[Gold prices to benefit from the Current World Economic Cycle?]

By David Mapley, November 2002

The theory of Kondratieff's long wave cycles (K-wave) was originally used to explain long wave economic cycles. Its originator, Nickolai Kondratieff, was a Russian economist (1892-1938) in Stalin's Agricultural Academy and Business Research Institute ("Long Waves in Economic Life" - originally published in German in 1926). Kondratieff's major premise was that capitalist economies displayed long wave cycles of boom and bust ranging between 50-60 years in duration. Kondratieff's study covered the period 1789 to 1926 and was centered on prices and interest rates. Kondratieff's explanation for these cycles included the sequence of speculation and over investment at the top of the cycle, which drains resources and sparks inflation. Although commissioned by the communist regime to discredit capitalism, Kondratieff concluded that capitalist economies self-correct by this mechanism. Excesses are wrung out and a new period of growth can then begin. Stalin wasn't impressed - Nickolai was sent to the Gulag where he purportedly died.

Still Kondratieff may have stumbled on to something. The 50-60 year cycle of catastrophe and renewal had been observed and recorded by the ancient Mayans of Central America and by the ancient Israelites. Further studies have discovered similar long economic waves from the period of the ancient Greeks and Romans.

Kondratieff identified four distinct economic phases - a period of inflationary growth, followed by stagflation, then deflationary growth and finally depression. Some characteristics are as follows:

Inflationary Growth (expansion): - stable to slow rising prices, low commodity prices, low and stable interest rates, rising stock prices. The period might also be characterized by strong and growing corporate profits and technological innovations.
Stagflation (recession): - rising prices, rising commodity prices, rising interest rates, stagnant to falling stock prices. Stagnant profits, rising debt. This period usually sees a major war that contributes to the commodity and price inflation, and to the rising debt and misdirects business resources.

Deflationary Growth (plateau): - stable to falling prices, falling commodity prices, falling interest rates, sharply rising stock prices, profit growth but probably not as good as in the inflationary growth phase. Sharply rising debt. Possible period of considerable technological innovation. Excess debt contributes to speculative bubbles.

Depression: - falling prices, rising commodity prices (particularly gold), stable interest rates, falling stock prices, falling profits, debt collapse. As the stock market collapses numerous scandals will emerge. A major war occurs that helps contribute to end of the depression phase and the start of the new expansion period.

Most analysts estimate the last K-wave to have entered its final trough in 1949 when interest rates and prices bottomed. The effects of the Great Depression in America were softened by WW2 and it was in the 1950's that the world firmly started to shake off the two decades of depression and war. The K-wave has followed quite true to form with the solid growth and low inflation of the 1950's and 1960's followed by the commodity/price inflation and recession driven 1970's. Commodity prices peaked in 1980.

Following the steep secondary recession of the early 1980's the markets embarked into the K-wave plateau of Deflationary Growth. We had stock market and real estate bubbles, a collapse in commodity prices, a collapse in interest rates and low inflation. But we also had a huge build up in debt that allowed us to buy our way out of the recessions of the early 1980's and early 1990's. Each succeeding recession required higher levels of debt to purchase an additional dollar of GDP.

Now the debt has become unsustainable and the ability to buy our way out of further problems is severely compromised. One only needs to look at the decade long nightmare of Japan to see that zero interest rates and all the stimulation in the world has failed to bring it out of its slump. We are witnessing merely the beginning of the debt implosion that inevitably follows the excesses.

The collapse of the tech market and NASDAQ, Enron, Adelphia, K-Mart, Global Crossing, WorldCom, Arthur Andersen and numerous others are the corporate face of the scandals and the debt collapse. At a national level we have the implosion of Argentina and possibly Brazil, which would imperil all Latin American investor confidence. African countries never seem to be out of bankruptcy. As the job losses mount the consumer driven economy will fall into a deep funk and the consumer will go through their own debt implosion.

As occurred at the end of previous Deflationary Growth plateau (1920-1929) the phase that followed revealed numerous financial scandals. This K-wave phase brings on excesses in both the stock market and the boardroom. Even the early part of this current Deflationary Growth phase has had its share of scandals and debt implosions with the insider trading scandals of the 1980's followed by the debt implosion and scandals of the Savings & Loans. If the 1990's were a decade of loss of faith in government for its excesses of debt build-up then the first decade of the millennium will see the same occur with capitalism and the corporation.

We have now entered the depressionary phase of the current K-wave cycle. This wave could last anywhere from nine to twenty years as we saw in earlier K-waves. The K-wave is the rise and fall of a generation and covers both the social and economic life of the period. The ancient Mayans knew of the inevitability of the cycle and took steps to mitigate its effects (although ironically in the end it did not save them). Our challenge will be to see that we come through so that once again we can rebuild.

The current depressionary period is still young. We have noted in the past that following a speculative bubble things have a tendency to return to where they started with the gains of the previous period are wiped out. Already some stocks such as Nortel Networks have fallen 98%. Other big names have disappeared. We can predict the NASDAQ will ultimately lose at least 90% of its value from its peak. That implies a fall to at least 500 over the next decade. We have already fallen about 75%.

For the Dow Jones Industrials, in theory at least that could translate into a fall back to 1000. While that may be only for some super bears vivid imagination we believe that at a minimum the Dow Jones Industrials will ultimately fall at least 50%-60% or down to around 5000. The highs of January 2000 are but a dream for years to come. The current 4-year stock cycle has coming to an end… **Based solely on the average cycle length, the next bottom is thought to be due in 2003….**

The Depressionary period of the K-wave is a dangerous period, but will be eased for those holding gold or gold stocks. That new bull market is still in its infancy and may yet face a significant shakeout to make its final bottom. But we would all be wise to hold at least a little gold.

What really interests us is the gold price – as a strategy we are busy accumulating gold reserves, mostly in production, in Russia & the other old soviet republics (Celtic Resources, Gulf International, Kartvelo Holdings). Gold hovers just below US$320 per oz, the range (US$320-330 per oz) where the 10 largest banks in the world hold shorts on the precious metal, to the tune of 15,000 tonnes, or US$172bn. exposure! Any attempt to buy back 8 years of global gold production, notwithstanding the forward sales, claims by contracted buyers etc. is likely to result in the price of gold soaring towards US$1,000 per oz. (witness the short squeeze on Palladium in late 2000), with the average hit per bank of US$30bn. doing little to bolster investor confidence... Banks have already been ravaged by WorldCom/Enron tainting, so this little cluster bomb could be the precipice for the market. Their minor salvation is the 400 tonnes of annual sales of gold from the Swiss Central Bank, but this is still insignificant vis-à-vis their overall exposure.

One of our managed vehicles is placed to buy low-cost production of gold, nickel, oil & gas, and other such commodities found in abundance in 'Emerging Europe'. We anticipate the Russian economy and trade balance benefiting tremendously from higher commodity prices and increases in investment in the resources, mining and oil & gas sectors. Those scholars of Kondratieff and his long-term cycles may recognise the confluence of deflationary pressures, rounds of currency devaluations, asset price drops (the housing sector next???), followed by the rush to hard assets. At these price levels we make money, but the academic interest would support the blatant questioning of bank CEO's on their exposure to gold, for the record...