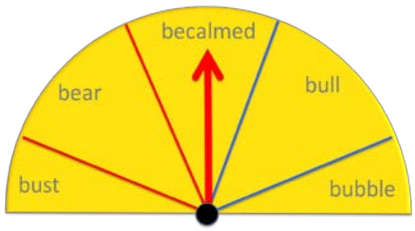
Atlas Pulse Gold Report

See the facts, trade the action and ignore the noise



The Atlas Pulse Gold Dial

Jan 2013	downgrade to bull market at $1,675
Feb 2013	downgrade to becalmed at $1,663
May 2013	downgrade to bear market at $1,476
Feb 2016	upgrade to becalmed at $1,175

In this issue…

- **Gold is in a neutral environment and is fair value –** ***bit dull I'm afraid***
- **Bitcoin's optimism returns –** ***a scaling solution will see $10,000***
- **It's never been easier to buy bitcoin –** ***thanks to the Swedes***

It's not often I find myself with literally nothing to say about gold that I haven't already said, but this month, the gold market is as dull as dishwater. Gold remains in a becalmed environment and it neither wants to rise nor fall. Earlier this year, I was expecting the rise in inflation to follow through, but alas, it came to an abrupt halt.

I find myself much more excited about bitcoin. The price has broken out to an all-time high, the bad news is behind us and a scaling solution is on the way. I'll also show you how you can buy bitcoin through Hargreaves Lansdown. This is a breakthrough. Prepare for a surge.

But before we get to that, a few points on gold.

Becalmed and fair value

The price of gold is sitting on the Atlas Pulse fair value line. After the US election, gold dropped to a discount. Gold perked up on rising inflation expectations in January but these soon receded. With volatility at just 9% - compared to a historic average of 18%, don't expect much to happen anytime soon.

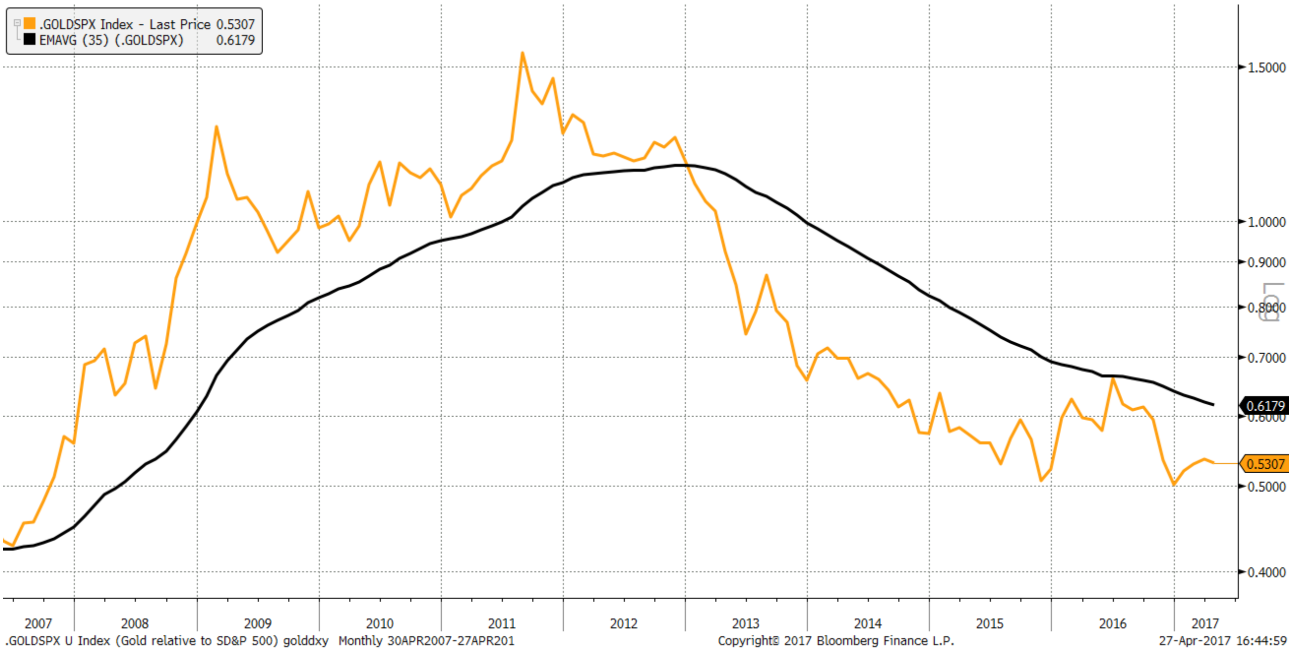
Source: Bloomberg Atlas Pulse Gold Bond Model (black) and gold (gold) – past ten years

New readers can read more about the *Atlas Pulse Gold Bond Model* on the last three pages of this letter.

Gold is becalmed because inflation remains muted. Yet, that doesn't make the situation bearish, just neutral. If inflation picked up, gold would surge higher while equities would get punished – especially if inflation came within reach of 4%. And that's why you should hold onto your gold. At some point, that may well happen.

Other than inflation, gold could move higher by shooting to a premium. However, for that to happen in sufficient size, you would need to see the gold price start to beat the stockmarket. That is still not the case and that's why the Atlas Pulse view is that the long-term gold trend remains neutral.

Equities are too strong for gold



Until gold can start to out-perform equities, there is little incentive for fund managers and asset allocators to pile in. That's important because investment demand is typically the swing factor. Fair value would be boosted by higher inflation. Investor demand will drive gold to a premium.

Source: gold versus the S&P 500 with a 35-month moving average (black) - past decade

When there's little to say, say little. Now I will move onto bitcoin. Fasten your seatbelts.

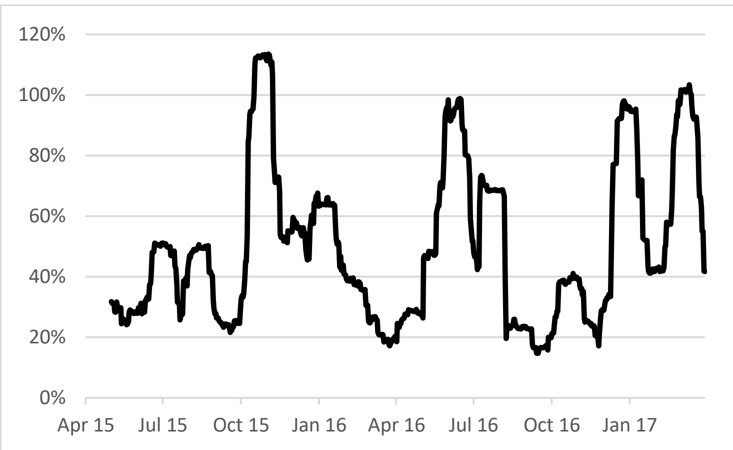
Bitcoin optimism returns

I wrote in January that bitcoin's volatility was extreme as can be seen on the chart. That followed an over-bought situation and a series of bitcoin heartaches soon followed. There was drama at the Bitfinex exchange, a rejection of the "ETF" that was to be launched by the Winklevoss Twins – not to forget the clampdown in China. Fortunately, that's all behind us.

Bitcoin is preparing to surge

Source: Bloomberg – Bitcoin USD past year

…and volatility is falling again



Bitcoin volatility is down to 40%. A few more days of calm will see this drop below 30%. All the best trading set-ups have occurred from periods of low volatility. High volatility on the other hand has led to sharp reversals. This is bullish and there is no overhead resistance as bitcoin moves into fresh price territory.

Source: Blockchain.info, Atlas Pulse. Bitcoin realised 30-day volatility - past 2 years

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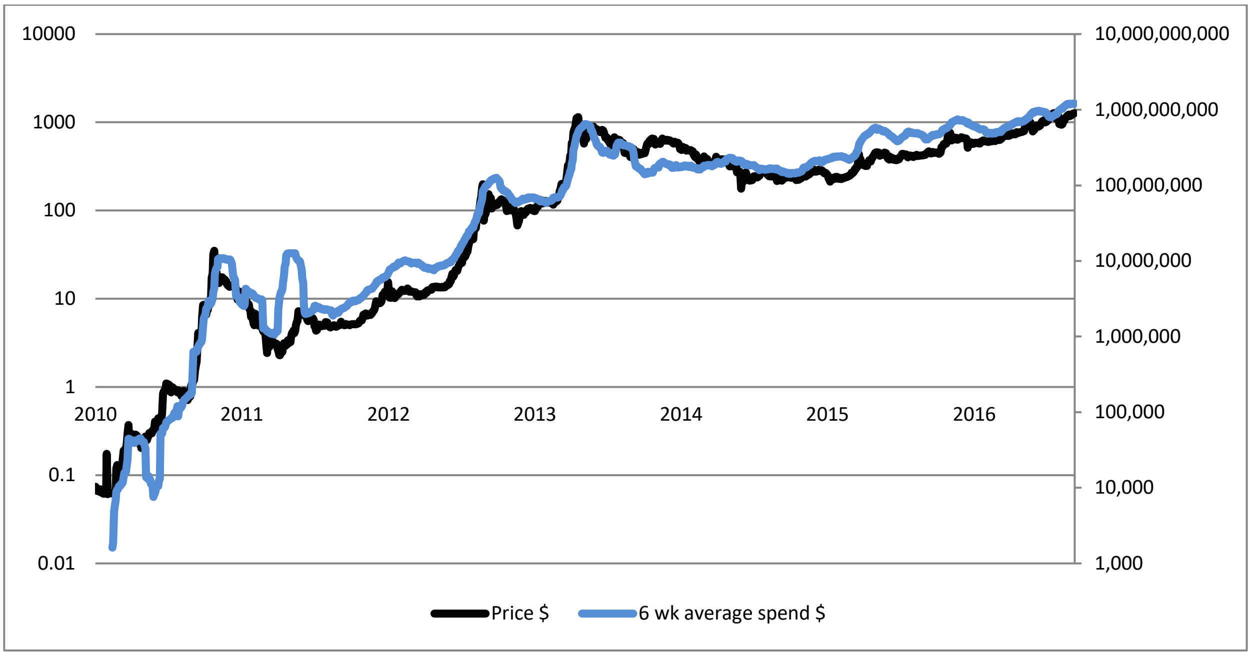
However, the most important issue facing bitcoin is unrelated to these events. That is scaling. As many of you know, the bitcoin network is running at full capacity. And since the price of bitcoin is directionally proportional to network size (or the amount of money changing hands), the fair value is effectively capped at current levels. Naturally, the bitcoin price can shoot to a premium or drop to a discount on sentiment, but the fundamental fair value can only grow if the size of the network rises.

There is real economic activity in bitcoin taking place other than speculation. Admittedly, some of this activity is on the dark side, but it's activity nonetheless. That has helped bitcoin's long-term volatility to fall and stabilise the market.

My old model focused on fees – the tip you give to the miners for prioritising your transaction. These have risen much faster than the network. It's a bit like the price of a stamp rising above the rate of inflation because they have been rationed.

Over the past year, the price of bitcoin has trebled yet the fees have risen 15-fold. For this reason, I put the fee-based model out to pasture late last year. The good news is that I have a new model that is even better. The R squared between the network size and the price is a whopping 0.86.

The network size explains the price

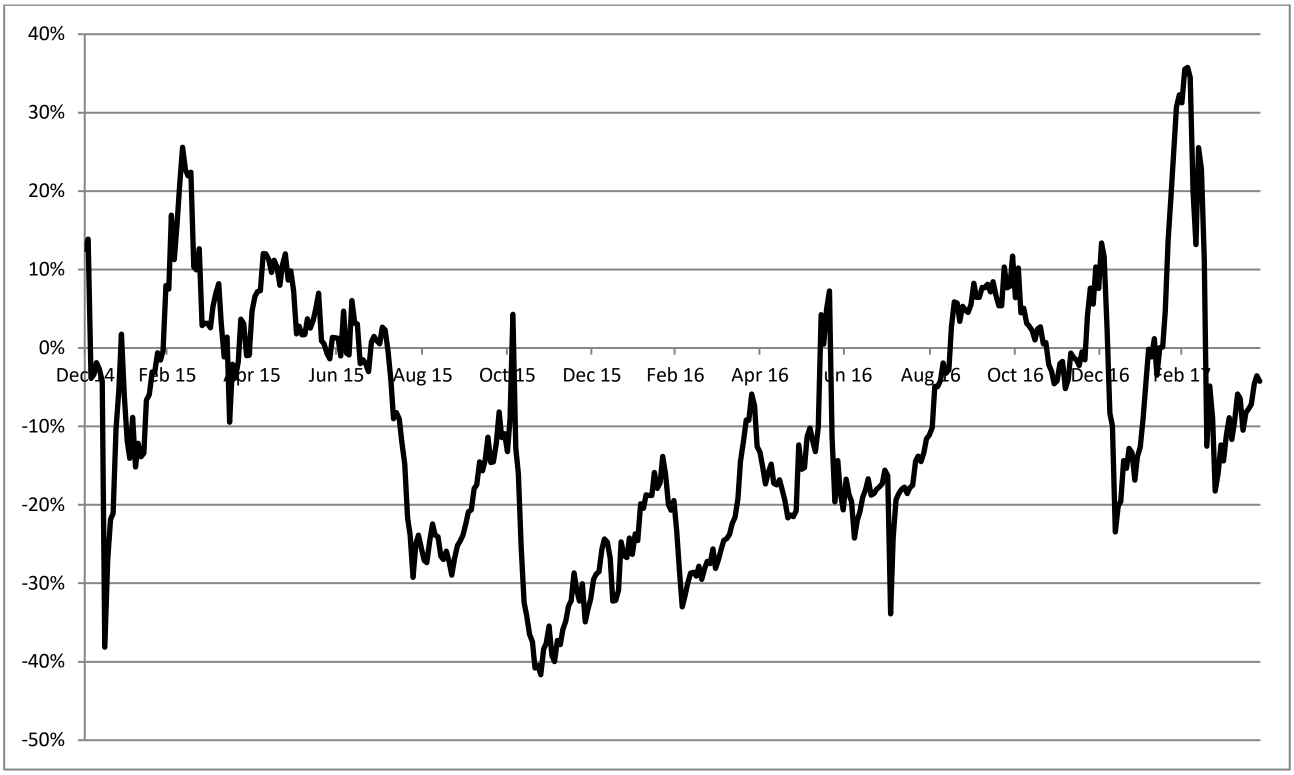


The bitcoin price has followed the size of the network. This model had a pretty good fit in 2010/11 but now it's even better. If you buy bitcoin in search of profit, you are simply betting that more people will use it in the future. That's a bet worth taking.

Source: Blockchain.info, Atlas Pulse. Bitcoin price $ (RHS black) and Bitcoin adjusted network spend $(LHS blue)

As you might expect, the new fair value model enables us to measure the premium or discount that bitcoin is trading at relative to fair value. Since fair value is currently $1,312, the current price is about right, but I expect a premium to follow as I'll explain.

Prepare for a premium



Bitcoin was cheap in late November 2015 as the network had grown faster than the preceding price rise. That buy signal at $350 paid off handsomely. Bitcoin was cheap again in July 2016 at $600. More recently, bitcoin was 35% ahead of itself in March and subsequently pulled back into the $900s. **I believe that was the last time you will ever see bitcoin trading below $1,000.** Currently, bitcoin is fair value but expect a sizeable premium to follow.

Source: Blockchain.info, Atlas Pulse. Bitcoin premium/discount to fair value %

The good news for the bulls is that a 30% premium is not unreasonable – and that's before a scaling solution is implemented. I'm therefore comfortable suggesting the immediate price target should be around $1,700.

However, if a scaling solution comes into being, then I'll up that target to $10,000 and then some. There will be no stopping this beast. Given that Litecoin (a competitor biting at bitcoin's ankles) has successfully implemented a scaling solution called SegWit, it won't be long before bitcoin follows suit.

I don't understand SegWit as it's a subject in complex computer land, but I get the point – it allows the network to scale. It's something to do with compressing the data so that the blockchain is used more efficiently. And then you add Lightening (or something like that) which enables "sidechains". I think this is blockchains sitting on top of blockchains – a bit like a fund of funds.

Assuming SegWit, or even Bitcoin Unlimited (another scaling solution), is implemented, this network can keep on growing. And I understand markets. There is huge pent-up demand both to buy bitcoin for speculative purposes and for its utility. I believe the price of bitcoin will rise.

It's never been easier to buy bitcoin

Obviously, you can buy the real thing using an online bitcoin exchange, but now you can buy the exchange traded note (ETN) in Sweden via the UK online broker, Hargreaves Lansdown. I have personally tested it and it works. (You have to phone them at this stage but it's fairly painless).

The Winklevoss twins failed to launch their "ETF" (it was never an ETF in the technical sense) in New York. Yet the Swedes have had a regulated product available for two years – and it works. Find more details on the issuer here https://xbtprovider.com/

This is not a recommendation. Trade at your own risk.

Summary

Gold is a safe-haven in waiting. It's unlikely to fall far, yet at some point it will surge. That'll come in good time. Be patient.

As for bitcoin, the future is bright. And it's not just bitcoin, it's the creation of a new digital asset class. It's only worth $32 billion in aggregate. By the time this peaks a few years from now, that'll look more like $32 trillion.

Thank you for reading *Atlas Pulse*.

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After a career as an officer in the Grenadier Guards, Charlie spent 17 years as the Head of Absolute Return at HSBC Global Asset Management, managing more than $3 billion in client funds. Between 2003 and 2015 his fund made a cumulative return of more than 100%. He is widely known and respected for his specialist interest in gold, crypto-currencies and momentum investing. As well as his Atlas Pulse newsletter, he has made over 200 appearances as a guest expert on financial television programmes and was recently appointed the editor of the Fleet Street Letter.

The Atlas Pulse Gold Bond Model Explained *(written June 2016)*

There's much confusion about the link between interest rates, bonds, inflation and the gold price. Everyone knows that rate hikes are 'bad for gold' even though it's not always the case. It depends on other factors. There's also confusion about gold as an inflation hedge. Fear not. Atlas Pulse is here to help. I'll show you the link between gold and the bond market.

The link between gold and bonds is REAL

Chart note: Inflation can rise or fall and gold could respond either way. Similarly, rates could rise or fall and gold surprise the uninformed.

What's consistent is the inverse relationship between real interest rates and the gold price. That is rates less inflation. If you use 20 or 30 year yields and inflation expectations, the results are excellent. Let me show you.

Atlas Pulse readers already know my line on gold the bond. If gold were a bond, what kind of bond would it be?

Gold is a zero coupon, long-dated, credit risk-free, inflation-linked bond that was issued by god.

Breaking that down.

Zero coupon is obvious as there are no dividends. Revenues from lending and so on don't count.

Credit risk-free is also obvious. A piece of metal that can't rust and lasts forever, can't default. An ounce will always be an ounce. That's it.

Long-dated it lasts forever.

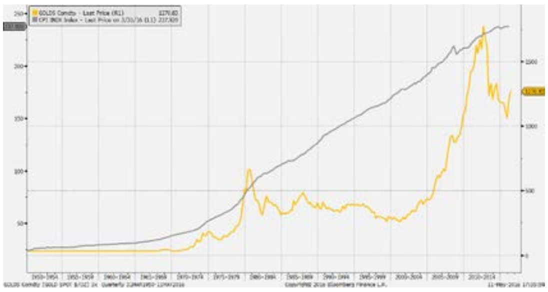
Inflation-linked holds true provided you believe that gold is a long-term store of value - along the lines of 'The Golden Constant'. That's simply the idea that gold doesn't make you money, nor does it lose it over the course of history. Obviously the cycles are very long indeed. The controversy comes from the inflation data which many believe to be manipulated. Personally I believe it is a true and fair estimate – at least in OECD countries. You are welcome to disagree.

Issued by god because who else could possibly construct an element that is universally admired by all?

Modelling gold as a bond in six easy steps

I’m going through this in detail because it’s important to understand why you might want to own gold when inflation is low and falling. Bear with me – it’s actually quite simple.

Inflation is the long-term tail wind



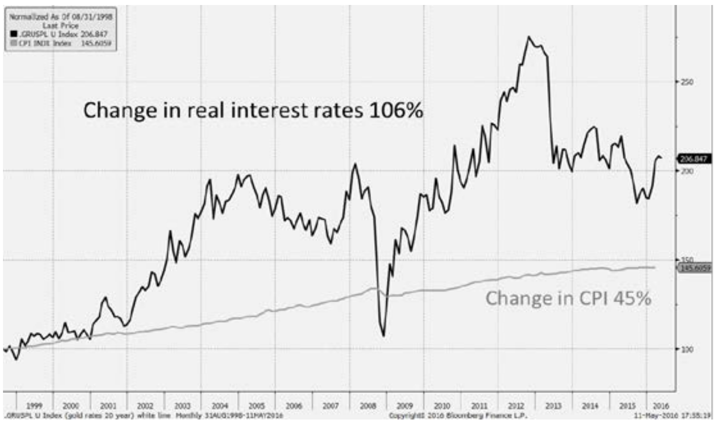
We start by taking historic CPI. There’s some sort of link but it’s questionable at this stage. Inflation drives the long-term return for gold. Next we need to add a discount rate, which is easy to understand. If cash on deposit earned 10% when inflation was 5%, that would make a bank deposit attractive at 5% real. Clearly that’s bad for gold. However, if rates were zero and inflation was high, that would be good for gold.

Determining real yields

The blue line shows you the 10 year US bond yield. The red line shows you the 10 year inflation expectations. The difference between them is shown in black – the 10 year real yield.

As they fall, the price of gold rises. Notice the spikes in 2008 and 2013. Real rates rose. What did gold do? It fell.

Inflation and rates have boosted the price



Using 20 year real rates (they work best), just add a discount rate and you’ll see the impact of changes in bond prices. The discount rate is:

$(20\ year\ inflation\ expectations)^{20}$ /
$(20\ year\ real\ rates)^{20}$

The chart is starting to resemble gold. Then we need to add on historic inflation as that’s historic return in the bank. If real rates rise, gold will fall. However, the only negative from historic inflation comes when it actually goes into reverse. That’s rare as governments print even more when it happens.

Calibrating the model

The Atlas Pulse bond model is starting to resemble gold. However, now it needs to be calibrated and this is the tricky bit. Gold is shown on the right axis at $1,273. The left is 305. Now the debate begins. What's the adjustment factor and the implied fair value for gold?

Average = 3.3.	FV $1,006
Regression = 4.1.	FV $1,250
30% cheap in 1998 = 4. (Atlas Pulse choice)	**FV $1,220**

The Atlas Pulse bond model works like a treat

These past two years have seen extraordinarily high correlation between the workings of the Atlas Pulse bond model and the price of gold in dollar terms.

Even better is that gold leads bonds. People who think gold is irrelevant should consider that it **has displayed leading and predictive** behavior over the bond market.

That's not even the best bit. It gets better. We now have a framework that can predict the gold price under different macro-economic scenarios. To forecast the gold price, all you need now, is an opinion.

$$\text{Atlas Pulse gold bond model} = \text{CPI Index} \times 4 \times \frac{(20\ year\ breakeven\ rate)^{20}}{(20\ year\ real\ rate)^{20}}$$

Please remember the name - the Atlas Pulse Gold Bond Model (APB).