Cavelti

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December 31, 2015

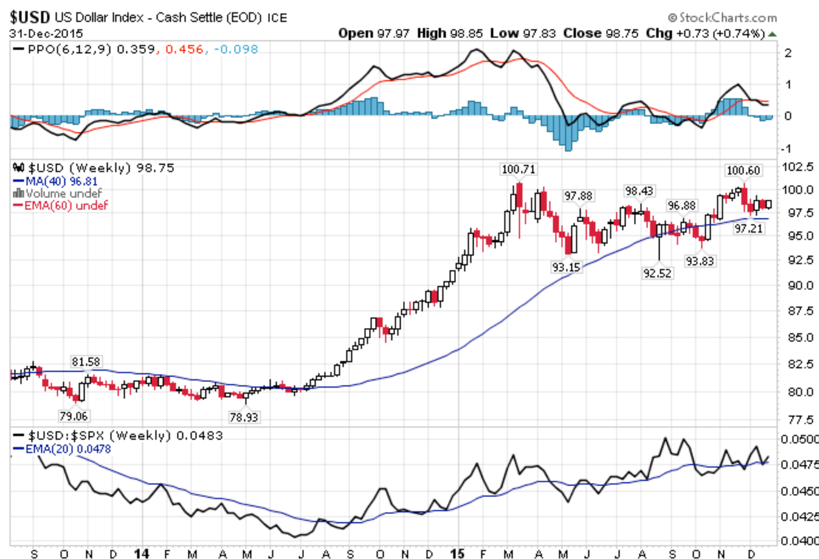
To: Our Clients
From: Peter Cavelti

Solid Value in Gold

Dear Client:

Once again, I am writing about gold's improving fundamentals and its poor price action—poor that is, when viewed through the lens of the U.S. dollar.

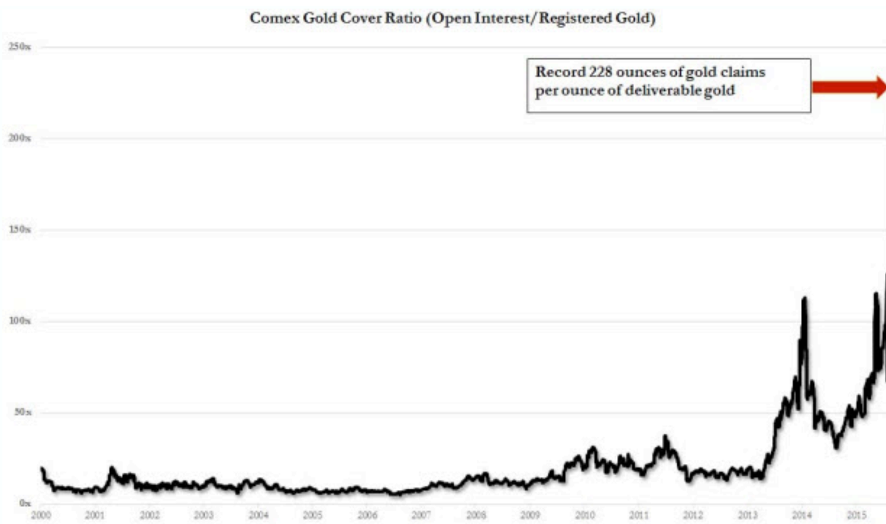
Gold closed the year at $1,062, reflecting a drop of around 9% during the year. While a string of disturbing geopolitical and economic development shored up the case for holding bullion, the soaring U.S. dollar held the metal back. Against a basket of foreign currencies, the dollar has now gained a whopping 25% during the past two years. Gold, during the same time, has fallen by almost the same margin.



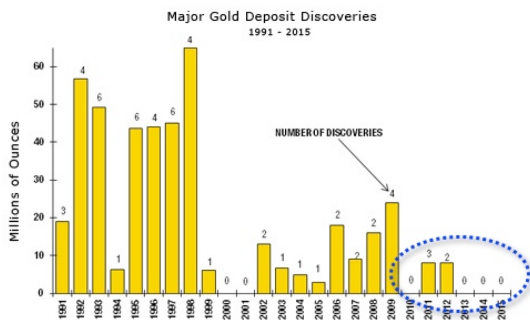
Given the metal's strong negative correlation with the dollar, one obvious question we need to ask is where the U.S. currency is headed from here. As the above chart shows, it appears that the dollar is forming what analysts might call a lazy topping formation. However, I should note that the dollar's fundamentals are by no means uniformly negative.

From many perspectives, the U.S. is still the best house in a badly run-down neighborhood: America is politically stable and its economy is healthier than those in Europe, Japan, China and several key developing countries. This helps capital flows into the United States and as long as this is the case, there is a risk that speculative activity will continue to challenge gold.

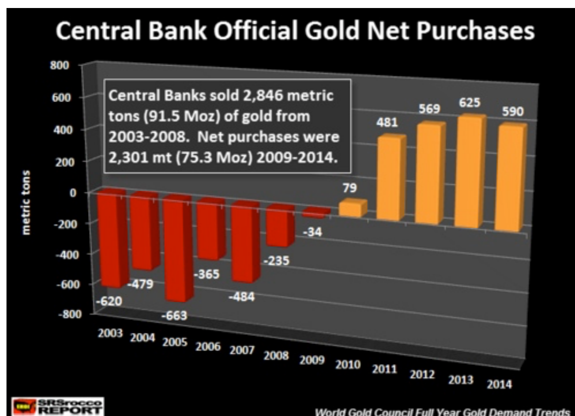
I would like to stress the word *speculative,* for an important reason. When speculators sell gold, they sell something they don't own. But for every ounce sold on a futures exchange, an ounce is bought. On expiry of the contract, the buyer has the right to demand delivery of the metal and, conversely, the seller is obliged to deliver. Typically, sellers keep the metal that will be due for delivery at the exchange warehouse, but they don't have to—an alternative is to lodge sufficient collateral in the form of money.



At this point, at the world's largest commodity exchange, there is hardly any gold on deposit, while paper promises to deliver gold abound. The actual ratio of gold promised vs. gold held is 228:1—an all-time record. What that means is that if those holding gold contracts for delivery asked for the actual gold, there would be a massive squeeze on physical demand. The gold price would be sent sharply higher. We believe that something like that is going to happen once short speculators lose faith in an ever-higher dollar.



As I've noted before, gold's commodity fundamentals are strong, with supplies being challenged both as a result of low prices and sharply fewer gold discoveries, and demand likely to remain brisk, as geopolitical uncertainties abound, investors almost everywhere in the world look for hedges against depreciating paper currencies, and central banks continue to shore up their gold holdings.



Like I noted in my last letter, the mechanics of financial markets frequently defy logic, which means that we cannot forecast the timing or extent of gold's next movements. What we can do is attempt to seek the best relative value among a large array of offerings. And in line with that approach, we feel it is very advisable to continue holding a meaningful percentage of overall assets in physical, segregated gold.

Best regards,