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2013 – The Year That Optimism Ruled Asset Markets

Years from now, when analysts and market historians look back at the year that was 2013, it's a fair bet that it will be looked upon as the year where hope and optimism ruled asset markets.

It is a year that has been characterized by a phenomenal run in listed asset markets, with equity, REIT and listed infrastructure markets up strongly nearly all around the world. We've also witnessed potentially the beginning of the end of the three-decade-long bull market in bonds, which began in the early 1980s, and of course, we've seen a savage sell-off in precious metals and related investments.

The hope and optimism which have dominated market movements this past year have been fuelled by two themes, both of which have been repeatedly spruiked by the mainstream financial media, traditional economists and asset managers, and central bankers around the world, namely that:

- the Fed is on the verge on unwinding QE3 and that the risks of money printing (namely higher inflation) have been successfully avoided
- the global economy is on the verge of a sustainable economic recovery.

Talk about tapering, and the eventual unwinding of QE3 began in January of this year, when a report in Bloomberg highlighted that most FOMC members saw QE3 **ending** by the end of 2013.

This was an extraordinary conclusion. Remember that it was only in September of 2012 that the Fed even began QE3, originally implementing a \$40bn a month bond purchasing programme, and it was in December of 2012 that they decided to more than double this programme, to \$85bn a month.

In hindsight, it beggars belief that in the very same meeting they decided to more than double QE, they expressed a consensus opinion they were within 12 months of winding the entire programme up.

Indeed, for all the excitement that last week's taper announcement generated (one well-noted Australian economist said it was 'proof the GFC was over'), it's worth remembering that as it stands, the Fed is still on track to print \$900bn next year, rather than the \$1tn they'd have printed without tapering.

The Fed also reaffirmed their commitment to lower interest rates for longer, whilst over in Europe the European Union has lots its AAA credit rating whilst the ECB ponders negative rates, and the Bank of Japan is busy printing hundreds of billions of yen in at attempt to boost inflation to 2%.

Meanwhile, growth rates around the world continue to decline with the last four years of GDP growth in a clear downtrend, starting with 5.20% in 2010 and then printing 4.0%, 3.2% and 2.80% respectively. Some recovery!

Nevertheless, this theme of improving economic fundamentals and a need for less 'policy accommodation' has been one the market has run with for the entire year, with an almost euphoric consensus that the 'global debt crisis' is over, and we can all go back to leveraging up and spending without any thoughts of the consequences.

I think this will prove to be yet another false dawn for the global economy, and that more of the negative consequence of ZIRP and QE will become apparent in 2014, but the optimism and rally in more traditional assets in 2013 has been of particular detriment to precious metal bulls, who've seen gold prices fall for the first time in over a decade this year.

Approaching bullion in 2014 and beyond

Despite the violent pull back we've seen in precious metal prices in 2013, the last 10 years have been incredibly positive for those with any capital invested in either physical gold or silver, with average returns of well over 10%.

But that all seems like a long time ago today, after a 2 year bear market that began in late 2011 and which, starting with the sharp sell off in April 2013, saw gold prices experience their sharpest sell off in decades this year.

Indeed, whilst only 2 years ago gold seemed the obvious trade, today it is anything but, with nearly every major investment bank issuing bearish reports on the outlook for gold prices, sentiment at rock bottom lows, and speculative positioning overwhelmingly tilted to the downside.

Any sign of speculative froth that might have existed in the bullion space back in 2011 is well and truly gone today, and the Fed's 'tapering' of QE, announced last week, has only reinforced the view the gold has had its day and it's time to cash in your bullion.

But is this true? Is now the time for bullion investors to find a new home for their hard-earned capital, and begin rotating into other asset classes like equities, fixed-income or property?

To answer this, I think it's important to first remember why one might choose to own bullion in the first place.

And whilst I can't answer this for everyone, I own bullion for two reasons. Insurance is reason number one, and the second is as investment with potential for capital appreciation, competing with other asset classes I can choose to dedicate capital to.

Let's examine each of these in turn, and see if they're still relevant today.

The insurance argument

Physical precious metals have always been the ultimate insurance against financial upheaval. As even the Reserve Bank of Australia states, they hold gold as part of our foreign exchange reserves to help provide insurance "against the breakdown of the international financial system."

People will argue that that's a pessimistic way of looking at the world. My response is that if the RBA think it's prudent to own gold as insurance, and ultimately it's institutions like the RBA and their international counterparts the Fed, the ECB, the BoJ and the BoE that run 'the international financial system', then it makes sense for me to own some too.

As for this being pessimistic, consider this. It's pretty pessimistic to think you'll get a life-threatening disease, or that your house is going to burn down. Despite that, it still makes sense to take out health, and home and contents insurance, even though it will cost you money to do so, and you hope to never claim on it.

Considering gold's long run return since 1971 has been roughly 9% per annum, it's an insurance premium that's generated a positive return, irrespective of decade-long bullish and bearish cycles along the way, and provided you haven't piled all your capital into it at inopportune times (a strategy that can ruin your returns no matter what asset class we're referring to).

It's also been a proven portfolio diversifier across that time, helping reduce the volatility of a portfolio with a higher concentration in listed-risk assets.

With that in mind, and bearing in mind that gold is essentially money, I don't think there's ever an environment where it won't make sense to own some gold in a portfolio as a long-term insurance policy for your wealth.

And whilst the percentage of your portfolio that you might wish to allocate to insuring your wealth will be different for everyone, for practical and illustrative purposes, this might equate to 10% of your total assets as a general rule.

On a \$500,000 investment portfolio this would equal \$50,000 in bullion.

The potential for capital appreciation

Now that we've covered the insurance angle, and let's assume you have put 10% of your portfolio in gold, then there's still a decision to be made about what to do with the remaining 90% of your investment capital.

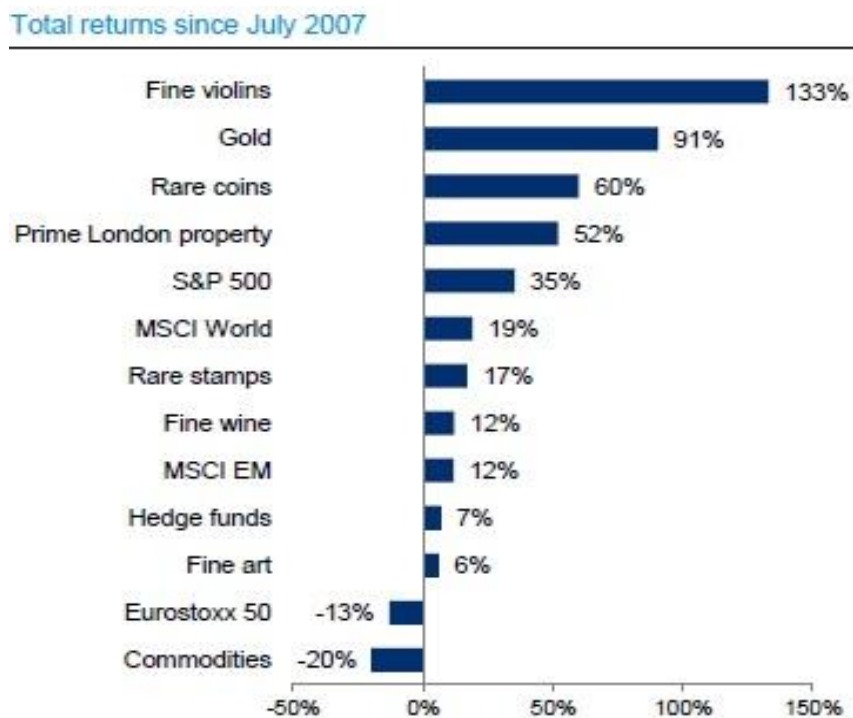
Where does one go when it comes to investing in these highly uncertain times?

Well, whilst there are boutique asset classes and niche markets that some individuals might like to invest in (rare coins, fine wine, art, farmland etc.), for

the majority of people there are 5 major options for to consider: equities, bonds, property, cash and gold.

Before looking at their potential going forward, the following chart shows the returns of many assets (including some niche markets like fine violins and rare stamps) since 2007.

As you can see, gold has been the second best performer, up 91% over this period. More importantly, fine violins, rare coins and Prime London property (the other 3 best performers) are all niche markets with potential liquidity challenges, making gold clearly the best performing market over this period that is both highly liquid and accessible to all investors.



Moving forward though, what is the outlook for each of the major asset classes for the foreseeable future?

Cash

The outlook for cash is questionable at best. Already rates are at all-time lows in Australia, and there's a good chance they'll need to head lower into next year, as the mining capital expenditure boom unwinds, and our economy stagnates.

If we do get a lower AUD, we'll also have to contend with higher inflation, making the real return on cash even lower (if not negative). This will be particularly painful for households already having to deal with utility bills, childcare fees, and healthcare costs which are running at 3-4 times the pace of official inflation

Whilst cash is no longer a legitimate way to save or store wealth over the medium- to long-term, there are still some advantages to holding cash in a portfolio.

Think of it as effectively a put option on the market, in that it provides you with the opportunity to buy more of any particular asset class that suffers a price correction.

The premium you pay for that option is effectively the rate of inflation, minus any income you earn on the cash in the meantime.

Bonds

The medium-term outlook for bonds is terrible. They've been in a bull market for the better part of three decades, and yields are still near all-time lows all around the world, which means prices are near all-time highs.

This is despite the fact that right now, most sovereign nations have never been more indebted than they are today. Worse than that, with relatively subdued economic growth and the challenge of the ageing population still to be dealt with, the outlook for public finances has never been worse, meaning the risk of some kind of default has never been higher.

At present bonds represent a triple threat to your capital:

- Issuers could default, meaning you'll get nothing back.
- Inflation could take off, reducing the real value of your coupon payments and eventual principal repayment
- Yields could continue rising like they have this year, reducing the capital value of your bonds should you wish to sell them.

And whilst bond yields could fall (and prices rise) in a 'risk off' equity environment, there is considerably less upside than downside in the bond market at this point.

Anyone choosing to invest more money into bonds right now is effectively taking the maximum possible risk for the minimum possible return. Not a strategy I'd be recommending or taking with a large portion of my capital.

Equities

After an incredibly positive equity market rally in 2013, investor exuberance (not to mention margin debt) is near enough all-time highs, with most people, and most investment banks predicting that equities are again the place to be in 2014.

But this does not mean equities are cheap.

In fact, with US equities trading at a price/earnings ratio of roughly 25 times earnings ([according to the Shiller CAPE model](#)), equities are already very expensive by historical standards.

This conclusion is further strengthened when one realizes corporate profits (which are cyclical) are also at record highs, [driven by stock buy-backs](#) and drastic cost cutting, rather than headline sales growth.

In Australia, whilst our equity market hasn't reclaimed its previous highs on a price only basis, when one factors in the impact dividends, we are effectively at all time highs as well.

This has primarily been driven by the hunt for yield, with our banks now 40% higher than they were pre-GFC, despite credit growth weakening in the country.

Anyone plowing money into equities right now is taking significant risks with their money at these levels, as stock market investors have tended to lose, rather than make money in the following few years when buying in at the kind of prices on offer in the market today.

Property

Australian property prices are at all-time highs. That's great news. If you're looking to sell your home, you have never been able to get a better price.

On the flipside, there's never been more risk being a buyer, especially when, from an investment perspective, the rental yield you'll earn (around 4% gross as a national average) is near enough all-time lows.

Whilst low interest rates are spurring investor demand, first home-buyers have abandoned the market, and with the baby boomer generation needing to downsize as they approach retirement, there are considerable headwinds to housing in the decade ahead.

A bit like bonds, property has been a 'can't lose' investment for the better part of 30 years. But the glory days are likely over, and caution is of paramount importance in this asset class, especially when one considers the leverage that is typically required to invest in it.

Gold

The medium- to long-term outlook for bullion remains positive, as the fundamental factors which have pushed both gold and silver prices higher between 2001 and 2011 are just as if not more relevant today as they have been for each of the past 10 years.

The world is yet to resolve the global debt crisis and governments have not yet gotten budget deficits under control.

Nor have they done anything to deal with the enormous debt burdens they've already built up, or reformed their totally broken social welfare models that will see these debt levels escalate rapidly in the years ahead.

Furthermore, interest rates around the globe are still zero bound, or negative after you take into account the impact of inflation, and they are set to remain like this for many years to come, meaning that the opportunity cost of investing in bullion will remain low.

Finally, on a global scale, despite the Fed 'taper', central banks are still committed to printing money on a historically unprecedented scale, and will continue to do so for the foreseeable future, whilst emerging markets, particularly China, continue to buy physical bullion at an unprecedented rate as they seek to diversify their assets away from paper liabilities and into real, physical, tangible wealth.

All of these factors are bullish for bullion, despite the pullback in prices that 2013 will be remembered for.

Remembering that for every \$100 in global investable capital, there are roughly \$99 not invested in gold for every \$1 that is invested in gold, it's obvious there is significantly more money that can move into precious metals versus money that can move out of precious metals.

Whilst that is no guarantee of higher prices, it's helpful in terms of understanding that gold is no bubble today, and that there is considerable potential for capital appreciation in the coming years.

Investors will not need to completely abandon other asset classes for gold prices to go up, as even a 5-10% shift of traditional portfolios into gold would see prices rise substantially.

Summary

With bullish fundamentals for gold still in place, and with the outlook for all the other major investment options cloudy, to me personally makes sense to continue investing in gold in the hope of capital appreciation and portfolio diversification, as well as the insurance angle covered earlier.

No other major market is 'cheap' on a historical basis, and no compelling investment rationale exists for any of them at this time.

Therefore it would be highly risky to concentrate too much capital in any one of the more traditional asset classes, and even spreading the risk solely amongst these asset classes might lead to large portfolio losses in the years ahead, as they did during the GFC.

If it can all go up together it can all go down together too, and merely owning two or three of these different asset classes doesn't necessarily mean your portfolio is diversified.

How you then allocate that remaining 90% is obviously going to be different for all people, but as simple as it may sound, a sensible starting point for investors to consider might be as simple as dividing your capital evenly across all 5 of the major asset classes discussed.

This will at least give the peace of mind that you are genuinely diversified, don't have too many eggs in any one basket, and have various components of your portfolio that will work in whatever economic and market scenario come to pass in the next few years.

With that in mind, if investors were to put 20% of their remaining \$450k into gold (on top of the \$50k, or 10% they're holding as long-term portfolio insurance), then in total, they'd have a gold allocation of \$140k, or 28% of their total investable funds.

Whilst this may sound like a lot of money to have in precious metals, especially in light of the volatility we've witnessed this year, it's almost exactly in line with the recommended allocation of the 'permanent portfolio', which advocated keeping 25% of your money in gold, shares, bonds and cash at any one time.

The concept behind the 'permanent portfolio' was simply that the future was unknowable, and the best way of protecting your portfolio no matter what economic environment we head towards (inflation, deflation, high-growth, low-growth etc.) was to spread your assets out across these different asset classes, and rebalance accordingly.

It was never intended to be the best returning portfolio (as that requires concentrating capital into one or two asset classes alone), but one which ensured diversity of investment and protection through the economic cycle, whilst at the same time giving yourself the opportunity to grow your wealth steadily over time.

I'll be writing more on the 'permanent portfolio' concept next year, including a discussion with an Australian fund manager who utilizes this concept for his clients, but with a long-run return of around 10% per annum and with considerably lower volatility and maximum annual losses than a more equity centric portfolio, I think it's an idea with a lot of merit when it comes to investing today, especially for those looking for genuine balance.

Before finishing I should note that this does not represent my own portfolio, as I have a much larger allocation of my own investments in physical precious metals and related investments and am even more bullish on silver than I am gold at today's levels.

Furthermore, this article most certainly is not and doesn't purport to be investment advice for any one individual, as you'll all have your own ideas and comfort levels around risk and volatility.

Nevertheless, looking at the returns the 'permanent portfolio' has generated over 40 years (through a number of economic cycles), the sound risk management principles it is built around, and the fact it has an allocation to precious metals of 25 should give many comfort that this a sensible framework to have in mind when investing capital today and approaching your precious metal investments.

Therefore, whilst it's understandable many bullion investors are nervous about their holdings today, particularly with the potential for further short-term weakness, it's more important than ever as we enter 2014 to assess the economic realities we are facing, and the current valuations in alternative investment opportunities when deciding what to do with your money.

In my opinion, now is not the time to be giving up on investing in bullion, and maintaining or even adding to one's holdings in physical gold and silver is likely to be very rewarding in the years ahead.

Furthermore, as they alone have always done, physical gold and silver will continue to provide the much-needed portfolio insurance we require in these incredibly challenging times.

With that said, all that remains is to thank everyone who reads my market reports and updates and especially to those who have written in with comments, questions and suggestions over the course of the year.

I wish you all a Merry Christmas and fantastic New Year with your friends and family, and all the best for 2014.

Until next year,

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