Part 2: There is no way out! The markets are on a "high". Gold will show the way!

The current correction in gold is not unusual! It also happened in the '70s. We could go to $1,000 or even $700. Though the bull market is not over if anything it is only beginning!

From January 1975 to September 1976 the gold price fell by 47.8% from $192/oz to $100/oz (see chart here below) before taking off to $850/z. On September 2011 gold reached an all-time high of $1,923.70/oz. Since then it has fallen to a low this year of $1,179.40/oz on June 28, 2013, a fall of 38.7%. In order to match the 47.8% decline of the seventies gold would have to go to $1,004.17 (see also the Aden sisters gold chart where the $1,000 level equals the 2008 top).

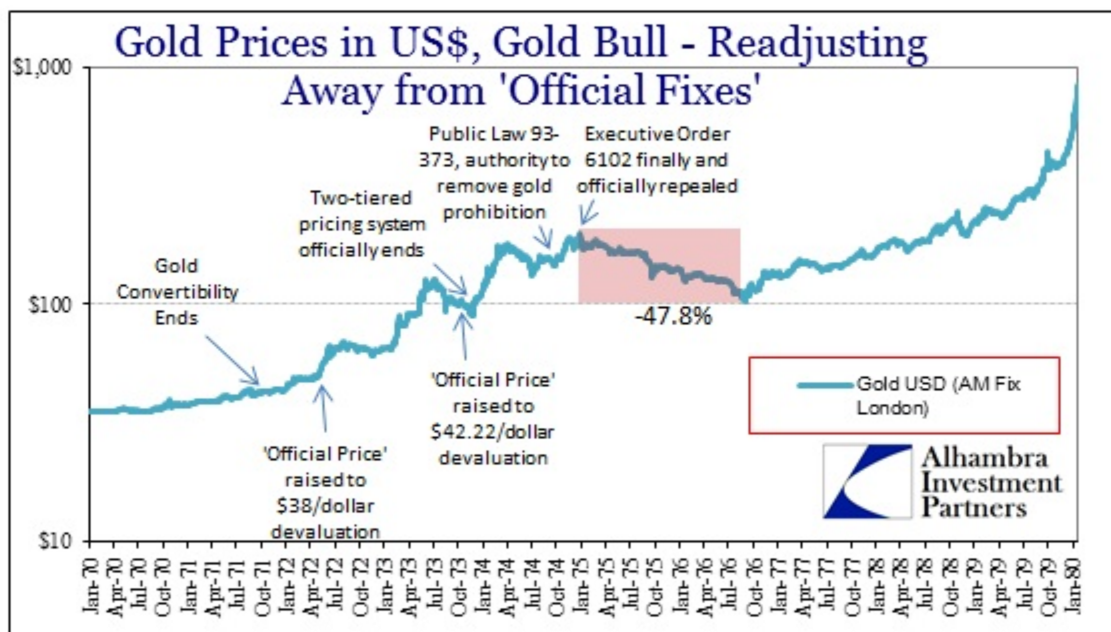


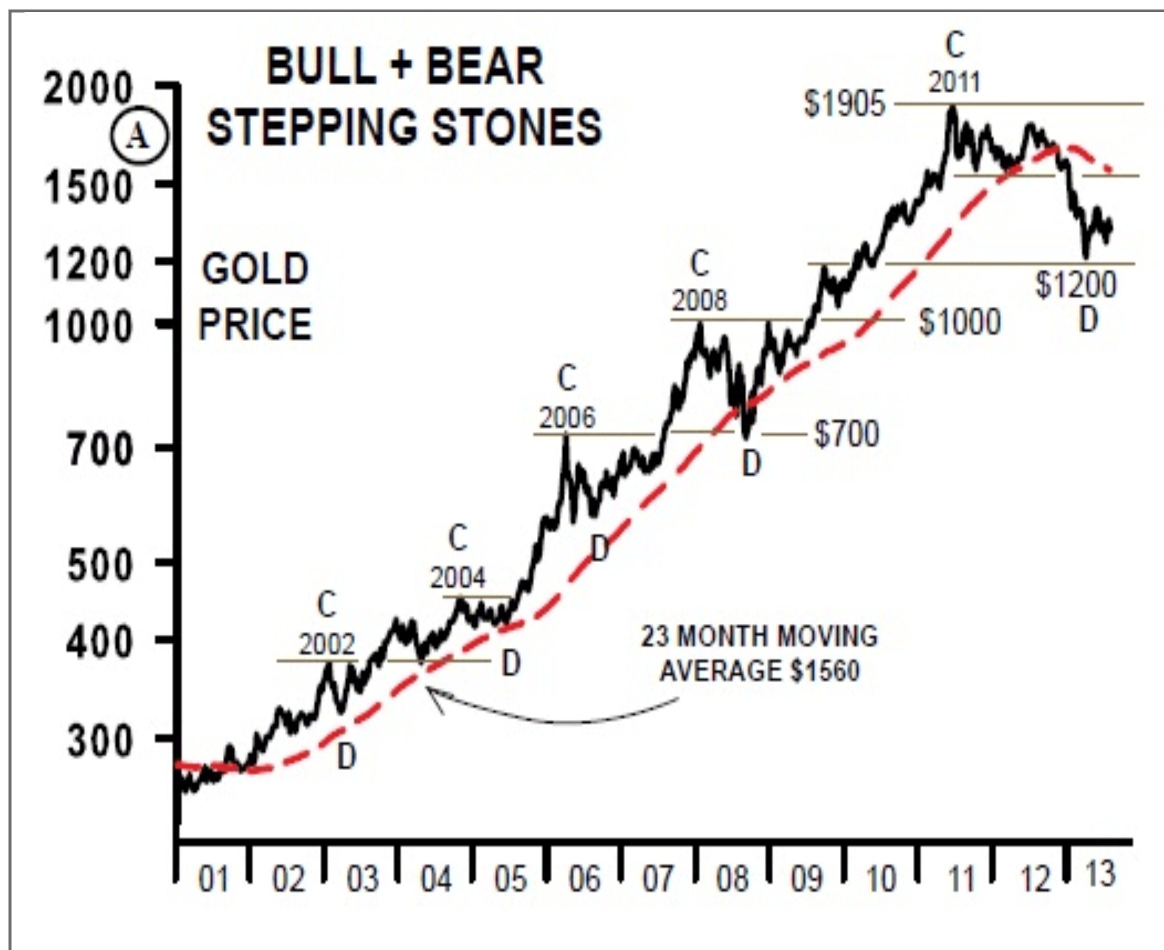
Chart of the gold crash of 1975

What we can learn from the Great Crash of 1975-76 is that exogenous factors (politics, monetary policies, liquidity conditions) can have an outsized influence in gold prices regardless of fundamental conditions. However, ultimately fundamental monetary properties of the global system will determine the real value of everything from fiat currencies (paper money) to real money (gold) over the longer term hence why gold went after the reprieve to $850/oz. In January 1980 gold was fixed at a record $850/oz following high inflation, strong oil prices, Soviet intervention in Afghanistan as well as the impact of the Iranian revolution.

By the way in the seventies silver declined earlier than gold. It fell from $6.55/oz in February 1974 to $3.90/oz in September 1974 or 40%. A similar fall of 40% today from the $49.21 peak in April 2011 would give a silver price of $29.52. At today's price of around $19.50/oz silver has already fallen by 60% from the peak and could even fall further to the $15-$16 level in my point of view. We shouldn't disregard that the silver market is a much smaller market than the gold market hence its stronger volatility and extreme moves. But don't be mistaken the same happens on the way up.

On average, and across the last 42 years, a 1% move in gold is matched by a 1.75% move in silver, both up and down. In other words the 47.8% fall in gold would equal a 1.75 x 47.8% = 83.65% decline in silver to (100%-83.65%=16.35% of $49.21) $8. I believe this is highly unlikely because at one point massive physical buying will kick in. Why? Because investors, especially the ones in the Far East, will believe that silver will represent much more value than the paper value of the currency it is denominated in: US dollars.

Anyway my point is that n'importe quai today's decline in the gold price, the main reasons to buy gold, the debasement of the US dollar and other currencies and out of control debt, haven't changed. In fact the conditions are favoring gold even more with uninterrupted increasing government debts, continuous country downgrades, geopolitical tensions (Syria, Iran, China) and constant loss of credibility of the US Government. If history is any guide for the future have a look at the following chart from the Aden sisters.



Aden sisters gold chart with its mega 23 month moving average.

During the up moves, the C peaks generally mark the support for the future D declines. The interesting point today is that the low in June near $1.200/oz is still higher than the prior C peak in 2008 of $1,000/oz. This is technically a good sign and if $1200 holds, it'll be a bullish signal. Though if the June low is broken for a few days, we could then see the $1000 level tested, the 2008 prior C peak. This would coincide with the 1975/1976 47.8% correction. This would probably be the worst case scenario although I don't exclude that depending on market conditions, a sell-off in the general markets following tapering or other reasons, the gold price could spike down to $700/oz. because of liquidation following redemptions, so purely for technical and not fundamental reasons. Though as mentioned here above strong physical demand, especially driven by Chinese demand, will put a V bottom in the market and cause a very strong rebound in my point of view.

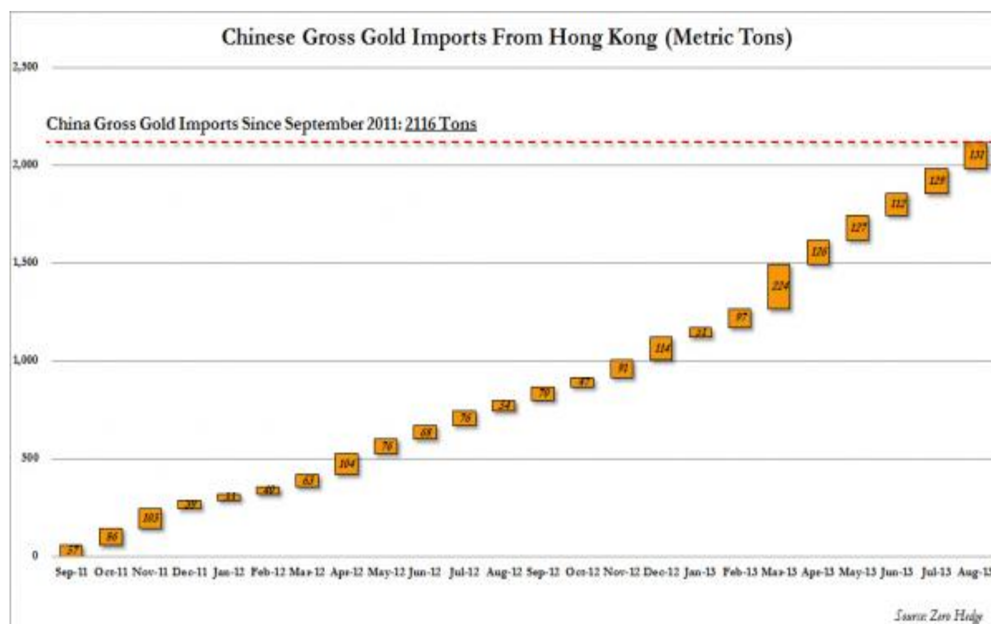
The Chinese continue to buy record amounts of gold

In China the gold rush continues as Chinese people buy jewelry, coins and bars as a store of wealth to protect from inflation. The world's largest jewelry group,

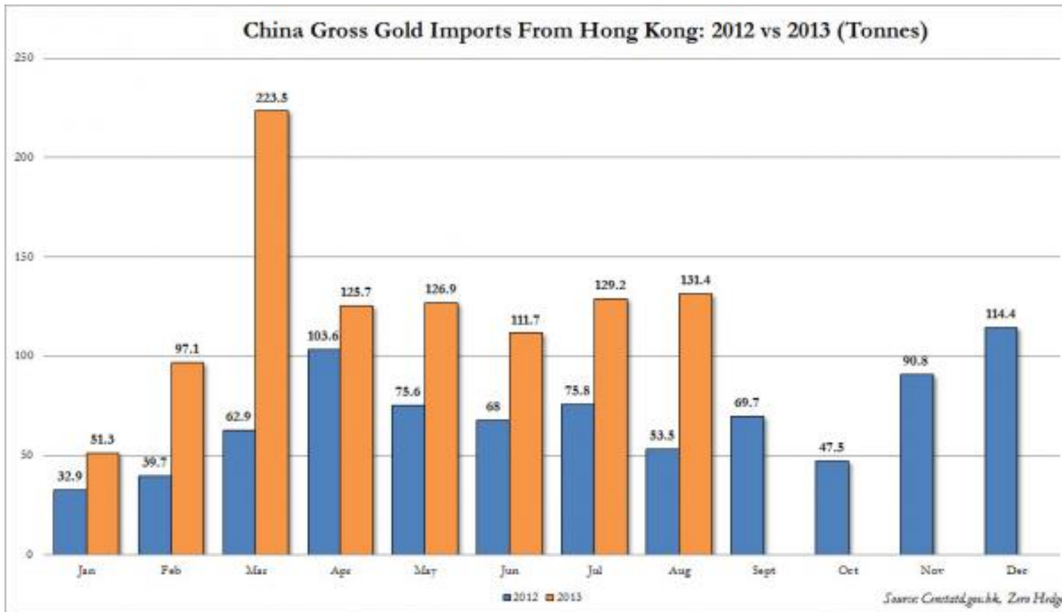
Chow Tai Fook Jewelry Group Ltd., established in 1929, saw sales jumped 49% during the first half of 2013. Jewelers in China and throughout Asia are benefiting from continuing robust demand for gold. This has led Chow Tai Fook and jewelry outlets having to buy gold bars and rebuild gold inventories. Retail sales of gold tripled across China after the peculiar “flash crash” of April 15-16 when gold fell 10% in two days. Demand has remained robust and the recent weakness has seen continued demand. “Tai Fook” means “big blessing” in Chinese!

According to a story on Zero hedge gold shipments to China from Hong Kong rose in October to the second-highest on record, as mentioned jewelers and retailers bought the metal to build up inventories ahead of a peak-demand season at the end of the year. Net imports, after deducting flows from China into Hong Kong, were 129.9 metric tons in October, from 109.4 tons in September, according to calculations by Bloomberg based on data from the Hong Kong Census and Statistics Department. Purchases reached an all-time high of 130 tons in March, with the amount in the first 10 months of 2013 more than doubling to 955.9 tons from a year earlier, the data show.

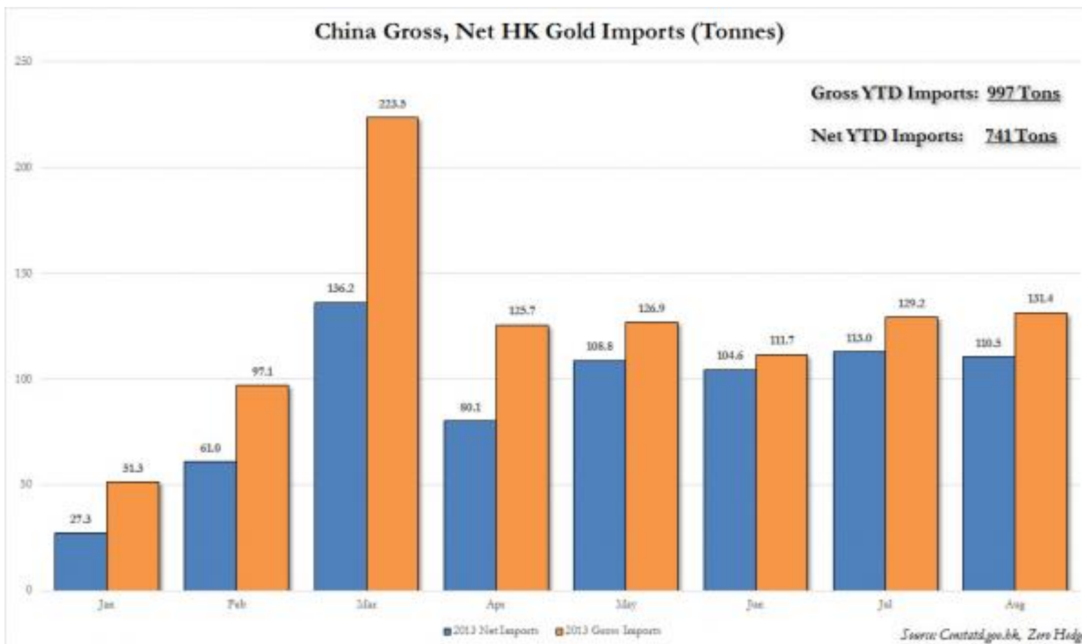
As the chart below shows, in the past two years since September 2011 the mainland has imported an unprecedented 2,116 gross tons of gold from Hong Kong (in addition to the hundreds of tons produced domestically)



In the next chart we see how much imports have increased in 2013 compared to the previous year.



The next chart shows gross and net exports to China. Since imports so far account for just two-thirds of the year China will likely import over 1500 gross and over 1000 net tons for all of 2013: an absolutely stunning record in gold demand by just one nation.



Anyway the point is, as is discussed in former articles, that China is accumulating gold at a pace never seen before and clearly is challenging, by doing so, the hegemony of the US dollar as the reserve currency. And the main reason is that the US has let it come so far by its irresponsible monetary and fiscal policies. If the US dollar wouldn't have weakened as a result of these reckless policies gold wouldn't have a chance of challenging the US dollar supremacy and would

neither have given the Chinese the chance of a lifetime.

Stockman, former director of the budget office, is warning of "the mother of all bubbles"

Americans should be bracing for the explosion of a "mother of all bubbles" brought about by the Federal Reserve's gross and irresponsible manipulation of interest rates, according to David Stockman, the colorful supply-side economist and director of the Office of Management and Budget under President Reagan.

The central bank has created a false prosperity that shows up in an overpriced stock market, Stockman told Fox Business Network. The Fed's massive stimulus since 2008 is "the greatest gift to the 1 percent, to the speculators, to the leveraged traders, to the carry trade ever imagined," he said.

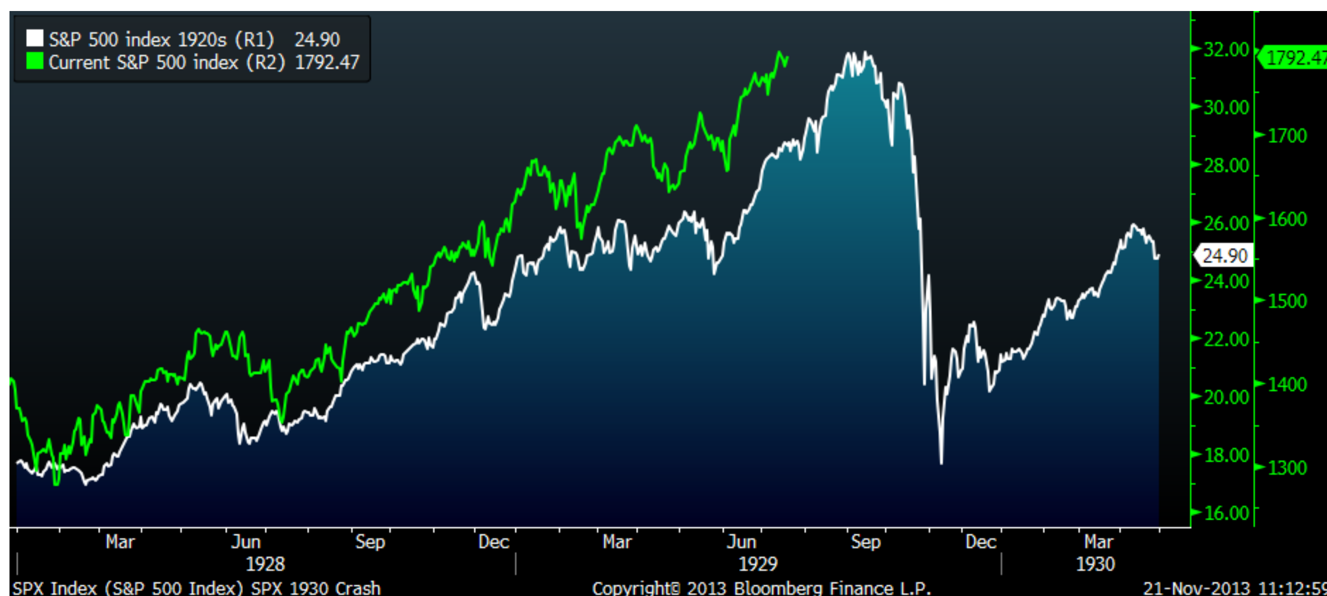
"Now we have the greatest mother of all bubbles. And there's nobody left in the stock market today except drugged-up day traders and robots that are being mainlined by the daily injections of liquidity from the Fed. This is utterly irrational."

By suppressing interest rates in an effort to stimulate the economy, the Federal Reserve's quantitative easing campaign boosted borrowers and banks at the expense of retirees and other income-oriented savers and investors. A recent report from McKinsey Global Institute (MGI) estimate that between 2007 and 2012, U.S. households cumulatively lost $360 billion in interest income compared with what they would have earned if rates had followed their pre-recession trends. Though MGI estimates that low interest rates boosted U.S. real estate values by 15% and contributed to a 37% increase in bond prices. Those factors together, excluding the stock market gains, meant a $5.6 trillion increase in household wealth (be aware this is different from GDP, jobs economic growth) of which mainly the top 10% benefitted. Though one has to wonder what happens to these "gains" when interest rates break out of their 32-year downtrend.

The United States is at the mercy of the same crew of central bankers who brought the nation the dot-com crash and the housing bubble, according to Stockman — not exactly a track record of success.

Another Wall Street Crash Coming?

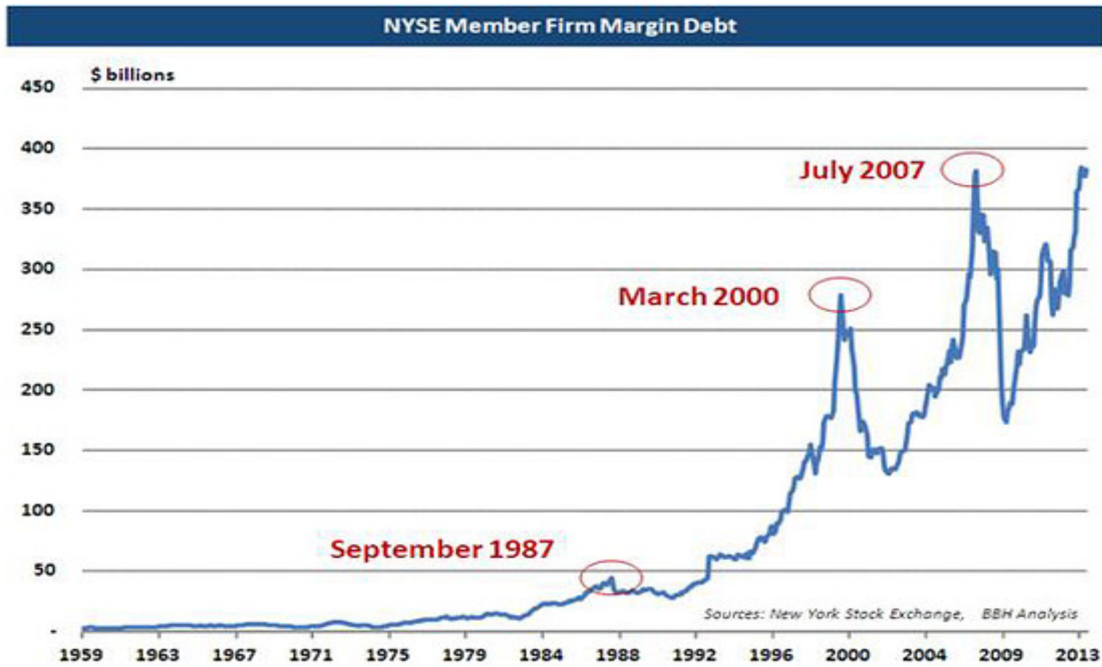
See the chart below showing the analogies between the S&P500 in 1929 and now. Although the circumstances are different they are the same! And if "L'histoire se repete" we are close to the top. Aren't charts a reflection of the psychology of investors?

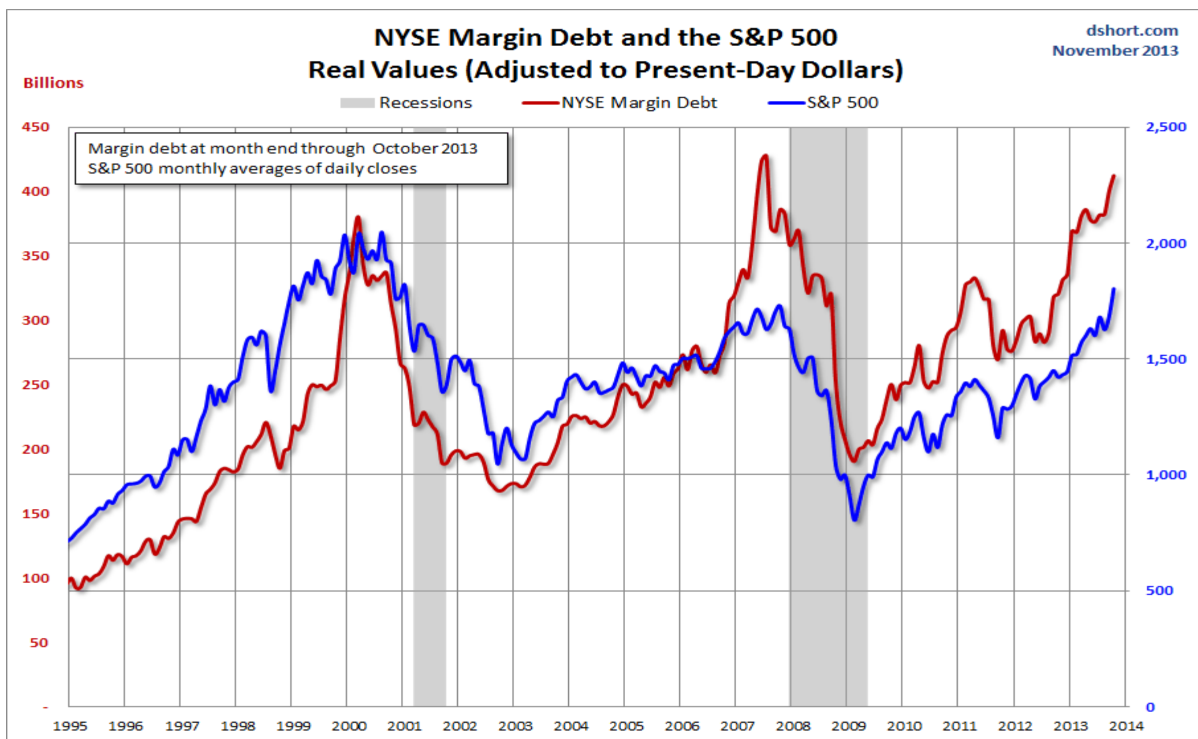


Some cycle theories are also indicating that a peak in general markets is near calling for a to in January/February 2014. Next to the lower gold price the record margin debt could be another factor indicating that we are close to the top.

High-margin debt flashing warning signal

Margin debt hit a pre-crisis peak of $378.2 billion in June 2007, just a few months before the highs in October, and reached a cycle low of $173.3 billion in February 2009, a month before the market bottom prior to the current bull run. As investors feel emboldened by the seemingly unstoppable stock market rally, they're borrowing money at record levels to keep things going. Moreover there is no other place to go. October 2013 margin debt—a measure of how much market participants are borrowing to buy stocks—soared to $412.5 billion on the New York Stock Exchange. The number represents a 13.2% increase from the beginning of 2013 and is fully 50% higher than the level in January 2012.





Other indicators include slowing earnings growth and valuations that appear "full" at current levels. Investors seem to be so confident in the market that they believe they're safe by funding their purchases from other sources and the market will rise sufficiently that they'll be able to repay their debts and pocket an attractive profit.

Whilst earnings have been rising only moderately and the economy has been more or less stagnant the Standard & Poor's 500 rose an impressive 28% with similar gains in the other major indexes. Blame it on the 33% increase of the Federal Reserve's balance sheet and the margin debt increase leading to the multiple expansions because the earnings don't justify it.

Under the stretched market conditions a market-moving event, another Washington budget crisis or taper resulting in (much) higher interest rates could be the trigger for a selloff of at least 25% in my point of view. Most experts see the Fed beginning to decrease the amount of its $85 billion monthly bond-buying program in March, especially after the strong Q3 GDP figure and the adding of 215,000 jobs in November, that could send negative market signals with respect to interest rates as witnessed earlier in the year.

Bitcoin, alternative to controlled currencies or manifestation of bubble (a la tulip mania) in markets

And especially under the current circumstances the emergency of Bitcoin (www.bitcoin.org) is interesting to say it at the least. Bitcoin is a "virtual" currency it is a digital currency or crypto-currency, that has no intrinsic value, that allows users to exchange online credits for goods and services. Price is set by supply and demand. While there is no central bank that issues them, bitcoins can be created online by using a computer to complete difficult tasks, a process known as mining. Some 12 million bitcoins are believed to be in circulation, with a cap of 21 million—meaning no more bitcoins can create after that point.

Putting aside whether the novelty of Bitcoin can survive any number of stress tests, which it is undergoing now in China, operating outside of the existing central banking cartel's fiat scheme has enormous appeal, it clearly shows the appetite for an alternative to any fiat currency uncontrolled by deceiving central banks/governments.

After the People's Bank of China outlawed the country's banks from using it, Bitcoin dipped around $200 in value below $1,000 on Thursday December 5, the currency was trading at $980 on major exchange Mt Gox and $932 on CoinDesk's index, which measures of basket of prices around the world. Bitcoin rallied to $1,200+ last week almost the same price as gold! Two weeks ago, it traded at $460.

A statement released on the website of the China's central bank detailed Bitcoin volatility and its risks regarding price speculation. It added that it could be exploited by criminals and facilitate money laundering and terrorist financing activities. With this in mind, the central bank said it was barring financial and payment institutions from using bitcoin, including buying and selling or insuring bitcoin-linked products. It added that ordinary individuals were free to use bitcoin but it had no legal status in the country.

Is the prominence of Bitcoin an indication that the world finally waking up to the central banker's huge fiat Ponzi scheme or is it an expression of the bubble we are in, or both? It reminds me of the Dutch tulip mania of 1637 which expressed the blatant disconnect between an asset price and its fundamental value. At its peak, the price for a single tulip bulb in 1637 stood at 10 times the annual income of a skilled Dutch craftsman. The tulip mania was in my point of view just an expression of wealth and greed fuelled by the perceived scarcity and uniqueness whilst having no functional usefulness whatsoever. The crazy prices for tulips had lost any touch with reality, an extreme deviation of prices from fundamental values and the end of an era.

Conclusion

Gold dropped on Monday December 2, 2013, as the dollar strengthened and investors awaited a series of U.S. data later in the week that could provide clues on when the Federal Reserve will begin scaling back or tapering its monetary stimulus program.

Though on December 4 when the Private-sector hiring report for November was released and showed that 215,000 jobs were added (178,000 were expected), the 10-y interest rates went to 2.85% whilst gold jumped approx. $25. Gold in my point of view should have gone down because a stronger economy bodes well for the US dollar and thus not for gold (inverse correlation). It is probably because investors were getting scared that the bond market might suffer some substantial falls if and when yields will exceed the 3% level (moreover everybody owns treasuries and everybody wants out when interest rates break out of the 32 year downtrend) and therefore take out an insurance in the form of gold. This is the only explanation in my point of view. Important to keep this in mind for the future.

There is no way out! The reason I choose this title for this article is that even if the economy is perceived to improve, hence higher interest rates, the resulting

higher interest rates will implode the huge overhanging debt (worldwide debt is estimated at some $220trn+), which in turn will eradicate any improvement in the economy. At present we already have huge problems financing the overall debt and not only at a Federal level, see Puerto Rico or Detroit (pensions will be cut!), so imagine what 10-y treasury interest levels of 5% or 6% would do to budgets and the overall economy. By 2020 entitlement expenditures of the Government will be $2.5trn or 2/3 of the current budget!

And Europe improving? Hell no! The European markets – the United Kingdom FTSE-100, French CAC-40, German DAX, and Dutch AEX in particular – tend to follow the patterns of the US market very closely though of the three major European indices, only the German DAX is near its record high of 9425. The French index is well below its 2007 high – which was also well below the 2000 high. The U.K. market is sagging considerably as the U.S. markets have pushed higher. The Dutch AEX index – while pushing to new recovery highs in the latest advance – remains well-below its previous cycle all time high of 702 in September 2000 and is now at 383.

Anyway as earlier mentioned there would be no need for gold as a currency when the US dollar is strong. Only when the reserve currency is weak and the US monetary policies undermine the credibility of the US dollar gold will come to the fore as the ultimate currency. At the same time investors should be aware that the US is giving the Chinese the opportunity of a lifetime to buy gold on the cheap with a strongly devalued dollar. And at the same time the US is enabling the Chinese through their gold purchases to take over the reigns of the reserve currency. Again if the US would have been more responsible with its policies ensuring a strong dollar its hegemony couldn't be touched by gold and not by other currencies such as the Renminbi (the Chinese have economic power and gold reserves). Moreover who has the gold has the power in case of a weak and undermined reserve currency. Anyway I believe we are on an all-time high, and yes I mean both highs.

December 7, 2013
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