J Taylor's

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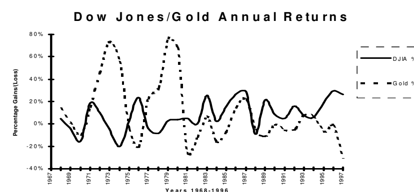
Gold



Energy & Tech Stocks

Weekly Message (excerpt) ***(Now in Our 38th Year)*** **January 4, 2019**

Which Safe Haven Markets Will Dominate in 2019?

So far in 2019, the equity markets have been characterized by very substantial volatility as stocks are entering what I think will be a very significant bear market. With equities heading into dangerous territory, traditional safe havens like U.S. Treasuries, and to a lesser extent gold, have benefitted. As we enter 2019 here are some of the dark clouds hovering over the horizon that I think will likely bode well for these traditional safe havens.

- The U.S. China trade war.
- Italian elections in May that raised questions about the future of the European Union (EU)
- Fears of a hard Brexit lifted credit spreads above those in the U.S. for the first time in years.
- China continued its slowdown.
- In the U.S., optimism started to fade as interest rates rose, economic data disappointed and oil plunged to less than $50 per barrel amid forecasts of weak demand.
- U.S. corporate earnings projections were also reduced as the effects of the recent tax cuts started to decline.
- The world benchmark U.S. 10-year Treasury yield, which reached a 7-year high of 3.2% last year, changed gears after the Democrats won control of the House of Representatives in the November mid-term elections. Investors believed that their victory reduces the chances of further tax incentives from President Trump. The 10-yr Treasury yield has been on a continuous slide since, ending 2018 at 2.66%.
- Global debt reached a whopping 225% of world GDP.

As money has come out of stocks, it has largely flowed into fixed income and primarily into U.S. Treasuries and German Bunds. Only a small dribble has found its way into gold. After all, why should investors seek out gold as a safe haven when the gods of the universe—the central bankers—have proven capable, cycle after cycle, of "saving the dollar centric global monetary system."

And now with U.S. equities on the verge of a nervy bust, a more dovish milieu is being proclaimed by central bankers. Jay Powell of the Fed, for example, has backed away from three rate hikes in 2019; now it's just two. And there could be more of a back away from honest money with more economic decline. In fact, markets are actually pricing in zero U.S. rate hikes in 2019 and cuts in rates in 2020.

I'm personally assuming we are in the early days of a major bear market in stocks. If you don't agree with that view you might not wish to read any further. But believing as I do that we are on the precipice of a major decline in stocks, the question in my mind as we head into 2019 is to what extent U.S. Treasuries will continue to be the main go-to market in the risk-off trade and to what

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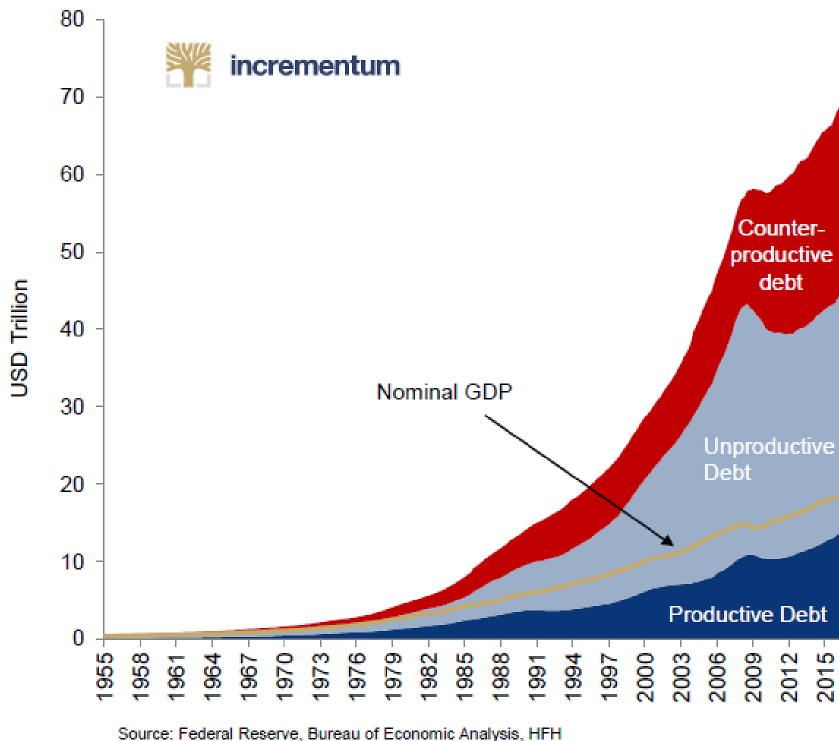
extent might a loss of confidence in the dollar as the world's reserve currency lead to a rise in the price of gold? As Alasdair Macleod of Goldmoney.com logically concludes, the answer to my question requires an examination of likely flows of money in 2019 and beyond, and those flows are very much determined by the point at which we exist in the current credit cycle.

We are in one of the longest credit cycles on record, with 2018 being the tenth year of expansion. Alasdair quite correctly points out that in the late stages of the credit cycle money flows out of the financial sector into the real economy and with the flow out of financial assets, interest rates begin to rise. And so, as you can see from the 10-Year, U.S. Treasury chart, yields have risen dramatically from 1.385% on July 5, 2016, to 3.227% on October 1, 2018. The 10-year rate has corrected to 2.652% as of this writing, but it is clear that with the real economy doing better, interest rates have risen, which in turn has put downward pressure on stocks. With increased volatility in U.S. equities, the recent decline in rates reflects the safe haven risk off attitude.

But should we take it as a given, as most mainstream analysts do, that a flow out of stocks automatically means the only safety bunker to hide out in when stocks collapse is the U.S. Treasury market? The answer is an unequivocal "NO!" As Alasdair points out, in the late stages of a credit cycle, Main Street bids the total flows of money away from financial assets. So yes, some money has flowed from stocks to U.S. Treasuries in the latest equity market decline, thus providing the "correction" noted above since October 2018 in the 10-Year Treasury. But the point remains that in the late stages of the credit cycle, less money flows into financial assets, thus causing their prices to decline. Once a major crash occurs and a new round of QE is administered, a new cycle usually begins. But can we assume that will happen again, especially with the existing credit cycle bubble, which is now the biggest global bubble yet by far?

Given its confidence in the ability of the PhD standard to replace the gold standard, mainstream pundits assume the U.S. Treasury market is better than gold. And the standard answer to my question is a resounding "Yes!" Taylor, can't you see the performance of geniuses like Greenspan and Bernanke? Well, this 71-year-old author is old enough to remember when the gods of money were not able to hold the system together. During the late 1970s, there was a massive exodus from both stocks and bonds, while at the same time, gold rose from $35 to a momentary $850 price tag.

A Replay of the 1970s?



Might we now be facing a replay of the late 1970s when confidence is lost in the government's ability to repay its debt obligations? And given the magnitude of much greater debt and debt to GDP ratios, might the pathology be many, many times greater than the late 1970s when confidence was lost in the dollar and gold skyrocketed from $38 to $850 in just a couple of years?

Alasdair noted in his January 3 missive that "*The credibility of government debt is based on the assumption the issuer can afford to continue to roll it over rather than repay it.*" Everyone knows the U.S. debt of $22 trillion will never be repaid, but at present the assumption remains that it can always be rolled over. But that assumption was lost in the late 1970s after Nixon removed the gold standard from international trade and the U.S. began printing mountains of dollars out of thin air to pay for socialism and Vietnam.

Years of con-artistry since then by Keynesian central banks have left most investors confident that elitist bankers can always save the day. But now take a look at the exponential level of debt since the late 1970s until now and note how much faster debt is growing relative to GDP (yellow line). You don't have to be a rocket scientist to realize at some point if debt is growing exponentially and income (GDP) on at some low level of linear growth, a day of bankruptcy lies ahead. Yet with each bubble, the U.S. continues to pile more debt upon debt, and the ratio of Debt to GDP continues to grow still further.

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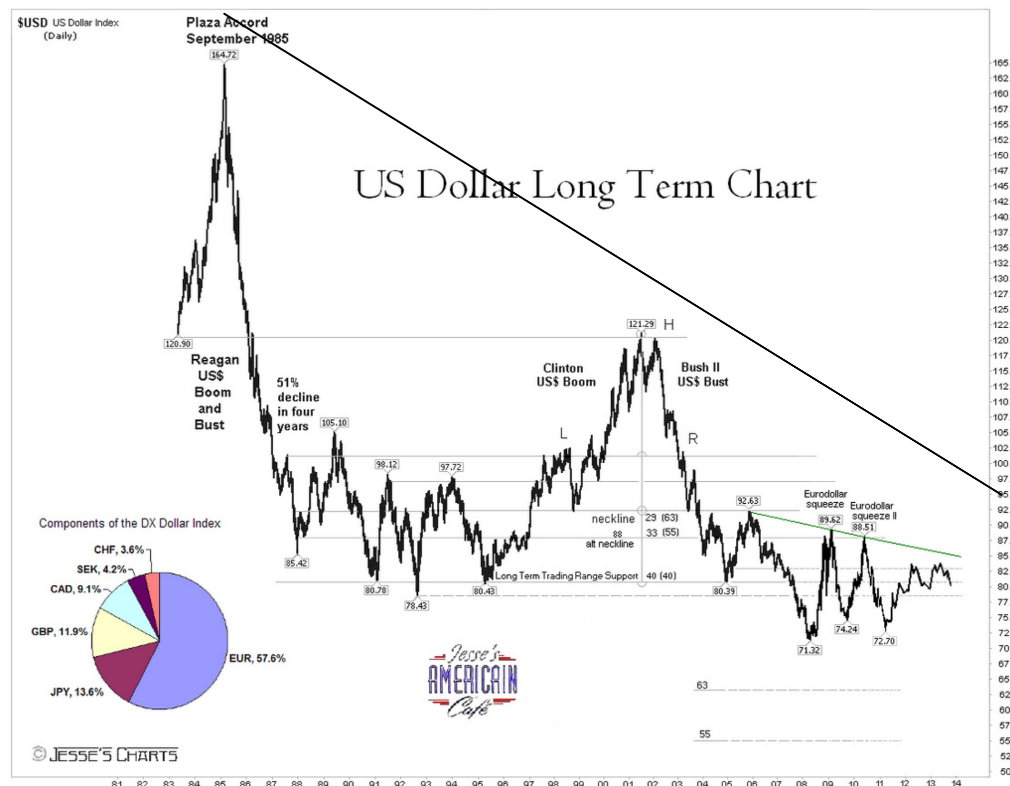
The graphic above displays total USD debt now approaching $70 trillion! It includes not only U.S. federal debt (now approaching $22 trillion), but also debt from local governments in the U.S. and the private sector as well. This picture really illustrates the pathology of a fiat/debt-based monetary system. Over time, more and more debt-based money becomes less productive and eventually counterproductive so that the more debt owed, the less income is generated. We are clearly at the counter-productive level now, not only because of mal investment that occurs with artificially low interest rates, but also because the cost of servicing the debt becomes greater and greater at the expense of productive use of capital. What happens is that income declines to such an extent that the only way debt can be serviced is one of two ways: (1) Either rates must rise to levels that reward savers, resulting in horrendous depression, necessary to set the table for long-term honest growth; or (2) Governments/central banks engage in hyperinflationary money growth that totally destroys the fabric of society and sets the stage for radical changes of government.

I believe the U.S. is at such a crucial point of time now. In the 1970s when double digit interest rates were required to dampen rising levels of inflation, the problems faced by then Chairman Volcker were "kids' stuff" compared to the problems Jay Powell faces now. Even so, Treasury rates north of 12% were required to dampen excess consumption caused by excess government spending and a lack of monetary discipline by the Fed, which was pushed by President Nixon, much as President Trump is pushing Jay Powell now. But the Federal debt then was just a few billion dollars, about the amount Trump wants to build his wall, not $22 trillion as it is now! A mere 1% rise in interest rates now leads to $220 billion of additional government expense, without the government providing any additional services!

To add to the problems of Jay Powell, the U.S. continues to spend trillions on wasteful military excursions, and aging baby boomers are now leading to a spiral of debt, taking the U.S. debt levels north of $50 trillion over the next 30 years. But that's not all. In the past, the U.S. has gotten away with living beyond its means because foreigners like Japan and China have been willing and even eager to buy U.S. Treasuries. That began to change in earnest with the financial crisis of 2008 in no small part because of the financial injury to foreigners by dishonest U.S. bankers. Also, the rest of the world was then realizing that the U.S. empire was expanding to the point where bankruptcy lay at some point in its not-too-distant future.

So now late in the current credit cycle, we are going to face a moment of truth. With interest rates far from anything like the double digits of the late 1970s and with a declining appetite to own U.S. Treasuries by foreigners, we are seeing rates rise rather dramatically, leading to massive volatility in stocks and the beginning of a very painful bear market in equities.

At some point, history suggests that the Fed will begin to print money in whatever quantity it takes to keep the banks from going bankrupt, just as they did in 2008-09. The big question is, at what point is it obvious that the Emperor is wearing no clothes and there are no longer any takers of U.S. Treasuries, causing the Fed to print so much money so rapidly that foreigners completely abandon the dollar, leaving the Fed with no choice but to hyper inflate? The timing of such an event is based in large part on global psychology and geopolitical dynamics, so it is impossible to predict timing.



However, given the timing of the current credit cycle, we are nearing a point in time when either the Fed is somehow able to hold the dollar system together for another cycle or the system itself blows up or implodes, leading to a new global monetary regime.

The best outcome for those of us older people living today of course would be a preservation of the existing system for another cycle. But even if the Fed is somehow able to pull that rabbit out of a hat one more time, you can count on the dollar losing value vis-à-vis other currency, as it has been doing since the Plaza Accord during the Reagan

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years. You may be thinking that the dollar is strong, given its performance since 2011, but judging from the chart above, you can see just how much of a decline the dollar has been in over the past 33 years.

Gold is pretty much the mirror image of the dollar since the Plaza Accord in 1985 and that has taken place while the system has remained intact. The main point to keep in mind is that the major increases in the price of gold have occurred as a result of major monetary disturbances. The first one occurred in the late 1970s after Nixon removed gold as a legitimizing anchor from the dollar. That led to the very real threat of hyperinflation in the late 1970s. Only by the rise as a result of Volcker slamming on the monetary breaks in 1980, leading to double digit Treasury rates was the system saved from the fires of hyper inflation.

The next major rise began in the early 2000s following the frightening equity market collapse that came with the dot-com collapse, which was also followed by 9-11. Greenspan kept the pedal to the metal with each and every equity market pullback, leading to what was known as the Greenspan put. With that, the Fed ushered in the destruction of capitalism by disallowing price discovery of capital. To keep the economy from collapsing, more and more debt-based money was created, culminating in the biggest financial market collapse to date in 2008-09 as the system became ever more insolvent.

At present we are perched at the end of a 10+ year credit cycle, meaning that the flows of capital have begun moving out of financial assets into Main Street. Jobs and wages are picking up in the U.S., leading to Jay Powell's sense of urgency to be ready to fight inflation in addition to "Normalizing" the Fed's balance sheet so it has ammunition to lower rates during the next recession. But he has a couple of major problems that Paul Volcker didn't have in the late 1970s. First, with the Fed at $22 trillion in debt as noted above, a mere 1% rise in rates increases federal expenditures by $220 billion! The math simply doesn't work if you tried to raise rates to a level that could restore us back to a free market interest rate. Secondly, the world is much more hostile to owning U.S. Treasuries now than in 1980 not only because of growing hostility toward the American empire but also because of a loss of confidence in the stability of the existing dollar system. Third, I would suggest America is far less stable morally now than in 1980 because of a decimated middle class and a leftist intellect and poverty-stricken Democrat-voting immigrants who threaten the U.S. with a second civil war.

In summary, I'm sure my comments here will seem radical and out of touch with reality to many of you. But if you simply take the more optimistic assumption of the mainstream that the Fed can pull off one more cycle before the system finally self destructs, at the very least we are in for a doozy of an equity market decline. And if the system survives, the safe haven will continue to be U.S. Treasuries, with gold playing a secondary role for safe haven status. Even so, history shows that owning gold in this more optimistic scenario will serve you extremely well. That last example was from 2008 to 2011.

On the other hand, if my more pessimistic but I think very realistic possible outcome takes place, the dollar will be replaced as the world's reserve currency and gold will be the only safe haven, leaving it priced at levels in terms of dollars that may be beyond the imagination of even the craziest gold bugs. It's simple math: if the dollar nears a state of worthlessness, gold rises to levels approaching infinity.

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