
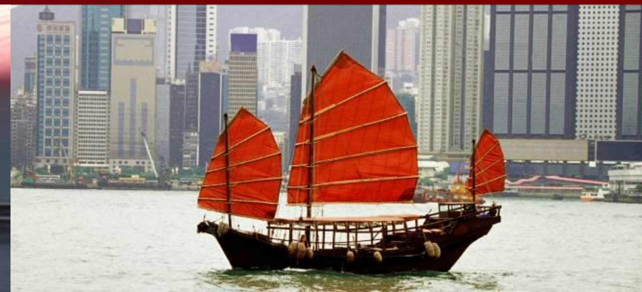


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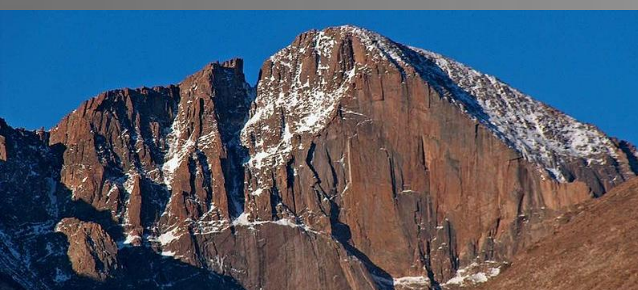
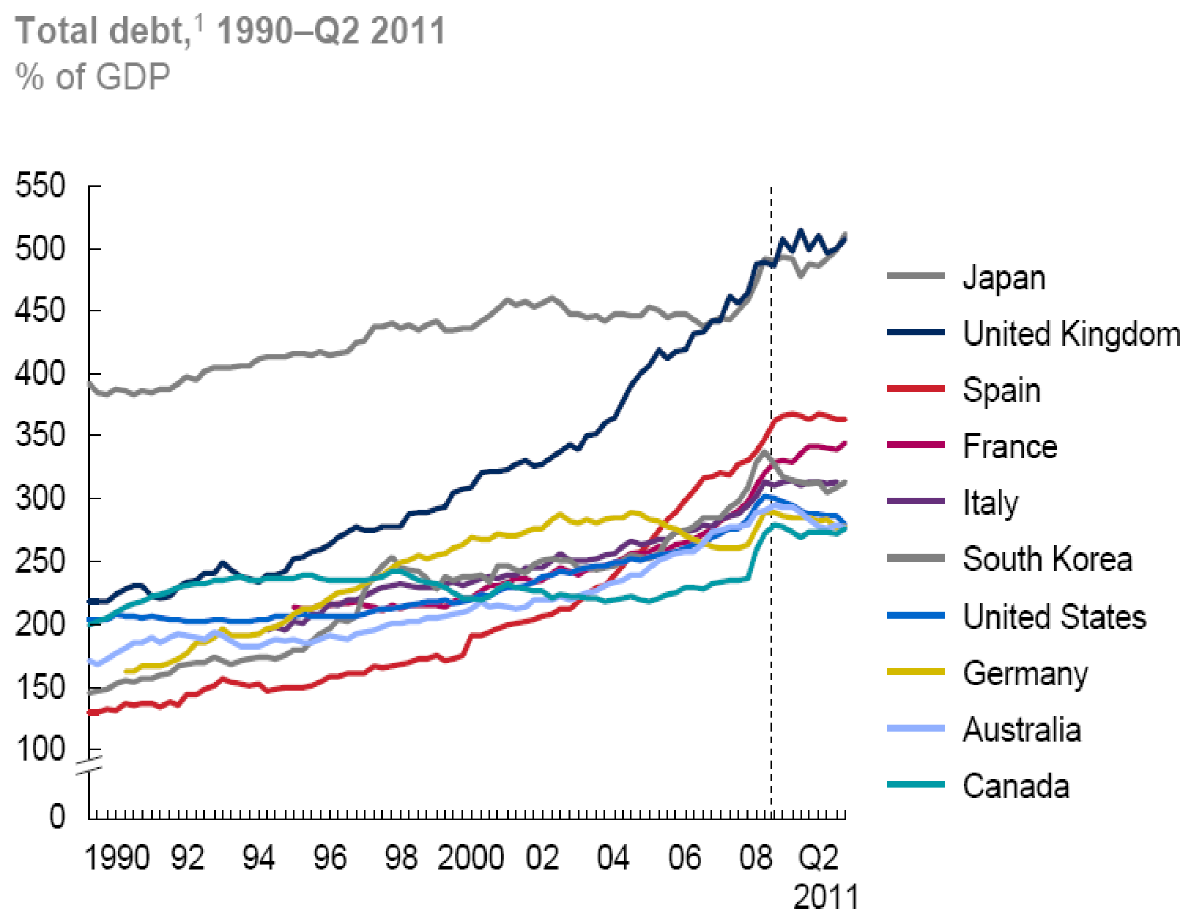


Crescat Capital

The Valuation of Gold

July 3, 2013

Global Debt-to-GDP Imbalance



[1] Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
Source: McKinsey Global Institute

Resolution of the Global Debt-to-GDP Imbalance

The global debt-to GDP imbalance reached historic unsustainable excess in the wake of the 2008 global financial crisis. The imbalance is still excessive and only in the early innings of being resolved. It is being resolved with fiat money printing by global central banks to combat otherwise deflationary debt deleveraging. Money printing helps to deliver nominal GDP growth to deleverage overall debt to GDP with inflation and possibly some real economic growth to go along with it. By printing money and artificially suppressing interest rates, central banks can spur real economic growth, but only if low interest rate financing is applied to productive investment in economy as a whole while wealth is extracted from fixed income savers. Otherwise, money printing just creates outright inflation.

One risk of money printing is that a critical mass of investors flee stocks, bonds, and fiat currencies all at the same time in favor of inflation-protected assets like gold. This would force central banks to monetize new and existing debt at ever increasing rates. Historically, this phenomenon has manifested itself as hyperinflation in many different countries around the world. Hyperinflation has been launched from even lower debt-to-GDP and money printing levels than we have in the world today. If we can transition from a deflationary to an inflationary environment gradually, however, we could enjoy a period of rising real economic growth with only moderate inflation that could resolve the debt-to-GDP imbalance over time. Investments in stocks could do quite well in that environment, particularly ones that make productive use of long-term fixed rate financing. Gold should also do well in that environment, particularly starting from today's market price, which is extraordinarily undervalued, as we will show.

In either case, one should be prepared now for rising inflation, and one should also have protection against potential hyperinflation, particularly given the valuations that the market is giving us in precious metals today. Stocks, meanwhile, offer opportunity on both the long and short side globally.

What is the difference between money and debt?

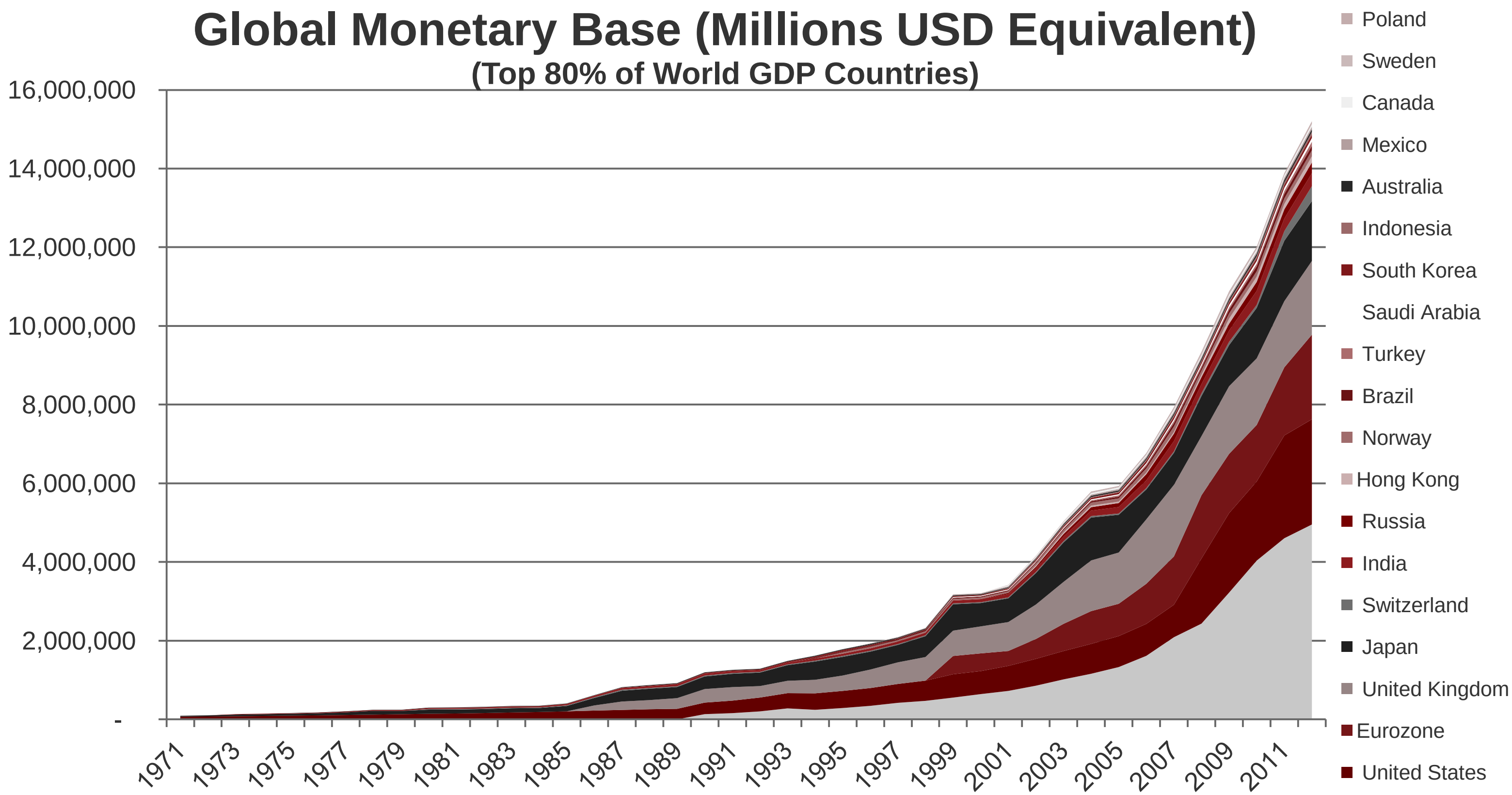
- Sovereign fiat currencies constitute the widely accepted understanding of money today.
- We can measure the core amount of fiat currency using monetary base figures reported by central banks.
- Government and other perceived high quality credit are also considered money today.
- But debt and fiat currency do not meet the classical economic definition of money if they do not offer a "store of value".
- Both debt and fiat currency depreciate in real value when their supplies are increased relative to the growth rate of the real economy.
- Precious metals have endured and performed for centuries as money that retains a long-term store of value and protection against rising inflation, debt collapse, and fiat currency debasement.
- Over shorter time frames, precious metals can be over- or under-valued on a real basis if they are not accurately discounting future inflation.

"Gold is Money. Everything Else is Credit."
- J.P. Morgan

The lesson of economic world history over hundreds of years in country after country is that precious metals represent the only form of true money capable of maintaining a store of value over long time periods. Time and again, countries have swung back and forth between gold- and silver-based monetary regimes and fiat-monetary regimes with the value of debt and fiat monetary regimes being destroyed each time with inflation and/or hyper-inflation with precious metals returning to fully constitute the real monetary base. China is a serial offender with epic rises and falls of its fiat/paper monetary systems that each time reverted back to precious metals after the value of paper money was fully destroyed by overprinting. Each occurred during a major imperial dynasty: Sung (960-1126) Chin (1127-1234), Southern Sung (1127-1275); Yuan (1260-1360); Ming (1368-1644).

Today, China is a command economy in the midst of world record real estate and credit bubble. China currency is likely to go bust in a big way, and few are expecting it. China's central planners have been stuck in a loop of excessive, poor quality, and unnecessary infrastructure building that has driven the bulk of China's economic growth in the last decade. It has been funded by ongoing cycle of money printing and bank bailouts. Westerners have been getting sucked into helping fund the China Ponzi scheme for years, based on the false notion that China's growth model is sustainable. It isn't. It is poised to unwind badly. The problem of fiat money is always the same. Sovereign-based fiat monetary systems lend themselves to excessive credit expansions which lead to bubbles, busts, that ultimately lead only to more money printing, currency devaluation, inflation and/or hyperinflation. After substantial currency devaluation and inflation, precious metals re-assert themselves as money. **This time will almost certainly prove no different. What is unique about this cycle is that today we live in the most leveraged fiat-based debt bubble in world history. Gold is the cheapest it has ever been relative to the global fiat monetary base. Silver is even cheaper.**

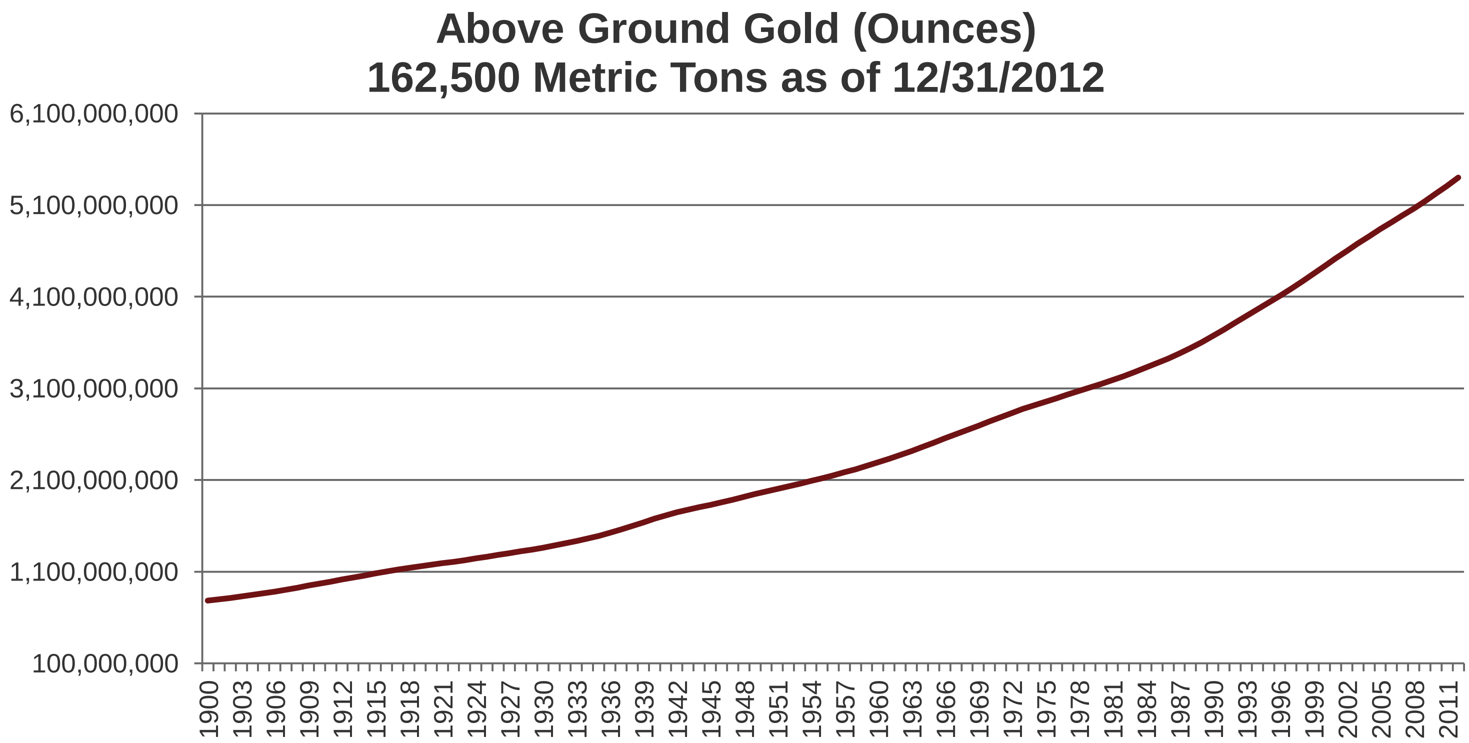
The Global Monetary Base Has Been Growing At a 15% Compounded Annual Growth Rate Over the Last 10 Years – China Has Been the Largest Money Printer. Monetary Base Growth Forecasts Inflation With a Lag.



Source: Global Central Banks

The global monetary base continues to expand at a brisk pace to monetize the record unsustainable level of debt to GDP. China, contrary to most people's understanding, is the world's largest money printer based on its narrowest reported monetary aggregate. Japan, the highest debt-to-GDP country in the world, is challenging the U.S. and China by accelerating its monetary base expansion to twice that of the U.S in the relative to its GDP. The Eurozone and UK also lead the world in absolute levels of fiat money printing.

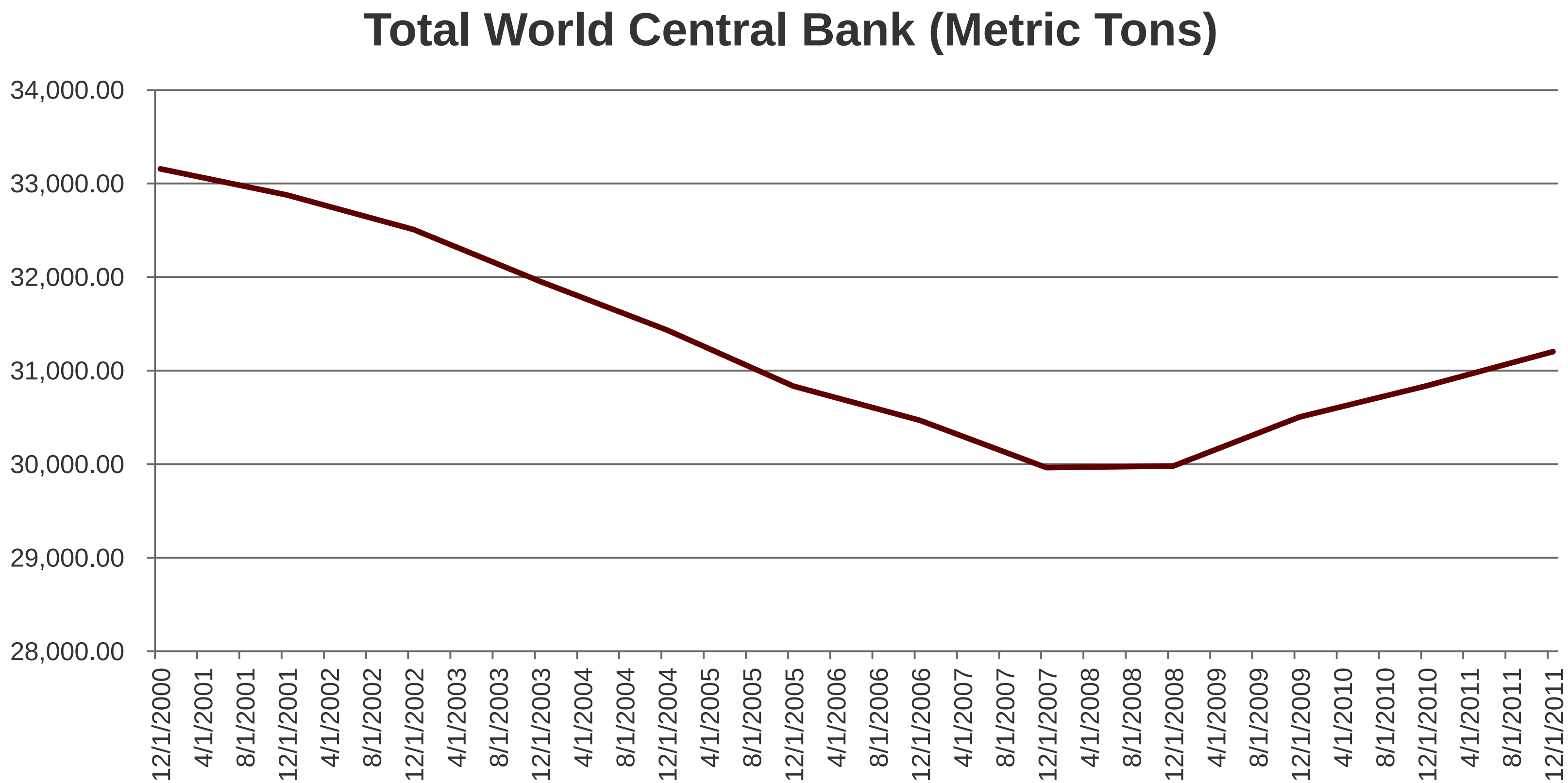
The Global Gold Supply Grows At Only Approximately 1.7% Annually.



Source: USGS & World Gold Council

Gold is hard to find and produce. It exists in the earth's crust at approximately .005 parts per million.

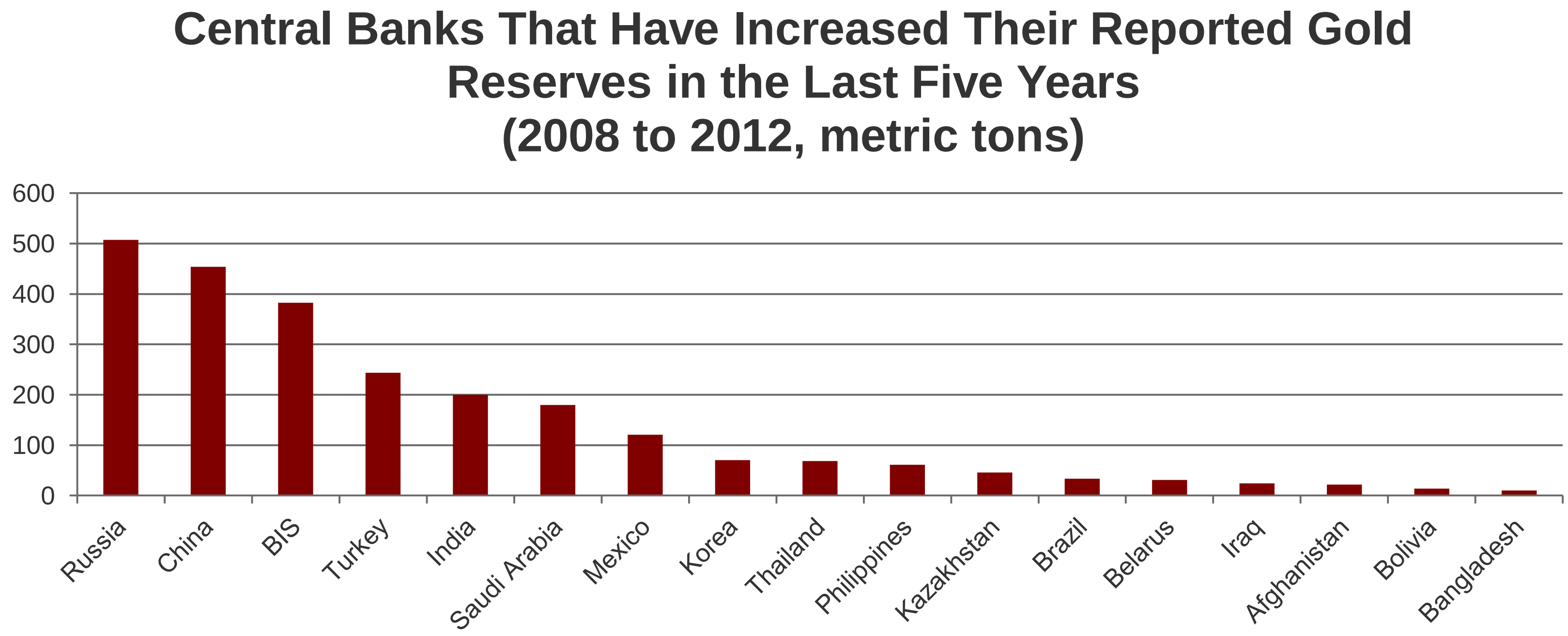
Global Central Banks are 800-Pound Gorilla Buyers of Gold Who Will Drive The Price Substantially Higher, Particularly When The U.S. Eventually Jumps In



Source: World Gold Council

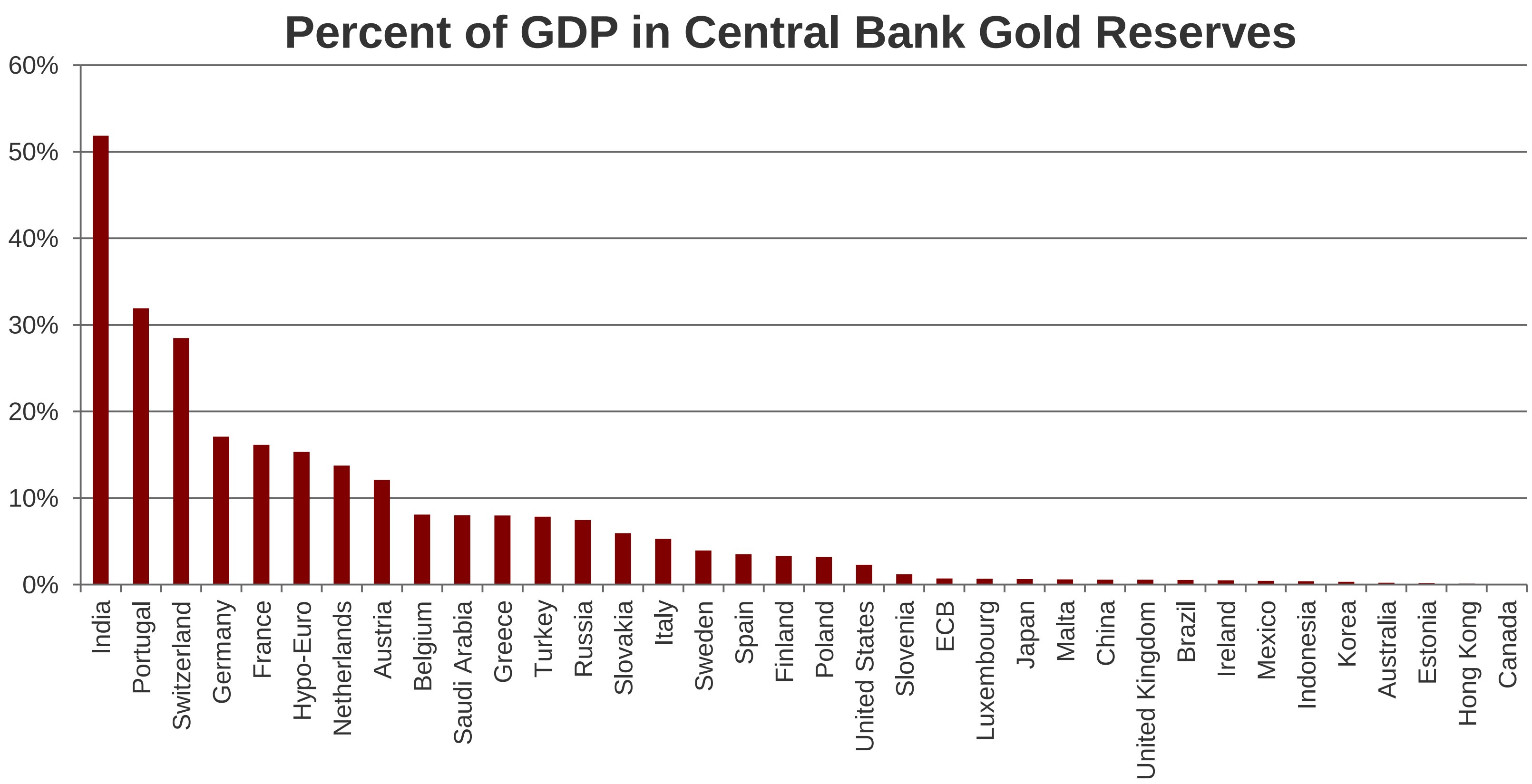
We expect central bank gold buying to accelerate rapidly as central banks augment their QE with gold asset purchases. We hope Bernanke and Yellen get the memo and pay particular attention to the low valuation of gold relative to the USD monetary base as they consider their range of QE asset purchase options.

For Now, Russia, China, Turkey, India, Saudi Arabia, and Mexico Lead the Charge Along With the Bank For International Settlements, A Central Bank Vehicle Dominated by U.S. and Western European Interests.



Source: World Gold Council

Countries With The Most Gold to GDP Today



Source: World Gold Council & Bloomberg

Notice that many European sovereigns have solid gold-to-GDP levels which they could use to exit the euro and re-form their own currencies. India would be the biggest beneficiary of a rise in the price of gold.

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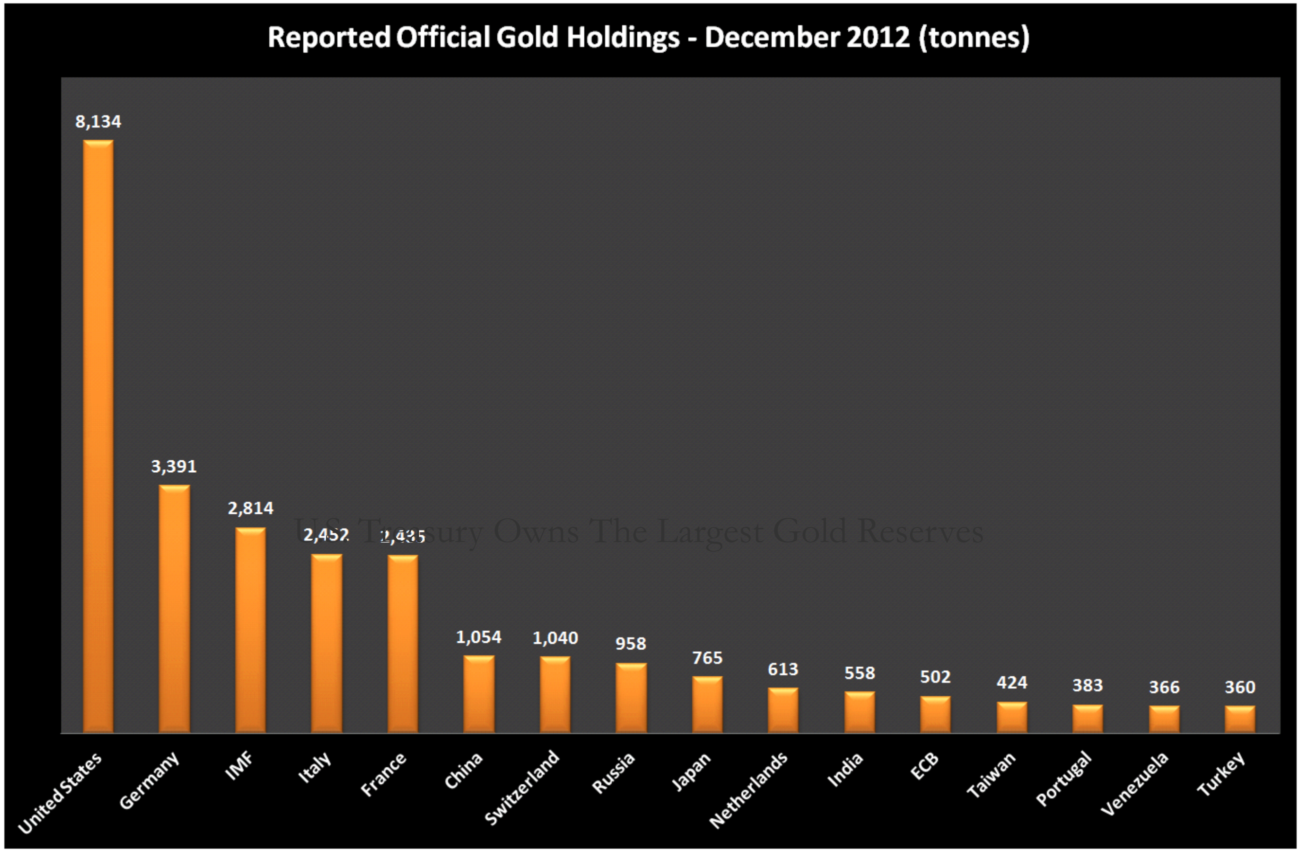
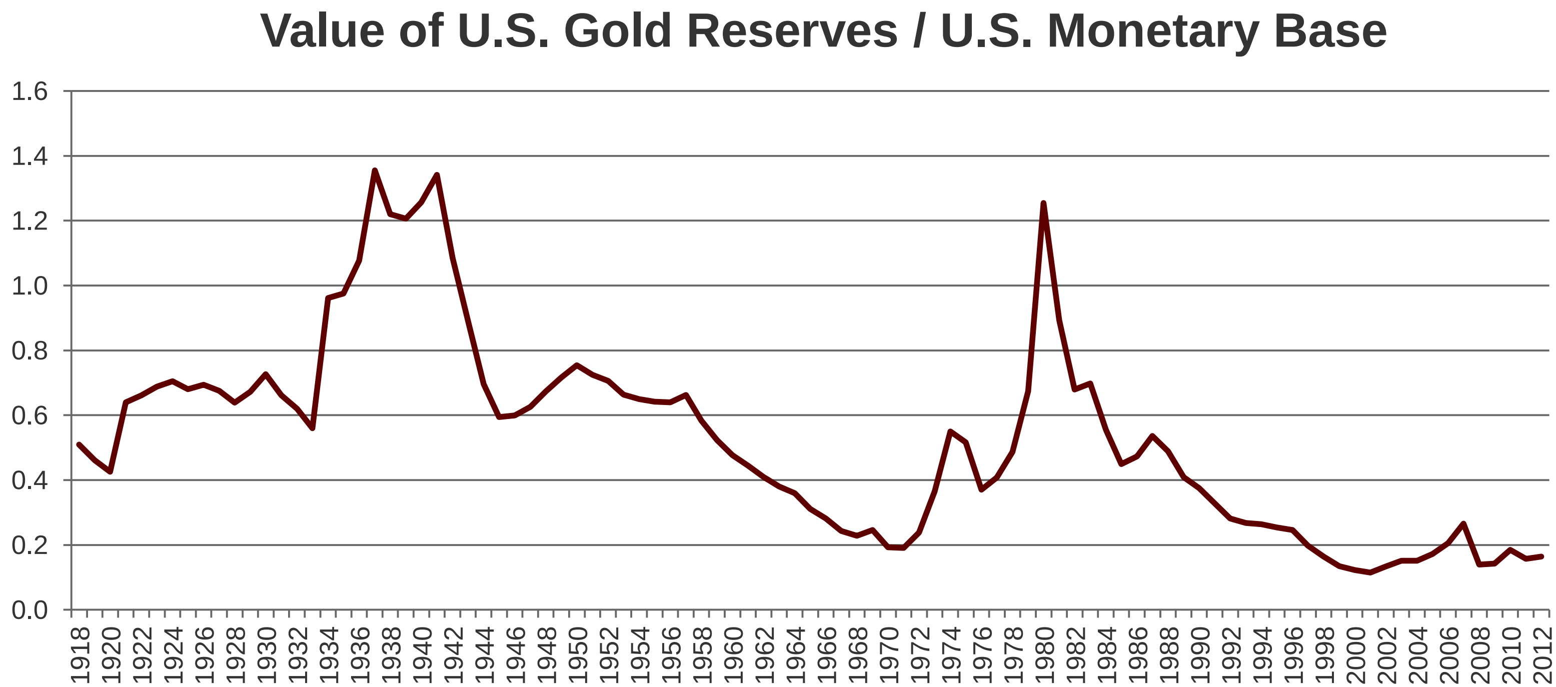
Sovereign/Central Bank Gold Holdings



The U.S. Treasury Owns The Largest Gold Reserves

Source: World Gold Council

Gold Is Historically Undervalued Based On U.S. Reserves To USD Monetary Base



The U.S. monetary base has been backed at least 1:1 by the value of its gold reserves twice in the last 100 years: 1934 to 1942 (on a gold standard) and again in 1980 (not on a gold standard). In prior periods, gold and silver have served as the global monetary base.

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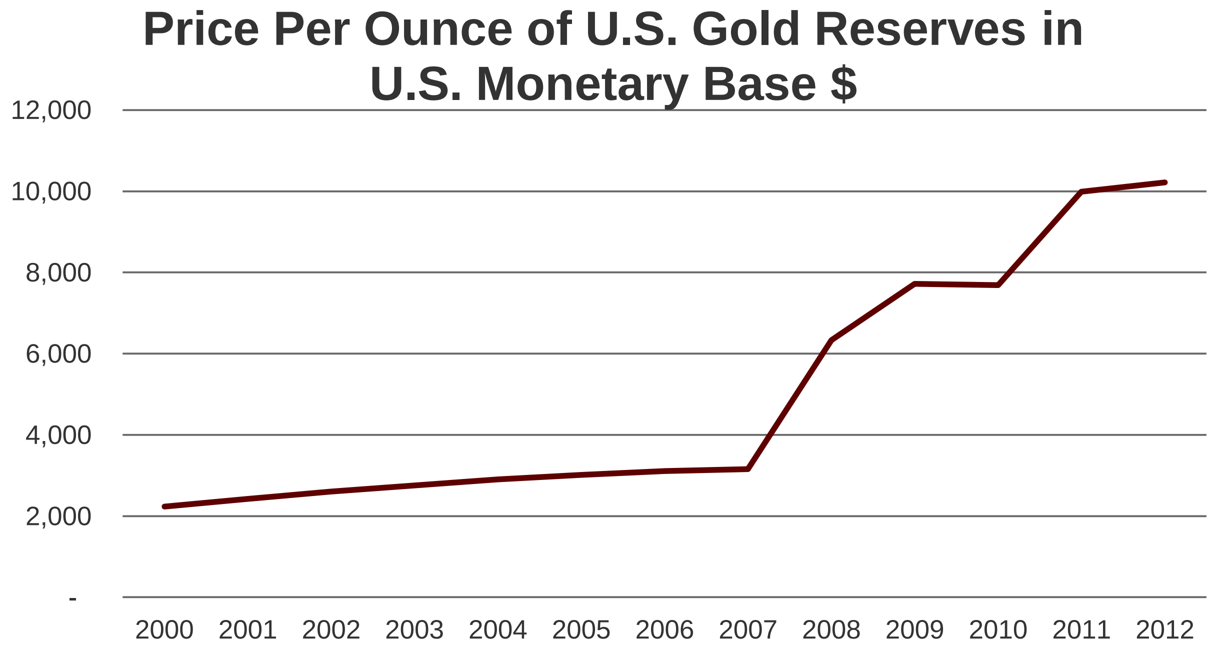
Gold Is Worth $10,000/Ounce Today Based On The Value Of U.S. Gold Reserves Priced in U.S Monetary Base. This Is The High End Of Crescat's Valuation And Target Price In Today's Dollars (Real Price) For Gold



Market and global central bank forces can combine to realize this value:

1. Fed can buy gold in free market with printed dollars (QE) both increasing its gold reserves and driving up the price of gold.
2. Private investors around the world can buy gold, driving its price in dollars up.
3. Non-U.S. central banks around the world can print their own money, buy gold.

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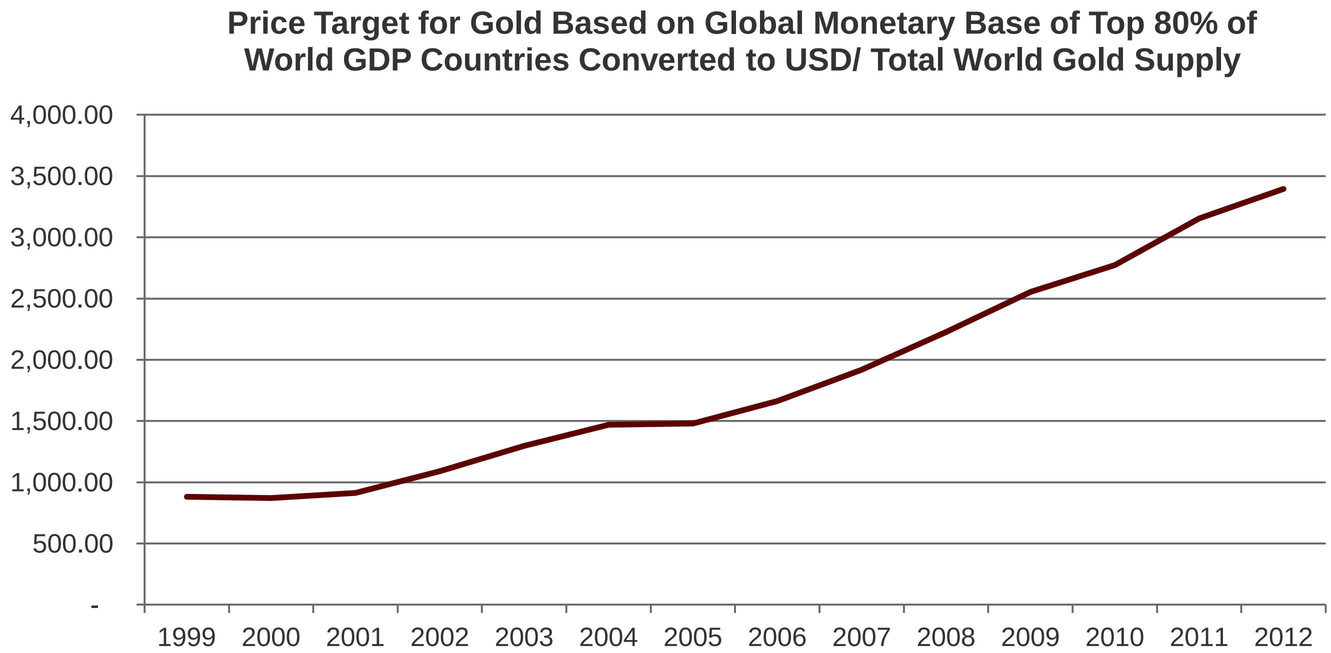
Gold Is Worth $3,400 Per Ounce Today Based On The Global Fiat Currency Monetary Base Compared To Total Above Ground Gold Ounces. This Is The Low End Of Crescat's Valuation And Target Price For Gold In Today's Dollars (Real Price)



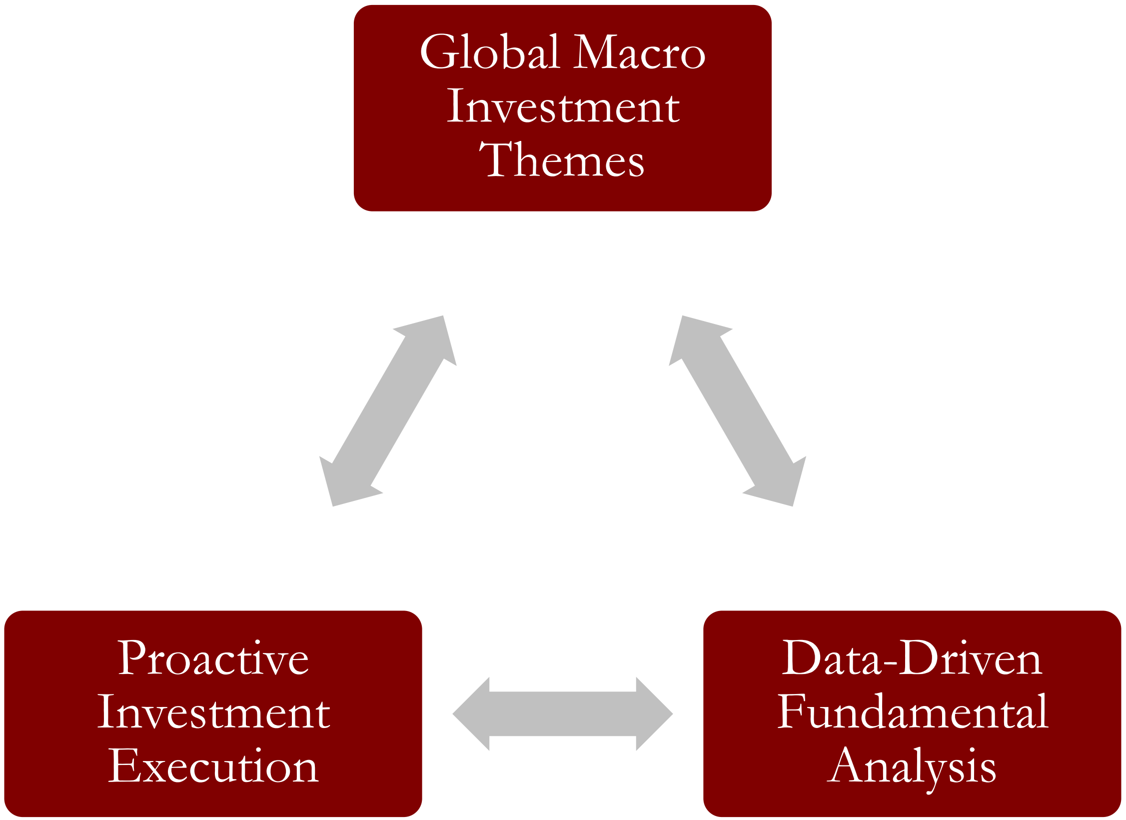
Source: Global Central Banks, USGS, World Gold Council

The target price will continue to increase in line with the dollar value of the global monetary base until inflation is perceived and global consciousness shifts from deflation to inflation, at which point money velocity will spike, and the price target for gold will almost certainly be achieved in a parabolic step function.

Why Would Central Banks Want to Buy Gold?

- Excessive debt to GDP is resolved most easily and conclusively by surreptitious inflation through fiat money printing.
- Buying gold strengthens a Treasury's balance sheet.
- It is the best form of central bank asset purchases (quantitative easing or money printing) because it uses expensive fiat money to acquire cheap real money.
- It is like an all-stock cash flow accretive acquisition.
- It's a net positive present value transaction, capturing a value arbitrage.
- It is a much better way to devalue a country's debt and money than to buy other countries' overvalued Treasury bonds.
- Central banks will likely need gold again in the future to collateralize their sovereign bonds and fiat currencies.
- The outcome is almost certain: central banks will secretly print money and buy gold because it is in their own best interest.
- In game theory, the extremely high probability of this outcome is driven by the preconditions for what is called a prisoner's dilemma.
- It is a reflexive process that feeds on itself.
- Best to buy precious metals now while they are historically cheap on a real basis relative to global fiat money printing and the future inflation that can be discounted today.
- Best to buy precious metals now while hedge funds and investing masses have been shaken out and/or are short and are about to be squeezed by central bank buying.

Investment Process – Dynamic and Reflexive



Current Macro Themes

- New Oil and Gas Resources
- Digital Evolution
- Nanoscale
- U.S. Housing Recovery
- Global Fiat Currency Debasement
- China Infrastructure Bubble
- Aussie Housing Bubble
- Resolution of the Global Debt-to-GDP Bubble

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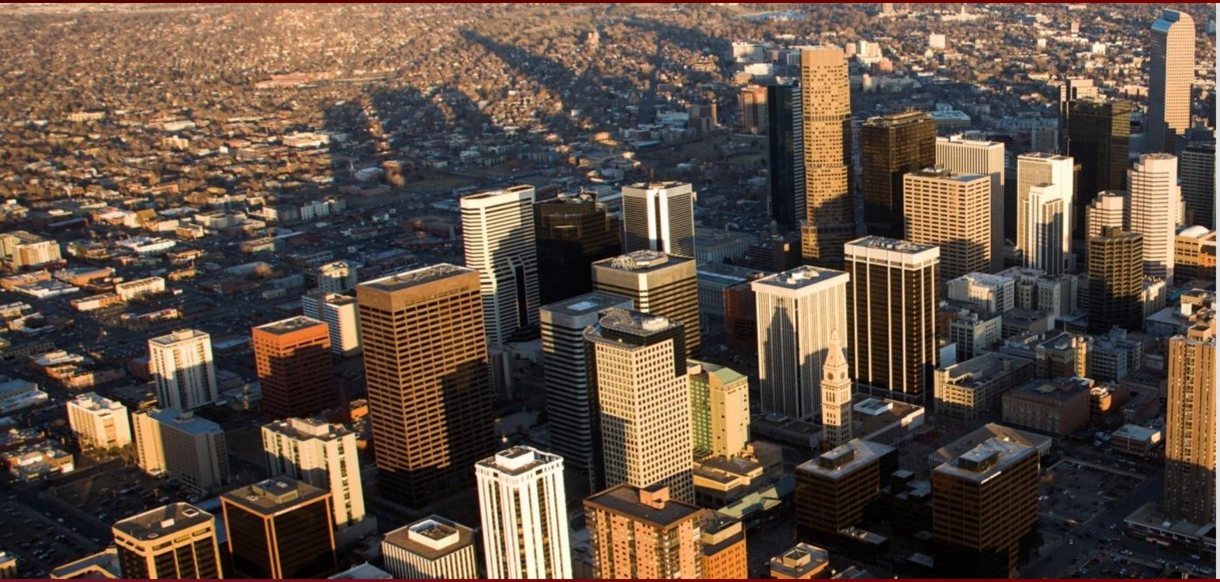

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