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# Gold and Debt Cycles

*By Paul Mylcreest, Hardman & Co Analyst*

## Gold and Debt Cycles

### Gold's risk/reward is improving

The trade-off in the risk/reward for gold and gold mining equities is improving, as central banks push the current iteration of the post-World War II Bretton Woods financial order towards its limits.

Bretton Woods began as a gold exchange standard, which pegged the US dollar to gold at \$35/oz until 1968. The framework required modification after monetary discipline was jettisoned by the US, and policy coordination between the US and other major economic powers broke down. The peg to the gold price became unsustainable and a bull market in gold, lasting more than a decade, ensued.

### The underpinnings of the status quo

The subsequent modification to Bretton Woods, sometimes termed the "Petrodollar", is a free-floating system built on the US dollar's dominance in global trade and reserve balances. It requires a framework in which confidence in central banks remains strong, economic policies of major powers are coordinated and debt levels are manageable.

Looking at today's "big picture", the current economic expansion is the longest in post-World War II history. Meanwhile, even the Federal Reserve has scrapped its attempts to normalise monetary policy, with the reversion to rate cuts and QE (sorry Mr Powell, it is QE). Trade tensions between the US and China continue and the debt burden, which is a good place to begin this discussion, is unprecedented.

### The global debt cycle is key for gold

Our position in the global debt cycle is significant for gold because:

- ▶ it performed strongly versus other major asset classes in the final ("Winter") stages of the three previous debt cycles, which have played out since the Industrial Revolution (see table below);
- ▶ gold has no counterparty risk, which increases in loans/credit instruments as the debt carried by the financial system increases; and
- ▶ debt has a time function – bringing forward consumption from the future into the present – in a sense "buying time". Rising debt ultimately acts as a tax on growth.

### Gold outperforms in the late stages of debt cycles

The table below shows the relatively strong performance of gold and bonds vis-à-vis other assets in the final ("Winter") stages of the last three debt cycles. Whether this cycle is resolved by deflation, inflation, or deflation followed sequentially by inflation, remains to be seen. The three previous cycles ended with **debt deflations** of varying lengths and intensities. Consequently, we have also noted the real (adjusted for inflation) change in the gold price. Obviously, central bank policies in previous debt cycles were *far* more constrained, especially in terms of credit creation.

#### Gold versus other asset classes in final phase of debt cycles

Debt cycle	Final "Winter" stage	Gold act./real	Stocks	Bonds*	Commodities
1788-1843	1825-1843	0%/+26%	-78%	3.54% to 3.17%	-27%
1844-1896	1873-1896	-10%/+20%	-22%	5.49% to 3.61%	-44%
1897-1933	1929-1933	+69%/+122%	-89%	4.73% to 4.49%	-46%

\* Change in long-term interest rate  
Source: Hardman & Co Research

A detailed examination of previous debt cycles – reflecting years of research, which has included reviewing several centuries of data and numerous academic studies – is beyond the scope of this report. However, we have concentrated some of that research into idealised representations of a "Classic debt cycle", which include:

- ▶ a protracted rise, followed by a more rapid fall, in debt across the cycle;

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- ▶ the general trend in other key economic variables, i.e. inflation/price level, interest rates and the rate of GDP growth, during a typical cycle;
- ▶ the four phases (“seasons”) in a typical cycle and brief characteristics;
- ▶ the approximate timing of the phases during each debt cycle since 1788; and
- ▶ which of five major asset classes – equities, government bonds, real estate, commodities and gold – have generally outperformed or underperformed in each phase (note: back-testing, we estimate that the expected outperformance or underperformance for each asset class in each phase of every cycle worked 90.1% of the time).

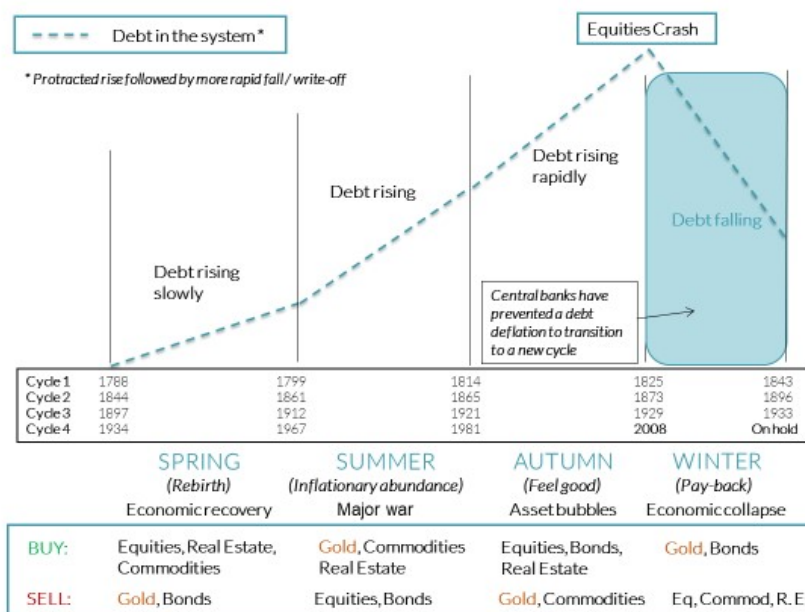
### Central banks extended the current cycle

The timeline of the current cycle was extended by unprecedented central bank interventions, which rescued the global banking system from insolvency after the 2008 crisis. Lehman’s collapse put the system at the mercy of simultaneous crises in Eurodollar funding and subprime assets, along with the disintegration of the repo market. Absent this intervention, the crash would have been a prelude to a prolonged debt deflation. Instead, central banks put the resolution/end to this cycle on hold.

The chart below shows the progression of the rise and fall in debt across a typical cycle. There is no scale to the charts, and they are primarily indicative of the general direction over periods of years.

### Classic debt cycle – showing the idealised trend in debt

#### CLASSIC DEBT CYCLE: DEBT



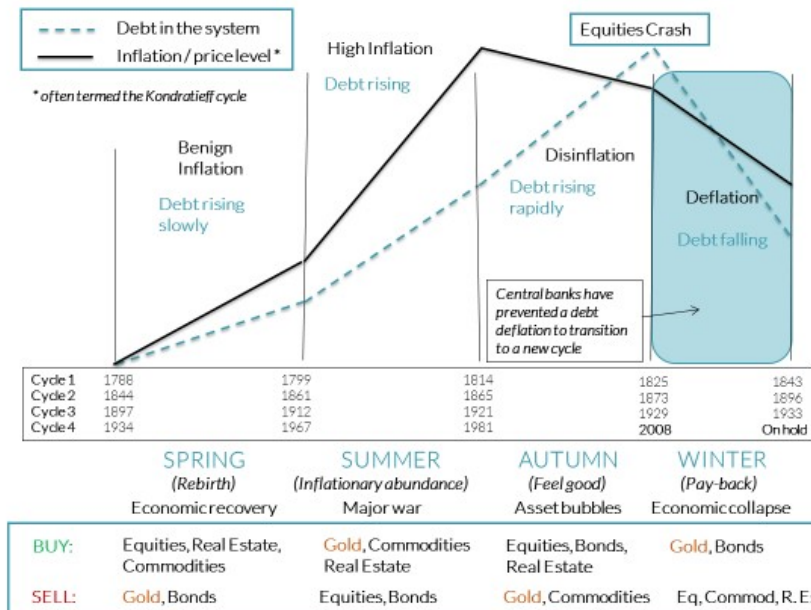
Source: Hardman & Co Research

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The next chart shows the typical progression of the rate of inflation/price level across a debt cycle. This is well-known to economists as the “Kondratieff cycle” or “Kondratieff wave”. While it normally unfolds across the duration of a debt cycle, the peak is generally midway through the latter.

### Classic debt cycle – adding the idealised trend in inflation/price level

#### CLASSIC DEBT CYCLE: DEBT & INFLATION / PRICE LEVEL

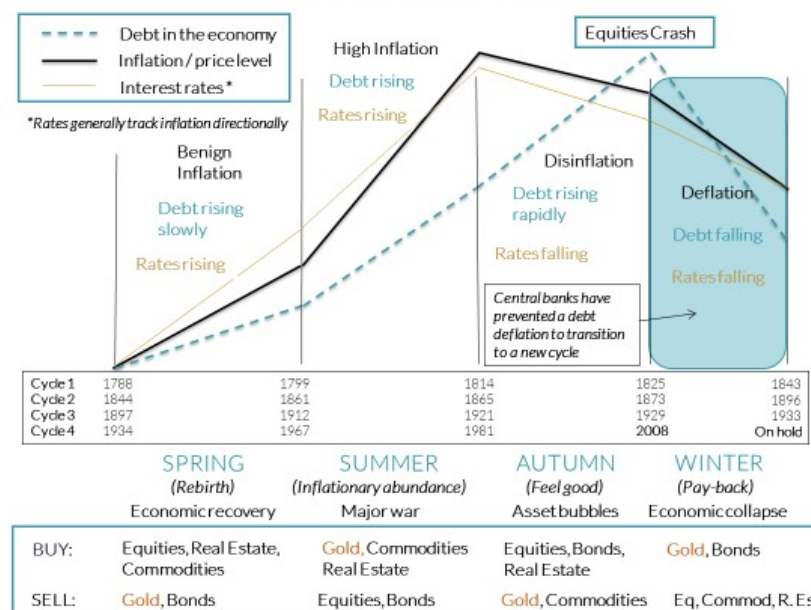


Source: Hardman & Co Research

The trend in interest rates tends to track the direction of inflation.

### Classic debt cycle – adding the idealised trend in interest rates

#### CLASSIC DEBT CYCLE: DEBT, INFLATION & INTEREST RATES



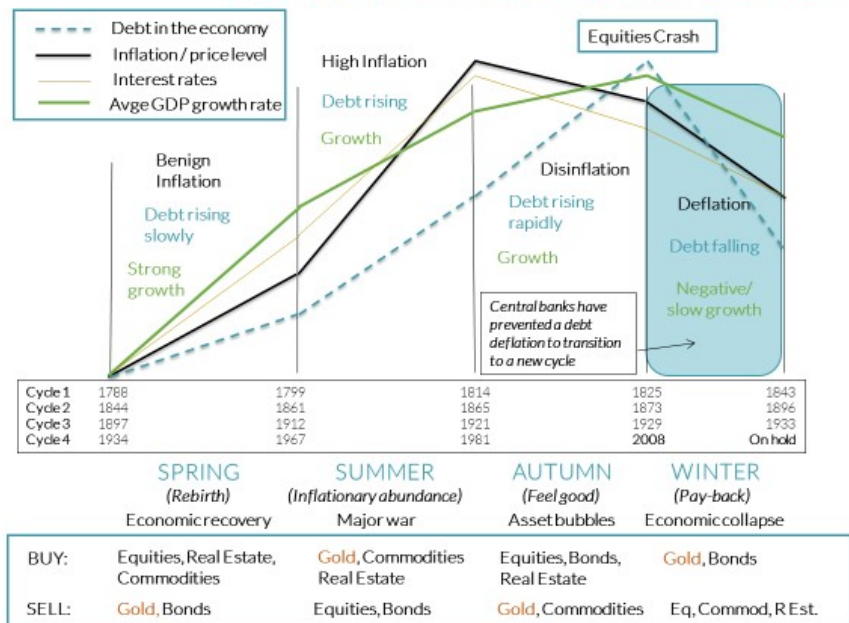
Source: Hardman & Co Research

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The average rate of GDP growth tends to be relatively higher in the earlier phases of a cycle, with the accumulation of debt eventually acting like a tax on economic growth.

### Classic debt cycle – adding the idealised trend in GDP growth

#### CLASSIC DEBT CYCLE: DEBT, INFLATION, INTEREST RATES & GDP GROWTH RATE



Source: Hardman & Co Research

Global debt has risen from \$84tr to ca.\$250tr since 2000

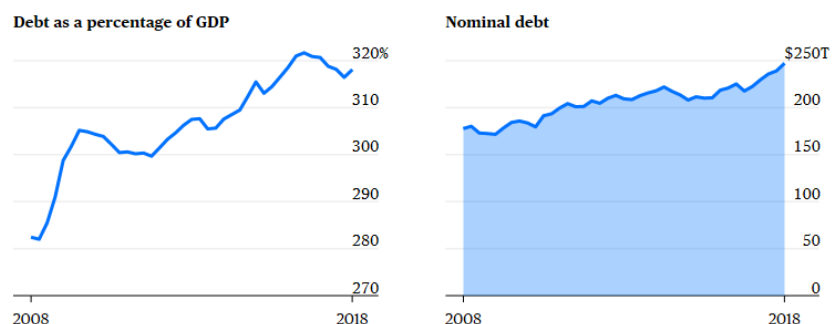
The excesses carried by the system have exploded

Global debt was \$84tr when the “tech bubble” burst in 2000. Without Greenspan’s aggressive rate cutting, the cycle might have come to an abrupt end ... **but this is the era of hyper-interventionism.** By 2008, global debt had risen by a further \$89tr to \$173tr ... and central banks circumvented the typical cyclical progression again.

We think it’s naïve to argue that the recent successes mean that debt no longer matters. While zero interest rates and QE saved the financial system a decade ago, excesses in the system – specifically debt – are now substantially greater. For 1Q’19, Washington-based International Institute of Finance estimates that global debt rose to \$246.5tr, a ratio of nearly 320% of global GDP. In comparison, the peak in the debt/GDP ratio in the US during the Great Depression was 275%.

### Global debt bubble

#### The World's \$250 Trillion Debt



Source: Bloomberg

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### Central bank interventions have been based on distorting financial markets

The central bank policies that fermented the latest surge in the current global debt cycle are founded on distortions to financial markets on a scale never previously attempted. These distortions have focused primarily on manipulating interest rates lower across sovereign bond markets, although the knock-on effects have been felt strongly elsewhere, especially in equities and corporate debt.

In *Fix What Broke, Building An Orderly And Ethical International Monetary System*, gold advocate and economic advisor to President Trump, Judy Shelton, argued:

“In truth, the experiment with floating rates since the end of Bretton Woods has brought about (Milton) Friedman’s worst nightmare: It has empowered central banks – particularly the Fed – and strengthened government control over the private sector.”

### Can this heavy-handed central planning have an enduring benefit?

Using the financial crisis as cover, the world financial order was introduced to a far more heavy-handed version of central planning. The question for investors is whether the impact of this intervention, beneficial as it has been so far, will be enduring. Has the debt cycle been tamed?

Alternatively, have central banks not only temporarily obscured profound structural weaknesses, but exacerbated them by what, in hindsight, will be seen as overreaching themselves?

While the unprecedented stimulus, courtesy of the central banks, led to all-time highs in most financial assets, the gold price plunged into a prolonged bear market, seemingly reinforcing gold’s position as the “anti-central bank” asset *par excellence*.

**From gold’s perspective, the task for central banks is poised to become a lot harder. Among other challenges, they are facing the convergence of an unprecedented debt burden, with an extended economic expansion.**

### About to become the longest economic expansion since World War II

While the current debt bubble is decades in the making, the current economic expansion is almost exactly a decade-long, having begun in the US in June 2009 (according to the National Bureau of Economic Research). The current US economic expansion is now the longest in post-World War II history. This is shown in the table below, along with the other five longest expansions.

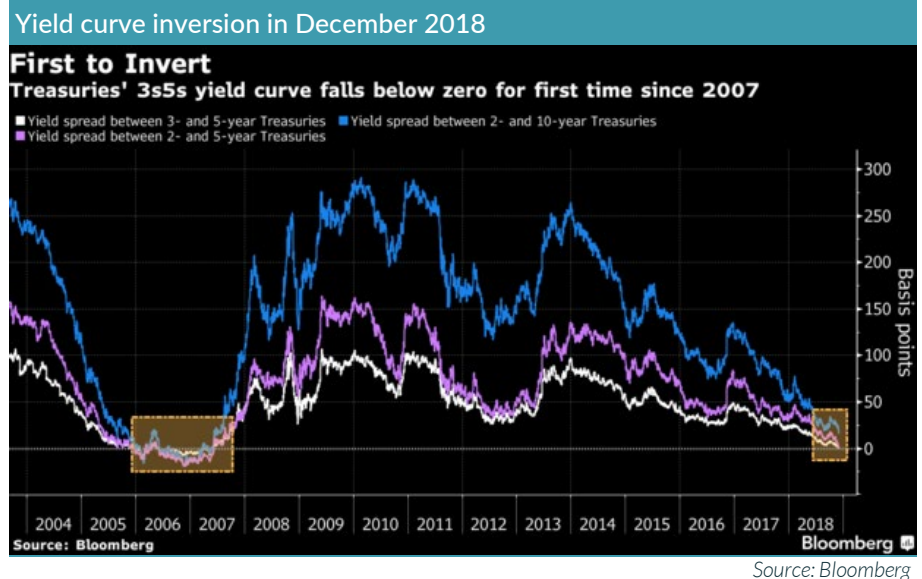
Longest US economic expansions since WWII		
Period	Duration (months)	Average annual GDP growth
Jun 2009 –	124	+2.3%
Mar 1991 – Mar 2001	120	+3.6%
Feb 1961 – Dec 1969	106	+4.9%
Dec 1982 – Jul 1990	92	+4.3%
Nov 2001 – Dec 2007	73	+2.8%
Mar 1975 – Jan 1980	58	+4.3%

Source: Hardman & Co Research

It is worth noting how the average annual GDP growth in the current cycle is lower than the others – with the greater debt load acting like a “tax” on growth.

### Yield curve inversion signals deteriorating economic outlook

Market-based indicators – in the form of inversions in the yield curve – are flashing a warning about the deteriorating economic outlook. On 3 December 2018, Bloomberg highlighted the inversion of the first portion of the US yield curve – the three-year/five-year spread – for the first time for more than a decade.



Source: Bloomberg

A recession within two years has followed an inversion in the US yield curve in every case, except one, since 1995. The closely followed 2s10s (two-year/10-year) yield curve followed the 3s5s into inversion nine months later, on 14 August 2019, although it is currently 17bps away from inversion. However, the yield curve is generally steepening once again, as recession hits (as policy makers aggressively cut short rates).

#### Gold's investment case dovetails with current financial risks

In investment terms, gold has unique properties, which dovetail with risks associated with the current position in the extended economic, debt and asset price cycles. For example, gold is:

- ▶ positively correlated with declining real interest rates;
- ▶ the only financial asset that outperforms in either **inflation or deflation** (cf. Roy Jastram's detailed study covering a timeline of several centuries in his book, *The Golden Constant*); and
- ▶ the only financial asset that has **no counterparty risk**, since it is the only one that is not the liability of a third party.

#### Gold is insurance against financial system mismanagement

Gold was accumulated, historically, to protect capital values and purchasing power from the after-effects of financial system mismanagement, which comes in various guises, including:

- ▶ excessive leverage, leading to rising credit risk and defaults;
- ▶ inflation or deflation;
- ▶ sharp declines in the prices of other major asset classes; and
- ▶ waning confidence in policy makers and the status quo in the world financial order.

All four have typically occurred simultaneously in the late stages of previous debt cycles.

The analysis above is part of a larger report on the gold mining sector, which will be published shortly by Hardman & Co. While the fundamentals for gold are arguably better now than they have been for more than a decade, the dynamics affecting the price are more complex than the investment case for gold, being heavily dependent on the structure and mechanics of the gold market. This is covered in greater detail in the upcoming report.

### About the author

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*Paul has 30 years' analytical experience, having started his career in the Chemicals sector. He was an Extel-rated analyst at S.G. Warburg, Schrodgers and Citibank. As well as a brief foray into Oil & Gas, he worked for several years as a Global Macro & Cross Asset strategist, firstly setting up on his own, and later working at US commodity trader, Archer Daniels Midland (ADM Inc.). He began his mining coverage at Crédit Agricole Chevreux in 2005.*

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