated liquidity squeezes could be in store.

Gold (left hand scale) vs. iTraxx Senior Financials Index (right hand scale)



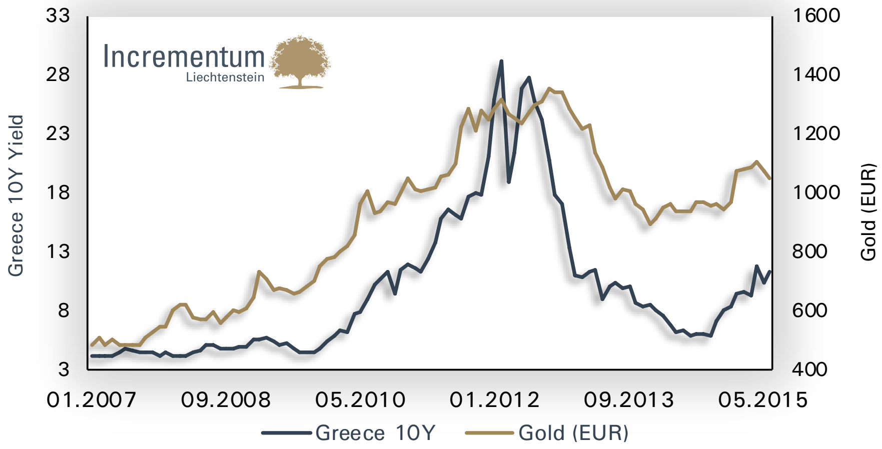
Sources: Erste Group Research, Incrementum AG, Bloomberg

Moreover, as the next chart reveals, the gold price remains under pressure from (temporarily) increasing confidence in the euro zone. The fact that less importance has been attached to systemic risks in the euro zone in recent years is also confirmed by the following graph. It appears as though Greek government bonds might be a useful proxy for the break-up of the euro zone. It can be seen that the probability of this is perceived to have increased again since 2014.

"The Euro was supposed to be the manifestation of a grand political project. It feels more like a loveless marriage, in which the cost of breaking up is the only thing keeping the partners together."
The Economist

However, opinions on the ongoing "Greek tragedy" are divided: Some market observers argue that the euro zone might even benefit from a Greek exit from the euro, while others feel that since a Greek exit would prove that euro membership is not "irreversible" (contrary to often repeated official claims), it could mean the beginning of the end of the common currency. It is not possible to predict with certainty which camp will turn out to be correct. **Moreover, it is clear that the EU will go to great lengths to prevent a Greek exit.**

Yield on 10 yr. Greek government bonds vs. gold in euro terms



Sources: Incrementum AG, Federal Reserve St. Louis

c) The lifecycle of the international monetary order

„We're all Keynesians now."
Richard Nixon

The evolution of national and international monetary orders is immensely important in economic history. In the course of the past 150 years, the international financial architecture has changed fundamentally several times. The classical gold standard of 1870 – 1914 was replaced by a chaotic interwar order with a gold exchange standard. This was followed by the Bretton Woods agreement, the foundation of the post-war order.

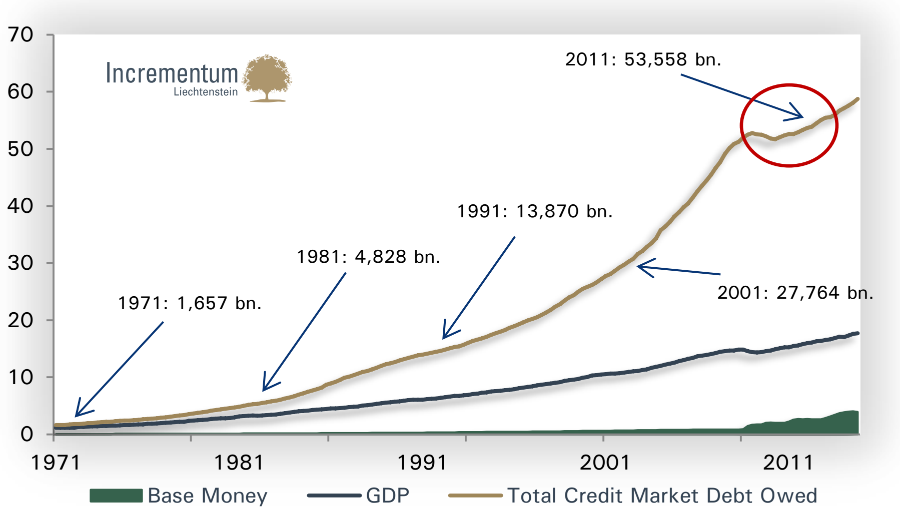
"Our monetary system is lurching from crisis to crisis, on its way to collapse. Debt is growing out of control, rising at an exponential rate… The problem is that the dollar is irredeemable. It's an IOU. An IOU cannot extinguish a debt, only shift it. The interest can't be paid off either, so it accumulates. Every year, the debt grows by at least the accrued interest."
Keith Weiner

The most fundamental watershed was the ultimate virtualization of the monetary system in the early 1970s, when Richard Nixon closed the US dollar's gold window. Since then we are experiencing the historical precedent of a global, completely untethered monetary order, in which the US dollar serves de facto as the reserve currency. The paradigm change from an at least partially gold-backed monetary system to a pure debt based monetary system is in our opinion the key reason for today's systemic crisis. This step untethered monetary policy and thereby enabled unfettered disproportional growth in the supply of money and credit.

A commitment to "sustainability" is currently in fashion in all spheres of life. Banks and asset managers love to decorate their investment products with this fashionable expression. However, the "sustainability" of the modern-day monetary order, within which they are operating, is hardly ever questioned by representatives of the world of banking.

The instability of debt-induced growth is illustrated unmistakably by the following chart. Total credit market debt - the most comprehensive debt aggregate in the US - has increased by a factor of 35 since 1971, the monetary base by a factor of 54 and GDP by a factor of 14. In order to reignite debt-induced GDP growth after the first decline in aggregate debt in 2009, the Federal Reserve reacted by massively blowing up the monetary base.

GDP, total credit market debt and monetary base since 1971

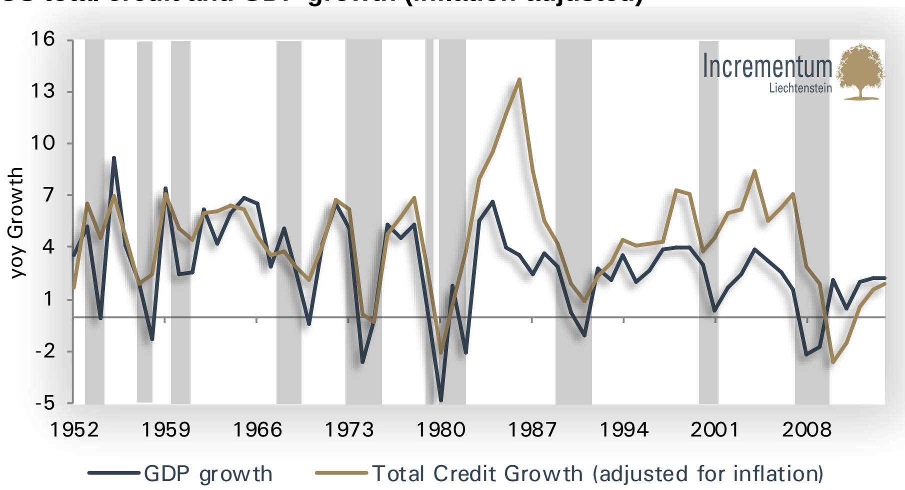


Sources: Federal Reserve St. Louis, Incrementum AG

In the following chart, we show the change rates of the aggregates depicted above. Obviously the trends of these two time series are nearly congruent. In the current debt based monetary system, positive GDP growth requires an expansion in overall debt levels. The confidence of market participants plays an essential role in the context of increasing the volume of debt. [19]

"There was a time, not that long ago actually, when it was the economy that drove asset prices like equity and real estate valuations. But today, the causation is viewed, even in policy circles, as running in the opposite direction. It is asset prices that now drive the economy."
Dave Rosenberg

US total credit and GDP growth (inflation-adjusted)



Sources: Richard Duncan, Incrementum AG, Federal Reserve St. Louis

"When there's already a lot of red ink, Keynes does not work."
Woody Brock

Economists of the Keynesian persuasion argue that the government should provide demand-oriented "stimulus" by means of deficit spending in times of crisis. If households and companies fail to produce a net increase in debt, the government has to do so. **In this context, the (allegedly) prosperity-enhancing "multiplier" effect is often cited.**

The following table is unlikely to provide much joy to Keynesians. The table shows trends in US economic output as well as the rise in debt levels

[19] It is no coincidence that the term "credit" is derived from the Latin "credere", which means "to believe" or "to trust".

over the respective time periods. It can be seen that ever more debt is buying less and less growth. In short, the marginal returns per unit of additional debt are continually declining. While an increase in debt was still associated with a large effect on output in the 1960s, it has nowadays become almost impossible to boost economic output by increasing debt. Additional stimulus programs achieve only anemic economic growth. **If the doses of debt should not be escalated further, resp. should debt growth even cease entirely, the withdrawal symptoms would likely be extremely painful.**

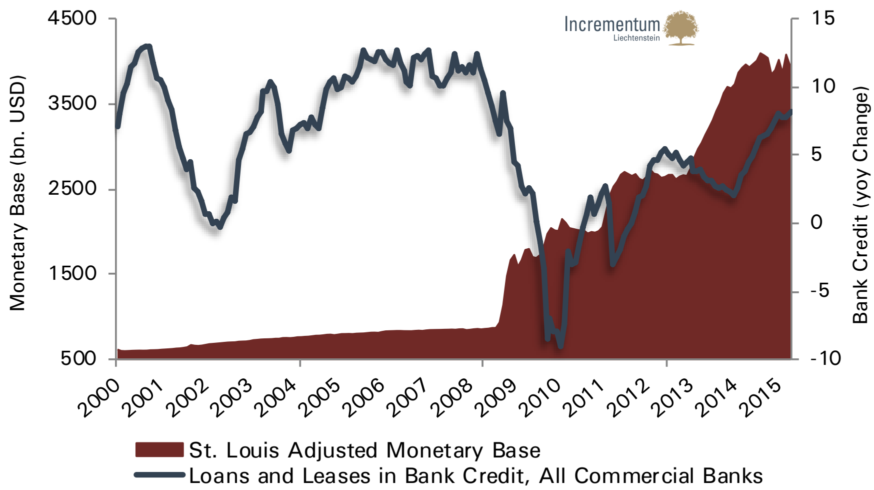
Clearly declining marginal utility of additional units of debt

Diminishing Returns from debt financing by decade 1950 – 2014			
Date Range	Change of debt, USD bn.	Change of GDP, USD bn.	Debt/GDP
1950 - 1960	33.6	243.1	0.14
1960 - 1970	90.4	497.4	0.18
1970 - 1980	528.1	1,612.3	0.33
1980 - 1990	2,297.3	3,025.5	0.76
1990 - 2000	2,422.4	4,002.9	0.51
2000 - 2010	7,900.1	4,758.1	1.66
2010 - 2014	4,265.7	2,454.5	1.74

Sources: Federal Reserve St. Louis, Incrementum AG

Last year, we stated that "tapering"[20], i.e., the gradual exit from quantitative easing, should have noticeable effects on financial markets. However, these effects have so far largely failed to appear. Having said this, it should be noted that we are also still miles away from the much-invoked normalization of monetary policy. It appears that the decline in money creation by the Fed is largely compensated for by commercial banks currently. And despite this, the (temporary?) exit from unconventional monetary policy has left noticeable marks in US economic growth within just a few months. **Should the exit turn out not to be temporary, correspondingly strong reactions in financial markets have to be expected.**

Monetary base (left hand scale) vs. credit growth (right hand scale)



Sources: Federal Reserve St. Louis, Incrementum AG

[20] The term originates from sports science and describes a reduction in the extent of a training program ahead of a major exertion (such as a competition).

The finite nature of an international monetary order is predictable in light of the historical context. The drawbacks of today's debt based monetary system discussed above are reason enough to consider the possible phases within the life-cycle of a financial order. In this context, we believe Peter Millar's deliberations to be quite important.

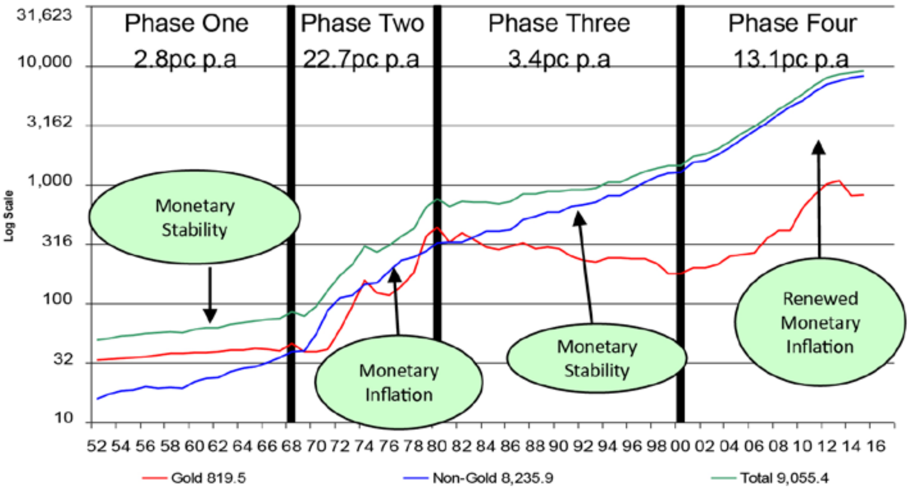
"Governments have recognized that gold is the only obstacle to erecting a tower of Babel of irredeemable debt."
Ferdinand Lips

The following chart depicts the trend in consolidated worldwide monetary aggregates since 1952 (in SDR terms), as well as the gold price (red line). According to Millar, there exists a cycle that consists of altogether five phases. In phase 1 (1952 to 1968), a stable money supply growth rate of 2.8% per year was in evidence. Phase 2 (1968 to 1980) was characterized by strong monetary inflation and an increase in the global money supply of 22.7% per year. In phase 3 (1980 to 2000), the fight against price inflation dominated, with money supply growth declining significantly again (+3.4% p.a.).

Since 2001, we are in phase 4, which is characterized by inflationary instability. In phases 1 and 3, money supply growth was largely aligned with economic trends. During these periods, the environment was negative for the gold price, as other asset classes were more attractive. Phases 2 and the current 4, are, however, associated with a clearly positive environment for the gold price (inter alia due to negative real interest rates).

In phase 5, the debt problem will likely be tackled with vulgar Keynesian policies, by creating even more debt and price inflation. Millar expects this phase to end with a currency reform or a revaluation of gold reserves, which should initiate a return to quantitatively lower levels of monetary inflation, after which a new cycle can begin.

Trend in global monetary base (log scale)



Source: Valu-Trac Research

d) Monetary policy: waiting for Godot

"Janet Yellen at the FED is equivalent to having a biology schoolteacher who has never seen blood perform brain surgery."
Nassim Taleb

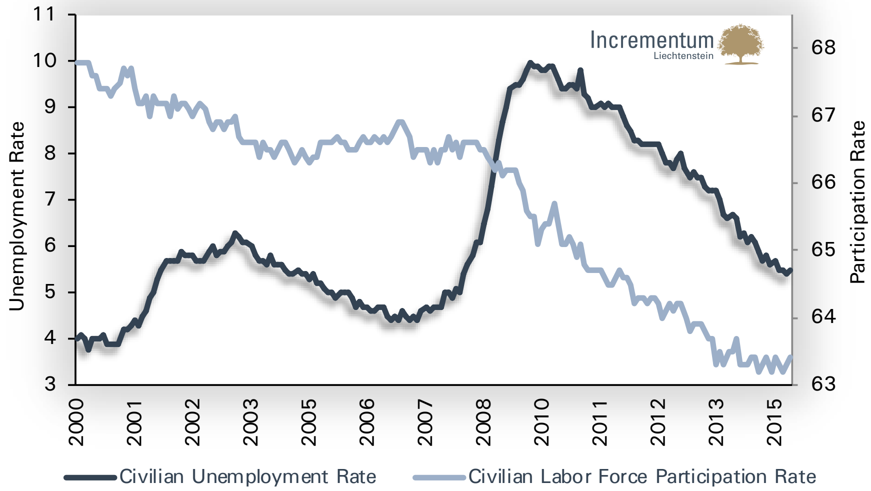
Market participants are currently watching every blink of the eye and every frown of Fed chair Janet Yellen like hawks. The fact that even the tiniest hint regarding a change in monetary policy is received with great nervousness by the markets, shows that the financial system is balanced on a knife's edge. Market participants have by now become so accustomed to this situation that most are inured to it and almost regard it as normal and inevitable. However, it represents nothing but government-generated uncertainty, which is by no means necessary.[21]

After the markets were focused on "tapering" last year, the investment community now expects a rate hike and the beginning of a monetary policy normalization. **We believe this widely expected – but continually postponed at the drop of a hat – turning point for interest rates is little more than wishful thinking**. Monetary policy normalization hinges on way too many ifs and buts.

"The global debt money system cannot handle rising interest rates without the problems coming to the fore which governments and central banks want to hide."
Thorsten Polleit

The US unemployment rate is currently at its lowest level since May 2008. However, if one looks below the surface, it becomes clear that this is primarily the result of a significant decline in the labor force participation rate. The share of employed people and job seekers of the total US population currently stands at only 62.9%. **If the participation rate were at a similar level as in 2008, the unemployment rate would be more than three percentage points higher.**

US unemployment rate and labor force participation rate since 2000



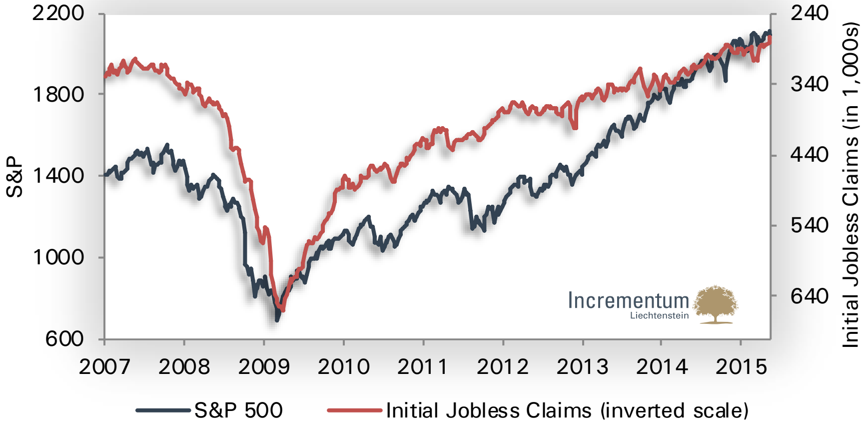
Sources: Federal Reserve St. Louis, Incrementum AG

The following chart illustrates how important labor market data have become for the trend in the US stock market in the meantime. Employment data are in principle a lagging indicator of the economy, and as such would hardly be considered to be of great relevance in a free market. However, since the Fed as a result of its dual mandate is also responsible for keeping the unemployment rate at a low level, market participants try to anticipate the Fed's reaction based on employment data. Due to an increasing dependence on easy money, interest in jobs data has therefore

[21] See: "Oesterreichische Schule fuer Anleger", Taghizadegan, Stoeferle and Valek

greatly increased in recent years. **Rather average figures thus have the counter-intuitive effect of creating positive sentiment in the stock market – while the much hoped for self-sustaining growth remains absent, the Fed's long mooted rate hike will likely remain in abeyance as well.**

Initial jobless claims (right hand scale, inverted) vs. S&P 500



Sources: Federal Reserve St. Louis, Incrementum AG

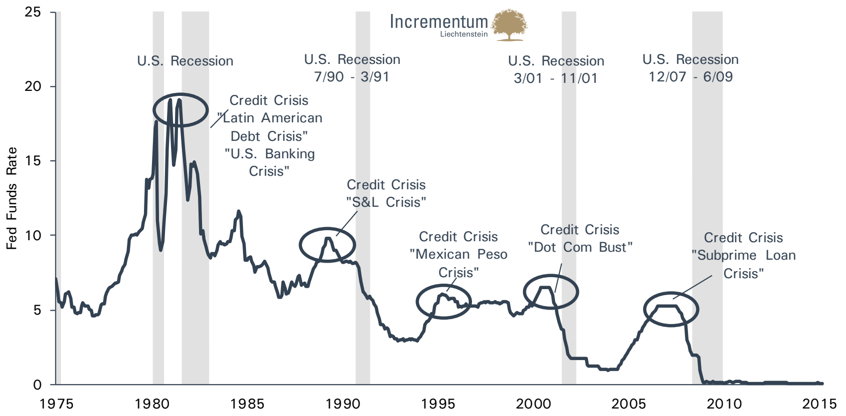
In short, macro-economic factors that would indeed point to self-sustaining growth, and with that, provide significant leeway for rate hikes, aren't really in sight. The resulting hopelessness of endlessly waiting for a rate hike is reminiscent of Samuel Becket's drama "Waiting for Godot". In Becket's work, the figure of Godot personifies the human need to wait for the arrival of a prophet who is supposed to bring salvation, in spite of unspecified and ultimately unfulfilled illusions. It is quite similar with **the Federal Reserve's attempts to exit unconventional monetary policy**. Two such attempts have already failed in the past five years. Both after the end of QE1 and after the end of QE2, massive volatility in financial markets ensued in short order. In the current, third attempt, the Fed is now attempting to stop money printing in a more "gentle" fashion. **Some observers speak in this context of the loosest tightening of monetary policy ever**.

"Stocks are currently supported by three layers of debt: an indebted consumer buying products from companies that have issued debt to buy back equity owned by speculators on margin. Any diminution in the availability of credit will collapse the accordion of debt and send markets far lower than most observers think possible."
Daniel Oliver

Generally it appears obvious that the Fed's room to maneuver is extremely limited. As long as *de facto* every other major central bank prolongs its zero interest rate, resp. negative interest rate policy, we regard a significant deviation by the Federal Reserve as unlikely, as the upward revaluation pressure on the US dollar would be too great, which in turn would definitely have negative consequences for the fragile US economy. This was already evident in the most recent economic data releases in the first and second quarter, according to which the much-heralded US economy barely avoided falling into recession in the wake of a 15% rally in the US dollar. **As a result, we consider the narrative of an isolated US rate hike cycle to be naïve**.

If one looks at a long-term chart of US policy rates, one can see that rate hikes have been implemented prior to every recession and prior to every financial crisis. Often, the economic contraction only happened with a lag of several months. Nevertheless, the cyclical occurrence of booms and busts is quite obvious. It is clear that monetary policy and the business cycle are closely connected. The Austrian Business Cycle Theory (ABCT) provides helpful explanations for these concatenations in our opinion.

Federal Funds rate and economic crises



Sources: RealForecasts.com, Federal Reserve St. Louis, Incrementum AG

e) Who's afraid of recession?

"There are three key biases in financial forecasting. Economists never forecast recessions, equity strategists are always bullish, and bond strategists are always bearish."
Albert Edwards

The approach to the phenomenon "recession" of many central bankers as well as mainstream economists strikes us as ignorant, resp. even negligent. We want to critically examine this topic at this juncture. First let us look at the "official" definition of the term according to Investopedia:

"*A significant decline in activity across the economy, lasting longer than a few months. It is visible in industrial production, employment, real income and wholesale-retail trade. The technical indicator of a recession is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP); although the National Bureau of Economic Research (NBER) does not necessarily need to see this occur to call a recession*"[22]

"The return to monetary stability does not generate a crisis. It only brings to light the malinvestments and other mistakes that were made under the hallucination of the illusory prosperity created by the easy money."
Ludwig von Mises

Since 1971, there have been six recessions in the US. The duration of the average economic expansion between these contractions amounted to 5.4 years, whereby the longest period without a recession lasted 10 years.[23] **Currently, the US economy is already in its seventh year of economic expansion**. This suggests that the beginning of a recession is increasingly likely. An economic recession in the near future would, however, represent a harsh loss of face for central bankers. Their controversial monetary policy measures were justified as an appropriate means to nurse the economy back to health, and will allegedly contribute to the eagerly awaited self-sustaining recovery.

It is remarkable that practically no relevant forecast by economists is taking the regular occurrence of recessions into account. The forecasts that are based on stochastic equilibrium models, always predict a medium term convergence of future growth with so-called "potential growth". **An**

[22] http://www.investopedia.com/terms/r/recession.asp
[23] http://en.wikipedia.org/wiki/List_of_recessions_in_the_United_States

economic contraction is never part of any of the base case scenarios. At most, it is mentioned on the side as a potential "tail risk".

"Mises's solution follows logically from his warnings. You can't fix what's broken by breaking it again. Stop the credit gavage. Stop inflation. Don't encourage consumption, but rather encourage saving and the repayment of debt. Let all the lame businesses fail – no bailouts."
Mark Spitznagel

Concerns over the evil "R" word shouldn't lead to attempts to avoid a recession at all costs. We regard recessions as healthy and necessary. Economic downturns only correct the aberrations and excesses of the boom. Sclerotic structures in the labor market are broken up, labor costs decline, productivity and competitiveness increase. Misallocations are corrected, unprofitable investments abandoned, written off or liquidated, and governments guilty of economic mismanagement are voted out of office. Investors and entrepreneurs who were taking overly risky actions suffer losses and prices adjust to actual consumer preferences. A recession also allows a restructuring of production processes. In line with our analogy of monetary tectonics, one could also say that smaller earthquakes help to forestall bigger ones, because they reduce tensions. It is similar with recessions, which remove economic imbalances.

"To combat a depression by a forced credit expansion, is akin to the attempt to fight an evil by its own causes; because we suffer from a misdirection of production, we want even more misdirection – an approach that necessarily leads to an even more serious crisis once the credit expansion comes to an end."
Friedrich August von Hayek

However, this also means that these adjustment processes will become all the more uncomfortable, the longer they are delayed and the more one attempts to keep them at bay by means of monetary and fiscal interventions. In practice, there is a danger in every democratic system, that too painful an adjustment process simply cannot be allowed to happen, because the interventions preceding it have been too extreme, and it would take too long for the necessary adjustment processes to bear fruit. No democratic government that is presented with the bill for the obvious successes and failures of its administration at the next election, will voluntarily allow a deep recession to occur (even if it were to agree that the adjustment was necessary). In this case, inflationary policy is always a welcome method of impoverishing the population by decree and thereby push through a real adjustment of prices by force. The debasement of money as a rule always hits society's most underprivileged hardest, as rich people can easily avoid a devaluation of their wealth.

"*Over the years, all the governments in the worlds, having discovered that gold is, like, rare, decided that it would be more convenient to back their money with something that is easier to come by, namely: nothing.*"
Dave Barry

What is actually a healing process is, however, presented as the principal problem in public debate, which often creates the impression that "Austrian" economists are almost pining for a crisis. In reality, they simply see necessary deflationary corrections as a precondition for growth in prosperity that is sustainable in the long term.[24] At the end of the corrective process, the foundation for a renewed upswing is more stable and healthy – at least until central banks lead us into the next boom phase. **With this view, the "Austrians" are however at odds with the general consensus.** Economic upswings are generally welcomed, crises are damned, as they are only associated with the bitter taste of medicine, but not with its healing properties. **Popular opinion therefore holds: upswings are good, downturns are bad.[25]**

"The prospects for a bumpy exit together with other factors suggest that the predominant risk is that central banks will find themselves behind the curve, exiting too late or too slowly."
BIS, Annual Report

Representatives of the Austrian school are no longer alone in warning about the fatal long-term consequences of the zero interest rate policy. In the meantime, the BIS[26] also sees parallels between Western industrialized nations and Japan, where the correction of the 1990s was delayed: *"This delay has destabilized the banking system and in the end prevented the extension of new loans as well",* the BIS admonishes in its

[24] See: "Oesterreichische Schule fuer Anleger", Taghizadegan, Stoeferle and Valek
[25] See also: „Der künstliche Aufschwung ist die Krise", Prof. Dr. Thorsten Polleit, Ludwig von Mises Institut Deutschland („The artificial boom is the crisis")
[26] Bank of International Settlement, often referred to as the "central bank of central banks"

annual report.[27] The BIS also warns of overly euphoric financial markets, which are increasingly decoupled from reality. New debt serves primarily to keep the fragile edifice of debt from collapsing; it doesn't lead to new investment activity. The attempt to combat a crisis that was triggered by too loose monetary policy by the very same means must be regarded as having officially failed. **It is all the worse that the ECB is now also betting on increased monetary stimulus – in keeping with the motto: *"It isn't working, so let's do more of it!"*[28]**

Summary "Where Things Stand":

The majority of the charts and data presented above point to a decline in the pricing in of risk, growing risk tolerance and, associated with that, a perceived decrease in the need to hold gold. However, this fails to convince us; we rather tend to regard it as evidence of recklessness on the part of market participants. **The main reason why we are not abandoning our fundamentally positive assessment of gold, is the continuing combination of obvious over-indebtedness, expansionary fiscal and monetary policies, and the ironclad determination of policymakers to generate price inflation.**

Should this backdrop change significantly, such as in 1980 for example, when Paul Volcker hiked the Federal Funds rate to 20% and inflation consequently fell markedly, we would – taking into account the remaining framework conditions – definitely question the fundamentally positive environment for gold. As already explained at the outset, very little is currently pointing in this direction.

[27] As it were, it appears paradoxical in this context that the administrative council of the BIS is manned by no lesser lights than the governors of the most important central banks (i.e., inter alia Yellen, Draghi, Carney, Weidmann, et al.).
[28] „Die krachende Niederlage der Notenbanker", Daniel Stelter, Manager Magazin ("The crashing defeat of central bankers")

3. GOLD AND INFLATION

Inflation, rising prices and real interest rates fundamentally influence gold price trends. We will discuss this complex of topics at this juncture.

"***What is needed for a sound expansion of production is additional capital goods, not money or fiduciary media. The credit expansion is built on the sands of banknotes and deposits. It must collapse."***
Ludwig von Mises

The term ***inflation*** is usually employed as a synonym for the rate at which consumer prices increase. In reality, this perspective is far too limited in scope. In order to discuss the phenomenon of monetary debasement with precision, it is crucial to differentiate between the terms **inflation and rising prices (or "price inflation")**. Most economists don't dispute the causal connection between an increase in the money supply (inflation) and rising prices (price inflation). Very often the actual cause-effect relationship is however lost in today's linguistic usage.[29]

a) Why the gold price rises at all

"Gold pays no interest, and is therefore pure speculation."

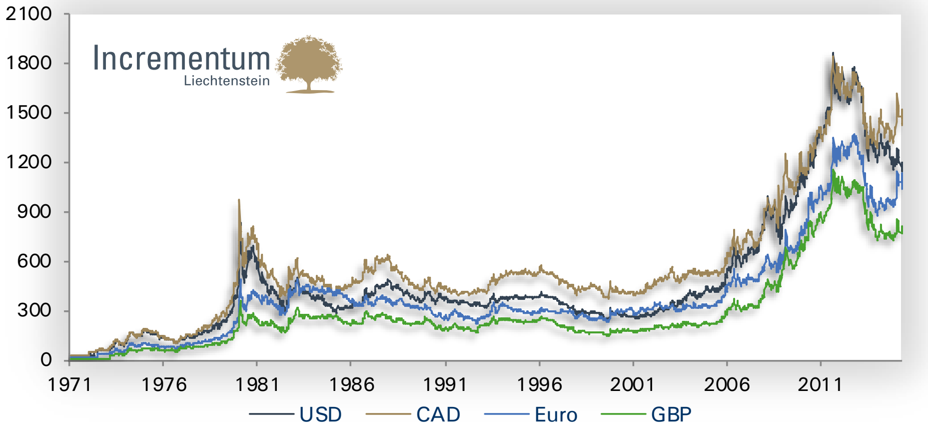
"In order to make money with an investment in gold, one needs to find a "greater fool" who is prepared to buy one's gold at a later point in time at a higher price."

"Gold is the ultimate bubble."

These or similar sounding arguments are routinely mentioned by investment advisors who argue against any allocation to gold in principle. In our opinion, a fundamental question which every investor – with or without gold allocation – should be able to sensibly answer is the following: **Why is the price of gold rising at all?**

Even though the gold price in dollar terms is currently not at an all time high, the data is clear. The dollar price of gold has risen by a factor of 34 since 1971. **The gold price is rising in terms of every paper currency, at least in the long term.**

Long term gold price in various currencies



Source: Bloomberg, Incrementum AG

[29] See: "Oesterreichische Schule fuer Anleger", Taghizadegan, Stoeferle and Valek S. 97 ff.

Why is this happening? The statements critiquing gold listed above are not easy to falsify, and superficially appear to make sense. We hereby aim to untie the Gordian knot of the proper understanding of gold as an investment asset:

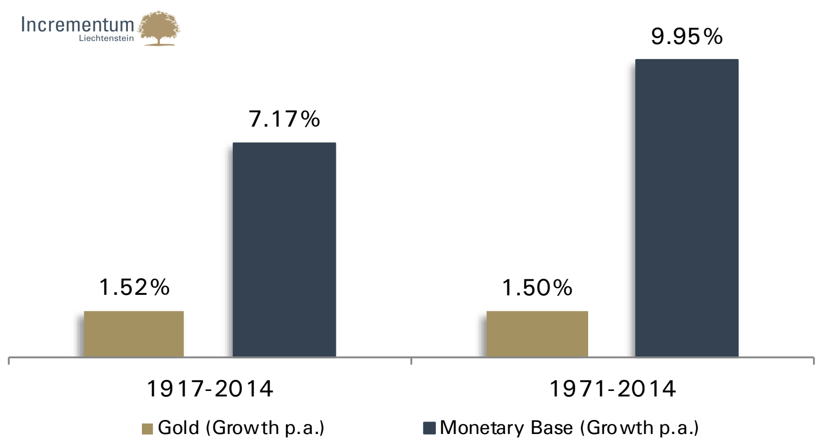
Gold does not represent productive capital. Contrary to productive capital, gold does not contribute to the creation of added value, as it produces nothing. **Financial investment in companies through equity or debt capital is sharing in the value added through interest or dividend payments (resp. reinvestment of profits**). The economic rationale for the long-term increase in the value of stocks or corporate bonds is therefore easy to understand. The coupon payments received by creditors holding government bonds are economically a share in future tax revenues. These government bonds are backed by coercive taxation, i.e., the government's ability to service principal and interest payments from future tax revenues.[30]

It can be shown empirically that the price of gold is rising in the long term even though it does not provide dividend or coupon payments. In order to understand this phenomenon, one must be able to look beyond the horizon of the fiat money system. A big problem in this endeavor is posed by the illusion of nominal value.

One of the major tasks of money is its function as a unit of account.[31] Every price is mathematically a ratio of the unit of a good divided by the number of monetary units required to pay for it. **In a monetary system in which the total number of monetary units rises faster than the supply of goods, the phenomenon of price inflation occurs**.

The annual increase in the total available supply of gold has historically always been below the expansion of the fiat money supply. Gold therefore protects investors in the long term against the incessant money supply inflation that characterizes the fiat money system. **Higher gold prices are solely a consequence of money supply inflation.**

Annualized rate of change: gold vs. monetary base 1917-2014 and 1971 - 2014



Source: Incrementum AG, James Turk

[30] See: "Oesterreichische Schule fuer Anleger", Taghizadegan, Stoeferle and Valek
[31] See: "Begriff und Aufgaben des Geldes" ("The concept and tasks of money"), Deutsche Bundesbank

"The idea that when people see prices falling they will stop buying those cheaper goods or cheaper food does not make much sense. And aiming for 2 percent inflation every year means that after a decade prices are more than 25 percent higher and the price level doubles every generation. That is not price stability, yet they call it price stability. I just do not understand central banks wanting a little inflation."
Paul Volcker

The fact that gold continues to be hoarded as an investment asset even after the end of its official monetary role is due to its high stock-to-flow ratio. We have already discussed this subject in detail.[32] Throughout history, currencies tied to a limited stock of precious metals were always suspended in order to be able to issue a higher quantity of currency to finance wars or the welfare state through the dishonest "inflation tax". **Long term increases in commodity prices, especially rising gold prices, are as it were a deterministic consequence of these interventions in the monetary system.**

We are convinced that in a fiat money system, gold should not be regarded as a replacement for traditional securities like stocks or bonds, but rather as complementary. It would be correct to view gold in a portfolio rather as a liquid, alternative cash position, which bears exchange rate risk relative to fiat money and exhibits remarkable diversification characteristics. **A direct comparison of gold and the asset class stocks reminds us of the proverbial apples and oranges comparison.**

Due to steady inflation of the broad monetary aggregates in the fiat money system, price inflation results in both asset and consumer prices rising. The price increases occur with a time lag and in different phases. The price of gold tends to rise especially strongly in an environment of rising consumer prices (resp., declining real interest rates). Thus, we want to take a closer look at the dynamics of this inflationary process below.

The growth of monetary aggregates is in our opinion not sufficient as the sole indicator for timing gold price trends. **In the framework of the investment process of our funds, we use several market-based indicators, which shed light on current price inflation momentum.**

Excursus: the illusion of nominal value

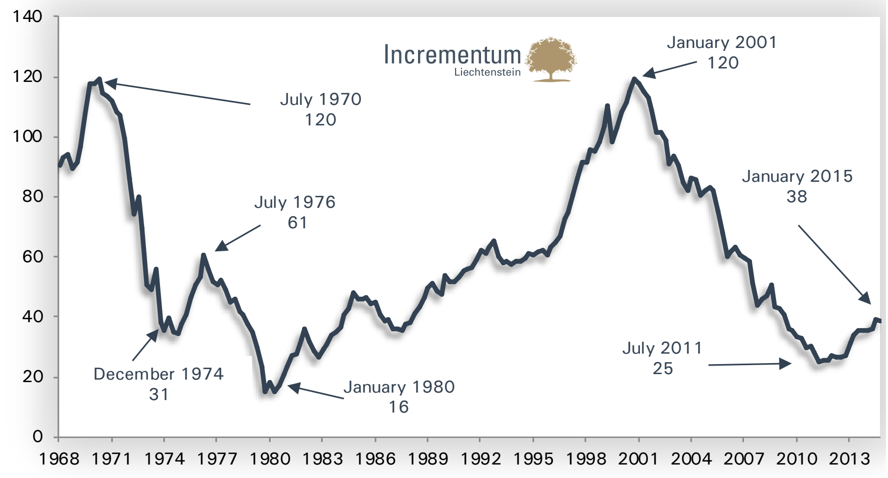
We are all victims of the illusion of nominal value. The incessantly increasing money supply leads to a steady trend of rising consumer prices. As incomes are rising as well, we tend not to question the rising level of prices.

"Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars worth of groceries. Today, a five-year-old can do it."
Henny Youngman

Currently, much points to a steady erosion of living standards. By measuring prices and salaries in gold terms, we can contrast these rather intuitive perceptions with actual data and are indeed able to reveal an illusion of nominal values. According to Keith Weiner, the wage of unskilled workers in the US in 1965 stood at 71 ounces of gold per year. In 2011, the salary of an employee in a supervisory capacity stood at the equivalent of 63 ounces of gold.[33] Measured in gold terms, a clear decline in purchasing power could thus be observed. This is also confirmed by the following chart, which depicts the relationship between average personal incomes and gold in the US. In January 2001, the average purchasing power was at the same level as in 1970. On average one was able to purchase 120 ounces of gold with one's annual income. Since then, the purchasing power of average incomes is in a downtrend, and currently stands at 38 ounces per year. **Measured in gold terms, it can thus be shown that both prices are rising and wages are declining.**

[32] See: "In Gold we Trust 2014" p. 50-55
[33] See: „Measured In Gold, The Story Of American Wages Is An Ugly One", Dr. Keith Weiner, Forbes

US personal income per capita vs. gold ratio

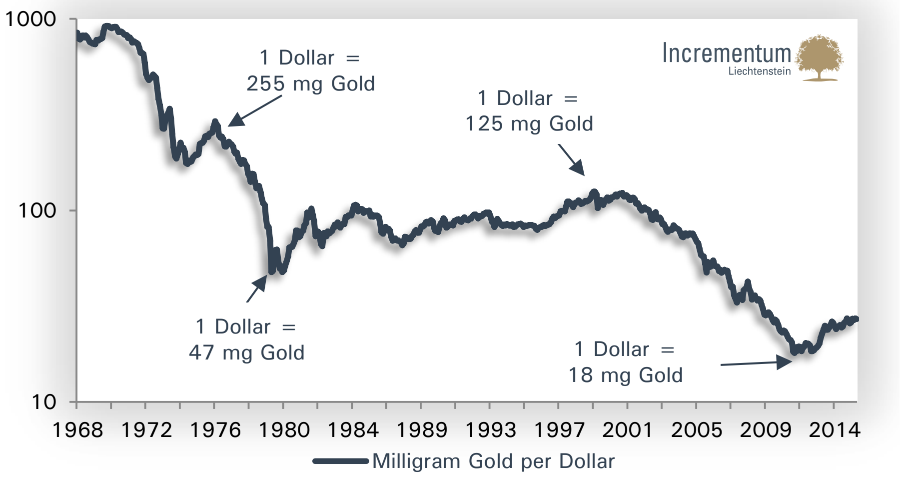


Sources: Federal Reserve St. Louis, Incrementum AG

"100 years ago, the dollar was worth 1555mg of gold. Today, it is worth about 26mg. The long-term price target is 0."
Dr. Keith Weiner

The decisive question of whether gold is currently expensive or cheap, cannot be easily answered. However, a change of perspective delivers – as so often in life – interesting insights. The following chart depicts the purchasing power of one US dollar in milligrams of gold. Thus, we don't see here that one ounce costs approx. USD 1,200, but that one US dollar costs 26.8 milligrams of gold. This inversion of the perspective is not only semantic sophistry, but actually opens up a completely different approach to the subject.

How many milligrams of gold can I get for 1 USD? (log scale)



Source: Federal Reserve St. Louis, Incrementum AG

Let us draw a comparison: if you were sitting in a rowboat in stormy seas, would you say that the lighthouse is moving from side to side and up and down? Or would you employ a rubber band as a tape measure? Certainly not, and for good reasons, as the lighthouse and steel are stable, and waves and rubber bands are not. **The relationship between gold and paper currencies is roughly analogous.**[34]

[34] See: "The Dollar is Going Up", Monetary Metals, Dr. Keith Weiner

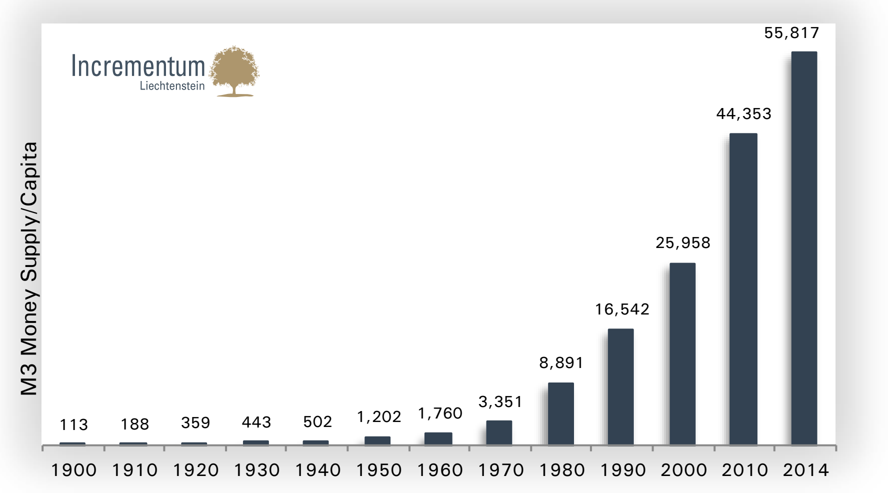
This is not to say that the exchange value of gold would be perfectly stable. It would change over time, depending on the growth in the supply of gold, the change in the demand to hold cash balances, and the growth in goods and services on the market. However, given its much lower as well as easily foreseeable annual supply growth rate, it would be far more stable than paper currencies.

"If a good is to remain money, the public must not come to believe that a fast and unstoppable increase in its supply is to be expected."
Ludwig von Mises

Ludwig von Mises always argued that money is a good like any other. It differentiates itself by one important characteristic: Money is the generally accepted medium of exchange, because it is the most marketable good. According to Mises, money's function as a medium of exchange is thus the central one, while its store of value and unit of account functions are merely subordinate functions (they are derived from, or implied by the central function). **This also implies that a rising money supply must lower the exchange value of money.**[35]

In 1913, the population of the US was 97 million. The monetary aggregate M3 at the time amounted to approx. USD 20 billion, i.e., USD 210 per capita. Currently the population of the US is 318.9 million, while the monetary aggregate M3 has increased to USD 17.8 trillion.[36] This translates into a money stock of USD 55,817 per capita.

M3 per capita since 1900 (in USD)



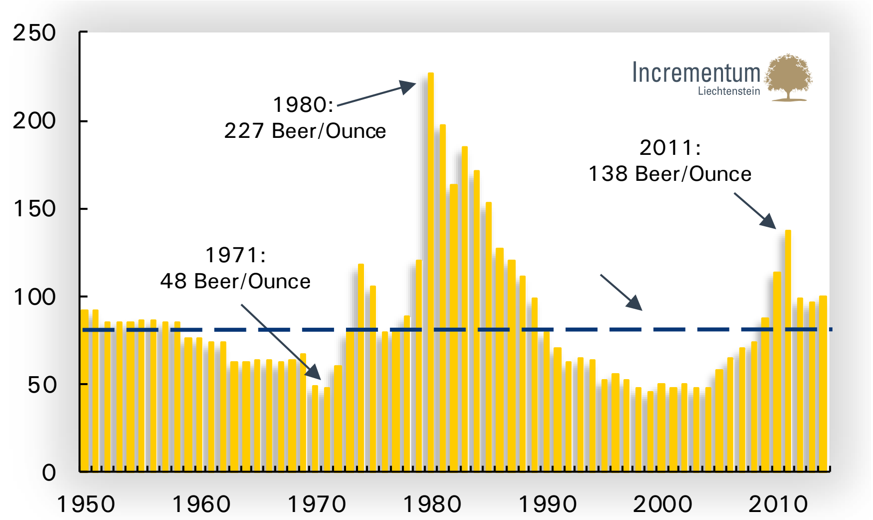
Sources: US Census, US Geological Survey, Wikipedia, Incrementum AG

Many comparisons from everyday life show that gold is currently not valued at an excessively high level. While a "Mass" beer (one liter) at the Munich Oktoberfest in 1950 still cost a converted EUR 0.82, the price in 2014 stood between EUR 9.70 – EUR 10.10 (average EUR 9,90). Thus, the annual price inflation of beer amounts to 4.2% per year since 1950.[37] If one measures the beer price in gold terms, then one received 97 liters of beer per ounce of gold in 2014. Historically the median is at 87 "Mass", the "beer purchasing power" of gold is therefore currently quite high. The peak occurred in 1980, at 227 liters per ounce of gold. We believe it is easily

[35] See: "Die wahre Lehre vom Geld", Dr. Thorsten Polleit, Liberales Institut („The true science of money")
[36] Source: www.nowandfutures.com
[37] A value that is probably closer to the actual change in CPI than official inflation statistics suggest.

possible that this level will be reached again. **Beer-aficionados holding gold should therefore so to speak expect a rise in beer liquidity.**

Gold/Wies'n-Beer ratio



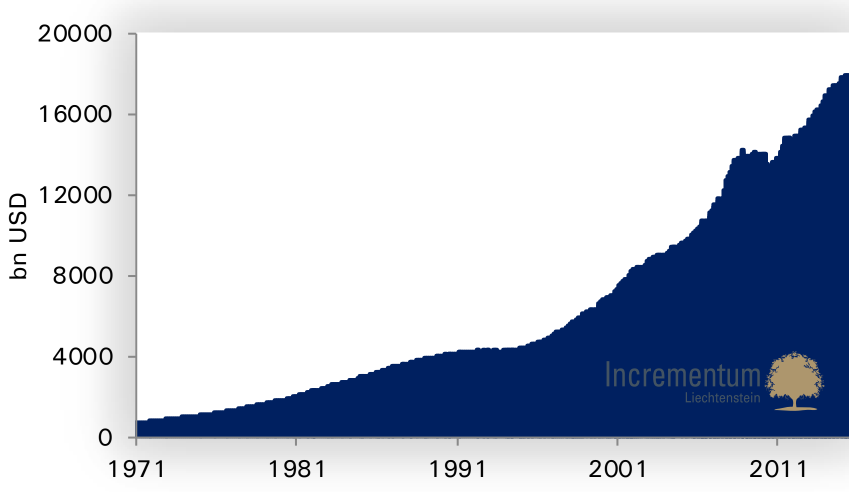
Sources: www.HaaseEwert.de, Historisches Archiv Spaten-Löwenbräu, Incrementum AG

b) Monetary tectonics

The inflationary process in a fiat money system does not occur in linear fashion. In order to create “steady inflation rates”, the broad money supply needs to be expanded continually. A large part of the money supply is created by credit extension of commercial banks. In addition, the propensity to exercise a demand to hold money (i.e., cash balances) is a crucial factor determining general rates of price inflation. Monetarists like to calculate the velocity of money in this context.

As long as commercial banks fully exploit their money creation potential, the central bank can always orchestrate steady money supply inflation with conventional monetary policy tools. Primarily, this method consists of fixing short-term interest rates via the central bank's policy rates.

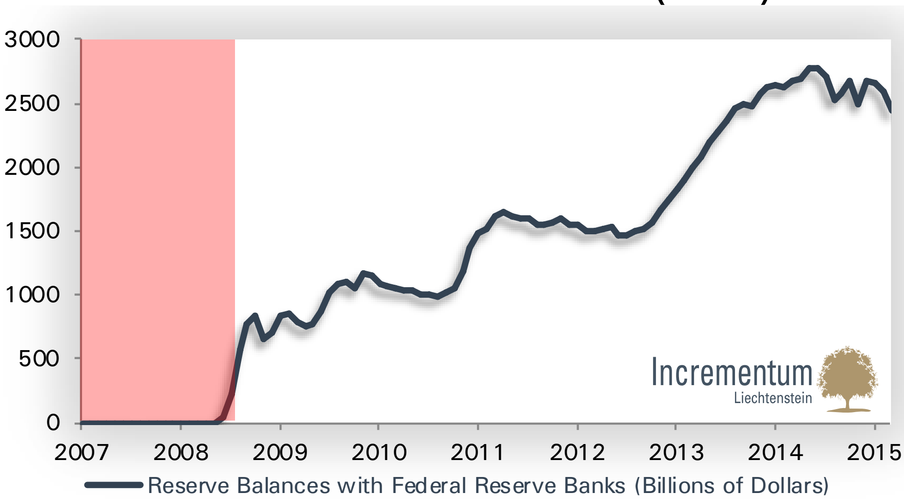
Exponential inflation of the monetary aggregate M2 (USD bn)



Sources: Nowandfutures.com, Incrementum AG

Orchestrating a steady process of inflation becomes a lot more difficult as soon as the monetary system enters a period of instability. A major indicator for an unstable fiat money system is when commercial banks cease to fully exploit their potential to create money. This becomes outwardly visible when excess reserves that exceed required minimum reserves are beginning to pile up at the central bank.

Reserve balances held with Federal Reserve Banks (USD bn)



Sources: Federal Reserve St. Louis, Incrementum AG

„Base money inflation is the most ineffective tool to deliberately create price inflation."
Mike Maloney

In the wake of systemic banking crises, central banks therefore fall back on "unconventional monetary policy measures", in order to ensure steady rates of price inflation. Blowing up the amount of central bank credit, which has come to be known under the euphemism "quantitative easing", is the best-known instrument in the tool box of the money supply planners. Broad monetary aggregates stop rising due to problems in the banking sector. Thus consumer price inflation is driven up by brute force via an expansion of the central bank's balance sheet. This method is probably the most inefficient way of influencing consumer prices. **Since the money newly-created by the central bank is primarily used to**

purchase assets, the danger of misallocations and the emergence of bubbles is high, indeed inevitable.

The interaction between central bank directed inflation and credit deflation can be compared to the reciprocal pressure between two tectonic plates. Below a seemingly stable surface, pressure is steadily building up, which is subsequently discharged in the form of volcanic eruptions and earthquakes. These eruptions are the inevitable consequence of processes that occur far below the earth's surface.

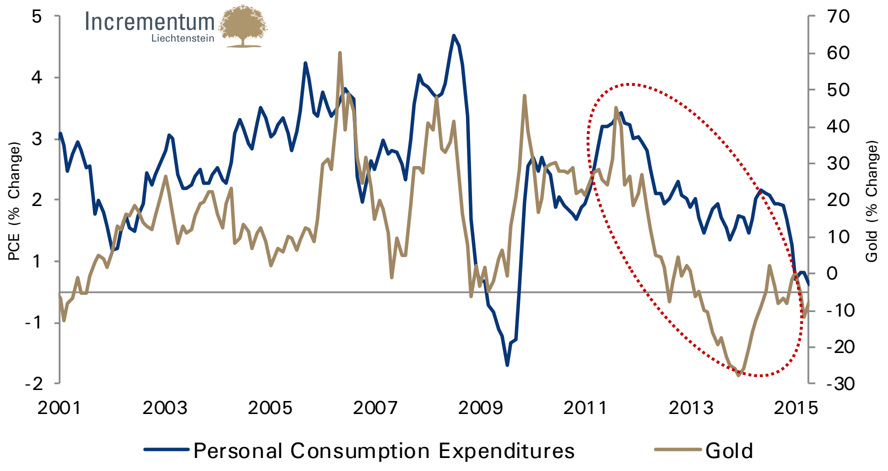
Disinflationary forces have been dominating since 2011. In last year's gold report, we stated the following in the context of monetary tectonics: "*The power struggle between market-cleansing natural deflation and politically-induced inflation continued throughout the last year. Inflationary measures taken by central banks have so far compensated for the deflationary trends emanating from the commercial banking sector and have created a superficial stability with respect to price inflation, even though the pendulum has swung increasingly towards disinflation in the past 12 months."*[38]

This year, we come to a similar conclusion with respect to the momentum of inflation over the past 12 months: the forces of disinflation again had the upper hand last year. **The systemically unstable situation has led to a "deflationary earthquake" in the second half of 2014**.

Not the absolute level of price inflation is relevant, but rather the direction

As we have already discussed, it isn't the absolute level of price inflation that is relevant for the gold price, but rather the direction. Rising rates of price inflation generally imply a positive environment for the gold price, while declining rates of price inflation (= "disinflation") create a negative environment for gold. This can also be seen in the following chart. **Since autumn of 2011, the PCE index[39] is clearly declining, but it appears at the moment that a change in trend may be in the cards.**

Price inflation (PCE Index) and gold price (rate of change in %)

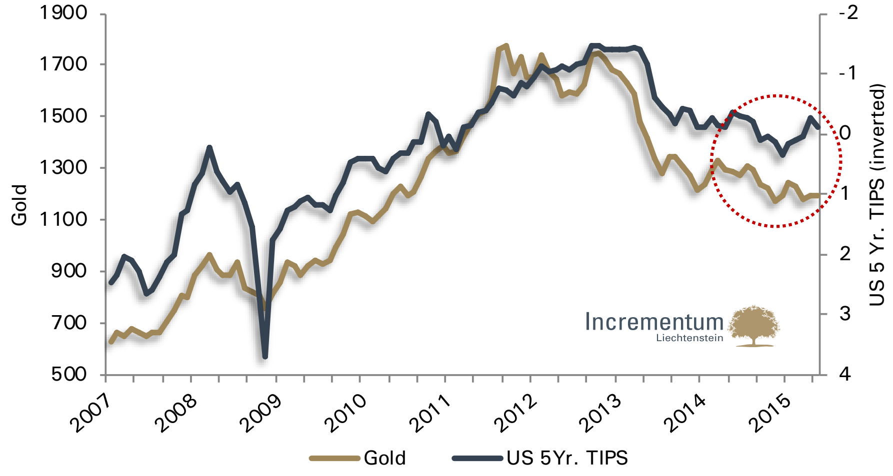


Sources: Federal Reserve St. Louis, Incrementum AG

[38] See: "In Gold we Trust" Report 2014
[39] Personal Consumption Expenditure Index, an important inflation measure for the Fed, which is derived from the core inflation rate.

The real yields of inflation-protected bonds have been rising since 2012, however, they could be close to a turning point now. **From our perspective, rising price inflation rates are definitely likely and could be a decisive factor in this trend change.**

Gold price vs. yield of 5-year TIPS (inverted)



Sources: Federal Reserve St. Louis, Incrementum AG

We diagnose an inflation addiction inherent in the system, which is ever more difficult to satisfy. Price fluctuations – especially those of inflation-sensitive assets – have increased enormously in the past 10 years. One only needs to look at the huge volatility in the prices of oil and silver. Last year provided a prime example of this effect. In our opinion, these volatile periods represent both opportunities and risks. **As anticipated, investor interest in the topics of inflation and deflation is increasing. We expect that this interest will continue to grow in coming years.**

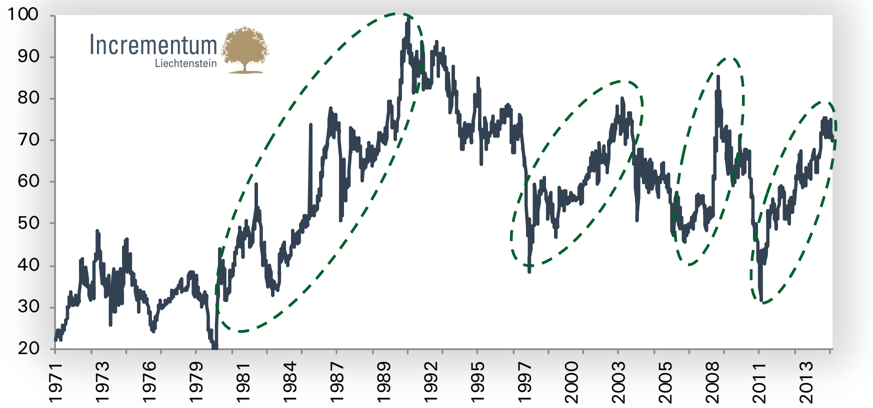
c) The gold-silver ratio as an indicator measuring inflation momentum

As we extensively discussed in our last report[40], we regard the gold-silver ratio (G/S ratio)[41] as an **excellent indicator of the interaction between inflation and deflation. Our thesis: the relative price movements between gold and silver are especially helpful in identifying periods of disinflation. A rising G/S ratio is thus a warning signal for gold investors.**

Let us first take a look at the history of the gold-silver ratio since the gold exchange standard was abandoned in 1971.

[40] See: „In Gold we Trust“ 2014, p. 23-24
[41] Explanation: The ratio tells us how many ounces of silver are needed to buy an ounce of gold. It therefore reflects the relative price of gold expressed in ounces of silver.

Gold/Silver ratio after the end of Bretton Woods



Sources: Bloomberg, Incrementum AG

A basic consideration regarding this ratio: it cannot permanently trend in one direction. It would be nonsensical to assume that one ounce of gold will one day be worth as much as all the silver in the world, or vice versa.[42] **Thus by definition, a reversion to the mean has to take place over the long term.**

What would a change in trend mean for the gold price? Can one exploit the dynamics of the gold-silver ratio for investment in gold? To this end, we show an overlay of the gold-silver ratio and the price of gold below.

Gold/Silver ratio (left hand scale) vs. Gold (right hand scale)

Sources: Federal Reserve St. Louis, Incrementum AG

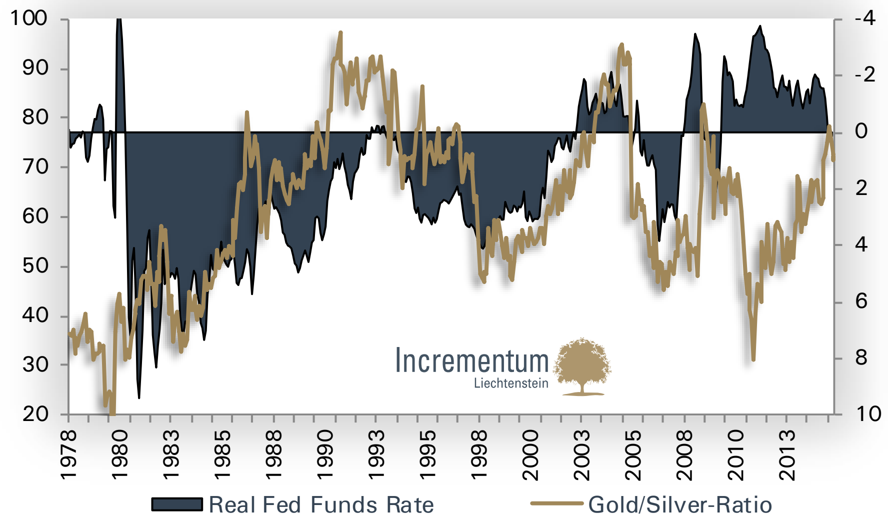
The chart illustrates that the G/S ratio has declined during most gold bull markets. This implies that silver has risen even more strongly than gold during gold bull markets. However, in gold bear markets, an increase in the G/S ratio can be observed most of the time. Silver was not able to gain in value relative to gold in such an environment.

[42] This by the way applies to all ratio charts that represent an exchange ratio between two real, material goods. If a ratio depicts money prices (which can be inflated infinitely), a permanent increase is possible.

Moreover, it can be seen on the chart that the G/S ratio has experienced large fluctuations over time. Around 1980, a low in the ratio of 16 can be discerned, while in 1991, the ratio almost exceeded the level of 100. Currently, the ratio has reached a potential turning point after an upward trend that has lasted four years. Since the end of the Bretton Woods agreement, it has averaged 54x and 56x since the outbreak of the financial crisis in 2007.

Apart from a few exceptions[43], we can discern a positive correlation between gold and silver prices. **In addition, since the bursting of the dot-com bubble, greater volatility (variance) in silver can be observed**. We have already hinted at this phenomenon indirectly in the above section on monetary tectonics. To return to our initial statement regarding the interpretation of the G/S ratio as an indicator of deflation/reflation, we compare it to the real Federal Funds target rate[44] below.

Gold/Silver ratio (left hand scale) vs. real Federal Funds target rate (right hand scale, inverted)



Sources: Federal Reserve St. Louis, quandl.com, Incrementum AG

This also confirms our hypothesis. As soon as real interest rates decline (in the chart above shown as an increase due to the inverted scale), gold gains in relative strength vs. silver. Silver, by contrast, rises relative to gold in periods when the real Federal Funds rate is rising. The only significant deviation observed since the early 1980s was the accelerated trend in silver in 2011.

Conclusion:

According to our statistical analysis, a sustainable gold price rally is unlikely to develop while the gold-silver ratio is in decline. We are therefore watching the trend of the ratio very closely at the moment, because the levels it has reached in recent weeks could possibly represent a turning point. **A new downward trend in the ratio would on the one hand indicate a positive outlook for gold, but also warn of an increase in the momentum of price inflation.**

[43] Period June 1973 to November 1973, as well as January 1975 to January 1977.
[44] To calculate the real Federal Funds rate, the percentage change in the consumer price index for all urban consumers was deducted from the Federal Funds target rate.

Excursus: Incrementum Inflation Signal

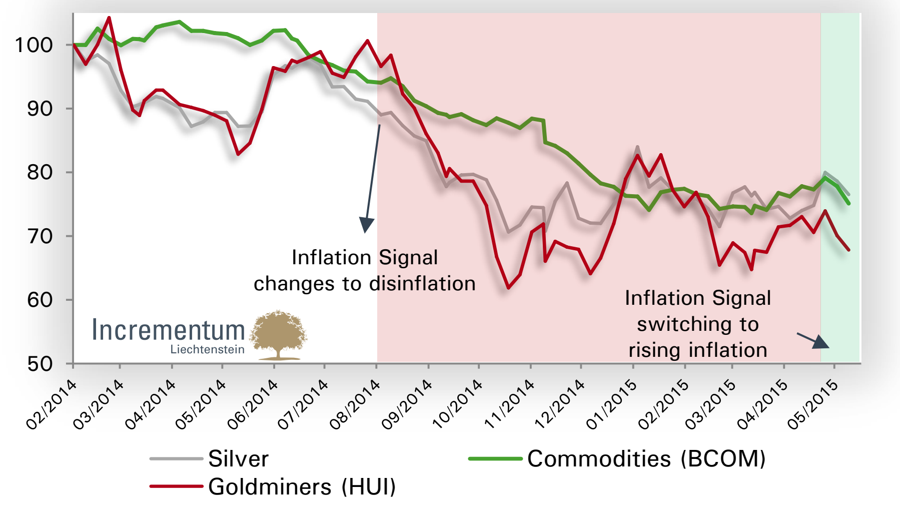
As has by now been extensively discussed, we regard inflation clearly as a monetary phenomenon. Due to monetary tectonics there can, however, be alternating inflationary and deflationary periods.

Incrementum Inflation Signal indicates rising inflation rates since May

In order to measure how much monetary inflation actually reaches the real economy, we use a number of market-based indicators. Our proprietary measure can be compared to a "monetary seismograph". The result of the measurement is the "Incrementum Inflation Signal", which depicts the prevailing trend of price inflation.

One of the inputs for the signal is the gold-silver ratio we discussed above. We have combined it with other quantitative factors and derived an overall signal from this combination. **Depending on the respective signal, the fund we are managing takes positions aligned with rising, neutral and declining inflationary trends**. Historically, there have time and again been periods (lasting from 6 to 24 months) during which disinflationary forces have dominated and when it was not advisable to invest in inflation-sensitive asset classes. While the signal was warning us in August 2014 that a strong disinflationary trend was under way, it has begun to show a slightly rising inflationary trend since May of this year. **We conclude from this that the risk/reward ratio for investments in inflation-sensitive assets is especially attractive at present**.

Incrementum Inflation Signal is indicating rising price inflation rates since May



Source: Incrementum AG

d) Monetary policy playing with fire - why inflationary momentum cannot be controlled

In the meantime, there are more and more voices arguing in favor of raising inflation targets as the only practicable solution to lowering debt ratios. Thus Eric Rosengren, president of the Federal Reserve Bank of Boston, argued that inflation targets should be raised, in order to finally jump-start the economy's sputtering engine.[45] IMF chief economist Olivier Blanchard, one of the most influential architects of the international financial system, has averred several times already that higher rates of price inflation should be targeted.[46] **Due to the impossibility to control the momentum of inflation described in more detail by Murray Rothbard below, we believe this is akin to gambling**.

"To me, a wise and humane policy is occasionally to let inflation rise even when inflation is running above target."
Janet Yellen

First, we take a step back and note that there is no such thing as a "general level of prices". There exists a vast array of price relations between different goods and services. **The primary purpose of money is to facilitate exchange**. Similar to every other good in the economy, money has a price – namely its exchange rate versus all other things that are traded for it. Money is therefore subject to the forces of supply and demand like any other good.

Murray Rothbard's book "The Mystery of Banking" contains important thoughts on the reasons for hyperinflation. Rothbard defines the desperate fight against deflation and the associated priming of the pump as the cause of most hyperinflation events. The collapse in the demand to hold money is a crucial factor thereby, which is at best underestimated by the mainstream, but in most cases simply ignored.

Rothbard identifies three phases of the inflationary process:[47]

- **In the first phase, the money supply is increased, but prices barely rise**. Since people assume that the money supply expansion is only a temporary policy, they continue to prefer saving money instead of spending it. This phase is like the Land of Cockaigne for politicians, as it appears to be possible to finance deficits and buy votes without consequences, without creating price inflation.

- **In the second phase**, the public slowly but surely begins to anticipate rising prices. Rothbard writes: "*Rather than hold onto its money to wait for price declines, the public will spend its money faster, will draw down cash balances to make purchases ahead of price increases. In Phase 2 of inflation, instead of a rising demand for money moderating price increases, a falling demand for money will intensify the inflation."*[48]

  At this precise juncture, policy-makers are facing a fork in the road: Either they allow a natural deflationary process to happen and accept a recession, which will help to painfully correct excesses, or they continue on the path of easy money and risk the emergence of the third phase.

- **Phase three is commonly called the "crack-up boom" after Ludwig von Mises (in the German original: "Katastrophenhausse", which literally translates as "catastrophic boom").** The public becomes aware that there is no intention to halt the momentum of inflation, and that it is steadily accelerating. People abandon the currency system in a concerned mood and choose alternative currencies. Rothbard describes this

[45] See: „Inflation goal may be too low, says Fed's Rosengren ", Financial Times
[46] See: „Finanzpolitiker attackieren Geldpolitik der Bundesbank", Handelsblatt ("Financial policymakers attack monetary policy of the Bundesbank")
[47] See: "The Mystery of Banking", Murray N. Rothbard
[48] See: "The Mystery of Banking", Murray N. Rothbard

> phase as follows: **"***A frantic rush ensues to get rid of money at all costs and to buy anything else. In [Weimar Germany circa 1923], this was called a 'flight into real values.' The demand for money falls precipitously almost to zero, and prices skyrocket upward virtually to infinity."*[49]

In our opinion, it is quite possible that we are in the transition period between phase 1 and phase 2. However, forecasting the turning point with precision is impossible according to Rothbard:

"There is no scientific way to predict at what point in any inflation expectations will reverse from deflationary to inflationary. The answer will differ from one country to another, and from one epoch to another, and will depend on many subtle cultural factors, such as trust in government, speed of communication, and many others."

"…inflation can gain substantial momentum before the general public notices it. It was not until 1974, nine years into an inflationary cycle, that inflation became a potent political issue and prominent public policy concern."
Jim Rickards

We explained last year why it is impossible to regulate the momentum of inflation. The widely held belief that the Fed is able to push the "inflation genie" back into the bottle without any problem is based on numerous fallacious assumptions. **Thus, the time lags of an inflationary process are underestimated.** Enormous monetary inflation has already taken place, but has so far only affected asset prices. Strongly rising food prices are generally viewed as disastrous, while rising house prices are celebrated. Both, however, indicate a decline in money's purchasing power, it matters not whether it is expressing itself by rising food prices or rising house prices.[50]

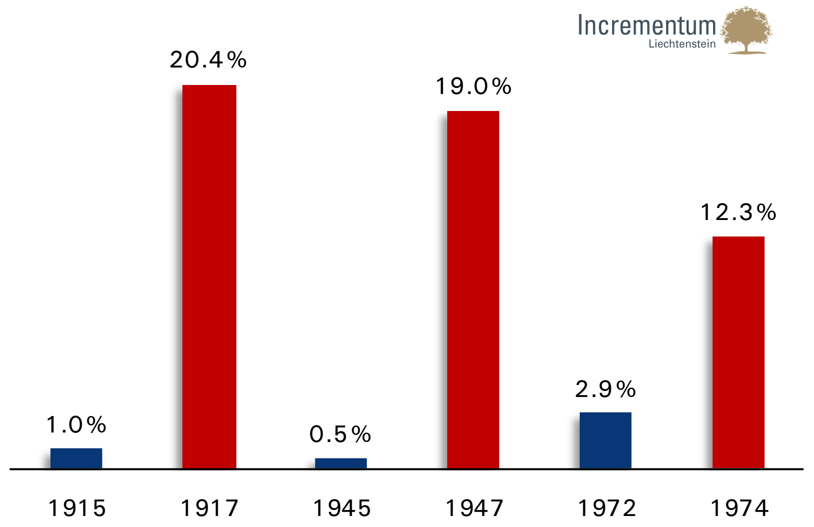
Current developments correspond precisely to the textbook Austrian Business Cycle Theory (ABCT). In the course of the inflationary process, the prices of capital goods (=asset price inflation) thus rise first, and consumer prices begin to rise (=consumer price inflation) only later. The asset price inflation that is currently underway is impossible to overlook. Apart from substantial price increases in real estate and stocks, the prices of antiques, luxury goods, fine wines, vintage cars, works of art, etc. have increased considerably.

"It's funny, in a human kind of way, how we can convince ourselves that we're in control at the very moment we are beginning to lose it."
William C. Moyers

Conclusion:
We are currently witnessing one of the greatest experiments in human history. History teaches us: **Neither mainstream economics nor central bankers are aware of how to control the specifics of inflationary dynamics**. The pitiable attempts to regulate the level of inflation like a thermostat are testament to the hubris of monetary policymakers. **Waves of price inflation happen unexpectedly and in very compressed time periods**. As the following chart shows, this is confirmed by numerous historical episodes.

[49] See: "The Mystery of Banking", Murray N. Rothbard
[50] See: „Why Keynesian Economists Don't Understand Inflation", Frank Hollenbeck, Mises.org

Inflation dynamics: Dramatic increases in price inflation can occur within just two years



Sources: Federal Reserve St. Louis, Incrementum AG

e) The evil of falling prices

"A bank is thus an institution, which regularly has to hold less in reserve than it promises, and which makes a living from concurrently promising more than it can actually deliver in an emergency."
Wilhelm Roepke

Last year was characterized by hyperinflation in media reports about alleged deflation dangers. **The scaremongering over declining prices appears however quite strange, after all, consumers always welcome lower over higher prices**. This has been evident for many years in the technology sector, in products such as smart phones, TVs, or services such as long-distance travel. From the perspective of mainstream economics, the argument is that declining prices would "*become anchored in people's minds*"[51] and they would therefore postpone all consumption till kingdom come.

The essential human phenomenon of time preference is responsible for the fact that consumers will as a rule always prefer to enjoy a good in the present rather than in the future. This is likely attributable to the awareness of – the probably indisputable – finite nature of earthly life.

Declining prices – combined with a rising purchasing power of money – mean rising living standards for consumers. **Thus it has to be regularly explained to these economically illiterate serfs why they should – against all common sense – cower in fear of declining prices and feel pleased about regular price increases**. A variety of communication channels are used for this purpose. For instance, the ECB offers "educational videos" that warn already children of the evil of falling prices.

[51] See "Annual Report 2014", Flossbach von Storch

Educational video by the ECB about inflation and deflation

Source: Youtube.com[52]

"The goal of any regime, any organism, is to maximize its chances of survival. Deflation is the perceived existential threat of our age, and this is the dragon our Heroes will guarantee to slay."
Ben Hunt

Representatives of the prevailing economic orthodoxy always assert that the crisis can only be resolved by an increase in demand. The proper means of incentivizing consumption-averse people to engage in prosperity-enhancing behavior allegedly consist of credit-financed government stimulus programs in combination with extremely expansionary monetary policy. The evil of declining consumer prices is blamed for allegedly negative, consumption-postponing behavior. **The promising solution is provided by the dwindling value of our modern money, which is supposed to make abstention from consumption and the hoarding and saving of reserves as unattractive as possible and fire up consumer demand.**

"People tend to see the price deflation as the cause of the recession, because in a recession there is simply sometimes price deflation at the same time. However, the opposite is true, the price deflation is not the cause of the recession but the consequence of the bank credit contraction, that itself has its roots in the bank credit expansion. People conflate price deflation with depression and price inflation with boom."
Philipp Bagus

The general harmfulness of price deflation represents a sacred dogma of today's monetary policy. Theoretical or empirical proof that could buttress these assertions is however weak, to put it mildly. The Great Depression is regularly mentioned as the prime example of this asserted concatenation. **Ever since the Great Depression, falling prices have been equated with economic depression. The sample size of n=1 is extremely small.** With the sole exception of the Great Depression, no empirical connection between periods of deflation and depressions can be found. The alleged cause-effect chain definitely has to be questioned. Were falling prices really the cause of the problems, or rather a symptom of getting back to health? This question is even suggested by a historical study performed by staff economists of the Federal Reserve[53]:

*"Our main finding is that the only episode in which we find evidence of a link between deflation and depression is the Great Depression (1929-34). We find virtually no evidence of such a link in any other period….**What is striking is that nearly 90% of the episodes with deflation did not have depression. In a broad historical context, beyond the Great Depression, the notion that deflation and depression are linked virtually disappears."***

[52] ECB Inflation Monster Cartoon: https://www.youtube.com/watch?v=pbgY0dYoBvA
[53] See: Deflation and Depression: Is There an Empirical Link?" Federal Reserve Bank of Minneapolis, Andrew Atkeson and Patrick Kehoe, January 2004. The study analyzes data from 17 nations over a time period of 100 years.

Other scientific studies **also** come to this conclusion. **In his dissertation "In Defense of Deflation", professor Philipp Bagus provides a fascinating analysis of historical deflation periods and their causes and consequences, which he concludes with the following statement:**

"In sum, even if price deflation could be proven to be harmful, which according to this study is not possible, it would be difficult to prove it to be more harmful than its prescribed medicine: inflation." [54]

"It all sounded too easy. Push this button twice and out pops full employment. Equations do not work on people as well as they do on rockets. I remember sitting in a class at Harvard listening to Arthur Smites say, 'A little inflation is good for the economy.' And all I can remember after that was a word flashing in my brain like a yellow caution sign: 'Bullshit.' I'm not sure exactly where that came from...but it's a thought that never left me."
Paul Volcker

Thus, there exists no statistically significant evidence for one of the most fundamental basic assumptions of modern-day monetary policy. Moreover, the underlying causal chain on which the hypothesis is based is extraordinarily dubious. The Austrian School has a fundamentally different perspective with respect to deflation: Deflation is an increase in the quality of money, and a decrease in its quantity. It represents a partial reorientation of relative prices, which have been distorted during the boom period. Prof. Joerg Guido Huelsmann explains in his book "Krise der Inflationskultur" ("Crisis of the Culture of Inflation") that a deflationary policy is a growth policy by means of accepting painful, short-term sacrifices. It causes an adjustment in the structure of wealth in favor of creditors.

The interest groups within a society are split into two groups: Holders of savings and recipients of (quasi) fixed payment streams like pensions, interest from savings, etc. will tend to benefit from such a policy and thus support price deflation. Debtors by contrast are naturally supporters of price inflation. **The higher indebtedness becomes, the greater the desire for inflation.**

With reference to governments, it can be concluded from this that **the higher a government's debt burden, the greater its aversion to price deflation. A massive (deflationary) upward revaluation of the currency, such as occurred in Switzerland in January of 2015, would be unthinkable in a country like Japan for example.** Disputes within societies between the old (savers) and the young (debtors)[55], as well as national conflicts of interest between creditor and debtor countries are direct consequences of these circumstances.

Excursus: Alan Greenspan - Gold and Economic Freedom

"…Gold is a currency. It is still, by all evidence, a premier currency. No fiat currency, including the dollar, can match it."
Alan Greenspan

Alan Greenspan's essay "Gold and Economic Freedom" from 1966 is possibly among the best publications ever to appear on the topic of gold. We recommend a thorough study of this treatise to every reader. Greenspan reveals himself in it as a proponent of the classical gold standard and argues that excessive credit growth should be regularly held in check by recessions.

The "Maestro" noted that the laws of supply and demand couldn't be suspended. Consequently, if the supply of credit were to grow relative to the supply of goods, prices would inevitably rise. As a result, a steady devaluation of savings would occur. With prophetic foresight, Greenspan stated that it wouldn't be possible to protect savings from expropriation

[54] See „In Defense of Deflation", Prof. Philipp Bagus
[55] See: "Deflation: Alt gegen Jung", Think Beyond the Obvious, Dr. Daniel Stelter ("Old versus Young")

through inflation without a gold standard, as paper money couldn't possibly be regarded as a safe store of value. If such a store of value existed, the government would have to declare possession of it illegal – which the US government in fact did from 1933 to 1975, as private persons were prohibited from owning gold.[56]

Money creation by the fractional reserve banking system is also strongly criticized by Greenspan:

"Under a gold standard, the amount of credit that an economy can support is determined by the economy's tangible assets, since every credit instrument is ultimately a claim on some tangible asset. But government bonds are not backed by tangible wealth, only by the government's promise to pay out of future tax revenues, and cannot easily be absorbed by the financial markets. A large volume of new government bonds can be sold to the public only at progressively higher interest rates.

"As the supply of money (of claims) increases relative to the supply of tangible assets in the economy, prices must eventually rise."
Alan Greenspan

Thus, government deficit spending under a gold standard is severely limited. The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. They have created paper reserves in the form of government bonds which — through a complex series of steps — the banks accept in place of tangible assets and treat as if they were an actual deposit, i.e., as the equivalent of what was formerly a deposit of gold. The holder of a government bond or of a bank deposit created by paper reserves believes that he has a valid claim on a real asset. But the fact is that there are now more claims outstanding than real assets."

Understandably, Greenspan is often criticized for having betrayed his ideals. At the age of 40, Greenspan was still a vociferous enemy of unrestricted money printing. As chairman of the Fed, he made a U-turn. He himself excused this astonishing divergence between thought and deed with the fact that he was the only Fed member thinking that way.

"Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights."
Alan Greenspan

These days, Greenspan appears to be rediscovering his roots: At the end of a recent conference he remarked that discontinuing QE and the zero interest rate policy couldn't be done "*without causing great turmoil*". **He referred to the Fed's balance sheet total, which has been blown up to nearly USD 4.4 trillion, as a "pile of tinder". A small spark would be sufficient to let loose inflationary forces.[57] We can but concur.**

Summary - gold and inflation:

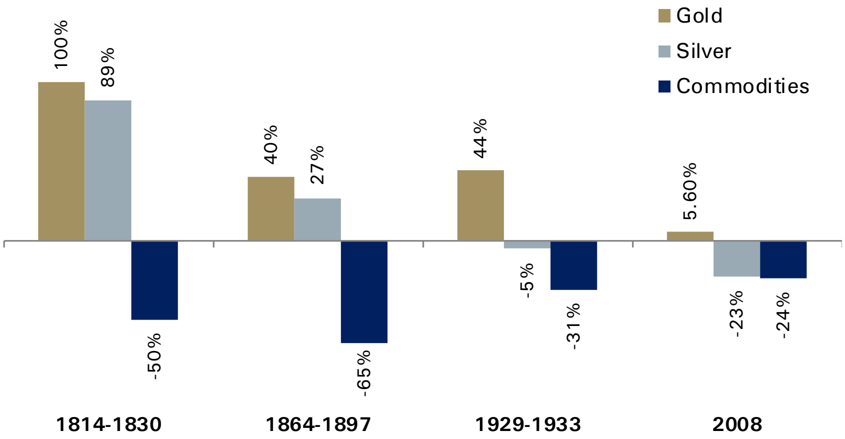
From our perspective, it is not a given whether inflationary or deflationary forces will be victorious in this monetary power struggle. However, due to the high indebtedness and the associated socio-economic incentive structures, higher price inflation will definitely be favored over a deflationary cleansing when push comes to shove. However, disinflationary forces shouldn't be underestimated either. Especially the Southern European banking system isn't yet sufficiently recapitalized in the wake of the credit bust, and extends new credit only very reluctantly. A noticeable deflationary echo left by the previous inflationary boom can still be

[56] See: "Spaete Einsicht?" ("Recognition in hindsight?"), Dr. Kurt Becker, Institutional Money
[57] See: "Der alte Mann und das Gold" ("The old man and gold"), Die Presse, Nikolaus Jilch

discerned. **Should the trend of inflation finally reverse, excellent opportunities in inflation-sensitive investments will emerge.**

In a world of monetary policy experiments, we regard gold as an exceptionally valuable portfolio component. We have already presented its characteristics during times of rising rates of inflation. However, deflationary periods also represent a positive environment for gold, which is especially evident when considering very long time periods. The following chart shows that gold (and to some extent also silver) has clearly gained in purchasing power during times of deflation. **Moreover, this chart also demonstrates clearly why gold in particular is a monetary asset, and not just another another commodity**.

Gold, silver and commodities in historical deflation eras



Sources: Roy Jastram, "The Golden Constant" & "Silver, the Restless Metal", Incrementum AG

4. FROM RISK-FREE RETURNS TO RETURN-FREE RISK

a) Bubble territory?

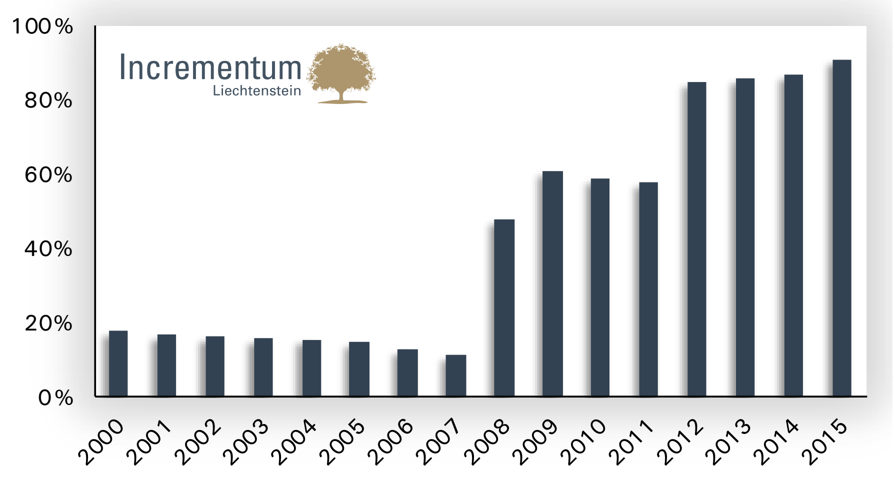
"At the core, the "this time is different" syndrome is simple. It consists of the firm conviction that financial crises only happen to other people in other countries and at other times; here, now, in our country, there can be no crisis. We are better at everything, we are smarter, we have learned from the mistakes of the past. Old rules of valuation are no longer important.

Unfortunately, a highly indebted country can stand with its back at the edge of a financial abyss unnoticed for years, before fate and circumstances trigger a crisis of confidence, upon which the country plummets into the depths."[58]

Apart from money, nothing is cheap anymore

There has never been before a comparable era of global zero interest rate policy. Since the beginning of this year alone, 25 central banks have lowered their base interest rates. The following chart shows the number of industrialized nations that have implemented a zero or negative interest rate policy.

Number of industrialized nations with a zero interest rate policy



Sources: IMF, Incrementum AG

Last year, we remarked the following in this context:

"In view of the ongoing low interest rate policy, investors are forced to take on ever greater risks in their search for yield. This hunger for yield is in the meantime producing rather disturbing effects."[59]

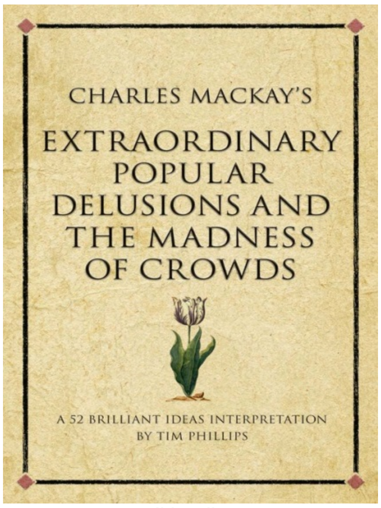
"Funny how bonds were labelled "certificates of confiscation" back in the early 1980's when yields were 14%. What should we call them now?"
Bill Gross

We believe this assessment has been confirmed. A historical first occurred on April 8: Switzerland's government was the first to succeed in generating a nominal return for itself from issuing a 10-year bond. The bond with a coupon of 1.5% was placed at an issue price of 116%. This "security" thus offers its buyers a guaranteed negative yield over its entire term to maturity. In the rest of Europe, one can also "safely lose money": in the meantime, bonds valued at more than one trillion euro trade at such high

[58] See: "This time is Different", Carmen Reinhart und Kenneth Rogoff
[59] See: "In Gold we Trust" 2014, p. 37

prices, that their yields-to-maturity are negative. In mid April, the yields of some 35% of all outstanding European government bonds were trading in negative territory. This means that these securities are massively overvalued. **Concurrently most market participants regard these securities – in keeping with prevailing financial market theory – *as risk-free*.**

After a correction of financial market excesses, a multitude of books is usually written about this previously "unpredictable" bubble. We wouldn't be surprised if the topic of negative yields were to enter a number of books as a catastasis a few years down the road.



Source: www.wikipedia.org

„Safety' is a tricky and paradoxical concept. The safe assets are often the ones that people regard as hopelessly risky."
Jim Grant

From a purely evolutionary perspective, such a herd mentality probably makes sense. If a herd is hunted, it is better for it to stick close together – anyone who leaves the herd soon falls prey to the hunters. However, this tactic doesn't always work. There are times when it is definitely better to keep one's distance from the herd. Such as in the bond markets right now. However, it appears to be difficult for most market participants to fight against a herding instinct that is deeply embedded in their subconscious mind.[60]

"Of course, this bubble is really a bubble of faith, and its main derivative is faith-based currency. And it's global. Bubbles take time to burst roughly proportional to their size, and these nested bubbles the Fed and other central banks have engineered are by far the largest ever in human history."
Chris Martenson

In a fascinating study[61], professors Schnabl and Hoffmann describe the main characteristics of a bubble formation: *"Although speculative bubbles are easily identifiable ex post, they are not recognized by the majority ex ante, and carried forward by the belief that a timely exit prior to the bubble's bursting is possible, or that the rapid ascent will be followed by a soft landing. Decisive in this are irrational factors like herding ("monkey see, monkey do") or uneasiness over seeing one's neighbour growing rich. Although Kindleberger acknowledges that crises at the end of speculative waves are not predictable, he identifies two factors that make them more likely. For one, waves of speculation are tied to positive economic expectations. Secondly, plenty of liquidity is in play, which provides the breeding ground for the excesses."*

[60] See: "Die große Geldschmelze", Hanno Beck und Aloys Prinz, p. 245
[61] See: "Monetary Policy, Vagabonding Liquidity and Bursting Bubbles in New and Emerging Markets", Gunther Schnabl and Andreas Hoffmann

Investment in government bonds increasingly involves leverage, due to low yields and the generally high marginability of such bonds. From a regulatory perspective, it is for instance easily possible for regulated funds to greatly leverage a fund's capital in order to multiply low yields through external financing. These funds have in recent years inter alia employed increasingly popular "risk parity" concepts. Investment in government bonds specifically is thereby massively blown up beyond a fund's capital by purchasing financial futures.

"You can't make yesterday's returns tomorrow, so the only question people really need to ask themselves is whether they think the next 30 years will be the same."
Jordan Eliseo

Bonds are asymmetrical investment assets. An investor cannot receive more than the coupon payments and the repayment of principal. The maximum return is limited, but the risk of loss is unlimited. Moreover, interest rate risk rises when yields are low. **Bond investors have been frightened in the months of April and May of this year.** 10-year German Bunds (resp. Bund futures) suffered a drawdown of more than 7% in just a few weeks time. The last comparable sell-off has taken place more than a decade ago. Even after this setback, yields are still at less than 1% for maturities of ten years. **In the event of a rapid increase to significantly higher yield levels, the potential for losses is enormous (esp. for supposedly safe investments).**

"Eurozone bond prices have entered a Kafkaesque world of negative yields."
Jeremy Warner

A variety of sources has for quite some time warned about possible crash scenarios in the bond markets, as the central bank is no longer (as was the case until 2014) a buyer, but possibly soon a seller of bonds. Market participants would anticipate this step and significantly reinforce the effect, by switching sides concurrently. **In our opinion it is especially this factor that makes the intended reduction of the Fed's balance sheet via selling bonds the Fed has purchased impossible.**

"Junk bonds have really gone to levels which under our analysis are pretty much the most overvalued in history."
Jeff Gundlach

The party in bonds is, however, not limited to government bonds: wherever one looks, caution has been thrown to the wind. Numerous short to medium term bonds of international corporations including the likes of Roche and Nestle now exhibit negative yields-to-maturity as well. If one considers these bonds to be too boring, one can always invest in junk bonds, which are currently trading in the 98th percentile, in other words, they have historically been valued more highly in just 2% of all cases. **If "return-free risk" has ever existed, it is alive and well today**.[62]

Institutional investors such as pension funds and life insurance companies, and especially their beneficiaries, are the biggest losers of loose monetary policy. The yields of most government bonds are once again far below the guaranteed yields on life insurance policies. In Germany, this guaranteed insurance policy interest rate currently stands at 1.25%[63], while the yield on a 10-year German government bond stands at 0.55%.[64] As soon as higher-yielding bonds mature, reinvestment has to be undertaken at significantly lower yield levels. **The longer this discrepancy persists, the greater the threat to the survival of many insurance companies becomes. The following statement by a pension fund manager illustrates the pressure under which many institutional investors are working:**

[62] See: "Junk Jumpers: The Era of Return-Free Risk", Acting-man.com
[63] It was lowered from 1.75% to 1.25% on 1.1.2015
[64] As of 25 May 2015

"In a world where bonds are yielding inflation minus 1 percent, if you can get something which yields a bit more than that, it's the way to go."[65]

„An emerging market is one you cannot emerge from in an emergency."
Don Coxe

This pressure on institutional investors to produce returns has the effect that even governments that have defaulted fairly recently are able to obtain fresh capital at extremely favorable conditions. Ecuador, which defaulted in 2009, was able to issue USD 2 billion of government bonds. Armenia, which is considered "highly speculative" by the credit rating agencies, was likewise able to issue 10-year bonds effortlessly at the most favorable conditions ever.

"***The money rate can, indeed, be kept artificially low only by continuous new injections of currency or bank credit in place of real savings. This can create the illusion of more capital just as the addition of water can create the illusion of more milk. But it is a policy of continuous inflation. It is obviously a process involving cumulative danger.***"
Henry Hazlitt

Among the biggest beneficiaries of the low interest rate environment are frontier markets.[66] Their bond issuance activity has increased by 300% since 2012. Especially bonds from the sub-Saharan region have recently sold like hot cakes. Thus Ghana, Senegal, Angola Zambia, Rwanda and Kenya all have issued bonds denominated in US dollars.[67] Ivory Coast was able to place a 10-year government bond yielding 5.6% in the middle of a civil war and only three years after defaulting – demand exceeded supply by multiples. We are highly critical of this bond bonanza: The questionable creditworthiness and fragile outlook of these issuers hardly justify coupons ranging from 5.5% to 8%. **One must suspect that the risks are massively underestimated and that far higher risk premiums would be appropriate.**

„I can calculate the motion of heavenly bodies, but not the madness of people."
Isaac Newton

In terms of bond maturities, one can also detect signs of a mania. Mexico issued yet another "century bond". The most recent 100-year bond with a yield of 4.2% is denominated in euro, has a volume of EUR 1.5bn and is set to be redeemed in April 2115 (!!!). And this is not the first of its kind. In 2010, nearly USD 2.7bn of century bonds were issued denominated in dollars. In a historical context, a bet that a system of irredeemable currency will still exist in 100 years is extremely daring. **However, if one can rely on Theo Waigel's expertise, who believes the euro will last another 400 years, then even this government bond may turn out to be a sensible investment for one's descendants.**[68] **We remain somewhat skeptical.**

<u>Conclusion</u>:
The most recent mania in the bond markets, which is characterized by massive over-subscription and record prices at increasingly speculative price levels, reminds us of the excesses in Germany's "Neuer Markt" and the Nasdaq at the end of the 1990s. While exponential growth can often be observed in nature as well, it is always temporarily limited.

"...when it changes it does so quickly, and the impossible becomes the inevitable without ever having been probable."
Bill Fleckenstein

Based on the facts, it can immediately be stated that the situation in the bond markets has reached the most extreme end of the historical range in terms of prices and yields – never has a market depended more strongly on irrational faith. **Once creditors have to pay borrowers for the dubious "privilege" of lending them money, there is essentially only one direction left in which this market can possibly move.**

"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. The new error is born not an infant, but a giant."
Arthur Cecil Piquot

[65] See: "Pension funds seek riskier, illiquid bets to make returns they need", Reuters, March 2015
[66] "Frontier markets" are countries with high growth rates, which have however not yet reached the status of "emerging market". At the moment frontier markets e.g. comprise Algeria, Mocambique, Tunisia, Bangladesh or Colombia.
[67] In light of the recent rally in the dollar, these bonds have become a good sight riskier.
[68] See: "Theo Waigel gibt dem Euro noch weitere 400 Jahre", Die Welt

Yield chasing such as is currently underway means individual market participants will require a “greater fool” to be able to get out of the market in the nick of time before the bubble bursts. While the 2008 crisis was focused on the sub-prime market and the derivatives tied to it, we are now in an entirely different bubble dimension: government bonds are at the epicenter of the debt money system and represent the bulk of assets held by central banks. **Ultimately the bursting of such a bubble can be averted by launching an “infinite QE program”. This means however that sooner or later, confidence in the currency will evaporate and it will lose all purchasing power.**

b) What is seen and what is not seen: the fatal consequences of the zero interest rate policy

Interest rates are such a crucial factor in economic activity, that they must not be allowed to be “manipulated” by governments. They are the market's “price of time”.
Roland Baader

300 years ago, Newton formulated his third law, also called the principle of action-reaction. It states: *“Forces always appear in pairs. When one body A exerts a force on a second body B (action), the second body B simultaneously exerts a force equal in magnitude and opposite in direction on the first body A (reaction).”*

In a dynamic economy, an action not only triggers just one effect, but always an entire series of different consequences.[69] While the cause of the first effect is easily recognizable, the other effects often occur only later and no such recognition occurs. Frédéric Bastiat described this phenomenon in 1850 in his ground-breaking essay “What is seen and what is not seen”:[70]

“In the economic sphere, an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; it is seen. The other effects emerge only subsequently; they are not seen; we are fortunate if we foresee them…
There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen. Yet this difference is tremendous; ***for it is almost always the case that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa.*** *Hence it follows that the bad economist pursues a small present good that will be followed by a great evil, while the good economist pursues a great good to come, at the risk of a small present evil.”*

“Right now macro doesn’t matter. But that will change. When it does matter it will be all that matters.”
Bill Fleckenstein

A similar phenomenon can be seen with the consequences of artificially suppressed interest rates and monetary stimulus: In the short term, they appear to have positive effects, the long term effects are however disastrous and bear no relation to the advantages. If one studies these processes closely, it becomes clear that the underlying problems cannot be solved by global zero interest rate policy, but that this instead undermines the natural selection process of the market. Governments, financial institutions, entrepreneurs and consumers, who should actually be declared insolvent, all remain on artificial life support.

[69] Note: Carl Menger had already stressed causality in terms of economic laws, thus the very first sentence in his revolutionary work “Principles of Economics” is: *“All things are subject to the law of cause and effect. This great principle knows no exception, and we would search in vain in the realm of experience for an example to the contrary.”*
[70] “Ce qu'on voit et ce qu'on ne voit pas”, Frédéric Bastiat

In line with Bastiat's thoughts, numerous fatal long-term consequences of zero interest rate policies can be identified:[71]

- Conservative investors by nature come under increasing pressure with respect to their investments and take on excessive risks in light of the prospect that interest rates will remain low in the long term. This leads to capital misallocation and the emergence of bubbles.
- The sweet poison of low interest rates leads to massive **asset price inflation (stocks, bonds, works of art, real estate).**
- Structurally too low interest rates in industrialized nations due to carry trades lead to the emergence of asset price bubbles and contagion effects in emerging markets.
- Changes in **human behavior patterns** occur, due to continually declining purchasing power. While thrift is increasingly mutating into a relic of the past, taking on debt comes to be seen as rational.
- **As a result of the structurally too low level of interest rates, a "culture of instant gratification" is created,**[72] which is among other things characterized by the fact that consumption is financed with credit instead of savings. The **formation of wealth** becomes steadily more difficult.
- The **medium of exchange and unit of account function** of money increases in importance, while its role as a **store of value** declines.[73]
- Incentives for **fiscal discipline** decline.
- **Zombie banks** are created: Low interest rates prevent the healthy process of creative destruction. Banks are enabled to roll over potentially non-performing loans practically indefinitely and can thus lower their write-off requirements.
- **Distributive injustice (Cantillon effect)**: Newly created money is neither *uniformly* nor *simultaneously* distributed amongst the population. This results in a permanent transfer of wealth from later receivers to earlier receivers of newly created money.[74]

***„Interest rates are the heart, soul and life of the free enterprise system.*"**
Michael Gayed

Conventional monetary policy – this is to say the promotion of credit creation by lowering interest rates – reaches its limits once the "zero-bound" is reached. In order to continue the spiral of stimulus, "unconventional monetary policy" becomes ever more important. The multitude of "newfangled" monetary policy measures is seemingly only limited by the imagination of central bankers, whereby recent years have shown that central bankers can be extraordinarily creative. That this phenomenon is nothing new, is inter alia shown by this quote from 1922:

"But an increase in the quantity of money and fiduciary media will not enrich the world […] Expansion of circulation credit does lead to a boom at first, *it is true, but sooner or later this boom is bound to crash and bring about a new depression. Only apparent and temporary relief can be won by tricks of banking and currency. In the long run they must lead to an all the more profound catastrophe*."

Ludwig von Mises [75]

[71] See: "In Gold we Trust" 2014, p. 33-34
[72] See: „Wenn Menschen zu Ratten werden", Linus Huber („When men become rats")
[73] See: „Ein Staatsgeldsystem lädt Regierungen immer zum Betrug ein", Hubert Milz, Ludwig von Mises Institut Deutschland ("A state money system always invites governments to commit fraud")
[74] See: "Cantillon Effect describes the uneven distribution of newly created money", In Gold We Trust, 2013.
[75] "Socialism" (1922), part II, p. 460-462, Ludwig von Mises

"If you think as I do that this is the beginning of the end for the Golden Age of the Central Banker (or at least the end of the beginning), gold is pretty interesting here."
Ben Hunt

<u>Conclusion</u>:
The seeds for the next crisis are already being sown. The longer the zero interest rate policy lasts, the greater risks investors will have to take, especially the ones who have certain return requirements. The point at which confidence in the fragile edifice of debt will be lost is difficult to forecast. **We are strongly convinced that gold represents a sensible hedge against such a crisis of confidence.**

c) Zero interest rate policy and the fatal distortion of the capital structure

"Occasionally it may appear sensible to heat one's house by burning the furniture. However, if one does that, one should be fully cognizant of all consequences."
Ludwig von Mises

In line with the tradition of the Austrian School, we do not regard capital as a statistic or uniform blob, but believe a more differentiated perspective is appropriate. Thus, we acknowledge that capital has a heterogeneous structure, which has formed historically as the result of countless individual decisions. At any given point in time, individuals are anticipating potential opportunities to profitably expand on the existing state of the capital structure based on their specific knowledge and are thereby modifying it. Some technologies become obsolete over time, and the associated ends or links of the structure will accordingly regress.

In order to achieve a higher level of consumption, men began to forego some of their present consumption, in order to employ it in investments and the creation of more efficient production methods. In this context, there exists the following famous illustrative example of the Robinson Crusoe economy: Crusoe decides to no longer expend all his time and effort on catching fish barehanded, but also on weaving a fishing net. As a result, he has to reduce his level of consumption for the time being, but will be able to increase it in the future.

Transposing this to a complex economy, the basic recognition remains that solely by foregoing consumption can resources be freed up which can then be employed in investment projects. In this more complex economy, one not only confines oneself to creating capital goods which serve directly in the production of consumer goods – so-called goods of second order, such as the above mentioned fishing net (the consumer good fish represents a good of first order, i.e., a good that directly satisfies a need) – but also goods of higher orders, which in turn serve to produce other producer goods, and hence are even further removed from consumption.

„The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics."
Thomas Sowell

Two aspects are of key importance in this context: Specificity and time. The former term designates the fact that available resources will take on specific forms and functions in the largely irreversible process of investment, and with that obtain a specific position in the capital structure. An investment's success is thus dependent on whether the created capital good fits well into the capital structure as a whole (i.e., that it is capable - in combination with other capital goods - to expand final consumption opportunities as desired).

The second aspect, namely time, is often underestimated, or in an environment in which investments in the real economy appear as cash values in balance sheets or structured financial products, even neglected completely. However, in the Austrian tradition, the time factor is accorded a prominent role; Murray Rothbard explicitly refers to it as a factor of production.[76] This is based on the fact that every human action is connected with the passage of time – and that includes the act of investing. If therefore, as noted above, resources are set aside in the present and invested in more efficient production technologies, time is required until these investments bear fruit. The consumption one renounces today is thus contrasted by greater consumption, but only at a later point in time.

Austrians approach the concept of interest rates differently

This brings us to the concept of interest rates, which Austrians also approach differently than economists of the neoclassical or monetarist traditions. Their fundamental assumption is that people would prefer to have a clearly defined consumer good available for immediate consumption rather than at a future point in time. Thus, if savers are renouncing present consumption and are making the resources which are thereby freed up available for investment, they are doing so on the precondition that they will be compensated for this by having greater consumption opportunities available in the future. In a free market, the interest rate essentially represents a measure of the compensation payment in return for which actors in the economy are prepared to exchange present against future goods. This interest rate is called the "natural" or "originary" interest rate and provides information about the time preferences of market participants. Investment projects whose expected returns are lower than this interest rate, won't be initiated in a free market economy, as their returns would not offset the losses in present consumption.

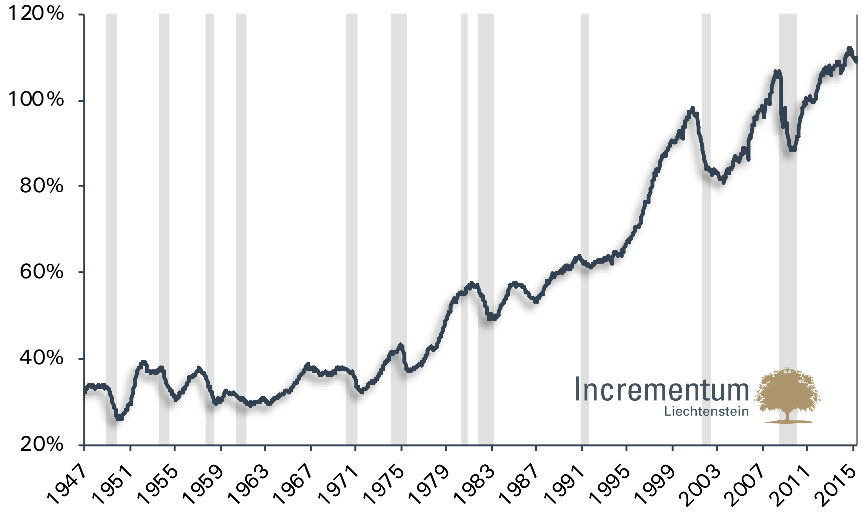
Sooner or later, the scarcity of real resources will become obvious

Against the backdrop of the concept of the "natural" interest rate, it is now somewhat easier to understand why the current situation of artificially suppressed low interest rates is not sustainable in the long run: At best, they can - akin to a "tracheotomy"[77] - keep a foundering economy from collapsing, if a liquidity squeeze occurs upon the outbreak of a crisis. However, since interest rates that are kept low in the long term on the one hand foster investments that wouldn't be profitable under different circumstances, and on the other hand stimulate present consumption as well because savings will produce lower returns, such a policy cannot possibly be sustainable. Ultimately, there simply won't be enough resources available. Unfortunately, long term investments will appear to be especially profitable, as in the calculation of their viability, discounting by low interest rates will result in very high net present values. Monetary policy manipulations may be able to obscure the actual situation for a long time, and stock markets may rally by chasing a monetary illusion – but sooner or later, the scarcity of real resources and malinvestments will become obvious. **Then there is either a crisis in which debts are liquidated and the money supply contracts, or the next step in terms of loose monetary policy is undertaken, which sustains the illusion for longer and leads to an even greater distortion of the capital structure.**

The following chart depicts the ratio between spending on capital and consumer goods production over time. A rising ratio indicates that relatively more capital than consumer goods are produced. While it cannot be deduced from this chart how much capital has been malinvested, it is quite conspicuous that the ratio left the range within which it had historically oscillated shortly after the gold exchange standard was abandoned in 1971 and it has risen strongly ever since. Moreover, periods of extreme increases in the ratio are regularly followed by recessions, which tend to go hand in hand with a decline in the ratio.

[76] See: "Man, Economy, and State with Power and Market", p. 515, Murray N. Rothbard
[77] See: „Banken liquidieren", Mayers Weltwirtschaft, FAZ ("Liquidating banks")

Ratio of capital to consumer goods production (gray areas indicate US recessions)



Source: Federal Reserve St. Louis, Incrementum AG

An increase in the ratio primarily allows one to conclude that the capital structure is deepening, i.e., that production activities are increasingly focused on higher order goods. In an unhampered economy, this wouldn't be cause for concern: A deepening of the capital structure would indicate that people are saving more in order to invest in more efficient and capital intensive technologies, which will provide them with higher consumption opportunities in the future. However, as savings actually don't increase in times of artificially suppressed interest rates, but will on the contrary actually tend to decline, an accelerated increase in the ratio points to an unsustainable distortion of the capital structure.

Artificial suppressed interest rates result in distortions – in the long term it will become evident that real resources are insufficient

<u>Conclusion</u>:
Capital is a complex structure, which contains the decentralized knowledge of countless market participants. The natural interest rate is an expression of the time preferences of acting men, i.e., it reflects to what extent market participants are prepared to employ available resources either in present or future consumption. Thus, a capital structure that comes into being on the basis of natural, freely-formed interest rates, is aligned with people's needs and wishes.

Artificially suppressed interest rates by contrast result in distortions: A deepening of the capital structure occurs, i.e., investments in segments far removed from the consumption stage are encouraged, while consumption increases simultaneously. In the long term, it will become evident that real resources are insufficient for these investments, and that these projects have to be abandoned and written down. However, at present the illusion of a monetary *perpetuum mobile* still prevails in the markets.

5. DEBT AND PUNISHMENT

"The financial history of the last century shows a steady increase in the amount of public indebtedness. Nobody believes that the states will eternally drag the burden of these interest payments. It is obvious that sooner or later all these debts will be liquidated in some way or other, but certainly not by payment of interest and principal according to the terms of the contract."

Ludwig Von Mises[78]

"Creditors have only themselves to blame", Philip II of Spain is said to have remarked. He was leading by example, and with three government insolvencies within his 40-year reign, established himself as a kind of superstar among government bankrupts.[79] Little has changed over 400 years later. Even though the government debt of industrialized nations is held to be akin to the gold standard of safe investments, one nevertheless has to wonder about the complacency of investors considering 320 government insolvencies within just the past two centuries.[80] In the following chapter, we want to more closely examine modern-day debt dynamics.

a) About the ethics of thrift

"Saving is the indispensable precondition of investment. There simply exists no investment that isn't funded by savings"
Guido Huelsmann

The term *"economy"*[81] was coined by Aristotle. He employed it to describe the running of a household. The fundamental laws of economics are always the same; they apply just the same to a family household, a company or a nation.[82] The central goal is thereby to spend less than one's income and thus build up reserves. What is fascinating in this context is that the building up of reserves as such appears to be a virtue, while the reserves themselves are only rarely needed. It is therefore no coincidence that precisely those people (or nations) that have no reserves, are conspicuous in their bad manners.[83] A declining propensity to save and an increase in immoral behavior historically exhibit quite an interesting correlation. Thrift is, especially in an inflationary environment, an act of self-control, and expression of a virtuous lifestyle – Mises speaks of an "apparent sacrifice".[84]

Thrift – or even worse "hoarding" – is no longer considered *bon ton*. The vast majority of mainstream economists believe in the so-called "paradox of thrift".[85] From the perspective of the Austrian School, this

[78] „Human Action", Ludwig von Mises, The Scholar's Edition, S. 228
[79] See: „Die grosse Geldschmelze", p. 128, Hanno Beck und Aloys Prinz
[80] See: „Die grosse Geldschmelze", p. 131, Hanno Beck und Aloys Prinz
[81] Greek: "Eikonomos"
[82] As Rahim Taghizadegan remarks trenchantly in this context: "*One should keep in mind that the largest number of economists that has ever been employed, has served in the Soviet Union. Not because it was such an economically minded nation, but because at the time, the illusion that human action was calculable and steerable was at its strongest. The more economists, the worse for society, the stronger the illusion of the ability to exert control. Economics always was an ancillary discipline. Ultimately, the only thing the ancient oikonomia was about, was running a household well."* ("The more economists, the worse", Interview with Rahim Taghizadegan, Die Presse)
[83] See: "Dawn of Gold", Philip Barton
[84] See: „An der Eigenverantwortung kommt man nicht vorbei", Rahim Taghizadegan ("One cannot get past personal responsibility")
[85] Wikipedia: "*The paradox states that if everyone tries to save more money, then aggregate demand and therefore income will fall and will in turn lower total saving (the autonomous portion that changed initially plus the portion induced by the level of income) in the population,*

is a defective fairy tale: savings don't magically “disappear” from the economy, rather they are directed into different channels, in order to fund investments and/or to fund consumption at a later date.

Does this also apply in a recessionary environment? Definitely. According to the Austrian School, manipulation of interest rates fundamentally distorts the economy. In order to mitigate the length and depth of a recession, economic actors should increase their savings, which reduces the discrepancy between artificial and natural interest rates.[86] This approach is diametrically opposed to the prevailing economic orthodoxy.

b) Debt trends in the developed world

According to Milton Friedman, there are four different ways to spend money:[87]

- **1. We spend our own money on ourselves:** in this case, one pays attention to both price and quality of the good or service
- **2. We spend our own money on someone else:** one buys a birthday present for an acquaintance for example. In this case, there is price sensitivity, quality is relatively unimportant
- **3. We spend other people's money on ourselves:** in this case, the quality of the good or service is most important, price is secondary
- **4. We spend other people's money on someone else:** if we buy lunch for someone we don't know using an expense account paid for by a third party for example, we will neither worry too much about the price nor the quality of the food. Especially compared to the first case, this is the clearly most inefficient variant.

Since government spending in most industrialized nations accounts for more than half of economic output these days, the fourth method of spending money plays a central role in today's world. Even though in most cases good intentions are in play, the results of the statist administrative reality are as a rule quite poor. Sooner or later the welfare state must run into problems, after all the state will never allocate money with the same care individuals employ in spending on themselves.[88] **In the following pages, we will discuss the most important trends of the policy of indebtedness.**

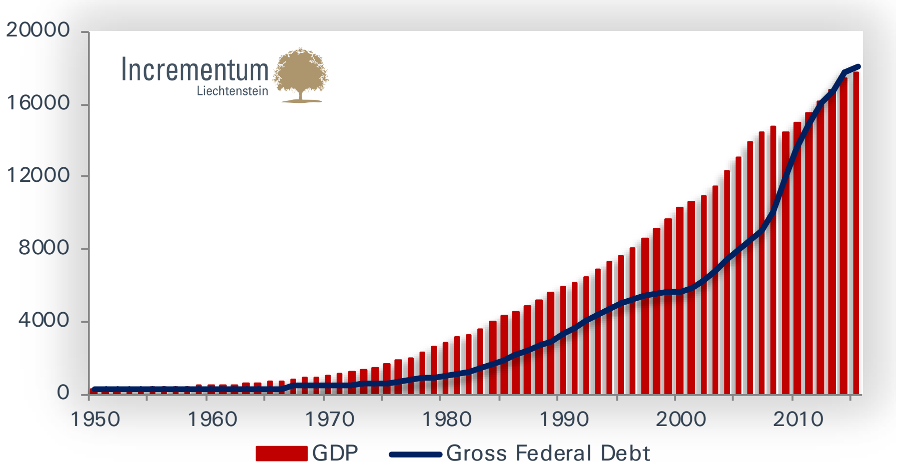
In the US, government debt now amounts to more than USD 18 trillion.[89] For the first time since the end of the 1940s, the level of debt has risen above the value of economic output (as measured by GDP). In the last fiscal year, debt service costs amounted to USD 430bn, at an average interest rate of 2.4%.

---

because the tendency to save is directly related to the amount of income received. The paradox is, narrowly speaking, that total saving may fall even when individuals attempt to increase their saving, and, broadly speaking, that increase in saving may be harmful to an economy”

86 See: Why the Wealth Effect Doesn’t work“, Chris Casey, Mises.org
87 „The 4 Ways to Spend Money by Milton Friedman“, Youtube.com
88 See „Fremdes Geld für fremde Leute“, Freunde der offenen Gesellschaft („The money of strangers for strangers“)
89 This is equal to 475,000 tons of gold

Gross Federal Debt and US GDP (USD bn.)

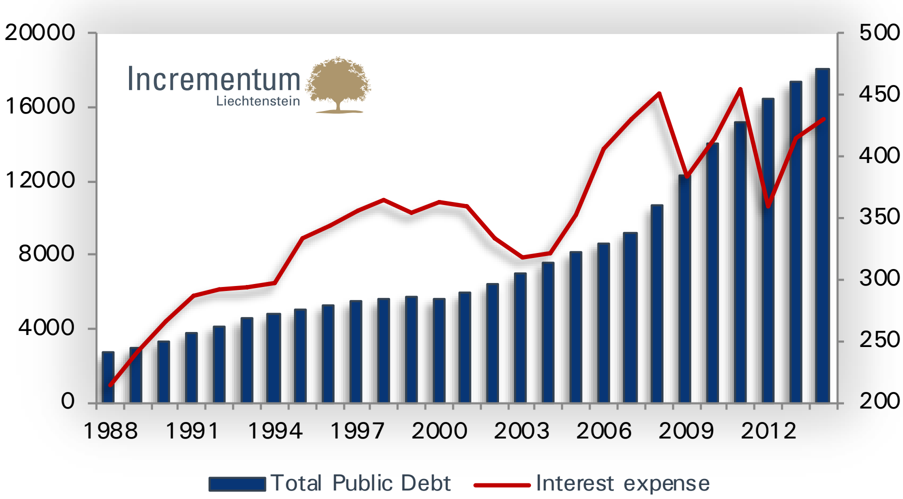


Sources: Federal Reserve St. Louis, Incrementum AG

Germany enjoying the „lucky time window“

The big illusion of debt redemption is only maintained by constantly rolling over maturing debt. As long as interest rates are declining, refinancing costs become steadily more favorable. One could also refer to this time period as a "*lucky time window*". Germany's example shows that many nations are currently enjoying such a "lucky time window". The share of interest expenses in Germany's federal budget has shrunk since 2008, from 14.2% in 2008 to 8.4% currently. This is equivalent to the level of 1990, when the total public debt amounted to only 38% and not 75% of economic output, as is the case at present.[90] **This implies that the government's dependence on steadily declining interest rates is ever more pronounced, as this is the only way the debt burden can be sustained.**

US: total public debt (left hand scale) and interest expense in USD bn. (rhs)



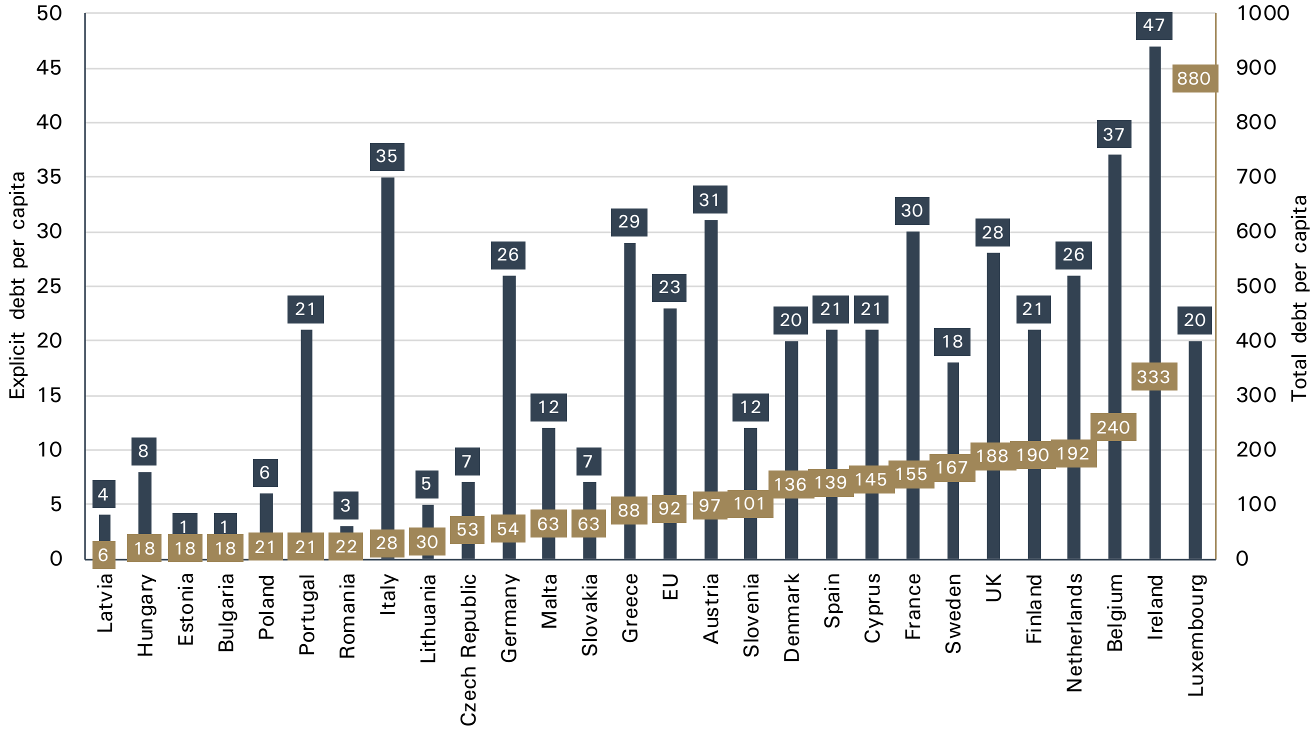
Sources: Federal Reserve St. Louis, Incrementum AG

Even though Keynesians love to ignore relevant examples, there is some evidence that austerity policies can be implemented successfully. The Baltic nations were hit especially hard in the debt crisis

[90] See: "Zeitfenster des Glücks", Wellenreiter-Kolumne, April 23rd, 2015

and bowed to the "diktat of empty coffers". They implemented courageous and drastic reforms and balanced their budgets.[91] The relatively low indebtedness of these countries can also be seen in the following chart. It shows their explicit as well as their total debt (= sum of explicit and implicit debt, a.k.a. unfunded liabilities) per capita.

EU: Explicit and total debt per capita



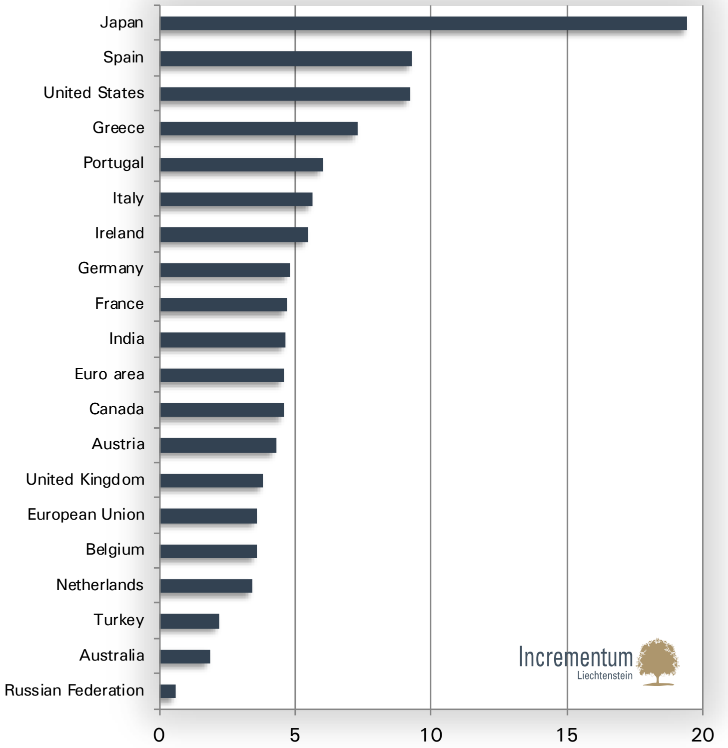
Source: Stiftung Marktwirtschaft

"Much of the Western world will require defaults, a savings tax and higher inflation to clear the way for recovery as debt levels reach a 200 year high."
Ambrose Evans-Pritchard

In order to assess the solvency of a government, we regard the ratio between public debt and tax revenues as far more informative than the ratio between public debt and economic output (debt/GDP). Japan's public debt for instance stands at 19 times annual tax revenues. By altering the denominator, one can discern what effect changes in interest rates would have. If, for example, public debt exceeds revenues by a factor of ten, an average increase in financing costs by one percentage point would indicate that tax revenues would have to increase by 10% to maintain the status quo. **The following chart shows how far advanced the Keynesian endgame already is.** [92]

[91] See: "The Keynesians' New Clothes", John Butler
[92] See: „The Critical Chart in Sovereign Debt Analysis", Greshams-Law.com

Ratio of public debt to tax revenues



Sources: World Bank, Incrementum AG

Most of the time the debate is focused on explicit, directly visible debt. This present and past-oriented perspective, however, only illuminates one side of the coin, while future fiscal trends and demographics are completely ignored.

***"One day the day will come when every citizen must learn that he has to pay for the debt which the government is taking on and declares as being for the "welfare of the people"*.**
Ludwig Erhart

By looking at the so-called fiscal sustainability gap, one can account for this problem. This gap consists of explicit public debt already reported today, and implicit debt. Implicit debt (or unfunded liabilities), includes future services and payments that, according to currently applicable law, must be paid, resp. will be received by all people living today as well as future generations. **In other words, the sustainability gap shows what reserves need to be accumulated in order to ensure the financing of today's level of services in the future as well.** Among these hidden debts are all services that the government owes its citizens in the form of pensions, old age care, or health insurance.[93]

"What the government spends more, the public spends less. Public works are not accomplished by the miraculous power of a magic wand. They are paid for by funds taken away from the citizens."
Ludwig von Mises

Due to demographic trends, spending on health, pensions and old age care will rise significantly in practically all industrialized nations. At the same time, the share of people of working-age is declining. However, they bear the tax burden and the majority of social security contributions. It is therefore practically impossible to avert a further increase in government debt – unless massive consolidation efforts are undertaken. As a consequence, *Stiftung Marktwirtschaft* notes that public revenues and expenditures threaten to drift ever further apart.

The following chart shows the fiscal sustainability ranking of the EU member nations. Compared to the previous year, the sustainability gap,

[93] See: https://en.wikipedia.org/wiki/Generational_accounting

i.e. the sum of explicit and implicit public debt has declined in 13 of 27 countries. There is no public budget in the EU that is managed in a sustainable manner. However, according to the authors of the study, the efforts of crisis countries such as Greece and Portugal are slowly bearing some fruit.

Implicit vs. explicit debt / fiscal gap of selected European countries[94]

Source: Stiftung Marktwirtschaft

c) The globalization of over-indebtedness

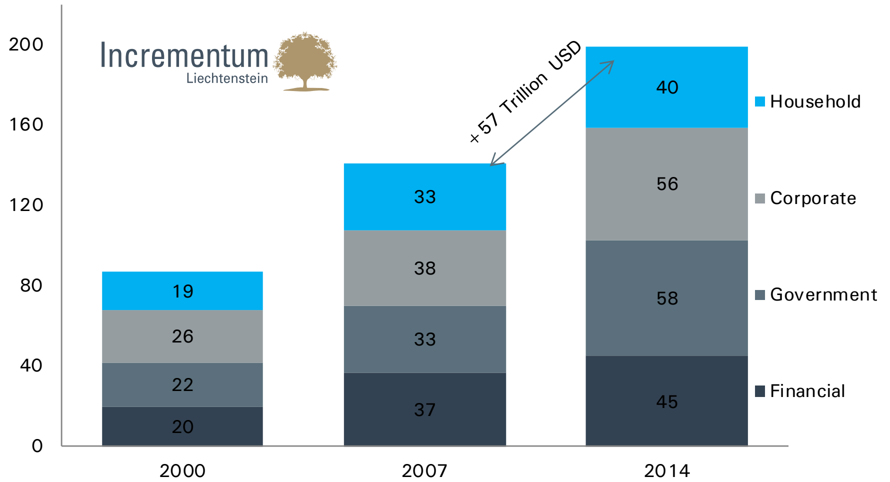
"The crux of the problem in the global financial system today is not money but debt."
Jim Rickards

Seven years after the beginning of the financial crisis, the erroneous impression is often propagated that governments have massively reduced their expenditures, have implemented draconian austerity programs and whipped their budgets back into shape. **This is as far removed from reality as the idea that Austria might win the soccer world cup.**[95]

If one looks at the bare facts, one must wonder why such stories have ever made the rounds. According to a study by McKinsey[96], which is well worth the read, global debt levels have increased by USD 57 trillion since 2007. To illustrate the scale, this amount is about three times the annual US economic output.

[94] Note: While Luxembourg's high implicit debt is primarily based on an extremely generous retirement system, there is even an implicit surplus in Italy's case, as the share of age-related spending to GDP will barely increase in the long term and Italy moreover exhibits a primary surplus, i.e., a fiscal surplus before interest payments.
[95] **Unfortunately!**
[96] "Debt and (not much) deleveraging", McKinsey Global Institute

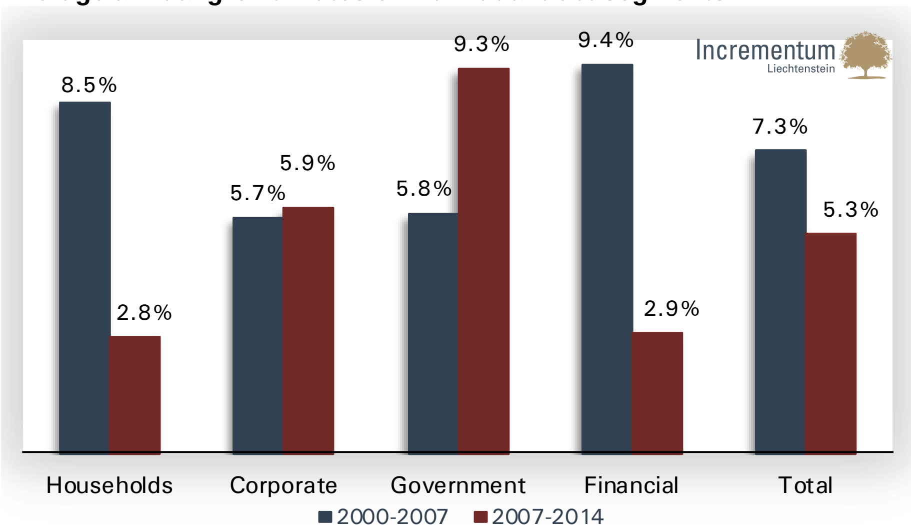
Debt trends of private households, companies, governments and financial institutions in USD trillion



Sources: McKinsey Global Institute, Haver Analytics, World Economic Outlook, IMF, Incrementum AG

All in all, the growth momentum of new borrowing has declined from 7.3% per year to 5.3%. If one looks at growth rates of individual debt segments, it is remarkable that only households and financial institutions have reduced the pace of debt growth. This mild "deleveraging" was, however, compensated for by governments that increased their borrowings by 9.3% p.a.

Average annual growth rates of individual debt segments



Sources: McKinsey Global Institute, Haver Analytics, World Economic Outlook, IMF, Incrementum AG

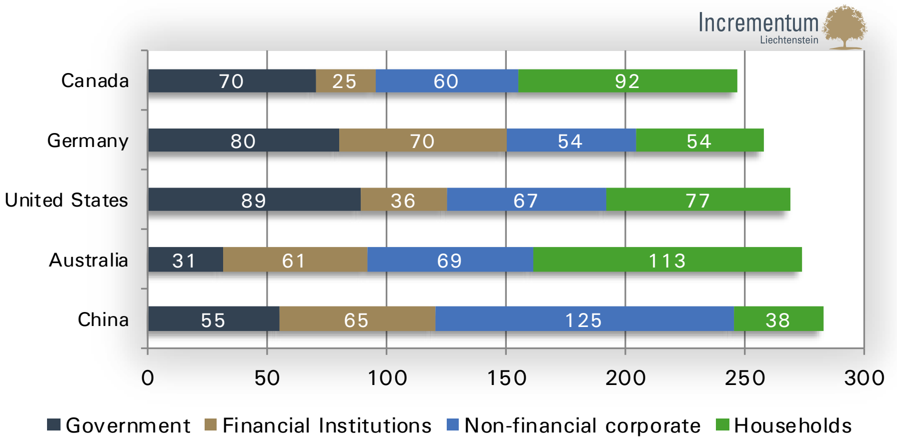
"The level of risk of shadow banking in China could soon be tested by the slowdown in the property sector."
McKinsey

According to a recent report[97], the BIS asserts that the global economy is just as vulnerable today as it was in 2007 – with the main difference that debt levels are now far higher and that emerging market countries have in the meantime erected a colossal tower of debt as well.

[97] "Debt", BIS Paper No 80, January 2015

In China, debt levels have grown especially strongly as a result of the unconditional expansionary reaction to the crisis. Driven by a real estate bubble and financed by an opaque shadow banking system, the total level of debt has increased fourfold, from USD 7 trillion to USD 28 trillion.[98] McKinsey estimates that half of all Chinese loans are related directly or indirectly to real estate investments. Such a concentration of credit risk represents a significant threat – especially in light of the fact that real estate prices in China's 320 most important cities have risen by 60% or more since 2008. Due to the opacity of the shadow banking system, China's tower of debt appears especially fragile. According to the study, loans extended by shadow banks amount to almost 30% of total credit volume outstanding and nearly 50% of newly extended credit.

Debt/GDP (Q2 2014)

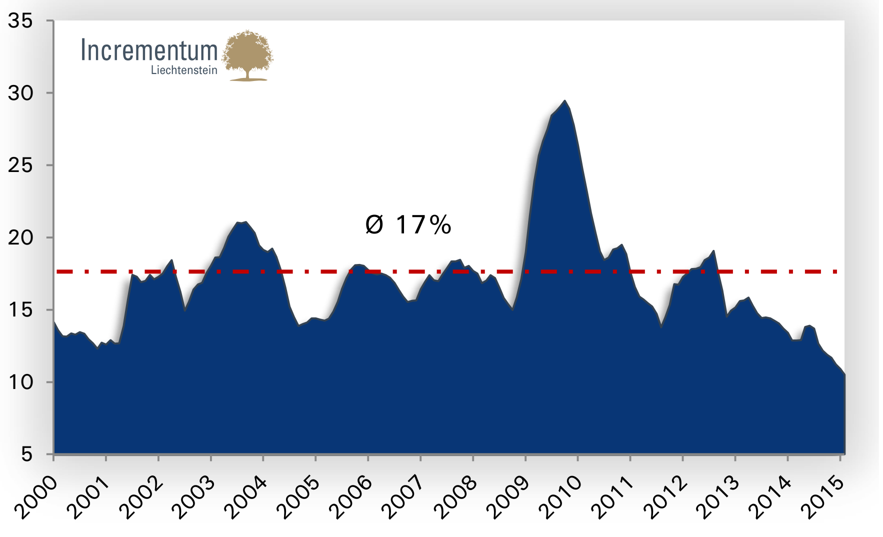


Sources: MGI Country Debt database, McKinsey Global Institute analysis

A slowdown in real estate markets therefore represents an existential threat for China's economy. The leadership in Beijing now faces the great challenge of stepping away from the vicious circle of leverage and growth and slowly letting the air out of the real estate bubble, without provoking a collapse of the shadow banking system. **That's a tall order if ever there was one. Declining money supply growth rates already indicate that the situation is inching ever closer to the edge of the abyss.**

[98] Whereby this actually excludes the financial sector.

China M2 rate of change (3-month moving average)



Sources: Bloomberg, Incrementum AG

"Players lose a typical game of Tetris when they can no longer keep up with the increasing speed, and the Tetriminos stack up to the top of the playing field. This is commonly referred to as topping out."
Wikipedia on Tetris

Historically, planned "soft landings" have in most cases become abrupt collapses. If one were to follow the teachings of Ludwig von Mises, one would leave the markets to fend for themselves in the framework of a *laissez faire* policy, and rely on the healing process of a recession. Massive interventions in the economy by contrast only delay the necessary adjustments and will ultimately lead to an even more pronounced downturn. **In our opinion, a sharp contraction of the Chinese economy is highly likely. This scenario may well represent one of the greatest potential negatives for the gold price.**

d) Demographic headwinds are picking up

"The plunge from consumer heaven into old age penury will be sudden, deep and painful."
Hans-Werner Sinn

We already pointed out last year that demographic trends in most industrialized nations are akin to an overarching deflationary superstructure: while young adults are the growth drivers of the economy, the aging population is reducing its savings, divesting its assets and reducing consumption.

A decisive metric illustrating the demographic situation is the age dependency ratio. It shows the ratio between retirees (older than 65 years) and the working-age population (20-64 years). As members of the baby-boom generation gradually enter retirement over the coming 10 to 15 years, the ratio will steadily increase in most developed nations.

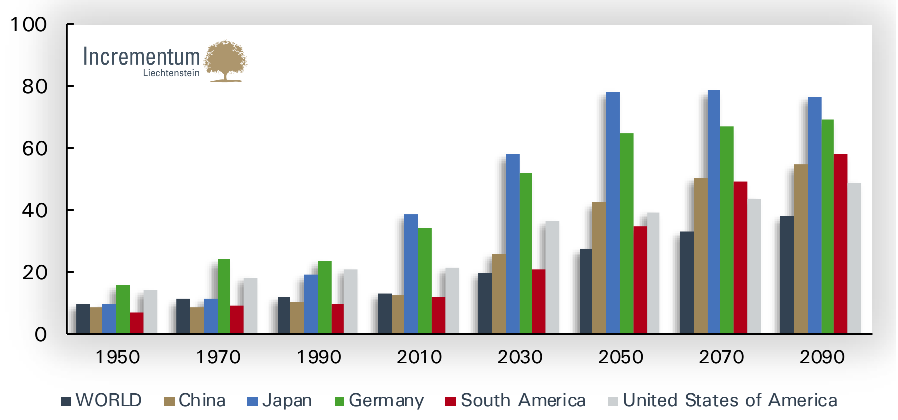
Japan is the pitiable frontrunner in terms of demographic trends – while Germany has the lowest birth rate in the world

Japan is the pitiable frontrunner. Thus the UN estimates that Japan's age dependency ratio will stand at nearly 80 by 2050. This means that for every 100 working age people there will be 80 pensioners that will have to be financed. After Japan, Germany is the most rapidly aging country in the world.[99] The ratio is set to exceed the level of 50 for the first time in 15 years. Looking at the past, it becomes clear how rapid this demographic

[99] Moreover, Germany exhibits the lowest birth rate in the world. In the past five years only 8.2 children were born on average for every 1,000 inhabitants. This is even below the level of Japan, which hitherto brought up the rear (source: BDO Compass 2015: Hamburgisches Weltwirtschaftsinstitut, BDO).

decline actually is. As recently as in 2000, 100 people of working age in Germany had to finance only 24 people of retirement age. By 2035, the latter will increase to 60 people. **Pension payments are already the largest line item in the federal budget. In coming years, these costs will rise at an exorbitant pace.**[100]

Old age dependency ratio 1950 to 2090



Sources: United Nations World Population Prospects, Incrementum AG

What consequences does this have for economic developments? On the one hand, it is clear that the "wealth effect" often aimed for by central banks, is facing demographic headwinds. On the other hand, as a result of zero interest rate policy, many people who rely on the return from their savings are losing out: **The lower interest rates are, the more an aging population must save in order to be able to maintain its living standards.**

Expectations gap: real GDP growth of 3% to 4% is still regarded as benchmark

Contrary to widespread perceptions, lower economic growth doesn't pose a problem in principle. The only problem is the expectations gap which we seem to have fallen prey to.[101] If one attempts to counter demographic headwinds by means of monetary stimulus and deficit spending, which are prone to creating budget deficits and debts that can only be clawed back again by a certain extent of growth in the future, lower growth can indeed be a considerable problem. During the baby-boomer years, real GDP growth of 3% to 4% was regarded as normal. While the preconditions for achieving such growth rates have fundamentally changed, these growth figures are still regarded as a benchmark in light of past experience.

A very unfavorable set-up for the medium term becomes evident if one considers the life-cycle hypothesis of consumption and saving in the context of demographic trends. The hypothesis assumes that people are smoothing their consumption out in the course of their life, and accordingly amass savings during their working life, which they begin to draw down once they retire. If the share of the population of retirement age that lives off its savings increases significantly, this means that fewer people will save and many more people will dis-save on a society-wide basis. Should the average savings of people of working age not shoot up in order to

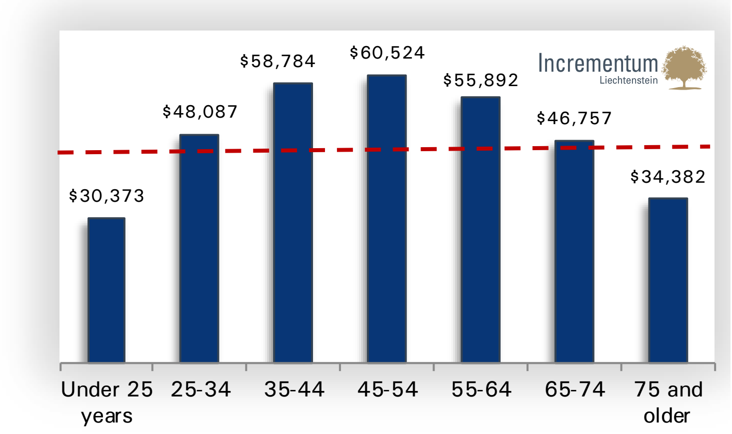
[100] See: "Zeitfenster des Glücks", Wellenreiter-Kolumne, 23. April 2015
[101] „Mind the (Expectations) Gap: Demographic Trends and GDP", Rob Arnott und Denis Chaves

compensate for the relative contraction of the camp of savers, society will end up losing a considerable amount of savings.

Demographic tailwind has turned into a massive headwind

The following chart shows this life-cycle. From their mid 20s onward, people are spending steadily more, reaching a peak in their mid 50s. In the US this peak stands at a level of approx. USD 60,000 per year. Thereafter, the amount of spending steadily decreases. Japan is a prime example in this respect: In the 1960s to 1980s its demographic dividend[102] amounted to nearly 3% per year. In the meantime, this demographic tailwind has turned into a massive headwind. Those who were young adults in the late 1940s and 1950s are now retired, while the collapsing birth rates of the 1980s are now taking their toll.

Average spending by age group (USD)



Sources: "Consumer Expenditures in 2013", BLS Report, Incrementum AG

It must be pointed out at this juncture that society faces major challenges, as the resources required for capital formation are going to contract. This is in addition to the credit-induced boom, which has resulted in a distorted production structure in which many investments that have been undertaken aren't adequately funded by real resources. **The expected self-sustaining recovery appears even more unlikely in light of this**. Conflict between the generations will gain considerably in importance once the baby-boomer generation crosses over from the wealth-creating into the wealth-consuming camp.

Demographics becomes a crucial democratic test case

This long term problem has enormous sociological consequences as well: According to economist Hans-Werner Sinn, young people will no longer be the political majority in Germany as of this year. From now on, voters who are old enough to benefit from rising pension payments and contributions will have more votes than those who on balance (over their entire lifetime) stand to lose. Germany thus becomes a "*gerontocracy*", Sinn says[103]. **The aging of the population therefore fosters structurally conservative policies.** Radical reforms, especially of pension systems, appear increasingly unlikely as a result of these demographic headwinds.

[102] The demographic dividend shows the benefit that can be obtained by development-related changes in a country's demographic structure. In a certain time window the share of the working age population increases, while the share of elderly people and children who have to be cared for declines on a comparative basis. With declining fertility rates, the window eventually closes, which can currently be observed in the majority of industrialized nations.
[103] See: „Deutsche Gerontokratie", Hans-Werner Sinn, Wirtschafts Woche

Summary "Debt and punishment":

Excessive public debt lowers a government's room to maneuver. David Hume already discussed this in his 1752 essay "On Public Credit": an excess of public debt leads to the government essentially pawning off its future revenues, and falling into a *state of fatigue and paralysis*.

In light of demographic trends it is obvious that the majority of government pension systems will collapse without exorbitant subsidies. **Insofar as more and more resources have to be shifted toward safeguarding pensions, there will definitely be negative effects on consumption behavior and credit growth. This ultimately represents a kind of deflationary superstructure**.[104]

[104] See: Wellenreiter-Invest „Deflationäre Vollbeschäftigung", Robert Rethfeld ("Deflationary full employment")

6. FINANCIAL REPRESSION: ESCAPE ROUTE FROM OVER-INDEBTEDNESS?

"Unlike income, consumption, or sales taxes, the 'repression' tax rate […] may be a more politically palatable alternative to authorities."
Carmen Reinhart und Belen Sbrancia

It appears as though citizens are meant to act as guarantors of the State. Similar to private life, low debt levels are a problem for the borrower. Over-indebtedness, however, is a problem for the creditor, since creditors can always be blackmailed by borrowers threatening to declare insolvency.[105] So-called financial repression, which we have already discussed extensively in our last gold report, is a hidden kind of blackmail.

In a nutshell, financial repression means that the government takes repressive measures in order to reduce its debt service costs. This happens primarily at the expense of citizens, by redirecting financial means from savers to debtors. Since we first wrote about the topic, our fears that financial repression would be the preferred method of solving the over-indebtedness problem have – unfortunately – been amply confirmed. **Numerous small pieces of evidence show that the perfidious strategy of a state-directed wealth transfer is blithely practiced.**

"Successful financial repression requires a widespread belief that conventional government bonds are safe."
Peter Warburton

In its attention-grabbing study "*Financial repression: the unintended consequences*"[106], Swiss Re analyzed the consequences of this policy. The analysis came to the conclusion that US savers alone lost USD 470 bn. in interest income between 2008 and 2013.[107] Insurance companies in the US and the EU (resp. their beneficiaries), have lost an additional EUR 360bn in interest income. This amounts to an annual "repression tax" of approx. 0.8% on all financial assets.

"The leeway of actors in the capital markets is to be limited further, in order to forestall possible breaking points in the already overextended debt money system in advance."
Thorsten Polleit

According to the study, artificially suppressed interest rates and financial repression are lowering incentives for policymakers to implement urgently needed structural reforms. Other unintended consequences of financial repression include potential speculative bubbles, displacement of long-term investors, rising dependence of governments on low interest rates, increasing economic inequality, and the potential of significantly higher price inflation. **For institutional investors, especially life insurance companies, pension funds and reinsurance companies, this environment poses an existential threat, since guaranteed interest rates are in most cases significantly higher than the yields of the respective benchmark bonds.**[108]

In our opinion, the most important problem is, however, that saving is increasingly punished. **Savings are a precondition of capital formation and with that the guarantor of future economic growth.** This is especially important in times of crisis.

[105] See: „Die Zentralbanken haben die Konjunkturpolitik übernommen", Prof. Dr. Eberhard Hamer ("Central banks have taken over economic policy")
[106] See: "*Financial repression: The unintended consequences*", Swiss Re
[107] Net of lower debt costs
[108] According to EIOPA stress tests, 24% of all insurance companies won't be able to fulfill solvency capital requirements in a long term low interest rate environment.

Concrete examples of financial repression measures taken last year:

- **Collective action clause (CAC):** All European government bonds with a maturity of more than one year are now issued with collective action clauses. Simply put, this implies that a simple majority of creditors can already enforce a compulsory change in a bond's terms. In this manner, it is ensured that recalcitrant creditors cannot defy debt restructurings (e.g. the lowering of interest payments, extension of maturities, haircuts, etc.). Since all maturing bonds are replaced by new CAC bonds, all outstanding government bonds in the EU will contain CAC clauses within a few years.

- **In Spain, a new tax on bank deposits was introduced.** At present, it amounts to only 0.03% of assets, however, it will sweep a none too shabby EUR 400m into Spain's cash-strapped public coffers. The measure applies retroactively from the beginning of the year, so as to make avoidance of the tax impossible. It is remarkable that this measure – which was called a "tax harmonization" – was more or less accepted without demur by the population. With a deposit volume of almost EUR 1.1bn, it is, however, likely that covetousness will increase, now that a trial balloon has been successfully launched. **Spain's savings book tax is probably a portent of a brutal expropriation of savers.**

- **The SEC in the US has introduced new rules for US money market funds.** Withdrawals can be delayed for up to ten days in volatile market periods, and in some cases even refused altogether. "Exit fees" can be charged in the event of early payouts. This represents a massive watershed event, since it restricts what is normally the most liquid form of fund assets. US money market funds held ***USD 2,400bn*** in assets last year. For comparison: this is approximately equal to the UK's annual economic output. The background to this is that rapid selling of money market funds would lead to rising interest rates. This would quickly create market dislocations, especially in the relatively illiquid junk bond market.

Another major component of financial repression consists of the gradual lengthening of government bond maturities. In this manner, governments are able to more comfortably lower their real debt burden by means of inflation in the future. This is most evident in the euro zone, in which 45% of all recent government bond issues had maturities of 10 or more years. In 2009, the share of such long-dated bonds amounted to a mere 6%.

a) The war against cash

As a result of global low interest rate policies, traditional savings vehicles, especially savings accounts, have become less and less attractive. Since they earn practically no interest anymore, there is a growing incentive to withdraw money from bank accounts and hoard it. **In recent months especially, another facet of financial repression is increasingly gaining momentum:** numerous (supposed) star economists, including the likes of Paul Krugman and Larry Summers, are currently overtly propagating the opinion that too much is being saved and not enough is being invested. In order to compensate for this imbalance, interest rates should be pushed into negative territory. According to Keynesian logic, this will supposedly boost consumption and provide urgently needed stimulus to the economy.

In order to be able to implement negative interest rates[109], Larry Summers, Harvard economist and former US treasury secretary, bluntly demanded the global abolition of all cash currency at an IMF research conference.[110] His presentation gave the impression of being a declaration of war against cash. The primary goal according to Summers should be to enable governments and banks to push interest rates below the level of zero. Consequently, every saver would then have to pay a fee for the warehousing of his money. In order to prevent a run on banks, cash would have to be completely abolished.

"Those who would give up essential Liberty, to purchase a little temporary Safety, deserve neither Liberty nor Safety."
Benjamin Franklin

Peter Bofinger, German economist and economic advisor to Germany's government[111], also regards coins and banknotes as an anachronism. He too categorizes cash as potentially criminal and points to the possibility of draining funds from the drug market and illicit employment. However, this doesn't appear to be the main argument against cash currency. The journalist Roland Tichy summarizes the main goal of a cash-less society as follows: "***The main goal is the manipulation of interest rates and consumers, in order to attain specific goals of economic policy."[112]*** Mr. Bofinger admits this as well. He explains: "*If there is no more cash, the zero interest boundary no longer exists, and nothing stands in the way of negative interest rates anymore".* It would make sense if the euro area, the UK and Switzerland were to abolish cash concurrently, according to Bofinger.[113]

"Paper money is the decisive obstacle standing in the way of further interest rate cuts by central banks. Banning it would be a very simple and elegant solution to this problem."
Kenneth Rogoff

With that, Bofinger joins the ranks of an ever-longer list of – primarily Keynesian – economists who are making similar arguments. Kenneth Rogoff[114] and Willem Buiter, chief economist of Citigroup[115], are also pleading in favor of the abolition of cash. Without cash, it would no longer be possible to escape negative interest rates, and one would finally be able to "boost" the economy. Even though the idea is controversial according to Buiter, and there are a number of drawbacks (resistance of the population, high rates of cash usage among poor and elderly people, loss of seignorage income of central banks and governments, loss of privacy and security risks due to cyber-attacks), these disadvantages are "negligible".[116]

However, the criticism of cash has an additional background: due to tiny minimum reserve requirements, banks are in a permanent state of "latent illiquidity". Deposits are the base of the fractional and massively leveraged credit pyramid. A bank run due to a loss of confidence would quickly lead to a collapse of this credit pyramid. Banning cash currency is

[109] The by now often used expert term is "breaching the lower bound"
[110] https://www.youtube.com/watch?v=KYpVzBbQIX0#action=share
[111] The correct term for the council of economic advisors is "Expert council for the examination of overall economic development", which sounds a bit like a threat or a joke, and is somewhat reminiscent of the Soviet Union.
[112] See: „9 Fakten, die Sie zu der Bargeld-Abschaffung wissen müssen", Tichys Einblick („9 facts you need to know about the abolition of cash")
[113] See: „Einfluss für Notenbanken: Wirtschaftsweiser Bofinger fordert Ende des Bargelds", Der Spiegel Online („Influence for central Banks: Economic advisor Bofinger demand the abolition of cash", Der Spiegel Online
[114] See: "Costs and benefits to phasing our paper currency", Kenneth Rogoff, Harvard University
[115] It is hardly surprising that Buiter recently called gold "the biggest bubble in human history".
[116] See: "Another Shill for Statism and Central Planning Demands a Cash Ban", acting-man.com

therefore the only effective tool the "junta of paper money jugglers" has at its disposal to block all escape routes from the paper money system for the citizenry. The emergency exits would thus be locked down.[117]

"We as citizens have only very few legal possibilities to resist, such as e.g. paying bills and taxes already in advance. Or we try evasion: by using alternative means of payment, such as coupons or cigarettes, foreign currencies or even gold after all. Prohibition of gold ownership would be the logical next step"
Daniel Stelter

Moreover, in a cash-less society, assets could be more easily monitored, controlled, taxed and if occasion demands, expropriated. This final factor is seen as ever more essential for governments which are buried in debt up their eyebrows. Restriction of cash holdings thus represents a major pillar of financial repression and moreover the last hurdle prior to the possible introduction of negative interest rates.

Numerous examples show that the path toward the abolition of cash is already pursued:

- In Italy, Spain, and Greece, the possession and use of cash has already been significantly restricted. Since 2011, it is illegal in Greece to perform cash payments exceeding EUR 1,500. In Italy, this limit stands at EUR 1,000 and in Spain at EUR 2,500.
- Denmark wants to abolish the legal obligation to accept cash.
- In Sweden, which was incidentally the first European country to issue banknotes[118], cash has almost disappeared from everyday life. In 2012, only 2.7% of all transactions in Sweden were still performed with cash, vs. 9.8% in the euro zone and 7.2% in the US. The use of cash is now so frowned upon, that the following rule of thumb is in force: "If you have to pay in cash, something is wrong".
- In France, legal cash payments will be limited to EUR 1,000 from September 2015. Moreover, currency exchange offices are obliged to store the personal data of anyone engaging in foreign exchange transactions exceeding EUR 1,000. Purchases of gold also have to be reported to the authorities from now on, as well as gold shipments within the country, which curiously have to be reported to customs. As one might expect, the measures are justified by invoking the "war on terror".
- In Germany, Bundesbank board chairman Thiele still appeared a bit stand-offish with regard to restricting the use of cash: "The Bundesbank won't restrict the freedom of consumers to choose. **This is something that would have to be done by the legislature**."[119]

Apart from economists and governments, actors in the financial industry are of course also singing from the same hymn sheet. It is not too big a surprise that credit card company, MasterCard, found out in the course of a study on behalf of the University of Oxford that cash currency was dirty and unhealthy.[120] Since 2011, there is even a "No Cash Day" (invented in Italy), which is celebrated every year in June.

Conclusion:
The abolition of cash currency and the associated implementation of negative interest rates represents a "*consistent continuation of misguided*

[117] „Illegales gesetzliches Zahlungsmittel", Henning Lindhoff, eigentümlich frei ("Illegal legal tender")
[118] See: „Illegales gesetzliches Zahlungsmittel", Henning Lindhoff, eigentümlich frei
[119] See: "Attacke auf das Bargeld", Beyond the Obvious Blog, Dr. Daniel Stelter ("Attack on cash")
[120] See: "Dirty money", Mail Online

monetary policy".[121] It would pave the way for economic totalitarianism of an Orwellian character (as Martin Armstrong would call it). Alternatives like gold and crypto-currencies could of course benefit from this, as long as they manage to escape "regulation" or a ban in the framework of financial repression.

b) Modern "Dwindling money": Silvio Gesell 2.0?

"Popular, but completely misguided attacks on interest ignore that it is not interest, but money created out of thin air that is the problem of our times."
Markus Blaschzok

As we have discussed above, the consistent implementation of negative interest rates is only possible if a ban of cash currency is concurrently enacted. **According to the Austrian School, negative interest rates are a kind of economic voodoo.** The natural interest rate is a result of human time preference, which is fundamentally positive. This originary interest rate can never be negative, as it expresses the human desire to consume today rather than tomorrow. This is based on the finiteness of human life. As long as human beings differentiate between "sooner" and "later", there can be no negative real interest rate. If it were otherwise, these terms would lose all meaning.

If the natural interest rate were to turn negative, it would mean that future consumption would be preferred completely over present consumption – thus all available means would be directed toward future consumption. Ultimately, present consumption would have to cease entirely in order to achieve this. Since we are however necessarily dependent on present consumption (since we would otherwise starve to death), negative interest rates are unthinkable in a market economy.[122] Professor Hans-Hermann Hoppe summarizes this insight as follows:

"Every acting person needs a certain amount of time to reach their goal, and since human beings always need to consume something and never stop consuming in the course of their life, time is always scarce. Thus, present or earlier obtainable goods are ceteris paribus valued more highly, in fact must inevitably be valued more highly, than future or later obtainable goods"[123]

"All these monetary salvation teachings – of which the so-called "Freigeld" theory of Silvio Gesell is the best known – with monotonous regularity amount to nothing but inflation."
Wilhelm Roepke

The fact that present goods are always valued more highly than future goods is called *positive time preference*. This positive time preference carries over to the natural interest rate, which therefore has to be positive as well. In a complex market economy, interest rates are an indispensable compass required to allocate scarce resources efficiently. **Thus we can state with apodictic certainty that negative interest rates represent an extreme market distortion. They would intensify the extent of misallocations further and would have fatal consequences.**[124]

The creeping trend toward negative interest rates and cash bans is increasingly reminiscent of the "Freigeld" notion (a "dwindling" money that constantly depreciates). This plan was conceived by Silvio Gesell and Pierre-Joseph Proudhon and is connected to the monetary concepts of the so-called "*Freiwirtschaft"* (literally: "free economy"). The concept is based on the erroneous assumption that consumption is the decisive determinant of

[121] See: „Konsequente Fortführung der falschen Geldpolitik", Wolfgang Baumbast, Pressemitteilung der Liberalen Vereinigung
[122] See also: Hoppe (1994): *Time Preference, Government, and the Process of De-Civilization*.
[123] "Zeitpräferenz", Prof. Dr. Hans-Hermann Hoppe, Ludwig von Mises Institut Deutschland ("Time preference")
[124] See: "Peggywhack – The Wonderful Stability of Centrally Planned Fiat Currencies", Acting-man.com

economic prosperity, while hoarding of money is regarded as evil. According to the “Freiwirtschaft” theory, economic crises are triggered by a reduction of the circulating money supply.[125] The goal should therefore be to increase money's velocity of circulation. In order to achieve this, the value of paper money in issue is supposed to depreciate over time relative to other goods, so as to stimulate consumption and punish thrift.

“Either much of the world will get the “Cyprus treatment”, or we will indeed see hyperinflation emerge. It will be a default either way. Is there any possibility to hedge against such an outcome, or even a slightly less apocalyptic one, that still involves a great deal of financial and economic distress? If anyone has a better idea than gold, we’d love to hear it.”
Acting Man

Several errors are underlying this argumentation:
On the one hand, the size of the money supply is completely irrelevant.[126] Since a higher, resp. lower demand for money merely alters the height of prices, but not the structure of prices, an economy can practically function with any supply of money. An increase in hoarding (rising demand for money) merely leads to a decline in money prices, which simply means that the purchasing power of every monetary unit increases. On the other hand, a decline in the demand for money and greater velocity of circulation don't lead to an increase in wealth or greater prosperity. Rahim Taghizadegan unmasks this myth by means of the following analogy:

“Higher velocity of circulation doesn't create greater prosperity. Otherwise, a group of men could increase its wealth be merely letting a coin run around in circles ever faster. The error results from a misguided focus on consumption – which has however nothing to do with rising prosperity, it is the goal and not the cause of wealth creation.”[127]

“Either the nation must destroy public credit, or public credit will destroy the nation.”
David Hume

It isn't consumption that is the decisive determinant for economic progress, but the successul accumulation of capital through savings. To believe otherwise is akin to putting the cart before the horse. If we look at today's paper money more closely, we can see that today's money is indeed “dwindling money”. It consistently depreciates due to the inflation tax, which impedes the formation of savings and artificially stimulates consumption.

Summary “Financial repression”:

„Along with encouraging borrowing, low and falling interest discourages savings. Isn’t that perverse, to discourage saving? What happens when an entire society doesn’t save?”
Keith Weiner

Our culture of thrift is being stood on its head. The path toward wealth taxes and negative interest rates is already being paved. Even though such measures will probably be referred to as a ”millionaire's tax”, a one-off “infrastructure levy” or a “cash levy” to make them more palatable, caution is highly advisable. The collection of such wealth taxes will have enormous effects on savings behavior and thus have decidedly negative consequences for capital accumulation.[128]

[125] See to this also the comprehensive analysis by the Institut fuer Wertewirtschaft, „Kritik der Freiwirtschaft nach Silvio Gesell“ (“A critique of Silvio Gesell's Freiwirtschaft”).
[126] See: “The Ethics of Money Production” by Joerg Guido Huelsmann
[127] „Kritik der Freiwirtschaft nach Silvio Gesell“, Rahim Taghizadegan, Institut fuer Wertewirtschaft
[128] See: “Oesterreichische Schule fuer Anleger”, Taghizadegan, Stoeferle and Valek

7. GOLD IN THE CONTEXT OF PORTFOLIO DIVERSIFICATION[129]

"*In no national economy which has advanced beyond the first stages of development are there any commodities, the saleability of which is so little restricted in such a number of respects—personally, quantitatively, spatially, and temporally—as the precious metals."*

Carl Menger[130]

a) The extraordninary portfolio characteristics of gold

"The wise man plans ahead."
Friedrich von Schiller

As we have done in our previous studies, we want to analyze the advantages of gold in the context of portfolio diversification. Due to its unique characteristics, we are firmly convinced that gold – especially in the current environment – is an important portfolio component. Below we once more summarize the major advantages:

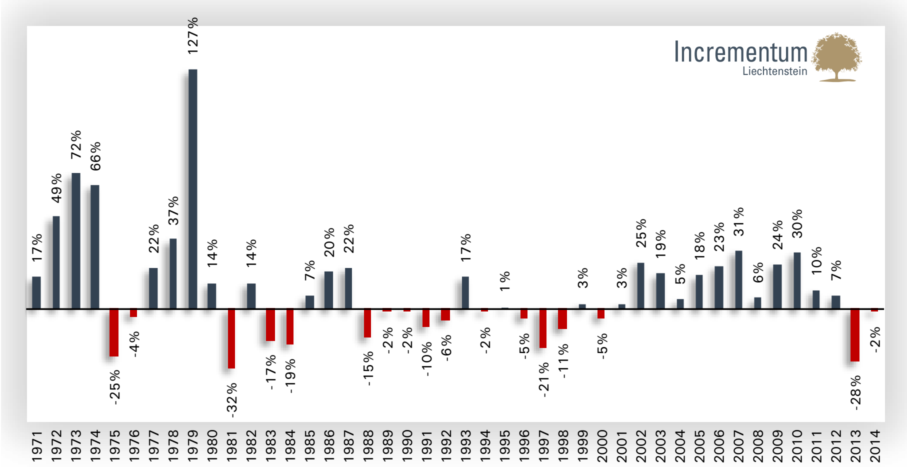
- **increased portfolio diversification**: gold's correlation with other assets is on average 0.1[131]
- **effective hedge against tail risk events[132]**
- **highly liquid asset:** gold's liquidity is significantly higher than that of German Bunds, UK Gilts, US agencies and the most liquid stocks
- **portfolio hedge in times of rising price inflation rates** as well as during strongly deflationary periods (but not in times of disinflation!)[133]
- **currency hedge**: gold correlates negatively with FIAT-currencies

„Most investors are primarily oriented toward return, how much they can make and pay little attention to risk, how much they can lose.“
Seth Klarman

Below we take a brief look at the annual performance of the gold price since the beginning of the new monetary era, i.e., since the end of the Bretton Woods system. **The annualized growth rate since 1971 amounts to 8.1%.**

[129] We have already discussed the portfolio characteristics of gold in great detail in our previous gold reports, see "The extraordinary portfolio characteristics of gold" - Gold Report 2013, "Gold as a stabilizing portfolio component" - Gold Report 2012, as well as "Gold as a Portfolio Hedge" - Gold Report 2011
[130] See: "On the Origins of Money", Carl Menger
[131] See: "Gold: a commodity like no other", World Gold Council
[132] See: "Gold: hedging against tail risk", World Gold Council
[133] See: "The impact of inflation and deflation on the case for gold", Oxford Economics

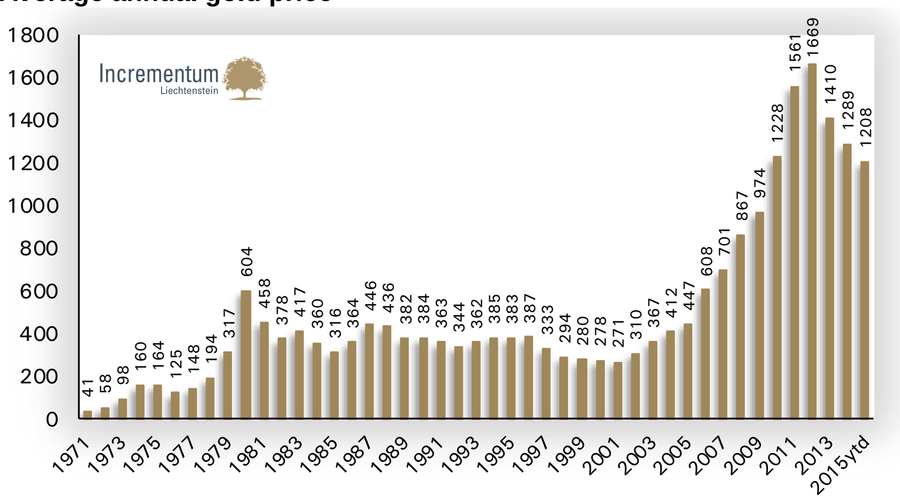
Annual performance of gold since 1971



Sources: Federal Reserve St. Louis, Incrementum AG

The current correction is put into perspective in a longer term context by the chart of average annual prices below.

Average annual gold price

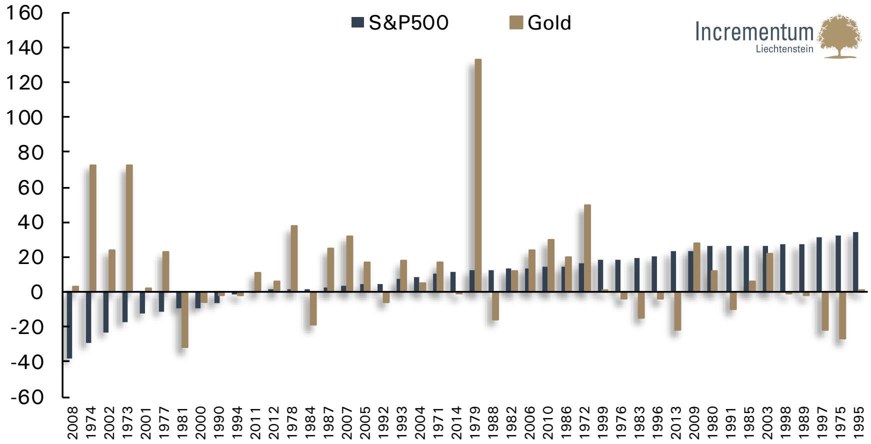


Sources: Incrementum AG, Datastream

"Risk is not about what happens but what could happen and what the consequences could be. Russian Roulette is statistically a 6:1 winner…until you lose."
Prof. Dave Collum

Numerous studies prove that adding gold lowers the volatility of a portfolio and hence improves statistical portfolio characteristics. This is also shown in the following chart. The annual performances of the S&P 500 are sorted from left (weakest year) to right (strongest year) and contrasted with the respective performance of gold. One can see that during the S&P's six worst performance years, gold clearly outperformed not only on a relative, but also on an absolute basis. **This confirms its usefulness as a portfolio hedge. On the other hand, it can also be seen that rally phases in the US stock market are usually not a positive environment for the gold price. From this perspective, it is plausible that the continuation of gold's bull market should coincide with the end of, resp. a pause in the stock market rally.**

Comparison annual performance Gold vs. S&P

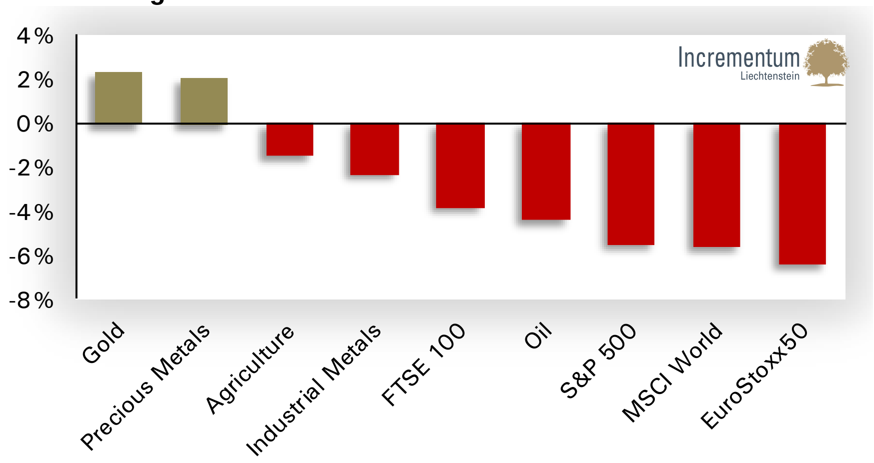


Sources: Federal Reserve St. Louis, Incrementum AG

"Only a desperate gambler stakes everything on a single throw of the dice."
Friedrich von Schiller

The fact that gold is an excellent "event hedge" can be discerned in the following chart. It compares the performance of different asset classes during the weakest 20% of trading days in the S&P 500. Only gold and other precious metals exhibit a positive performance during these crash periods.

Return during S&P 500 worst 20%[134]



Sources: ETF Securities, Bloomberg, Incrementum AG

"It is a case of better having insurance and not needing it, than one day realizing that one needs it but doesn't have it."
Acting-man.com

However, correlations are never immutable, which can be seen in the following table. It shows how strongly the correlations between gold and other important asset classes have fluctuated in previous years. Thus the correlation between EUR/USD and gold stood between 0.10 (nigh insignificant) and 0.5. Against stocks, gold partly exhibited negative and partly positive correlation. Only its correlation with silver appears stable, having fluctuated between 0.74 and 0.90.

	2009	2010	2011	2012	2013	2014
EUR/USD	0.32	0.16	0.10	0.50	0.34	0.33
Silver	0.82	0.81	0.74	0.84	0.90	0.80
Oil (WTI)	0.17	0.34	0.27	0.36	0.28	0.24
S&P500	0.03	0.21	-0.03	0.26	0.17	-0.16

Sources: GFMS, Thomson Reuters

[134] Monthly data, 2005-2015

When you're a distressed seller of an illiquid asset in a market panic, it's not even like being in a crowded theatre that's on fire. It's like being in a crowded theatre that's on fire and the only way you can get out is by persuading somebody outside to swap places with you.

Gold is often seen as a hedge against geopolitical crisis situations. An analysis of the most important political and economic crises since the beginning of the 1970s shows that such crises on average result in a 13% rise in the price. **However, it should be noted here that such "geopolitical premiums" tend to be fleeting affairs** (often with the obvious exception of the region directly affected). Only if an event actually clearly influences the monetary and economic backdrop are such premiums sustainable (an example of this would be the WTC attack, which likely contributed to the Fed subsequently adopting a looser monetary policy stance than it would have done otherwise). In this sense, financial market crises are more likely to exert a lasting effect on gold prices, as they always provoke an opening of the monetary spigots. If a geopolitical crisis takes place when a gold bull market is already underway, it may affect the size of the rally (the Iranian revolution/hostage crisis and the Soviet invasion of Afghanistan are pertinent examples). However, in these cases it is hard to prove the actual cause-effect relationship. **In a gold bear market, price spikes due to geopolitical events more often than not create selling opportunities.**

A major reason for our gold affinity is gold's high liquidity. As we have already discussed in our previous reports, gold is among the most liquid investment assets in the world, only three currency pairs (USD/EUR, USD/JPY and USD/GBP) exhibit higher daily trading volumes.

"Skill is successfully walking a tightrope over Niagara Falls. Intelligence is not trying."
Marilyn Vos Savant

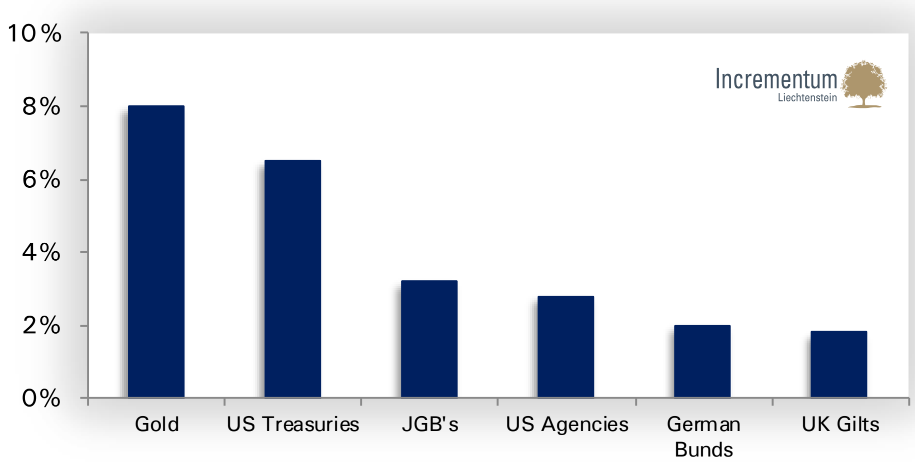
Often liquidity is defined as *saleability* or *marketability*. Investopedia provides a better definition: "*The degree to which an asset or security can be bought or sold in the market without affecting the asset's price."* The decisive question is therefore not "*can I sell*", but rather, "*can I sell at a price that is close to the last traded price*". True liquidity thus means that one can sell big positions without a significant price discount.[135]

This feature is often also referred to as "*ultimate liquidity*". In mainstream analysis, the liquidity of an asset is however often measured relative to normal situations, whereas we believe that liquidity during stress situations is more important. In such periods, it is never the offers, but always the bids that suddenly disappear. Due to its high liquidity and tight bid/ask spreads, gold is therefore often quickly sold in stress situations in order to obtain liquidity.

According to a highly interesting study by Thomson Reuters GFMS[136], global trading volume amounted to 550,000 tons of gold last year. This is roughly equivalent to three times the total stock of gold, resp. 188 times annual mine production. In terms of value, this turnover amounts to USD 22tn, higher than the annual trading volume in Dow Jones Industrial Average stocks, S&P 500 stocks or the entire German stock market. It is rather interesting that trading is steadily shifting East: **While London a few years ago still accounted for nearly 90% of all trading volume, this has declined to approx. 70% today.[137]**

[135] See: "Liquidity", Howard Marks, Oaktree Memo
[136] See GFMS Gold Survey 2015
[137] See: "Annual gold trade reaches $ 22 trillion", Frik Els, Mining.com

Daily turnover as a percentage of the total stock[138]



Sources: German finance agency, Japanese MOF, SIFMA, Thomson Reuters GFMS, UK DMO, WGC

"Despite the generally dismissive posture towards gold among global economists and monetary authorities, and its unpopularity among the great majority of large capital allocators in the West, global central banks continue to buy, re-patriate, and hoard it, which suggests the potential for future use in a currency devaluation."
Paul Brodsky

It is difficult to make a generally valid statement as to the optimal size of the gold allocation a portfolio should contain, as this depends on individual preferences, risk tolerance, time horizon and the economic backdrop. In order to get an idea, one could use central banks as a model. Despite gold's official "demonetization", the bulk of strategic currency reserves continues to be held in the form of gold. **They serve as the ultimate insurance against risks in an increasingly virtual financial world, and oddly enough, it appears that in recent years, not Western central banks, but primarily Western private investors have reduced their gold holdings.**

Most recently, Germany's Bundesbank has pointed to the value, characteristics and usefulness of gold. In a presentation by the Bundesbank's board, the central functions of gold were summarized as follows[139]:

- Diversification
- Universal acceptance
- Robustness against shocks (country and currency risks)
- Confidence building
- Timeless classic in its function as a medium of exchange and store of value
- We consider gold on the basis of monetary policy reasons as part of Germany's currency reserves

"Predicting rain doesn't count - building the ark does."
Warren Buffett

Conclusion:
Apart from these highly relevant portfolio characteristics, gold also has a qualitative characteristic as an investment asset that differentiates it from most other assets. Gold is a debt-free asset and therefore in contrast to bonds – but also bank deposits – is free from any inherent counterparty risk. **Gold is pure property. The paper market by contrast is based on countless promises by a variety of counterparties**. The attractiveness of a liquid asset without counterparty risk is valued less highly in periods of (perceived) security. Once concerns over potential default risks increase

[138] Daily turnover is calculated as daily average volume divided by total outstanding value. In the case of gold, total outstanding is calculated using private and public bullion holdings
[139] See: Board presentation, Deutsche Bundesbank 2013

(deflationary environment), this characteristic of gold will once again be valued more highly.

b) The relationship between gold and interest rates

Rising interest rates = declining gold price. This is a widely held opinion. In the following chapter, we will analyze this topic and point out both factors that support and contradict this thesis.

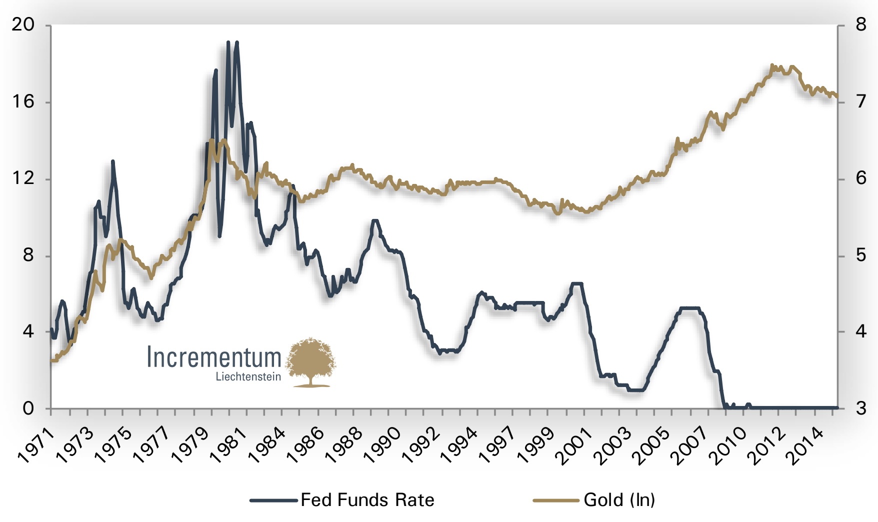
Rising rates = declining gold price? Fact or myth?

To come back to the initial statement, at first glance the assumption appears to make sense intuitively. As the level of interest rates in an economy rise, investments producing a yield will gain in attractiveness for many investors. By contrast, investment assets such as gold or commodities that do not produce a steady return become less attractive, so the argument goes.

However, one should not forget that interest rate levels are not determined by market forces in the paper money era and therefore are no longer a phenomenon of the market economy. The free formation of interest rates, which would occur in a free market, is hampered by the policies of central banks, as well as the extension of circulation credit.[140]

The Federal Funds rate is an important indicator of the Fed's monetary policy and thus also of great importance to the trend in the gold price. Declining rates signal an expansive monetary policy and rising rates a tightening of the monetary reins. Gold, as the ultimate means of payment, should therefore react counter-cyclically. As monetary policy becomes loose, the gold price should strengthen, and it should weaken in periods of tightening monetary policy. In order to illustrate this relationship, we have created an overlay between the effective Federal Funds rate and a logarithmic chart of the gold price.

Federal Funds target rate[141] and gold (right scale, log)



Sources: Federal Reserve St. Louis, Incrementum AG

[140] According to Mises, circulation credit consists of loans that are not backed by savings
[141] Since the introduction of the target corridor, we have used the upper limit (0.25%) in our calculations used in the charts and tables of this chapter.

In order to examine the history of gold price performance in times of rising interest rates, we have analyzed all eight tightening phases that have taken place since 1971.

Gold price in monetary tightening cycles:

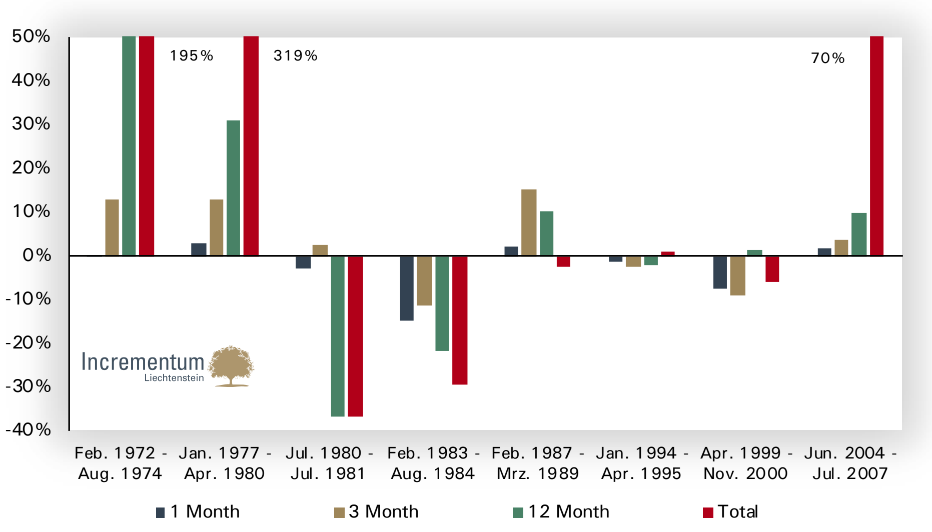
	Change Fed Funds Effective Rate			Gold
	Start	End	Change	Return
Jan. 1977 - Apr. 1980	4.61	17.61	13.00	318.93%
Feb. 1972 - Aug. 1974	3.30	12.92	9.62	194.97%
Jun. 2004 - Jul. 2007	1.03	5.26	4.23	69.81%
Jan. 1994 - Apr. 1995	3.05	6.05	3.00	1.09%
Feb. 1987 - Mar. 1989	6.10	9.85	3.75	-2.69%
Apr. 1999 - Nov. 2000	4.74	6.51	1.77	-5.88%
Feb. 1983 - Aug. 1984	8.51	11.64	3.13	-29.55%
Jul. 1980 - Jul. 1981	9.03	19.10	10.07	-36.62%

Sources: Federal Reserve St. Louis, Incrementum AG

Tightening cycles can also be a positive environment for gold

Although the Federal Funds rate and gold prices exhibit a clear negative correlation, some periods can be observed during which the relationship collapses. In the tightening phase between February 1972 and August 1974, the Fed Funds rate doubled from 5% to 10%, and gold rose from USD 48 to USD 155. From January 1977 to April 1980, gold rallied from USD 132 to USD 520, and especially between June 2004 and August 2007, the US base rate was raised from 1% to 5.25%, while gold rallied from USD 395 to USD 715.

Gold price in monetary tightening cycles: 1m/3m/12m change after the first rate hike



Sources: Federal Reserve St. Louis, Incrementum AG

What are the reasons for the relationship breaking down in some time periods?

- The Federal Funds rate is a nominal interest rate. Real interest rates are however usually more important for the gold price trend. The prime example for this is the period from 1977 to 1980, when the Federal Funds rate was hiked aggressively by Paul Volcker, real interest rates however fell due to quickly rising price inflation and Gold rallied.

- The desired effect which central banks expect from the lowering or raising of interest rates, only unfolds as long as the money multiplier works, i.e., as long as banks are willing to pump more credit money into the economy. If the money multiplier does not work (as was recently the case) and banks only make loans reluctantly despite historically low interest rate levels, the relationship between declining interest rates and a rising money supply collapses. A historically very low Federal Funds rate doesn't necessarily lead to an increase in the money supply in such an environment (no additional fiduciary media are created). The initial interpretation – that declining interest rates represent an expansive monetary policy and with that also an increase in the money supply – therefore isn't applicable in this scenario.

Three of the largest upward gold moves occurred in rising rate environments

<u>Conclusion</u>:
Although statistically, there clearly exists a negative correlation between the effective Federal Funds rate and gold, we advise caution. From a historical perspective, the correlation could be observed in several interest rate cycles. Nevertheless, the initially mentioned assumption that a rising level of interest rates is necessarily reflected by a falling gold price, appears dubious. **Three of the largest gold rallies of the post 1971 era occurred in rising nominal rate environments.**

c) The relationship between gold and the dollar

As a rule the strength or weakness of a paper currency[142] relative to another currency is expressed by the exchange rate. We regard this, however, as a very limited measure. All major currencies have arrived in the paper money age and especially since the financial crisis, are caught up in a reciprocal devaluation competition. **Exchange rates thus provide very little information on the real trend in the exchange value of a paper currency**.

If one is interested in the actual strength or weakness of a currency, one has to consult other indicators. One such indicator is gold. As we have already pointed out in previous gold reports, we regard gold not as a commodity, but rather as a currency. Due to its special characteristics, gold was able to establish itself as the most marketable commodity in the past, which is why it continues to occupy an important role in the global financial

[142] As we have discussed in our book, we don't regard any of the currently existing paper currencies as money, but as state-issued circulation media. These are *"(...) according to Ludwig von Mises bank notes that take the place of money, are however not fully covered by money with respect to their maturity and liquidity"* See: "Oesterreichische Schule fuer Anleger" Taghizadegan, Stoeferle, Valek, p. 36, 69 („Austrian School for Investors")

system. Contrary to today's paper currencies, it is well-known that gold cannot be infinitely multiplied[143] and is therefore especially useful as an informative parameter for comparison purposes.

One way to depict the real strength of a currency is through currency indexes. In currency indexes, certain exchange rates of different currencies are bundled in a currency basket. The data thus obtained provide a more comprehensive picture than individual exchange rates, as they more clearly reflect the potential interdependence of individual exchange rates in context. A measure often used for the US dollar is the US dollar index (USDX). It measures the dollar's relative value vis-a-vis a basket of foreign currencies. This basket currently comprises the following currencies, with their respective weightings indicated below:

- Euro at 57.8%
- Yen at 13.6%
- British pound at 11.9%
- Canadian dollar at 9.1%
- Swedish kroner at 4.2%
- Swiss franc at 3.6%

US dollar index is flirting with the 30-year downward trend

The USDX rises, when the dollar's exchange value is upwardly revalued relative to the above listed basket of paper currencies and vice versa.[144] On the following chart it can be seen that the dollar declined by approx. 50% against this basket of currencies between 1985 and 2011. From there an impulsive upward move followed, which is now flirting with the 30-year downward trend. **The psychologically important level of 100 has already been tested, and may well fall.**

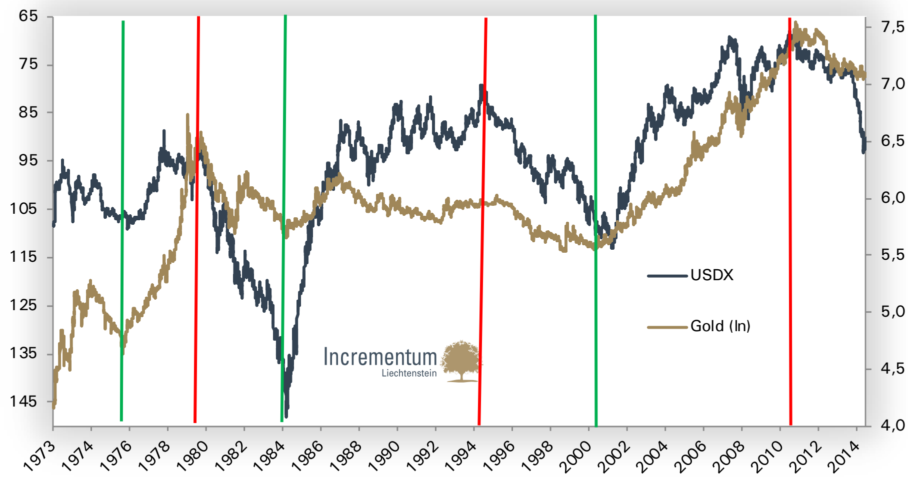
US-Dollar-Index (USDX)

Sources: Federal Reserve St. Louis, Incrementum AG

The relationship to gold is of interest. **If one looks at the trends in the USDX and gold, it is clear that the USDX exhibits a strong negative correlation to gold.** In the past, a rally in the USDX went hand in hand with a decline in the gold price and vice versa in most cases. By depicting the USDX inversely, the negative correlation can be very clearly seen in the chart.

[143] See to this also our remarks in „In Gold we Trust 2013“, p. 16-18
[144] To this end the geometric mean of the currency basket is calculated.

USDX and gold



Sources: Federal Reserve St. Louis, Incrementum AG

The relationship becomes even clearer if we measure strong trending periods, i.e., strong bull and bear markets in the dollar and their effects on the gold price.

Table: 1971 – 2015: Trend of gold during trending periods in the USD

Period	Change of USDX	Return Gold	Correlation USDX vs Gold
1976 - 1980	-9.99%	412.23%	-0.66
1980 - 1985	46.17%	-55.11%	-0.84
1985 - 1995	-37.35%	25.06%	-0.43
1995 - 2002	27.96%	-25.60%	-0.90
2002 - 2011	-34.58%	382.84%	-0.76
2011 - 2015	24.67%	-11.92%	-0.68
Total	-16.01%	1,739.87%	-0.63

Source: Incrementum AG

The inverse correlation between the USDX and gold can be clearly discerned in the table above. In addition, it turns out that the USDX and gold are not only negatively correlated in general (correlation coefficient: -0.63[145]), but also that this inverse correlation is especially pronounced in times of USDX bull or bear markets.

A study by the World Gold Council[146] comes to a similar conclusion. The study examines the annual performance of gold in different dollar regimes (i.e., falling/rising and stable dollar). The result shows that the gold price rises most (+14.9% p.a.) when the dollar is declining. In a rising dollar environment, gold on average returned -6.5% p.a.

Interesting asymmetry: gold rises much more when dollar declines, than it falls when the dollar is rallying

Especially noteworthy – and hardly ever mentioned in public discourse – is the seemingly obvious asymmetry: Thus the gold price rises more than twice as much when the dollar is declining than it falls when the dollar is rallying. The WGC study moreover shows that the correlation between gold and stocks, as well as commodities, is lower in times of a rising dollar. This is, in our opinion, important information in a portfolio construction context.

[145] A value of -1 symbolizes perfect negative correlation, while a value of +1 signals perfect positive correlation
[146] See: „Gold Investor: Risk management and capital preservation, Volume 8“, World Gold Council

Table: Annual gold price performance, volatility and correlation in different dollar regimes

	Overall Period	Dollar depreciating	Stable Dollar (Trading Range)	Dollar appreciating
Return	6.2%	14.9%	7.8%	-6.5%
Volatility	19.5%	18.4%	20.2%	19.7%
Corr. Equities	-0.06	0.07	-0.16	-0.11
Corr. vs Commodities	0.15	0.16	0.14	0.07

Sources: World Gold Council, Incrementum AG

The historically negative correlation between gold and dollar appears to be weakening ever more though, this could be seen last year, when the dollar rallied, and gold entered a sideways trend. This may be connected with the ever greater importance of emerging markets (esp. China, India) to the gold price. While gold demand in the 1970s and 1980s was confined to industrialized nations, almost two thirds of demand comes from emerging markets these days. **Our analysis shows that changes in real interest rates in emerging markets have an increasingly strong effect on investment demand for gold**.

Conclusion:
The consensus opinion appears to be that a strong US dollar automatically leads to lower gold prices. This thesis can be buttressed with empirical data. However, our analysis shows that this relationship is clearly asymmetrical: the damage a strong dollar inflicts on the gold price is far weaker than the wind a weak dollar blows into gold's sails.

Autonomous rate increase of gold is likely to climb further

Moreover, it appears as though historical patterns are changing. The "***autonomous rate of increase***" – the rate of increase in the gold price that is independent on exchange rate fluctuations[147] – is likely to climb further. This is inter alia due to the fact that the influence of emerging markets on gold demand has greatly increased. As a result, the historical inverse relationship between the dollar and the gold price could weaken further in the future. **What is good for the dollar does not necessarily always have to be bad for gold.**[148]

d) Opportunity costs of holding Gold

Opportunity costs are essential for gold's price trend. What are the competing economic risks and opportunities one faces, resp. one foregoes, when holding gold? Real interest rates, growth rates of monetary aggregates, volume and quality of outstanding debt, political risks, and the attractiveness of alternative asset classes (esp. stocks) are the most important determining factors. **We therefore want to discuss the opportunity costs of holding gold in the following pages.**

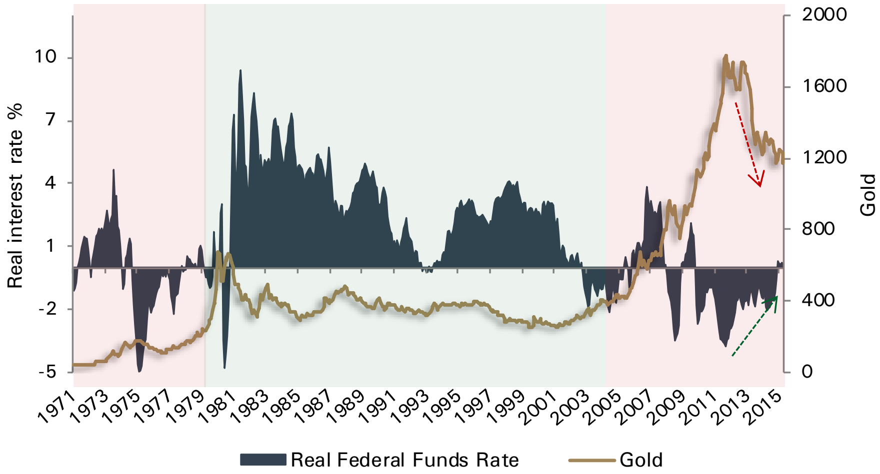
[147] See: "Das goldene Erbe des US-Dollar", Prof. Dr. Thorsten Polleit ("The golden heritage of the US dollar")
[148] See: „Gold Investor: Risk management and capital preservation", Volume 8, World Gold Council

Real interest rates:

"Amazingly, people are paying Switzerland to warehouse their money for 10 years…That makes gold a high-yielder, because it yields zero."
Jeff Gundlach

The chart below shows real interest rates[149] and the gold price. It can clearly be seen that negative real interest rates have prevailed in the 1970s, as well as since 2002, creating a positive environment for gold.

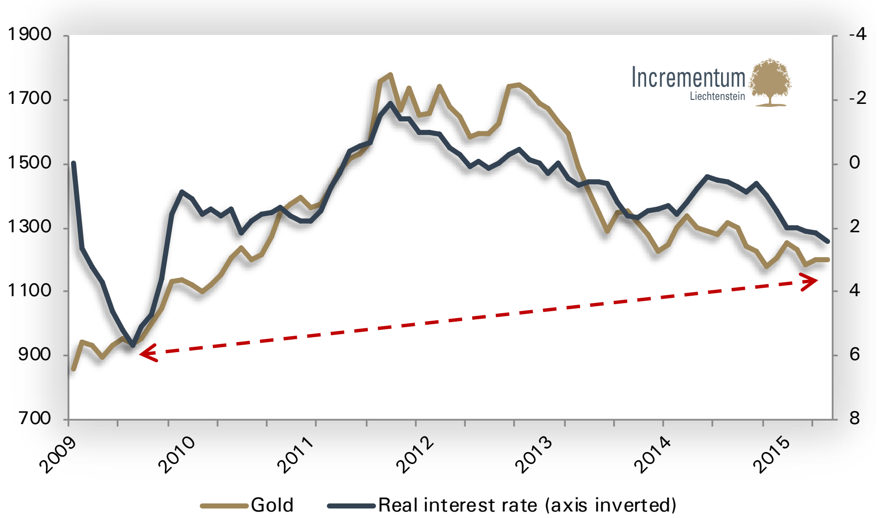
Real interest rates vs. the gold price since 1971



Sources: Federal Reserve St. Louis, Incrementum AG

In a shorter-term depiction of real interest rates, the assumption formulated above can be discerned more clearly. The period since 2011 is characterized by rising real interest rates, which in turn resulted in a declining gold price. **In 2009, however, it can be seen that gold correctly anticipated the change in the trend of real interest rates, and it appears as though the current situation may be similar.**

Gold vs. real interest rates (axis inverted)



Sources: Federal Reserve St. Louis, Incrementum AG

The following table shows the average monthly gold price performance in times of low, moderate and high real interest rate levels. In addition, it shows the trend in a context of rising and/or falling real interest rates. **The**

149 Federal funds rate minus CPI

best environment for the gold price (+1.5% per month) is when real interest rates are low and declining.

Historical performance during different real interest rate regimes

	Level of real yields			Trend of real yields	
	Negativ (<0%)	Moderat (0%-4%)	High (>4%)	Trending downward	Trending upward
Ø monthly. Return	1.5%	0.7%	-1.0%	0.8%	0.3%
Standard-deviation	0.5%	0.4%	0.6%	0.3%	0.4%

Source: World Gold Council

Conclusion:
A long term negative gold price trend would have to go hand in hand with rising, resp. consistently positive real interest rates. Due to the levels of debt that have been amassed by developed nation governments, companies and households, we regard this as scarcely imaginable. **Central banks have long become prisoners of the policy of over-indebtedness**.

Stocks:

"The funny thing is there is a disconnect between what investors are saying and what they are doing. No one thinks all the problems the global financial crisis revealed have been healed. But when you have an equity rally like you've seen for the past four or five years, then everybody has had to participate to some extent. What you've had are fully invested bears."
Gerard Minack

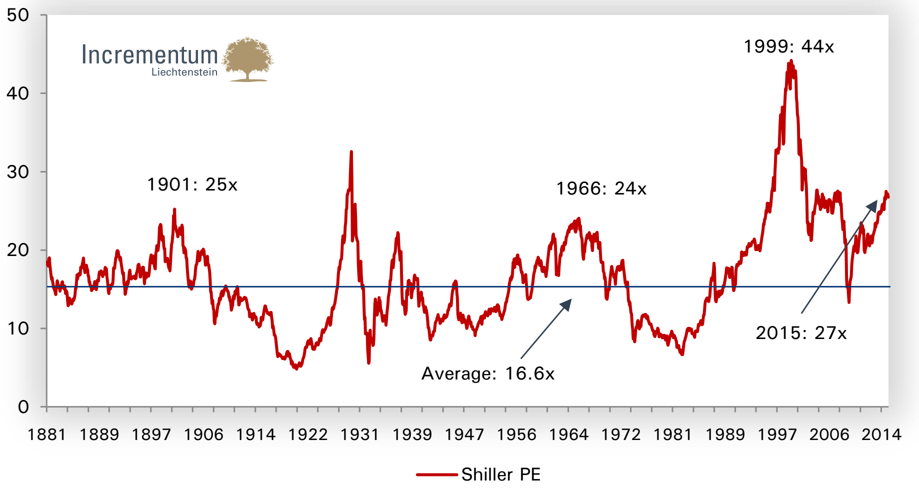
The bull market in stocks began in March 2009. In the course of the above-mentioned asset price inflation and the disinflationary environment, stocks have evidently been among the greatest beneficiaries of the zero interest rate policy. Last year we wrote: "***The current "lowflation" environment that still prevails, which is characterized by low price inflation and growth figures that largely remain below expectations, has turned out to be a Land of Cockaigne for stock market investors."*** **As the disinflationary environment continued to persist, stocks were among the best performing asset classes over the past 12 months.**

However, the fact that the stock market has advanced to an alarming extent is evident in numerous indicators and comparisons. Thus, the share of margin debt relative to market capitalization is by now at a far higher level than at the peak of the dotcom bubble.[150]

A look at long term valuation levels thus appears to be a good idea. The so-called Shiller-PE or CAPE (cyclically adjusted P/E ratio) is a suitable means of defining the market's long term position. In order to smooth out the effects of the business cycle, it calculates the inflation-adjusted average price-earnings ratio of the past 10 years. According to this metric, the outlook for US stocks doesn't appear very enticing, as valuations are far from cheap. The current level stands at 27x, which has been exceeded only two times in history. The long term average stands at 16.6x, which is significantly below current levels.

[150] See: "IMF tells regulators to brace for global 'liquidity shock'", Ambrose Evans-Pritchard, The Telegraph

Shiller P/E ratio since 1881



Sources: Prof. Robert Shiller, Incrementum AG

"Ultimately, investors will need to choose where to place their faith – in history books or in crystal balls."
Jordan Eliseo

An analysis of the four historic peaks in the Shiller P/E ratio to date and the subsequent performance of the US stock market should dampen the optimism of investors who are currently bullish on stocks. Investors have made no money in the decades following these peaks, and suffered drawdowns up to a maximum of 81%.[151]

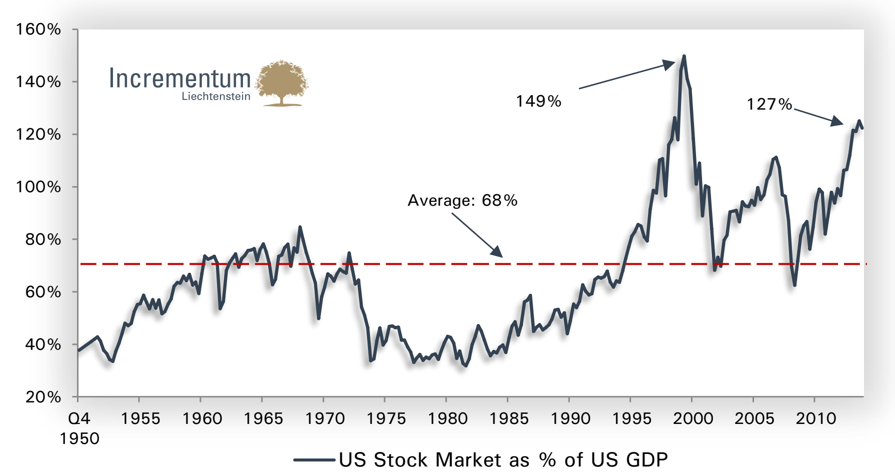
	Shiller PE peaking at	Return in the following decade p.a.	Maximaler Kursverlust
June 1901	25	-0.2%	-38%
Sept. 1929	33	-6.7%	-81%
Jan. 1966	24	-5.1%	-56%
Dec. 1999	44	-4.9%	-58%
???	???	???	???

Sources: Jordan Eliseo – ABC Bullion, Incrementum AG

Another long term indicator – the so-called Buffett indicator – likewise suggests caution is advisable. It shows the total market capitalization of all corporations listed on US exchanges as a percentage of US GDP. Only once in history, in the 1st quarter of 2000, was this ratio higher than today. The indicator therefore confirms that the valuation of US stocks is anything but favorable from a historical perspective.

[151] See: „Dire Straits: Money for Nothing – Debt for Free", Jordan Eliseo

Total US stock market capitalization as % of GDP



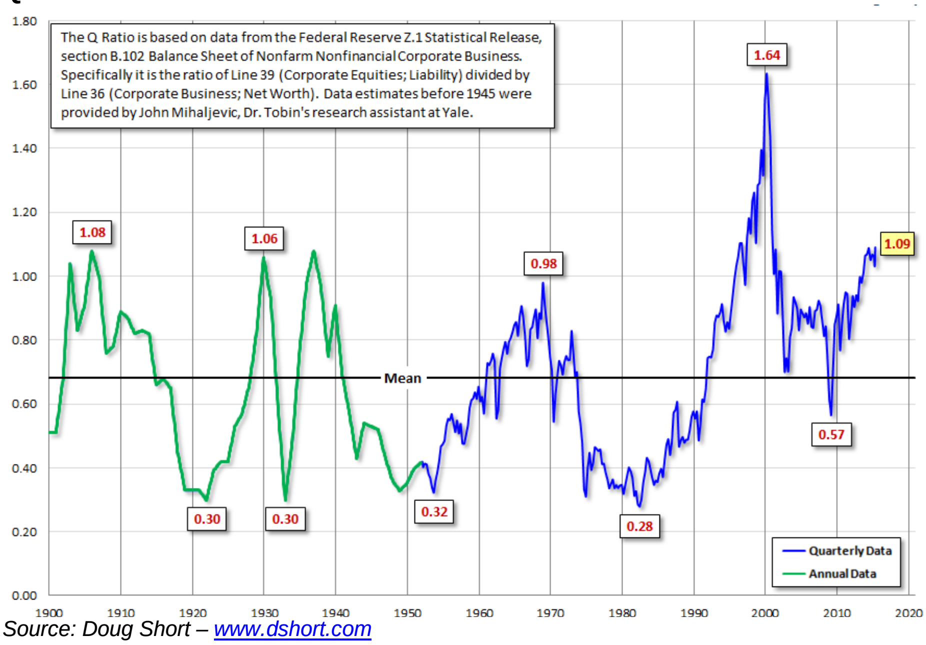
Sources: Federal Reserve St. Louis, Incrementum AG

"My fear is that because interest rates are suppressed, therefore earnings are inflated. So when rates go up … the hall of mirrors is shattered and we look at each other and see what actually is real rather than what the Fed wants us to believe."
James Grant

Tobin's Q ratio (the ratio of market capitalization to book values) of US stocks is at an extreme level as well. The metric is calculated by dividing the enterprise value of a company (market capitalization plus liabilities) by the replacement costs of its assets[152].

Since 1900 the ratio's median has stood at approx. 0.7x. Since 2009 (0.56x) a significant increase in Tobin's Q can be observed. In the meantime, it has risen to 1.12x, the second highest peak in history. By now the ratio is two standard deviations above its mean. **The further it rises, the more likely it becomes that there will be a major price correction or even an economic collapse.[153]**

Q-Ratio since 1900

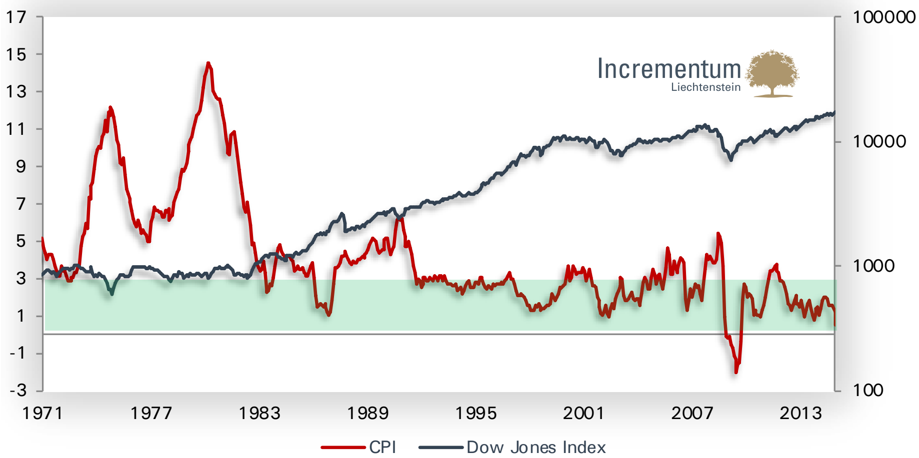


Source: Doug Short – www.dshort.com

[152] See "Tobin's Q", Wikipedia
[153] See "Oesterreichische Schule fuer Anleger", Taghizadegan, Stoeferle, Valek, p. 263-264 (an English version will become available later this year)

According to our analysis, the best environment for stocks prevails if price inflation rates stand between +1% to +3%. This "feel good corridor" was e.g. continually breached in the 1970s, and while stock markets trended sideways in nominal terms, they lost significant ground in real terms. Periods exhibiting relatively high inflation rates such as e.g. 2000-2002, 2005 or 2007 until mid-2008 also tend to provide a negative environment for stock markets.[154]

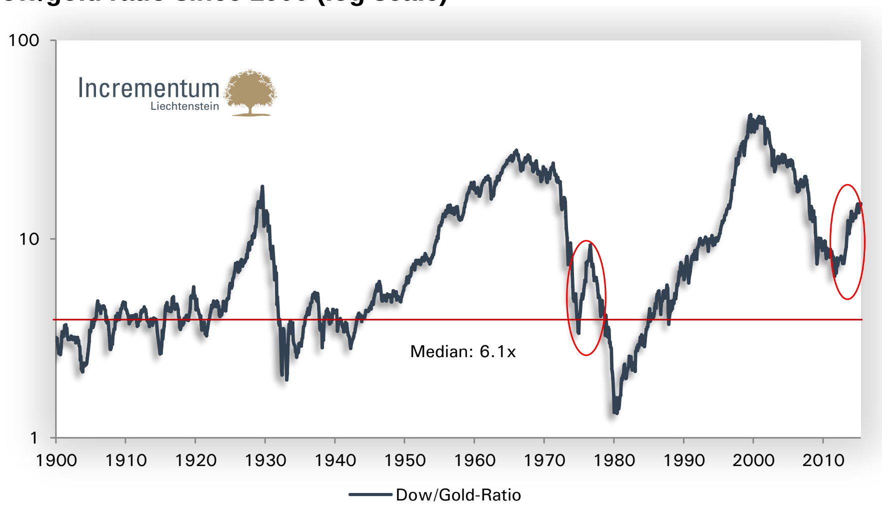
US price inflation and Dow Jones Index since 1971



Sources: Incrementum AG, Wellenreiter Invest, Federal Reserve St. Louis

A look at the Dow/Gold ratio over the long term shows that gold is relatively undervalued compared to stocks. With a value of slightly over 15x the ratio is currently well above the long term median of 6x. In 1932 the ratio stood at 2x, at the end of the last bull market in 1980 it stood at 1.3x. We expect that in the course of the current secular bull market, levels near 2x can be attained again. **The current trend in the ratio reminds us – not least due to the pronounced disinflation backdrop – of the mid-cycle correction from 1974 to 1976.**

Dow/gold ratio since 1900 (log scale)



Sources: Federal Reserve St. Louis, Incrementum AG

[154] See: „Ausblick 2015", Wellenreiter-Invest study, Robert Rethfeld und Alexander Hirsekorn („2015 Outlook")

Conclusion:

US stocks: mean reversion only appears to be a question of time

US stocks are trading at extremely generous valuations in comparison to historical levels. A reversion to the mean appears to be only a question of time. In our assessment the performance of stocks currently represents one of the largest opportunity costs for holders of gold. The conviction that one might be missing out on even greater gains tends to rise in concert with a stock market advance, and these potential gains must necessarily be foregone to the extent one is holding gold instead of stocks. **However, investors would do well to keep a tight rein on their emotions and assess the situation as calmly and rationally as possible.** Historically, the stock market has always suffered mean reversion after becoming overvalued, even though it can never be forecast with precision just how much greater the overvaluation will become. **When such a mean reversion occurs, gold's characteristics as a portfolio hedge will come to the fore. As is always the case with insurance, it is better to have it and not need it, than to suddenly find out that one needs it and doesn't have it.**

8. PAST, PRESENT AND FUTURE OF THE MONETARY ORDER

*“Auro loquente omnis oratio inanis est –
When gold speaks, the world falls silent“*

Gold has played a decisive role in monetary history since at least the times of King Croesus around 600 BC. Even today, when there is no longer any formal tie between gold and state-issued means of payment, the topics of gold and money remain inseparably interlinked. Currency systems have always changed. A glance at the history books reminds us that gold was needed time and again in order to create confidence in new currencies. **Looking into the future suggests that this will likely sooner or later be the case again**

a) Bismarck and the monetary system-related fall of civilizations[155]

The example of the fall of the Roman Empire provides an impressive account of how a growing bureaucracy and increasing misallocation of resources will lead to inflation and ultimately economic collapse.

“The state of a people's monetary system is a symptom of its overall condition.”
Joseph Alois Schumpeter

An important study about the decline of major empires has been performed on behalf of former German chancellor Otto von Bismarck. He entrusted the historian, economist and agricultural politician Gustav Ruhland with the task of finding out why historical advanced civilizations and global empires collapsed. When the study was finalized, Bismarck was no longer in office, its insights were therefore not implemented. Ruhland's insights should nevertheless be required reading for every citizen and politician.[156]

“Nations are not ruined by one act of violence, but gradually and in an almost imperceptible manner by the depreciation of their circulating currency, through excessive quantity...”
Nikolaus Kopernikus

Ruhland came to the conclusion that the reasons for the decline of the ancient Greeks and Romans, as well as the Spanish and British empires were in all cases rooted in monetary policy. Ruhland noticed that peasants were always the first group that was no longer able to withstand growth pressures. It is impossible to endlessly exploit fields or milk cows. The peasants abandoned their fields and the government had to import food for the citizenry from ever more far-flung regions, which had to be conquered militarily.

“A great Empire, like a great Cake, is most easily diminished at the Edges.“
Benjamin Franklin

According to Ruhland, in the downfall of the advanced civilizations he studied, this agrarian crisis was followed by a credit crisis related to land ownership, sovereign default, socialism and finally unrest.

Ruhland concluded:

“Different societies in different times and places all exhibited the same symptoms of ill health in their decline. This alone suggests that different

[155] From the book: "Kredit verspielt - Warum Sie über (Ihr) Geld nachzudenken sollten, bevor es andere tun", www.kredit-verspielt.de, Markus Weis (“Credit Lost - Why You Should Think About (Your) Money, Before Others Are Doing So”)
[156] The entire work “System der politischen Ökonomie“ (“System of Political Economy”) can be found here: http://www.vergessene-buecher.de/uebersicht.html#anfang

people in history ***have experienced calamity due to the same economic malady****. (…) And what should this genocidal malady be called? Economic science provides no reply to this question nowadays.* ***As has already been stressed, modern-day macroeconomic specialization in its monographs regards every symptom as an isolated malady and treats it with reforms that fail to consider the big picture****. Such a method (…) cannot be reconciled with the notion of the economy as an organism."*

With respect to the fall of Roman Empire, Ruhland formulated the following chain of causation:

- Growing impoverishment of the common people contrasted with an exorbitant increase in wealth/luxury of the few (Cantillon effect)
- Decline of tradesmen's incomes due to cheap slave labor
- Increasing signs of decadence among the ruling classes (pomp, larceny, corruption, greed)
- Rising taxes, special levies; the government increasingly uses the military to collect taxes
- Government subsidizes the impoverished citizenry (keeping it calm with welfare statism, bread and circuses)
- Signs of decadence in the population, "barbarization" and a decline of morals
- External military conflicts to defend the status quo and/or as a distraction
- Bankers take over government
- Government intervenes in markets, national and monetary socialism
- Devaluation of money (e.g. by lowering the precious metals content of coins)
- Price inflation
- Uprisings, civil wars, external wars
- Chronic government insolvency
- Decline in population
- Barter trade replaces monetary economy

Parallels to the present are hardly deniable.

b) King dollar and the heirs to his throne

The current global monetary architecture is unique in the history of money. Following the Bretton Woods conference, the British pound had finally was replaced by the US dollar as the globally reigning currency. The United States emerged as the undisputed leading economic power in the post-war era. This was also reflected by the country's gold reserves. With more than 20,000 tons of gold, the US was in possession of by far the largest gold reserves of all nations in the world.

During the second world war, US gold reserves increased rapidly, as the country's large export surplus during the war was paid in gold at the time. Moreover, numerous rumors remain about the whereabouts of the gold held by the war's losers, which possibly also found their way into the vaults of the victorious nations.

The gold exchange standard that was agreed upon in Bretton Woods in 1944 can be subsumed under the slogan "*the dollar is as good as gold*". Due to an insufficient availability of gold, the finance ministers and central bank governors of 44 nations agreed to hold the dollar as a reserve currency[157] in addition to their existing gold reserves. The Federal Reserve in turn committed itself to back at least 25% of the dollars in issue with gold and to convert dollars into gold if creditor central banks demanded it. **The dollar's exchange rate was fixed at 1/35th ounce of gold.**

The International Monetary Fund was established as a "Bretton Woods institution", inter alia in order to administer trade imbalances between countries by means of currency adjustments.

From this time onward, official foreign exchange reserves consisted partly of gold, but also of US dollars, resp. interest-paying treasury bonds. Central banks were able to obtain an interest income from holding treasury bonds, while the US was able to receive seignorage on a global level due to the demand for US debt securities.

The US started to abuse this "exorbitant privilege", as French finance minister Valéry Giscard d'Estaing called it, in the 1960s at the latest, by monetizing its growing debt through the Federal Reserve. A number of countries were beginning to suspect that the gold reserves were no longer sufficient to back the amount of dollars in issue to the promised extent. After more and more countries, in the course of the so-called "gold drain", demanded conversion of their dollar reserves into gold, Richard Nixon finally broke the convertibility promise on August 15, 1971.

After a very turbulent decade, the irredeemable dollar managed by the mid 1980s to regain its status as a global trade and reserve currency even without a formal gold backing. A major factor in obtaining this "King Dollar" status was the perception of disciplined monetary policy under Paul Volcker.

The international monetary system in force today is often called a "non-standard". While the dollar is theoretically facing serious competition for the first time with the introduction of the euro, it nevertheless remains the undisputed number one currency in the world. This can be quantified by looking at its share of foreign exchange reserves (USD: 60.7% vs. EUR 24.2%), resp. its share of global currency trading (USD 87% vs. EUR 33.4%).[158]

Despite the US dollar's continued dominance, there is ever more evidence that the dollar-centric worldview is slowly crumbling. We will discuss the most important indications of this trend in the following pages.

"It would be illogical to assume that all conditions remain stable."
Mr. Spock, second officer, USS Enterprise

Today, the global financial system is dominated by the Bretton Woods' institutions, IMF and World Bank. Voting rights in the two institutions no longer reflect the current economic balance of power, as a result of which emerging market nations (the BRIC countries in particular) increasingly feel they are underrepresented. For years they have argued in favor of reforms, which have already been agreed to on the level of the international organizations. However, the US Congress has to date refused to ratify these reforms, which would amount to a loss of power for the US.[159]

[157] https://en.wikipedia.org/wiki/Bretton_Woods_system
[158] Note: the sum of daily foreign exchange transactions sums up to 200%, as both currencies of each currency pair are counted. See: https://en.wikipedia.org/wiki/Foreign_exchange_market
[159] See: „China spaltet den Westen – und bringt die Finanzarchitektur ins Wanken", Manager-Magazin.de („China splits the West – and shakes the financial architecture")

An additional trigger for the now openly waged conflict could be a paradigm change, which one only recognizes upon closer inspection of the relationship between the two largest powers. **Historian Niall Ferguson has coined the term "*Chimerica*", which describes the strong dependency between the two largest economies.** The distribution of their roles is clear: while the Chinese consume little and save much, the exact opposite is the case with Americans. Americans buy Chinese products on credit, Beijing in turn uses its savings to extend credit to the US.[160] However, this community of interests may be about to change, which would have wide-ranging economic and political consequences.

c) Repatriation of gold reserves

"It is not the cost of returning to gold circulation that is astronomical, but the cost of not returning."
Antal E. Fekete

A century ago, the idea of a currency without a fixed tie to gold, resp. without gold backing, would have been considered utterly absurd. Gold reserves represented the foundation of government sovereignty. **Thus, it is not very surprising that the number of initiatives demanding a repatriation, resp. a proper audit of government gold reserves keeps growing.** This desire for transparency illustrates the growing skepticism people feel towards the monetary experiments currently underway. However, they also express a strengthening desire for decentralized, sovereign and more individualistic policies.

While Germany continues to rather timidly remove its gold from Paris and New York[161], the Dutch central bank astonished the world by announcing (after the fact) the surprising repatriation of 122.5 tons from New York. In Austria, the National Bank (OeNB) announced its "*new gold strategy*". A total of 110 tons of gold will be repatriated by 2020, in small tranches over the five-year period. Going forward, central bank governor Nowotny aims to have 50% of the country's gold reserves stored in Vienna, 30% in London and 20% in Switzerland. The OeNB reacted to a critique by Austria's court of auditors, which recommended a "*rapid evaluation of all possibilities to achieve a better diversification of storage locations*".[162] After Germany and the Netherlands, Austria is the third European country to have decided to bring its gold back home. **We are witnessing the biggest movement of international gold reserves in many years.[163]**

Peter Boehringer, who started the German gold initiative, has made a remarkable statement. It is interesting that reports about Germany's state-owned gold generate far more interest in the media than articles about the ESM, TARGET2 balances, and other guarantee cascades. **According to Boehringer, this shows that people continue to perceive gold as real money. Physical tangibility, look and feel, are intuitive and indelibly etched in the part of the human mind that is responsible for the definition and perception of money, as Boehringer says in his highly**

---

[160] See: „Schulden ohne Sühne?", Kai A. Konrad, Holger Zschäpitz ("Debts without punishment?")
[161] The Bundesbank justified this by the signal effect during a time of crisis and with the complex logistics of providing security during transport and the creation of storage capacity.
[162] See: „Nationalbank denkt über Goldkonzept nach", Der Standard ("National Bank thinks about gold concept")
[163] See: „Bestätigt: Österreich holt 110 Tonnen Gold heim", jilnik.com („Confirmed: Austria brings back 110 tons of gold")

interesting book “Holt unser Gold heim”. (“Bring our gold back home”).[164]

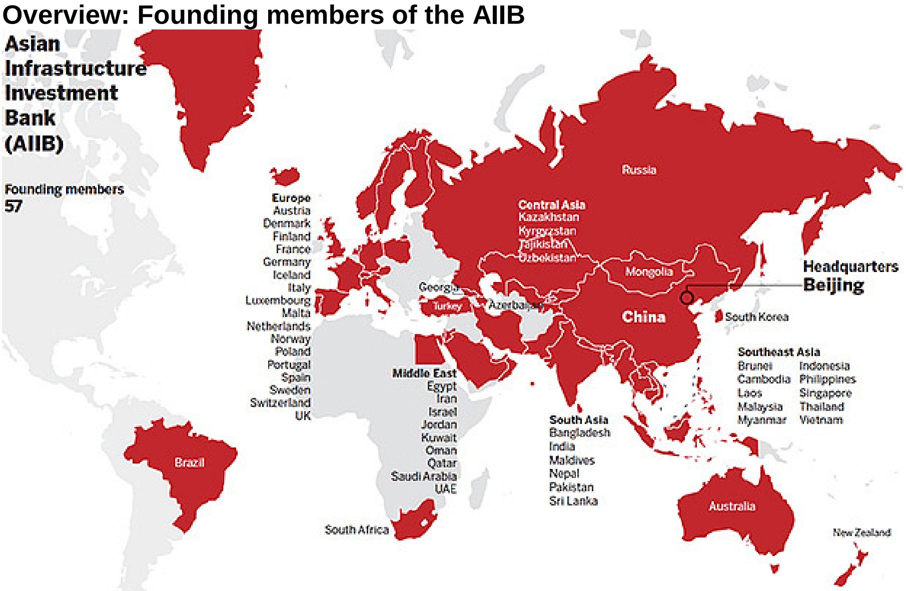
d) AIIB, NDB & Co.: The new challengers of Bretton Woods institutions?

“There is no doubt that the AIIB is a direct challenge to the World Bank, just as the new 'BRICS bank' takes aim at the International Monetary Fund. The two China-led bodies are intended to break Western control over global finance through the Bretton Woods institutions.”
Ambrose Evans-Pritchard

October 24, 2014, could well go down in the history books as a turning point. On this day, the Asian Infrastructure Investment Bank, AIIB for short, was launched.

Why does this step send such a noteworthy signal? For the first time in the 21st century, an important international institution was established without the participation of the US. Especially peculiar is the fact that numerous close US allies, such as e.g. Great Britain, Australia, France and Germany are among the founding members – against an explicit US “recommendation” not to join.

Overview: Founding members of the AIIB



Source: The Telegraph

The AIIB will primarily provide financing for the rapid development of infrastructure projects (communication networks, railways, roads) and should finance projects worth several billion dollars within the coming few years.

“The US and China, the world’s two main economic powers, have locked horns over establishing a major development bank that could rival the twin Bretton Woods institutions – and Beijing has emerged, for the first time, as the clear winner.”
David Marsh, OMFIF

The bulk of the financing volume will be directed towards the “new silk road” project. Many observers already call it the largest economic undertaking since the Marshall Plan. With this new version of the silk road, which once connected China to Central and South-East Asia, the Gulf states, Africa and Europe, Beijing hopes for an enormous economic boost, as well as the internationalization of its economy. Thus, Chinese companies are supposed to build airports, shipping ports, highways, railway lines and nuclear power stations on a grand scale in the nearly 65 countries connected by water and land.

[164] See: „Holt unser Gold heim – der Kampf um das deutsche Staatsgold“, Peter Boehringer

Gold will also play a significant role in connection with the silk road. By means of a new gold fund with approx. USD 16 billion in AuM, stocking up on their gold reserves is to be made easier for member nations located along the silk road. Gold production in the likes of Afghanistan and Kazakhstan is also to be financed, according to state press agency Xinhua.[165]

New Development Bank as competition to Asia Development Bank

In order to undermine the dollar's dominance, emerging market countries have set a number of additional initiatives into motion: A milestone on the path to a multi-polar currency system was set in July last year. The BRICS nations, i.e., Brazil, Russia, India, China and South Africa, founded the New Development Bank (NDB). It is domiciled in Shanghai and supposed to develop into an alternative to the World Bank, the IMF and the Asian Development Bank.[166] With a population of three billion people (41% of the global population), 25% of global economic output and 42% of global foreign exchange reserves, the NDB combines an enormously important economic and growth area. In contrast to the World Bank, every member nation will have exactly one vote. **Ironically enough, the establishment of the NDB was announced precisely on the 70th anniversary of the Bretton Woods agreement. The choice of this date is as subtle as a flying brick (so to speak).**

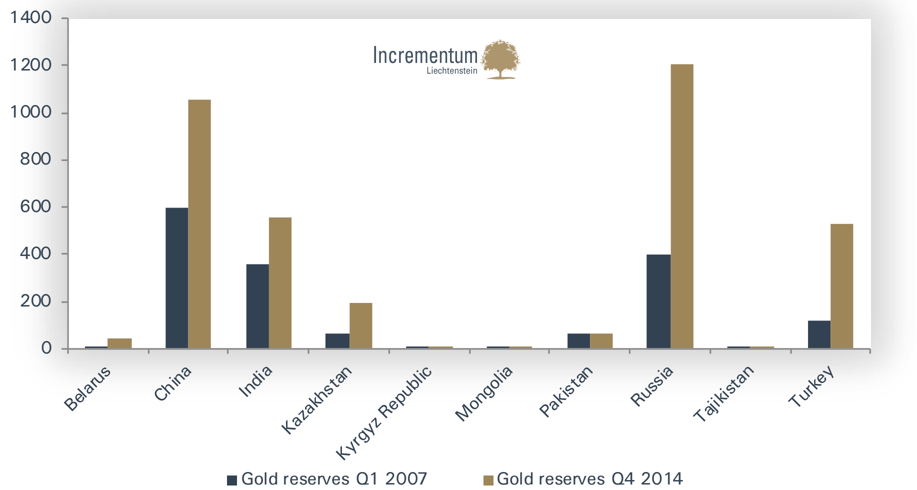
"The successful remonetisation of gold by a major power such as Russia would draw attention to the fault-lines between fiat currencies issued by governments unable or unwilling to do the same and those that can follow in due course. It would be a schism in the world's dollar-based monetary order."
Alasdair Macleod

The Shanghai Cooperation Organization (SCO), will play an ever greater role as well in the future. The organization currently comprises China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, Uzbekistan as well as India, Pakistan, Mongolia and Iran in the role of observer nations. Turkey and Turkmenistan have also expressed interest in joining. Belarus, Afghanistan, the CIS and ASEAN are dialogue partners of the organization.

In our opinion, the importance of the SCO is vastly underestimated in the West. It is intended to unite the economic, as well as the military interests of Russia, China, and commodity-rich Asian nations in a single bloc. Should the current dialogue partners join the community, the SCO will comprise more than half of the world's population. **It would be naïve to believe that considerations with respect to currency policy aren't going to play a role in this.** We believe that gold is one of the pillars of the strategy. Interestingly, the region has a significant share of global gold production. Most of these countries have moreover significantly expanded the gold reserves of their central banks, as can be seen in the following chart.

[165] See: „China Creates Gold Investment Fund For Central Banks", Goldcore.com
[166] Although China is by now the by far largest economic power in Asia, the Asia Development Bank continues to be controlled by Japan. Thus Japan has twice as many votes in the ADB, and moreover the ADB's president always comes from Japan.

SCO members: Gold reserves, Q1 2007 vs. Q4 2014



Sources: World Gold Council, Incrementum AG

The largely unknown **Eurasian Economic Union** should not be left unmentioned at this juncture either. Its current members are Russia, Kazakhstan, Belarus, Armenia and Kyrgyzstan. Apart from establishing a free trade zone, one of its goals is to launch a common currency. The so-called "Altyn" is supposed to be put into circulation within the coming five years. **The currency's name is originally from the Tatar language and actually means "gold".**

Beijing is taking things into its own hands

<u>Conclusion:</u>
The initiatives of emerging market nations, primarily those of China, express increasing impatience with the United States for blocking IMF reforms. Now Beijing is taking things into its own hands. It appears as though we are observing a big power struggle between China and the US, which is now no longer merely about influence in Asia, but globally.[167] Whether a sufficient renovation of the Western-dominated Bretton Woods Institutions succeeds, or whether the new institutions will become serious competition for the existing system, will be decided at the highest diplomatic levels. **The main question is whether a multi-polar monetary architecture in the framework of competing institutions will be created, or whether a transition to one is only possible by means of fundamental reform of established structures (see also sections e, f).**

e) Russia and China – gradual emancipation from the US dollar

"I believe in the Golden Rule – The Man with the Gold….Rules."
Mr. T

For years, Vladimir Putin was known as a supporter of the euro. In 2010, he even mooted a currency union between the EU and Russia. This would have transformed the euro into a de facto petro-currency and would have put it on an equal footing with the US dollar.[168] However, in the

[167] „Amerika verliert Machtkampf mit China", FAZ ("America loses power struggle with China")
[168] See: „Chinas langer Währungsmarsch", Nikolaus Jilch, Die Presse ('China's long currency march')

wake of the imposition of sanctions, Moscow is increasingly turning towards Asia. **The sanctions could prove a boomerang, as it appears as though they have strengthened the Beijing-Moscow axis further.**[169]

Gold is likely to play a very prominent role in this geopolitical power struggle. Russia has been gradually increasing its gold reserves for years. Since 2005 alone, its gold reserves have more than tripled, as a result of which Russia now holds the fifth largest (officially reported) gold reserves in the world, after the US, Germany, Italy and France. Since the beginning of the Ukraine conflict, Moscow has shifted into a higher gear and increased the momentum of gold purchases. These purchases are an unambiguous statement against the hegemony of the dollar, especially in combination with the fact that since January 2014, Russia has sold more than half of its US treasury holdings.

Russian gold reserves in tons (left scale) and value in USD bn (right scale)

Sources: World Gold Council, Incrementum AG

Does Moscow plan to introduce a gold-backed ruble? Economist Jude Wanninski had already recommended this in an attention-grabbing editorial in the Wall Street Journal back in 1998.[170] Only a gold-backed ruble would be able to lead Russia out of the debt crisis and provide the ruble with international acceptance. It appears as though Vladimir Putin has adopted this idea two decades later.[171] **Putin's quite pronounced aversion to the monopoly of the dollar is summarized trenchantly in the following quote:**

"The Americans are living well beyond their means and are shifting a part of the weight of their problems to the global economy. They are living like parasites off the global economy and their monopoly of the dollar. If there is a systemic malfunction in the US, this will affect everyone. Countries like Russia and China hold a significant part of their reserves in US securities. ***There should be other reserve currencies."***[172]

[169] The participation of official representatives from China in the Victory Parade in Moscow, a giant military parade celebrating the victory over Nazi Germany, was hugely symbolic in our opinion. In the West the participation was barely noticed.
[170] See: "Fixing Russia with Gold", Jude Wanniski
[171] See: "As the Sanctions War Heats Up, Will Putin Play His Gold Card?", John Butler
[172] See: "Putin says U.S. is "parasite" on global economy", Reuters

However, critique of the dollar's dominance is also becoming more widespread and frequent on the part of high-ranking institutions. Justin Yifu Lin, the former chief economist of the World Bank, proposed replacing the US dollar with a single global currency: *"The dominance of the greenback is the root cause of global financial and economic crises. The solution to this is to replace the national currency with a global currency."*[173]

The fact that emancipation from the dollar is gaining momentum is confirmed by numerous other examples:

- **At a conference in Krasnoyarsk in Siberia, Russia's vice prime minister Dvorkovich remarked that Chinese companies would be permitted in the future to purchase stakes of more than 50% in state-owned Russian oil and gas fields.** This would represent a milestone in the strategic economic partnership between these two nations. And the measure would not be limited to just the energy sector. Closer relations are also planned in other key sectors, such as the financial and the defense industries.

- **The gas delivery agreement struck between Russia and China last year is a turning point in the strategic energy cooperation between the two countries**. The exact size of the transaction is not yet known, some have reported up to USD 500bn. **For the time being, payments will be made in USD. However, the contracts can be changed into yuan or ruble-based contracts at any time, upon which the US dollar would no longer be needed**. Apart from this deal, 48 additional economic agreements were signed. The volume of trade between the two countries is set to double over the coming five years to an annual USD 200bn.

- **The "China International Payment System" (CIPS) is designed to increase the renminbi's importance in cross-border trade and associated international payment transactions.** Russia is working on an alternative to SWIFT, after the British government threatened Russia with an exclusion from the financial messaging system.

- **Russia and China have opened a USD 25bn (equivalent) currency swap line.** Currently, some 75% of all trade between Russia and China is settled in US dollars. As a result of this agreement, the dollar can be circumvented from now on.[174]

- **China has entered into a comprehensive foreign exchange agreement with Canada,** traditionally one of the US's closest allies. A further agreement was also struck with the ECB, in this case over EUR 50bn. Additional agreements were signed with Switzerland, Malaysia, Argentina, Ukraine and New Zealand. Companies in those countries can thus now completely circumvent the US dollar in trade and foreign exchange transactions.

- **The liberalization of China's bond market is moving**

[173] See: „Replace dollar with super currency: economist", China Daily USA

[174] See: "China prepares to bailout Russia", Zerohedge.com

forward rapidly. More than 20 foreign financial institutions have so far received licenses allowing them to enter China's bond market. Currently the bond market has a volume of nearly USD 6 trillion, and thus appears to be – after the US and Japan – the third largest bond market in the world.[175] More than 50 central banks are by now holding RMB bonds as part of their foreign exchange reserves.

- London, Paris as well as Frankfurt harbor ambitions to establish themselves as the main trading hub for European renminbi trading. In London, the first RMB denominated bonds have been issued, which are held as a reserve by the Bank of England.

Numerous nations want to free themselves from the slavish dependency on the dollar

Conclusion:
We are currently in a transition period to a multi-polar currency system. The period of dollar dominance appears to be slowly but surely coming to an end. In the wake of Russia and China significantly strengthening their strategic alliance in recent months, it appears as though Western sanctions have heralded a new round in the struggle over the global monetary architecture.

f) Special drawing rights: monetary LSD as the currency of the future?

"SDR's are nothingness dressed up as currency."
Jaques Rueff

One possibility to postpone national currency problems is to move them to an international level. The next step in the monetary system's road to perdition could be provided by special drawing rights[176], which former French president Valéry Giscard d'Estaing once referred to as "monetary LSD".

Since the balance sheets of Western central banks have been strongly expanded already in the course of the 2008/09 crisis, our advisory board member Jim Rickards sees only limited possibilities for additional monetary rescue operations, without risking a fatal loss of confidence in paper currencies. **According to Rickards, the next higher authority, i.e., the IMF, will therefore have to step into the breach in order to re-inflate the system**:

"But the problem is, the Fed printed trillions of dollars without a liquidity crisis. What is going to happen when we do have a liquidity crisis, which I expect in the next couple of years, when there is a 2008-style panic starting again? What are they going to do? Print $6 trillion? $9 trillion? There is a limit to what they can do. And so at some point, it is going to get handed over to the IMF, and they are going to have to print SDRs (special drawing rights)."[177]

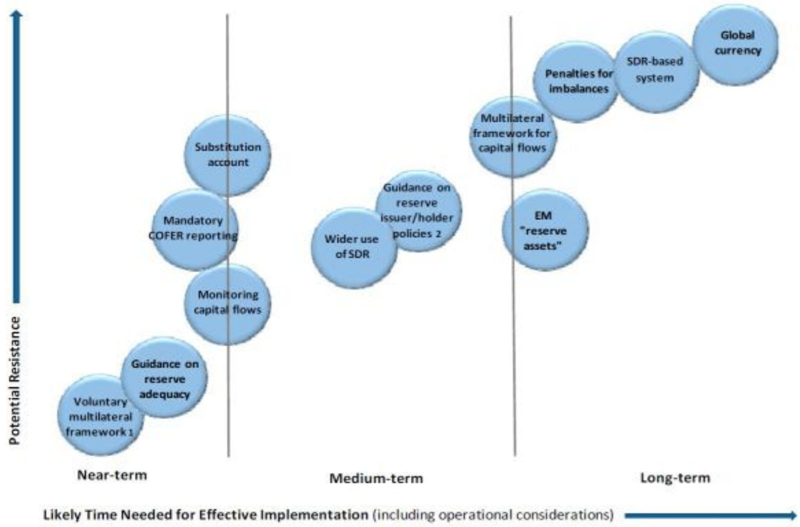
The IMF itself makes no bones about its ambition to establish special drawing rights as a global reserve currency. The following multi-step

[175] See: „China widens foreign access to domestic bond market", Financial Times, 4. Mai 2015
[176] The sesquipedalian term special drawing rights (SDR) designates an artificial currency unit introduced by the IMF that isn't traded on foreign exchange markets. For a detailed analysis see also "In Gold We Trust 2014".
[177] See: Jim Rickards, interview with Peak Prosperity, Sept. 21 2013

plan to position SDRs as a global reserve currency was presented in a study[178].

Step by step plan to transform SDRs into a "reserve currency"

Figure 1. Ideas to Mitigate Demand and Diversify Supply of Reserves for IMS Stability



Source: IWF, Reserve Accumulation and International Monetary Stability

As they are currently constituted, special drawing rights are a pure fiat money; this is to say they are neither covered, nor redeemable. More and more often it is stated that a "grounding" with metals or even agricultural commodities should be introduced in order to create confidence in special drawing rights. From our perspective this makes little sense, **while Jim Rickards refers to the idea of "paper gold" as "the greatest oxymoron of all times".[179]**

Nevertheless, such proposals, which are harking back to the origin of SDRs[180], find ever more prominent supporters. Meghnad Desai, chairman of the influential OMFIF council, recently pleaded publicly for the inclusion of gold in SDRs: "*By moving counter-cyclically to the dollar, gold could improve the stabilizing properties of the SDR. Particularly if the threats to the dollar and the euro worsen, a large SDR issue improved by some gold content and the R-currencies may be urgently required.*"[181]

China and the SDR

2015 could become the year that efforts to internationalize the Chinese renminbi are given direction: In October, the IMF will decide on altering the composition of special drawing rights, and it appears as though the Chinese currency has good cards. So far, only the US dollar (41.9%), the euro (37.4%), the British pound (11.3%) and the Japanese yen (9.4%) make up the currency basket.

[178] "Enhancing International Monetary Stability – A role for the SDR?", IMF, 2011
[179] See also our book "Oesterreichische Schule fuer Anleger", p. 164-168, Taghizadegan, Stoeferle, Valek (an English version will become available later this year)
[180] Originally the value of an SDR was defined as 0.888671 grams of gold. Only after the breakdown of the Bretton Woods system was the SDR currency basket newly defined.
[181] See: "Emsiger WGC: Treffen am Rande von Weltbank und IWF" ("Busy WGC: Meeting on the sidelines of World Bank and IMF") Foonds.com

Should the RMB become part of special drawing rights, this would on the one hand have symbolic, but on the other hand also real economic consequences. With the admission of the renminbi to the elite circle of currencies contained in the SDR, the IMF would acknowledge the ascendency of the second largest economy and concurrently decrease the dollar's dominance. The classification as a reserve currency would make the yuan suddenly a lot more attractive for the central banks of emerging countries, which want to diversify their foreign exchange reserves away from the US dollar.

"In order to "join the club", China must play by club rules. The rules of the game say you need a lot of gold to play, but you don't recognize the gold or discuss it publicly. Above all, you do not treat gold as money, even though gold has always been money."
Jim Rickards

The conditions set by the IMF in 2010, especially with regard to the renminbi's tradability, have largely been fulfilled. Capital movement regulations were changed, and access to China's bond market has been eased for foreign investors. The classification as an "important export currency" has already been attained, as the share of China's trade volume settled in yuan now stands at 20%. In the meantime, the RMB is the fifth-most traded currency in the world. From a purely formal perspective, Beijing appears to have done its homework, which is **why IMF chief Lagarde already indicated that the admission of the renminbi was no longer a question of "if", but of "when".[182]**

China has expressed interest in special drawing rights since the 1970s already.[183] Recently, its wishes have been expressed ever more strongly, e.g. by People's Bank of China governor Zhou Xiaochuan. He demanded that the dollar should be replaced as the global reserve currency by SDRs:

"… *the role of the SDR has not been put into full play due to limitations on its allocation and the scope of its uses. However, it serves as the light in the tunnel for the reform of the international monetary system… The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight. The allocation of the SDR can be shifted from a purely calculation-based system to a system backed by real assets, such as a reserve pool, to further boost market confidence in its value."*[184]

We regard this largely as posturing. We assume that China doesn't want to destroy the IMF and the dominant Western institutions, but that at the end of the day, it wants to become a member of the "big boys' club", as Jim Rickards has put it.[185] China's leadership knows that the yuan is far from ready to overtake the dollar, despite the rapid progress of its efforts at internationalization.

Conclusion:
The admission of the renminbi into the SDR basket appears to be a purely political issue. The US have a veto and can block its admission. As a result, China will have to be flexible and offer some kind of quid pro quo. We believe that the US would only agree to the admission of the RMB into the SDR basket if it becomes fully convertible. Including it in the SDR currency basket would in our opinion make little sense unless the RMB's managed peg to the dollar were removed. If it was to remain pegged to the

182 See: "IMF's Lagarde says inclusion of China's yuan in SDR basket a question of when", Reuters
183 See: "Wikileaks 1976: PBoC Focuses on Gold and SDRs", Koos Jansen, Bullionstar Blog
184 See: "Zhou Xiaochuan's Statement on Reforming the International Monetary System", cfr.org
185 See: "China and the Gold Bugs", Jim Rickards, www.acting-man.com

USD, there would seem to be little point in including it, aside from the potential symbolic effect.

"..Gold is instantly and optically recognizable as money. You don't have to explain it. Special drawing rights (SDRs), like a bad joke, have to be explained."
Jim Grant

Last year, we already wrote the following regarding the future of special drawing rights: ***The next big crisis will lead to a reorientation of the international monetary architecture***. *Most proposals regarding an intensified use of special drawing rights appear to make little sense from an "Austrian" perspective, as a global institutionalized fiat money cannot circumvent the true problems inherent in the debt based monetary system.* With prophetic foresight, Ludwig von Mises warned against a further centralization of the central banking system in 1912: *"Once common principles for their circulation-credit policy are agreed to by the different credit-issuing banks, or once the multiplicity of credit issuing banks is replaced by a single World Bank, there will no longer be any limit to the issue of fiduciary media."*[186]

g) Gold-backed digital currencies

"The advantages of competition do not depend on whether it is 'perfect'."
F. A. Hayek

In the course of a competitive discovery process, people should be given the opportunity to learn which type of money is most sensible for them based on their individual situation and needs. Since obviously no one will want to use unsound money, healthy competitive pressure would incentivize both private and government money producers to issue money of better quality.[187] To what extent precious metals-backed currencies would dominate in a free market monetary order is difficult to tell ex ante. **However, a glance at monetary history suggests that humanity has always harbored a natural preference for gold and silver**.

In the wake of Bitcoin, more and more new digital and crypto-currencies are being created. According to the web site *mapsofcoins.com*, more than 800 crypto-currencies based on Bitcoin's technology currently exist – and the trend continues.[188] On the crypto-platform *coinmarketcap.com*, a total of 563 electronic currencies are listed. The sector has attained a market capitalization of USD 3.7bn, albeit the lion's share thereof is attributable to Bitcoin (approx. USD 3.3 bn.).[189]

The rapid development phase, the ups and downs of individual digital currencies (esp. Bitcoin) and the competition over the possible money of the future of course does not steer clear of gold. Thus a new crypto-currency called HayekCoin was presented in the US only a short while ago.[190] Named after Austrian Economic Nobel Prize winner Friedrich August von Hayek, it represents a gold-backed digital currency, with every virtual coin backed by one gram of physical gold. Physical gold can be transformed into the digital currency by paying it into an account. Thus every HayekCoin issued will not only be fully backed by gold, but will at all times exhibit the same value as one gram of gold.

This project and numerous other gold-covered crypto-currencies are an attempt to combine the advantages of a crypto-currency (easy and fast transfer over large distances, low transaction costs) with the

[186] See: "The Theory of Money and Credit", Ludwig von Mises
[187] See: "Währungswettbewerb als Evolutionsverfahren", Liberales Institut, Frank Schäffler und Norbert F. Tofall („Currency Competition as an Evolutionary Process")
[188] http://mapofcoins.com/
[189] https://coinmarketcap.com/
[190] „Anthem Vault Joins Freedom Fest 2015: Featuring 'The Hayek'", AnthemVault News

advantages of gold. By tying them to gold, these crypto-currencies are supposed to be less susceptible to the vagaries of the market, in contrast to Bitcoin, which has experienced quite a roller-coaster ride since its introduction.

Another important provider is BitGold. The official goal of the Canadian enterprise is "*(...) to make gold accessible and useful for digital payments and stable savings*."[191] In order to make this possible, BitGold intends to become a platform that works similar to PayPal. In the future, virtual, gold-backed BitGold is intended to be transferable via e-mail or smart phone to any desired recipient.

The payment network Ripple also appears to be developing well. Ripple is a digital standard for payments with which any currency can be traded. Thus, Ripple is similar to the e-mail standard for digital messages. Big names are among the investors in Ripple, such as Andreessen Horowitz, a venture capital firm with AUM of more than USD 2.7 bn., but also Google Ventures, Google's internal venture capital company.[192] In its first round of financing in 2013, Ripple Labs raised USD 3.5 million, and in 2015, more than USD 30 million.[193] **Two currency suppliers in the system have already switched their trading to gold.[194]**

Conclusion:
A lot seems to be happening in the currency markets at the moment. Whether the highly innovative companies will ultimately be successful remains to be seen. They will first have to prove that they can overcome the difficult legacy of eGold, which hangs like the sword of Damocles over the entire sector of gold-backed digital currencies.

In principle, framework conditions are currently significantly better than they were just a few years ago. If new providers of gold-backed digital currencies can overcome the problems and the wind isn't taken out of their sails politically, they could well be looking forward to a "golden future" - almost literally. **However, until then, numerous obstacles will still have to be overcome.**

[191] https://www.bitgold.com/about-bitgold
[192] https://www.ripplelabs.com/investors/
[193] "Digital-Payments Company Ripple Labs Finalizing $30 Million Funding Round", Wall Street Journal
[194] Gold Bullion International as well as Ripple Singapore

9. THE GOLDEN “LOVE TRADE“

The steady migration of gold from West to East continues unabated

Gold has always moved out of regions in which prosperity is stagnating and fled to those regions in which the economy is prospering and the volume of savings is rising. In 1980, Europe and the US were still responsible for 70% of gold demand; in the meantime they account for a mere 20%.

The following table shows the change in consumer demand from 2000 to 2014. Measured in tons, the largest increase is attributable to China (+574 tons) followed by Europe (+124 tons) and India (+119 tons). In percentage terms, Germany was in the top spot with a gain of +550%, followed by China (+196%) and Europe ex CIS (+87%). **These figures are impressive testament to how unimportant Western demand has become relative to that of Asia and the Near East.**

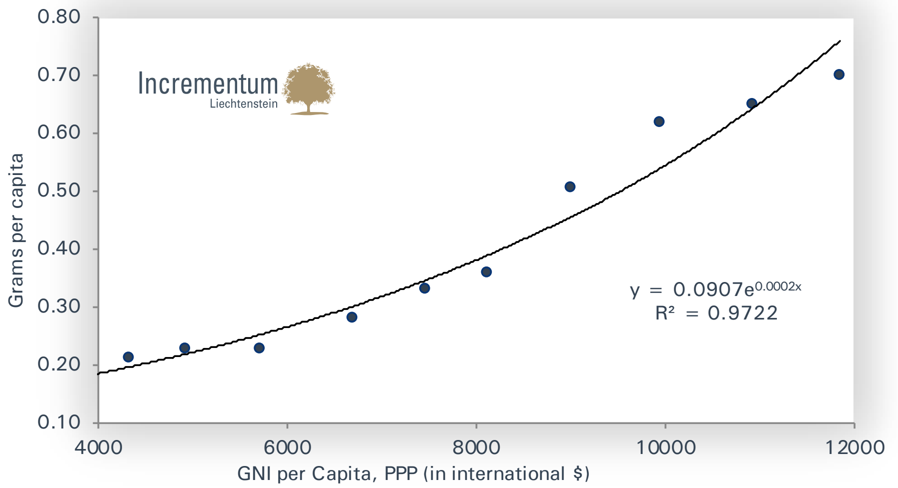
Consumer demand for gold 2000 vs. 2014

Consumer demand	2014		2000		Change	
	Tons	%	Tons	%	Tons	%
India	843	26.2%	723	21.6%	119.7	17%
Greater China	868	27.0%	292.6	8.8%	574.9	196%
Japan	17.9	0.6%	105.1	3.1%	-87.2	-83%
Middle East	216	6.7%	457.9	13.7%	-242.2	-53%
Turkey	123	3.8%	177.4	5.3%	-54.4	-31%
USA	266	8.3%	368.5	11.0%	-102.1	-28%
Europe ex CIS	266	8.3%	142.4	4.3%	124.0	87%
Germany	101	3.2%	15.6	0.5%	85.8	550%
UK	28	0.9%	75	2.2%	-47.4	-63%
Italy	18.8	0.6%	92.1	2.8%	-73.3	-80%
France	2.2	0.1%	19	0.6%	-16.8	-88%
Others	412.6	12.8%	1076.2	32.2%	-663.6	-62%
Total	**3,217**	**100.0%**	**3,343.1**	**100.0%**	**-126.5**	**-4%**

Sources: World Gold Council, Incrementum AG

“Chindia”, i.e., China and India, remain the most important forces on the demand side. Apart from the “fear trade”, they represent the major drivers of the bull market. A significant increase in investment demand has recently become evident in China. The main reason is likely fear of a creeping devaluation of savings. Moreover, it appears as though many Chinese citizens are turning away from overheated real estate and stock markets and are looking for protection from inflation in the form of gold investments. If one looks at the relationship between per capita demand and incomes, the following picture emerges.

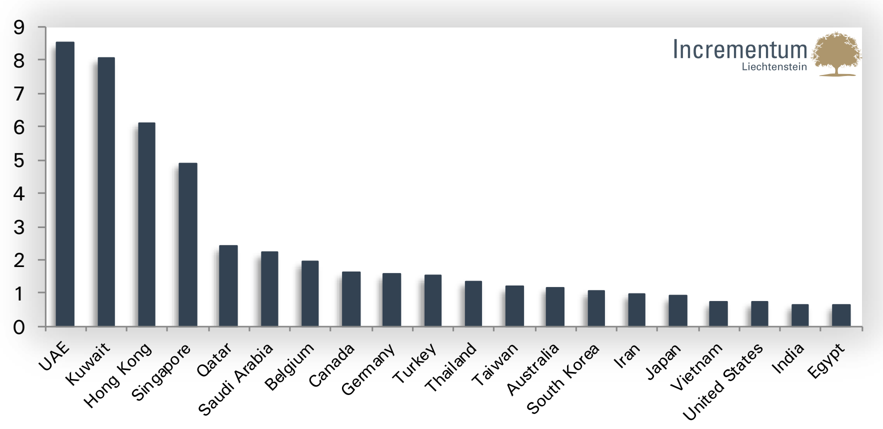
Per capita demand for gold vs. per capita income



Sources: Worldbank, World Gold Council, Incrementum AG, eigene Berechnungen

Looking at global per capita demand last year, one can see that numerous emerging market economies are already amongst the 20 largest gold buyers.[195] This is especially surprising considering their significantly lower purchasing power. Furthermore, it is remarkable that 14 of the 20 countries with the highest per capita demand are located in Asia.

Global per capita demand 2014 (grams/capita)



Sources: WGC, Thomson Reuters

We regard a doubling of Asia's gold demand over the coming decade as realistic, even likely. Decisive for this optimistic assessment are primarily sharply rising incomes, high savings rates, increasing urbanization and transformations from agrarian to industrial nations, as well as a lack of investment alternatives and rising fear of inflation.

Not only private individuals, but also central banks in emerging market nations are steadily increasing their gold reserves. According to the World Gold Council, overall central bank purchases amounted to 477 tons last year. The largest buyer was Russia for the third time in a row (173 tons), followed by Kazakhstan and Iraq (48 tons each). India, Mexico, and the Philippines were once again buyers. **While central banks in emerging**

---

195 The leading role of city states like eg. Hong Kong and the UAE is due to the fact that they often serve as bridge heads for an entire region

markets continue to be net buyers, Western central banks have at least stopped their selling for the time being.

China's gold strategy

"No asset is safe now. The only choice to hedge risks is to hold hard currency - gold."
Zhang Jianhua, PBoC

Although China is by now the second largest economy and has amassed almost four billion dollars in foreign exchange reserves, the renminbi does not yet live up to the economic status that has been achieved. **As we already noted in previous years, the renminbi's "gold content" will likely be an important criterion for its international acceptance.**

This was recently confirmed by no less a person than Song Xin, president of the China Gold Association and party secretary of the CP, in an attention-grabbing commentary: Reserves of 4,000 tons are to be reported in a first step, overtaking Germany. At the end of the day, 8,500 tons are supposed to be held, exceeding those of the US. Specifically, the People's Bank of China is supposed to buy gold directly in the market. Moreover, import controls for gold are to be loosened and a special gold-based government fund is to be created. This fund is to take stakes in gold mines around the world.[196]

"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 former Fed chairman, Alan Greenspan, recently also remarked on China's gold policy. In an astonishing article for Foreign Affairs[197], he recommended China to boost its gold reserves and replace the US as the largest holder of gold. This measure would increase the renminbi's importance in the global financial system in one fell swoop. According to Greenspan, gold represents universal value that the US dollar cannot replace – gold was the only form of payment exporters to Germany would accept when WW2 was coming to a close. **The acceptance of fiat money by contrast is based on a pure credit promise – a guarantee that cannot come close to gold in terms of universal acceptance.** If gold really were a barbaric relic as Keynes asserted[198], central banks around the world wouldn't hold as much of it as they do, according to Greenspan.

Does China hold 4,000 to 6,000 tons, and thus the second highest gold reserves in the world?

According to the World Gold Council, China's central bank has not undertaken any official gold purchases since 2009. Based on Hong Kong import data and a plethora of comments by high-ranking Chinese politicians, we assume that the PBoC has already far higher reserves at its disposal than the 1,054 tons that have been officially reported. Cumulative domestic gold mining alone amounts to approx. 2,500 tons since 2009. **We believe it is realistic that China now holds 4,000 to 6,000 tons and has thus already become the nation with the second-highest gold reserves in the world. We expect that the precise amount of gold held in reserve by China will be published in the course of the coming several months.[199]**

In spite of China's impressive ascent, one shouldn't get carried away and expect a very fast replacement of the US dollar by the renminbi. The previously outlined establishment of the renminbi as a new global

[196] See: "Parteisekretär: China muss Goldreserven auf 8.500 Tonnen erhöhen", Goldreporter.de („Party secretary: China must increase its gold reserves to 8,500 tons")
[197] See: "Golden Rule: Why Beijing Is Buying", Alan Greenspan, Foreign Affairs
[198] To be fair it should be noted that Keynes referred to the gold standard, not gold as such.
[199] However, this should be put into perspective: even if China were to hold 10,000 tons of gold, this would merely be equivalent to 7% of the narrow money supply M1, which currently amounts to USD 5.4 trillion.

reserve currency is a centennial project. We believe that gold will play an important role in the current phase. When the British pound and the US dollar became leading international currencies, their gold backing amounted to more than 50%. **When the euro was introduced, the gold reserves of member nations amounted to 10,000 tons and likewise represented a foundation of confidence for the new common currency.**[200]

However, we doubt that China's leadership plans to introduce a gold-backed renminbi. That would have two important disadvantages: On the one hand, the PBoC would lose its monetary policy flexibility, which it is making active use of at present. Why would the PBoC relinquish its money issuing monopoly? Every central bank prefers uncovered paper money. On the other hand, a gold backing would result in a far stronger renminbi. This would be seen as anything but conducive to China's currently fragile economy.

Conclusion:

The "love trade" will continue to gain in importance

Due to China's long term and counter-cyclical strategy, it appears as though lower prices may definitely be wanted. This was already mentioned a few years ago by Cheng Siwei, a high-ranking economic representative of the people's republic: *"Gold is definitely an alternative, but when we buy, the price goes up. We have to do it carefully so as not to stimulate the market…China is buying the dips"*. This statement fits well with gold's current technical picture. **China continues to act counter-cyclically, while Western financial investors usually act pro-cyclically.**

China is buying the dips…

The steadily growing importance of Asian emerging markets with respect to gold demand is in our opinion widely underestimated. Large parts of Asia have a far greater predilection for gold than Western developed nations. **This traditionally high gold affinity and rising prosperity will support demand in the long term.**

[200] See also: "China Aims For Official Gold Reserves at 8500t", Koos Jansen, Bullionstar Blog

10. VALUATIONS, SCENARIOS AND PRICE TARGETS

"Value does not exist outside the consciousness of men."
Carl Menger

Value is always subjective, it is therefore in the eye of the beholder. Objective factors, such as e.g. production costs are entirely irrelevant for valuations. This can e.g. be seen by the fact that the market value of a Vincent van Gogh painting is significantly higher than its production costs. Similar considerations apply to used cars, the market prices of which are as a rule considerably below their production costs.[201]

According to Carl Menger, the founder of the Austrian School of Economics, the value of a good is determined by the expected marginal utility the good has to a valuing individual. The value of a good or service is therefore not an objectively measurable magnitude, but is always the result of a subjective act of valuation.

Since there are as many different scales of preferences as there are human beings (and because every scale of valuations is continually subject to change as well), it is impossible to ascertain the value of a good or service in an objective manner. **It is therefore also impossible to calculate a "fair value" for gold.**

Is it nevertheless possible to approach the topic of valuation analytically? **A helpful method can be the comparison of the exchange ratio between two items over time**. This ratio develops over long time periods and as a rule isn't permanently moving in a specific direction, as this would mean that one good would relative to another eventually reach an infinitely high value, while the other good would have become completely worthless.[202]

If we look at a variety of relative prices, we can get an idea of whether current exchange ratios are favorable or not.

a) Gold vs. monetary aggregates

Based on our remarks up to this point, it should be clear that we believe that gold must continue to be regarded as a monetary asset. Therefore, comparisons between gold and the money supply immediately suggest themselves. The fractional reserve banking system creates difficulties with respect to the precise definition of the money supply. Thus, one can approach such comparisons in various different ways.

Shadow Gold Price currently at USD 18,000

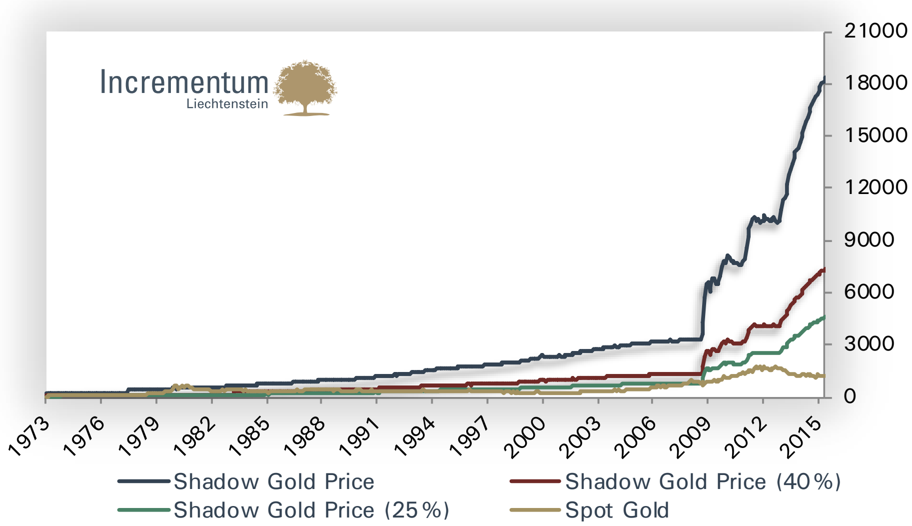
We have first presented the so-called "shadow gold price"[203] calculated by Paul Brodsky and Lee Quaintance in 2011. This way of looking at the gold price is by no means a mere intellectual game. Rather, it is in line with how the exchange rate between paper money and gold was determined according to the Bretton Woods agreement (US monetary base divided by US gold reserves). As Brodsky and Quaintance explain: "*The Shadow Gold Price extrapolates forward the Bretton Woods model for valuing US dollars (USD base money/US official gold holdings), used from*

[201] See: „Die Produktionskosten und der Marktpreis des Goldes", Degussa Marktreport, 19. Juli 2013 ("The production costs and the price of gold")
[202] This applies especially to the comparison of two material goods. The exchange value of a material good expressed in paper money terms can indeed rise permanently over a very long time, and in extreme cases to infinity (hyperinflation)
[203] See: In Gold we Trust, 2011

1945 to 1973. Rather than fixing the gold/USD exchange rate (at 1/35 of an ounce, which assumed a static quantity of base money), it uses the actual quantity of base money vs. actual gold holdings. A rising SGP implies USD purchasing power dilution in gold terms experienced under the post-Bretton Woods flexible exchange rate system. The widening gap between the SGP and the spot price from 1980 to 2008 reflects the steady creation of USD base money as US and global output expanded. The sudden exponential rise beginning in 2009 reflects extraordinary base money creation through Fed QE."

Currently, the shadow gold price would stand at more than USD 18,000. However, historically lower coverage ratios for gold-backed currencies have been employed as well. Since the Federal Reserve Act of 1914 stipulated a minimum gold cover of 40%, we have depicted the 40% coverage level in the chart as well. In order to reach this level, the price of gold would have to rise to USD 7,300. Between 1945 and 1971, gold cover of only 25% was necessary, and we show this line on the chart as well. At a coverage level of 25%, the gold price would amount to USD 4,500.

Shadow gold price (at 100%, 40% and 25% gold backing) vs. current gold price



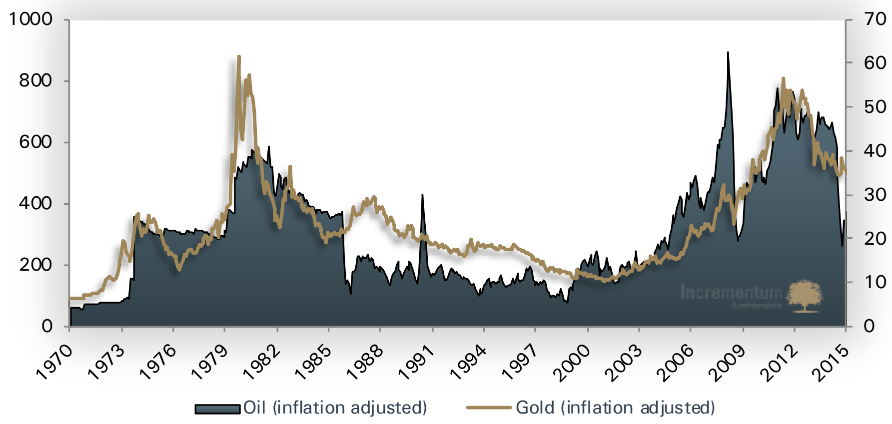
Sources: Paul Brodsky, Macro Allocation Inc., www.macro-allocation.com

b) Relative valuation by means of ratio analysis

Price comparisons based on nominal price series are inappropriate. The quality of today's dollar is significantly different from that of a dollar in 1980 or 2000. When the gold price hit its final record high in January of 1980 at a price of USD 850, average US household incomes amounted to approx. USD 17,000 per year. Today one would be considered as living well below the poverty line with such an income. The amount of outstanding debt has also changed significantly since then. While US public debt amounted to approx. USD 863 bn. at the time the 1980 record high was reached, it amounts to USD 18.2 trillion today, i.e., it has grown by a factor of 21.

A comparison of nominal gold prices over periods spanning several decades therefore has only limited utility. Thus, we will take a look at the gold price and the oil price, adjusted by official price inflation rates. The fact that exceeding an inflation-adjusted all time high is quite normal in the course of a secular bull market was already demonstrated by crude oil in 2008. The inflation-adjusted peak was exceeded by more than 50% in the parabolic advance at the end of the cycle. For gold this would imply a price level above USD 2,770. **We therefore believe it is realistic to expect that our long term price target of USD 2,300 will be clearly exceeded at the end of the bull market.**

Price inflation-adjusted oil and gold prices



Sources: Bloomberg, Incrementum AG

"Markets are where buyers and sellers simultaneously agree on price but disagree on value."
Ben Davies

In the following table we show additional ratios between gold and a selection of "real assets" and bonds. One can see that the gold price is trading above its long term average relative to US real estate, but also relative to silver and the CRB index. Relative to fine wines, stocks, works of art and high yield bonds, gold appears undervalued.

Ratio	Current	Average	Low	High	Gold expensive?
Gold/Silver[204]	74x	54x	14x	99x	Yes
Gold/Oil (Brent)	18.1x	15x	6.5x	39x	Fair
Gold/CRB[205]	2.8x	1.74x	1.02x	3.6x	Yes
Gold/Fine Wine[206]	0.75x	1.31x	0.43x	4.6	No
Gold/Sotheby's[207]	25.3x	29.8x	6.1x	144x	No
Gold/High Yields[208]	1.1x	1.6x	0.69x	4.5x	No
Gold/Housing[209]	0.0045x	0.0031x	0.0014x	0.009x	Yes
Gold/S&P 500	0.55x	1.22	0.17x	7.5x	No

Sources: Incrementum AG, Datastream, Liv-ex, Federal Reserve St. Louis

Thus, a long term comparison between gold and other asset classes by and large suggests a positive scenario. Both relative to money supply aggregates as well as to traditional asset classes (stocks and bonds), gold is trading below long term average levels. Compared to a selection of "real assets", several ratios are above the average, however they are far from extreme levels.

[204] Since 1971
[205] CRB Index since 1981
[206] Liv-ex Fine Wine Investables Index since 1988
[207] We regard the stock of Sotheby's as a proxy for the art market
[208] BOFA ML US High Yield Masters Total Return, since 1986
[209] Mean Sales Price of Existing Single-Family Homes

c) Forecast

"The future belongs to those who prepare for it today."
Malcom X

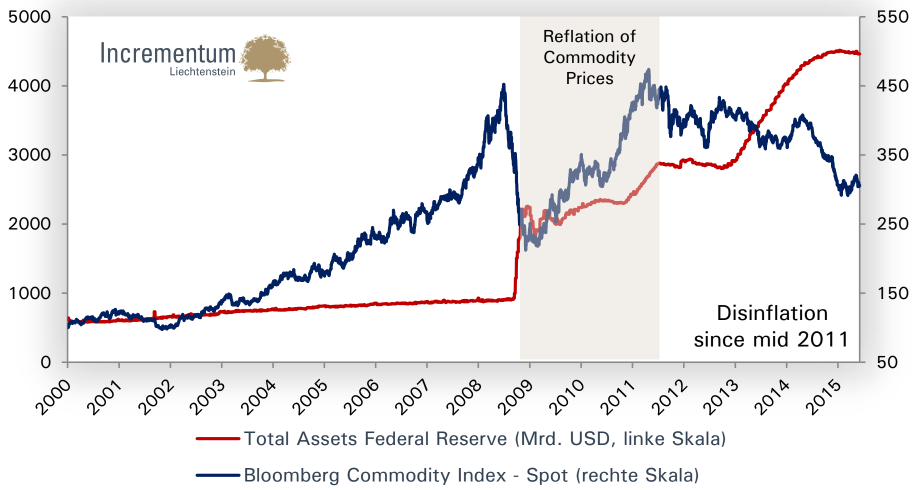
We have discussed in detail that the debt situation in many regions of the world is unsustainable. **The idea that "growing out" of over-indebtedness would be possible, is in our opinion a highly unrealistic expectation, as there is no realistically achievable combination of tax rates and growth rates in most countries that would allow for a sustainable reduction of the extant debt burdens.**

A consistent, drastic austerity policy shouldn't be expected either. Southern European countries are an example showing the democratic limits with respect to austerity policies. **Zero interest rate policies are a major pillar supporting high debt ratios and are even increasing the incentive to amass additional debt**.

A debt haircut by a major industrialized nation is unthinkable, as the deflationary follow-on effects would be too dramatic in today's highly interrelated financial system. The only politically palatable path is a flight forward: Aggressive re-inflation of the economy is intended to make debt burdens sustainable by increasing nominal prices. **Note in this context the example of Japan, which has progressed the furthest in terms of indebtedness.**

The economic cycle appears quite mature by now. After 2008, money supply inflation has been employed in unprecedented fashion in order to artificially boost the economy. Especially the increase in economic activity in the US in recent years is attributable to the illusion of growing prosperity through the so-called "wealth effect".

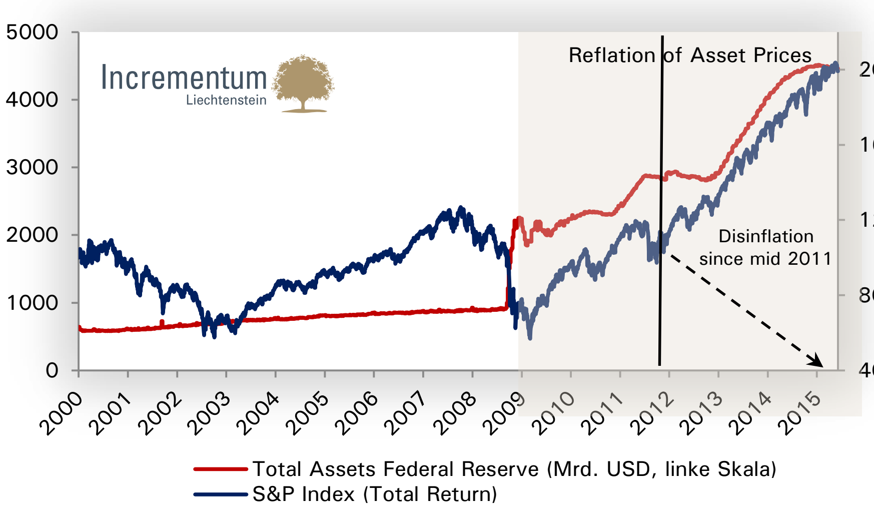
US monetary base and commodity prices



Sources: Bloomberg, Incrementum AG

This can be illustrated by dividing the reflationary trend after 2008 into two segments: pre and post 2011.

US monetary base and stock prices



Sources: Bloomberg, Incrementum AG

While from 2008 to 2011 the prices of both stocks and commodities (and thus the prices of real assets) were driven higher, a disinflationary trend in commodity prices can be discerned since 2011. Since then, money supply inflation primarily induced financial asset price inflation. This phase has culminated in a disinflationary tsunami in 2014. A strengthening US dollar exerting deflationary effects once again delayed the probability of a rate hike and left the much-desired zero interest rate environment in place, benefiting stock markets.

Three different scenarios for gold and financial markets

We are strongly convinced that we are now close to a fork in the road. Over the coming three years, a paradigm change is likely to become evident in the markets, quite possibly including rising inflationary trends. We believe the following scenarios to have the highest probability:

Scenario I: The current economic cycle nears its end and the fairy tale of a self-sustaining recovery is increasingly questioned by market participants. **This leads to a significant devaluation of the US dollar relative to commodities, since the Fed – as it has stressed time and again – will once again employ quantitative easing or similar interventions if occasion demands it.** In this case gold would benefit significantly from wide-ranging repricing in financial markets. A stagflation-type environment would become a realistic alternative in this scenario, something that is currently on almost no-one's radar screen.

Scenario II: **Rising yields lead to an increase in credit creation and an increase in money velocity (= decline in the demand for money).** Economic activity picks up, is however accompanied by accelerating price inflation.[210] In this scenario, both financial assets (with the exception of bonds) and real assets (such as gold) would benefit in nominal terms.

Scenario III: The system hasn't become any healthier since 2008, but has in fact become more fragile in many respects. Due to further concentration in the banking sector, the balance sheets of the largest banks have grown enormously. The volume of outstanding derivatives has continued to grow, with many off-balance sheet positions. In addition, the geopolitical situation

[210] The Austrian School refers to this phenomenon as a “crack-up boom”.

hasn't been this tense since the end of the cold war. **The probability of a "black swan" event striking is therefore in our opinion higher than it has been in a long time.** In this type of scenario, gold would likely emerge as a beneficiary as well.

Conclusion:
All in all we are convinced that gold remains in a secular bull market, which is likely close to a renaissance. Should this assessment be correct, we would expect to see a trend acceleration in the coming phase. As discussed above, a variety of scenarios is possible which would mostly have positive effects on the gold price. We believe that this is a good time to provide a concrete time horizon for our long ago formulated price target. **In light of the perspective discussed above, we have decided to set a time horizon of three years for our long term gold price target of USD 2,300.**

d) A gold bug's nightmare

What's the worst case scenario for gold?

We have revealed our base case scenarios above. Not least due to the fact that ours is a minority opinion in the analyst community, we have so far enumerated many arguments in this report which have led us to our – currently counter-cyclical – conclusions.

Making investment decisions (and price forecasts) is always associated with uncertainty. No-one really knows what the future will bring, and even if one's decisions are based on a thorough analysis and are well founded both in terms of theory and empirical evidence, the future can still turn out to be different from what one has expected. **We therefore also want to discuss potential negative scenarios for the gold price at this juncture.**

Short term risks for the gold price:

Many reasons for a short term decline in the gold price are thinkable. Primarily these comprise scenarios that would create a liquidity emergency, resp. would lead to a significant strengthening of the US dollar. A few possible scenarios are listed below:

- **The euro crisis becomes more acute,** the markets assume that a "Grexit" would have a bullish effect on the US dollar, and gold weakens in reaction to this.
- **In the framework of a debt restructuring, Greece is forced to sell part of its gold reserves (112 tons),** putting pressure on the gold price (the effect would be mainly psychological, but it is a good bet that the market would interpret such news as bearish).
- Out of concerns over faltering economic growth, **China decides to make a U-turn in its currency policy and devalues the RMB against the USD**. The strengthening dollar affects the gold price negatively.
- **A rate hike in the US triggers a crash-like decline in bonds**, with yields rising suddenly and significantly. The resulting better returns from higher yields raise the opportunity cost of gold and weigh on the gold price.
- **The stock market bubble becomes even more pronounced, with stock markets beginning to advance in parabolic fashion.**

Gold continues to sell off in light of the better opportunities offered by a continued rally in stocks.

- **A highly unlikely scenario: Goldilocks really comes to life.** Against all odds, a seemingly sustainable strong economic expansion begins to take hold in developed markets and price inflation concurrently remains tame. The conviction that central economic planning actually works becomes even more deeply ingrained, and gold prices fall as a result. The error is only discovered with a significant delay, by which time gold trades at bargain basement levels.

<u>Preconditions for a longer term negative environment</u>

The monetary policy framework is more important for our long term estimate over the coming three years than short term events. The following factors were primarily responsible for the decline in the gold price over the past several years:

- **The price premium embedded in the gold price due to the euro area debt crisis** evaporated in the wake of the ECB's "whatever it takes" rescue policies.
- **Strong disinflationary trends** and associated with them, **rising real interest rates.**
- **The expectation of a beginning rate hike cycle** in the US, combined with a sustainable acceleration in economic growth.
- **Partly decelerating money supply growth** (especially in the US).

Implicitly, market participants have already **priced in the "victory of monetary policy interventions" and a return to a normalization of monetary policy – at least in the US.** In order for an unfavorable long term scenario for the gold price to develop, we believe that the following framework conditions would have to emerge:

- High expectations with respect to economic growth in coming years not only would have to be fulfilled, but actual economic developments would actually have to exceed these expectations in the future.
- A disinflationary environment would have to persist, in order to keep rate hikes in check even in the face of such a growth scenario.
- The euphoria regarding investment in "risk assets" (primarily stocks and spread products) has to become even more pronounced, in order to make investment in such assets still appear attractive even in light of extremely low yields.

<u>Conclusion:</u>

"Great Moderation" would be a horror scenario for gold

A longer term horror scenario for the gold price would be falling inflation trends combined with rising economic growth. Precedents were on the one hand the 1990s, when price inflation rates gradually declined in the US, but economic growth accelerated in the course of the decade. This phase is also referred to as the "Great Moderation" and is associated with the Greenspan era at the Fed. On the other hand, the disinflationary period since 2011 can also be regarded as an example, whereby growth momentum has in this case recently declined.

Price inflation rates are currently at extremely low levels in all developed countries. A further decline in inflation rates over many

years is therefore no longer possible, as negative price inflation rates – as mentioned above – cannot be allowed to persist for systemic reasons.

A congeneric environment would be a continuation of the "low-flation" phase. Additional stimulus measures don't lead to an increase in economic activity, but light an even bigger fire under asset prices. **This scenario cannot be categorically ruled out in light of extreme monetary policies.**

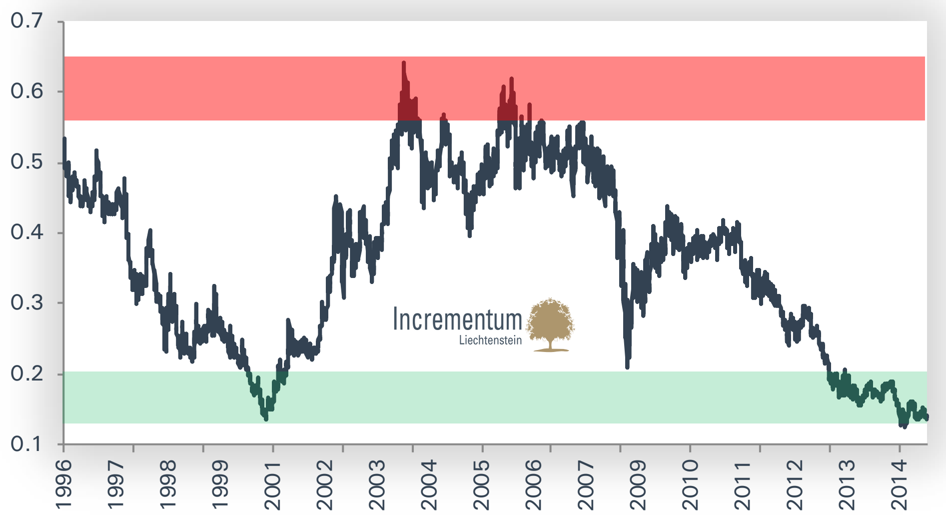
11. GOLD STOCKS

When our last gold report was published, the Gold Bugs Index (HUI) stood at 233 points. The (final?) low was reached on November 5 2014 at a level of 146 points. Since then, six higher lows have been put in place. **In the following pages, we will explain why we believe that the downtrend in gold mining shares is now finally over.**

a) Relative valuation of gold and gold mining stocks

Relative to the gold price, the gold stocks in the HUI Index are at their lowest level since 2000. The phases during which gold stocks were trading at an extremely low level relative to gold are marked in green below, and vice versa in red. It can clearly be seen that mining stocks look extremely undervalued relative to gold right now. This is, however, not really helpful from a timing perspective – there is a big difference between being right in principle and getting the timing right.

HUI/gold-Ratio

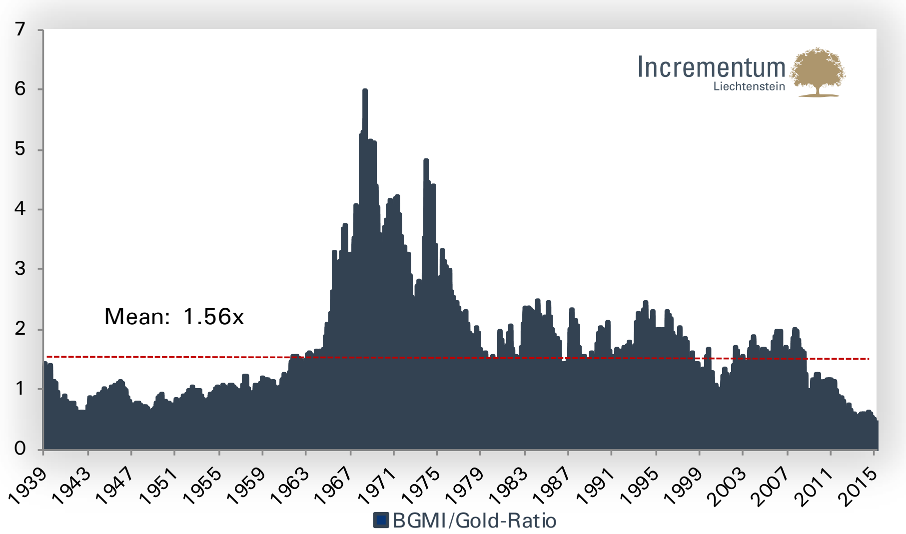


Sources: Bloomberg, Incrementum AG

Gold stocks relative to gold at the lowest level in more than 70 years

The true extent of undervaluation is best seen by looking at a long-term comparison. The Barron's Gold Mining Index (BGMI), the oldest available gold index, has recently reached its lowest level relative to gold in more than 70 years. The current ratio of 0.4 is significantly below the long term mean of 1.56. Incidentally, the low in 1942 was reached in the wake of the stock market's “mini crash” following the Pearl Harbor attack.

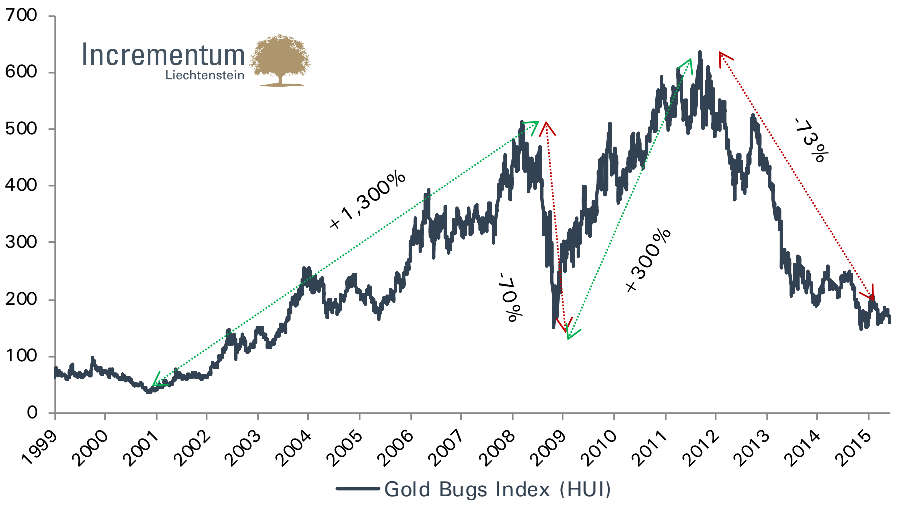
BGMI/gold ratio at lowest level since 1942



Sources: Nick Laird, Sharelynx.com, www.nowandfutures.com, Barrons, Incrementum AG

The following chart illustrates that gold stocks are anything but "buy and hold" investments and have to be actively managed. In our opinion, mining stocks react – analogous to gold and silver – most strongly to *changes* in the rate of price inflation. As a result, we actively time them using our inflation signal.

Amex Gold Bugs Index: Bull and bear market cycles since 1999

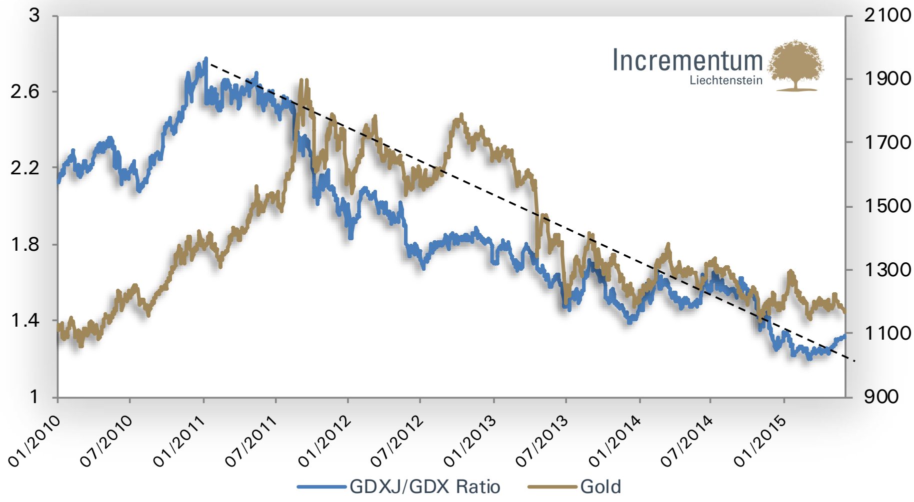


Sources: Datastream, Incrementum AG

**"*In investing, what is comfortable is rarely profitable.*"
Robert Arnott**

The next chart shows the ratio between the ETFs GDXJ and GDX and is an excellent indicator of risk appetite in the gold mining sector. GDX contains primarily stocks of senior gold producers, while GDXJ contains stocks of junior and small cap gold stocks, and thus exhibits a far larger beta. **If the ratio rises, it indicates rising investor risk appetite. At the moment, the ratio is attempting to build a bottoming formation.** In fact, in the most recent downturn in the sector, GDXJ held up clearly better than GDX. In all likelihood, investors with deep pockets and patience are scooping up stocks of juniors while they are still at very depressed levels. Given the relatively low liquidity of these stocks, it can take some time to accumulate a significant position (liquidity tends to contract after large declines, but will expand again during the next rally phase. It is therefore easier for big investors to sell high than to buy low).

GDXJ/GDX-Ratio

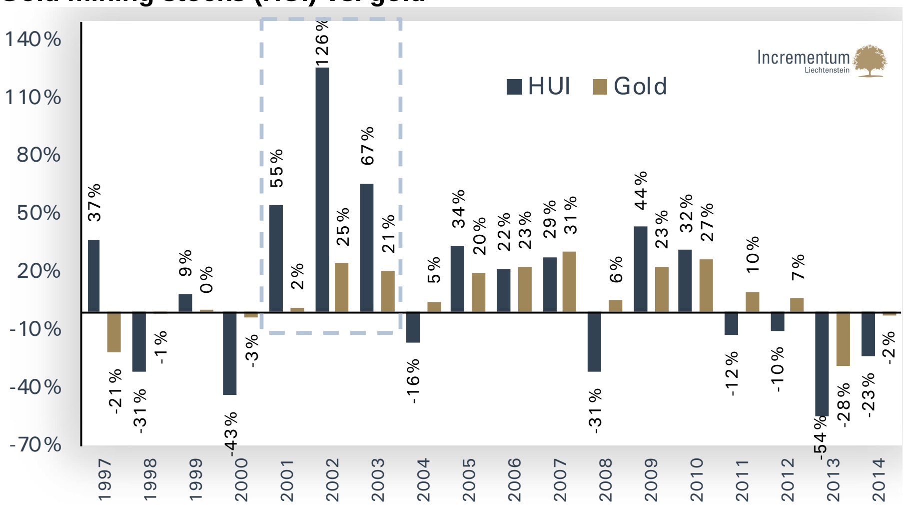


Sources: Bloomberg, Incrementum AG

b) Why have gold mining stocks performed so badly?

If one compares the annual performance of gold and mining stocks, it becomes evident that mining stocks only significantly outperformed from 2001 to 2003. Since then, they have reacted far more forcefully to corrections than to rallies.

Gold mining stocks (HUI) vs. gold



Sources: Bullion Management Group Inc., Incrementum AG

Last year, we analyzed and criticized the failure of gold stocks to deliver the expected leverage to the gold price in recent years.

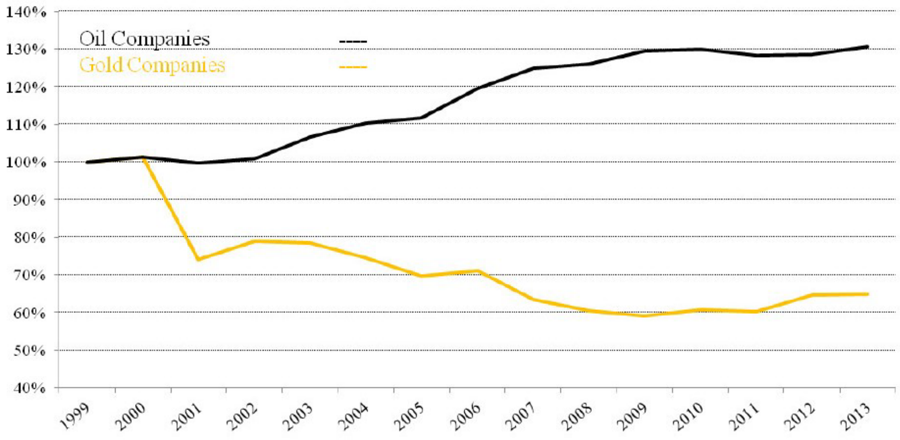
- **Greenfield exploration has been wantonly neglected.** Instead, the focus was on highly risky and expensive takeovers, which were in most cases financed through stock issuance.

- **Sharply rising input costs** (a lack of skilled labor, higher fuel costs, expensive mining of low grade ore-bodies, foreign exchange effects) and the resulting pressure on margins.
- **Expensive dissolution of hedging programs.**
- **In the course of the bull market, the industry relied on ever higher price assumptions,** in order to include ounces that were previously not economically viable into their mine plans. As a result, mine lives were lengthened, and production was increased. The majority of this increased production was, however, from very costly ounces.

In an attention-grabbing keynote speech at the 2014 Denver gold show[211], Douglas Pollitt addressed the major shortcomings of the sector:

The following chart shows production per share of gold miners and oil producers. Anyone who has held gold stocks since 1999 has had their holdings clearly diluted in recent years in terms of production per share. Oil producers by contrast managed to significantly increase production per share over the same time span.

Effect of share issuance/capital increases: Dilution



Source: Pollitt&Co

The thought strikes one as grotesque, considering that many investors buy gold stocks in order to hedge themselves against the digital printing of central bankers. It appears as though the gold mining sector is on a par with central bankers in terms of inflationary efforts.

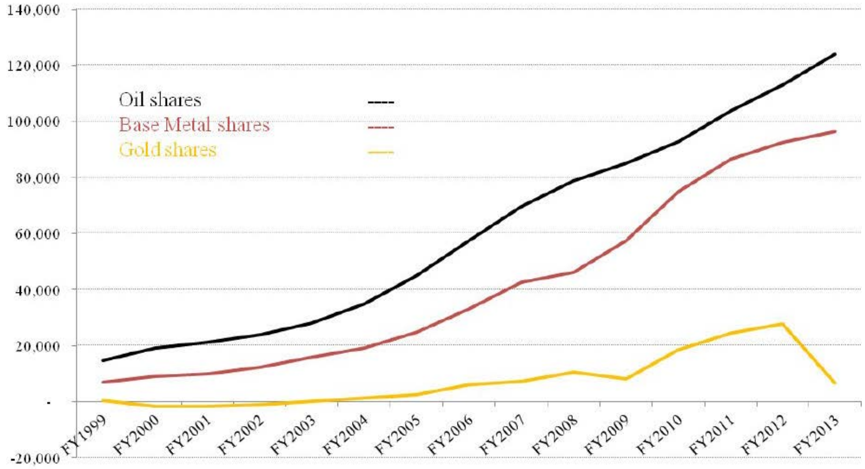
The underlying earnings results were a major reason for the poor performance. If one compares a representative sample of 10 senior producers in the oil, gold and base metals sectors, one can see significant differences.

The retained earnings plus cumulative dividends of 10 senior gold producers rose by a mere USD 6bn. This is more than disappointing over a 15-year period in which the gold price rose six-fold. By comparison, oil producers managed to increase their earnings from USD 150bn to USD 1.3tn, an increase of 800%, over the same period. And base metal producers increased their earnings from USD 23bn to USD 313bn, an

[211] See: „How not to piss it away next time“, Keynote Speech by Douglas Pollitt, Pollitt & Co

increase of more than 1,200%. Both sectors exhibited an incredible degree of outperformance versus the gold sector.

Retained Earnings & Accumulated Dividends



Source: Pollitt&Co

Another reason for the disappointing performance of many gold mining stocks is the fact that the sector is almost uniquely exposed to political risk: Once a company has invested billions of dollars in a mine, the company can become a hostage of politicians, who can set arbitrary tax rates or even confiscate a company's assets.

Consequently, the choice of jurisdiction is now one of the most critical decision criteria when investing in gold stocks. The following table shows the most and least attractive mining jurisdictions according to a survey by the Fraser Institute. It can be clearly seen that North America is considered the most stable region with 8 out of the top 10 rankings.

Fraser Institute: Investment Attractiveness Index 2014

Top 10	Flop 10
1. Finland	1. Malaysia
2. Saskatchewan	2. Hungary
3. Nevada	3. Kenya
4. Manitoba	4. Honduras
5. Western Australia	5. Solomon Islands
6. Quebec	6. Egypt
7. Wyoming	7. Guatemala
8. Newfoundland & Labrador	8. Bulgaria
9. Yukon	9. Nigeria
10. Alaska	10. Sudan

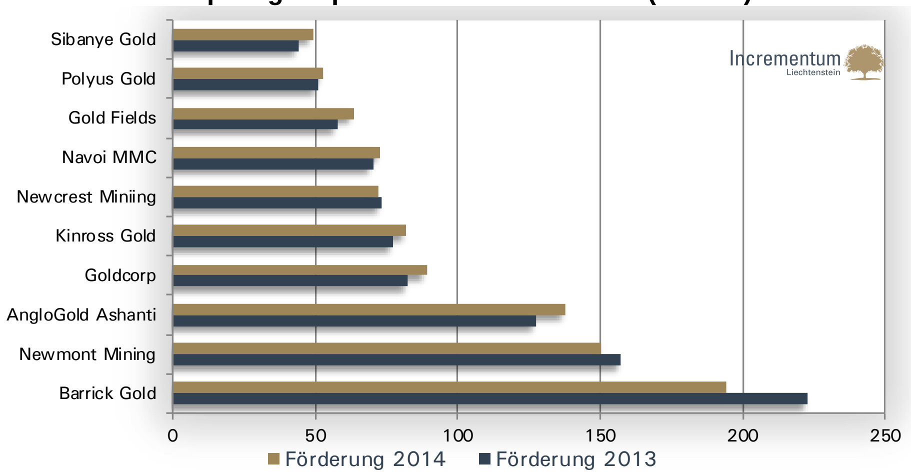
Source: Fraser Institute Annual Survey of Mining Companies 2014

c) Consolidation in the sector is set to continue – developers as the biggest beneficiaries?

Last year, M&A transaction volume amounted to approx. USD 7bn, lower than in 2013.[212] We expect that takeover activity will accelerate again in coming months. On the one hand, exploration was neglected due to cost cutting. On the other hand, numerous projects were written down or sold. As a result, the reserves of the largest producers have declined by 14% on average compared to last year.

We expect therefore that producers will pad their shrinking reserves by means of takeovers and mergers. The biggest beneficiaries of this trend are likely to be junior producers and especially fully funded developers. The majority of takeovers will take place in mining jurisdictions that exhibit low political risk. This was fundamentally different during of the bull market, i.e., until 2012. Due to excessive optimism and high-risk appetites, investments were made most of the time in countries with high political risk.[213]

Production of top 10 gold producers 2013 vs. 2014 (in tons)[214]



Sources: Company Reports, GFMS, Thomson Reuters

"Gold is a current asset, with no future cash flows—it is the financial opposite of biotech. This is why gold is the ultimate loser during the growth of a credit bubble, but a sure winner when it collapses. It is why gold mining companies will go from being worth next to nothing to something, a nearly infinite percentage increase."
Daniel Oliver, Myrmikan Capital

In principle, there are two different phases in which M&A activities tend to be undertaken. Firstly, close to historic price highs, when managers are extrapolating rising prices far into the future and are in the grip of megalomania. The second phase is close to the end of bear markets, when managers fear that prices might still fall further. In this period, the hunt is on for mine projects that promise to be economically viable in an environment of low prices. **An increase in M&A activity is therefore often a reliable signal of an imminent trend change, similar to the 1998 to 2000 period, when numerous large-scale takeovers took place.[215]**

[212] A large part thereof was attributable to the takeover of Osisko Mining by Yamana Gold and Agnico-Eagle Mines (USD 3.7 bn.)
[213] See: "Goldminen-Branche: M&A-Transaktionen in geographischer Zuordnung", Oliver Gross („Gold mining sector: M&A transactions by geographical segmentation")
[214] Numbers for Kinross Gold, Navoi MMC and Gold Fields are based on estimates by GFMS Thomson Reuters
[215] See: „Gold Sector – Tentative Signs of Life", Acting-man.com

d) Reasons for our confidence

What is the reason for our optimism that better times are in store for gold mining companies?

- **Production cost deflation:** Some radical productivity increases, labor force reduction, new negotiations over existing contracts with suppliers, etc. are leading to lower operating and capital costs.
- **Write-offs or sales of high-cost projects:** Numerous exploration and development projects were sold or put on care and maintenance. Balance sheets were strengthened.
- **Commitments to shareholder value**: renewed focus on dividends, free cash flow and profitability.
- **Increase in reserve grades:** this implies that ounces mined in the future will no longer be of lower quality than previously mined ones. This will result in stronger cash flows.[216]
- **Attractive portfolio characteristics of gold mining stocks:** The gold price is benefiting from a decline in economic confidence and recessions. As a result, the gold mining sector is one of the few sectors that exhibits a long-term negative correlation with the broader stock market.
- **Relative valuation and sentiment** (see above charts)

Summary "Gold Stocks"

"Gold will continue to vanish into private hoards against the day that even no metallic money will be had or seen any more...Gold mines will once again be viewed as mini-central banks."
Daniel Oliver, Myrmikan Capital

Market participants appear not yet to have realized that the margins of numerous gold mining companies have recently significantly improved, due to an increase in the real gold price. The real gold price (or the purchasing power of gold) is not directly measurable, but certain proxies such as the gold/CRB ratio or the gold/oil ratio can provide helpful pointers to its trend. It is after all not the nominal gold price that determines the profit margins of gold mining operations, but the difference between gold revenues and input costs.

We believe that the new commitment to cost transparency, greater financial discipline and shareholder value represent a crucial – if late in coming – insight into the sector's managers. Whether this new focus turns out to be mere lip service or not will become evident in coming quarters. **Since the sector's massive write-downs and value adjustments were one-off events, they could result in greater upside leverage. We therefore believe that gold stocks continue to exhibit a strongly asymmetrical risk/reward profile at present.**

[216] See: „Good times, bad times", Mining Journal

12. TECHNICAL ANALYSIS – are we close to the final stages of the bottoming phase?

The comparison of past bear markets[217] in gold shows that the magnitude of the current correction is still below average historically. In terms of duration, however, only one bear market (1988-1993) lasted longer.

Gold Correction Analogues (Trading Days Out As Gold Topped)

Source: ShortSideofLong.com

"Where everybody thinks the same, there isn't much thinking going on."
Karl Valentin

A glance at the consensus of analysts always provides interesting insights, especially for contrarian investors. Naturally, analysts become ever more optimistic the longer a bull market persists: at the end of 2011, a survey of 23 analysts produced a consensus forecast of a 21% rally to USD 1,900 for 2012. At the end of the year, gold had gained a mere 6% to USD 1,658. For 2013, the forecast was for a further 14% rally to USD 1,900. Seven of 25 analysts had price targets of USD 2,000 or higher. The most pessimistic estimate stood at USD 1,500. Gold ended the year at USD 1,200, a decline of nearly 30%.

"It is impossible to produce a superior performance unless you do something different from the majority."
Sir John Templeton

Looking at the forecasts for the end of 2015, one can see that analysts as a group have apparently lost interest and faith in gold. The average price target stood at USD 1,179, or a loss of 0.42% compared to year-end 2014. The lowest price target stands at USD 950 (Société Générale) and the highest at USD 1,350 (NordLB and LBBW). Despite a multi-year bear market and a price decline of roughly 40%, there are barely any bullish analyst estimates. Moreover, only 12 institutions provided an estimate, which very clearly signals that banks are losing interest in gold.[218] **We believe the combination of declining interest and strong pessimism is a foundation for the resumption of the advance.**

Be fearful when others are greedy, and be greedy when others are fearful

In typical fashion, the financial media have been brimming with bearish commentary every time gold traded close to what has hitherto been its correction low. Here are examples from November 2014:

[217] Defined as declines of 25% or more from peak to low
[218] http://www.boerse.de/boersen-prognosen-2015/

- *"We are betting on lower gold prices…our clients should have zero allocation in gold"* Bloomberg, November 3, 2014
- *"A final purge to $700? What gold bulls' surrender might look like",* Yahoo Finance, November 11, 2014
- *"I think gold is headed straight down. As pessimistic as sentiment has gotten, we think it becomes more pessimistic",* CNBC Yahoo Finance, November 11, 2014
- *"Here's why gold could be headed to $800",* CNBC, November 21, 2014
- *"Should the US sell all of its gold?"* Bloomberg News, December 1, 2014

We have already discussed the fact that gold exhibits clear seasonal trends in detail in our previous reports. Traditionally, June is an excellent time for purchases. **Seasonal upside momentum is clearly at its strongest in the second half of the year.**

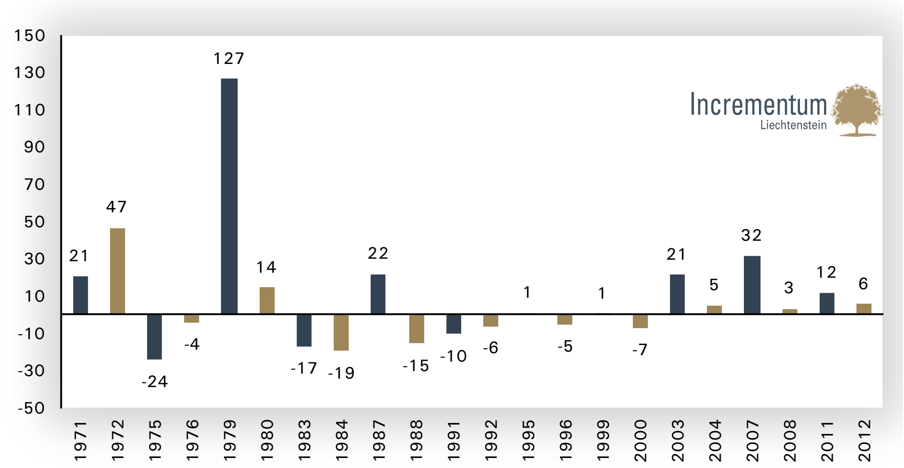
Seasonality of gold and silver (1971-2014)

Source: www.seasonax.com

„Your best work involves timing. If someone wrote the best hip hop song of all time in the Middle Ages, he had bad timing."
Scott Adams

Do US presidential elections have an effect on the seasonality of gold? The following chart shows the annual trend of gold in election years, resp. the year prior to US elections (i.e., 2015). It can be seen that gold often tends to be weak in election years (golden bar). The average annual performance stands at just 1.8%, with a median of -3.7%. This could, on the one hand, be due to an ostentatious show of strength in the US dollar prior to elections, and on the other hand, a strongly rising gold price, as a clinical thermometer of the financial system, is probably not welcome. **As the blue bars illustrate, the years preceding election years exhibit a positive trend**. An average gain of 16.8% was recorded, however, this figure is distorted by the years 1979 and 1971. The median gain was 11.6%.

Annual performance of gold in pre-election years (blue bars) vs. election years (golden bars)



Sources: Incrementum AG, Datastream

The commitments of traders report (CoT)[219] currently also shows a largely positive picture for precious metals. While the positioning of commercial hedgers hasn't yet reached the extreme of the last price low, relative strength could recently be discerned in the data for gold futures. **In platinum and palladium resignation and capitulation are in evidence, as even small speculators are now betting lopsidedly on declining prices**

"After having spent many years on Wall Street and having made millions and lost them again, I want to stress the following: It was never my thinking that made the big money for me, it always was sitting."
Jesse Livermore

Moreover, commercials have reduced their gross short positions markedly. This indicates that the largest, best financed and best informed traders have positioned themselves for rising gold prices. **In our opinion this signals an attractive counter-cyclical entry point. Only in silver are we currently still seeing a clearly negative set-up in the futures market.** Given that silver often provides reliable signals for the trend in gold prices, we believe that a final sell-off – possibly in connection with a rate hike in the US – is possible. In the course of this support at USD 1,140 could be tested and even undercut in the short term. This would likely go hand in hand with a final capitulation in terms of sentiment. **Such a development would represent reliable evidence of an imminent primary trend change in the gold market.**

[219] The weekly report of the Commodity Futures Trading Commission shows the positions of commercial dealers, large speculators, and small speculators. Commercials are often referred to as the "smart money" and tend to act counter-cyclically. The most valuable information is provided when the commercial position reaches extremes; usually their role is largely that of liquidity providers. Large speculators are hedge funds, institutional investors and others who trade in lots above the reporting threshold. They tend to act pro-cyclically, and are actually the main drivers of bull and bear markets. Here too extreme values are usually reliably contrary indicators. Small speculators are also most of the time trend followers and are held to represent the "dumb money".

Source: www.BlaschzokResearch.de

Summary "Technical Analysis"

The support area between 1140 and 1170 has been tested successfully several times by now. In our opinion, the large double-bottom formation of November 2014 and March 2015 represents a solid low. We don't expect this support to be sustainably broken.

We believe that on account of CoT-data, overly negative sentiment and gradually improving seasonality, opportunities are currently clearly predominating. Recent relative strength in silver and the fact that mining stocks are severely oversold relative to gold are giving us cause for cautious optimism. We therefore expect to see higher prices in the coming months. On the upside, the level of 1,530 would likely represent massive resistance, based on the basic technical rule that "support becomes resistance, resistance becomes support". **On the way to this level there are numerous resistance levels of lesser importance – if and when these come into view, the ease or difficulty with which they are tackled should be informative with respect to whether or not the trend has turned around for good.**

13. CONCLUSION

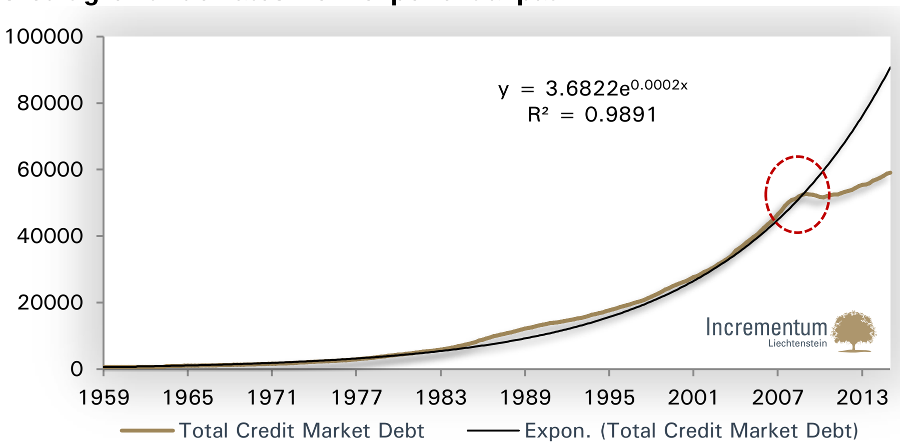
Even the allegedly unsinkable Titanic had life boats aboard

We have all become involuntary guinea pigs in an unprecedented monetary experiment, the economic (and sociological) outcome of which remains uncertain. Ever more frequently observable phenomena including asset price inflation, chronic over-indebtedness, extreme boom-bust cycles, but also the fragile interaction between inflation and deflation are **symptoms of a problem with a systemic cause**.

"The last word of destructionism is inflation"
Ludwig von Mises

It seems obvious to us that the crux of the matter[220] is the current inflationary uncovered debt money system. This system requires exponential inflation of the supply of money and credit. A consistent expansion of monetary aggregates in the traditional manner is no longer possible in the current phase. **Consequently, the financial system finds itself in an increasingly unstable situation.**

Credit growth deviates from exponential path



Sources: Federal Reserve St. Louis, Incrementum AG

"Confidence in central bankers' ability to learn from past inflation is as likely to be misplaced as it was in their ability to learn from past credit booms. Gold remains the cleanest insurance against such overconfidence"
Dylan Grice

The endogenous addiction to money supply growth and rising prices is - especially in light of the over-indebtedness problem – a central pillar of our thesis that a turning point in the trend of price inflation is close. In the course of an interventionist spiral, ever more dubious measures are adopted by monetary authorities in order to force a reflation of the economy and higher rates of price inflation. These steps include interventions like quantitative easing, negative interest rates, financial repression and possibly even a cash ban.

In order to attain the well-known goal of achieving higher nominal growth, the method known as "GDP targeting"[221] could eventually be employed. This allegedly innovative monetary policy endeavor is in reality nothing but old wine in new skins. Nominal growth is supposed to be fabricated – as this is no longer possible otherwise – by rising rates of inflation. **Since real economic growth so far remains anaemic, rising**

[220] In the German language, there is a nice saying expressing "crux of the matter": "Des Pudel's Kern" (literally: "the poodle's core"). It comes from Goethe's drama Faust, in which Mephistopheles appears in the form of a poodle. When he reveals himself, Faust remarks: "So that was the poodle's core". It soon became a winged word.
[221] This concerns an explicit nominal economic growth target, which is reached by expanding the money supply accordingly.

price levels are supposed to create higher revenues for the State[222], in order to enable it to service its nominal interest obligations.

"One of the greatest pieces of economic wisdom is to know what you do not know."
John Kenneth Galbraith

Even though we know of countless deterrent examples that show that such aggressive money supply expansion ends with "too high" price inflation, this dangerous gamble is being tried yet again. Inflationary policy is always a desperate attempt to create artificial prosperity by means of the printing press, which, as any objective assessment shows, will never be sustainable. The perpetuation of zero interest rate policy suspends the market's self-healing corrective forces and fosters the nurturing of new asset bubbles. Following the technology and housing bubbles, we are once again right in the middle of another asset bubble. While the previous bubbles were focused on individual sectors or specific market segments, we are currently in the midst of an entirely different bubble dimension. **Government bonds are at the center of the debt money system and represent the majority of the assets held by central banks and institutional investors. All available means will be exploited to prevent this bubble from bursting.**

Gold has historically been the best hedge against such excessive inflationary efforts. Gold was and remains an outstanding pillar as a store of value and medium of exchange. These qualities are likely to be rediscovered if, or rather when, paper currencies suffer a general loss of confidence. **Lengthy periods of rising price inflation and negative real interest rates are the main catalyst for such a loss of confidence.**

The global race to debase currencies is progressing to the next round. It appears as though Japan has handed the baton to Europe now. The weak euro is likely to enter the history books as a Greek gift[223]. **We are convinced that gold will emerge as the victor in this ongoing devaluation competition.**

Below we list the most important arguments in favor of investing in gold:[224]

- Global debt levels are currently 40% higher than in 2007
- The systemic desire for rising price inflation is increasing
- Opacity of the financial system – volume of outstanding derivatives by now at USD 700 trillion, the bulk of which consists of interest rate derivatives
- Concentration risk - "too big to fail" risks are significantly higher than in 2008
- Gold benefits from periods of deflation, rising rates of price inflation and systemic instability
- Gold is a financial asset that has no counterparty risk

Relative to the monetary base, the gold price is currently at an all time low. In our opinion, this is a temporary anomaly, which we believe provides an extraordinarily favorable buying opportunity. Moreover, as we have

[222] Government revenues are highly dependent on nominal GDP growth
[223] A Greek gift designates a gift that turns out to be detrimental or even fatal to the recipient. The term is taken from Greek mythology, and refers to the gift the Greeks made to the Trojans – the famous wooden horse that helped the Greeks to conquer Troy. The Latin saying "Timeo Danaos, et dona ferentes" is also connected with this ("I fear the Greeks, even though they bring gifts"). Euroland has problems with both proverbial and literal Greek gifts these days.
[224] See: „Gold Bullion & The Need for Systemic Insurance", Tocqueville Bullion Reserve, Simon Mikhailovich

demonstrated, gold is quite cheap relative to stocks and bonds, but also relative to a number of hard assets. **As a result, widespread assertions that gold continues to be exorbitantly overvalued are not tenable.**

"..market gains are like compensation for pain and suffering. First come the pain and suffering, then comes the money"
André Kostolany

From a technical perspective, the overall picture is not unequivocal. On the one hand, the downtrend that has been in force since 2011 hasn't been broken yet. On the other hand, negative sentiment indicates widespread resignation and capitulation by gold bulls. Moreover, seasonality and the fact that gold stocks are extremely oversold relative to gold, is giving us further confidence. CoT data were up until recently still negative, but have improved considerably in the meantime. **Only in silver the set-up in futures markets positioning still looks negative**. Given that silver often provides reliable signals for gold price trends, we consider a final sell-off – possibly in connection with a rate hike in the US – to be possible. In the course of this, the support at USD 1,140 could be tested or even breached in the short term. **A reversal following such a retest would be a reliable technical signal of a primary turning point in the gold market.**

Gold stocks as a counter-cyclical speculation with an asymmetric payoff profile

In the context of this environment, we remain more strongly convinced than ever, that gold stocks represent an interesting, if highly volatile, investment opportunity. Creative destruction in the sector is normal and healthy in the long term. In the course of the market adjustment, mining company managements have set new priorities, with profitability, capital spending discipline and shareholder value having replaced the maximization of gold production. Moreover, there is probably no other sector that is viewed with more skepticism by investors at present.

"*Gold is the inverse of paper, unlimited to the upside, limited to the downside. It's not the total stock of gold that matters, but the flow from those that already hold it"*
FOFOA

Based on the "big picture" analysis that is packed into this report, we see no reason for a change of course: *In gold we (still) trust*. We are strongly convinced that gold remains in a secular bull market, which is close to making a comeback. Should our assumption be correct, we expect to see a final trend acceleration at the end of the cycle. We believe the time has come for us to provide a concrete time horizon in addition to our long-term price target. In light of the outlook discussed above, **we have have set a time horizon of three years (June 2018), to reach our long-term price target of USD 2,300.**

We don't believe this is the right time to warn of the great dangers associated with investing in gold. The potential for setbacks has historically been higher in times of high price inflation rates, from which we obviously remain far away (for the time being). Even if one does not share our bullish assessment, **an overly critical attitude towards any gold investment whatsoever in our opinion displays ignorance of monetary history.**

"*My fondest dream is that I will give what insurance gold I have to my grandchildren. And that they will give it to their grandchildren. If that happens, nothing disastrous occurred in our lifetimes that caused us to part with the insurance gold."* **John Mauldin**

APPENDIX – ABOUT US

Ronald-Peter Stoeferle, CMT

Ronald is a managing partner and investment manager of Incrementum AG. Together with Mark Valek, he manages a global macro fund which is based on the principles of the Austrian School of Economics.

Previously he worked seven years for Vienna-based Erste Group Bank where he began writing extensive reports on gold and oil. His benchmark reports called 'In GOLD we TRUST' drew international coverage on CNBC, Bloomberg, the Wall Street Journal and the Financial Times.

During his studies in business administration, economics and finance at the Vienna University of Economics and the University of Illinois at Urbana-Champaign, he worked for Raiffeisen Zentralbank (RZB) in the field of Fixed Income/Credit Investments. After graduation, he participated in various courses in Austrian Economics and obtained a Chartered Market Technician (CMT) and a Certified Financial Technician (CFTe) designation. Next to his work at Incrementum he is a lecturing member of the Institute of Value based Economics and lecturer at the Academy of the Vienna Stock Exchange.

Mark J. Valek, CAIA

Mark is founding partner and investment manager of Incrementum AG. Together with Ronald Stoeferle he manages a global macro fund, which is based on the principles of the Austrian School of Economics. In 2014 he co-authored a book on Austrian Investing.

Before founding Incrementum he worked at Raiffeisen Capital Management for more than ten years. There he was fund manager and responsible for inflation protection strategies and alternative investments. During his studies Mark worked in equity trading at Raiffeisen Zentralbank and at Merrill Lynch Private Banking in Vienna and Frankfurt.

Mark's education includes a degree in business administration from the Vienna University of Economics and Business Administration. He is CAIA charterholder and Certified Portfolio Manager. Next to his work at Incrementum he is a lecturing member of the Institute of Value based Economics and lecturer at the Academy of the Vienna Stock Exchange.

About Incrementum AG

Incrementum AG is an owner-managed and fully licensed asset manager & wealth manager based in the Principality of Liechtenstein. Our business focus is the management of investment funds that we believe to be unique.

What makes us exceptional in the traditional asset management space? We evaluate all our investments not only from a global economy perspective but taking the current state of the global monetary regime into account. This analysis produces what we consider a truly holistic view of the state of financial markets. We believe our profound understanding of monetary history, out-of-the-box reasoning and prudent research allows our clients to prosper in this challenging market environment.

We want to thank Marc Waldhausen, Tobias Müller, Sebastian Müller, Douglas Moser, Maximilian Tarrach, Raphael Schaad, Yannick Möhring, Henning Lindhoff, Markus Blaschzok, Taki Tsaklanos, Jordan Eliseo and Thomas Vesely for their outstanding support!

Contact

Incrementum Liechtenstein AG
Landstraße 1
9490 – Vaduz/Liechtenstein

Web: www.incrementum.li

Email: contact@incrementum.li

Disclaimer

This publication is for information purposes only, and represents neither investment advice, nor an investment analysis or an invitation to buy or sell financial instruments. Specifically, the document does not serve as a substitute for individual investment or other advice. The statements contained in this publication are based on the knowledge as of the time of preparation and are subject to change at any time without further notice.

The authors have exercised the greatest possible care in the selection of the information sources employed, however, they do not accept any responsibility (and neither do Incrementum AG or Erste Group Bank AG) for the correctness, completeness or timeliness of the information, respectively the information sources, made available, as well as any liabilities or damages, irrespective of their nature, that may result there from (including consequential or indirect damages, loss of prospective profits or the accuracy of prepared forecasts).