Q&A: China, Gold, Inflation, Energy… and More

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Bob Weir, CFA
Contributing Analyst

Q&A: China, Gold, Inflation, Energy… and More

By John Persinos (bio at end)
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Q&A with Dr. Stephen Leeb

I first started working with Dr. Leeb way back in 1990. Here is what he has to say about the present and future of the investment world.

Q: You have written several prescient books about the emergence of China as an economic rival to America. In which areas does China pose the greatest threat to America and how should investors position themselves?

A: The greatest threat to the U.S.A. from China's emergence will be commodity scarcities. They will have the potential to drive down economic growth and apply pressure to stock markets. Scarcities are just beginning to show up now, but I expect they will intensify over time. One investment implication will be rising gold prices, as I will explain.

I would recommend that, for now, investors have around a 10% weighting in precious metals, and especially gold, and a somewhat smaller weighting in major diversified commodity stocks.

As commodity scarcities become more visible, I would switch the entire commodities weighting into gold.

For the rest of an investor's portfolio, my theme is GARP, or growth at a reasonable price. While there is a widespread assumption that this long-lived economic expansion is due to end, I think that, for as long as commodity scarcities remain relatively modest, growth has further to go. GARP means sticking with a mix of stocks with low forward price-to-earnings ratios (P/Es) and prospects for decent growth.

Q: What's your take on the U.S.-China trade war? Do tariffs actually work? And, if in your view they don't, what are more effective ways for the USA to counter China's allegedly unfair trade practices?

Tariffs don't work with countries that are relatively equal, meaning ones where each has economic advantages and disadvantages, which is the case today with the USA and China.

By contrast, in 1987, the USA used tariffs successfully against Japan, largely dictating a new trading relationship between the two countries. But Japan's gross domestic product (GDP) was 60% to 70% smaller than ours.

Today, based on some measures, such as international dollars, the measure used by both the International Monetary Fund (IMF) and World Bank, China's economy is bigger than ours.

On the other hand, because China exports much more to us than we export to China, we have more Chinese goods on which to place tariffs. But this has proved a Pyrrhic victory, because — as reported in early March by several think tanks — U.S. consumers are bearing the entire cost of the tariffs, to the tune of around $3 billion a month. That does not count the extra costs of relocating supply chains. Increasing tariffs further will only add to the burden on American consumers.

While China's economy has slowed, it is not clear how big a role the tariffs played. The Chinese have been deleveraging, which has been a factor in slowing growth. Even if you attribute the entire slowdown in China's economy to U.S. tariffs, China's GDP is still growing three times faster than ours.

Many economic historians blame the Smoot-Hawley tariff act of 1930 for exacerbating the worldwide depression that paved the way for WWII. Today, any full-fledged trade war would be lose-lose and possibly catastrophic.

The USA is far more vulnerable than many realize because of our dependence on other countries, and especially China, for many critical commodities, including rare earths, cobalt, and graphite. These are essential in every high-tech product from computers to electric vehicles to advanced military equipment. China could wreak major damage to our economy by placing exorbitant tariffs on these materials.

A far better way to confront the challenge China clearly poses to our position in the world would be to treat today as a "Sputnik moment." When the Soviet Union shocked us in 1957 by launching the first unmanned satellite, undermining our belief in our technological superiority, we did not respond with tariffs. Rather we launched an all-out effort to catch up and surpass the Russians by spending billions of dollars on science, technology, engineering, and math (STEM) education and research.

In little more than a decade, we established a hegemony in technology that lasted 50 years. We need to make a comparable all-out effort today to invest in education and infrastructure that would ensure our economy can compete as the century proceeds.

Q: What is your view of gold prices in 2019 and beyond? Is the yellow metal poised for resurgence and if so, why?

I believe gold will be entering a bull market likely to dwarf anything seen before. One reason is my expectation that gold will be at the heart of a new monetary system that China has long been intent on mid-wifing.

A window into China's intentions comes from comments made in 2009 by the then-head of China's central bank, who trenchantly summarized the risks to global economic stability when a sovereign currency such as the dollar is the world's reserve currency, an analysis many Western economists would agree with.

In its place he proposed a reserve currency modeled on special drawing rights (SDRs), administered by the IMF. He said such a basket of currencies should be backed by an asset that he did not name but that clearly referred to gold. I believe that, in coming years such a system will become reality, and it will propel gold far higher.

That is because the quantity of gold in the world is limited. All the gold ever mined is less than 200,000 metric tonnes and, with a lot of that used for jewelry, the amount available for monetary purposes has a current value of about $3.5 trillion.

Assuming that monetary gold is used only to back up international transactions, gold prices would have to climb more than 10-fold to accommodate trade. That means a long-term target for gold would likely be north of $10,000/ounce, and maybe higher.

Shares in gold-mining companies could rise even more dramatically, especially those with major undeveloped mines with massive deposits, some of them in geopolitically safe America.

In the gold bull market that lasted from mid-1976 to early 1981, some gold mining stocks rose 50-fold and more. I expect the coming bull market in gold to last longer and rise much further.

Q: Is inflation only modest or are price pressures worse than investors realize?

Both. Compared to historical averages, inflation as measured by the consumer price index (CPI), is indeed moderate. But this conceals the reality that, for the majority of Americans, price pressures are historically high.

This conclusion is based on a recent study I did that compared two periods over the past 32 years: 1987 to 2002 and 2002 to present. In the first period, inflation as measured by the CPI averaged about 3.3%; in the second it was 2.1%. Yet, it was in the latter period, when inflation supposedly was lower, that living standards markedly worsened for Americans in the bottom 50% of the income distribution line.

Among other significant signs of being forced to make do with less, they are consuming less protein and buying more used cars. I see that as a sign that inflation in the second period has been more insidious than appears on the surface.

Insight into this comes from a surprising contrast in the behavior of commodity prices. In the earlier period, a broad measure of commodity prices fell by over 20%. In the more recent period, the same measure of commodities more than doubled, keeping up with the S&P 500, making it one of the best periods ever for commodities.

As we enter the third decade of this century, it is accurate to say most commodities are in up-trends that date from 1975. There is no other 50-year period in which such a broad swath of commodities has been climbing together.

Higher commodity prices obviously should relate to inflation. In particular, they translate into higher prices for essential goods, such as foods. While such essentials constitute a fairly small part of the CPI, they have been accounting for an ever-growing portion of spending by lower-income Americans.

Looking ahead, it is significant that, for the first time at least in modern times, fast-growing emerging countries — which are huge consumers of commodities to fuel economic growth — now constitute the biggest portion of the global economy. This means commodities of all sorts will be growing scarcer and more expensive, almost surely making life harder than ever for lower-income Americans and widening the gap between the haves and the have-nots.

Returning to the previous question about gold, an investment implication of higher commodity prices is that, even if I am wrong about a new monetary reserve system, gold prices will be sharply up-trended.

Q: What is the single most underrated threat to investors this year?

I think most investors have become complacent in regards to energy, assuming that oil prices will stay low. While the world is indeed well supplied with oil today, it would not take a lot to change that dynamic.

If OPEC agrees to a deep production curb; if USA producers hit unexpected snags; if there is an out-of-the-blue major terrorist attack or outbreak of conflict in a sensitive region — any of these could impact supply and send oil prices up.

Sudden spikes in oil prices tend to wreak havoc on economies and portend rough times for the stock market. Few people expect a big jump in oil this year, making it a potential negative surprise that could blindside the market. For that reason, I believe it is very important to keep a close eye on the oil market.

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See "About the Analyst" on the next page.

About the Guest Analyst

Stephen M. Leeb

Stephen Leeb, Ph.D. is the chief investment strategist of ***The Complete Investor*** and ***Real World Investing.*** Dr. Leeb's books have been notable for predicting the secular bull market that started in the 1980s (***Getting in on the Ground Floor***, Putnam, 1986); the tech stock crash and rise of real assets, including oil and gold (***Defying the Market: Profiting in the Turbulent Post-Technology Market Boom***, McGraw-Hill, 1999); and the surge in oil prices (***The Oil Factor: Protect Yourself and Profit from the Coming Energy Crisis***,Warner Books, 2004).

About the Host Analyst

John Persinos is managing editor of *Personal Finance*, *Utility Forecaster*, and *Radical Wealth Alliance*. He also writes the *Mind Over Markets* daily stock market recap.