Goldreport 2014 – In GOLD we TRUST

We believe that the currently comprehensive "monetary measures" will have numerous unintended consequences, the extent of which is difficult to gauge at the moment. Gold, as the counterpart of unbacked paper currencies, remains an excellent hedge against worst case scenarios.

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All prices are closing prices as of 20 June 2014

The power struggle between market-cleansing deleveraging and the goal of the central banks for price stability has continued last year. So currently various potentially inflationary as well as deflationary forces are offsetting each other. Last year, we coined the term **"monetary tectonics"** which describes the battle between these powerful forces.

In our opinion, it is by no means certain that inflationary forces will win the race. However, socio-economic incentives and high indebtedness clearly suggest that in case of doubt, higher inflation rates might be tolerated. Should the disinflationary trend reverse, there would be excellent opportunities in inflation sensitive assets like gold, silver and mining equities.

The migration of gold demand from West to East is continuing. In our opinion, the growing importance of Asia's middle class for gold demand is widely underestimated. A traditionally high affinity for gold and rising prosperity will support demand in the long term. Assuming that incomes in China and India will continue to rise, gold will inevitably be one of the beneficiaries of this "love trade".

In the course of the price collapse of the gold price, a lot of technical damage was inflicted. The past months have seen a significant decline in speculative activity in the sector. The majority of bulls appear to have thrown in the towel. We like the fact that consensus considers the gold bull market over. Gold is now a contrarian investment.

From a technical perspective, our assumption is that the gold price is near the end of its long consolidation period. The clearly positive market data and the recent revival of gold mining shares all suggest as much. **We are therefore convinced that the technical picture has been repaired and that a stable bottom has formed. Our 12-month price target is the USD 1,500 level.**

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1. INTRODUCTION

The last gold bulls appear to have thrown in the towel

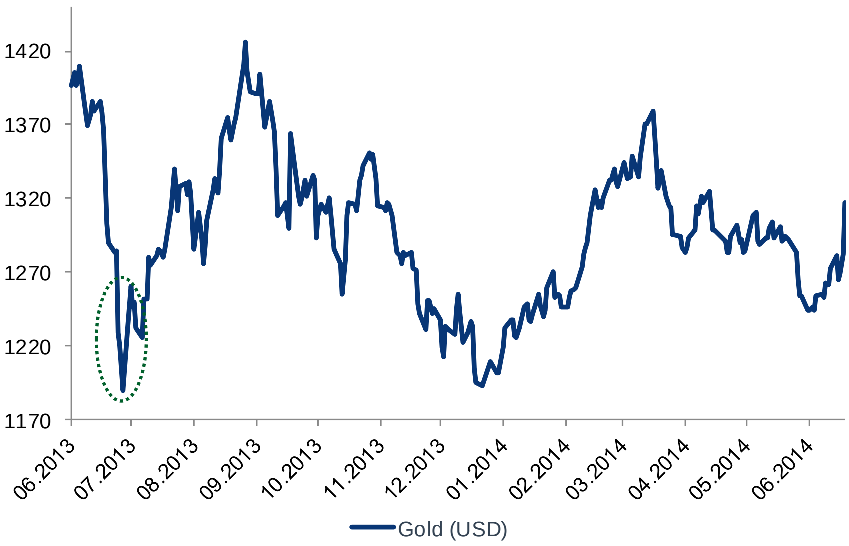
Our last gold report was published on 27 June 2013, just as the anxiety over the metal's declining price trend reached its peak. In hindsight, this date turned out to coincide with a multi-year low. Last year, we came to the conclusion that massive technical damage had been inflicted and that it would take some time to repair the technical picture.

That forecast has turned out to be correct, even though the counter-trend move we expected turned out to be significantly weaker than thought. **Recent months show clearly that many speculators have given up on the sector.** A majority of bulls appear to have thrown in the towel. Volatility and market participant interest have decreased significantly in the last year.

Gold 5 years

Source: Datastream

Gold in USD since the last Gold Report



Source: Federal Reserve St. Louis, Incrementum AG

"So we did the right thing. I hope."
Ben Bernanke in his farewell speech

With their monetary interventions, central banks have entered *terra incognita*. In a crisis, monetary policy doesn't work like a scalpel, but like a sledgehammer.[1] Superficially, extreme monetary policy stimulus has calmed financial markets overall. The results, in terms of the real economy by contrast, continue to lag behind expectations. The often invoked 'self-sustaining recovery' is rather modest in many regions and is not 'self-sustaining' anywhere so far. It will probably still take months or years before the full extent of the consequences from these monetary measures will become visible. In our opinion, these will be predominantly negative. Interventions always result in keeping existing misallocations afloat, while new ones are added to them.

"*The crisis was yesterday*" seems to be the consensus

The current "lowflation" environment that still prevails, which is characterized by low price inflation and growth figures that largely remain below expectations, has turned out to be a Land of Cockaigne for stock market investors. As long as stimulus does not show up in inflation data, market participants don't fear a drying up of the monetary aphrodisiac. Among investors, the prevailing sentiment is "the crisis was yesterday", and the "Yellen Put" is considered an integral feature of asset

[1] "The Lords of Finance", Liaquat Ahamed

allocation decisions in many portfolios. **The longer the low interest rate environment continues, the higher risks will investors take.**

As readers of our annual report know, we analyze gold primarily as a monetary asset and not as an industrial commodity. In our eighth "In Gold We Trust" report, we want to once again take a holistic look at the big picture and perform a holistic analysis of the gold sector.

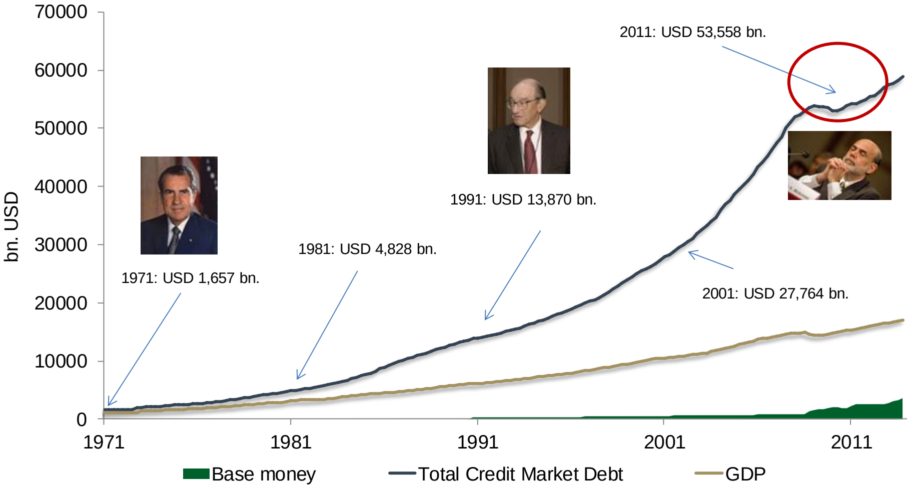
2. ASSESSMENT OF THE MONETARY CLIMATE

a) 1971: Monetary Paradigm Change

"The monetary system is the lifeblood of the economy, and therefore, artificial tampering with money, credit, and interest rates will affect the entire structure of the economy. When the credit bubble pops Austrian theory implies that it will have widespread fallout as the malinvestments are cleared." **Seth Daniels**

The virtualization/dematerialization of the monetary system at the beginning of the 1970s unleashed monetary policy and enabled disproportional growth of credit and debt. Economic activity based on savings and real investment was replaced by a credit-induced growth mania. In today's debt money system, credit-induced growth is mainly "created" by pumping additional money into the economy through an increase in lending by the banking system or by an increase in government debt.[2] The superficial stability of financial markets now depends to a large extent on ceaseless monetary inflation. **Since credit growth is still sluggish, this has to be compensated by unconventional central bank monetary policy measures.**

GDP, total credit market debt and monetary base since 1971



Source: Federal Reserve St. Louis, Incrementum AG

"Monetary tectonic" **gains in importance**

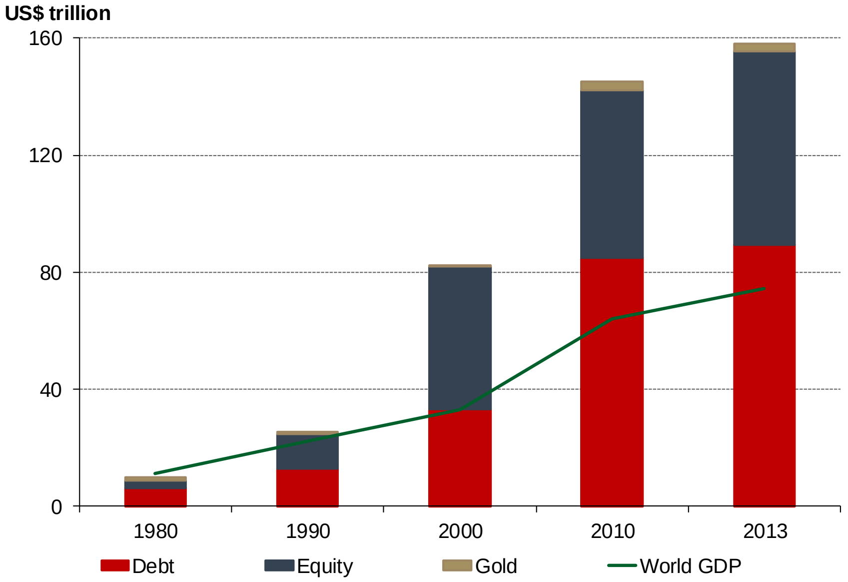
This debt-induced growth is strikingly demonstrated in the above chart. "Total credit market debt owed" in the US has risen 35-fold since 1971, the monetary base 54-fold and GDP only 14-fold. The visible dip in debt expansion since 2008 had to be compensated by the Fed's major expansion of the monetary base. **Last year, we introduced the term 'monetary tectonics' to designate this situation, which describes the interaction between credit deflation and central bank-induced inflation.**

[2] In this context we want to point to the ever more frequently discussed policy of "NGDP targeting", which entails monetary policy pursuing an explicit nominal GDP growth target.

"It should promise that monetary policy will not remove the punch bowl but allow the party to continue until very late in the evening to ensure that everyone has a good time."
Charles Plosser
President of the Federal Reserve Philadelphia

The significant bubble in paper assets relative to hard assets is illustrated in the next chart. In spite of substantial volatility, global financial wealth has doubled since 2000 alone. **The growth stems primarily from the bond markets.** Between 2000 and 2013, the value of outstanding debt securities has almost tripled (from USD 33 trillion to USD 100 trillion). Over the same period, the total capitalization of stock markets has increased by a mere 35% (from USD 49 trillion to USD 66 trillion). The share of gold can also be seen. While it has grown considerably since 2000, it nevertheless remains at an extremely low level.

Global financial assets are increasing faster than ever



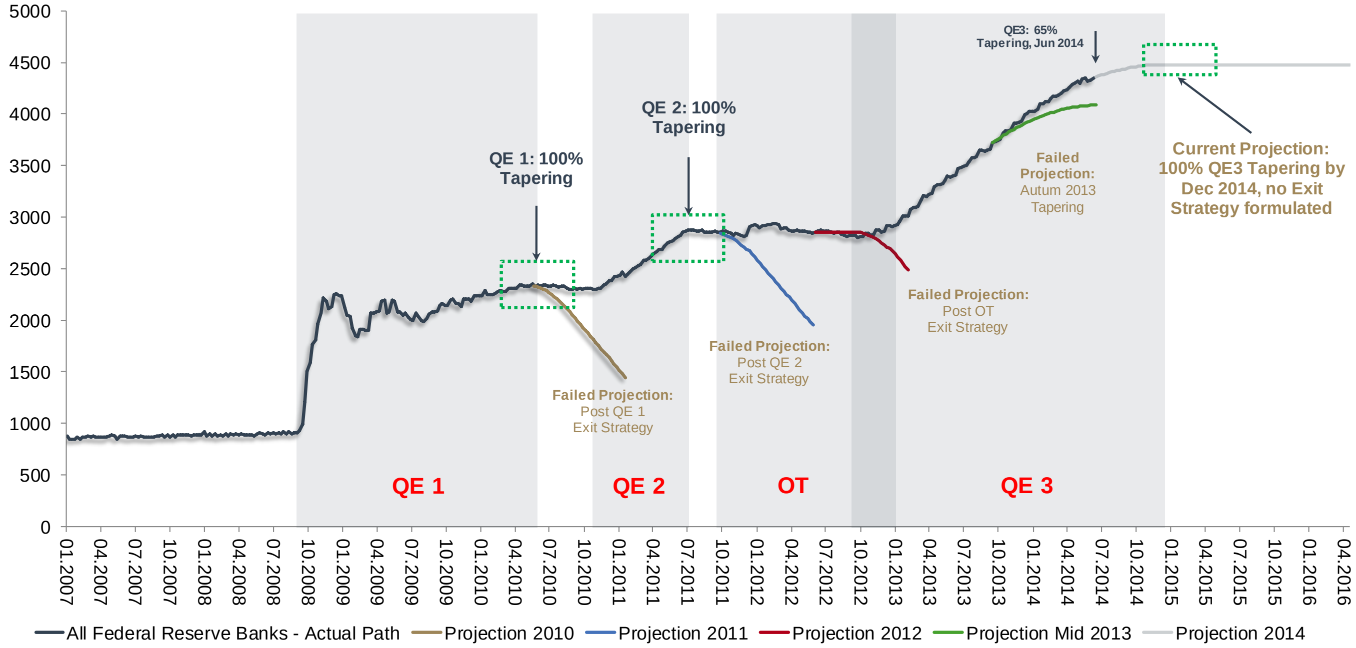
Source: BIS, Thomson Reuters GFMS, World Bank, World Federation of Exchanges, World Gold Council

b) The status quo

„Crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought."
Rudi Dornbusch

Market participants are currently watching the Federal Reserve's repeated attempts to exit its unconventional monetary policy with eagle eyes. Over the past five years, two such attempts have failed already. At the end of both QE1 and QE2, increasing volatility in financial markets ensued almost immediately. In the current third attempt at an exit, the Federal Reserve is attempting a 'softer exit' from its money printing.

Fed balance sheet vs. expectations

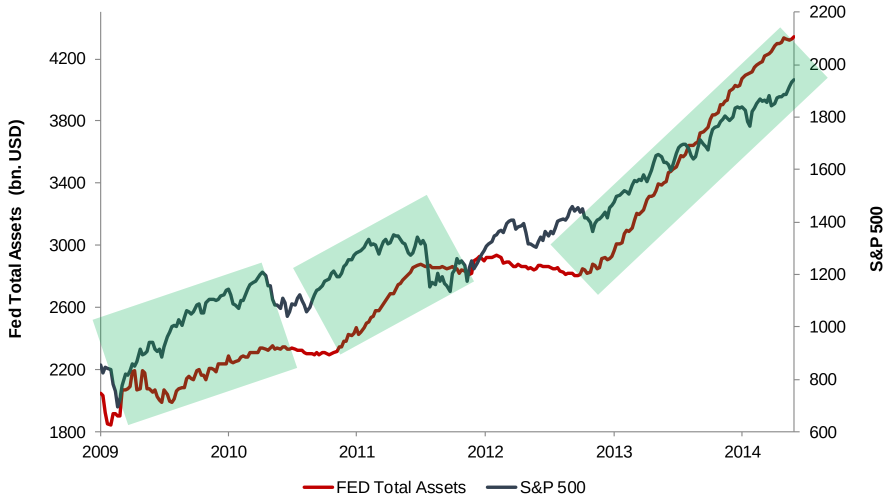


Source: Federal Reserve St. Louis, Incrementum AG

Tapering = Tightening

We believe that so-called 'tapering', i.e., the slow exit from 'QE', will once again have a significant impact on capital markets[3]. Should the attempt be made to actually reduce the amount of money created hitherto as well, a recession might ensue. **For a system that – as a result of the rapidly declining marginal utility of every additional monetary unit that is created – requires a steady increase in monetary stimulus, the 'tapering' currently underway definitely amounts to 'tightening'.**

Balance sheet Federal Reserve vs. S&P 500

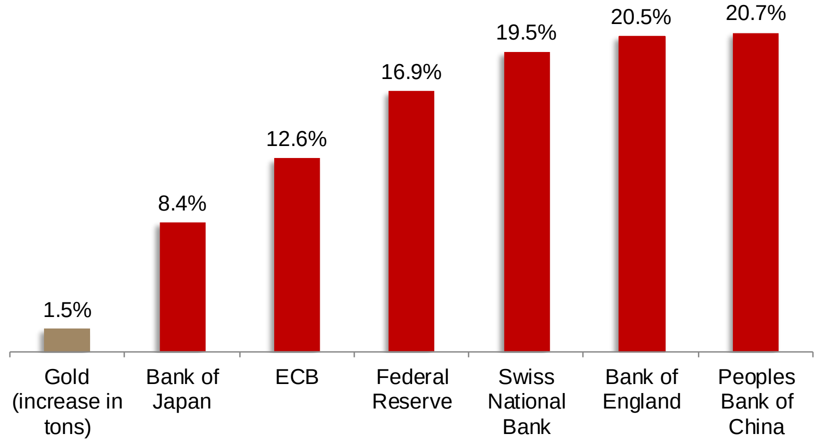


Source: Incrementum AG, Federal Reserve St. Louis

[3] The term is by the way borrowed from sports science, and describes the reduction in training prior to activities tasking endurance (e.g. during a competition)

The following chart shows the annual growth rates of central bank balance sheets since 2002. The Bank of Japan has pursued a comparatively restrictive monetary policy, which is, however, changing rapidly now due to 'Abenomics'. The ECB was also restrictive, at least on a relative basis, with an annual rate of inflation of 'only' 12.6%. Inflationary world champion remains the People's Bank of China, closely followed by the Bank of England. By way of comparison, the global supply of gold grew by a mere 1.48% per year. **This underscores the relative scarcity of gold compared to fiat currencies that can be inflated at will.**

Annualized rate of change of central bank balance sheets vs. annual growth in gold supply (2002-2014)

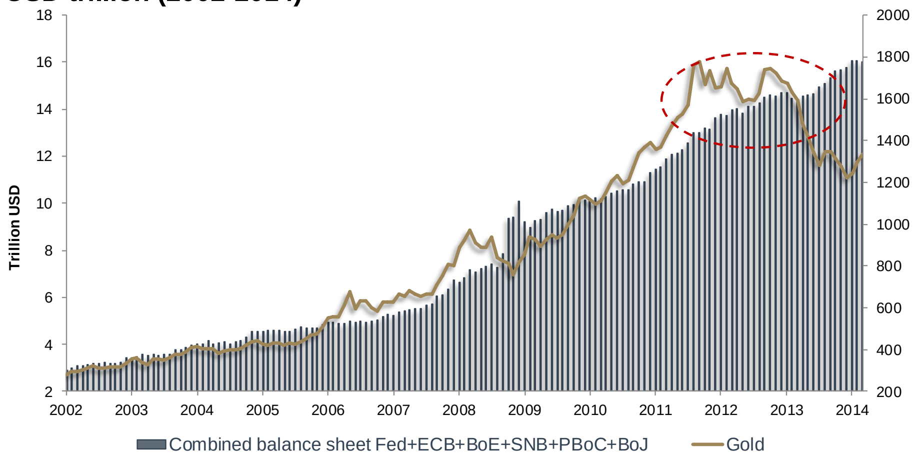


Source: Datastream, Bloomberg, Incrementum AG

Divergence between the growth in the money supply and the gold price

The following chart shows the divergence between money supply growth and the trend in the gold price that has been underway since 2011. It shows the combined balance sheet totals of Federal Reserve, ECB, Bank of England, People's Bank of China and Bank of Japan. **Whenever the money supply grows at a faster pace than the supply of physical gold, the gold price should rise and vice versa.** The chart shows us that either the gold price has corrected too much, or that central bank balance sheets will stagnate, resp. decline, in the future. Anyone familiar with economic history knows how few precedents of sustained reductions in central bank balance sheets exist.

Combined balance sheet totals Fed+ECB+BoE+SNB+PBoC+BoJ in USD trillion (2002-2014)



Source: Bloomberg, Datastream, Incrementum AG

c) Reasons for the recent correction in the gold price

"Gold always does what it should do… it just never does it when we think it should."
Richard Russell

Since the publication of our last report on 27 June 2013, the trend has been patchy. To be fair, given that our price target of USD 1,480 was clearly not reached, we have to exercise some self-criticism. We therefore want to analyze below what the reasons for the weaker than expected gold price trend were.

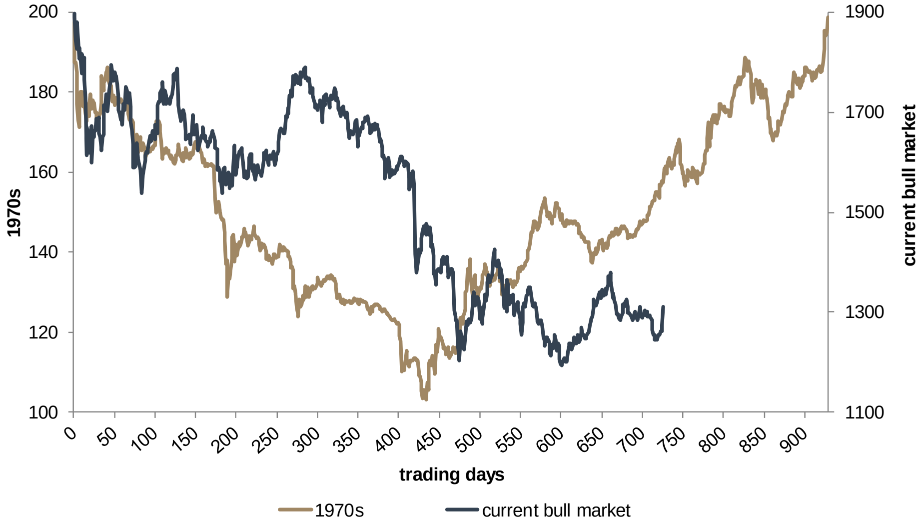
In our opinion, the following factors are, resp. were, decisive for the weak trend:

- **strong disinflationary tendencies**
- **rising real interest rates**
- **partly declining money supply** (esp. ECB), resp. slowing momentum of money supply growth (tapering by the Federal Reserve)
- **rising opportunity costs** due to the rally in stock markets
- **ETFs[4]:** strong outflows of approx. 900 tons last year. The exodus has however slowed markedly, in February the first net inflows since 2012 were recorded.
- **tightening credit spreads**
- analyst opinions turning increasingly negative (among others Goldman Sachs, Credit Suisse, Société Générale,...)

Consensus sees gold bull market as over: gold is now a contrarian investment by

Even though consensus now assumes that gold's bull market is over, we believe that the fundamental case remains intact more than ever. In our last gold report we already mentioned the similarities to the 1974-1976 "mid-cycle correction". The period is similar to the current one, especially due to significant disinflation, rising real interest rates and extremely high pessimism with respect to the future gold price trend.

"Mid-cycle correction" 1974-1976 vs. current correction (since 2011)



Source: Datastream, Incrementum AG, Erste Group Research

[4] ETF sales were a consequence rather than a cause of the price decline

In the meantime, it appears as though – analogous to the situation in 1976 – sentiment towards gold has tilted toward pessimism. An excerpt from the New York Times from 29 August 1976[5] strikingly confirms the similarities to the current situation:

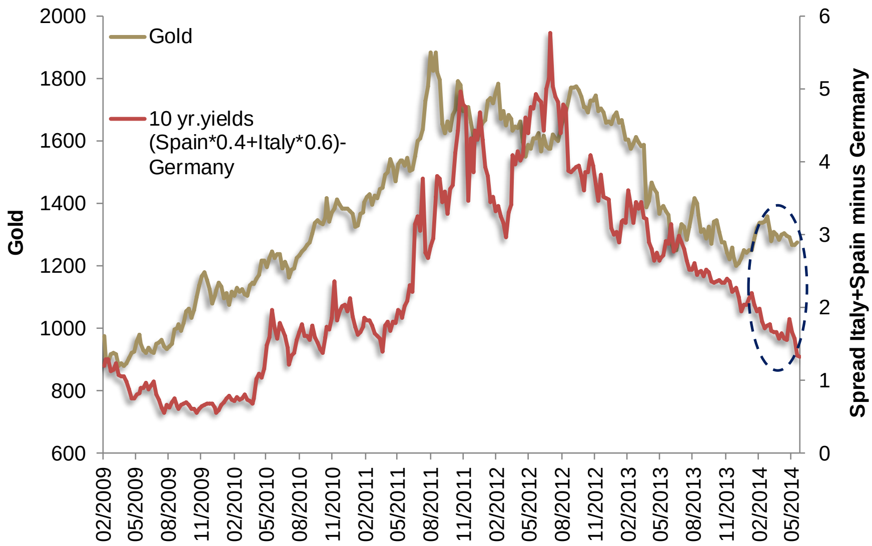
"*Two years ago gold bugs ran wild as the price of gold rose nearly six times. But since cresting two years ago it has steadily declined, almost by half, putting the gold bugs in flight. The most recent advisory from a leading Wall Street firm suggests that the price will continue to drift downward, and may ultimately settle 40% below current levels…*

…The sharply reduced rates of inflation combined with resurgence of other, more economically productive investments, such as stocks, real estate, and bank savings have combined to eliminate gold's allure….

…Although the American economy has reduced its rapid rate of recovery, it is still on a firm expansionary course. The fear that dominated two years ago has largely vanished, replaced by a recovery that has turned the gold speculators' dreams into a nightmare."

The next chart shows that the gold price is definitely suffering from the (temporary) return of confidence in the euro area as well. The spread between Italian and Spanish to German government bond yields has been declining significantly for many months and is currently at the lowest level since 2011. **This signals that the debt crisis in the euro zone has recently taken a back seat.** Interestingly, however, the gold price is exhibiting a small degree of divergence since the beginning of 2014 and may therefore be giving advance warning of rising nervousness in the euro zone.

Yield spread between Italy+Spain vs. Germany vs. the price of gold



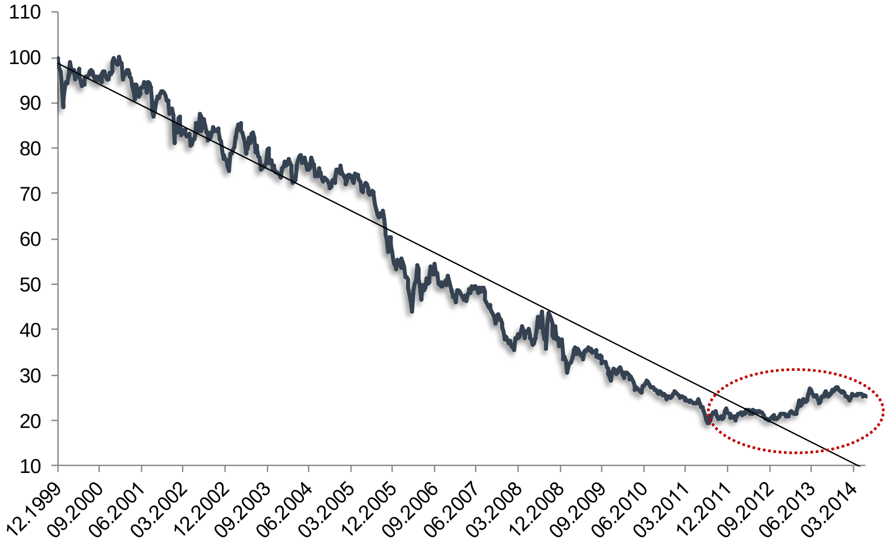
Source: Erste Group Research, Incrementum AG, Datastream

The long-term downtrend of most currencies relative to gold can be seen in the following chart. The downtrend in the equal-weighted basket

[5] i.e., only a few days after the trough of the correction

of currencies[6] has however flattened out recently and broken through a downtrend line.

Basket of currencies measured in gold terms: long term downtrend intact, however currently bottoming out?



Source: Datastream, Incrementum AG

"100 years ago, the dollar was worth 1555mg of gold. Today, it is worth about 25mg. The long-term price target is 0."
Dr. Keith Weiner

3. MONETARY TECTONICS: THE INTERPLAY BETWEEN INFLATION AND DEFLATION

„Since inflation favors the government and deflation favors the worker, governments always favor inflation"
Jim Rickards

The power struggle between market-cleansing deleveraging and the goal of the central banks for price stability has continued last year. Measures taken by central banks have so far compensated for the deleveraging of the commercial banking sector and have created a superficial stability with respect to price inflation, even though the pendulum has swung increasingly toward disinflation in the past 12 months.

Currently various potentially inflationary as well as deflationary forces are offsetting each other. We have listed the most important influence factors below:

Deflationary forces:

- shrinking balance sheets: banks continue to be restrictive with respect to extension of credit
- deleveraging: over-indebted consumers are reducing their debt burdens
- regulations: Basel III
- currently low money multiplier and velocity of circulation[7]
- productivity increases
- debt restructuring (Greece, Cyprus)

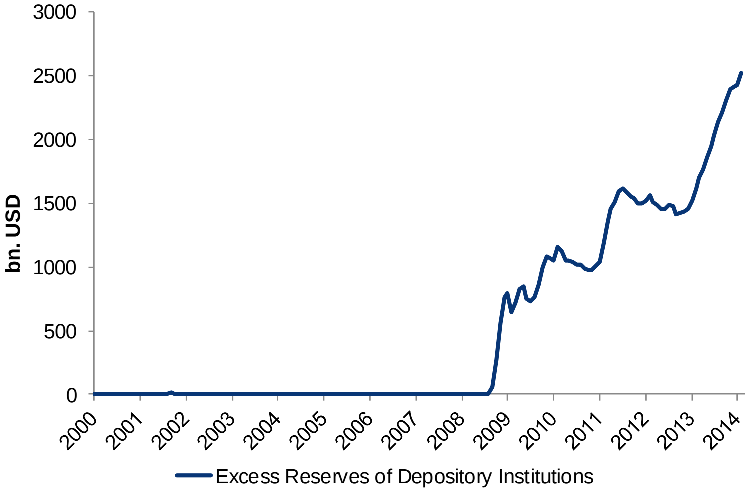
[6] The basket consists of: US dollar, euro, Swiss franc, Japanese yen, renminbi, Indian rupee, British pound, Canadian dollar and Australian dollar
[7] The Austrian School correctly speaks about the "demand for money" in this context

Inflationary forces:

- zero interest rate policy
- communication policy (forward guidance)
- Operation Twist
- quantitative easing
- devaluation of currencies
- eligibility criteria for collateral
- penalty rates (negative interest rates for banks)

So far the effort to get more money into circulation via credit expansion has failed. Demand for credit continues to be low. Bank reserves newly created by quantitative easing are parked as excess reserves with the central bank for now. QE nevertheless is not without consequences: the market-distorting effects of low long term interest rates must not be underestimated. The already mentioned spectacular inflation of asset prices is merely a side effect of QE.

Excess Reserves (bn. USD)



Source: Federal Reserve St. Louis, Incrementum AG

An excellent indicator for the interaction between inflation and deflation is the gold/silver ratio. The economic background is plausible: silver has the characteristics of a hybrid, as there is monetary demand for it on the one hand and industrial demand on the other. The possible applications for silver are quite diverse, e.g. in medical technology, in batteries and chemical catalysts, solar panels, etc. It is often used in "early cycle" industries, which means that it can provide reliable "economic forecasts" and tends to provide accurate signals of rising inflationary trends. Industrial use of gold is however scant, the demand for it is foremost of a monetary nature. In addition, gold benefits not only from rising inflation rates but also from deflationary episodes. **One could therefore also refer to the gold-silver ratio as the "deflation/reflation" ratio.[8].**

The ratio remains currently in an uptrend, i.e., the relative weakness of silver continues. Moreover, one can see that the gold rally earlier this year was not confirmed by silver. This suggests that the move in the gold price could mainly be explained as a political premium due to the Ukraine crisis.

[8] See "Why we are optimistic about silver vs. gold and non-U.S. EPS?", Barry Bannister, Stifel Nicolaus

According to our statistical evaluations, the probability of a sustainable gold price rally is significantly diminished when the gold-silver ratio is rising at the same time. We are closely monitoring the current situation on the gold/silver ratio. We could be observing a significant reversal right now.

Gold/silver ratio since 1971 (circles indicate disinflationary periods)

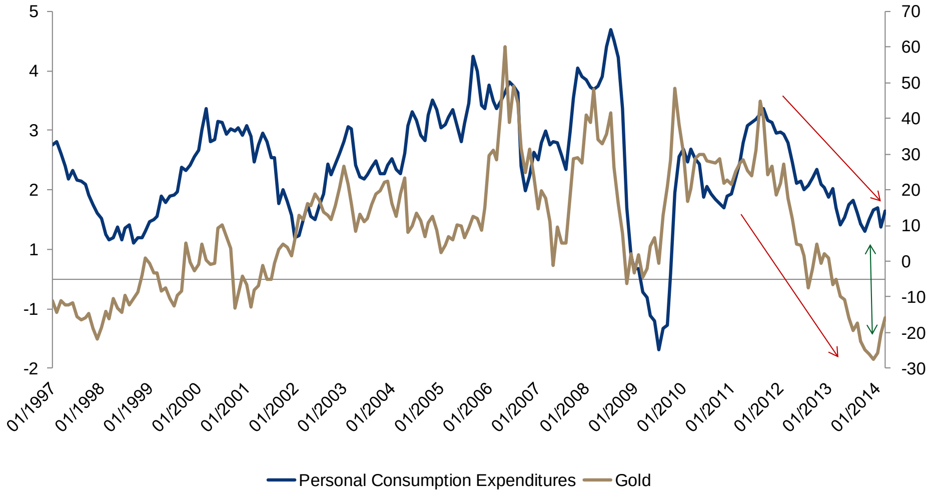
Source: Bloomberg, Incrementum AG

a) The gold price and the rate of price inflation

Gold is often called a hedge against inflation. This is not entirely correct. Last year we showed quantitatively that it is not so much the absolute rate of inflation that is relevant for the gold price, but rather the rate of change of inflation. Rising inflation rates generally mean that the environment for the gold price is positive, while falling rates of inflation (=disinflation) indicate the environment is negative. This can also be discerned in the following charts. Since autumn of 2011, the trend of the PCE index[9] is clearly declining, however, it currently seems to be stabilizing.

[9] Personal Consumption Expenditure Index, an inflation measure regarded as essential by the Fed, as the core inflation rate is derived from it.

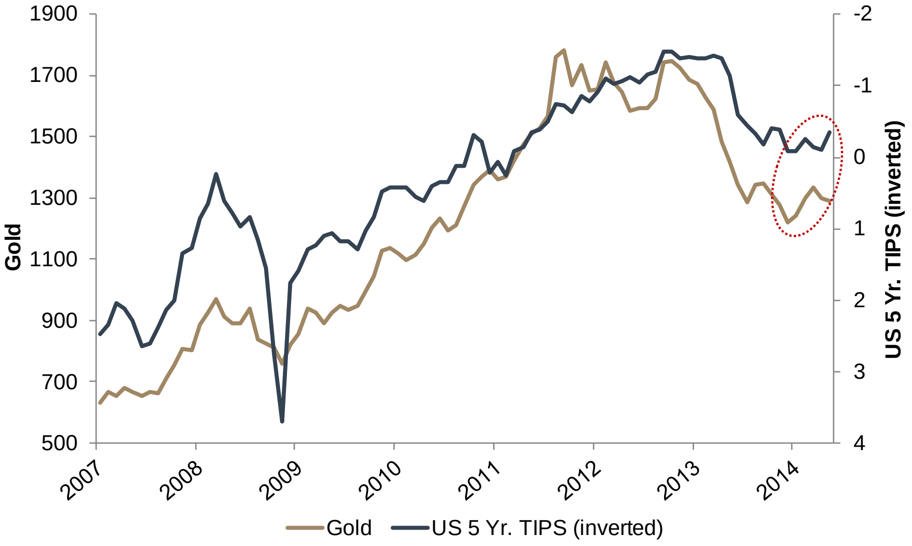
Price inflation and the gold price (rate of change in %)



Source: Federal Reserve St. Louis, Incrementum AG

Inflation-protected securities also show that rising price inflation has been 'priced out' since 2011. **However, over the past few weeks, TIPS seem to be factoring in rising inflation again. This was also confirmed by the action in the gold price.**

Gold price vs. 5yr. TIPS yield (inverted)

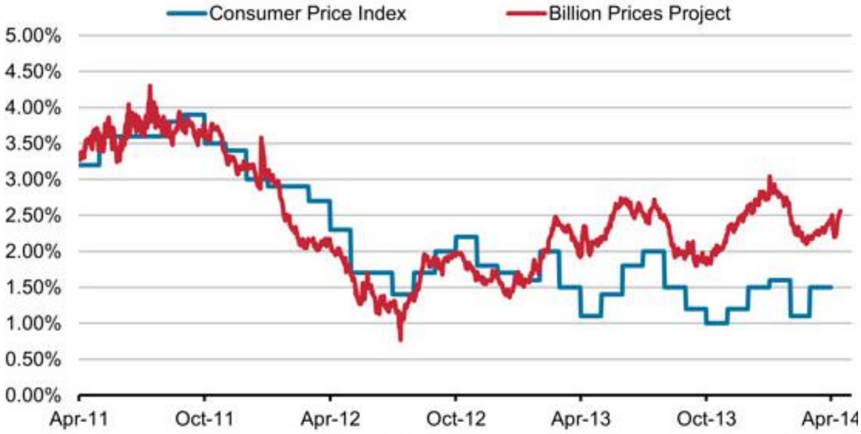


Source: Federal Reserve St. Louis, Incrementum AG

Alternative inflation measures already show rising price inflation rates

An alternative method of measuring the rate of price inflation is provided by the Billion Prices Project of the MIT. The goal of the project is to measure inflation trends more quickly and accurately than traditional price indexes. The price changes of five million goods in 70 countries are recorded daily with the help of software. For the US, the consumer price index “MIT Daily Index” is calculated, which has proved to be a leading indicator at every CPI turning point since 2009. **As the following chart shows, the index is currently diverging from CPI and has recently been trending upward.**

Billion Prices Index vs. CPI (y/y rate of change in %)



Source: State Street Price Stats, WSJ.com

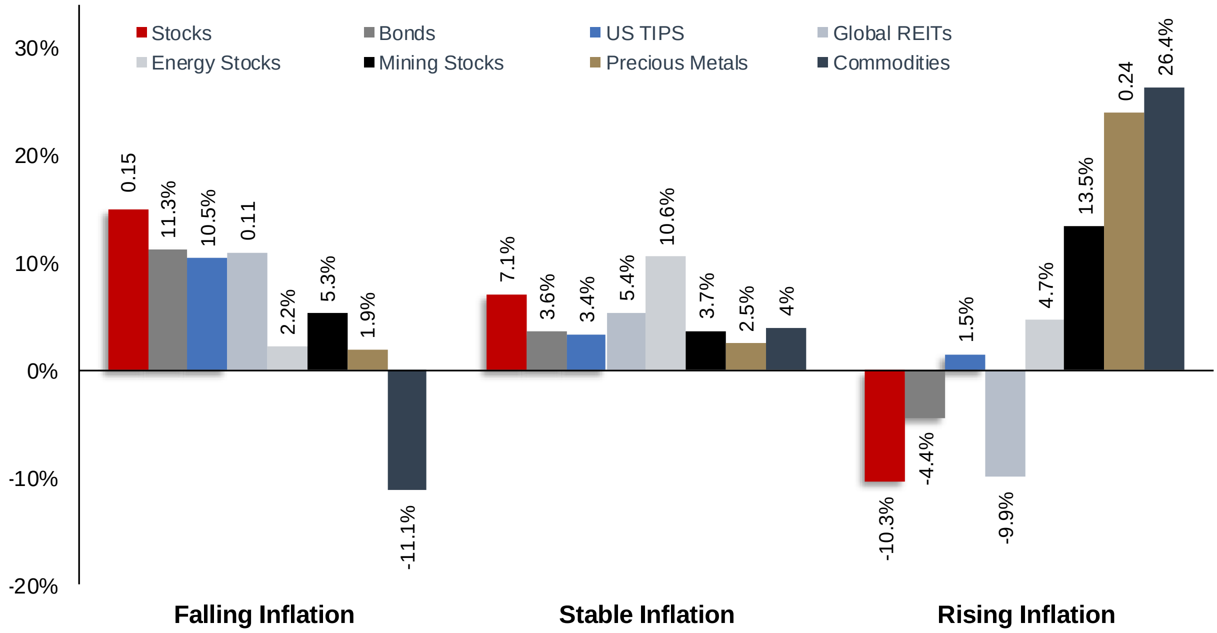
Stocks and inflation-protected bonds provide only a very limited inflation protection

We believe that the inflation outlook currently represents one of the most important macroeconomic data points for the financial markets. As soon as market participants take rising price inflation seriously, market sentiment could change significantly. The current expectation that "*if in doubt, there will be further measures taken by central banks*" would be increasingly questioned if inflation expectations were to rise.

Gold, energy and commodities are highly inflation-sensitive

The following chart clearly shows that both stocks and bonds are among the losers in an environment of rising inflation rates. Even though stocks are often numbered among inflation hedges due to their real value characteristics, this is historically not quite clear. Numerous studies show that stock prices and inflation are negatively correlated. This means that an increase in price inflation normally has a negative effect on stock prices. Naturally, the effect clearly depends on the industry. **This is an important reason why gold and commodity stocks have attractive characteristics in terms of prudent portfolio diversification.**

Performance of different asset classes in different inflation regimes



Source: Wellington Asset Management, Incrementum AG

b) Conclusion: inflation vs. deflation

"Acquiring gold is not an investment. It is a conscious decision to REFRAIN from investing until an honest monetary regime makes rational calculation of relative asset prices possible."
Andreas Acavalos

"Deflation is every central bank's nemesis because it is difficult to reverse, impossible to tax, and makes sovereign debt unpayable by increasing the real value of debt."
Jim Rickards

The monetary experiments currently underway resemble a walk on a knife's edge. A low rate of inflation can be driven up through decisive central bank action. Whether the flood of liquidity that is currently put at the banking system's disposal can really be removed in time is more than questionable. In a worst-case scenario, a loss of confidence in the currency may occur that can no longer be reversed. It was said in the 1920s that central bankers were like ships captains who not only refused to learn the basic rules of navigation, but even asserted that they were superfluous.

From our perspective it cannot be stated a priori whether inflationary forces will prevail in this power struggle. However, due to existing socio-economic incentive structures, when in doubt, higher price inflation will definitely be preferred over a deflationary adjustment. However, disinflationary forces should not be underestimated. The southern European banking system has not yet been sufficiently recapitalized in the wake of the credit bust and is very reluctant to extend new loans. **The preceding credit boom has left a palpable deflationary echo behind.**

Since the autumn of 2011, when inflation rates in the US stood at an annual rate of change of more than 4%, we have seen a strong disinflation trend. This trend has weakened significantly recently. **Should the trend of price inflation reverse sustainably, excellent opportunities in inflation-proof investments would present themselves.**

4. THE EXTRAORDINARY PORTFOLIO CHARACTERISTICS OF GOLD[10]

"Only a desperate gambler stakes everything on a single card."
Friedrich von Schiller

As we have already stated in previous reports, we are firmly convinced that gold is a sensible addition to portfolios due to its unique characteristics. Below the important advantages are summarized again:

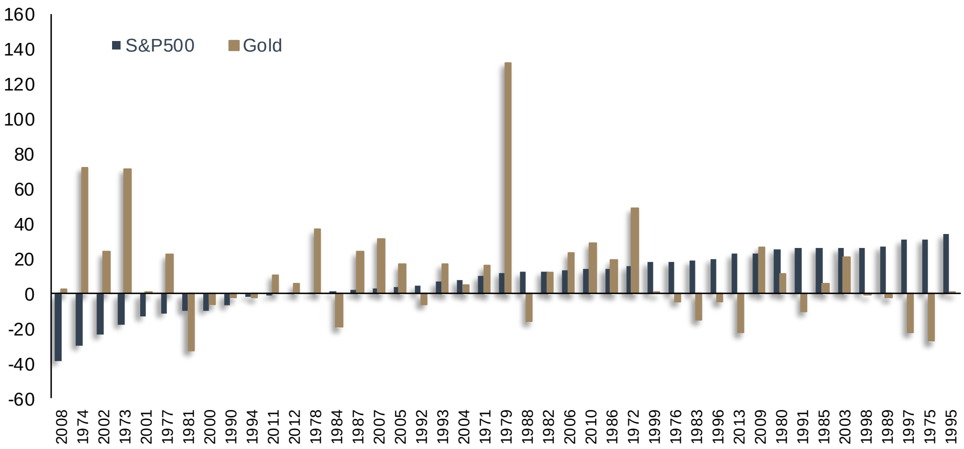
- **increased portfolio diversification**: gold's correlation with other assets is on average 0.1[11]
- **effective hedge against tail risk events**[12]
- **highly liquid asset:** the daily liquidity is significantly higher than that of German Bunds, UK Gilts, US agencies and the most liquid stocks
- **portfolio hedge in times of rising inflation rates** as well as during strong deflationary periods (but not in disinflation)[13]
- **dollar hedge**: gold has a correlation of -0.5 with the US dollar and correlates negatively with most other currencies as.

Numerous studies prove that adding gold lowers the volatility of a portfolio and hence improves statistical portfolio characteristics. This is also shown in the following chart. The annual performances of the S&P

[10] we have already discussed the portfolio characteristics of gold in great detail in our previous gold reports, see "The extraordinary portfolio characteristics of gold" - Gold Report 2013, "Gold as a stabilizing portfolio component" - Gold Report 2012, as well as "Gold as a Portfolio Hedge" - Gold Report 2011
[11] see "Gold: a commodity like no other", World Gold Council
[12] see "Gold: hedging against tail risk", World Gold Council
[13] see "The impact of inflation and deflation on the case for gold", Oxford Economics

500 are sorted from left (weakest year) to right (strongest year) and contrasted with the respective performance of gold. One can see that during the S&P's six worst losing years, gold clearly outperformed not only on a relative, but also on an absolute basis. **This confirms its usefulness as a portfolio hedge. On the other hand, it can be seen that rally phases in the US stock market are usually not a positive environment for the gold price. From this perspective, it is plausible that the continuation of gold's bull market will coincide with the end of the rally in the stock market.**

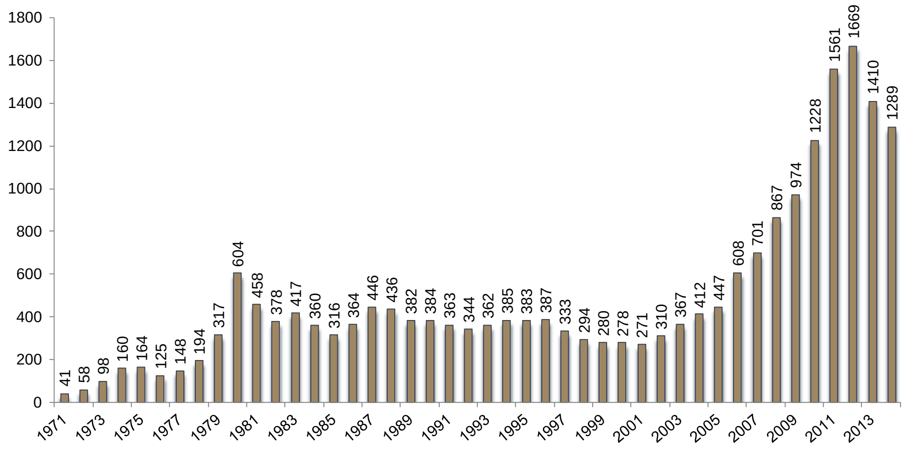
Comparison annual performance Gold vs. S&P



Source: Federal Reserve St. Louis, Incrementum AG

Since 15 August 1971 – the beginning of the new monetary era – the annual rate of increase in the gold price amounts to 8.25%. In real terms, gold appreciates on average by 4.3% per year against the dollar. The current correction is put into perspective in a longer term context, as can be seen from the following chart of average annual prices.

Average annual gold price



Source: Incrementum AG, Datastream

Fungibility as a crucial advantage of gold

High marketability is an important characteristic of gold. The easier a good can be converted, the more pronounced its “moneyness” is. Carl Menger already developed the theory of marketability or saleability in the 19th century already. According to this theory, gold has prevailed in a long term evolutionary process, because its marketability was higher than that of any other good. **Gold and silver didn't attain their monetary status due to their alleged scarcity, but rather due to their superior marketability.**[14]

There is a significant difference between gold and other stores of value such as real estate, diamonds or works of art: a van Gogh painting, an expensive Bordeaux wine, or real estate are not easy to sell quickly at an acceptable price during a crisis. The fungibility of gold is therefore an important distinguishing feature. **This feature is one reason why central banks continue to hold gold as a major currency reserve, but not real estate, works of art or commodities.**

Gold is pure ownership and has no counterparty risk

In addition to these features, gold as an asset class has the qualitative characteristic of representing a debt-free asset and therefore, contrary to bonds and bank deposits, inherently harbors no counterparty risk. **Gold is pure property. The market of paper assets by contrast consists of numerous promises issued by a variety of counterparties.** In periods of (supposed) safety, the attractiveness of an asset without counterparty risk is valued less highly. Once worries about potential default risks increase (deflationary environment), this characteristic of gold will be valued more highly again.

This is also a reason why we are critical with respect to ETFs. Gold held in ETFs may have certain advantages during quiet times (low bid/ask spread, high liquidity), however, in rough waters the claim to gold provided by an ETF does not have the safety characteristics that can be ascribed to physical gold. In such periods, the faith that the ETF's administrator will fulfil his conversion duties may well falter.

Another important characteristic should be mentioned as well: paper money can only render the services of money, while commodity money renders <u>both</u> monetary and non-monetary services. **It follows that the prices paid for paper money can shrink to zero, while the price for a commodity money must always remain in positive territory.**

The opportunity cost of holding gold

„Gold still represents the ultimate form of payment in the world. Fiat money, in extremis, is accepted by nobody. Gold is always accepted."
Alan Greenspan

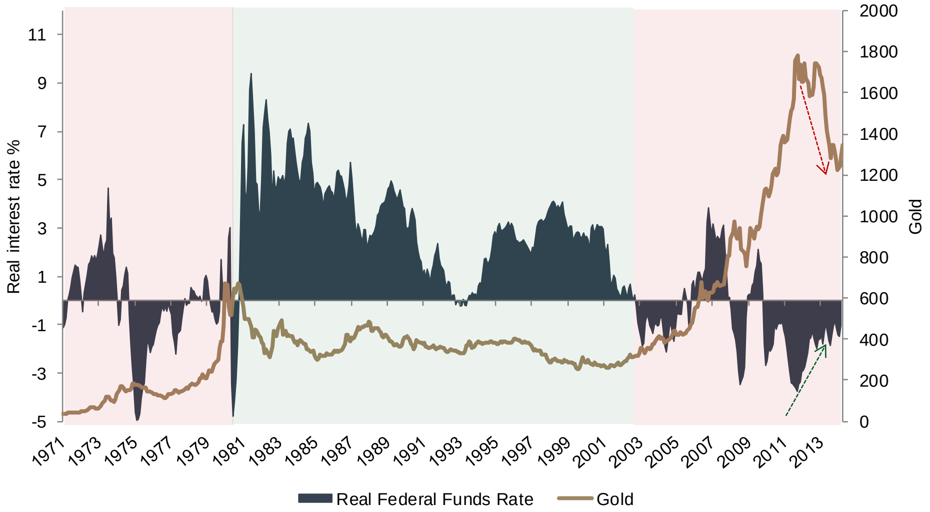
There are a number of reasons to hold gold, to buy or to sell it. It is used for jewelry, as a currency reserve, for works of art, as well as in technological applications. Similarly varied are therefore also the respective time horizons, which range from the short term speculation of a trader to monetary insurance spanning several generations. These decisions are not transparent, but depend on opportunities that compete with each other over the course of time.

Opportunity costs are therefore essential for the gold price. What are the competing economic opportunities and risks which one accepts by holding gold? Real interest rates, growth rates of monetary aggregates, volume and quality of debt, political risks as well as the attractiveness of other asset classes are the most important determinants of opportunity costs. All market participants employ different filters and have different thoughts and time preferences, all of which influence price determination.

[14] see „Critique of Mainstream Austrian Economics", Prof. Antal Fekete

The following chart shows real interest rates and the gold price. It can be clearly seen that in the 1970s and since 2002, a predominantly negative level of real interest rates prevailed, which created a positive environment for gold.

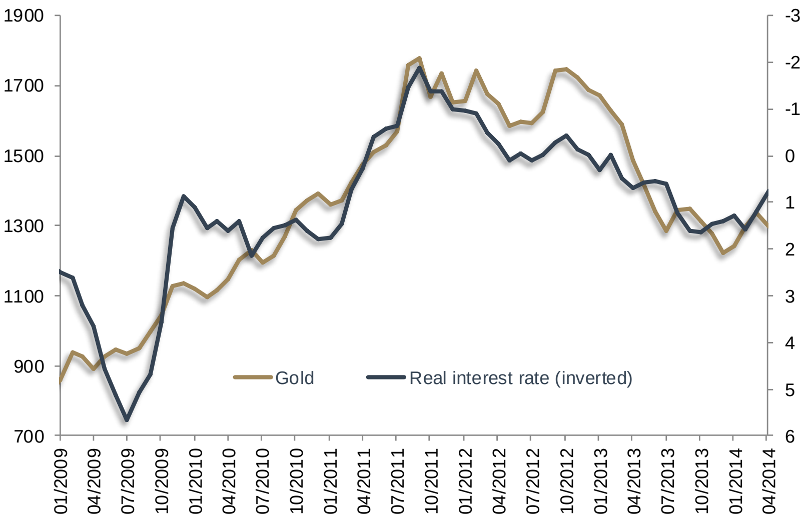
Real interest rates vs. the gold price since 1971



Source: Federal Reserve St. Louis, Incrementum AG

A shorter term consideration of real interest rates reveals that the period since 2011 was marked by rising real interest rates, which was in turn reflected by a falling gold price.

Gold vs. real interest rates (inverted)



Source: Federal Reserve St. Louis, Incrementum AG

A negative long term gold price trend would therefore have to go hand in hand with rising, resp. continually positive real interest rates. Due to the level of debt that has been reached in the meantime – on the part of industrialized nation governments, corporations and households – this is in our opinion difficult to imagine.

5. THE STOCK-TO-FLOW RATIO AS THE MOST SIGNIFICANT REASON FOR GOLD'S MONETARY IMPORTANCE

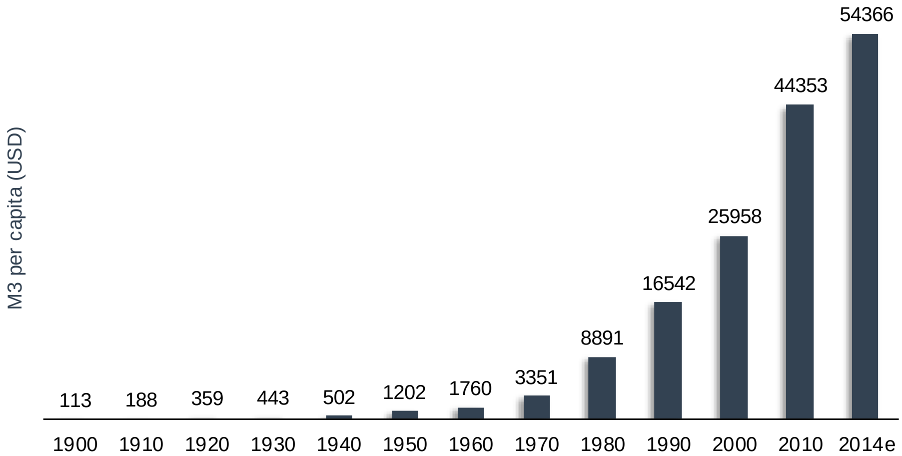
"If a good is to remain money, the public must remain convinced that there won't be a sudden and unstoppable increase in its supply"
Ludwig von Mises

Ludwig von Mises always held the opinion that gold is a good like any other. It differs only in terms of one important characteristic: money is the generally accepted medium of exchange, because it is the most liquid good. According to Mises, its role as a medium of exchange is therefore its crucial characteristic, while its function as a store of value and unit of account are only subsidiary features. This implies also that a rising money supply must lower the exchange value of money.[15]

Supply and demand thus determine not only the prices of goods and services, but also the price of money, resp. its purchasing power. Confidence in the current and future purchasing power of money depends decisively on how much money is in existence currently, but also on expectations regarding the future supply of money. The more money is supplied – relative to the goods and services offered – the more its value declines.

This can also be seen in the following chart. In 1913 the population of the US stood at 97 million people. The money supply M3 at the time amounted to approximately USD 20 billion, i.e., USD 210 per capita. Currently the population stands at 317 million people, while the money supply M3 has risen to USD 17.26 trillion.[16] The per capita supply of money thus amounts to USD 54,366.

M3 per capita since 1900 (USD)

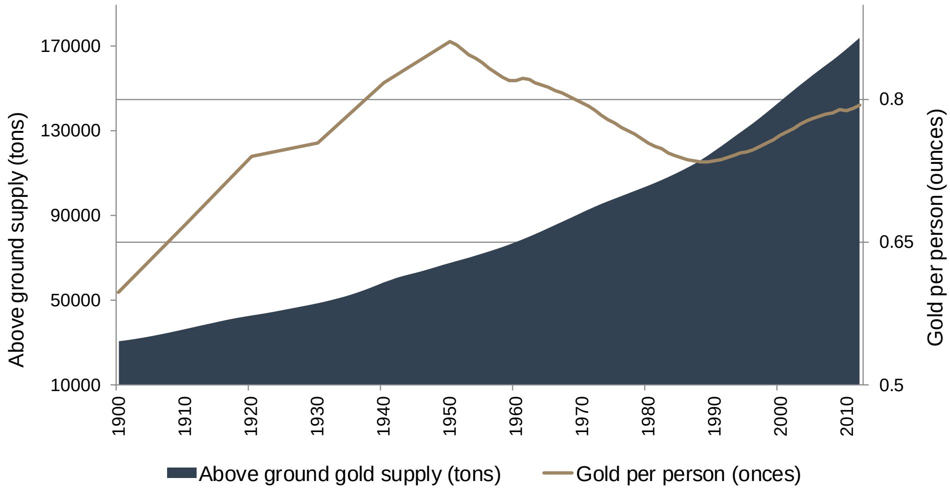


Source: US Census, US Geological Survey, Wikipedia, Incrementum AG

The next chart illustrates that the global stock of gold per capita since the beginning of the 20th century is fluctuating in a fairly tight range of 0.6 to 0.85 ounces. This is remarkable, as the global population has exploded from 1.65bn people in 1900 to some 7bn people today.

[15] see "Die wahre Lehre vom Geld" („The true science of money"), Dr. Thorsten Polleit, Liberales Institut
[16] source: www.nowandfutures.com

Gold stock in tons vs. gold per capita (ounces) since 1900



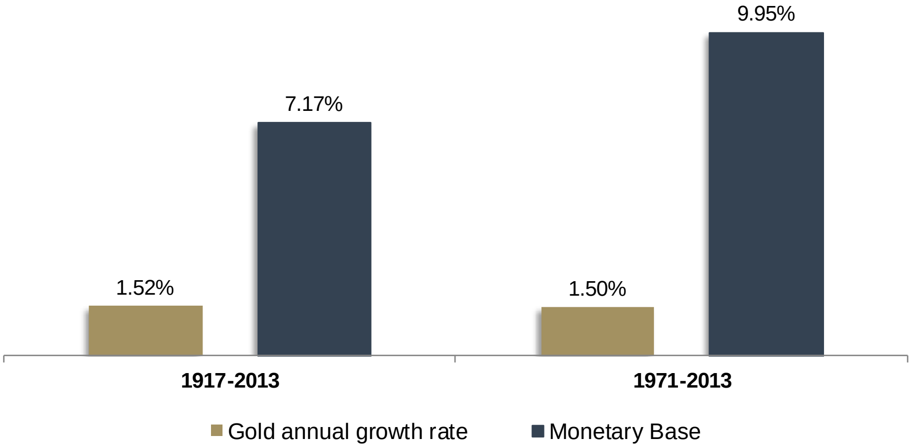
Source: Myrmikan Capital, Incrementum AG

"It's all about relative supply curves – the supply curve for bullion is far more inelastic than is the case for paper money. It really is that simple."
Dave Rosenberg

The gold supply curve only changes marginally. Scrap supply can be volatile, while mine production is highly inelastic. If one compares this to the supply curve of paper currencies, this is one of gold's major advantages: governments can print currency at will. There is no difference between the (digital) costs of printing a 100 euro note or a 10 euro note. There is, however, a substantial difference between producing 100 ounces or 10 ounces of gold. The former takes exactly 10 times the effort.

The following chart illustrates this "***relative scarcity***". The average annual growth rate (CAGR) of the US monetary base between 1917 and 2013 amounted to 7.17%. The supply of gold by contrast only increased by 1.52% per year. If one looks at the rate of change since the beginning of the new monetary era – i.e., since the end of the Bretton Woods agreement – the growth rate of base money is actually significantly higher at 9.95%. The gold supply by comparison grew only by 1.5% per year in the same time period. **This relative scarcity is the main advantage of gold compared to fiat currencies.**

Annualized rate of change: gold vs. monetary base, 1917-2013 and 1971-2013



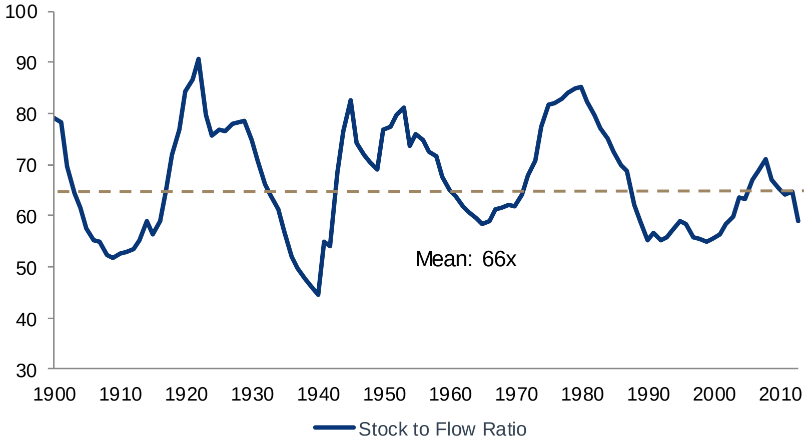
Source: Federal Reserve St. Louis, Incrementum AG

Gold is the money of kings; silver is the money of gentlemen; barter is the money of peasants; but debt is the money of slaves

We have already discussed the crucial importance of the stock-to-flow ratio in our previous reports. Simply put, the ratio means that in the case of gold and silver – as opposed to other commodities – there is a major discrepancy between annual production and the total available supply (= high stock-to-flow ratio). As we stated last year, we believe that the permanently high stock-to-flow ratio represents one of gold's (and silver's) most important characteristics. The total amount of gold amounts to approximately 177,000 tons. This is the stock. Annual mine production amounted to roughly 3,000 tons in 2013 – this is the flow. If one divides the total gold mined by annual production, one arrives at a stock-to-flow ratio of approximately 59 years. **The ratio expresses the number of years it would take to double the total stock of gold at the current rate of production.**

The following chart shows the trend of the ratio since 1900. One can see that it fluctuates akin to a sine curve around a mean value of 66.

Gold: stock-to-flow ratio since 1900



Source: US Geological Survey, Incrementum AG

6. THE MIGRATION OF GOLD DEMAND FROM WEST TO EAST

The steady migration of gold from West to East continues unabated

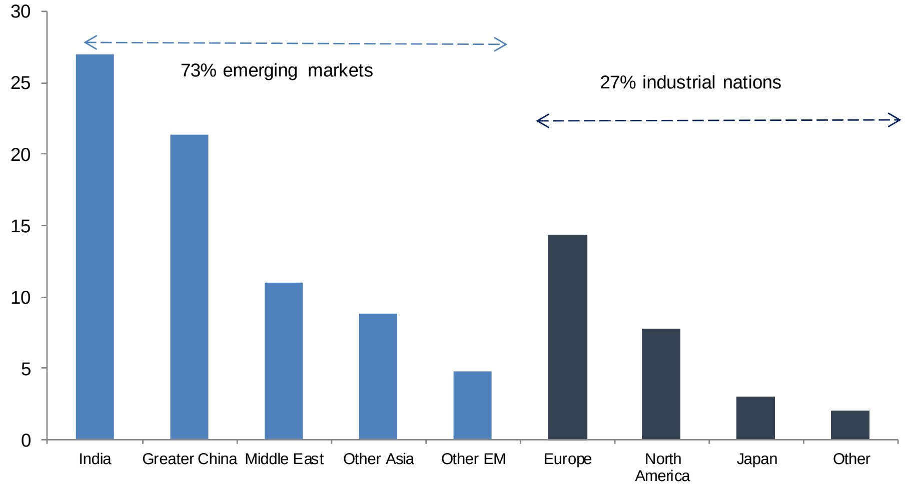
Gold moves from those countries in which capital is consumed to those in which it is accumulated. The Romans already noticed this 2000 years ago, when Chinese and Indians would only accept gold in exchange for spices and silk instead of Roman goods. We believe it is quite likely that gold is increasingly hoarded and its circulation is declining, as it is increasingly held by "strong hands."[17]

***"Chindia"* by now accounts for 62% of physical demand**

The bulk of gold demand by now comes from emerging markets. According to the World Gold Council, demand from emerging markets amounted to more than 70% of total demand in the past 5 years. "*Chindia*" alone was responsible for 62% of total demand last year. The decline in India's demand has in the recent past been (more than) compensated by China's demand. The change in India's government will have a positive effect on gold demand, as import restrictions are likely to be loosened.

[17] see „The Long Monetary March", Myrmikan Update, 23 September, 2013

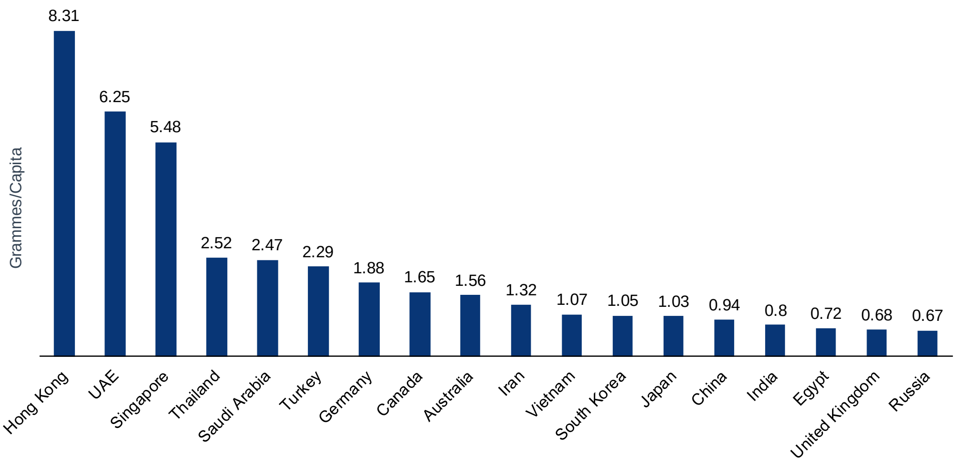
Gold demand by emerging markets and industrialized nations (5 year average) in %



Source: Thomson Reuters GFMS, World Gold Council, Incrementum AG

If one looks at per capita demand last year, one can also see that numerous emerging markets are among the top 20 gold buyers. This is especially astonishing considering their significantly lower purchasing power.

Per capita demand in grammes



Source: GFMS, Thomson Reuters

China's jewelry demand by now amounts to 30% of global jewelry demand. In recent years, investment demand has significantly increased as well. The main reason is probably fear of a creeping devaluation of savings. This is the understandable result of a policy of financial repression and negative real interest rates pursued over many years. **The following factors will affect Asian gold demand in the long term:**[18]

- **rising incomes:** Ernst & Young forecasts in a study that the number of persons belonging to China's middle class will increase to 500 million by 2020. In India the middle class will according to Economic Times amount to 267 million people in 2016 already. By 2030, 64% of the global middle class will live in Asia.

[18] see "China's gold market: progress and prospect", World Gold Council

- **Savings deposits:** Almost one third of disposable income is saved in China. Currently savings deposits amount to USD 7.5 trillion
- **Urbanization and transformation from an agrarian society into an industrialized nation**
- **Inflation fears:** China experienced hyperinflation from 1937 to 1949. Moreover, there is great skepticism (justifiably so) with respect to official inflation data.
- **A lack of investment alternatives:** disappointing performance of China's stock market (see next chart).

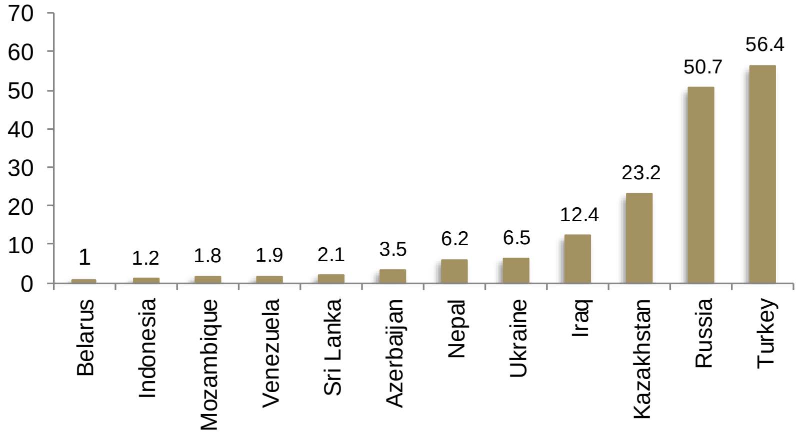
Shanghai Composite vs. gold in yuan

Source: Datastream, Incrementum AG

"The more gold a country has, the more sovereignty it will have if there's a cataclysm with the dollar, the euro, the pound or any other reserve currency."
Evgeny Fedorov

Official central bank purchases amounted to 409 tons last year, which was 135 tons less than in the previous year. The biggest buyers were once again Turkey and Russia. Developing countries are generally not only exhibiting more confidence with respect to their own economic and political power, but also more distrust with respect to established reserve currencies. This is demonstrated by the rising gold purchases of their central banks.

Central bank purchases since June 2013 in tons



Source: World Gold Council

While the central banks of developing countries continue to be net buyers, Western central banks have at least suspended their sales programs. Recently the central banks of the euro area, the ECB, the SNB and the Swedish Riksbank have signed a new gold agreement and agreed “not to engage in any significant gold sales” over the coming five years. The by now fourth such agreement for the first time doesn't include an upper limit for gold sales, as was still usual in the past agreements. Central banks continue to demonstrate a commitment to gold's importance in the modern currency system: “*Gold remains an important element of global currency reserves*” and “*the signatories to the agreement will continue to coordinate their gold transactions in order to avoid market dislocations*”.

Conclusion

“Love trade” will gain in importance

The growing importance of Asia's middle class for gold demand is in our opinion widely underestimated. People in the majority of developing countries have a much stronger affinity to gold than those in the industrialized nations. This traditionally high gold affinity combined with rising prosperity is going to support demand in the long term. **If one assumes that incomes in China and India will continue to rise, while real interest will concurrently remain negative, resp. low, one must inevitably recognize that gold will be a beneficiary of these trends (“love trade”).**

7. APPROACHES TO EVALUATING THE GOLD PRICE

“Value does not exist outside the consciousness of men.”
Carl Menger

In a science like physics, there is 100% precision. We know for instance how the velocity of falling items or the freezing point of water can be calculated. Such constants do not exist in economics, as the data continually change. Economics is about human action and its consequences. **This perspective is a characteristic of the Austrian School, which largely eschews econometric explanatory models.**

According to Carl Menger, the founder of the Austrian School of Economics, the value of a good is determined by the expected marginal utility the good has to a valuing individual. The value of a good or service is therefore not an objectively measurable magnitude, but is always the result of a subjective act of valuation. Since there are as many different scales of preferences as there are human beings (and because every scale of valuations is also continually subject to change), it is impossible to ascertain the value of a good or service in an objective manner. **It is therefore impossible to calculate a “fair value” for gold.**

a) Quantitative valuation model: Scenario analysis

„***In an ideal state of society perhaps the intrinsic quality of money might entirely disappear and be replaced by the value derived from the control of the state. But for that to occur the control of the state would need to be perfect in authority and god-like in intelligence.***”
Aristoteles

Even though we are convinced that every act of valuation on the part of individuals is distinct and subjective and that therefore no objectively ascertainable “fair price” exists, for the first time last year, we published a long term valuation model for the development of the gold price.

Although gold is not officially part of the international monetary architecture, it continues to play an important role as a currency reserve asset. As already mentioned in previous sections of this report, gold's relative position has tended to gain in importance for several years at a time. The most striking manifestation of this is the fact that central banks have once again become net buyers of the precious metal. We continuously monitor two parameters in this context in order to quantify the degree of gold's monetization:

1. the **future development of the central bank's balance sheet**
2. the **future implied balance sheet coverage** in terms of gold

Since the end of the gold standard, no explicit gold coverage ratio is required for central banks anymore. However, based on the market price and gold reserves, an implied gold coverage ratio can be calculated. A fundamental premise of our model is that an increase in the rate of expansion of central bank balance sheets will trigger higher market prices for gold in the long term (probably due to rising price inflation). **The "*degree of monetization*" of gold rises in times of waning confidence and falls in times of growing confidence in paper money.**

Gold coverage ratio of monetary base in %

Source: Incrementum AG, Federal Reserve St. Louis

Monetization degree of gold relative to the dollar at an all-time low

The degree of gold's monetization relative to the monetary base currently stands at 8%, which represents an all-time low. Confidence in US monetary policy is therefore very high. Very few market participants regard price inflation as an imminent danger.

Last year, we developed four scenarios for the future trend of the US central bank balance sheet over a 24-month time horizon.[19] We have adjusted these scenarios this year to reflect the developments that have taken place since then and have tabulated new assumptions for the probabilities of occurrence over the coming 24 months.

scenario	**probability 06/2013**	**Probability 06/2014**
QE ends with exit	**25%**	**5%**
QE ends without exit	**30%**	**70%**
QE doesn't end	**30%**	**10%**
QE accelerates/is renewed	**15%**	**15%**

[19] We want to point out that these assumptions diverge from the opinions of Erste Group Research.

Currently, it appears as though QE3 will be discontinued by year-end. However, the probability that the size of the central bank's balance sheet will contract anytime soon has decreased dramatically. **High-ranking US central bankers have only recently admitted for the first time that the central bank's balance sheet will not be contracted for many years.**[20]

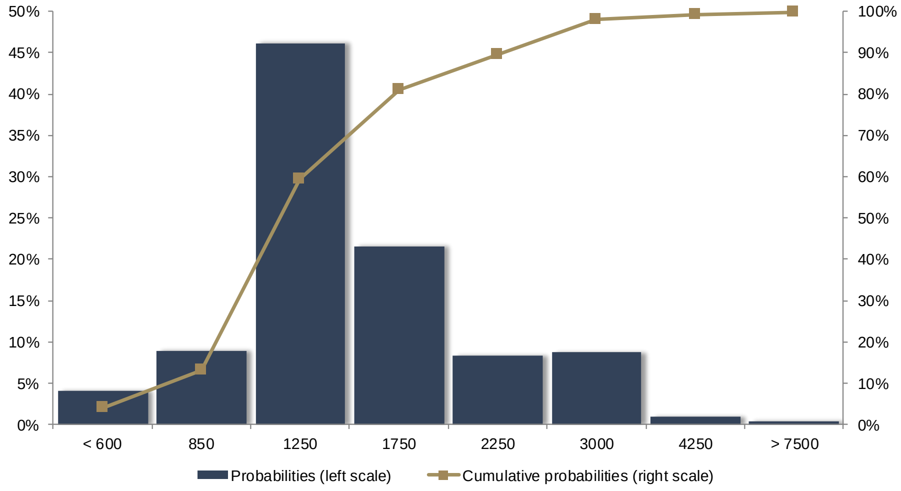
A more asymmetrical picture than last year

As a result, we see a more asymmetrical picture with respect to the future development of central banks' balance sheets compared to last year. The most likely scenario at this stage is clearly that the current "tapering" exercise will end by October or December 2014 and that the central bank balance sheet will be held at a stable level thereafter. We have therefore retained scenarios 3 and 4 with a low probability of occurrence, as the central bank continues with the data-dependent evaluation of its unconventional monetary policy measures. A renewed expansion of QE would, however, be a surprise for the great majority of market participants at this juncture, and would be highly likely to cause a reaction in the gold market. This, in turn, would have an impact on the balance sheet's implied gold coverage ratio. **Even if calculated with a low probability of occurrence, this has a notable effect in terms of a risk premium relative to the current gold price.**

Long term expected value of USD 1,515

Based on the weighted probabilities, the model's calculation arrives at a long-term expected gold price of USD 1,515 per ounce. This estimate is significantly more conservative than that of last year, due to the fact that from today's perspective, the end of the current QE program has become more likely. One year ago, this probability was still markedly lower. However, as the following chart shows, the distribution remains significantly positively skewed. Therefore, should there be a deviation from the currently widely expected path towards stabilization of the central banks' balance sheets, significant upside potential for the gold price would result.

Calculated probability distribution of all scenarios and the associated gold price



Source: Incrementum AG

[20] see http://www.bloomberg.com/news/2014-06-11/fed-prepares-to-keep-super-sized-balance-sheet-for-years-to-come.html

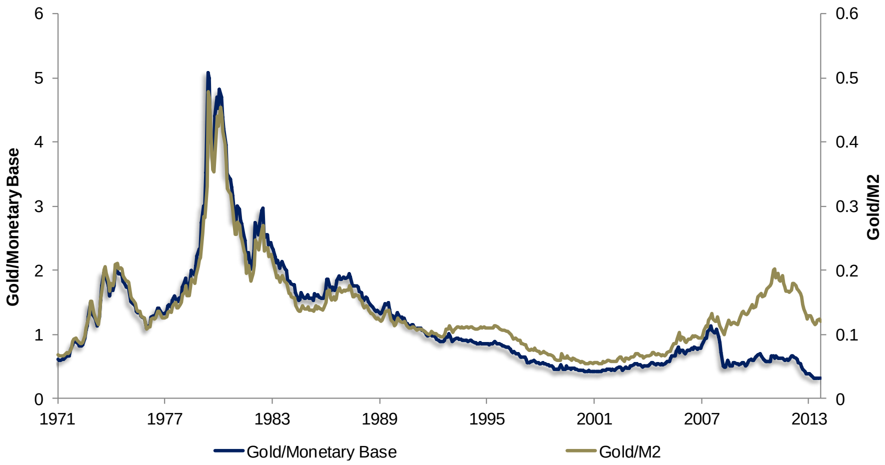
b) Relative valuation based on ratio analysis

In addition to our monetary valuation model, we want to analyze gold's under- or overvaluation relative to other asset classes. Ratio analysis is a simple and extremely useful form of technical analysis. By dividing one price by another, a ratio results, which is charted as a curve. Since we have used gold as the numerator (e.g. gold/stocks), a rising ratio means growing relative strength of gold versus the denominator.

1) Gold vs. monetary aggregates

As the following ratio chart shows, gold remains 'cheap' relative to both the monetary base as well as the money supply aggregate M2, and is well below the long term average. As we have mentioned before already, relative to the monetary base gold is actually trading at new all time lows.

Gold vs. monetary aggregates: monetary base (left hand scale) and M2 (right hand scale)



Source: Incrementum AG, Federal Reserve St. Louis

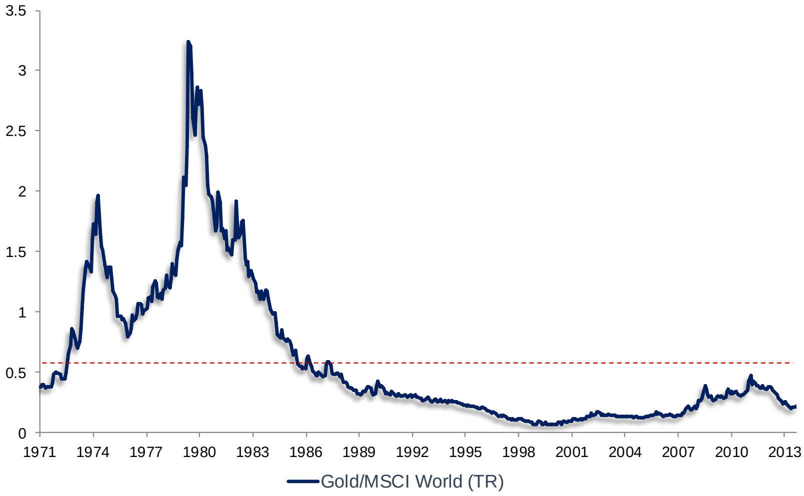
2) Gold vs. stocks

Gold undervalued relative to MSCI US and MSCI World

In a comparison to global stocks[21], one can also see that gold is undervalued on a relative basis. The ratio of gold to the MSCI World index of currently 0.20 is below the long term mean of 0.6 and well below the all time high of 3.4. Similar relative undervaluation is evident in comparisons to the DAX, DJIA and MSCI Europe.

[21] MSCI World Total Return Index, i.e.; incl. reinvested dividends

Gold vs. MSCI World

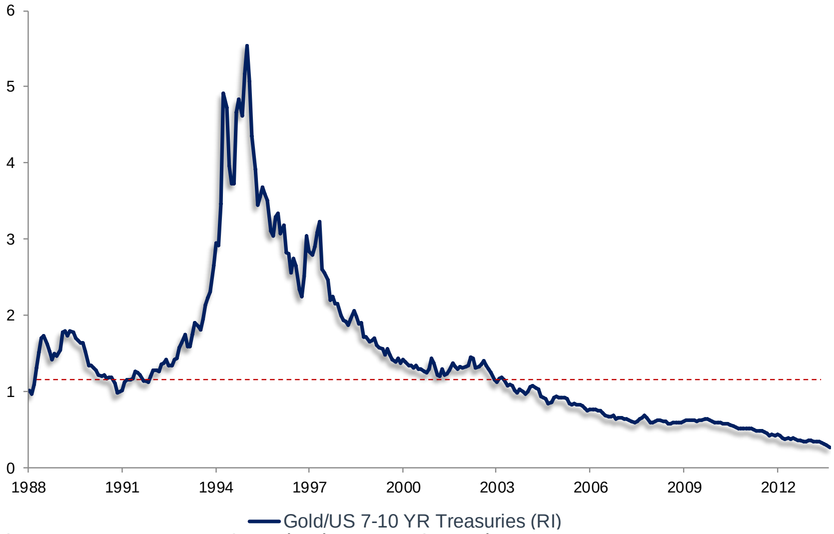


Source: Incrementum AG, Federal Reserve St. Louis

3) Gold vs. bonds

If one compares the gold price to bond indexes (also total return), there is no overvaluation of gold in evidence either. Relative to US treasury bonds gold currently trades well below the long term average. Similar results are obtained in comparisons to corporate bonds.[22]

Gold vs. BOFA ML 7-10YR Treasury



Source: Incrementum AG, Federal Reserve St. Louis

Gold undervalued vs. high yield bonds and crude oil

Below, we show additional ratios of gold and a selection of "real assets" and bonds. One can see that the gold price is above the long-term average relative to US real estate, silver, copper and the commodities index CCI. Relative to crude oil and high yield bonds, gold appears undervalued.

[22] BOFA ML US CORP MASTERS Total Return

Ratio	Current Ratio	Long-term Average	Low	High	Gold relatively expensive?
Gold/Silver	62x	56x	14x	99x	Yes
Gold/Oil (Brent)	11.5x	15x	6.5x	39x	No
Gold/CCI[23]	2.46x	1.6x	0.6x	3.2x	Yes
Gold/Fine Wine[24]	5.01x	4.9x	1.5x	15.1	Fair
Gold/Sotheby's[25]	32.5x	29.2x	4.2x	54.3x	Fair
Gold/High Yields[26]	1.21x	1.7x	0.69x	4.5x	No
Gold/Housing[27]	0.005x	0.0035x	0.0014	0.0095	Yes
Gold/Copper[28]	4.1	3.6	0.84	25	Yes

Source: Incrementum AG, Datastream, Liv-ex, Federal Reserve St. Louis

Conclusion

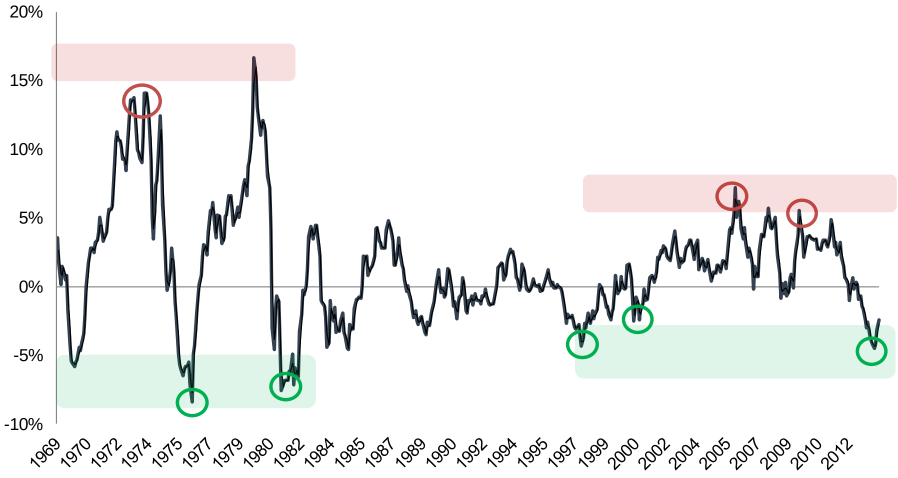
The long term comparison of gold to other asset classes therefore paints a very positive picture. Both in relation to monetary aggregates, as well as to traditional asset classes (stocks and bonds), gold is below the long term averages. Compared to a selection of "real assets" a number of ratios are above the mean, but remain far from extreme values.

8. TECHNICAL ANALYSIS: BOTTOMING PHASE ALMOST CONCLUDED

Gold still oversold

When the gold price reached its intra-day all time high of USD 1,920, the price was three standard deviations above the 40 day moving average. It was therefore extremely overbought. The oscillator shown in the following chart shows that gold is currently extremely oversold. The current corrective phase is the third largest sell-off since 1971. One can also see that the current bull market is characterized by a lot less volatility than that of the 1970s. **This could be an indication that the trend acceleration phase still lies ahead.**

Oversold/Overbought-indicator (1 year oscillator)



Source: Incrementum AG, Datastream

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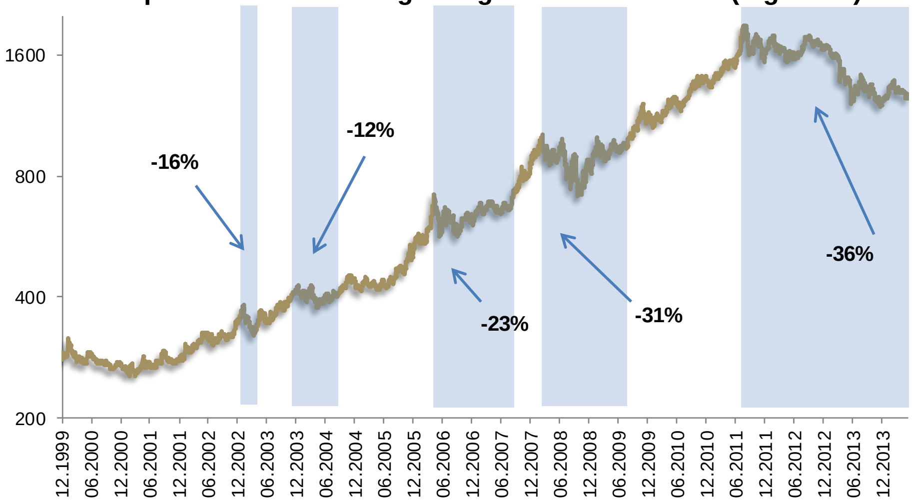
[23] Continuous Commodity Index
[24] Liv-ex Fine Wine Investables Index since January 1988
[25] We regard the stock of Sotheby's as a proxy for the art market
[26] BOFA ML US High Yield Masters Total Return, ab 1986
[27] US Average Existing Home Price, Single-family & Condo
[28] Copper Cathode C/LB

As the next chart shows, the current correction is roughly equal in percentage terms to the correction of 2008. The duration is however clearly above average.

Correction phases since the beginning of the bull market (log scale)



Source: Incrementum AG, Datastream

A longer term look at bear markets[29] shows that the current correction is still below average. The average price decline of the previous six bear markets was 43%.

Peak to Trough	Months	Change %
12/30/74 to 08/30/76	20.3	-47%
01/21/80 to 06/21/82	29.4	-65%
02/16/83 to 02/25/85	24.7	-44%
12/14/87 to 03/10/93	63.8	-35%
02/07/96 to 08/27/99	43.2	-39%
03/17/08 to 10/24/08	7.4	-30%
09/05/11 to 06/28/13	**21.8**	**-36%**

Source: Century Management, Incrementum AG

Be fearful when others are greedy, and be greedy when others are fearful

We see the fact that sentiment is by now at the most negative level since the beginning of the bull market as clearly positive. In view of sentiment indicators such as Market Vane, the Hulbert Survey or Rydex precious metals cash flow it can be clearly seen that there is currently anything but excessive euphoria in the gold market.

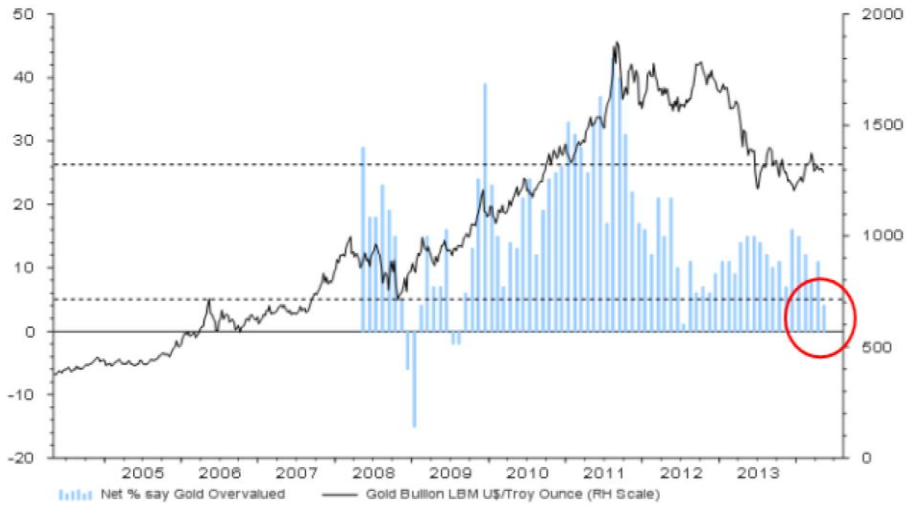
[29] Defined as 25% decline in price, measured from high to low

Public Opinion Index

Source: Sentimentrader.com

According to the Merrill Lynch "Global Fund Manager Survey", only 4% of all fund managers currently regard gold as overvalued. This is the lowest value since mid 2012.

Percentage of fund managers who regard gold as overvalued



Source: Bank of America Merrill Lynch, Wellenreiter Invest

That gold is subject to pronounced seasonality is something we have already discussed in detail in previous reports. **June is traditionally a good time to buy. In the second half of the year upward momentum is clearly at its highest. September is traditionally the strongest month.**

Seasonality Gold & Silver (1971-2013)

Source: seasonax

The commitments of traders report (CoT)[30] at the moment also displays - from a contrarian perspective - a positive technical setup. While positioning by 'smart money' traders (commercial hedgers) hasn't yet reached the extremes seen at the last price low, one can nevertheless conclude from the data that there is extreme relative strength. Commercials have sharply reduced their gross short positions. This means that the largest, best funded and best informed traders have positioned themselves for higher gold prices.

CoT setup is a recipe for a pronounced rally

The bullish picture in gold positioning is underscored by the extreme positioning of producers in silver futures, which currently clearly limits the potential for additional corrective price action. It is especially noteworthy that JP Morgan has massively covered and reduced its short positions in silver considerably, which argues for an imminent medium term rally. All in all we observe CoT positioning data that look similar to those of many previous bottoming periods. I**n our opinion, this signals an attractive counter-cyclical entry point. The current structure of the futures markets is a recipe for a pronounced rally.**

[30] The weekly report issued by the Commodity Futures Trading Commission shows the positions of commercial traders, large speculators and small speculators. Commercials are often called the "smart money" and act in anti-cyclical fashion. The most valuable information is provided by the CoT report at extremes. Large speculators are hedge funds and other institutional investors and act in a highly pro-cyclical fashion. Extremes in positioning can most of the time be interpreted as reliable contra-indicators. Small speculators are also most of the time trend followers and are held to represent the "dumb money".

CoT

Source: www.BlaschzokResearch.de

Conclusion

Opportunities outweigh the risks

The support zone between USD 1,250 and USD 1,270 has by now been successfully tested several times. **We believe based on futures market positioning data, negative sentiment and gradually improving seasonal tendencies, that the opportunities plainly outweigh the risks.** In the short term, the significant relative strength in silver and mining stocks clearly gives us cause for optimism as well. As a result, we expect higher prices in coming months. The USD 1,530 level should represent a massive resistance level on the upside, based on the principle that *"support becomes resistance, resistance becomes support".*

9. CONCLUSION

A glance at the (monetary) history books leads us to a clear conclusion: the fundamental arguments in favor of gold are more convincing than ever. The efficacy of monetary policy measures is becoming ever more questionable, risks are rising. Mohamed El-Erian compares the behavior of central bankers to that of a pharmaceutical company that forces the market to take a medication that has never before been clinically tested. Investors should not only focus on the near term successes of the treatment, but also consider the long term side effects.[31]

"Confidence in central bankers' ability to learn from past inflation is as likely to be misplaced as it was in their ability to learn from past credit booms. Gold remains the cleanest insurance against such overconfidence"
Dylan Grice

If one wants to understand the future, one must look at the past. Future problems are often rooted in the crises of the past. The West is still at the beginning of its great paper money experiment - 43 years are not a long time period for a monetary order. The Austrian School of Economics not only poses good questions in this context, it also provides good answers. The root of the calamity, is the unbacked, government regulated monetary system. Together with a growing number of economists, we are firmly convinced that the global monetary system needs an anchor again. Gold can play an important role in this context. Change will not come overnight through a central institution, but is rather a long-term process that has already begun.

***"The crux of the problem in the global financial system today is not money but debt*"**
Jim Rickards

Our outlook for the gold price clearly remains optimistic. The ongoing consolidation that began in the late summer of 2011 with the all-time high is important for the bull market's health. **The nominal gold price may appear to be still high, but relative to the monetary base it is actually at an all-time low.** In our opinion, this is a temporary anomaly, which we regard as an excellent entry opportunity. We have demonstrated that gold remains attractively priced relative to stocks and bonds, but also relative to a number of hard assets. **Hence, the gold bubble argument often promoted by pessimists is refuted as well.**

***"Inflation is a more fundamental danger than speculative investment. Some countries seem to be in the unusual situation where they are trying to create inflation. They will come to regret that.*"**
Paul Volcker

For the global economy, the question whether the tug-of-war between the "tectonic plates" of inflation and deflation will be decided in favor of one or the other will be very important. One thing is certain, the pressure that has been built up between them becomes ever stronger. **It is in our opinion by no means certain that inflationary forces will prevail.** However, the socio-economic incentive structures and all-encompassing high indebtedness clearly suggest that in case of doubt, higher inflation rates will be tolerated.

"Sell economic ignorance; buy gold"
Tim Price

From a technical perspective, our assumption is that the gold price is near the end of its long consolidation period. The clearly positive market data, negative sentiment and not least the recent revival in gold mining shares all point in the same direction.

„By failing to prepare, you are preparing to fail."
Benjamin Franklin

We are therefore convinced that the technical picture has been repaired and that a stable bottom has formed. Our 12-month price target is the USD 1,500 level.

[31] "EL-ERIAN: The Central Bank 'Pharmaceutical Company' Has Brought An Untested Medicine To The Market", businessinsider.com

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