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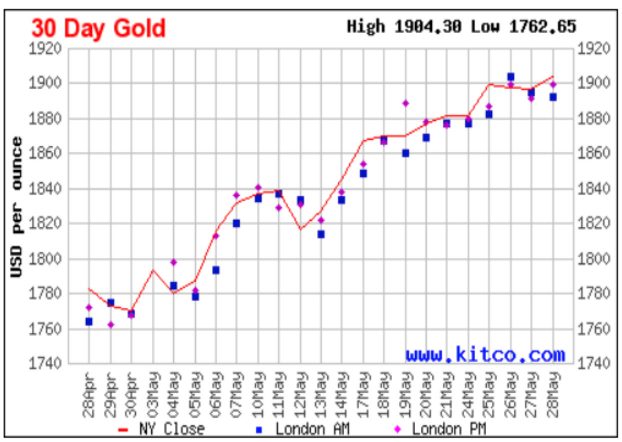
Gold: Stay the Course

Dear Reader,

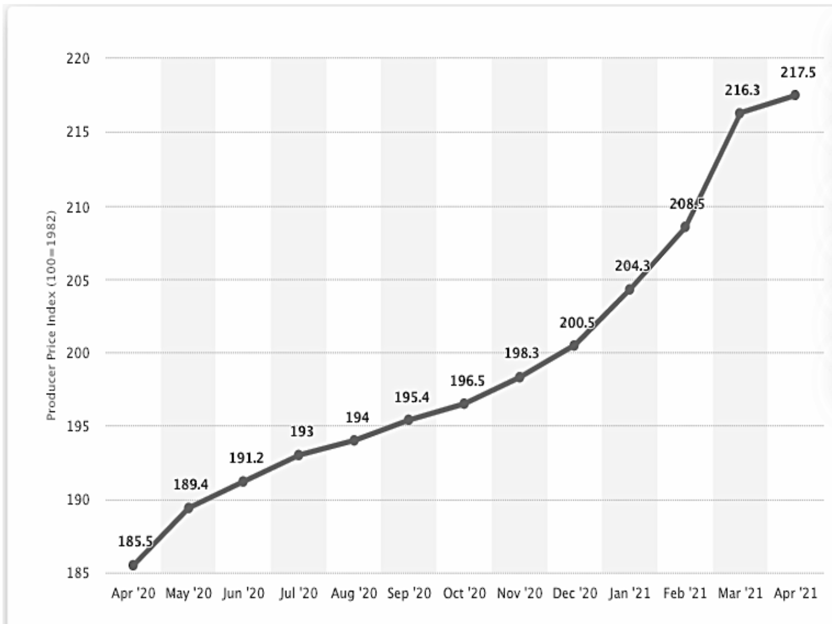
It looks like my January call for gold to start a second major advance was a bit premature. But then, most of my calls, both for market rallies and setbacks, tend to be that way. So here we are, a few weeks later. Round Two has unfolded, helping the gold price from its March low of around $1,700 to over $1,900.



Looking forward, I firmly believe that the current monetary and fiscal environments will continue to benefit gold. The world's central banks remain trapped in a highly accommodative mode, while governments the world over are boosting their spending to levels that defy the imagination. The inevitable consequence of abundant liquidity and historically low interest rates is a gradual loss of faith in money. At best, a cash reserve makes for a temporary parking spot; at worst it's a gradually depreciating asset.

For Americans, the depreciation of money expresses itself in two ways: the falling U.S. dollar and the rise in inflation. On both fronts, we no longer need to project; the evidence of the past two or three months speaks for itself. While the dollar is testing its 2018 low, consumer prices are 4.2% higher than they were a year ago—far above the Federal Reserve's 'maximum tolerance level' of 2% articulated just a few weeks ago. Yet central bank rhetoric suggests that we need not worry about inflationary pressures, since they will prove transitory.

Is it possible that the narrative served up by the Fed, The European Central Bank and others will prove correct? While anything is imaginable and the debt dynamic could well provide longer-term headwinds to inflation, the immediate outlook suggests that more pricing pressures are imminent. A quick look at producer prices, which invariably lead the prices of consumer goods, makes for a grim assessment. The chart on page 2 tracks producer price index for commodities in the United States during the past year.



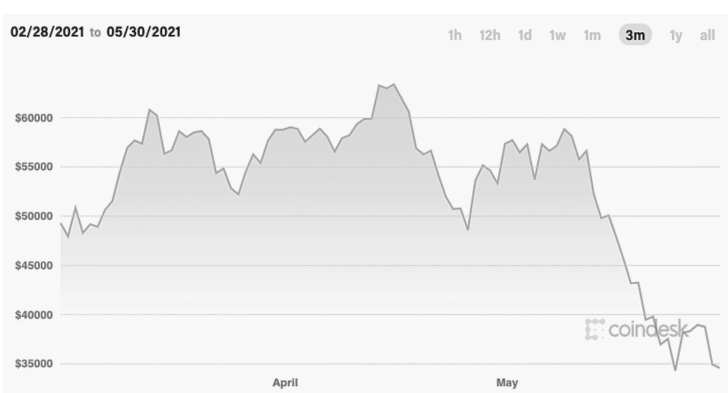
In addition to rising commodity prices feeding through into consumer prices, there are other problems. Wage costs are broadly rising, and COVID-inspired supply chain disruptions cause sporadic shortages, which can seriously aggravate price pressures.

As long as central banks dismiss these concerns and refuse to allow interest rates to rise, negative real interest rates make for an ideal environment for gold.

Given this backdrop, my advice remains unchanged: hold on to your gold position, ideally in physical form. There are also attractive opportunities in the gold mining sector. Several of the larger producers are well managed (something we haven't seen for a long time), trade at historically attractive multiples, and generate strong cash flows.

A Brief Look at Cryptos

Several readers have asked about crypto-currencies, especially in the context of the dramatic advance most digital assets experienced between early February and mid-April. Did the crypto space attract capital that might otherwise have flowed into gold? It certainly seems that way. Conversely, the brutal decline of more than 40% in leading cryptos like Bitcoin (see chart below) and Ethereum during the past six weeks may have redirected investors towards gold.



Another, more complex question: should cryptos be included in a diversified investment portfolio, despite their speculative character and their volatility?

Let me deal with the speculative element first. While the concept of a purely digital asset is a stretch to most investors, we need to recognize that many other financial instruments are arguably even more speculative. I can think of bonds issued by zombie corporations, stocks in companies with deplorable balance sheets and poor trading liquidity and—you may be surprised—the currencies issued by most governments. The only reason I feel more relaxed about owning a fiat currency like the U.S. dollar than owning Bitcoin is that it's widely accepted, more deeply integrated into everyday transaction platforms, and far less volatile.

On the other hand, volatility can be your friend, especially in the speculative realm, and a diversified investment portfolio typically contains a small allocation to speculative assets. The emphasis here is on *small*.

During my five decades in the investment business I've held small positions in risky assets on countless occasions, sometimes losing every penny, at other times phasing out the position after it doubled, tripled or five-folded. Typically, such bets have enormous price volatility while they are fairly illiquid. The best-known cryptos are equally volatile, but have a huge following and are consequently a lot more liquid. Moreover, they are easily bought and sold as exchange-traded funds.

The bottom line: even though I'm much more at home with commodity-related bets when it comes to higher-risk assets, I see little harm in buying a 2% position in cryptos after the recent, massive pullback—let's say 1% in Bitcoin and 1% in Ethereum, which I consider to be the two most intriguing choices. With banks and mutual funds entering the space, it's not inconceivable that they will stage a robust rebound.

Would I bet more than that? No, not without getting far more clarity on how the authorities will deal with the potential threat such digital assets pose to the standing of national currencies, to transaction transparency and, most important to government, to taxation.

Best regards,

Peter Cavelti