Why We Like Gold So Much

By Kareem Brantley
October 29, 2010

In this Newsletter Issue:

Fundamentals of Gold.

Well today I am looking at the fundamentals of real and nominal numbers and the fascination with gold. Starting with the later first, it is apparent that Americans and other investors have begun to have a strange and fanatical fascination with gold. Investors everywhere can't seem to get enough. Shares of Freeport-McMoRan Copper & Gold (FCX), a gold mining company, have gone from $23.99 per share in October of 2008 to $94.77 as of today's trading (a +295% gross return). Take your pick. Whether it is a gold mining company stock or a gold based Exchange Traded Fund (ETF), gold related investments have gone gangbusters. So why are we going gold crazy? Much of it is media hype and much of it is a fear that the purchasing power of the dollar and, in some people's mind, the purchasing power of most major paper currencies will fail miserably in the short run. I happen to believe it will be in the intermediate time frame that we will see significant loss of purchasing power by holders of certain currencies due to inflationary storms ahead. Simply put, purchasing power loss means that it will take more dollars to buy an item tomorrow than it will today.

The Old Lead Trick.

From an investment standpoint it is not that investors think they are going to hunker down and carry around pieces of gold to exchange for goods and services. Come on now, that would be turning the developed world around and walking back to the days of Adam Smith. We may as well just start to barter based on productive labor exchange. The issue is simply that gold will supply a real return that should exceed most other investment real returns. This is most likely because gold is considered a hard asset that does not have any associated liability and for a few more reasons as well. But just sticking to the basics, let's think of inflation this way…a "pure" gold coin represents a certain value. But what happens when you add something like lead to the "pure" gold coins you have and extend the amount of coins you have? This is sort of what inflation is. The more lead you add to the coin, the less the coin is worth in terms of "pure" gold. In fiat or papery money systems, printing more paper money causes this same inflation. The problem is that even though you have more coins or paper money, they buy a lot less because they are worth less. And thus it takes more money today to buy the same items you bought yesterday with less money.

Getting back to nominal and real rates, fluctuations in currency values affect real and nominal rates of return and real and nominal wages too. If no inflation existed then we would only have real returns or real wages. But no inflation is a fantasy in this lifetime. So when we say real wages, we are really saying that we have started with nominal wages and taken out the effects of inflation from nominal wages to get real wages. Or simply returning to our previous thought, we have determined the real value of the coin after factoring out the lead. I think that real growth in wages and real returns on paper based financial assets (investments like stocks and bonds, etc) will be very low in the intermediate time frame ahead. I believe this because as more money is printed into the system, as in the coin example, we will devalue the existing money already in the system. When other things like prices of goods and services react to inflation, prices rise. So even if you have more money than in the past, the money you now have loses value or purchasing power and goods or services use up more of the dollars you have.

How Inflation Affects Me.
In a basic example, imagine that you currently make $35,000 per year. Now imagine the next 40-50 years. Using all sorts of assumptions and hypothetical's based on history, that same job function or similar job you have today will probably pay around $80,000 per year in the next 40-50 years. But now you can see more clearly that certainly if the jobs are similar in role and function that $80,000 in 40-50 years will only buy similar or comparable things that $35,000 will buy today. This is how inflation brings large nominal gains back to earth in the form of small real gains.

It's funny to think about it in these terms. However, I was just speaking with my wife the other day and mentioned to her that her current salary exceeds both my parents and her parents' current salary after nearly 30 years of their hard work. Now that's inflation for you. Even though along the way my parents have received wage increases, those increases are mostly just to keep pace with inflation so that for their job role and function they can still have the same quality of life over the years. So if you want your children to have a jump on inflation find a way for them to have more dollars sooner rather than later in life. One thing I think that is overlooked often is that as each generation enters the workforce, it is precisely at this point where they can get a jump on inflation. If your child is talented enough in some way to command a very high salary relative to his/her peers, in real terms they will have surpassed their peers by getting a relatively larger initial salary starting point. The other way is to grow your wages faster than inflation. Good luck with that!