The Seeds For An Even Bigger Crisis Have Been Sown

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On occasion of the publication of his new gold report, Ronald Stoeferle talked with financial journalist Lars Schall about fundamental gold topics such as: “financial repression“; market interventions; the oil-gold ratio; the renaissance of gold in
finance;“Exeter’s Pyramid”; and what the true “value” of gold could actually look like.

By Lars Schall

Ronald Stoeferle, who is a Chartered Market Technician (CMT) and a Certified Financial Technician (CFTe), was born October 27, 1980 in Vienna, Austria. During his studies in business administration and finance at the Vienna University of Economics and the University of Illinois at Urbana-Champaign in the USA, he worked for Raiffeisen Zentralbank (RZB) in the field of Fixed Income / Credit Investments. After graduating, Stoeferle joined Vienna based Erste Group Bank (http://www.erstegroup.com), covering International Equities, especially Asia. In 2006 he began writing reports on gold. His five benchmark reports on gold such as “A Shiny Outlook” and “In Gold We Trust” drew international coverage on CNBC, Bloomberg, the Wall Street Journal and the Financial Times. Since 2009 he also writes reports on crude oil. The latest gold report by Stoeferle was published today.

Lars Schall: What is “financial repression“ according to Ronald Stoeferle?

Ronald Stoeferle: Financial repression is a perfidious form of redistribution. It always means a combination of incentives and restrictions for banks and insurance companies, which cause the investment universe to be substantially reduced for investors. This means that capital is channelled away from the asset classes that it would flow into in a more liberal environment.
I sincerely believe that financial repression will continue to crop up in many shapes and sizes over the coming years. However, the long-term costs of the lack in efforts made towards consolidating national finances are substantial. While low bond yields in the short run suggest that the saving measures are on course, one has to bear in mind that this has mainly been achieved by market interventions.
Therefore, we regard the gradual transfer of assets as a disastrous strategy in the long run.
What happens is that none of the previous problems of misallocation are resolved, but instead redistribution takes place (at the beginning mostly invisibly) and problems are dragged out, having to be addressed later. As the dependence on these measures rises, so does the collateral damage to be expected later, and the seeds for an even bigger crisis have been sown.

L.S.: What does all that mean for gold?

R.S.: Negative real interest rates are an important cornerstone of financial repression. And negative real interest rates represent the perfect environment for the gold price. During the 20 years of the gold bear market in the 1980s and 1990s, the average real interest rate level was around 4%. Real interest rates were negative in only 5.9% of all months. The situation in the 1970s, however, was completely different: real interest rates were negative in 54% of the months. Since 2000 real interest rates have been negative for 51% of the time, which constitutes an optimal environment for gold. Due to the overindebtness (that I am also
discussing in my report), I believe that this trend will continue.

L.S.: Are the interventions undertaken by western central banks and commercial banks in the gold and other markets more obvious than ever?

R.S.: Yes, especially after the 29th of February. In general I write in my report that there is a fine line between intervention (usually a governmental / political interference) and manipulation (negative connotation in terms of “exerting influence”).
There have been official and legitimised interventions by central banks in bond rates (Operation Twist, Quantitative Easing) and currencies (Swiss franc, Japanese yen). Both the quantity and the price of money are managed, i.e. controlled. The oil price is subject to interventions (OPEC cartel, release of strategic reserves), as are the food prices (subsidies).
Kevin Warsh has recently confirmed this:
“Now that I am out of government, I can tell you what I really believe… Central banks are now so heavily influencing asset prices that investors are unable to ascertain market values…

This influence is especially evident with the Fed’s purchase of government bonds, which has made it impossible for investors to use bond prices to learn anything about markets.” (1)

A strong gold price signals a decline in trust in the financial and monetary system, thus I believe that it would be naïve to think that gold is exempt from interventions. However, according to Dow theory, the primary trend cannot be manipulated, because the inherent market forces are simply too strong.

L.S.: Could the renaissance of central bank buying be interpreted as a contrary indicator?

R.S.: A legitimate question. It is no secret that central banks tend to be civil servants with an extremely pro-cyclical investment behaviour. And with good reason I have to say: since the purchase of asset classes with negative performance in the past years is difficult to justify vis-à-vis the public and also to internal committees, purchases tend to be made on a “past-performance” basis.
However, I believe that the central bank purchases signal a new phase of the bull market.
Since the buyers are mostly emerging countries, we regard these efforts as a

logical catching up. Compared with the industrialised nations, the majority of the central banks in emerging nations remain clearly underweighted in gold. Thus the hedging of their enormous US dollar holdings is inadequate.
Cynics would call the Bank of England the "ultimate contrary indicator". In the years 1999 to 2002, 395 tonnes of gold were sold at an average price of USD 275 under the then Chancellor of the Exchequer, Gordon Brown. Given that this was the absolute low of the gold price, it is also called the "Brown bottom". If the Bank of England were to announce purchases, I would therefore regard this as a warning signal for the gold price.

L.S.: What does the current oil-gold ratio tell you? And why is ist worthwhile to pay attention to it at all?

R.S.: One ounce of gold currently buys 15 barrels of oil. This is exactly the long-term median, and it means that gold is fairly valued in relation to oil. The all time high of 1986 would have bought 40 barrels of crude oil. The historical low was set in 2008 at close to six barrels for one ounce. But now it seems that the almost 25 years of outperformance of oil are coming to an end, and gold is gaining in relative strength again. The following chart highlights the substantial erosion of purchasing power since 1971. It
shows on the one hand the gold/oil ratio (i.e. how many barrels of oil does one ounce of gold buy) and on the other hand the inverted oil price (i.e. how many units of oil do I get for USD

1). For reasons of user-friendliness we have standardised both values at 100 on a logarithmic scale. Whereas the oil price in terms of gold has been stable since 1971, the USD has lost more than 98% of its purchasing power in terms of oil.

L.S.: Do you think the BRICS, SCO and ASEAN countries follow a very different gold policy than the West?

R.S.: Absolutely. They want to cast off the shackles of the US dollar. There are a number of examples indicating the increasing skepticism vis-à-vis the US dollar. For example South Africa has already taken concrete steps to replace the US dollar as the favoured currency for international trade transactions. From now on, the country wants to invoice in Chinese renminbi when trading with other emerging countries. Standard Bank, the largest African bank, expects trading volume in renminbi between China and Africa to hit USD 100bn by 2015. China seems to regard South Africa as the gate to the entire African market.
China and Japan, too, want to increasingly avoid the USD. In December, Prime Minister Wen Jiabao and the Japanese Prime Minister Noda agreed to promote trade in yuan and yen. China has become the most important trading partner for Japan (USD 340bn per year). The two countries hold the biggest volumes of US Treasuries. Therefore, the importance and symbolic power of this piece of news cannot be ver-emphasised.

L.S.: Quite a lot of people want to tell their audiences that gold is in a bubble. Your take?

R.S.: Well, while gold remains a highly popular issue for discussion, it is

not a highly popular asset in portfolios. The underweighting of gold by institutional investors is particularly profound. Institutions continue to hold only 0.15% of their assets in gold. I do not expect an imminent paradigm shift, this is practically impossible for regulatory reasons. But even a weighting of 2-3% in institutional portfolios would trigger enormous effects. The allocation of investment capital in gold mining shares is similarly insignificant. The market capitalisation of all 16 stocks in the Gold Bugs index amounted to USD 180bn as of the end of June. By comparison, the monthly budget deficit of the US was USD 198bn in March alone. To make a log story short, I would say no, gold is in no bubble at all.
L.S.: Do you welcome the possible new classification of gold as a zero-risk asset? What consequences would this likely have?

R.S.: Yes, absolutely. At the moment it is only a proposal, but I think that the decision would have a wide range of implications. Gold would officially become "as good as gold" again and would rank on the same level as cash. The opportunity cost of holding gold will be reduced massively. There's also a number of other aspects that I called "the renaissance of gold in finance".

L.S.: What are those aspects?

R.S.: For example, in a study, the IMF forecasts a drastic increase in the demand for safe investments as well as a significant decline in the supply of such investments. The IMF expects the share of safe haven assets to fall by 16% or USD 9,000bn by the year 2016. Due to the turbulences, which are expected to continue, the IMF envisages a continued strong increase in demand for safe investments, but at the same time a drastic decline in their availability.
This process has already started. At the end of 2007, 68% of all industrialised nations commanded a AAA rating, whereas nowadays this percentage has fallen to 52%. In accordance with the law of supply and demand, this will trigger an increase in the "insurance premium" of safe investments. I expect the debt and system crisis to cause a thorough review of the international monetary system. The downgrading of the ratings of numerous countries and companies will likely continue and come with a clearly positive effect for gold as safe haven.
Moreover, due to it's high liquidity and unique characteristics, gold is becoming ever more prominent as collateral. Along with LCH.Clearnet, IntercontinentalExchange, JP Morgan, and the CME Group, Eurex, too, now accepts gold as collateral. This step definitely makes sense for clearing houses. On the one hand these institutions can diversify their assets (due to the low or in some cases even negative correlation), on the other hand they honour the wish of many market participants, who want to lodge gold as collateral. This initiative is currently also supported by the World Gold Council, which in addition wants to have gold acknowledged as "tier 1" asset within the framework of Basel III.

L.S.: One big chapter of your report is dedicated to "the biggest misconception with regard to gold". What is this?

R.S.: From my point of view, the gold sector is riddled with an elementary misunderstanding. Many gold investors and analysts operate on an erroneous

assumption: they attach too much importance to annual production and annual demand. We often read that the gold price cannot drop below production costs. Therefore, I am discussing this misconception in the
report… In this regard, I would highly recommend the articles by Robert Blumen on this subject.
Now what do I mean by that? Every gramme of gold that is held for a variety of reasons is for sale at a certain price. Many owners would sell at a price slightly above spot, others would only sell at a substantially higher price. If, due to favourable prices, a private individual wants to sell his gold holdings that he acquired decades ago, it will not reduce the overall supply of gold. All that happens is the transfer from one private portfolio to another private portfolio. To the buyer, it makes no difference whether the gold was produced three weeks or three millennia ago.

L.S.: That's true.

R.S.: And this means the annual gold production of close to 2,600 tonnes is of relatively little significance to the pricing process. Rather, the supply side consists of all the gold that has ever been produced. The recycling of existing gold accounts for a much larger share of supply than is the case for other commodities. Paradoxically, gold is not in short supply– the opposite is the case: it is one of the most widely dispersed goods in the world. Given that its industrial use is limited, the majority of all gold ever produced is still available.

L.S.: Why do you see the stock-to-flow ratio in contrast as "the most important characteristic of gold"?

R.S.: Because it's what differentiates gold (and silver) from commodities. In contrast to commodities, the discrepancy between annual production and total available supply (i.e. the stock) for gold and silver is enormous. This is called a high stock-to-flow ratio. As I have pointed out already in my gold report of last year, I believe that this is the single most important distinctive feature of gold (and silver). The aggregate volume of all the gold ever produced comes to about 170,000 tonnes. This is the stock. Annual production was close to 2,600 tonnes in 2011. That is the flow. Dividing the former by the latter, we receive the stock-to-flow ratio of 65 years.
Gold reserves grow by about 1.5% every year, and thus at a much slower rate than any of the money supply aggregates around the world. The growth rate is vaguely in line with population growth. Trust in the current and future purchasing power of money or any means of payment not only depends on how much is available now, but also on how the quantity is expected to change over time.

L.S.: What does that mean in numbers?

R.S.: Well, if annual mine production were to double (which is highly unlikely), this would translate into an annual increase of only 3% in the supply of gold. This is still a very minor inflation of total gold reserves, especially compared to current rates of dilution of paper currencies. This fact creates a sense of security as far as availability is concerned and prevents natural inflation.

If production were down for a year, this would also have little effect on the total stock and on pricing. On the other hand, if a significant part of oil production were to be disrupted for an extended period of time, stocks would be exhausted after only a few weeks. This means it is much easier for gold to absorb any form of significant production expansions or shortages.

L.S.: You also mention in the report the term “reservation demand”. Why is this concept so fundamental for understanding gold?

R.S.: The demand side is made up of investors, the jewellery industry, central banks, and the industrial sector. But this is still only a fraction of total demand. From my point of view, reservation demand accounts for the largest part of demand. This term describes gold owners who do not want to sell gold at the current price level. By refusing to sell, they are responsible for the price remaining at the same level. (2)
Therefore, the decision not to sell at current prices is as important as the decision to buy gold. In net terms, the effect on the price is the same. The gold supply is therefore always high. At a price of USD 5,000, the supply of recycled gold would exceed annual production several times. This also explains why the often-quoted gold deficit is a fairy tale.

L.S.: One factor for the price of gold is the struggle deflation vs inflation. Given the commodity price data, do you see deflation as a major problem?

R.S.: I think that a massive deflation (hyperdeflation) would be the normal reaction of the market at the moment. What does usually happen during a period of profound deflation?
Public budgets are over-strained, the financial sector does face systemic problems, and currencies are depreciated in order to reflate the system. Moreover, the credit quality deteriorates gradually, and the creditworthiness of companies and government is questioned. The investment focus shifts from capital growth to capital preservation. The confidence in the financial system and paper currencies declines, while the importance of gold increases and a remonetisation takes place. Does that sound familiar to you?
The fear of deflation as manifested, for example, in numerous essays and speeches by Ben Bernanke (e.g. “Deflation: Making Sure ‘It’ Doesn’t Happen Here”) seems to argue very much in favour of further interventions in increasing magnitude. Therefore, I think that the natural shake-out during a deflationary recession will probably be avoided at all costs. This should continue to create a positive environment for gold.

L.S.: In connection to this it might be helpful to talk also about a topic that you are referrring to in your report as “Exeter’s Pyramid”. Could you explain this, please?

R.S.: Sure. The pyramid named after John Exeter (a US economist, former vice president of the Federal Reserve New York and member of the Council on Foreign Relations) shows the liquidity flows between the various asset classes. In an often-quoted interview, (3) Exeter expected a deflationary collapse, in the course of which gold would significantly gain in importance. He says that in a deflationary depression, as in an hourglass, liquidity

flows from the higher part of the pyramid downwards, amid falling willingness to assume risk. At the upper end, liquidity would dry up due to the lack of buyers and revert from a sellers' to a buyers' market. Since credit is "slumbering mistrust", (4) creditors try to sell the continuously falling number of liquid assets and head for the lower asset classes as a result of their rising risk aversion. At the bottom end is gold. Due to the general scepticism the circulation of gold declines, as it is increasingly being hoarded. The degree of hoarding always depends proportionately on the confidence in the government and the currency. Gold is never scarce unless it is hoarded – for good reasons – and deliberately hidden. Since gold does not hinge on any form of IOU, it is the only alternative to paper money and is thus at the bottom of the upside-down pyramid. Or as Alan Greenspan said in 2010: "Fiat money has no place to go but gold."

L.S.: If you would calculate the price of gold based on money supply and credit creation, where do you end up?

R.S.: Well, first of all I have to say that there is no objectively measurable value of a good, and according to Carl Manger's theory of subjective value, the value of a good is derived from the marginal utility with regard to the set goal. This means that the value of a good or a service is therefore of no objective value, but the result of a subjective process of valuation.

L.S.: Sounds fairly academic to me…

R.S.: Let me give you a classic example: a glass of water after a dry spell in the desert is probably the most valuable good on earth, correct?

L.S.: Yes.

R.S.: But after the thirst has been quenched, the marginal utility quickly declines. The one hundredth glass of water is hardly given any value anymore. But it is this last glass of water that sets the market price. The marginal utility is therefore the utility provided by the last available unit of a good that satisfies a need. In other words, the value of a good is determined by the subjective assessment of its last unit (the marginal unit).

L.S.: But in your report, you're still discussing possible price targets for gold, right?

R.S.: Yes, because that's basically what an analyst is supposed to do. (Laughs.) However, on the basis of the aforementioned, it is impossible to calculate a "fair value" of gold. It is only possible to analyse the relative (over- or under-) valuation vis-à-vis other asset classes and monetary aggregates.

L.S.: Is the comparison of the trends of different asset classes actually tenable?

R.S.: I think it is, since human behaviour and emotions are similar during periods of extremity. A chart reflects the collective vote of market participants.

L.S.: So how do you then "value" gold?

R.S.: Following Jim Grant I would answer this question by proposing that the price of gold be 1/T. "T" symbolises the trust of people in the currency guardians. The lower the trust in the abilities of the central bankers, the higher the price. This means the gold price equals the inverse of the trust in central banks. "1" divided by a falling number is the definition of a bull market and of a decline in trust.
I have got a number of charts in my report, that would indicate that gold is priced very reasonable at the moment. For example, applying the Pareto principle to the current gold price, I find a theoretical price target of USD 8,300. If we were to assume that the last trend phase were to start in August 2012 at USD 1,600 and the bull market had begun in August 2001, the parabolic phase would last 29 more months and thus end in Spring of 2015. The price target according to the 80/20 principle is therefore USD 8,300.(6)

L.S.: You are also mentioning the "Shadow Gold Price"…

R.S.: Yes, my friends at QB Asset Management calculate the so-called "Shadow Gold Price". This model is not purely academic, but rather it is the way the exchange rate of paper money and gold was calculated during Bretton Woods (US monetary base divided by US gold reserves). The Shadow Gold Price describes the theoretical gold price at which the entire monetary base would be covered by gold. This way a debt-based currency could be transformed into a currency covered by assets.

L.S.: Where is the Shadow Gold Price right now?

R.S.: Currently, the Shadow Gold Price is above USD 10,000. Given that the Federal Reserve Act of 1913 called for a gold cover of at least 40% we also depicted this cover ratio in one of the charts that I have mentioned. The gold price would have to rise to USD 4,040 for this percentage to be reached.

L.S.: Would you agree that gold mining stocks look pretty cheap at the moment?

R.S.: Yes, but first of all I would like to point out yet again that I regard gold as currency and thus as a form of saving, whereas I consider gold shares an investment. However, having said that, I believe that the gold mining sector has a solid base. Although the pessimism is about as profound as four years ago, the fundamental shape the gold industry is in, is substantially healthier today than it was back then. Strong balance sheets, high free cash flows, a substantial increase in margins, low debt levels, and rising dividends all speak in favour of the sector.
In addition, it seems like the industry has reassessed its former "growth at any cost" approach. Therefore we believe that solid mining shares in politically stable regions currently represent a high-leverage bet on the gold price with an attractive risk/return profile. Therefore, I believe that the current, historically low, valuations offer a very attractive opportunity to invest.

L.S.: Do you expect gold going at one point into permanent backwardation? And

what would this mean if it does so?

R.S.:Lasting backwardation of the gold price can only be interpreted as a lack of confidence in the future delivery of the physical good. In the case of a common good, physical scarceness is usually resolved by higher prices. At a sufficiently high price of wheat, demand will have fallen and the existing supply will be sufficient to meet the reduced demand.
But gold is different: backwardation should de facto never happen because due to the high stock-to-flow ratio there can be no "gold scarceness". In other words, backwardation indicates a massive erosion of trust in the financial system. (7) Gold backwardation means that the confidence in a future delivery – as compared to the safety that current ownership provides – is low. Given that at the moment only 0.3% of all contracts are exercised by physical delivery, any sudden increase in physical settlements could trigger massive turbulences. Generally speaking, it seems that we have been going through a gradual shift from paper gold investments towards physical purchases. This year, physical investment demand will probably exceed ETF demand by a factor of 5. Only a few years ago the situation was exactly the opposite, with ETFs accounting for 80% of investment demand. This paradigm shift shows the gradual loss of confidence in paper gold.

L.S.: Any final words?

R.S.: Have faith, buy gold.

References:

(1) Compare "Welcome to 2012 – the Financial System and the Real Economy", Philip
Barton, The Gold Standard Institute
(2) Compare "WSJ does not understand how the gold price is formed", Robert Blumen,
Mises Economics Blog
(3) See: http://www.istockanalyst.com/article/viewarticle/articleid/2599701
(4) Thomas Paine
(5) Compare "Safe haven – A History of Gold", Philip Barton, The Gold Standard Institute
(6) Based on this model, the increase from USD 260 to USD 1,600 accounted for 20% of the
total movement. This means that 80% equals USD 6,700, which, when added to the current
price, yields the hypothetical price target of USD 8,300.
(7) "Permanent Gold Backwardation: The Crack Up Boom", Keith Weiner

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