Gold@$2500/oz: All-time high OR All-time low prices?

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With gold prices hitting $2500/oz for the first time recently, the mainstream media that has largely ignored the ongoing gold bull market is likely to get a wake-up call. But as with all stories, there will be two sides and gold would certainly be no exception. The media is likely to present the narrative that the near-term uncertainties in the Iran-Israel conflict, the US political situation, the likelihood of multiple US Fed rate cuts later this year, and the probability of Trump tax cuts in 2025 leading to greater deficits are contributing to the upward movement in gold prices.

Further, I suspect the argument against gold prices increasing in the medium-term future would be along the following lines: Starting from the Oct 2022 low of $1630/oz, gold prices have given a greater than 50% return in less than 2 years and that is indeed more than a solid return for a safe-haven asset. In the context of a relatively stable US economy with low consumer price inflation (at least as officially reported), this is indeed an exceptional return and investors should not expect this recent trend to continue.

But as I have explained in my book "**RIP USD: 1971-202X …and the Way Forward**", this is just the start of a bull market wherein gold prices go at least to $24,000/oz and probably well beyond as well over the next 5 to 10 years. Just going by history, a 10X is not unusual for a gold bull market as indicated in the table below.

Periodic spurts / slump in Gold prices from 1971 to date			
S.No	Time Period	Gold Price Movements ($/oz)	Comments
1	1971 to 1980	$35 to $843	A 2300% increase over 10 years
2	1980 to 2001	$843 to $256	A 70% decline over 21 years
3	2001 to 2011	$256 to $1896	A 640% increase over 10 years
4	2011 to 2015	$1896 to $1049	A 45% decline over 4 years
5	2015 to Q1 2024	$1049 to $2064	A 97% increase over 9 years

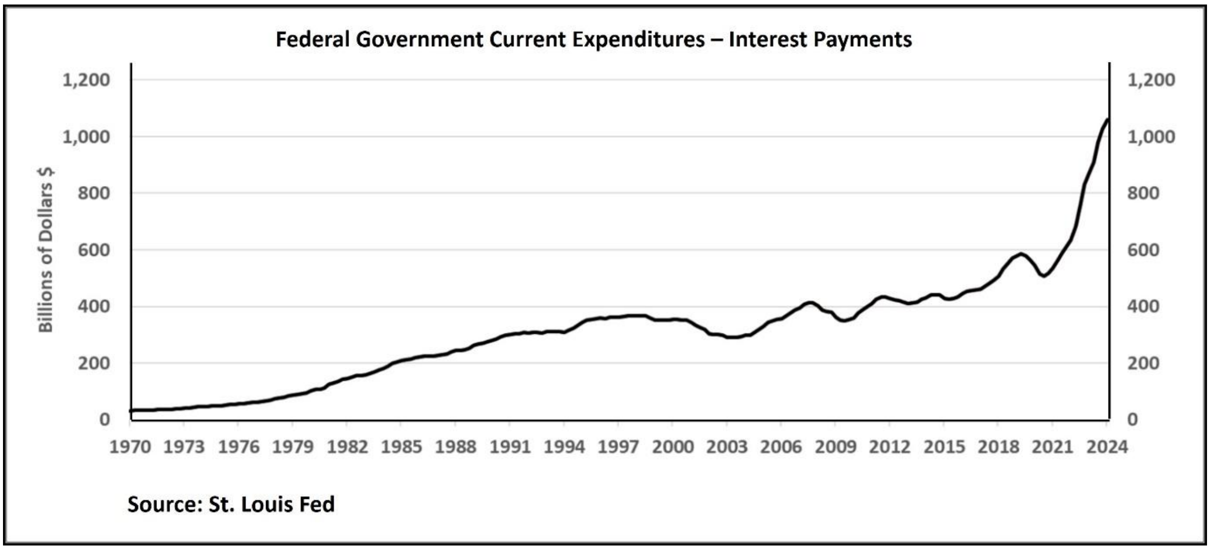
Source: MacroTrends.net

We witnessed a 23X in gold prices between 1971 & 1980. Between 2001 and 2011, there was a 6.5X movement in gold prices. Therefore, a 10X over the next decade is well within the historical patterns observed.

The Fundamental Drivers

The basic reason for the current bull market is the manifestation of the price inflationary consequences of decades of monetary price inflation (i.e. an increase in the supply of money and credit) as a policy followed by the US Government and aided by the ever-accommodative US Federal Reserve.

The US is at a point when it should be obvious to a critical observer that the Federal Government is running a Ponzi scheme. The annualized interest payments are currently at $1.06 trillion on projected revenues of $4.9 trillion for FY2024. The increase in national debt during the same period (FY2023 closing National debt was $33.17 trillion and as of July 2024, it is $35.2 trillion with another 2 months to close the fiscal year by Sep 2024) would be around $2.5 trillion. This is indeed the true federal deficit during FY2024 and the reported federal deficit would be much lower due to the lax accounting standards.



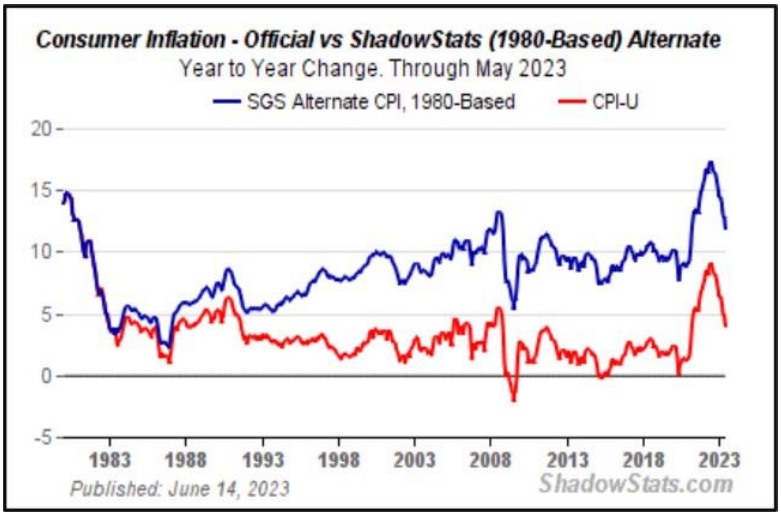
What this implies is that the US government has to borrow nearly $1.5 trillion to meet its obligations even before we consider interest payments on existing debt. This is the classical definition of a Ponzi scheme. With the exception that the mechanism of default is going to be slightly different as compared to what the markets are usually conditioned to. The default mechanism of the US government in the years ahead is going to be what I refer to as **Default through Monetary Inflation (DMI)** in my book referred to earlier. In this, the Federal Reserve would monetize the ever-increasing deficits of the US Government resulting in an explosion in the growth of money supply and the Federal Reserve balance sheet. The loss or the default would be experienced through a loss of the purchasing power of the US Dollar.

The trajectory of federal interest payments - Is it possible to reduce the interest payments on National debt by reducing the Fed funds rate? The current interest rate on the National debt is still a very low 3.3% as of July 2024. This rate will surpass the Fed funds rate, currently at 5.25% to 5.5%, over the next few years. So even a massive 1.5 to 2.0% reduction in the Fed funds rate would not lead to any reduction in the interest rate on National debt and would merely slow down the rate of increase. Indeed, the increase in the interest rate on the National debt accompanied by an increase in the quantum of the National debt could well cause the interest payments to go beyond $1.5 trillion and perhaps even touch $2 trillion in the next couple of years. That would cause interest payments alone to be more than 30% of the Federal revenues.

At this point, the Ponzi scheme would be obvious to even a casual observer.

This is the overriding reason why the US Fed will be desperate to reduce rates despite consumer price inflation staying above the "supposed 2% average" target i.e., to prevent the bankrupt nature of the US federal government from becoming obvious to everybody. But as mentioned earlier the rate cuts, at best, would hide the bankrupt status of the US Federal Government for a couple of more years.

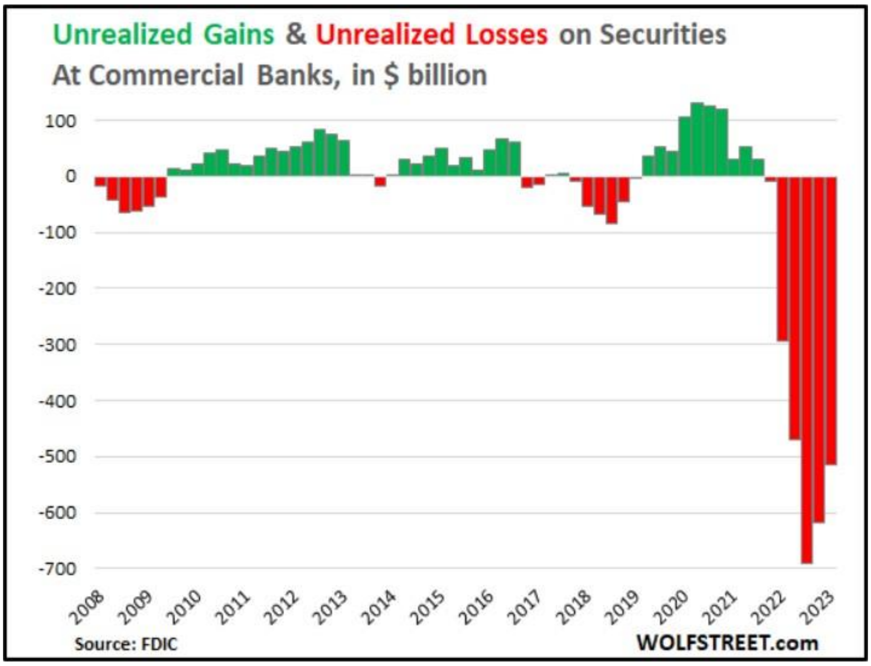
However, unlike the 2008 scenario, there is a limit to rate cuts this time around. Alternate estimates of consumer price inflation such as the one produced by Shadow Government Statistics indicate that reported CPI numbers understate the price increases by 8%. So, it is not the cooling inflation that is prompting the talk of a Fed rate cut.



A critical factor to remember is that we have assumed normal economic activity in the years ahead. That is an assumption that could be termed as "exceedingly optimistic bordering on insanity" for the following reasons

- ✓ **Unravelling of the Housing Bubble 2.0** – The current housing bubble is substantially bigger than the one that burst in 2008 and led to the GFC. The median housing prices peaked in Q42022 and after 20 months, prices are still down by more than 5% as compared to the peak.
- ✓ **Current Unrecognized Banking Losses dwarf the GFC period loss**: The current HB2.0 has still not burst and the associated panic-selling by

the homeowners as well as the banks that are holding the delinquent mortgages is yet to begin. Despite this, the current unrecognized losses in the banking system, dwarf the actual losses that happened during 2008-2010. When the HB2.0 bursts, these losses will grow manifold.



- ✓ **Loss by the US Federal Reserve**: The US Federal Reserve made a loss for the first time and this loss, at well over $100 billion, was on account of the US Fed funds rate hikes initiated in 2022.

There could be other reasons why the US Fed might want to reduce rates apart from the three mentioned above e.g. the real unemployment is substantially higher compared to the reported numbers, the real GDP is also lower due to underreporting of price inflation, etc. Still, the primary reason as mentioned earlier is to prevent the Ponzi nature of the US Federal Govt finances from becoming obvious to all. But then, rate hikes or rate cuts don't alter the nature of the Ponzi scheme. Rate cuts can merely delay the inevitability – and even that is very questionable at this juncture given the size of the debt and deficits.

It is way too late to do anything about the US Government finances and this is what Mises referred to as the "Crack-Up Boom" i.e. the stage in which markets lose faith in the stability of the currency. The path was set in stone once the US Fed embarked on the path of ZIRP and QE after the GFC 2008. After that, it was just a matter of time as to when the blow-out would occur. That we have lived with 15+ years of reckless monetary policy is something very hard to comprehend, but the longer the Fed stays on this path of easy money, the worse will be the consequences during the inevitable burst.

The US economy is but one pin-prick away from an inflationary depression that could last a decade or longer; a period in which the US dollar would most certainly lose its reserve asset status as well. There are multiple bubbles – HB2.0, Nasdaq 2.0, and the Bond bubble. There are also any number of pins – banks recognizing the mortgage/treasury bond losses, the launch of the BRICS gold-backed currency, a tech recession in the US leading to a crash in the AI markets etc. It's quite hard to forecast when or which pin is going to prick which bubble but it’s just a question of one pin pricking one bubble and we will witness a series of cascading dominoes leading to the inflationary depression, and eventually, the Crack-Up Boom.

The Return to Gold

If we are to look for a bright spot in this dire forecast, it is that the world is going to emerge on the other side of this prolonged depression with a gold-based monetary standard – in one form or another. The world has been on several versions of the gold standard over the last 200+ years, but even the most diluted version that prevailed during 1971, would be far superior to the current fiat currency system. Referred to as the “**Gold Exchange Standard**”, that is the most likely version that the world is likely to adopt as well.

Though far from ideal and notwithstanding the disadvantages as compared to the **Classical Gold Standard** that prevailed before 1913 (i.e. when the US Federal Reserve was formed to manage the currency), the *Gold Exchange Standard* would be the least disruptive way to bring some stability to the currency markets. This brings us to the topic of this article “At what price of gold can the world transition to this monetary system?”.

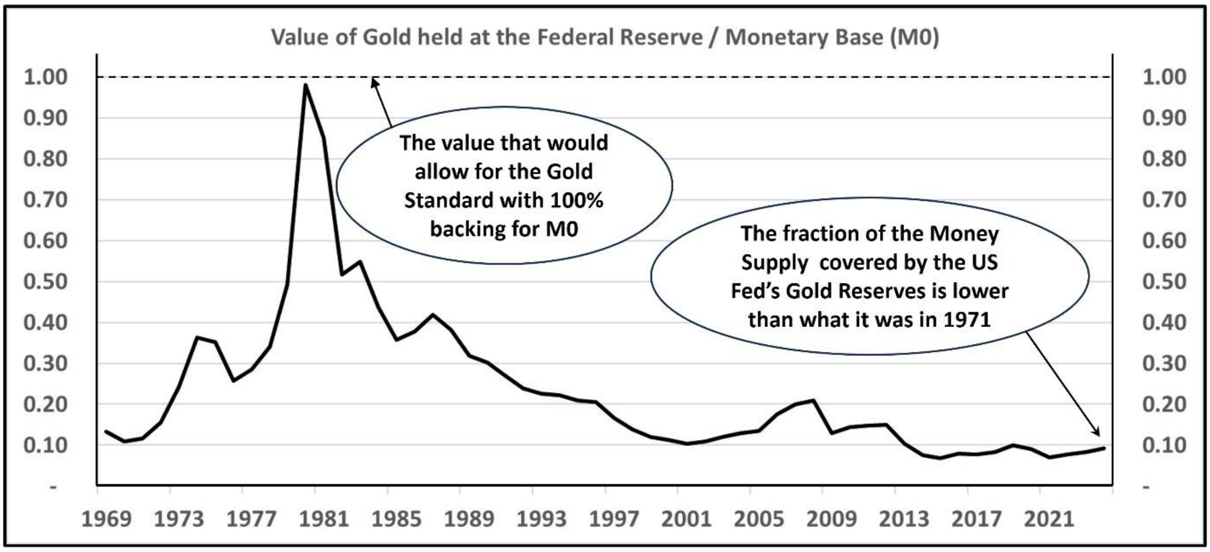
While this is not the forum to compare and contrast the Classical Gold Standard that prevailed before 1913 and the subsequent currency management under the US Federal Reserve, a few pointers would be useful:

- ✓ The value of the US Dollar stayed constant at 1/20th an ounce of gold between 1776 to 1913. The entire period under the Classical Gold Standard witnessed falling consumer prices accompanied by a nominal 4% GDP growth. In contrast, the US Dollar has lost 3/4th of its value between 1913 and 1971 with gold going from $20 to $35/oz.
    a. The fiat currency prevailing since 1971 has ensured that the US dollar has lost almost 99% of its value in gold over the last 53 years.
    b. As explained in the book **RIP USD: 1971-202X**, the US Dollar is on course to lose at least another 90% of its value over the next few years.

While the Classical Gold Standard would be the ideal solution, the Gold Exchange Standard would be a vast improvement over the fiat currency system prevailing now. As I have further postulated in the book, the world would probably go back to the Classical Gold Standard over the next few decades in stages. We now have the technology to implement the same circumventing some of the operational pitfalls associated with the Classical Gold Standard.

The US Dollar Price of Gold

Given below is the chart of the Monetary Base (M0) that is covered by the value of the gold held by the US Federal Reserve (quantity of gold multiplied by the average quarterly price of gold). This indicates the fraction of the money supply that is covered by the gold reserves and the inverse gives the no. of times the price of gold has to go up by for the US Federal Reserve to transition to the Gold Exchange Standard.



Fraction of the Monetary Base (M0) that is covered by the value of the Gold Reserves held by the US Federal Reserve. A value of "1" would allow for the Gold Standard to be implemented with 100% backing for the Money Supply.

This graph indicates that despite the current nominal high price of gold, given the huge expansion in the Money Supply over the decades, we are at almost the lowest price of gold on a monetary inflation-adjusted basis.

Many queries can be asked on the above – what component of the money supply should be used – M0, M1, or M2, what % of the money supply should be covered by the gold reserves as the world has largely operated with a 25 to 40% coverage etc. But whatever combination we choose for the implementation, the price of gold has to be several times the current price of $2500/Oz. Probably at about 10 times the current price i.e. $25,000/oz, the US Fed can go back to the Gold Exchange Standard and this would be the equivalent of the 1980 high price of $850/oz to account for the interim monetary inflation.

The US Federal Reserve Hammer of Liquidity

However, the most important determinant is not the historical monetary inflation created, but the one that is likely to be injected in the years ahead. The only hammer that the US Fed has used to handle every economic crisis (Nasdaq 2000, GFC 2008, Covid 2019) of the last few decades is that of liquidity injection. While all of the injections have merely served to postpone the "Day of Reckoning" while exacerbating the malinvestments, much of the world is convinced that these liquidity measures indeed worked. Bernanke was awarded the Nobel Prize in

Economics in 2022 as an affirmation of his policies implemented after the GFC 2008.

So it should not be surprising if a similar policy gets enacted when the current stocks-bonds-real estate bubble bursts. The bigger the economic crisis, the larger has been the monetary inflation. The current bubble dwarfs the 2008 housing bubble and so we will witness an unprecedented explosion in Money Supply in the years ahead.

How high will it send gold prices? It is probably a futile exercise to predict the quantum of monetary inflation. Suffice it to say at this juncture, in a few years, the current gold price of $2500/oz is going to look like a fantastic bargain.

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