Cheap at $2000 an ounce

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As spot gold prices zipped past $2000 an ounce on Aug 04th, it portended a historic moment that implies a lot more than a nice round number on the price of a commodity. As I will explain, what lies ahead is a disorderly change in the world's monetary system and one that will eventually bring back gold as the lynchpin around which world commerce functions. More than a 100 years of solitude in which gold was hitherto viewed as a barbaric relic is pretty much at its end and from the ashes of the dollar and other fiat currencies, we shall witness gold rise as a Phoenix.

When I wrote the Trilogy of "Would 2019 be a 1929?" (Part I, Part II and Part III published in Jan, Jun and Dec 2019), it was viewed either as a novelty or a blasphemy depending on the political perceptions of the reader. Fast forward a short 18 months, plenty of commentators have pointed out the similarities between what is happening today and what occurred during the stagflationary seventies (1971-1981) and the Great Depression of the thirties (1929-1946). But as I had outlined, we are going to inherit the worst of both the above periods. The consumer price inflation is going to be much higher as compared to the 1970's and the GDP contractions are going to be more pronounced than what we witnessed during the 1930's. In fact, the 2019 US GDP of $21.4 Trillion will not be eclipsed, in real terms, atleast for another decade if not for a much longer timespan.

What lies ahead for the US Economy is not a V or a W or L shaped recovery, but a long downward inclined staircase which could potentially lead to an abyss. On current trajectory, that is not only a possibility, but the most probable outcome. Barring dramatic changes to monetary and fiscal policies – not coincidentally, the exact opposite of what has been pursued in a bipartisan manner over the last few decades – the US Dollar would not only lose its status as the world's reserve currency, but is more than likely to meet the fate of the continental.

The Misesian "Crack-Up Boom"

The theoretical underpinnings of the above scenario can be best described by the "Crack-Up Boom" as Ludwig Von Mises had postulated. As he explains in his book Human Action "[I]f once public opinion is convinced that the increase in the quantity of money will continue and never come to an end, and that, consequently, the prices of all commodities and services will not cease to rise, everybody becomes eager to buy as much as possible and to restrict his cash holding to a minimum size," he said. "For under these circumstances, the regular costs incurred by holding cash are increased by the losses caused by the progressive fall in purchasing power."

Translating the above into more understandable language, what Mises postulated involves two specific pre-conditions for an economy to undergo the CUB.

1. An excessive increase in the monetary base towards the end of a normal business cycle in order to sustain the boom-time malinvestments i.e. asset bubbles.
2. As these asset bubbles reach a point of an impending implosion, the central banks have to choose between the two stark alternatives
    A. Refrain from creation of further credit leading to a disorderly fall in asset prices, business bankruptcies resulting in a disinflationary recession.

B. Accelerate the expansion of money supply in order to sustain the business cycle and delay the recession. In the face of this continuous credit expansion, consumers inflation expectation accelerates to a point where the rate of price increases outstrips the rate of central bank money expansion. This necessitates an even greater use of the monetary spigots until the end stage of hyperinflation makes the currency worthless.

While the trilogy referred above was essentially a forecast based on the above hypothesis, at this point, the Crack-Up Boom is no longer a forecast. The US Fed Crossed the Rubicon of choosing Option B (i.e. accelerate the expansion of money supply) when it started the rate cuts in July 2019 (referred to as "insurance cuts" by Powell) and QE4 ("not QE" according to Powell). All of this happened in the pre-Covid era and all that Covid did was to provide an impetus to the expansion. But the monetary easing process had started much earlier and Covid provided a very academically convenient cover.

Though I should point out at this juncture that had Covid really been the pandemic (and I do not subscribe to this view at all; but that's a different discussion altogether) as is being claimed by the WHO, CDC and indeed governments around the world, then the appropriate response ought to be a contraction of the money supply rather than an expansion. It is only under the perverse perceptions of Keynesian economics that every issue in the world requires the hammer of monetary easing.

So what are the signposts that we are living through the Crack-Up Boom? Ofcourse, by definition, it would be a steep expansion in the money supply. But even the bond vigilantes no longer seem interested in tracking that number these days. The most likely mainstream indicator is going to be the recognition of a double-digit Misery Index (inflation + unemployment) within a 12 to 18 months window. Measured accurately, both inflation (i.e. "16% trimmed-mean CPI" instead of CPI or core-CPI) and unemployment ("U6" instead of "U3") would each likely be in double digits in that time window. The Fed has been clamouring for inflation for the last few years and the markets are about to given them a poignant reminder of "Be Careful What You Wish For'.

US Fed in Full Throttle

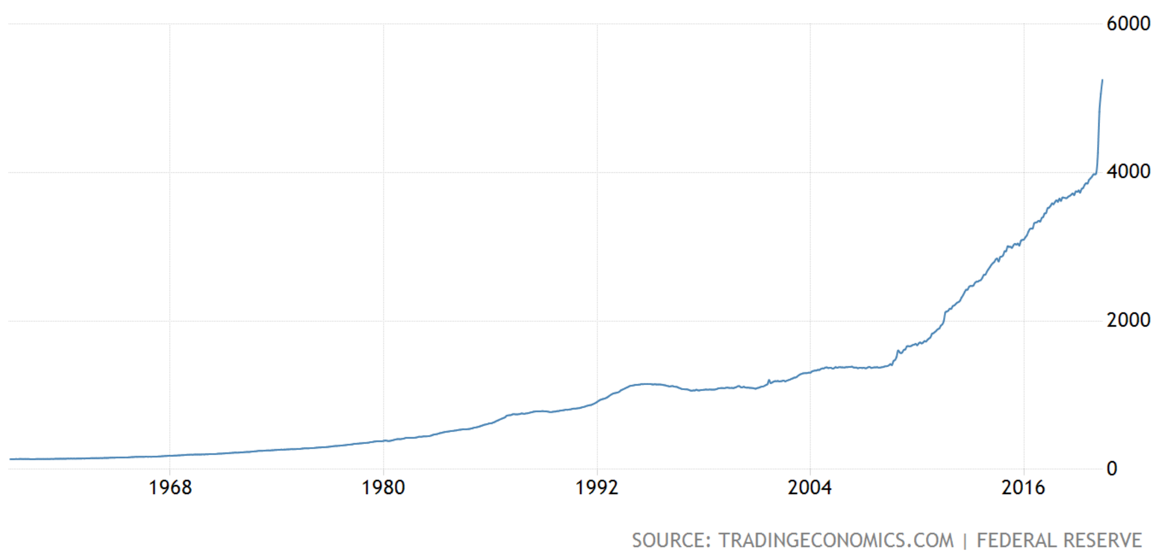

Chart of M1 from 1950 (Billions of dollars)

If ever one was dismissive about the possibility of a Crack-Up Boom, a cursory glance at the money supply chart and any lingering hope would vanish instantaneously. Right from its inception in 1913 to the beginning of this year, the Fed's M1 had reached 4 Trillion dollars. Before the end of this year, we are more than likely to hit 6 Trillion dollars i.e. 50% of the money it has created in all of its 107 year history to be created in just this calendar year.

Given below is the history of M1 growth since inception and its easy to observe the acceleration over the last few months

1st Trillion – 80 years (1913 – 1993)

2nd Trillion – 18 years (1994 – 2011)

3rd Trillion – 5 years (2012 – 2016)

4th Trillion – 4 years (2017 – 2020)

5th Trillion – 4 months (Feb 2020 – May 2020)

While the Covid crisis (real or manufactured is not relevant anymore though) played a huge part in this acceleration, now that the bubble has been pricked, there is no going back. The dominoes that are lined up – housing bubble 2.0, auto bubble, student loan bubble, Nasdaq 2.0 bubble, junk bond bubble – will ensure constant infusions of the monetary heroine by the US Fed to keep the zombie economy afloat. The number of bailouts that would be required over the next few months pretty much guarantees that the M1 growth will stay on current trajectory. Again, this is really a bipartisan issue and whether its Trump or Biden in 2021, would make little difference to the outcome.

Gold Prices – Cheaper at $2000 an ounce in 2020 compared to $35 in 1971?

Fundamental to this comparison is the recognition that gold is money and that the federal reserve notes that circulate today have value only because they represent a claim against money. So for a relative comparison of gold prices between today and 1971, we can ignore the various technical factors that ought to be used to value gold i.e. should we use M1 or M2?, what % backing should be considered i.e. 20%, 40% or 100%. Ofcourse, we will get to these factors in the next step, but for a relative comparison, these can be ignored.

If we just compare the Money supply ratios $M1_{2020}$ / $M1_{1971}$ or $M2_{2020}$ / $M2_{1971}$, we can see that these are up about 30 times. Gold prices on the other hand are up about 60 times and so looks relatively fairly valued. But what this comparison ignores are some critical differences between then and now – i.e. the future direction of money supply growth, the political will to tolerate higher interest rates and a relatively strong US economy that could afford the higher interest rates.

- Between 1971 and 1981, the money supply in the US just about doubled. We do know for sure that the growth in money supply between 2020 and 2030 is going to substantially higher than just a doubling. For starters, M1 has grown by about 35% in just the last few weeks.
- When Paul Volcker set short term interest rates at 20% and even while his effigies were burnt on the streets, Reagen unequivocally backed Volcker. Just think of the scenario today where Trump threatened to remove Powell for maintaining interest rates at 2%.
- The US economy today is floating on a number of asset bubbles – equities, housing and bonds. And all these bubbles need not only an ultra-low interest rate environment, but continuous infusions of capital to prevent them from bursting. So its impossible to raise rates to even 1% in the foreseeable future without causing a complete implosion.

If we account for these factors, then one could actually make a rational claim that gold at $2000 an ounce in 2020 is cheaper than $35 an ounce in 1971.

Regarding the valuation of gold itself, the fractional reserve banking system that we follow makes the distinctions between demand and savings deposits quite fungible. Therefore whether M1 or M2 has to be backed by money becomes a debatable issue. Besides, historically a 40% backing of currency in circulation by money has provided a "relatively" stable monetary system. Ofcourse, it could be rightfully argued that anything less than a 100% backing, by definition, constitutes inflation which is essentially theft.

So lets take the case of M1 which is about $5 trillion and if this has to be backed 100%, then the value of the 261.5Moz of gold held by the US Govt would have to be valued at about $20,000/ounce or about 10 times the current price. Depending on the various combinations of % backing and M1/M2 for our calculations, we could get a multiple of anywhere between 4 and 30 times.

So at a minimum gold prices have to go up atleast 4 times. Ofcourse the biggest tailwind behind gold prices is the future inflation that would be created by the US Fed and it would be quite conservative to conclude that Money supply would go up atleast 5 times during this decade of 2020 to 2030 (or about 18% CAGR). In the context of recent happenings, it appears to an assumption that would be considered naive bordering on stupidity.

What combination would I use to value gold? I think 100% backing of M1 would be the base case scenario in my opinion. What I can safely say is that the world will witness atleast a 5 digit price of gold this decade in which the first digit will not be "1".

Implications of a 5-digit Gold Price

Gold prices today mean a whole lot more than just a number.. it indicates a tumultuous future of monetary breakdown with tremendous social and economic upheavals. I will defer to Doug's interview for the reader to understand what all this means for them and what they should do to protect themselves.

What it means for India is something that could be very interesting – or tragic – depending on how we choose to respond. India has an estimated 25,000 t of gold and that too in private hands – an advantage that no other country remotely comes close to possessing. If only we had the likes of George Washington, James Madison and a Thomas Jefferson on top of our governance structure, we could rewrite India's destiny from one filled with poverty to one of Life, Liberty and the Pursuit of Happiness.

So what do I think we will do? No doubts in my mind that we will do the exact opposite of what is right. Barring a brief interlude in 1991, that's what we have done always since our independence from the British in 1947. Instead of moving in the direction of balanced budgets and the invisible hand of the free markets, we will see much greater deficits and the very visible hands of the bureaucracy at every level of the economy.

The political and economic acumen, much more of the latter than the former, is completely amiss. Let alone the bureaucratic and the political class, as I do not expect them to understand much of what I have written. But even the Economic advisory council members and the mandarins at the RBI, and both these bodies are supposed to represent expertise in Economics, do not have even an inkling of what lies ahead. If only..

About the Author

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