A Financial Crisis: The Golden Manifesto

In this The Golden Investor Case Study we shed a light on the current market environment and the circumstances in which investors need to maneuver. The decade of quantitative easing will put many people in liquidity problems, a huge collapse of the economy is inevitable and the people responsible won't face the consequences. It's again the poor who will be hit the worst. Ironically they are who were already the victim of years of quantitative easing. In this special Case Study, The Golden Investor will show how we never recovered from the previous crisis, we just postponed the consequences. Pension funds in trouble, bubbles in the housing market and in stock markets, this time the worldwide debt driven bubbles will be popped.

Gold is the classical safe-haven. When uncertain times start to hit and financial troubles seem to lie ahead, gold prices rise. The value of gold isn't measured in the use of the commodity, it lies in its ability to function as hedge or speculation against possible losses. This is exactly the reason why we recently have seen a drop in gold prices. Although several claims are made about gold not being a safe-haven anymore people forget that gold always outperforms the market even during sell-offs. The value of gold is purely a practical and psychological one. It is abundant enough for coin-making, but still is rare enough to maintain its value. It does not rust or corrode and people love the shining color of it. Even though gold hasn't got a very wide use, some is used in cellphones, gold has been a currency or valuable asset for thousands of years. This doesn't say that gold nowadays is as valuable as it used to be. However because of the safe-haven characteristics of gold the commodity still holds value. It is relatively scarce material making it allegedly safe against inflation. In that perspective platinum and palladium seemingly are better options, but they are too scarce to function as currency or trade-able good in a world market. And where palladium seems like a good option due to its wide use in labs, this same usage could deteriorate due to new innovations or a lower use by the industry, making this commodity less necessary and valuable. Gold is owned by all the powerful people worldwide. Moreover gold doesn't have a significant function in industries which makes it an asset with less conjunctural volatility. Gold has been a currency for centuries and it still is, we just forgot its value.

Bad Central Bank Policies

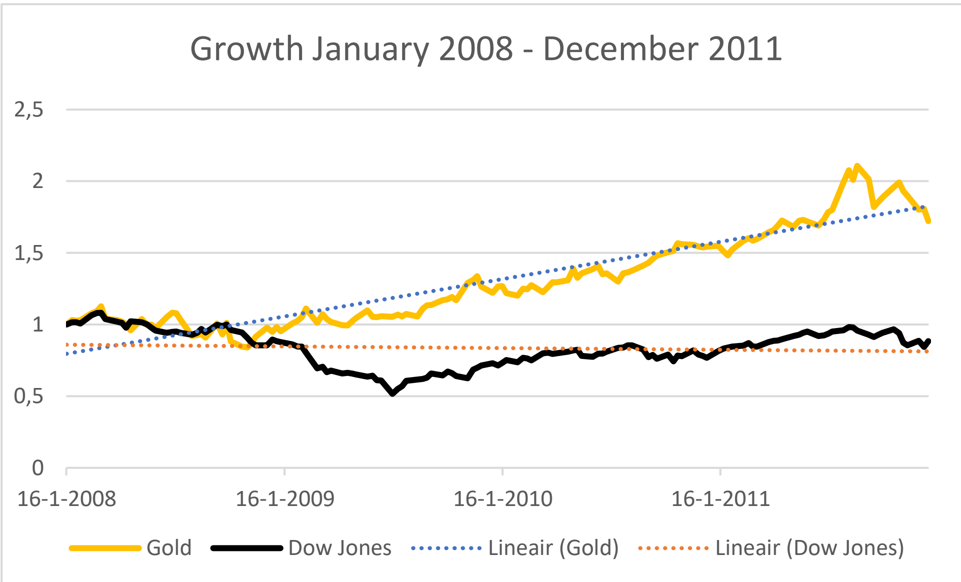
Years of quantitative easing have led to a huge monetary base of central banks. The ultra-low interest rate environment has left central banks out of ammunition to defend the economy against a downturn. The biggest problem of quantitative easing is that it's shifting the problem to the future to avoid an immediate downturn. The side-effects are huge, middle income households and especially the poor see the inequality gap rising. Monetary expansion increases profits more than wages, monetary expansion leads to higher gains for high income families who hold assets on financial markets. (Directorate-General for Internal Policies, 2015) Poor people don't own real-estate and stocks, and the main channel in which monetary policy has resulted in income effects is through those two channels. But still central banks continue to use this policy, the only reason seems to be the lack of an alternative. This is acknowledged by central banks, but still we have seen almost a decade of quantitative easing, which is meant to stimulate innovation and productivity, but eventually only leads to real-estate and stock market bubbles. This decade long policy by central banks seems rather reckless. The ultra-low interest rate environment creates the necessity for people to save more to be able to sustain oneself in retirement. Pensioners see their deserved pension allowance evaporate and need to work longer and longer to get less and less. Ten years ago pensioners benefited hugely by interest on their deposits, but their savings aren't worth anything nowadays.

Pension Fund Debacle

The resulting ultra-low interest rate environment has led pension funds across Europe to bleed, but since this is a long term problem central banks aren't interested. Pension funds and insurance companies aren't able to get enough return on their investments since bonds are at ultra-low rates. This is a result of the ECB quantitative easing, buying up all government bonds to lower the burden of the financial crisis for governments. Moreover this unconventional monetary policy has led to less creative destruction of companies. The amount of non-viable "zombie" companies has risen enormously. Basically, companies with liquidity problems were saved enormously by the ultra-low interest rate environment in which they were able to issue new corporate bonds at a lower interest rate. So paying off old loans with new cheaper loans. On the short term this is very effective, but this is a one time measure and creates a situation were many companies come in trouble if interest rates rise. The last two years this fear became reality when the FED decided to cut rates again after letting them rise: "because the economy was doing well". The three rate cuts in 2019 showed that the economy wasn't that strong after all. Along with the recent two significant rate cuts by the FED we're back at zero. Further measures are announced, even helicopter money is accepted as a measure to stimulate the economy nowadays. This is purely inflationary on the long run and along with new rounds of quantitative easing and stimulation measures this makes the gold bull case for 2020.

Comparison with the financial and sovereign debt crisis in 2008–2011

Now it becomes more and more interesting to hold gold instead of cash. Just look at the following chart which shows the growth of gold and the growth of the Dow-Jones during the last two crises. At first gold drops along with the stock market. The main reason for this is that



traders and investors always hold a certain percentage of their portfolio in cash, also known as margin calls. This is known among investors so during a sell-off at first also gold sells off. But as markets crash also the pressure on central banks increases. On 16 December 2008 the FED lowered their rates to zero. After that measure, gold more than doubled in value in the following years. The 13th of March of this year the FED decided to make the biggest rate cut since Black Monday 1987 of 1 percent back to the lowest rate possible. This ultra-low environment creates extra incentive for investors to turn to gold since other safe-assets like Swiss bonds get negative rates. This makes the ultimate case for gold as safe-haven asset, central banks can't alter the amount of gold, so every possible disastrous, inflationary measure we're going to see now is followed by increases in gold prices. The financial system is broken and this time the rise in gold value is not one of scared money, but of smart money avoiding the currency circus policy by central banks. And the time to invest in gold has already started. We've seen stock markets crash, gold was sold for liquidity, central banks have reacted. From now on, if the situation worsens, which is very likely, every other asset than gold isn't safe.

The End of Fiat Money

This decade will be known for the unconventional monetary policies, all to save the economy. We should not call this the corona-crisis. The corona outbreak is just the pin the bubble needed to bust. This debt driven financial system is going to collapse. Central banks will need to buy-up corporate bonds to be able to continue their quantitative easing measures and to save companies from collapsing. The divergence of Europe's financial wealth will increase, countries like Italy will need the ECB to survive this crisis. The biggest difference with the last debt crisis is that this time we will not be saved by a booming South-East Asian economy, because this time the whole world is affected. The Golden Investor doesn't like to make predictions, but it seems rather plausible that the corona crisis will last until real medication and vaccination is available. Stock markets will drop like a rock, and this whole bubble of money will need to flow somewhere, and this time it'll be gold.

Learning from an independent central banker: Paul Volcker

In the seventies, inflation seemed uncontrollable, in a time where economic growth slowed down, it is one of the time we actually saw central banks worst fear: stagflation. Then came Volcker. Instead of directly using interest rates, Volcker targeted the volume of bank reserves in the system. And it would allow the FED-rate to go as high as needed to reduce reserves. He made sure the excess of money supply got out of the system, just to get back in a natural balance again. This eventually lead to the FED-rate to almost double from 11 percent to more than 20 percent. But inflation got down to three percent down from a high of 13,4 percent, the impact was massive. He threw the American economy in a severe crisis, but eventually it worked and we didn't see a real crisis for years to come. His policy wasn't very popular, many people couldn't get mortgages due to the resulting high interest rates and his measures were followed by a big crisis in 1980-1982. But eventually his measures worked and has led the economy to recover. This time we did the exact opposite, we spoiled excess money supply in the economy just to reach our inflation targets and to boost the economy. Nothing has happened, the ten times higher monetary base has led banks to sit on cash and has only boosted real estate and stock markets to all-time highs. The Golden Investor is afraid for a Paul Volcker scenario since this unconventional central bank policy will lead to inflation at the wrong time. When banks start to fall because of the increasing defaulting debt, they will start to use these reserves. During this crisis cash will start flowing out of stock markets onto the real markets and leading to inflation during a global slowdown. This time we won't see one crisis, but two at the same time. The moment this quantitative easing will be stopped we will start to feel the burden of postponing the last crisis and on top of that carry the aftermath of the current corona crisis. It is very possible we will see stagflation, if central bank policies will prove incompetent we will start to see a time of great depression. The only way to resolve this crisis is to use Paul Volcker monetary policy, but this time the consequences of such a policy will be much bigger since we've been flooding the market with money. We should be more afraid of an inflationary depression if we continue QE than we should be afraid of a deflationary depression if we stop QE. Quantitative easing should be a short term policy, but is now used long term, ignoring the consequences. One time we will need to stop this infusion of money or we will face the consequences the hard way. And it is very possible the time is now.

With US dollar interest rates now officially at zero, this marks the end of the fiat dollar experiment which began in 1971. The path from this point to a gold standard is much shorter than most realize. We may not have a vaccine for the corona virus, but we'll drown it in money.

Bibliography

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