MAI VIEW

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Gold & Government

In March and April of 2011 I wrote a three-part report with my then-hedge fund partner Lee Quaintance entitled *Apropos of Everything.* In it we provided our macroeconomic perspectives and laid out a vision of an eventual structural shift in the global monetary system. Our conclusion was that, due to excessive and increasing leverage, the current monetary system would have to eventually fail – either in nominal terms (classic runs on currencies and banking systems) or in real terms (through administered hyperinflation). Our thoughts were that there was likely to be a little of both, first the former and then the latter.

We laid out a basic vision that too much leverage would force the productive economy to grind down, making it difficult for the masses to service and repay debt. Credit assets would come under great pressure. Bank and non-bank creditors would become stressed, further adding to a deep global balance sheet recession. The political dimension would ultimately have to intervene, directing central banks to devalue the exchange rates of their currencies against the value of production (rather than each other). To do so, there would have to be a monetary anchor, which we believed would be gold. Gold was used in this role prior to 1971, and we envisioned a reversion to some form of system in which the cost of global labor and the prices paid for global goods and services in trade would be reset to reflect sustainable value.

The implication would be that the price of gold would rise meaningfully, as it would re-assume its role as the global monetary anchor. We imagined the manner in which this would play out. The Bretton Woods monetary arrangement, in place from 1945 to 1971, valued the US dollar against gold by dividing the US monetary base by official gold holdings. It produced a gold price around $35/ounce. By 2011, that same model implied a gold price upwards of $15,000, which reflected monetary inflation since 1971.

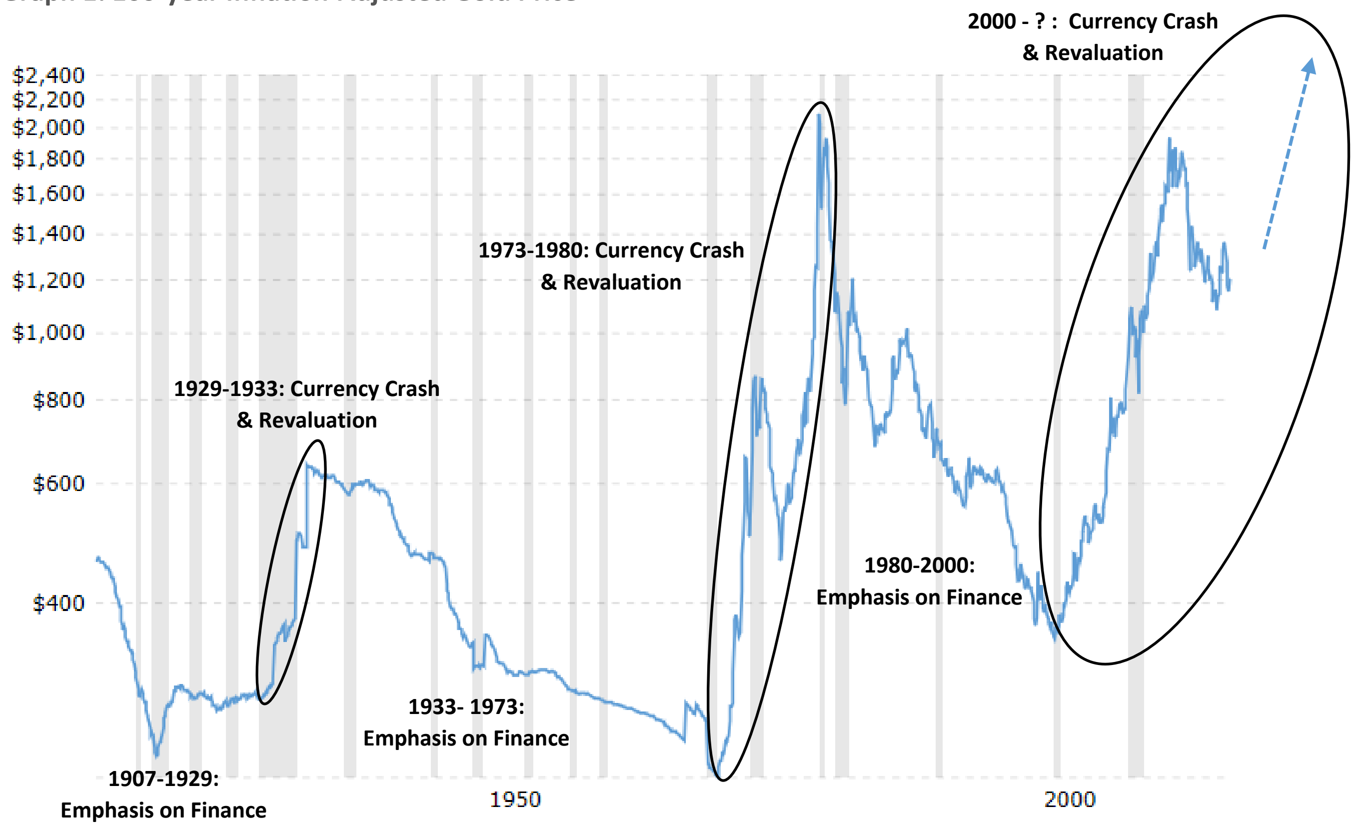
The "Shadow Gold Price" took on a life of its own. It provided gold bugs with a valuation target based on precedent and math. We not only heard from ebullient gold holders. Queries came from a broad range of investors as well as monetary administrators across the world including central bankers, policy strategists and academics. Six months after publishing the report in the spring of 2011, the price of gold in all major currencies began to fall, and gold's cyclical bull market was over.

Secular Leveraging Cycle

Graph 1 below illustrates the *inflation-adjusted gold price* since 1915, which lets us view a non-static value, even under the fixed exchange rate system of Bretton woods when the nominal price was fixed at $35/ounce. According to its publisher, *macrotrends* (www.macrotrends.net/1333/historical-gold-prices-100-year-chart), the graph deflates the price of gold "using the headline Consumer Price Index (CPI) with the most recent month as the base. The current month is updated on an hourly basis with today's latest value. The current price of gold as of January 18, 2017 is **$1,212.30** per ounce."

We took the liberty of providing further perspective on the graph by highlighting periods in which finance (i.e., credit) became the dominant economic force and periods when gold was needed to revalue money:

Graph 1: 100-year Inflation-Adjusted Gold Price



Sources: macrotrends; Macro Allocation Inc.

The three secular periods labeled "Emphasis on Finance" were leveraging periods when global commerce became dominated by credit growth.[1] There were three secular leveraging periods in the last hundred-plus years - 1907 to 1929; 1933 to 1970, and 1981 to the present. The first two secular leveragings were interrupted from 1929 to 1933 and from 1973 to 1981 by currency devaluations. This makes sense. The magnitude and duration of credit growth had gone beyond underlying economies' sustainable productive scale, making savers wary of their wealth denominated in credit-currency and producers wary of accepting that currency in exchange for goods and services. Currency boards could not maintain their fixed exchange rates to gold. *In short, when the scale of credit dwarfed the scale of production, there was a need for economic de-leveraging, which required credit-currency to be de-valued against base money (i.e., gold).*

Since 1971, base money has not been backed by gold or any other relatively finite asset (even though established major central banks retain gold on their balance sheets and central banks of large advancing

[1] Credit is ultimately a claim on base money (bank reserves and currency in float), and the difference between credit and base money is economic leverage.

economies are aggressively buying it). Thus, in the current leveraging experience, which began in 1981 and continues today, credit and debt creation is not constrained by money, which itself is credit. The only formal check on currencies' purchasing power today is the ongoing willingness and ability of global currency boards to coordinate the dilution of their currencies so that producers and consumers do not have alternative money forms in which to save.

As it stands, further balance sheet leveraging is constrained only by: 1) the ability of debtors to service their obligations while they INCREASE their production and consumption of goods and services (*increasing* output is necessary to service aggregate debt, which is lent with interest), and 2) faith that monetary authorities will not diminish the purchasing power of currencies too much in an effort to maintain the perception of ongoing output growth.

Most savers and investors have not viewed gold as a relevant store of wealth since the current leveraging phase began in 1981. Governments and central banks have had incentive to keep it that way. Why would the purveyors of fiat (i.e., notional) credit-based currencies acknowledge the validity of a potential competing money form with relatively finite supply?

The Role of Government

Whether gold is broadly seen as relevant again will depend not only on whether disparate savers around the world conclude in unison that it is in their interest to stop trusting the fiat credit-based currency they hold and are compensated in, but also based on whether it is in the interest of the global political dimension to make gold relevant again. At the end of the day, all monetary systems have to be endorsed by governments…and the power behind governments. Otherwise, the commercial marketplace would run on barter and myriad non-fungible IOUs, which in turn would cut out taxing authority and public services.

While purely free and un-regulated markets might seem like nirvana to some, they would be even more unsustainable than a government-heavy regime. This is not about how societies formally choose to allocate resources. It is about power, which always stems from wealth. Power seeks to sustain itself by creating an authority infrastructure for the masses called "government".

The easiest way to ensure the sustainability of government authority is to provide services to the factors of production in return for consideration in the form of taxes. It is a model generally perceived as effective and fair by the majority and a tool through which the powerful, which is to say those with sustainable wealth, can protect their status and further benefit themselves. (We learned from the failed communist experience of the twentieth century that there can be no government sustainability without popular acceptance of wealth inequality.) *We should expect the continuation of generally respected governments that help steer, sustain, ruin and then fix societies. We should also expect the continuation of the false perception that business cycles are based on an abstraction called "animal spirits", a catchall phrase that allows political economists to avoid acknowledging the long leveraging/de-leveraging cycle.*

We continue to expect gold to again anchor central bank-created base money once the global finance-heavy model no longer produces output growth for the majority of large economies, AND, once those holding their wealth in financial assets (including real estate) use government to change how wealth is measured. *We think gold will rise significantly…once the right people own enough of it.*

Brexit, Trump…

We live in exceptional times, but not *that* exceptional, and for this investors should be wary. The third leveraging phase in the last hundred years is getting old and tired, judging by the struggle to maintain positive real growth and quality employment in advanced economies and trend growth in emerging ones. It seems to us like a classic case of the scale of credit vastly exceeding the scale of production to the point where economic incentives are shifting from capital growth to zero-sum capital hoarding.

As tempting as it is to focus on valuations, fundamentals, technicals, and the Fed, investors cannot escape the reality that the markets are derived from the health and well-being of economies, politics and society. It is here, in the more human world, where things are getting a bit testy.

Last year, the British people opted out of a non-sovereign arrangement that obligated them to be the dominant financial arm for a larger economy dominated by goods and service production. We get it. The factors of production in the UK grew tired of promoting competing foreign production through an economic model that did not serve them. Securities exchanges and London real estate provided sanctuary for others' wealth. This could no longer be tolerated by the majority of voters that did not share in the largesse. That the foreign exchange value of Sterling would fall was at best a third-order consideration for families struggling to make ends meet. They were not stupid. They voted their interest and wanted a reset.

Donald Trump's election is the American personification of the same Brexit phenomenon. (The American people seem to always express themselves through the star-system.) The financial model heaved upon America's producer culture had gone too far. All that remains is outstanding debt that needs to be serviced and repaid and the memory of working for needs and saving for wants. Buying a home for $2,500 a month rather than $300,000; a car for $450 a month rather than $40,000; and Christmas gifts for an extra $500 minimum monthly credit card payment rather than $5,000; had quickly become *standard operating procedure*. This SOP always had to be temporary – not a structural cultural shift - because for the math to work either the debt or the debtor can never be extinguished.

Those that benefitted from the borrowed expansion and presumed it to be the result of superior intellect and industriousness were fooling themselves. Those that began to personally feel the weight of debt and its cancer-like consumption of their – and their children's – lifestyles, voted their interests. Like their British brethren, they too wanted a reset away from the financial model.

For investors, we think it is especially notable that both events occurred in 2016. You know that old saw that "they never ring a bell at the top"? Well, ding ding.

Always the last to know…

The elite, the intelligentsia, the illuminati, the credentialed opinion leaders that devote as much time to building status in their chosen networks as they do to building a purer sense of reason…these are the individuals to which the factors of production were thought to have been conditioned to respect and heed. These leaders promoted and confirmed each other's platforms, theories, doctrines and expectations during the leveraging phase, just as long as they abided by easily digested incrementalism.

Success came to those that fed the feedback loop and there was a natural survivorship bias that promoted individuals who made us think within an acceptable, non-threatening range of ideas. That range of acceptability narrowed with time and potential risk, in turn widening the range of intolerance of logical counter-arguments. The imminent onset of a secular global de-leveraging event would be one such radical projection (as was Brexit and Trump); another would be an extreme macroeconomic phase shift most experts do not envision and most investors are not planning for.

This is not to suggest intelligent people are unaware that something different is happening, but we do mean to suggest that the preponderance of reactive views among the elite to events like Brexit and Trump represent *misplaced fear and loathing*. In Trump's case, the establishment tends to conflate the ridiculousness of the man with the stupidity of the people (deplorables?) who voted for him. They cannot see a difference because they cannot validate Trump's message. They cannot validate Trump's message because it does not register with them. They think all is well but could be better. They do not see all is not well at all, and that they are contributing to this ailing and dangerous state of affairs.

Writing in the Los Angeles Review of Books, Jonathan Kirshner considered America's position:

> "Having spent three-quarters of a century fretting about enemies abroad, we have never fully processed a lesson of history: that great civilizations almost invariably collapse from within. We are Athens, we are Rome — we are, more than anything, Paris in the 1930s, another society divided against itself, living in what one historian described as "the age of unreason." France then boasted the mightiest army on the continent, but the country was so hollowed out it simply collapsed when placed under stress, leading to defeat, occupation, humiliation. "Better Hitler than Blum," many on the French right muttered, faced with the prospect of a Jewish Prime Minister — is "better Putin than Hillary" the 21st century equivalent?
>
> We will now find out. The social experiment on which we are embarking is a treacherous one, from which it will not prove easy to recover. Trump promises a revolution — empty rhetoric of course… Americans can have a soft spot for "revolution," since our war of independence from the British Empire was so nifty. But most revolutions are not. They are usually overtaken by their most extreme elements, spiral beyond the control of the principled, and lead to the collapse of social order and gratuitous and senseless bloodletting. "Reckless audacity came to be understood as the courage of a loyal supporter; prudent hesitation, specious cowardice," Thucydides described, recounting conditions on the eve of the corpse-strewn Corcyraean Revolution. "In this contest the blunter wits

> were most successful." Thucydides, in his commentary regarding the deterioration (and ultimate collapse) of Athenian democracy, hits too close to home: "Men now did just what they pleased, coolly venturing on what they had formerly done only in a corner" - this, more than anything, seems like the hallmark of the emerging Trump regime, replete with norm-trampling transgressions. We are in the hands of an ignorant, amoral, petulant authoritarian who has been handed the keys to the most powerful office on the country, and the world." [2]

One man's opinion? Perhaps, but it seems to capture the vitriolic response to change from those that were rewarded for having figured out how to proceed in the established order, now under threat.

We have been coy about Donald Trump - wondering out loud whether his bullying, bombastic ridiculousness might be the price we have to pay for the light he's shining on the equally bullying nature of self-serving, over-reaching, insouciant governments and their finance-based, growth-at-all-costs economic policies destroying the wherewithal and dignity of the nation's factors of production.

If we want to understand the pull of voters towards Donald Trump, we should first understand the counterfactual: what would the US look like today were a more conventional Republican or his Democratic opponent elected? Our answer: much the same as it has been under Bush and Obama, which is to say America would have definitely continued using leverage to gut the real wealth of the middle class and expand wealth and income gaps by rewarding the investor class. It was a path off an economic cliff.

To leave no room for doubt, we think America remains on that same economic path and that a Trump administration will actually accelerate the approaching cliff dive. It is no coincidence that financials have performed best since the election because Trump unambiguously emphasized top-line growth policies. It is also no small irony that Americans elected a real estate developer who used substantial leverage to amass a personal fortune. Incredulous politicians and pundits within the establishment should take note: half the population voted this way *not* in a desperate, albeit misguided attempt to change course, but in a desperate attempt to jump off the cliff sooner.

The factors of production intuit they will survive a structural shift from finance and credit-currency to production and sound money, and it made sense for them to speed the plough. In exiting the European Union and electing Donald Trump, the producer class chose long-term sovereign and familial sustainability over an abstract and unproven promise that they might someday participate in a dream constructed of assets but not liabilities. In their eyes, the system had to be destroyed. It is, Mr. Kirshner, a revolution without bloodletting (at least of the plasma kind), and for that we should all be grateful.

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[2] Los Angeles Review of Books; Jonathan Kirshner; America, America; January 15, 2017.

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