The true importance of gold lies in its possession, not its price

written by Edward Maas | July 2, 2013

“The Matterhorn Interview – July 2013: Ronald Stöferle”

“You have to be patient these days”

On occasion of the publication of his seventh annual “In Gold We Trust“ report, renowned gold market analyst Ronald Stoeferle discussed for Matterhorn Asset Management / GoldSwitzerland some aspects of his latest report and the larger picture, inter alia: the current bad market sentiment in gold; the rather strange fact that gold is traded like a currency but analyzed like a commodity; the question if it’s a problem that gold is traded now below average cash costs for mining companies; and the most contrarian call at the moment: gold mining equities.

By Lars Schall

Ronald Stoeferle, managing director of Incrementum AG in Liechtenstein is a Chartered Market Technician and a Certified Financial Technician. He 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 U.S., he worked for Raiffeisen Zentralbank (RZB) in the field of Fixed Income / Credit Investments. After graduating, Stoeferle joined Vienna based Erste Group Bank, covering International Equities, especially Asia. In 2006 he began writing reports on gold. His benchmark reports drew international coverage on CNBC, Bloomberg, the Wall Street Journal and the Financial Times. Since 2009 he also writes reports on crude oil. Recently, Stoeferle and his partners incorporated Incrementum AG in Liechtenstein. He will soon launch a global macro fund, based on the thoughts of the Austrian School of Economics. Furthermore, he is now senior advisor to Erste Group Bank and a lecturer at the “Institut für Wertewirtschaft” (“Institute for Value-based Economics“) focusing on the Austrian School of Economics.

Lars Schall: Mr. Stoeferle, your new report is called once again "In Gold We Trust". However, the sentiment in the market is currently extremely bad. Why so?

Ronald Stoeferle: Well, we've seen a massive price drop and in the course of the recent gold crash the market has definitely demonstrated once again its tendency to maximize pain. The fact that sentiment is by now at the most negative level since the beginning of the bull market, gives us cause to be clearly positive about the long term. Sentiment indicators like e.g. Market Vane, the Hulbert survey and Rydex precious metals fund cash flows show that the gold price is miles away from excessive euphoria. According to the Hulbert Financial Digest, the allocation recommended by gold newsletter writers was recently at minus 44%, an all-time low.

Therefore, I think we're at the point of maximum pain at the moment, the sentiment is as bad as it can get. From a technical point of view, massive technical damage has been inflicted and I am convinced, that repairing this damage will take some time.

However, from my point of view, gold, and especially gold mining shares, at the moment are the ultimate contrarian investment.

L.S.: So you're still confident in the prospects of gold?

R.S.: From my point of view, we're witnessing monetary policy experiments more or less on a global basis – have a look at the "monetary Harakiri" happening n Japan for example, have a look at the UK… There exists no back-test for the current financial era. If there ever was a need for monetary insurance, it is today.

I am seeing very strong similarities between the recent correction and the so called mid-cycle correction between 1974 and 1976. From my point of view, we're seeing a deflationary backdrop at the moment, very similar to the situation in the 70ies when gold dropped from USD 180 down to 100 and everyone called the end of the gold bubble…

However, let's have a quick look at the general monetary climate. Since 2008 there have been more than 500 interest rate cuts around the world. Non-standard monetary policy measures seem to have become standard procedure. Tapering and exiting from QE will be much more difficult than market participants currently envision. The current QE program is the most massive put ever written by Ben Bernanke. Both the extent of the current asset purchase program as well as its temporal horizon are unlimited. The Bank of Japan's policy is also increasingly expansive and will double the monetary base over the next two years in order to produce an inflation rate of 2%. Relative to economic output, Japan's QE package in the amount of 7.5 trillion yen per month is approximately twice as big as that of the US. If one adds up the monthly (!) QE amounts in the US and Japan, assets amounting to $160 billion are being bought with newly created central bank money. By way of comparison, this equates to far more than the annual gold production by mines, which is currently valued at $125 billion (2,700 tons). Again: This is the monetary endgame from my point of view. Let me quote Gottfried Haberler: "…there is no record in the economic history of the whole world, anywhere or at any time, of a serious and prolonged inflation which has not been accompanied and made possible, if not directly caused, by a large increase in the quantity of money."

L.S. In your report you write "The April crash showed how important it is to differentiate between the 'gold price' and the 'price of gold'." Could you

elaborate on this, please?
R.S.: Yes. The gold price refers most of the time to the price of a gold futures contract, e.g. at the COMEX. The price of gold by contrast is the price one must pay if one wants to buy physical metal.
These spot and futures prices are connected via arbitrage and for that reason can not, in principle, move diametrically away from each other. Nevertheless, an understanding of the link between these two markets is necessary to correctly interpret events in the markets. In the present environment, there are for example considerable mark-ups, supply bottlenecks in the physical (cash) market.
Many aspects of the April crash were unusual. For the first time, record high, anti-cyclical demand in the physical market could be observed on a global basis in the course of a large price correction:
However, I always said that the true importance of gold lies in its possession, not its price. A gold price decline or increase by 5% barely has an effect on physical possession, since probably only a share amounting to tenths of a percent of the total available stock changes ownership. The paper market by contrast consists of countless promises issued by a vast variety of counterparties. One should therefore refrain from equating participation in a price movement with ownership of an asset. There is for instance a fundamental difference between ownership of a cattle futures contract and being a farmer who raises cattle.
L.S: We have heard a lot of talk about tapering and the coming exit strategy by the Federal Reserve. What’s your take on that?
R.S.: I think the current developments clearly show how addicted markets are to cheap money and more QE. Just one number: Rising yields in the US will lead to an increase in monthly loan payments for a 30y credit by 20 to 25%. This will definitely have a large negative impact on real estate numbers. If the Federal Reserve wants to go cold turkey, please go ahead. But we’ll see a massive crash in bond markets and in equities, and I don’t think – as they always referring to the so called “wealth effect” – I don’t think that they are really going to do it, so it’s only tough talk from my point of view. The last time the Fed allowed the money supply to suffer a year-on-year drop was in 1981, under Volcker….and that was followed by the biggest year-on-year money supply expansion of the entire post WW2 period in 1982.
We have to emphasize that the monetary inflation has already occurred! According to Austrian Business Cycle Theory the prices of capital goods (= asset price inflation) increase first in the course of an inflationary process, while consumer price inflation (= rising consumer prices) only ensues later.

L.S.: In your report you’re addressing the special characteristics and virtues of gold in a portfolio. Please talk about those features.
R.S.: Countless studies confirm that gold as a portfolio addition lowers the volatility of a portfolio and thus improves the statistical portfolio characteristics. If one compares the monthly return of the S&P 500 with that of gold since 1971, one notices this diversification characteristic quite clearly. Apart from these quantitatively provable characteristics, gold has in addition the qualitative characteristic of being a debt-free investment asset. Gold is pure wealth, pure possession without any counterparties attached.

But by far the most important factor when it comes to gold is the stock-to-flow ratio, and what I call the “relative scarcity” of gold versus fiat currencies. I’ve got a number of charts in my report showing this, for example between 1868 and 2011 growth rate of the monetary aggregate M2 was 6.6 per cent, while the stock of gold grew only by 2.1 per cent. So from this point of view you can tell that gold is relatively scarce compared to fiat money. But the interesting thing is that the volatility of monetary supply is that enormous – it ranged from minus 15.6 per cent to plus 26 per cent, while if you compare it to gold it ranged only between 1.4 and a maximum of 3.5 per cent. So I think the reason why people have trust in gold is because of this relative scarcity.

L.S.: In your report you’re writing again once again about the stock-to-flow ratio of gold as something that distinguishes gold in the commodity sector. Please talk about the meaning of it.

R.S.: Well, it’s the absolute crucial factor for understanding gold. Unfortunately a lot of people within the gold sector do not really understand it. There is a clear difference between commodities, which can be explained by a consumption model – examples would be crude oil, copper, agricultural commodities –, and goods that are bought in order to be held, like gold for example. While the economic utility of a consumable good is created when it is destroyed or used up, the utility of investment assets lies in their possession and later resale. Industrial commodities therefore have low stock-to-flow ratios, this is to say, inventories usually only cover consumption demand for a few months.

The stock-to-flow ratio of commodities, for example oil, is much lower than the stock-to-flow ratio of gold. That means that the inventories of gold, which is officially something like 170,000 tons, are extremely high compared to annual production, which is roughly 2,700 tones. If you compare that to oil for example, there are inventories, but they are definitely not any near as high as when it comes to gold, it’s probably a few months of production. Therefore, we have to say this discrepancy between annual production and the total available supply is probably the most important factor when it comes to gold.

What does this actually mean? Let us assume that the price of gold rises considerably in the future and mining adjusts accordingly, then mining of e.g. 3,500 tons per year would certainly be possible within 10 years time. If we assume further that annual mine production grows by 3% p.a. over the next ten years, cumulative mine production would amount to about 31,000 tons over the period. The total stock of gold would then amount to approximately 203,000 tons by 2023. If mine production were to amount to 3,500 tons at that point in time, this would still only represent an annualized inflation of the stock of gold of 1.7%.

L.S.: We’ve talked about gold as a commodity – and usually people don’t consider gold as money. In fact, by law it isn’t. However, at the big banks gold is usually traded at the currency desks. Now, if gold is just another commodity, why would this be the case?

R.S.: This is not really a discussion for me: gold is money, and I think the market chose within the last few thousand of years the perfect money, and that’s gold, and to a certain extent silver, not paper. It’s interesting what you’ve said, that gold is traded at the currency desk, and it got a currency code, which is XAU. On the other hand, it is most of the times analyzed

within the commodity department, and that’s pretty interesting from my point of view, because as I’ve said most analysts analyze gold as a commodity, so they are focusing on annual supply, annual demand, which doesn’t have a real impact.
It’s strange isn’t it, that gold is traded like a currency but analyzed like a commodity – that’s one of the major flaws within the industry. However, I think what most of the people forget, especially these days, is the fact that gold is extremely liquid. There was a survey of the LBMA that I am mentioning in my report, it said that the average daily trading volume of gold is roughly 240 billion US dollars, just on the LBMA. That’s probably the reason why gold is often sold off in environments when people would suggest it should basically rise, because if there is a rush to liquidity, if people have to get out of leveraged positions and so on, they often sell their gold, because it’s extremely liquid, it’s traded all over the globe and around the clock.
L.S.: What are your thoughts on the wealth transfer in form of physical gold from the West to the East?
R.S.: Well, Lars, I remember we did talk about it a bit last year, when I wrote it in last year’s report. I mentioned then that gold always goes where real prosperity and real growth happens. I also mentioned James Steel, who once wrote that gold goes where the money is. (1) It came to the United States between World Wars I and II, and it was transferred to Europe in the post war period. Then it went to Japan and to the Middle East in the 1970’s and 80’s. And now it goes to places like China and India.
We all know that history repeats. While France was the most important critic of the dollar’s currency hegemony in the 1960s (prior to the collapse of the Bretton Woods system), China appears to have taken on this role today. France at the time criticized the “exorbitant privilege”, stopped buying US treasuries, converted dollars to gold and repatriated gold. China is currently behaving in a similar manner, calling the dollar’s status a “product of the past”. Based on a number of comments as well as statistics, I assume that the PBoC is currently massively expanding its gold reserves and holds far higher reserves than the officially reported 1,054 tons. I sincerely believe it is realistic that China has by now 4,000 – 6,000 tons, and with that the second largest gold reserves worldwide.
However, I think that there are very interesting things at the moment. For example, you have probably heard about the report by OMFIF, which is some sort of think tank by the central banks and wealth funds, arguing in favor of a remonetarisation of gold. (3)
L.S.: Yes.
R.S.: From my point of view they released a very sensational report, because it shows strikingly that real fundamental changes to the currency system are already being discussed at the highest levels these days. I mean, OMFIF recommends the inclusion of gold in the Special Drawing Rights by the IMF, which from my point of view is utterly nonsense. I think former French President Valéry Giscard d’Estaing once called them “Monetary LSD”… But the fact that they discuss those things is quite interesting. There was also a paper for the European Parliament, writing about gold-backed bonds. (4) And I think that from these little things you can tell that there is really something going on in the background, and that this remonetarisation of gold is currently happening.

L.S.: What needs to take place before the turn around in gold mining stocks really begins?
R.S.: That's a good question. If you're bullish on gold, you're already quite a contrarian and people will probably laugh at you, but if you're bullish on gold mining equities, well, then you're probably the ultimate contrarian. I think a lot of things happened within the gold mining industry recently. They replaced a lot of mining executives, they try to focus on transparency of costs, the companies have abandoned some development projects, and I think these are good sign. I mean at the moment, the ratio of the BGMI, which is the Barrons Gold Mining Index and the price of gold, so the BGMI-gold ratio is at the lowest point since 1943. So you can tell that gold mining stocks in comparison to gold are really cheap.
Moreover it's interesting that there is some sort of a mantra of eternally rising mining costs, and from my point of view, especially these days, where we're seeing a sharp decline in commodity price, where we're seeing sluggish economic growth, we already see that some input costs for the miners have started declining. The same goes for the big vehicle tires, explosives, but also labor costs, we're really seeing a brutal market adjustment, and that has definitely an impact on the labor costs. So therefore, I think going forward the costs for producing gold could start decreasing, and that would surely be a good sign, however, as I've said at the beginning, the sell-off caused some real serious damage to the price of gold and to the gold chart. If we some sort of see a bottom building in gold, I think it will still take a few weeks, maybe even months, before the mining stocks really start rising again, because a lot of people have lost trust in gold, and more so in gold mining stocks. So I think it is a bit too early to start piling big time into the gold mining stocks.
L.S. Is it a severe problem that gold is traded now below cash costs for mining companies? (2)
R.S.: For the miners, but not for gold. Because of it's extremely high stock-to-flow ratio, production costs are of limited significance when it comes to the pricing. They are mainly relevant for the performance of gold shares. From my point of view, analyses claiming that the gold price cannot drop below production costs are therefore based on a fundamental misunderstanding. While from a certain price onwards the production would turn unprofitable for mining companies, the trade of already produced gold would not suffer. The mining sector therefore has little influence on the gold price. However, the opposite is not true: the gold price has a substantial impact on mining and its profitability.
L.S.: One ratio that we both pay close attention to is the price ratio between oil and gold. Where is the ratio currently, and what does this tell you?
R.S.: The ratio is currently at roughly 1:12 (Gold to Brent Crude), and that shows that we're basically within the long-term average – the long-term average is around 1:15. And the fact that the price of oil is holding up very well from my point of view says that geopolitical factors are here and probably bigger than we are expecting. But it also says that the whole fracking euphoria in the United States, all this talk about energy independency for the U.S., that the U.S. would export oil going forward, that the U.S. would join OPEC, that kind of crappy analysis – well, to be honest, I don't see it really happening, or otherwise the price of oil would be much

lower.
L.S.: In your report you have some interesting long-term ratios.
R.S.: Yes, as you know I am an "Austrian Austrian". According to Carl Menger, the founder of the Austrian School of Economics, the value of a good is the result of its expected marginal utility on the part of the valuing individual. He once said that "Value does not exist outside the consciousness of men", which is a very central idea.
The value of a good or a service is therefore not an objective magnitude, but always the result of a subjective act of evaluation. Since there exist as many preference scales as human beings (and because this ranking of preferences is also continually changing), is it will never be possible to ascertain objectively what the value of a thing or a service should be. It is therefore impossible to calculate a fair value for gold.
However, you can still compare the current price of gold to other asset classes, monetary aggregates and their possible future development and so on. In the report, I drew some long-term ratios, for example between gold and fine wine, between gold and arts, between gold and housing, and definitely between gold and financial assets like bonds and equities. And from this long-term analysis you can say that gold is everything but expensive, it is much below the long-term averages, and as we all know, a big secular bull market ends in euphoria, and therefore the ratios would have to be at extreme levels, and As we're far away from that, I think that can make you pretty confident about the price of gold. The often cited argument that there is a 'gold bubble' can therefore be easily refuted. Bull markets end in euphoria, which buttresses our argument that there will be a final stage in the form of a trend acceleration phase.
L.S.: Mr. Stoeferle, you have no crystal ball; nevertheless, how will gold perform in the second half of 2013?
R.S.: Well, I am not young enough to know everything. (laughs.) But we have seen some very bullish divergences by the miners as well as silver last week. If I am really lucky, then I'll have exactly called the bottom last week. However, we shouldn't expect too much upward momentum in the short-term. Seasonality will get better in August. My 12 month target is 1.480 US dollars, which isn't too high, but again: we have to say that gold took a large hit and it will take time to recover.
L.S.: Thank you very much for taking your time, Mr. Stoeferle!
SOURCES:

(1) Lars Schall: "Gold goes where The Money is", Interview with Ronald Stoeferle, GoldSwitzerland, July 24, 2012, here:

https://goldswitzerland.com/gold-goes-where-the-money-is/

(2) "Gold Drops Below Its Average Cash Cost", Zerohedge, June 26, 2013, here:

http://www.zerohedge.com/news/2013-06-26/gold-drops-below-its-average-cash-cost

(3) Official Monetary and Financial Institutions Forum **(OMFIF):** *"Gold, the renminbi and the multi-currency reserve system", January 2013, here:* http://www.omfif.org/downloads/Gold,%20the%20renminbi%20and%20the%20mul

ti-currency%20reserve%20system.pdf

(4) Lars Schall: “**Gold emerges as euro debt-crisis option“, Interview with Ansgar Belke, Asia Times Online, January 12, 2013,**
here: http://www.atimes.com/atimes/Global_Economy/OA12Dj02.html

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