CPM Group

Market Commentary

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Gold and Economic Uncertainty

At present the gold mining and trading communities have almost universally convinced themselves that gold prices can only rise. The thinking is as follows. There are many long-term major economic, financial, currency market, and political problems, many extremely intractable and difficult to solve. No one knows how these problems will be resolved, and what effects they will have on the world economy and political systems. In the best case scenarios, these problems will persist for many years or decades, if the world is lucky, as the fiscal and debt excesses and imbalances of the past four or five decades are squeezed slowly out of the system. Such a series of long-term problems is unprecedented, will be with the world financial markets for decades to come, and will keep investors interested in gold and silver, as well as other tangible assets such as broader commodities, for the foreseeable future. Even if the world manages to effectively deal with these issues and problems on a long-term basis, there will be periodic episodes in which things go even more awry, leading to spasms of inflation or recession, currency crises, sharp or prolonged down-drafts in equity values, and wild and destructive swings in interest rates. All of this, the reasoning goes, will keep driving investors to buy gold in ways that are unprecedented.

All of this seems accurate. CPM Group has not been removed from believing these issues, and that they would be supportive of much higher gold prices. We, too, find it hard to imagine that the underlying economic and financial environment, which feeds the investment demand that drives gold prices higher, will resolve themselves anytime soon in a generally positive way, especially given the wholesale lapse of political leadership in the United States and European governments. Indeed, CPM Group issued its most recent intermediate term gold investment recommendation in November 2000, saying that it thought gold prices, then around $270 per ounce, were likely to rise to unprecedented levels over the next 'many' years, as these economic, financial, and political issues grew worse.

Furthermore, our long-term projections are that investors will continue to buy gold in unprecedented volumes for decades to come. Investors have been buying more than 26 million ounces per year consistently since 2002, driving prices higher, in a longer gold bull market than ever before in history. CPM Group's expectations are that investors will continue to build their gold holdings for at least the next decade (the forecast horizon in our long-term projections), and probably beyond that period as well. This will keep gold prices very high, above $1,000 per ounce, for at least the next decade. We do not have prices rising further, to $3,000 or higher, however. We have prices remaining near current and recent high levels. We will be the first to admit we could be proved wrong, and we will be the ones who can best describe the most likely ways in which our projections may be wrong.

However, all of the gold market observers who are convinced that gold prices can only rise need to consider the unpredictable and variable relationship between gold investment demand and prices, as the dependent variable, and overall economic uncertainty or chaos. Economic problems do not assure higher gold prices.

History, including recent history, has provided ample examples of periods of time when the collective wisdom of the gold market was that prices had no way to move but upward, only to find that gold prices indeed could decline even in the face of severe economic problems. Here are two examples.

1980 – 1982

Gold prices peaked in January 1980, at $850 per ounce. That was at the *beginning* of the then-deepest postwar recession. Inflation rose to 14%, and interest rates to 21%. American hostages remained in Iran until January 1981, and the Soviet quagmire in Afghanistan was just beginning. As the recession proceeded, U.S. unemployment rose to 11%, while European rates were even higher. By the middle of 1982 the economic crises had grown so severe that the world's financial system seemed to many about to collapse. Mexico, Brazil, and Argentina were on the verge of defaulting on their sovereign debt, having followed numerous countries in Eastern Europe down that path.

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In this environment, in January 1980, when gold prices touched $850 the gold market consensus was overwhelmingly that gold prices could only rise. Jim Sinclair famously took profits at $850, as did many other smaller investors. However, there were many market traders and commentators who looked around at the sorry state of the world economy and concluded that gold prices only could rise. The famous Aden sisters' projection of $8,000 gold by 1988 emerged during 1980 – 1981.

Instead, gold prices fell from $850 to less than $700, the next day. They proceeded to drop as low as $463 during 1980, and by the middle of 1982, just as the international debt crisis was growing most severe, to $298. So much for the incontrovertible truth that gold had to rise in the face of mounting economic problems.

In March 1982 gold was around $330 and we decided to issue a gold buy recommendation for investors. J. Aron, where we worked at the time, had become part of Goldman Sachs in November 1981. Goldman had never issued a gold buy recommendation, or any commodity recommendation, from what anyone there could remember at the time. That was why they had bought J. Aron, to offer gold and commodities to their investment clients. It took the company several months to take us seriously and decide how to organize an investment review committee to listen to our rationale for turning bullish on gold and recommending it to investors. By the time it had gotten the review process together it was June, and gold had dropped to $298. We were asked whether we still were bullish on gold, given its continued descent during the ensuring three months. Our reply was that we were $32 more bullish at $298 than we had been at $330.

1982 – 1983

The next example of a broad-based euphoric view that gold prices could only rise occurred almost immediately. In July 1982, seeing the risks to the overall global financial and economic systems of major Latin American governments defaulting, Fed Chairman Paul Volcker organized an emergency meeting of the major central banks in Washington. They agreed to 'open the spigots' in the vernacular of the time, to flood the world economy with liquidity in order to stave off sovereign debt defaults and deeper financial crises.

The world's financial markets watched as money supply growth rates sky rocketed in the United States, Japan, and major European nations. U.S. narrow money supply rose roughly 37% during the second half of 1982. Convinced that such monetary accommodation, the precursor of today's quantitative easing and the origin of the concept of 'throwing money from a helicopter' in response to financial crises that risk throwing the country into a deep or deeper recession, investors bought gold hand over fist. They drove gold prices from $298 in June 1982 to $510 in January 1983. The view was that the monetary policies had to be inflationary.

History has shown us that this was one of the worst times ever to buy gold. The monetary accommodation brought the world out of recession and back from the brink of collapse. After economic conditions strengthened, the Fed embarked in a then-unprecedented bond selling spree, to sop up the excess liquidity and finance the Reagan era deficits. Inflation, which had been a major problem from the 1960s through the 1970s, dropped to very low and stable levels for most of the next quarter century. The world's financial system did not collapse. The U.S. government devised Brady Bonds to help resolve the liquidity issues of Latin American governments, providing some fabulous investment returns for savvy investors in these bonds over the next decade (and perhaps pointing the direction to part of the long-term solution of the current European sovereign debt and deficit crisis should anyone in power choose to learn from even recent history). Gold spent most of the next 15 years trading between $320 and $400, with occasional spikes above and below that range.

Conclusion

None of this is to belittle the current state of economic disarray, or that gold prices will not keep rising. It is to inject a note of caution and humility into the current euphoric view prevalent among gold producers, traders, investors, marketers, and others, that gold prices are inexorably bound to rise over the next many years because of the enormous economic and financial problems facing the world. The world has faced big problems before, and it has survived them.

We will be honest: It is impossible to say with certainty whether gold prices are close to a cyclical peak, or have much further to rise. We can point out a lot of very useful information, both about current market conditions (signs of stale bull liquidation, nervous longs, weaker coin premia suggesting small investor selling, ETF holdings running flat). We can provide historical and theoretic insights. We can give it our best guess. In the end, it is a guess, the correctness of which is uncertain. Currently the volatility

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and unpredictability of gold prices both are at very high levels.

Future trends in gold prices will depend on a series of inscrutable factors. First, there is the outcome of the myriad of global economic and fiscal challenges. Second, the way investors and financial markets perceive and interpret these economic developments. These reports have stated repeatedly that the actual economic conditions are far less important to gold prices than are investor perceptions and interpretations of these. Third, what investors do with their interpretations of the world around them in terms of gold prices.

Taking just one current focus on financial market anxiety, Greek sovereign debt, one can see that there are no such things as foregone conclusions. First, let us examine the reality. Markets keep speaking about an imminent default. That is possible, but not likely. European banks, heavy with Greek debt, keep pushing for an ECB-issued bond to cover the Greek debt, a variation of the Brady bonds used to address the Latin debt crisis in the 1980s. An EU-issued bond is unlikely at this time, simply because the legal and political mechanisms are not in place to issue such a bond. Of course, the member central banks of the ECB could agree to unilaterally issue a series of national bonds for this purpose. That is somewhat beside the point. The key reality is that absolutely no one, including European policy makers, knows how the Greek sovereign debt issues will be resolved. Some form of restructuring seems more likely than an outright default, although the spectrum of outcomes is enormous. Regardless of what the final result is, it is likely to be accompanied by fiscal stringencies and reduced living standards for Greek citizens, which means political strife in that country. So, the first element – what actually will happen – is unknowable.

The second element thus becomes even more problematic for scenario building. Let us assume, for simplicity sake, a straight-forward outcome: The Greek government moves to restructure its debt, with the support of the ECB members and the International Monetary Fund. The bond holders, primarily banks, are pushed into accepting this as the least destructive approach. The second key unknowable is how financial markets would interpret this development. It is possible that any announcement of a move toward some sort of restructuring of Greek government debt would be taken as 'an acceleration in the move toward ultimate default,' precipitating heavy selling of the euro, stocks, and other assets. Alternately, the markets might take an announcement of restructuring as a sign the government leaders of Europe finally are facing the realities of their fiscal impasse, and see such a move as the first step toward stabilizing the sovereign debt situation and restoring some stability to financial markets. The latter would be the more likely approach CPM Group would take, but we often represent the rational minority in markets. Our opinions do not matter. What would matter is how the herd in the market would react, and that simply is not knowable.

The third variable is equally of total supposition. Financial markets might take a Greek debt restructuring as an opportunity to dump gold. There are a great many 'stale bulls,' investors with large long positions sitting on large profits and increasingly nervous that this market is topping out. You can gauge the level of long nervousness by the shrill repeated calls by bullion banks that 'this is not the peak,' and that gold is 'merely facing a massive correction in a longer bull market.' Those reports are being issued in reaction to nervous queries by a growing chorus of fretful customers who are long gold. Just as easily investors might interpret a Greek restructuring as the next step toward the 'collapse' of the euro (whatever that would entail), and race into the gold market. The nature of market reactions suggests that perhaps the most likely gold market reaction would be an immediate jump in gold prices to higher levels, followed by heavy selling and another decline in gold prices, similar to but larger than the three-day, $200 drop in the middle of August.

That is the analysis behind one of the many hot topics facing gold. The same degree of uncertainty applies to U.S. fiscal debt and deficit conditions, Chinese economic growth rates and inflation, oil prices, currency exchange rates, real economic growth trends in Europe, the United States, and other countries and regions, Arab political unrest and developments, and all the other exogenous variables that cause investors to buy, sell, or stand aside in the gold market. All of that, and we have excluded the important fact that next year the U.S. will be facing what is certain to be a very nasty presidential election characterized by fear-mongering political speeches.

We can put it all together and give you our best guess, which is that gold prices may be approaching a cyclical peak, but in the end, one of the key factors facing the gold market right now is the unpredictable nature of financial market sentiments. Thus, CPM Group has stated that it honestly thinks the gold price could range between $1,600 and $2,100 over the next four months, decline over the next few years, but remain far above any prices that existed in the gold market prior to 2010.