Investor Intelligence Report: Two global economic trends surface from Brexit

InvestorIntel is pleased to announce that it has been given the rights to publish Markethack Inc.'s first edition of the **Investor Intelligence Report** titled *Two global economic trends surface from Brexit* for our audience this month. Created as an economic data report for investors and members of the professional investment community, the **Investor Intelligence Report** provides "level setting" data and a way of saying "we are here" in the economic cycle.

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The Great Incredible Gold Subsidy

> *"Every individual is a potential gold buyer, although he may not need the gold. It may be added to the store of personal wealth, and passed from generation to generation as an object of family wealth. There is no other economic good as marketable as gold."* Hans F. Sennholz (Austrian School economist and editor of the 1975 book, *Gold is Money)*.

I was amused by this week's headline on Bloomberg, "The 500 Tons of Gold That Show Global Rise in Investor Angst." According to that article, global gold holdings have risen by:

> *"more than 500 metric tons since bottoming in January in a signal of investors' rising concern about slowing growth, a Federal Reserve that's probably on hold and the ructions caused by Britain's vote to quit the European Union."*

Gold in exchange traded funds rose 6.6 tonnes on Friday to 1,959.1 tonnes, up from 1,458.1 tonnes on January 5th, 2016. Again according to Bloomberg:

> *"Bullion prices climbed to the highest level in more than two years in June as investors absorbed the implications of the U.K. result, adding to a rally that's been driven by the Fed's hesitation in raising borrowing costs and the spread of negative rates in Europe and Japan."*

Well, I suppose after an hysterical, four month-long "Project Fear" campaign mounted by British Prime Minister David Cameron and the Remain side in the United Kingdom referendum on European Union membership – a campaign aided and abetted by leaders from all around the planet – the majority vote for Brexit would likely generate some nervousness, and even more investor "angst". Still, the gold Exchange-Traded Funds have some way still to go to regain their peak in 2012 of 2,632.5 tonnes.

But all of this misses the point.

In 1971, President Nixon was forced to abandon the dollar's convertibility link to gold at the then official price of $42 per troy ounce. In theory, all the west's currencies had a fixed link to the dollar with the greenback being convertible into gold for the west's central banks at the official rate. A two-tiered gold market had existed since 1968, with an official rate used by the central banks and a free market rate used by everyone else. Needless to say, the free market price went higher than the official price.

By agreement, central banks were not allowed to buy gold in the free market, though by late 1974 they could sell their gold reserves there if they wished. Few wished to sell gold at all, although some chronically mismanaged countries like Italy raised loans against their gold holdings, in Italy's case from the then West Germany. In the event of an actual physical gold transfer between debtor and creditor, the International Monetary Fund insisted the transfer take place using the official lower price. It was, and has been since 1971, a recipe for today's fiat money disaster.

At a stroke, and without consultation, the dollar and all the lesser currencies, became "fiat" currencies, exactly the same as with the communist currencies. The last systemic link to order, i.e. gold, was lost, and disorder took its place, lately in spades. Politicians and central bankers everywhere became profligate money spenders and money issuers. The free lunch had arrived, deficits didn't matter anymore.

Of course it was a Great Big Error and money supply ballooned everywhere, and has never stopped ballooning since. Instead of devaluing the dollar against gold in 1971 and keeping discipline, the world took off like a rocket on forever-devaluing fiat currency.

Now comes the really interesting bit, how gold has reached getting a subsidy of $67,000/oz by some measure, $47,600/oz by another measure, and $3,982/oz by the narrowest measure (the one I have chosen). I've opted to use the USA's figures, but the global fiat money problem is obviously much larger.

In August 1971 when America went off the gold link, M1 money supply (narrow money) according to the Federal Reserve was $226.5 billion, the currency component part of M1 was $51.3 billion. America held gold reserves totalling $262 million ounces. Each ounce of gold covered $195.80. At the official price of $42, each ounce had a deficit of $153.80.

Fast forward through wars, bubbles and busts to June 20, 2016.

The M1 currency component has ballooned to $1.3839 trillion. The gold position, we are told, is still 262 million ounces, though it has never been audited since the 1950s (and then only partially). Each ounce of gold now covers an impressive $5,282. With the gold price itself suppressed to $1,300/oz this means that, when the whole system crashes, each ounce of gold is carrying a subsidy of $3,982. Not too shabby considering the state of the world.

But by other monetary measures it gets even better. Though the Fed dropped M3, their widest monetary measure, back in 2006, privately-assembled M3 measures are available for use. At the end of December 2015, M3 was estimated at about $18 trillion. Each ounce of gold now covered by $68,702; deduct the present price of the metal and each ounce is carrying a gold subsidy of an incredible $67,402.

The central bankers seem to think that this state of affairs can go on forever, growing like Topsy to the sky. I think the whole system blows up long before then, releasing the gold subsidy – an interesting long term investment, I think. Gold flows from west to Asia's east in anticipation that the subsidy will one day get released.

To finish, a couple of other apposite quotations:

> *"It was a confusion of ideas between him and one of the lions he was hunting in Kenya that had caused A. B. Spottsworth to make the obituary column. He thought the lion was dead, and the lion thought it wasn't."* P. G. Wodehouse.

> *"If we went back on the gold standard and we adhered to the actual structure of the gold standard as it existed prior to 1913, we'd be fine. Remember that the period 1870 to 1913 was one of the most aggressive periods economically that we've had in the United States, and that was a golden period of the gold standard. I'm known as a gold bug and everyone laughs at me, but why do central banks own gold now?"* Alan

> Greenspan. June 28, 2016.

The Italians Need Some Gold!

> *"If we went back on the gold standard and we adhered to the actual structure of the gold standard as it existed prior to 1913, we'd be fine. Remember that the period 1870 to 1913 was one of the most aggressive periods economically that we've had in the United States, and that was a golden period of the gold standard. I'm known as a gold bug and everyone laughs at me, but why do central banks own gold now?"* Alan Greenspan. June 28, 2016

Why do I think that the Italians need to own some gold you might ask? Well it has a lot to do with the poor state of Italy's banks, the poor state of Italy's economy, and Italy's government about to make the mistake Ireland made when it guaranteed its banks, and then found Ireland was too weak to support the guarantee, and then needed a bailout from the EU. According to a report on Reuters "Italy is preparing to protect its banks from a destabilising share sell-off following last week's Brexit vote."

According to Reuters, Italy is proposing a state guarantee for bank bonds, by means of the Italian Treasury and Italy's state lender Cassa Depositi e Prestiti. Reuters posited that Prime Minister Renzi raised the subject with Chancellor Merkel in Berlin on Monday. Asked if the subject came up at the news conference afterwards, all Mr. Renzi said in reply was that Europe and the national institutions would cooperate to bring about "calm and confidence."

> According to Italy's media quoted this week by Reuters*: "Daily newspaper Il Fatto Quotidiano said the government's*

> *contingency plan involved taking stakes in ailing banks, to be financed by around 40 billion euros in new public debt, but the second, government source said there was no such plan."*

The paper said Renzi's administration was already in talks with the European Commission about possible support measures.

Two other papers, Corrieredella Sera and La Repubblica, said Italy would seek to take advantage of possible exemptions to European state aid rules in case of "exceptional events" in order to bolster its banks if stocks continued to fall sharply.

That tells me that Italy's banks are in deep trouble, and that following the UK's Brexit vote, that trouble just turned into a massive crisis. So what, you might be tempted to say. Well what Italy is asking for is against the European rules in place since 2013. State aid is only supposed to kick-in as a last resort after the bank bondholders and large depositors have been bailed-in, i.e. suffered a haircut, as in losing some money.

> This week the Financial Times commented*: "The strict EU rules against state-backed rescues took years to negotiate and are so new they have barely been tested in a crisis with a major bank. But they were an essential precondition to eurozone integration; without these guarantees Germany would not have accepted the risk-sharing involved in creating a banking union."*

Senior European officials fear Mr Renzi's effort is, as one said, an "*opera buffa*", putting off the deep-rooted reforms its lenders badly require, or a needs-must intervention that would shatter Europe's commitment to the new bail-in regime.

To mount any rescue, Mr Renzi needs a waiver from European Commission state-aid rules, and a legal route through the bail-in rules of the EU's Bank Resolution and Recovery

Directive – something Italy has tried and failed to secure in the past.

Rome has seized on the market turmoil triggered by the Brexit vote to restate its case on the grounds that “financial stability” is now threatened. In Brussels, many regard that claim as overblown. “What Renzi asks for and what he gets may be very different,” said one senior eurozone official.

For Italy, the question is whether a capital injection will ultimately address the deep malaise of 600 banks that operate on a business model that may no longer be viable.

Italy’s 600 banks are riddled with 360 billion euro of bad loans, with some 200 billion euro alone already believed to have gone terminal. But even if the European Commission relents and gives Italy the waiver it’s seeking, how likely is an extra 40 billion bailout to work in a business model gone wrong, no matter if a nearly bankrupt Italy guarantees its banks. Any large depositor with any sense will merely use the opportunity to get down to the minimum state guarantee level, and place their euros abroad.

But that’ not so easy as before. The ECB and Swiss National bank have imposed a negative interest rate regime over much of Europe. Which brings me back to gold. Why place money on deposit and get a negative return for the privilege, when a bullion alternative is around, with in the circumstances, every prospect of the gold price rallying for months and years ahead.

But any large depositors or nervous bondholders might need to be quick. Goldcore informs us that a physical bullion crisis seems to have developed:

Bullion banks “have been panicking” and advising that soon, they may no longer be able to quote prices on large gold bar orders. This response is previously unheard of and indicates the increasing illiquidity in the large gold bar market due to a recent surge in HNW, UHNW and institutional (wealth managers, hedge funds, banks etc) demand across the world coupled with already robust central bank demand.

The increasingly illiquid physical gold market where supply cannot keep up with demand underlines the importance of owning physical bullion coins and bars – either in your possession or having direct legal title to your individual coins and bars. Bullion should be owned in your name or your company's name and be stored directly in the safest vaults in the safest jurisdictions in the world – outside the financial, banking system.

It's the early bird that gets the worm, albeit it's the second mouse that gets the cheese. I suspect that we haven't heard the last of Brexit, Italian banks, and the new gold rush. Even fallen former guru "Bubbles" Alan Greenspan, who ran the Fed, seems to have found his gold side again.

> *"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value."* Alan Greenspan 1966.