Framework For Analyzing Gold & Silver

Similar to all other markets we trade, the foundation of our precious metals framework is the "Marcus Trifecta". A triangulation of the Macro, Technicals, and Sentiment. In this piece, we're going to cover the macro.

The macro framework is simple… It has little to do with inflation or "crisis insurance" of any other of the perfunctory narratives that commonly get passed around as wisdom.

Okay… so here it is… our macro framework is: RED. That's it, what do you think... Pretty good, huh?

Not impressed? Okay, that's fine, let me break it down for you then. RED is an acronym that stands for.

- **R**elative Size
- **E**xpected Real Returns
- **D**emand

Here's what each of those means.

Relative Size

Less than 15% of the gold mined throughout history is held in investment form. Gold's total market cap is somewhere in the ballpark of $1-$2trn. While the global capital stock (equity + debt) is in the realm of $250-$300trn. This creates a positively sloped investment demand function. More on that below.

Expected Returns

Read the following from a 1985 NBER working paper titled "Gibson's Paradox And The Gold Standard". Here's the link to the paper (emphasis from me):

> *Gold is a highly durable asset, and thus, as stressed by Levhari and Pindyck (1981), the demand for the existing stock (as opposed to the new flow) must be modeled.* ***The willingness to hold the stock of gold depends on the rate of return available on alternative assets.*** *We assume that the alternative assets are physical capital with a (instantaneous) real rate of return r, and nominal bonds with (instantaneous) nominal return i = r + P/P = r — Pg/Pg. The real rate of return is exogenous to the model, but subject to shocks. These shocks reflect changes in the actual or perceived productivity of capital as envisioned by Keynes and Wicksell.*

The above is just a fancy of way of saying two things (1) since gold is a non-perishable metal and the amount mined each year (new flow) is tiny relative to the existing stock, we should focus on the latter in our supply & demand calculations and (2) the attractiveness of gold is ALL relative and demand only becomes positive when the expected real rate of return offered on other assets (stocks and bonds) is low.

Demand

Demand, not supply, is what matters. Remember, potential demand is many multiples the size of the existing gold stock, which is fairly inelastic. So it doesn't take much of a change at the margins of asset preferences to cause very big moves in the yellow metal. And as we learned above, this demand or asset preferences are driven by the expected real returns of stocks and bonds. This is why gold tracks the real yield on bonds very closely. When the real yield offered on bonds is trending lower, gold goes up. And vice versa.

This inverse relationship can be seen below in the following matrix via the excellent book *Hedgehogging*, written by Barton Biggs (the chapter with Peter, the "Gold Guru" is also where I first became aware fo the above NBER paper).

FIGURE 19.1

Expected Real Return Matrix

Capital Markets		*Gold*
10%	– –	–8%
8%	– –	–3%
6%	– –	2%
4%	– ↔ –	7%
2%	– –	12%
0%	– –	17%
–2%	– –	22%

Source: Sun Valley Gold LLC

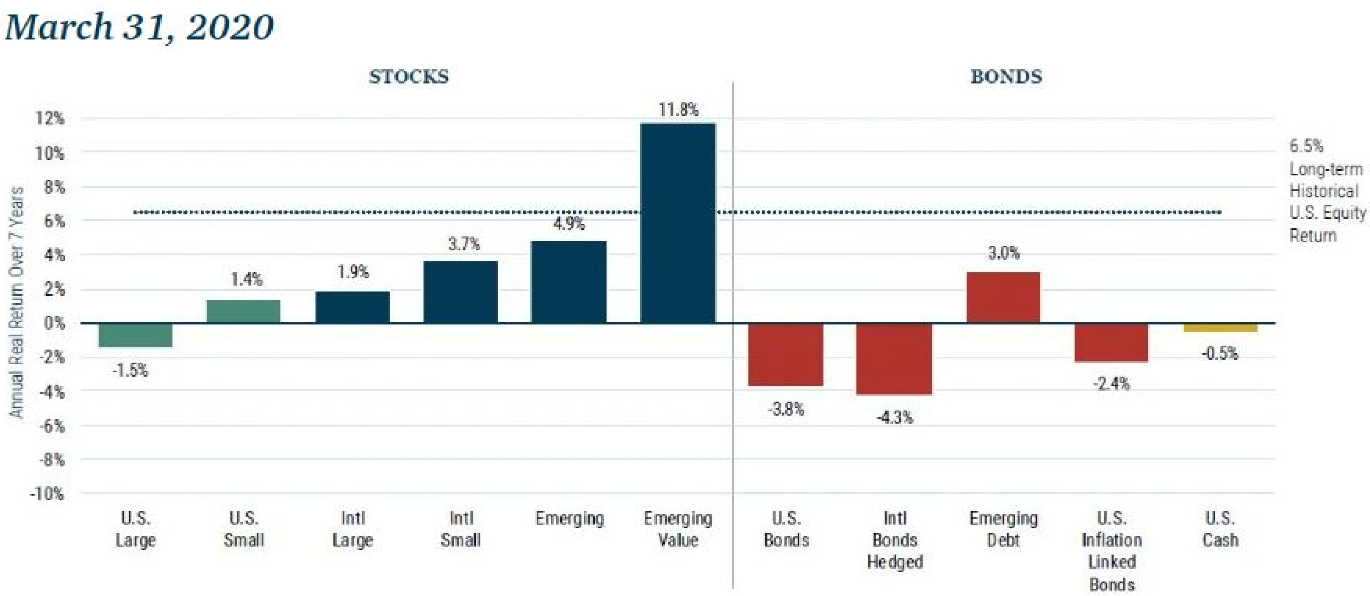
So that's it… That's RED. Our fundamental framework for analyzing gold.

The entire thing can be boiled down further into just two key points:

1. Over the long run (and this is one of Ray Dalio's "principles" regarding gold, as well) the price of gold will approximate **the total amount of money in circulation divided by the size of the gold stock**
2. And it's not inflation or deflation that is the principal driver of gold, but the expected real return from other long-term financial assets, particular equities.

Using the above we can quickly discern that there's a very high probability the bull market in gold will continue for the foreseeable future.

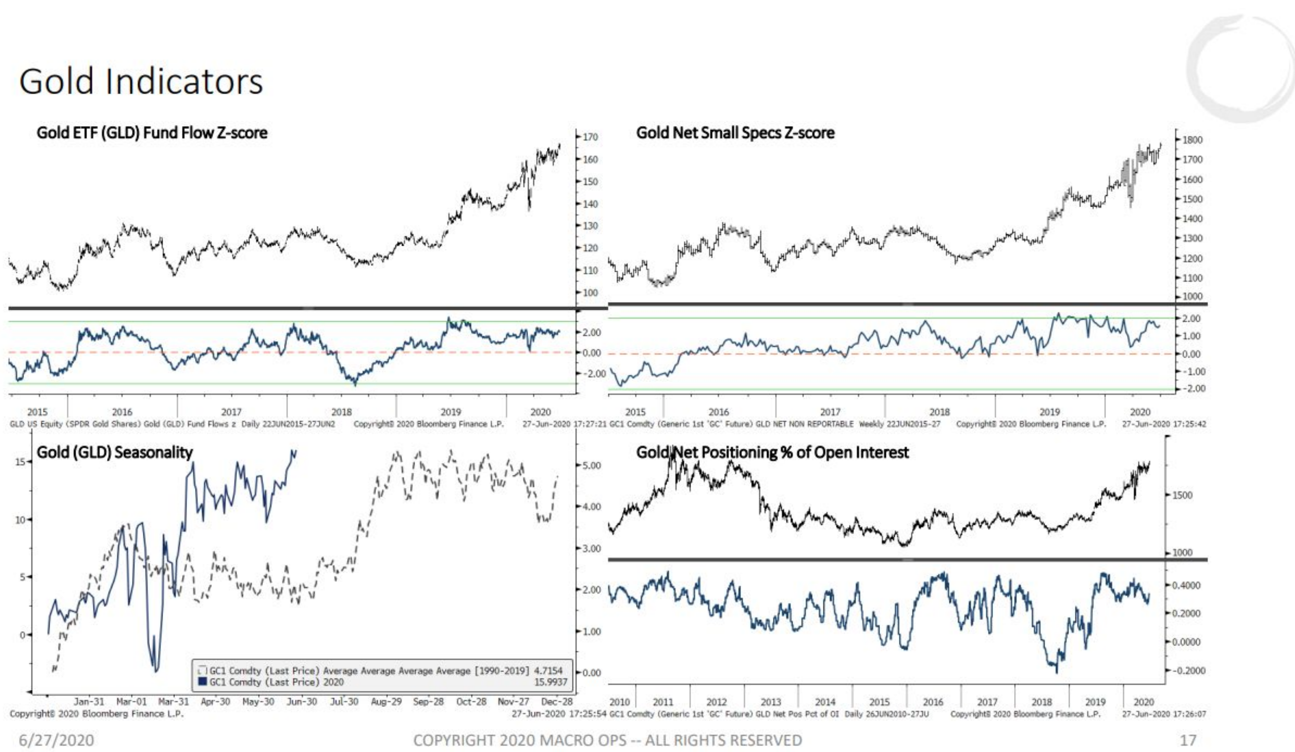
The global money stock has exploded and continues to rise… While the expected real return on financial assets is very low. Even negative in some cases. See GMO's 7-year forecast as case in point.



Gold obviously isn't going to go straight up from here. So, if you're a trader, then you'll want to pay attention to some key indicators and of course, read the tape.

Here's a slide from our regular weekly Trifecta Report that goes out every Saturday. In the report, we analyze the four main macro instruments: SPX, UST 10yr Bonds, Gold, and the dollar.

The below slide shows some of the key positioning, sentiment, and seasonal data that we track for gold. As of right now, fund flows, sentiment, and positioning all remain supportive of higher prices. Not to mention, gold is about to enter the strongest 2-months of the year for returns on a seasonal basis.



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