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GOLD ON THE RISE AS WE ENTER 2019

With its wild swings, the stock market has begun to anticipate the next recession and the potential for continued turmoil in financial markets. Stocks ended the year down with one of the worst Decembers in history. Through it all, gold has been on the rise, up $100 an ounce since the middle of November.

The recent weakness in energy and housing markets along with a surging fiscal deficit have some economists predicting a recession as soon as this year. However, the market is already looking ahead and unprecedented volatility has created massive uncertainty, which is great for gold.

The Fed's zero percent interest rates, ever-rising fiscal debt, and growing deficits helped drive the longest economic expansion since the Civil War. We are now entering what Wall Street regards as the "late cycle"--a period when it is normal to see the gold price rising. (2008: stocks down 37%, gold up 5%; 2001-02: stocks down 34%, gold up 27%.) Unlike recent late cycles, the market is presently pointing to a number of powerful green lights for gold, all of which have the power to independently move precious metals prices higher, suddenly and without warning.

GREEN LIGHTS TO BUY GOLD

A list of reasons:

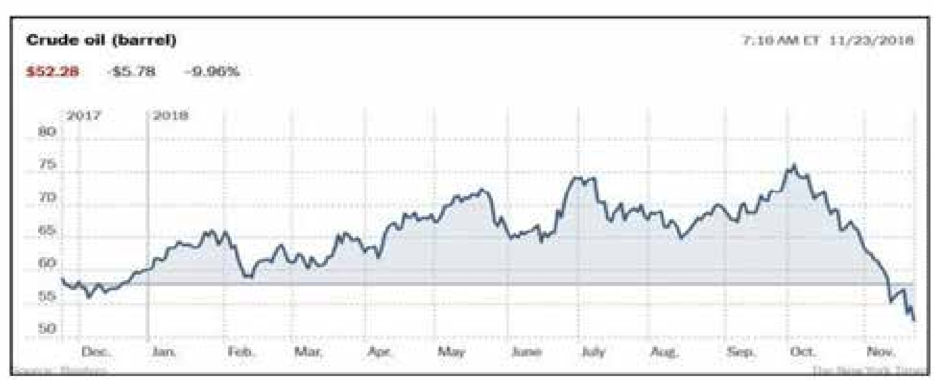
1. Decoupling of Oil
2. Bonds & Currencies
3. Europe
4. The Fed's Dilemma
5. Washington Turmoil

DECOUPLING OF GOLD AND OIL PRICES

The similarities between 2008 and today are uncanny as we watch many bank stocks plunging again. This time around there is a divergence of gold and oil where the rising price of gold has completely decoupled from sharply declining oil prices. In 2008, the price of crude oil skyrocketed to $145 a barrel on July 4th, a rise of 51%, and other commodities rose sharply as well; along with gold. In retrospect, as the reality of recession became apparent and oil began to collapse, gold initially went down--despite rising turbulence in financial markets. In fact, gold prices did not recover until later in the year, closing up 5%.

This time around has been completely different. Since October 3rd of 2018, when crude oil peaked at $76, its price has been declining sharply and plunged rapidly through the $50 level to just above $40 a barrel. Gold has gone in the opposite direction, rising 7%. Since the September stock market peak, gold has also outperformed bonds. Typically, the dollar strengthens in times of market turmoil, which can weaken demand for gold. While the dollar has been fairly stable since September (falling slightly, in fact), it is important to grasp that gold has risen across the board in all currencies since that month.

The fact that gold led the way in December points to the market anticipating dollar weakness, which is what we are currently witnessing here in January of 2019.



European Turmoil

In Europe, stocks are down and gold has been rising in euros. This is in part due to recent dollar weakness, but also because of deep concerns about the overall integrity of the Euro Zone. While Germany has prospered, there are serious concerns with the weaker economies like Italy and Greece, which are both on the edge of recession.

Former Dallas Federal Reserve head Richard Fisher recently said: "When the tide goes out in financial markets, we find out who has been swimming naked, as Buffett once said. Well, there are a lot of ugly naked bodies in the European credit system, the world's second largest." [1]

Europe was brought back from the brink of catastrophe in 2012 when ECB head Mario Draghi was willing to do anything necessary to save the Euro Zone. Now, attitudes are changing and Germany has shown itself unwilling to pay any price to keep the economic unit together.

With gold rising in euros, perhaps some know what monetary historian Barry Eichengreen said in 2010: "Adopting the euro is effectively irreversible. Leaving would surely require lengthy preparations, which, given the anticipated devaluation, **would trigger the mother of all financial crises.**" [2]

The Fed's Dilemma

A quick glance at the chart below explains the conundrum the Federal Reserve faces as it tries to continue raising interest rates without pushing the economy over the edge. This could cause what former Fed Chairman Ben Bernanke referred to as "The Wile-E-Coyote moment"-- when the positive impact of tax cuts wears off and reality sets in. [3]

It is a well-understood fact that the Fed needs to cut interest rates by roughly 5 percentage points to pull an economy out of recession. Next time it would have to cut rates well below 0%, deep into negative territory. Today, such a move is essentially unthinkable.

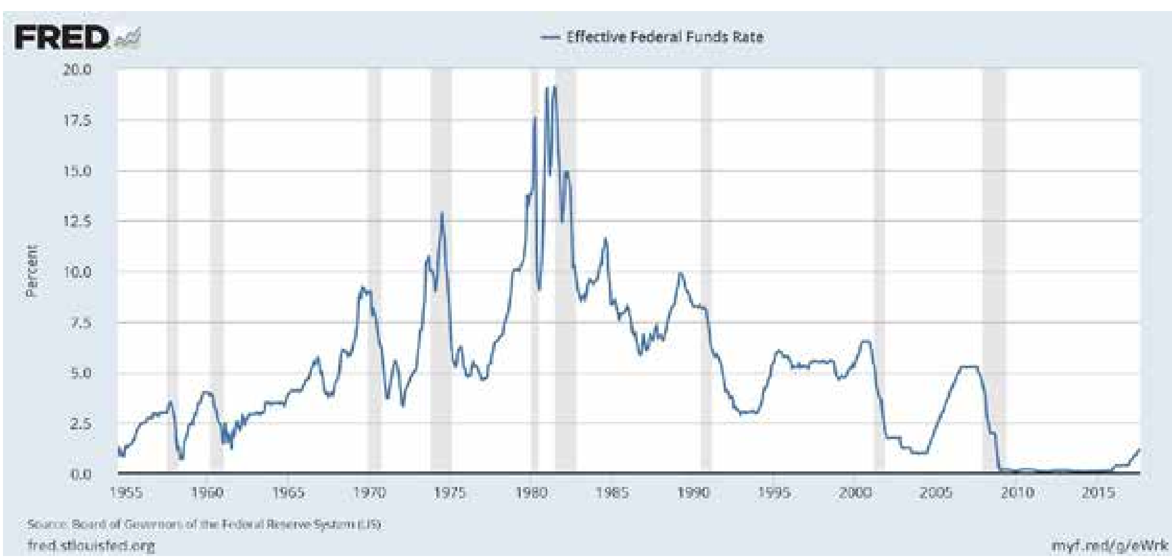
This explains why the Fed has remained so adamant about increasing rates: they need to go much higher so that they are ready for the next downturn. Will the Federal Reserve be able to increase interest rates significantly as the economy continues to soften? Either way, the outlook is very challenging.

The Dysfunctional State of Washington and Its Politics

One could argue that Democrats and Republicans have always been at each other's throats, but history has shown an ability to compromise in times of deep economic stress. Optimists can point to 2008, when both sides were willing to take some tough medicine, like agreeing to bail out the banks instead of American families holding mortgages.

When the next crisis comes, can anyone be so optimistic? That remains to be seen, but for now, we remain in a government shutdown.

It is undeniable that gold has held up remarkably well the past few years in the face of a booming stock market. It makes one think about what will happen to gold prices when the financial tides finally go out and we enter the next phase of the economic cycle. Be proactive and talk to one of our Austin Advisors today.



The chart above shows the Federal Funds Rate dating back to 1965. After historic lows for much of this century, the Fed is now trying to raise rates so that it has the ability to lower them when we enter a recession.

[1] Richard Fisher, interview on CNBC, Dec. 10, 2018.
[2] Barry Eichengreen, *"The Euro: Love It or Leave It?" voxeu.org,* May 4, 2010.
[3] "Bernanke Says US Economy Faces a *'Wile E. Coyote' Moment in 2020," bloomberg.com,* June 7, 2018.