7 March 2022

Gold's Pole Position in A Portfolio: The dollar, inflation, the world, and more

As this is written on 7 March 2022 the gold price has spiked to $2,007.50. Oil has spiked to $130 per barrel as investors assess the potential for Europe to stop paying Russia for its oil and gas.

The first chart in this report has been seen before: Most recently CPM used it in the second report we prepared for Gold Bullion International this year, the 21 January 2022 report that illustrated the extent to which gold and silver have been among the best performing assets or 'asset classes' over the past 21 years.

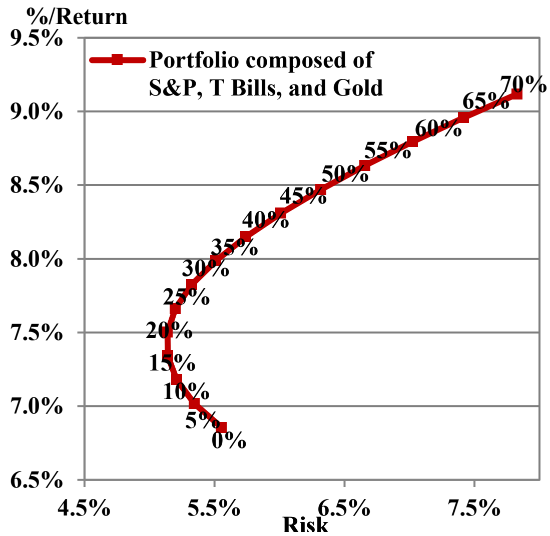
We are repeating it here because events over the past two weeks, as well over the first two months of 2022 have driven home the power of gold and silver as investments and the wisdom of having a significant part of one's wealth in physical precious metals.

Of course, we are referring to the Russian invasion of Ukraine, which has propelled gold and silver prices sharply higher.

- Ukrainians who own gold – and Ukrainians as a people traditionally have been active gold investors – have been able to use gold to find food, water, and escape routes.
- Russians who own gold have been able to use it to buy staples as their banks have closed or run out of rubles.
- Europeans have been remined of how fragile peace and stability are, even in our modern times.
- Investors everywhere else have watched these lessons being re-learned in Europe, have taken note, and have benefited from the rise in prices.

In other words, real-world events have demonstrated in terrifying ways the wisdom of owning gold, which these reports could only discuss in theoretical, empirical, historical, and quantifiable ways.

Efficient Frontier of Portfolio with Gold -1968-2020



The decision by the Russian government to start a major war in Europe for the first time in eight decades, destroying its chances of taking a more prominent position in global politics and economics, has been a shocking demonstration of the value and wisdom of gold as an investment.

Even before that, however, trends in interest rates and inflation have added to the empirical evidence of why gold commands a pole position among investments.

This report explores some of the current factors behind gold's investment strengths. They include currency market trends, interest rates, inflation, energy market trends, global politics, and the destinies of pretenders to the golden throne.*

One of the points that CPM would make is the need to distinguish between asset price moves based on event-driven short-term events and price moves based on longer term economic trends.

For example, at present there are longer term inflationary pressures, but there also are short-term factors such as the spikes in oil and wheat prices due to the Russian invasion of Ukraine. It is important for investors to parse the differences, to be able to allocate assets to be protected from and benefit from both shorter-term ups and downs in prices and longer-term cyclical and secular developments.

1. The Dollar Is Not Collapsing

First, some good news for the world, which is not actually bad for gold. The dollar is rising. It is not collapsing.

The dollar's trade-weighted exchange rate is up 30% from its July 2011 cyclical low and has been even higher few months and years.

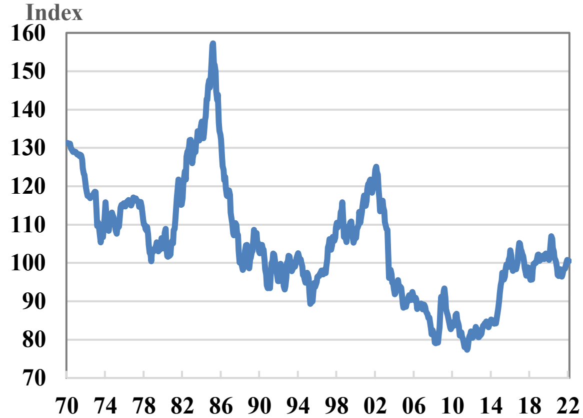
Russia's invasion of Ukraine most likely will make the dollar much more attractive and stronger both in the near term and in the long run. One of the ultimate consequences of Russia's aggression will be the long-term global diminution of Russia politically and economically. Another consequence will be a strengthening and spreading of the realization that Europe, and the eurozone have a hostile neighbor.

A third realization that is likely to emerge will be the relative strength and international standing of the United States, including its otherwise seemingly dysfunctional government and, more important to gold, its currency, the dollar.

While a sizable number of gold bugs think that gold trades against the dollar, it does not. In the history of modern free gold prices, the correlation between gold and the U.S. dollar's exchange rate has been -33%. In other words, gold 'trades against the dollar' only one-third of the time. The other two-thirds or 67% of the time they either do not move in opposite directions or, importantly, they rise and fall together.

U.S. Dollar

JPM trade-weighted index, monthly through Feb.



That is important to understand for gold. Gold and the U.S. dollar are the two most important safe haven investments. When things go bad in the world, investors, governments, and others run to the dollar, gold, or both for safety.

It is not a coincidence that the dollar and gold prices have both risen dramatically since 2014. Investors, governments, and others have been under constant siege, sometimes more or less intense, since 2000, and the risks to investments and assets have risen steadily and markedly over the past eight years.

So, the dollar's strength, which should be expected to be enhanced and furthered in the near- and long-term futures, is positive for gold, because it drives home the point that things are bad, they are not getting better, and investors will do well to add to their gold and dollar holdings.

2. *Russia's Militarism*

Russia's militarism and willingness to use brute force has been well known throughout history. Russian president Vladimir Putin has been explicit in his desires to 'rebuild' what he believes was the "Russian empire" since he emerged as a political leader in Russia in the 1990s.

He has written that the Soviet Union collapsed because it was bogged down in Afghanistan, with his opinion that the Soviets should have been much more brutal in that 10-year occupation and war in order to win. That view won him the attention of then Russian President Boris Yeltsin, who asked Putin to end the insurrection in Russia's southern province of Chechnya. He crushed the opposition in Chechnya with a scorched earth massive bombing campaign that is estimated to have killed roughly 50,000 civilians, agreeing to work with a thuggish warlord to control the province. (That warlord now is supplying around 1,000 mercenaries to fight in Ukraine.)

Putin widely broadcast his intentions, and his willingness to use crushing violence to subdue Ukraine. No one should have been surprised at what has happened.

The invasion and war in Ukraine have forcefully reminded the world of the brutality not only of Russian autocrats but of undemocratic societies around the world. It has brought to the forefront of consciousness how thin the protective lining between modern peaceful coexistence and genocidal warfare really is. It has focused attention on autocratic governments worldwide, and the range of 'hot spots' that could devolve into war on relatively short notice.

The MIT political scientist and China scholar Lucien Pye famously wrote that 'modernity is not assured,' meaning that the seemingly more globalized and civilized world that was emerging could vanish quickly with a reversal of fortunes.

(This was one of the thoughts behind CPM's November 2000 gold buy recommendation, when gold was around $270 per ounce, and we discussed the prospects that the political, economic, and financial environment may be more hostile and more favorable for gold investments for decades to come than it had been in 1979 – 1980.

On the positive side, Russia's aggression demonstrates the attractiveness of democratic principles and individualism to the world, with obvious benefits for the dollar but also for an improved chance of moving back toward the globalization and decentralization that powered the strong economic growth from 1983 through 2007.

All of this is good for wealth formation, and wealth formation is good for gold, especially when risks to liberty and the pursuit of wealth and happiness remain potent in the world from a number of non-Russian sources.

3. *Russia's Looming Impoverishment*

Russia will suffer mightily for many years, if not decades, from its Ukraine invasion. It will lose status and respect worldwide. Investors will be hesitant to invest in Russian companies for a long while, until there is a clearly sustainable change in the way Russia's economy, society, and political systems work.

Shorter term, Reuters has reported that most of the Russian Central Bank's $650 billion is in western banks and has been frozen. (The U.S. dollar accounts for around 16% of the central bank's monetary reserves. Gold accounts for around 21%.) The country is insolvent, and much of its foreign exchange reserves are likely to remain frozen for years while claims for war reparations work through the system.

Russia missed its monthly payments on its ruble denominated debt in the first week of March and seems likely to default on the $40 billion in foreign currency debt over the next two weeks.

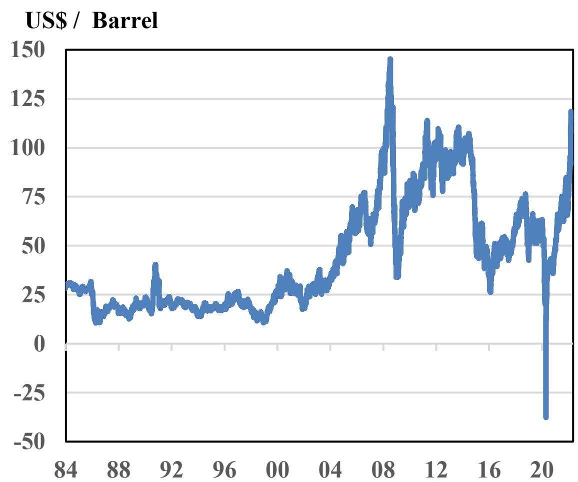
4. *Energy supply, demand, and prices outlook and reality.*

As mentioned earlier, investors need to be able to discern between events-driven, short-term asset price changes and longer-term cyclical or secular changes.

Nowhere is this more clearly demonstrated than in the petroleum market. Both are presently affecting the petroleum price.

WTI Crude Oil Prices

Daily, 2 January 1984 Through 7 March 2022



Oil prices were trading in a range roughly $45 - $65 per barrel into December, with the petroleum market relatively well balanced. Prices then rose above $65, moving to $90 by 3 February. This reflected stronger demand as economic growth gained pace coupled with OPEC's decision to *not* increase production beyond its previously agreed upon increases. Politically inspired delays in U.S. production added to what was, until two weeks ago, a cyclical upward move in oil prices.

Then Russia invaded Ukraine. WTI oil prices touched $130 this morning while Brent touched $137, the highest prices since July 2008.

The war-induced spike will persist for as long as the war does and could grow higher should Europe find the spine to halt Russian oil and gas imports. At some point that premium will come out of the market. Oil prices will remain high, however, due to the cyclical factors.

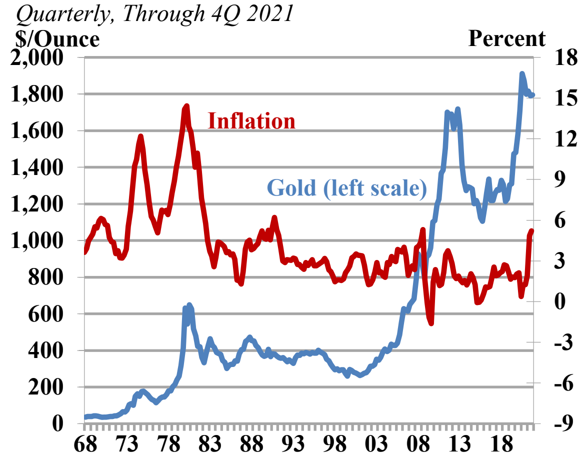
5. *Inflation*

CPM has written about inflation in recent reports. There are secular pressures pushing inflation higher at this time, as well as shorter term developments.

Our expectation is that inflation rates will come down later in 2022 and beyond but remain somewhat higher than they were prior to 2021. The war in Ukraine may delay the reduction in inflation rates. It is important to note that we expect the rate of price increases to slow, and not necessarily for prices overall to decline.

Gold and U.S. Inflation

Quarterly, Through 4Q 2021



More important to note is that gold prices have risen from $260 to $2,000 over the past 20 years in an absence of inflation. Inflation is not necessary for higher gold prices, but it helps.

6. *Interest Rates*

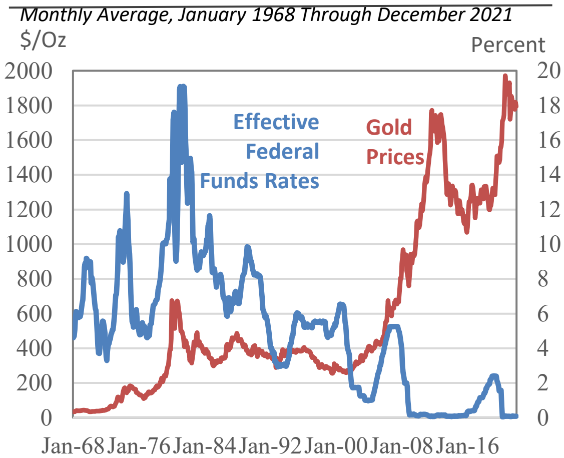
We also have written about the relationship between interest rates and gold prices. The most significant aspect is that the long-term correlation is zero. Gold prices do react to interest rates, but why interest rates are rising or falling, how high or low they are in absolute nominal and real terms, and how the markets interpret them all matter to gold and other assets.

Interest rates are starting to rise and should be expected to continue rising. The Fed is likely to raise the Fed Fund's rate twenty-five basis points next week with further increases later.

Nominal rates are extremely low, however, and are expected to remain below the threshold necessary for investors to pivot away from gold. Real rates meanwhile are expected to remain negative for years, perhaps a decade. Finally, the increase in rates reflects higher inflation, which is stimulative of investment demand and prices for gold.

Effective Federal Funds Rates And Gold Prices

Monthly Average, January 1968 Through December 2021



The rise in rates is unlikely to have a major negative impact on gold investment demand and prices. The bottom line is that rising interest rates should not be a negative factor for gold for years.

7. *Agricultural Prices 1*

This is one of those areas where it is important to distinguish between the event-driven short-term increases in wheat and other prices due to Russia's invasion of Ukraine and the longer-term inflationary pressures on food prices at the consumer level.

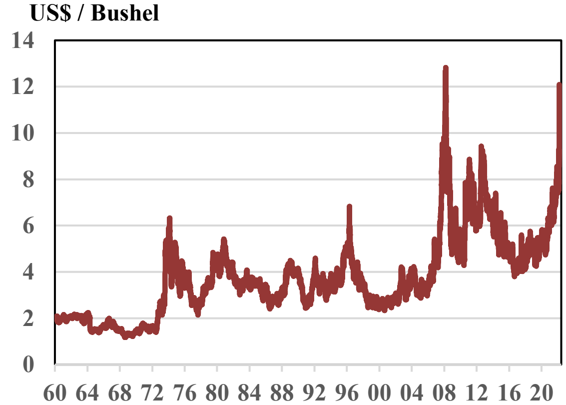
That said, it is important thing to pay attention to is the price of wheat. Just as with petroleum, the price spiked sharply higher in February and March 2008, at the peak of the global food crisis at that time, and then plunged more than 50% within weeks.

Prices have shot up more than 100% in the past week due to the interruption of Ukrainian and Russian wheat exports through the Black Sea, representing around 10% of global wheat production. As soon as the war subsides or is resolved, wheat prices should be expected to drop back.

Wheat Prices

Daily, 2 January 1960 Through 7 March 2022

US$ / Bushel



Source: https://www.macrotrends.net/2534/wheat-prices-historical-chart-data'>Macrotrends

This is not a permanent hike in prices with long-term inflationary implications. Wheat fields are not being burned. It is a short-lived phenomenon.

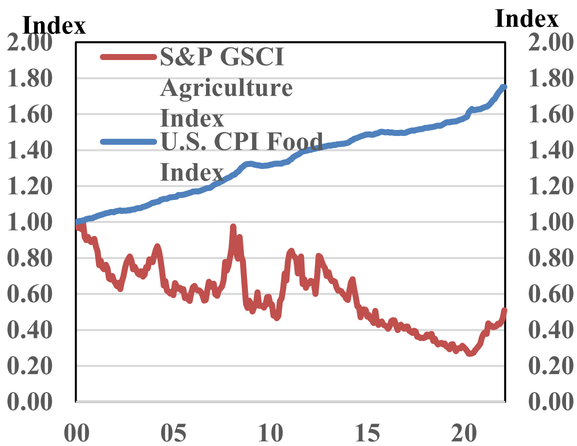
8. *Agricultural Prices 2*

Beyond the price effects of the immediate interruption of wheat exports to the rest of the world due to Russia's invasion of Ukraine, inflation continues to be problematic across sectors of the economy.

One area that has taken a lot of attention has been food prices. The chart below compares wholesale agricultural prices to the prices that consumers pay. Both price series have been indexed so that January 2000 equals 1.0.

The consumer food price index as of January, the last month for which data are available, was 75% higher than it had been in 2000. The wholesale price was 49% lower. This reflects growing ownership concentration and oligarchic market characteristics of large food processing companies, which are paying ranchers and farmers ever-lower prices while increasing consumer prices and limiting competition. Two decades ago, a rancher might be able to sell his cattle, sheep, or hogs to perhaps nearly two dozen meat processing companies. Now there are four.

U.S. CPI Food Index and S&P GSCI



Worse still, this process of increased concentration of distribution ownership and the pricing consequences are occurring across almost all sectors of the U.S. and global economies.

These trends compound the inability to reduce consumer food price inflation by a divided and contentious federal government.

9. *Crypto currencies*

The debate as to what extent crypto currencies compete with gold and silver as safe haven portfolio diversifiers has been won by gold and silver.

Even before Russia invaded Ukraine and sanctions began to be imposed on Russian oligarchs and government officials, the weaknesses and vulnerabilities of crypto currencies, and their inability to protect their owners from both government seizures and theft from hackers were being empirically demonstrated in the real world.

The experience since the Russian invasion has further exposed the extent to which crypto currencies do not and cannot really compete against physical gold and silver when it comes to safe-haven investments and ownership security.

Just today **Institutional Investor's** daily email had an article titled *Big Investors Are Finally Serious About Crypto*. That is reminiscent of the late move into tech stocks in 2000 and into collateralized mortgage obligations around 2006 by major institutional investors and sell side banks and brokers.

Summary

For these and other reasons, gold and silver belong as substantial portions of an investor's portfolio. And, events unfolding now, and likely to emerge in the years ahead, make gold and silver ownership that much more compelling.