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Will the Desire for Gold Return in 2014?

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Investment Summary

- **Gold Still a Barbaric Relic:** Looking for correction to end in H1 2014 in the $1,000 to $1,200 range; and subsequently, to track nominal global GDP growth (7% to 8%) over the next 3-5 years.
- **Surprises Tilted Towards the Upside:** Our indicators on the price of gold over the next 3-5 years are generally neutral but we are wary of the global monetary experiment, and central banks will continue to inflate to ease global debt burdens.
- **Buy low-cost gold producers**: Low-cost producers will survive in an unexpected global deflationary environment, but will enjoy the same upside if the global monetary experiment and consequently, global inflation, get out of control. Buy low-cost producers in politically and wage-stable environments. We believe the absolute bottom for the price of gold is $900 an ounce.

A Barbaric Relic: The Modern Desire for Gold Remains Limited

"*Get gold, humanely if possible, but at all hazards--get gold.*" -- King Ferdinand's orders to Christopher Columbus, 1492

Man's desire for gold is imprinted in our DNA. For millennia, gold acted as the foundation of nearly all of the most global and prosperous civilizations and financial systems, including Ancient Egypt, Ancient Mesopotamia, the Roman Empire, Ancient China beginning with the pre-Imperial Chu Dynasty,[1] and the Ancient Greeks. The Silver Standard (note the Chinese literal meaning of bank is "silver office"), Bimetallism, and other forms of currencies (barley, tobacco, etc.) were embraced by trading nations at various points in time, but they did not last.

The major impetus for Christopher Columbus' voyage in 1492 was profit; and gold was a major part of the equation. Columbus' contract with King Ferdinand and Queen Isabella of Spain--which was turned down by three different monarchies--entitled him 10% of all profits. The adventure was high-risk, but any payoff will be huge, as an influx in gold will (and did) finance Spain's naval and territorial ambitions.[2] In the three months leading to his departure from the New World, the word "gold" was mentioned in Columbus' diary more than 65 times. Indeed, Columbus' obsession with the precious metal led to his enslavement of the indigenous population

[1] The Chu State would later secure a prominent place in Chinese History. Led by the prominent political and military ruler, Xiang Yu (項羽), Chu forces would help bring about the downfall of the Qin Dynasty, the first imperial dynasty of China.

[2] By some accounts, the total European stock of gold and silver by the end of the 1500s was five times that in 1492, the year Columbus set sail for the New World. Interestingly, Spain would eventually suffer from today's equivalent of the "Dutch Diseases," as the new "leisure class" in Spain spent all the gold (and more) from the New World as opposed to putting it to productive use. Spain also expelled all Jews and Muslims in 1492, which were the two most educated and productive groups in Spanish society at the time.

in Hispaniola, a major Caribbean island. Hundreds of thousands perished due to overwork and disease as Columbus sought to expand the island's gold mining operations. Columbus' obsession with gold turned him into a madman.

Columbus and his invading cohorts were not the only ones seduced by the power of gold. Convinced of the power bestowed by his newfound wealth, Charles V, who took over the Spanish Crown in 1516, entered into a bidding war with Francis I of France for the title of the emperor of the Holy Roman Empire. Charles V spent 850,000 florins in bribes (equal to 95,625 troy ounces of gold) to win the title, and subsequently engaged in a 27-year war with Francis I.[3] His son, Philip II, inherited his father's entanglements but took it one step further when he invaded England in 1588 with the ill-fated Spanish Armada. Financing these adventures exerted a devastating toll on the Spanish Treasury. Despite the influx of New World gold, Charles V ran a cumulative deficit during his 40 years in power. Under Philip II, Spain defaulted on its debts, and would suffer repeated financial crises in 1596, 1607, 1627, and 1647. A desire for gold turned into an obsession; eventually morphing to the equivalent of slavery.

What modern central bankers and economists would call the "shackles of gold" was articulated eloquently by William Jennings Bryan in his "Cross of Gold" speech at the Democratic National Convention in 1896.[4] Arguing for Bimetallism (the farmers) and railing against the Gold Standard (the money-center banks), Bryan reached into history and evoked the crucifixion in his conclusion[5]:

"When a crisis like the present arose and the national bank of his day sought to control the politics of the nation, God raised up an Andrew Jackson, who had the courage to grapple with that great enemy, and by overthrowing it, he made himself the idol of the people and reinstated the Democratic Party in public confidence … Having behind us the producing masses of this nation and the world, supported by the commercial interests, the laboring interests, and the toilers everywhere, we will answer their demand for a gold standard by saying to them: "You shall not press down upon the brow of labor this crown of thorns; you shall not crucify mankind upon a cross of gold."

As discussed in our inaugural January 25, 2013 global macro issue, a thorough study of all of Fed Chairman Ben Bernanke's papers, speeches, and policy actions reveals Bernanke's (and the modern-day Fed's) inherent distrust and lack of faith in any form of gold standard. Bernanke argued that the U.S. economy could not recover from the Great Depression until she was freed of the "shackles" of the gold standard through The Gold Reserve Act of 1934, devaluing the U.S. Dollar through a re-pegging of the gold price from $20.67 to $35 an ounce. Bernanke further argued that Treasury Secretary Andrew Mellon's "liquidationist policy" fueled the crisis, and that a strong leadership at the Federal Reserve was needed to "anchor" inflationary expectations and to counter future financial and banking crises.

President Nixon removed all ties to the gold standard when he unilaterally suspended the convertibility of the U.S. dollar to gold in 1971. Since then, the world has been on a fiat currency standard (62% of all currency reserves are in U.S. dollars; 24% in Euros). A series of events shook global confidence in the U.S. dollar in the 1970s: Nixon's convertibility suspension, the Oil Shocks of 1973 and 1979, the Vietnam War, the adoption and expansion of LBJ's Great Society programs, and a general tolerance of inflation by the Arthur Burns-led Federal Reserve. Since the 1970s—despite U.S. spending on recent wars, run-away fiscal/trade deficits, and

[3] 850,000 florins is equivalent to 95,625 troy ounces of gold, worth approximately $120 million in today's dollars.

[4] William Jennings Bryan's three-hour speech for the Democratic Party nomination is now recognized as one of the greatest political speeches in U.S. history. The Chicago Coliseum immediately broke into pandemonium, and it took about 25 minutes to restore order as delegates rushed the stage, carrying Bryan on their shoulders.

[5] While Bryan was not elected President—and the U.S. reiterated its commitment to the gold standard in 1900—the story does have a happy ending for U.S. farmers and debtors. Between 1896 and 1914 (when WWI broke out), the global monetary gold supply doubled as major gold reserves were discovered and mined in South Africa. Economist John Maynard Keynes subsequently declared that such a chance event should not dictate the growth in the global monetary supply, and opposed the gold standard on such grounds.

the Fed's quantitative easing policies—faith in the U.S. dollar has been surprisingly steady. In previous commentaries, we contended the renewed faith in the U.S. dollar was due to: 1) the new energy revolution, energized by renewed domestic oil and natural gas production growth, 2) the new technology revolution, driven by the commercialization of 3-D printing, complex automation, and the revival of the U.S. manufacturing base[6], 3) the fact that other fiat currencies are simply not worthy of "reserve currency" status, including the Euro (lack of policy/political consistency). As such, we assert that the grand monetary experiment—beginning with the U.S. leaving the Gold Standard in 1971 and up to today's QE policies—is still going strong. Global confidence in fiat currencies, especially in the U.S. Dollar, remains high. In our January 25, 2013 issue, we argued that 2013 would be an "anti-climactic" year as global (and European) uncertainty will dissipate. We thus advocated a short position in gold. In 2014, we expect the European Union to stage a recovery (we are bullish on Spain, Italy and Greece). As such, global confidence in fiat currencies should remain high over the next 3-5 years.

However… Gold is Highly Oversold and Should Bottom in H1 2014 in the $1,000 to $1,200 Range

Our January 25, 2013 issue (when gold traded at $1,650 an ounce) argued that gold was hugely overbought and that the price of gold will correct to the $1,100-$1,300 range over the next 12 to 18 months—several weeks ahead of similar calls by Goldman Sachs and Credit Suisse. In our July 7, 2013 blog post, we subsequently revised our price target to $1,000-$1,200 range. Since then, the price of gold has declined, as expected. In this issue, we reiterate our call that gold should bottom in H1 2014 in the $1,000-$1,200 range. We also believe that the absolute bottom for the price of gold is $900 an ounce. From there, the price of gold should track global nominal GDP growth of 7% to 8% over the next 3-5 years. Our long-term target for gold (2020-2022 timeframe) is $2,000 an ounce, with an upward bias should global confidence in the U.S. Dollar or other fiat currencies erode significantly.

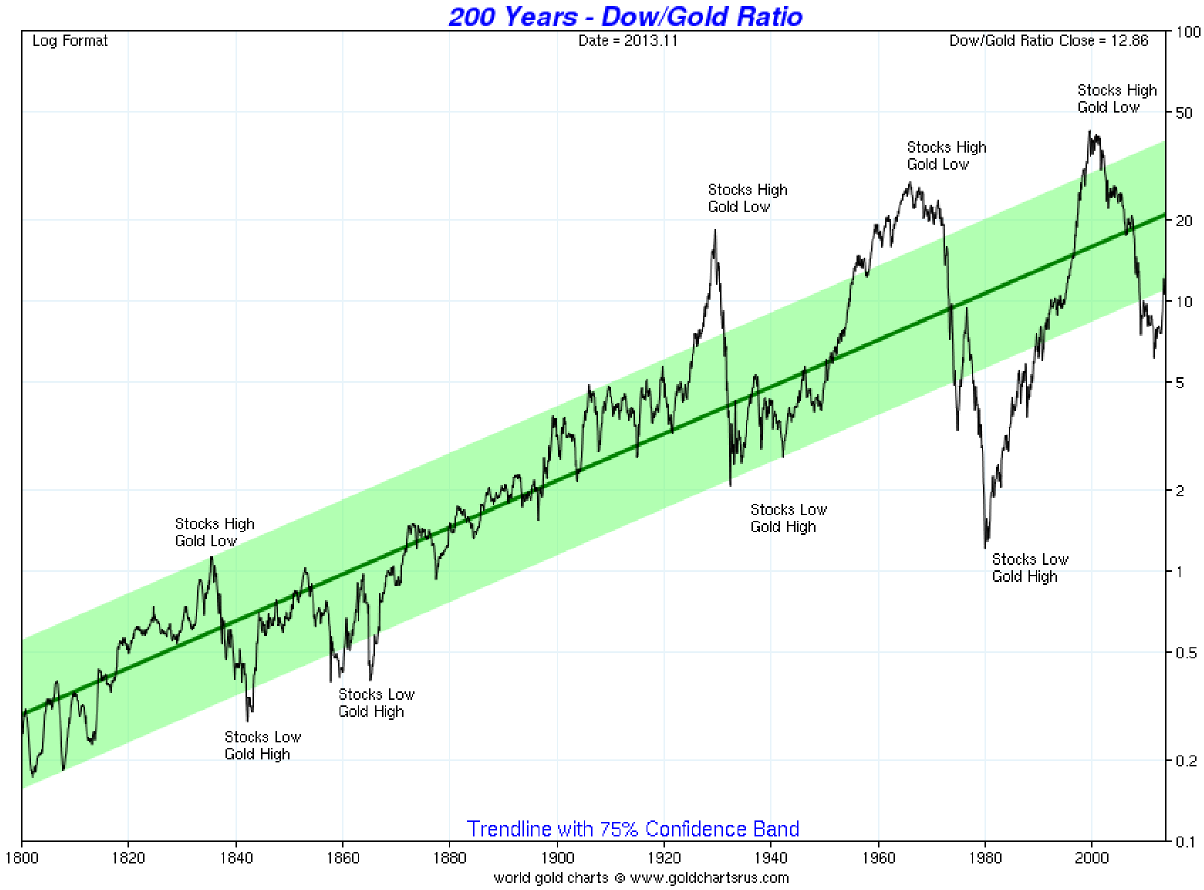
In general, three of our short-term indicators are showing signs of a highly oversold condition in gold. These three indictors will reach highly oversold levels should the price of gold decline to the $1,000-$1,200 range (gold is presently at $1,250 an ounce).

1. Gold peaked at $1,895 an ounce (London Fix) in early September 2011. A correction to $1,000 an ounce over the next several months would represent a 47% decline in a period of 2 ½ years. Such a correction is comparable to the major correction gold experienced during the last bull market, when it corrected by 47% (from $195.50 to $102.20 an ounce) from December 1974 to August 1976. Assuming gold is still in a secular bull market, a 47% correction is the largest we have experienced in modern history. Similarly, precious metals mining stocks have been the worst performing sector this year—down by 45% YTD according to Investor's Business Daily (IBD). Out of the 197 industry groups tracked by IBD, precious metals mining stocks are ranked dead last using a combination of fundamental, technical, and sentiment factors. We are not predicting that precious metals mining stocks (or the gold price) have bottomed, but they are getting awfully close. Should the price of gold correct to the $1,000 level, we will be buying with both hands.
2. The Dow-to-Gold Ratio, a "ballpark" relative valuation indicator between U.S. stocks and gold, has more than doubled from its trough of 5.88 in early September 2011 to 12.86 today.[7] A stand-alone reading of 12.86 is not high in itself, considering that the ratio has vacillated between as low as 1 and as high as 50 over the last 35 years. But given the recent

[6] The Boston Consulting Group recently estimates that the gap between U.S. and Chinese manufacturing costs (outside of low-labor content goods) will close in five years.
[7] We first covered the Dow-to-Gold ratio in our January 25, 2013 issue. The Dow-to-Gold ratio is calculated by taking the price of the Dow Jones Industrial Average and dividing it by the gold spot price. The trend of the Dow-to-Gold ratio is sometimes depicted as a battle between the forces of capitalism; and economic chaos/uncertainty, but it is more complicated than that. Consider that half of all gold demand in a given year comes from jewelry demand; or that capitalism—if allowed to function properly—is deflationary and "destructive" to obsolete businesses. The "creative destructive" nature of capitalism could collapse profit margins in certain industries in the short-run.

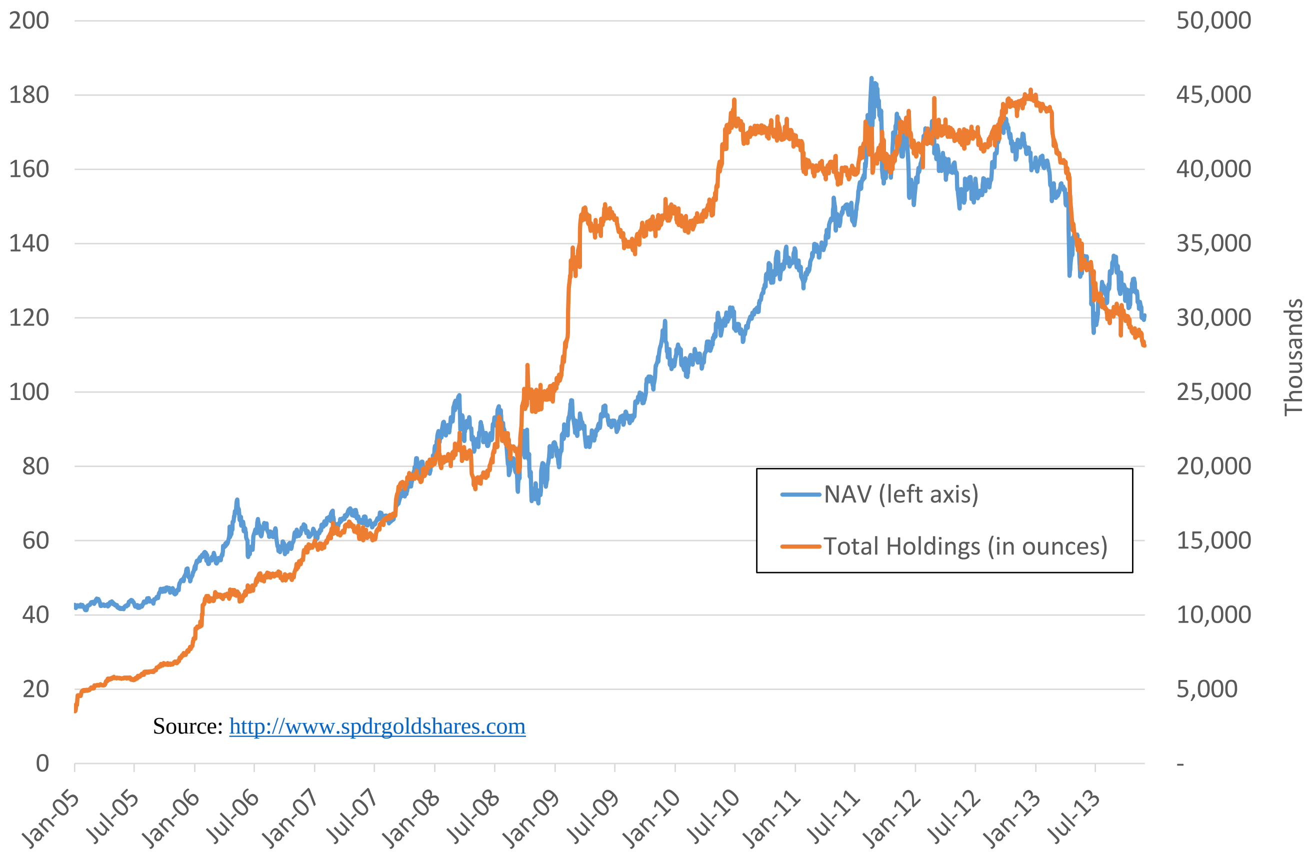
spike in the ratio—and assuming the world doesn't enter into a deflationary depression—we are overdue for a renewed uptrend in the gold price, especially if U.S. stocks continue to rise in 2014. Should the price of gold decline to $1,000 an ounce, this ratio will spike further to 16 (assuming a Dow Industrials reading of 16,000), or nearly a tripling of this ratio over the last 2 ½ years.

Figure 1: **The recent spike in the Dow-to-Gold Ratio suggests a highly short-term oversold condition**



3. Our final short-term overbought/oversold indicator is the change in the total holdings of the Gold ETF, GLD. Similar to holdings in precious metals mining stocks, retail investors have been dumping GLD en masse (hedge funds have been net short for at least the last six months). Gold holdings in GLD are highly indicative of marginal/short-term demand given its daily liquidity and the types of investors/speculators that it attracts. As shown in Figure 2 below, total holdings have declined from a peak of 45 million ounces (orange line; right axis) in early January 2013 to just 28 million ounces today, or a decline of 38%. This is the most significant decline in holdings since GLD's inception in November 2004. This dumping of GLD in 2013 by (mostly) retail investors suggests highly bearish sentiment in gold prices. As such, we believe the selling in GLD (and thus gold) is nearing exhaustion.

Figure 2: NAV of Gold ETF (GLD) vs. GLD Holdings in Thousands of Ounces (January 2005 to Present)



Source: http://www.spdrgoldshares.com

Again, we are not calling for a bottom in the price of gold yet. However, our three short-term indicators as discussed above are showing signs of a highly oversold condition. A further drop to the $1,000 to $1,200 range over the next 3-6 months will represent at least a short-term buying opportunity. Given the general neutrality in our longer-term indicators, we believe the average price of gold should then track global nominal GDP growth of 7% to 8% over the next 3-5 years. Our long-term target for gold (2020-2022 timeframe) is $2,000 an ounce, with an upward bias should global confidence in the U.S. Dollar or other fiat currencies erode significantly. We will now discuss the state of our longer-term indicators on gold; why they are generally flashing neutral signals, although we are biased to the upside given the incentive of central banks to ease global debt burdens through general inflation.

Neutral on the Price of Gold over the Next 3-5 Years, But Surprises Are Tilted Towards the Upside

My bullish position on precious metals began in late 2000, when gold traded at $275 an ounce and silver at $4.50 an ounce. At that time, virtually all of my short- and longer-term indicators for gold were all hugely (once-in-a-generation) bullish.[8] Our longer-term indicators are as follows: 1) jewelry demand, 2) industrial demand, 3) retail investors' demand, 4) pension funds' demand, 5) central bank purchases, 6) marginal cost of production of gold, and 7) confidence in the US$. In late 2000, I understood that—with the rise of China and India—both global jewelry and industrial demand for gold will inevitably boom. Secondly, demand from both retail

[8] The only possible exception was my outlook for industrial demand of gold, as I expected the U.S. to enter into a recession at that time (Chinese and Indian GDP growth were not sufficient to offset a slowdown in the U.S. economy in late 2000).

investors and pension funds were non-existent. In fact, investors were disgusted with gold, and in love with stocks (as exemplified by the Dow-to-Gold ratio hitting 50 in early 2000). Believe it or not, some corporate pension funds (fiduciary duty be damned) were 100% invested in equities at the time. At the trough in late 2000, many long-term holders of gold and silver mining stocks capitulated—I know some who had held since the early 1980s were selling at the lows! The Philadelphia Gold/Silver Index—which stood at 150 just a few years earlier, sank to just over 40 (we bought at that price). I witnessed the selling at the time—holders of physical gold and gold mining stocks were in utter despair. Thirdly, many OECD central banks were selling their gold reserves at that time, when they did not sell much when gold prices were higher. Keep in mind that central banks were not that sophisticated—central bank selling as such was a great contrarian indicator. Fourthly, the marginal cost of production of gold was substantially higher, forcing many miners to hedge their future production. Miners' hedging of production—given their inherent short positions—served to keep gold prices low. More important, low gold prices took production out of the market amongst the junior miners. Finally, I asserted in late 2000 that both the fiscal and trade deficits would rise. Combined with Fed Chairman Greenspan's inclination to ease interest rates, I asserted that the US$ would enter into a bear market, which would benefit gold prices. Let us now review where our longer-term indicators currently stand.

Figure 3: Today, Our Longer-Term Indicators for the Price of Gold are Generally Neutral

Impact on Gold Prices: (1 = Very Bearish, 5 = Very Bullish)	Very Bearish	Bearish	Neutral	Bullish	Very Bullish
Jewelry Demand			X		
Industrial Demand			X		
Retail Investors' Demand		X			
Pension Funds' Demand				X	
Central Bank Purchases			X		
Marginal Production Cost				X	
US$ Confidence			X*		
Average Rating	3.14 (1 Bearish, 4 Neutral, 2 Bullish)				

* High uncertainty given tremendous political and Federal Reserve policy uncertainty over the next 5-10 years

The average equal-weighted rating for our longer-term indicators is 3.14, which is generally neutral (titled a little towards bullish for gold prices). More specifically:

- **Jewelry and Industrial Demand (60% of all demand):** This is tricky to analyze, given the many moving parts. Consider that the vast majority of global jewelry demand come from India and China. Firstly, I believe both China and India are sufficiently protected from any financial dislocations over the next several years. The European Union is picking up, which would boost demand for Chinese goods. Secondly, the recent decline in oil prices (and ongoing supply growth from global shale plays) would limit the deterioration in both the Chinese and Indian trade deficits. We are still looking for another new low in the Indian Rupee this year, but we foresee no dislocation. This will support jewelry demand from India and China. Our indicators for global industrial demand for gold are also in neutral territory. Global economic growth should accelerate in 2014, but industrial demand for gold is relatively inelastic—i.e. it is not too response to economic growth, nor price changes. At the same time, we should be more cognizant of cultural and financial structural shifts in India and China. Remember that much of Indian jewelry demand is cultural in nature; and even though it is classified as jewelry demand, many Indians and Chinese purchase jewelry for investment purposes.[9] For a 21-year old Indian working at Infosys, would the new status symbol be gold jewelry or a new iPhone 5s (or chatting on a new iPhone at SBUX)? We surmise it is the latter. Furthermore, both Indians and Chinese have relatively few investment options for diversification purposes. As Indian and Chinese regulators liberate their financial systems, Indian and Chinese investors will gain more access to global financial products—thus dampening long-term Indian and Chinese gold demand growth. For now, we will rate this as "neutral" for longer-term gold prices.

- **Retail Investors' and Pension Funds' Demand (36% of all demand):** Both U.S. retail and pension fund investors are notorious for being contrarian indicators, although typically for different reasons (retail investors tend to get in at the tail-end of a boom, while pension funds are bureaucratic and thus slow-moving). Despite the recent decline in GLD holdings, retail investors are still relatively bullish on gold vs. stocks; while pension funds have ceased new investments in gold altogether. We would rate retail investors as having a "bearish" impact in the longer-term, while pension funds a "bullish" impact. Together, they balance out each other.
- **Central Bank Purchases (4% of all demand):** According to the World Gold Council, global central banks and international organizations such as the IMF hold about 20% of all above-ground gold (approximately 30,100 tons). Much of this gold is held by Western Europe and North American countries, given the legacy of the gold standard. Prior to 2009, central banks have been net sellers of gold for 21 consecutive years. Today, central banks are accumulating gold as insurance against another financial crisis, and as emerging market countries continue to grow their foreign reserves. Recently, central bank purchases have slowed down (Russia sold gold in September for the first time in 12 months), as the US$ strengthened against EM currencies. We rate central bank purchases as having a "neutral" impact on gold prices in the longer-term as the initial burst of purchases during and post the financial crisis seemed to have slowed down significantly. Unless the price of gold declines to $1,000 an ounce, central bank purchases should remain low for the foreseeable future.
- **Marginal Production Cost:** According to a Goldman Sachs September 2013 report, the marginal cost of production for gold is currently $1,300 an ounce. We believe it has dipped since then, given declining fuel costs and as more automation starts to take hold in the mining sector. Marginal cost of production is the sole fundamental benchmark that is the most easily measurable. Nonetheless, recall that 85% of all gold ever mined in history is still in circulation today—so year-to-year production shifts don't have much impact on price (unlike crude oil, for example, which is a perishable commodity). We view this as having a "bullish" impact in the longer-term, as current gold prices are very near the marginal cost of production.
- **US$ Confidence:** As we argued in our previous commentaries and blog posts, confidence in the US$ has recently returned, and rightfully so. That said, there are longer-term counter-balancing forces to a more bullish outlook on the US$, such as

[9] In Modern Portfolio Theory, this means Indians and Chinese investors have a very narrow efficient frontier, as they do not have many investment options.

the U.S. government's unfunded promises to the elderly, including Social Security and Medicare/Medicaid. Actuaries currently put the present value of these unfunded liabilities at over US$60 trillion. The key would be to reduce these obligations through: 1) more efficient healthcare delivery (such as remote care/monitoring and robotic technologies), 2) pushing back retirement and benefit eligibility ages, 3) quasi-default through currency inflation. As such, we rate this impact to be "neutral" over the longer-term, although there is high uncertainty in this indicator.

Any investment in gold in the $1,000 to $1,200 an ounce range—despite its short-term oversold condition—should be treated as just another form of diversification or insurance plan in case inflationary expectations take hold. For now, inflationary expectations remain well-anchored, but this could change quickly as baby boomers begin retiring and draw their benefits. We anticipate significant social dislocations given the widening gap in wealth/income between the young and the old. We foresee more support for inflation in the future, similar to the time of William Jennings Bryan when farmers/debtors supported higher inflation to ease their debt burdens. Similarly, a 22-year old fresh U.S. college graduate with $50,000 of student loans would have no problem supporting higher inflation, especially if his parents possessed no financial assets. This is why we have an upward bias in gold prices, even though we expect it to track nominal global GDP growth over the next 3-5 years. An investment in gold is an insurance plan for a politically-supported and systematic plan to inflate the currency (the Italians were used to this prior to the Euro adoption).

An Attractive Insurance Plan: Buy Low-Cost Producers in Politically and Wage-Stable Environments

One usually pays a premium for an insurance plan. In this case, we believe a purchase of low-cost producers in politically and wage-stable environments as not just an insurance plan, but a decent investment as well. Unless the world enters a deflationary depression (although gold miners were the best performing group during the Great Depression; President Roosevelt outlawed all physical gold holdings, so investors had no choice but to purchase gold mining stocks), we believe the absolute bottom for the price of good is $900 an ounce. Our base case calls for a bottom in the $1,000-$1,200 range in 1H 2014; then for it to track nominal GDP growth of 7 to 8% over the next 3-5 years.

Our long-term target for gold (2020-2022 timeframe) is $2,000 an ounce, with a tilt towards the upside should global confidence in the US$ wanes. Purchasing low-cost producers would be relatively safe even in a deflationary period; but would also provide significant exposure should the price of gold surprises on the upside. We like miners in politically and wage-stable environments, as we believe the frequency of labor/societal conflicts in areas like Africa and Mongolia would be higher than usual over the next 3-5 years. Certain U.S. miners look attractive at current levels. We believe an attractive investment awaits us in low-cost U.S. producers over the next 3-6 months.

Biography

Henry To, CFA, CAIA, FRM

Partner, Head of Research

Mr. To currently serves as Partner and Head of Research for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including education, crime, drug, national security, and international policy. Mr. To will again be teaching at the UCLA Luskin School of Public Affairs in summer 2014. In addition, Mr. To has been an instructor in the USC/CFALA Review Program, where he taught the CFA Exam Level II Economics section. Mr. To has been interviewed and quoted by the New York Times Business Section, the Wall Street Journal, among other publications. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, an MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.

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