INTRODUCTION

We live in a world of perpetual optimism – especially in the financial world. There are optimists (i.e., Wall Street, the financial media, and most of today’s investors), pessimists (who are perpetually bearish), and realists (who attempt to see things as they really are). The article that follows (written by David McAlvany, President of International Collectors Associates and the McAlvany Financial Group) will give you a sobering dose of realism and what we should be doing to prepare for the coming financial storm.

Gold is the answer. Yes, but what was the question? You might assume that after pioneering in the precious metals industry for 46 years our family business jumps to this conclusion. Well, for very strong reasons, we definitely do believe that gold is indeed the metal for all seasons – at least as a reserve of capital in a world addicted to depreciating fiat (paper) money. Consider the simplicity of keeping a reserve, a store of assets that at any moment can be put to productive use. Do you like having options to choose from? Well, gold gives you precisely that – options for any situation – good or bad (and a reliable monetary reserve for all seasons).

A. LIVING IN A WORLD WITH NO RESERVES

We live in a world where very few individuals, businesses, or governments plan ahead – or have contingency plans for hard times, unexpected crises, or serious financial/economic disruptions. The Boy Scout motto of “Be Prepared” has been largely ignored by most of the planet as the great majority lives in perpetual optimism. The great majority of Americans has virtually no savings and could not survive an unexpected $500 crisis. But our banks and local and state governments are really in no better shape financially. Their numbers and financial liabilities are simply much larger.

1. UNDER-RESERVED: RUNNING ON FUMES

When you pause and reflect on the fast pace of life, the overwhelming amount of information we encounter on a daily basis, and the numerous commitments you (we) make each day – stretching both your time and energy – you realize that you, along with a lot of other people, are running on fumes. If you hit the pillow hard at the end of the day, if you lose track of the days as they seem to flow into each other in an endless sequence of events, you probably are running on fumes. Are you under-reserved?

Now, apply this concept to the financial world. Rather than exclusively considering the reserve nature of gold as it applies to a portfolio, think about how under-reserved the whole world is. Being under-reserved may include too little time in your schedule to rest, reflect, or just relax – living with constant fatigue. Being under-reserved may include being so emotionally extended that the slightest of irritants triggers an out-sized response. Being under-reserved may include a home repair that requires a line of credit from your bank due to meager savings set aside for emergencies and surprise expenses.
Being under-reserved may include the funds manager that leaves nothing in cash and everything to hope in the markets' perpetual increase in value. Banks can be (and many are) under-reserved against loan losses. Corporations can count on access to credit as a source of reserves, leaving very little actual liquid capital in the business. America is dramatically under-reserved and living on borrowed capital via annual deficits of $500 billion to $1 trillion. According to the Pew Research Center, only seven states have a rainy-day fund greater than 10% of their annual expenditures.

What is the real purpose of holding reserves?

The experts tell us: “who cares about ‘dead’ assets lying around unproductive and collecting dust?” But my thesis is that we live in a world that has very little margin for error (or for the unexpected) – lacking the extra resources needed to navigate through the difficulties of life, the vagaries of market volatility, and the disappointments of the things that should have been, might have been, could have been – but were not!

2. GOLD AND SILVER ARE THE ULTIMATE RESERVE ASSETS

We live in an age that has faith in the “gods of the marketplace” that Kipling describes in his poetry, with a belief that perpetual growth and increasing wealth are possible by assuming access to infinite amounts of credit. While we strongly disagree with this concept, it certainly has taken hold in our day. The normal investor is fully invested, with few to no reserves for a plan B.

We will argue that the importance of gold in a personal asset allocation mix has never been greater. If you have thought of gold (and other precious metals) as an insurance policy, you are correct. But expand the concept of gold as insurance (paying off in the event of catastrophe) to a “personal reserve asset.” When you need a reserve of energy, do you reach for a snack kept available for just such an event? Financial reserves in the form of gold and silver have the distinct advantage of being financial assets, while not being exposed to the weaknesses of the financial system. They are the “IN CASE OF FIRE, BREAK GLASS” part of your portfolio.
These are not assets that are taken out of the game, as some gold critics contend. Quite the opposite, a reserve of precious metals serves a specific and crucial role within the game (i.e., they facilitate adaptation to changing financial circumstances). Each game has periods where fresh resources are needed. Think of a basketball team playing with no substitutes against a team with a bench full of good replacement players. Who wins, all other things being equal? Clearly the latter team has a crucial edge. Gold and silver are, in our opinion, the deep bench (the fresh, skilled reserves) coming in just when needed! They’re not wasted assets, they’re how you win the game!

The gold market does not exist in a vacuum. Interest rates, stock market trends, currency fluctuations (especially the US dollar), and most of all investor psychology all play a part in the pricing dynamics of the precious metals markets. So, to understand where we are and where we are going, consider these elements as they are revealed in the waves of investor migration to gold.

B. GOLD MOVES IN MAJOR WAVES

1. THE FIRST WAVE EMERGES

Beginning in the early 2000s, as a massive bull market in stocks was concluding and investor confidence in the high-flying technology sector began to collapse, gold quietly began a bull market run from the doldrums in the $200s per ounce. Very few suspected at the time that equities would suffer over a decade of flat to negative returns, or that gold would catch the spotlight as one of the most important assets to own in that period. From 1999 to 2011, the shiny and often mocked metal rose from $252 to $1930 an ounce (a 7.6-fold rise).

That period is remembered for discouraging equity returns, massive central bank interventions, and the subsequent bubbles – first in technology, and then in housing finance. In a matter of two decades, there have been no less than two epic boom-to-bust cycles, and increasingly a larger audience for gold ownership. Interest in gold has been growing as disappointments keep piling up.

A series of confidence killers characterized the period, where skepticism grew and suspicion crept into the investment community. Tyco, WorldCom, Enron, Arthur Anderson, and, perhaps the most shocking of all, the Bernie Madoff debacle underscored the inherent flaws in corporate America and Wall Street, and hardened a desire in the investing public for alternative assets, and diversification away from stocks. Then and now, gold has been attractive as an asset outside the grasp of Wall Street shills and market manipulators, corporate lobbyists and influence peddlers, and government socialists and control freaks. A period of distrust and disquiet found investors clamoring for the intrinsic value of gold.
Since the '70s, investors have been the swing vote in the gold market. Most of gold's annual supply is predictably used up by jewelers, central bankers, and, to very small degree, industrial users. But it is the investor category that sees the greatest variability from one year to the next, and is thus the defining factor in what moves the gold price up or down.

From 2000 to 2011, the investor audience interested in gold grew sizably for the first time in more than a generation. This period covers both the first wave and the beginning of the second wave. The period of growth in gold and silver was defined by lackluster relative performance in equities and negative sentiment (investor feelings about the prospects for future growth) through 2011. Everyone has their own reasons for purchasing precious metals. However, the underperformance of stocks in that period, and the volatility in the real estate markets and other “unusual” activities in the market place (i.e., central bank intrusions) had a predictable effect: They pushed investors towards a more cautious investment allocation that included gold and silver.

As the tech bubble burst, we had the first wave of gold investment interest that can be categorized as contrarian in nature. After multi-decade success in stocks and bonds through the 1990s, for most investors it remained unthinkable to consider anything but a continuation of past successes into the future. The majority continued to ignore the metals altogether. Alan Greenspan supported the majority belief that the stock and bond markets were well supported by the FED leadership. By that time, investors had come to believe in the Federal Reserve chief as a market demigod who would provide downside protection and pave the way for endless market expansion and growth.

Indeed, as Greenspan passed the baton to a young protégé with an academic expertise in Great Depression-era market dynamics (Ben Bernanke), there was peace and calm, and widespread optimism (as well as aggressive Wall Street engineering) that swept the globe with financial products imaginable only in an era of lax regulation (Glass-Steagall was killed in ’99), extreme speculative fever, and aggressive credit expansion.

Easy money was the magic pill for market speculation, and that was precisely what drove the recovery from 2003 to 2007. Meanwhile, the audience for gold continued to grow as the crowd of skeptics expanded, doubting the efficacy of the printing presses as a foundation for lasting economic growth and asset price inflation. That marked the end of the first wave, largely characterized by mavericks and independent thinkers.
2. THE BIRTH OF THE SECOND WAVE

For the first time in nearly a decade, starting in 2008, the “smart money” (hedge funds, some money managers, and super-high net-worth individuals) on Wall Street began to pour into metals. Why? The financial companies they relied on to be custodians of assets began to founder and disappear, and the reality of interdependence (called counterparty risk) emerged in their minds as a real threat. Billions of dollars flooded the gold market, not as a speculative bet on the price, but because gold was the single asset that big money could go to in order to get out of the financial storm – which at that point was spreading globally.

If you wanted a balance sheet asset that could not be whisked away through some contractual obligation or diminished by irrational market panic, gold was the place to go. The second wave of gold buying (starting in 2007) was this wave of Wall Street interest triggered by a financial earthquake (which had theretofore been considered to be an almost statistically impossible event) shaking the structures of Wall Street, and resurrecting the specter of a 1930s-style deflationary collapse.

The second wave of gold buying ended in 2011 as fear subsided, and as central bank creativity and interventionism eclipsed anything the market had ever witnessed. (Ever!) Virtually infinite credit was funneled into the financial markets. On a coordinated basis, the world’s largest central banks first brought calm, and then a revival of speculative enthusiasm. Consistent with the Liquidity Theory of Asset Pricing, there was a sufficient rise in the tides of money and credit to lift all boats – from stocks to bonds to real estate.

From 2011 through 2017, that is what the history books record. All boats were rising, not according to distinct, accurate profiles of opportunity or risk (or real fundamentals), but due to price inflation deliberately triggered by the central bank community. The effort, perhaps well intentioned, was to stimulate (supercharge) the price of everything and wait for the wealth consequently generated to spur consumption. The theory was: If consumption increased dramatically, so would economic growth. Well, they were half right! Asset price inflation globally boosted net worth figures to record highs, with the unintended consequence of increased political tensions between the haves and the have-nots. This in turn spurred a populist pushback at polling booths across the planet.

Central banks quadrupled their balance sheets and flooded the stock, bond, and real estate markets with $6.3 trillion in new liquidity (which netted out to a $2.1 trillion improvement in global GDP due to the liquidity provided). It was like giving a faltering drug addict a super injection of heroin. Easy money was the source of the price bonanza in everything from stocks to Bitcoin.

Low interest rates triggered a ravenous search for higher-yielding investments to meet the income appetites of retirees and pension managers. Momentum in stocks fed on it like a self-fulfilling prophecy, drawing the last of the holdouts on the sidelines into the stock market bonanza. Investor psychology morphed into a moth-like state, flying directly at the light of positive returns while ignoring the flame. This is now the backdrop for gold as we consider the 2018-2020 period ahead.
3. THE EMERGENCE OF THE THIRD WAVE

Unnoticed by the public (which has been mesmerized by the spectacular bubbles in stocks and cryptocurrencies) gold has been in a rising trend for two years. From the year-end lows of 2015 to the present, the price has risen more than 30%. The third wave has already begun, with very little fanfare. The fundamental shift away from pessimism in the metals market began overseas. Whether it’s pessimism or ignorance is debatable, but here in the US there is very little attention being given to either the physical metals or the companies that mine them. The public complacency in the US regarding gold has been the highest in almost half a century – which for contrarians is a strong sign of a major change in market direction!

a. GLOBAL DEMAND FOR GOLD IS EXPLODING

Today there is very strong global demand for gold. This stands in stark contrast to the US market, where investors have been consumed with the stock market’s rise to all-time highs, and with the emergence of the cryptocurrency bubble – which has become the largest speculative bubble in world history.

The two consistent buyers of gold continue to be China and India. India’s imports of gold were up 67% last year (according to GFMS) on the heels of a currency restart wherein Prime Minister Modi attempted to eliminate the majority of cash from the system and shift towards a new digital currency. Some questions remained at the time as to how this move against privacy and toward a cashless society was going to affect Indian purchases of gold, but now we know. They increased dramatically.

b. THE WEST’S GOLD IS MOVING TO THE EAST (TO ASIA)

In China, according to the China Gold Association, 1,089 tons of gold were consumed in 2017, with gold bars and jewelry both in high demand. Capital controls enforcement and a political consolidation of power by Xi Jinping have set the tone for investors to focus on an asset that remains largely off the radar and out of the financial system (an important lesson American investors should take note of). Investors may be seeking a safe haven – anticipating a painful collapse in the rapidly expanding Chinese credit markets.

Don’t forget that the majority of metals liquidated in the West in the 2012-2015 period were gobbled up in Asia – never to be seen again. Much of the above-ground gold available for investment purposes has been geographically moved, and for all practical purposes is gone. We believe that will act as an accelerant to dramatic price increases as the third wave progresses and Western buyers attempt to reacquire those ounces.
C. EUROPEANS ARE MOVING BACK INTO THE GOLD MARKET

The surprise buyer in 2017 was the European. Long-term selling has characterized a generation that inherited gold from the World War II generation. For years there were lax rules on the liquidation of gold, and most people did so on a cash basis – avoiding any taxes whatsoever in many places throughout Europe. As cash reporting has tightened considerably in Europe in the midst of the Financial Crisis, selling has slowed substantially, and now it seems there is growing demand for gold in both Eastern and Western Europe.

Germans took the number-one spot for per capita gold consumption last year, a rare phenomenon in recent years, which makes one wonder what they are anticipating. Do they see a break up of the euro as a monetary possibility? Is there fear of a “Hail Mary” attempt to keep the eurozone together and apply extraordinary pressure (i.e., command and control dynamics) to the member countries? Whatever the cause, there was a notable shift from disposing of gold to acquisition in Europe last year and up through the present, which marks a major shift in sentiment. As astute observers well know, when sentiment shifts in the gold market, it is frequently a harbinger (a leading indicator) of political and geopolitical anxiety and frequently anticipates and accompanies chaos in the financial markets.

By the end of February 2018, the investment world has reawakened to the fact that volatility is not dead, and markets can still move in two directions: UP and DOWN. It had been over a year since the DOW and S&P 500 experienced a correction greater than 3%, and all domestic markets were in their ninth year of virtually uninterrupted growth. That time frame is extraordinary. A 20 to 40 percent correction from these levels, after spending that amount of time in positive territory, would be normal – in fact expected and healthy! “Normal” in any market includes the ebbs and flows of price action. We have been limited to viewing the flows as mainly up for nearly a decade, but yes, we strongly believe the downside still exists – as recent stock market and cryptocurrency price action has demonstrated.

So far, 2018 represents a departure from the past period of central bank market participation. In Europe, the ECB is actively scaling back its asset purchase (i.e., market support) program – dramatically curtailing its purchases of corporate and sovereign bonds. Furthermore, the head of the ECB is retiring. The likely replacement for the outgoing ECB chief, Mario Draghi, is Jens Weidman. Dr. Weidman has objected to most of the market interventions by the ECB and would manage the ECB in a manner more consistent with German caution, sensibilities, and historical sensitivities to central bank excesses and overextended mandates. (In other words, Germans are terrified of inflation! They remember 1919-1923 and the Weimar hyperinflation – precipitated by the German Central Bank – which helped to bring Hitler and the Nazis to power!)
d. CENTRAL BANK TIGHTENING IS GOING GLOBAL

In summary, Europe is tightening the credit markets, and asset prices are sure to follow (heading lower, of course). This same trend of tightening is occurring here in the US. During the tail end of Janet Yellen’s time at the Fed, she oversaw the initial interest rate increases from the lowest levels seen in US history, and then passed the responsibility for more (expected) interest rate increases (in 2018) to Jerome Powell, her successor. In sum, the US is tightening its credit markets, and asset prices are sure to follow (again, heading lower).

The only hold out, it seems, is the Bank of Japan, which is doggedly committed to keeping interest rates near zero, indefinitely and at any cost. However, as credit and liquidity tighten globally as a consequence of central bank “normalization” and balance sheet reduction, the assets that have benefited the most from easy money are now likely to suffer the most—specifically stocks and bonds. Bond and stock prices (ordinarily considered a diversification or portfolio counterbalance), may move lower in tandem as interest rates increase – negatively affecting the bewildered (unsophisticated) investor.

C. RIDING THE THIRD WAVE

This is the perfect environment for both gold and silver. Bullish sentiment is at a peak in traditional asset markets, and no one seems to care about the metals. Prices and valuations in stocks have exceeded all past records save one. You say, “What could go wrong?” We are moving toward greater economic growth, tax reforms are being rolled out as we speak, incomes are inching higher, jobs data look impressive (U3 – for those of you who put stock in official statistics).

Fair enough, but once you’ve accounted for the positives, and know them all, consider that all of these positives must continue as expected in order for market prices to be maintained. If anything goes wrong, the question is whether there are sufficient reserves to take the breakdown in expectations in stride? What if everything does not happen as anticipated? What if the financial markets have, on the basis of hope and hype, reached a peak, and are not going to 30,000, 40,000, or 50,000? Where do you go from the apex? To the stars—or straight down?

No, the real danger in the markets today is that no one has reserved enough assets for a Plan B. The government has not reserved enough for a plan B. States have not reserved enough for a plan B. Corporations have not reserved enough for a plan B. Families and individuals have not reserved enough for a plan B. The operative assumption (conventional wisdom) at present is that tightening credit conditions will have no negative effects on asset prices, even though the opposite (loosening conditions) essentially spiked the punch bowl and got the party started. Inflation trends are beginning to pick up, interest rates are rising, and financial markets are severely overextended and ready to reverse course.
From here we finish the third wave. From this point forward we begin to see an awakening to risk, a return of volatility to the financial markets, and a shift in investor sentiment. In most cases, people act according to their feelings, not their intellect. Actions in the gold market are now shifting toward a globally revitalized interest in the metals for a variety of reasons. For some it will be diversification that causes them to invest in gold. For others it will be the elimination of counterparty risk. Still others will see gold as a guarantor of freedom, autonomy, and privacy in a world that is forfeiting those things for speed, convenience, and efficiency.

There are signs that suggest the market is already shifting dramatically and the financial flows will look quite different from 2018-2020. The dollar in 2017 gave up 10% of its value in spite of the FED being the first central bank to raise rates, which ordinarily would attract capital into US assets and drive the dollar higher. Something is wrong! The US treasury market is but one signal.

Investors are currently moving en masse to index funds, unable or unwilling to do the work to differentiate between opportunities and weigh them on a spectrum of risk and reward. This is behavior that reflects a world badly altered (misled) by previous years’ central bank meddling. Normalization of monetary policy will seriously hurt the average investor buying index funds by proving the value of fundamental analysis and showing how blindly made the purchases were in the stock market from 2017 into 2018.

The third wave of gold buying will convert many of these recent stock and even Bitcoin investors into gold bugs. The man in the street has taken gold for granted since about 1979, thus becoming part of the generation that has forgotten the intrinsic value of gold, that has passed on a collective ignorance for maintaining a reserve, that is about to become scorned for being greedy, that assumed that it knew everything about the future, and that in the end lost its life savings.

If $1,050 per ounce was the low in 2015, are there significant mile markers ahead to keep an eye out for? Yes. This does not mean we know the future, but we are looking for milestones. When gold rises above $1,400 per ounce, this will strongly indicate the imminent return to the old highs. The difference between the past journey to the highs of $1,930 and the next one are that today supplies to meet dramatically increased global demand are insufficient.

Gold is rising in a variety of global currencies and has been attractive to a global audience for several years. The net result is that the total quantity of available ounces has been sharply diminished. The US investor has been able to ignore the price trends up to this point. But a break above $1,400 advertises gold like floodlights on the darkest of nights.
The third wave has already begun. In this wave, the population of gold-owning citizens (globally) will grow to mirror the decline in confidence in central bankers. Gold in some respects is a no confidence vote on central planning and command and control dynamics. Never before has so much been entrusted to so few with academic degrees, political influence, and elite connections. The breakdown in trust was the starting point for wave one. Recall the corporate failures and prosecutions that followed.

Wall Street’s structuring of financial products in the mortgage market (an important component of wave two) complimented that trend of corporate malefiancence with one-sided, self-serving actions that left us, taxpayers, to pay off Wall Street’s risky, greed-driven bets. The taxpayer, if put to the test again and required to bailout the system, is likely to protest in tangible terms – moving out of the system and into a time-tested safe haven. That revolt will predictably include an opt-out of a game rigged by insiders for insiders.

My final thought is for the US investor who is contemplating the turning points in the markets and trying to anticipate the approaching pressure in stock and bond prices. You can reduce risk by owning physical gold and silver. Many US gold and silver products have suffered from domestic neglect as potential US buyers have been attracted to everything from junk bonds to Bitcoin to biotech stocks, and left US gold and silver overlooked and dramatically underpriced.

Value, asset protection, and a huge potential growth component are part and parcel of the US coin market today. From junk silver to platinum Eagles to $20 gold pieces, these are just some of the many undervalued precious metal assets in a world that in most respects is dramatically overpriced. They are a great place to start, heading into the third wave of growth for gold and silver.
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