MARKET LETTER

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Gold … Fair and Balanced

by Dean M. Dordevic

"Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard ... gold represents the ultimate form of payment in the world. It's interesting that Germany could buy materials during the war with gold. In extremis, fiat money is accepted by nobody and gold is always accepted and is the ultimate means of payment ..." – Alan Greenspan [1, 2]

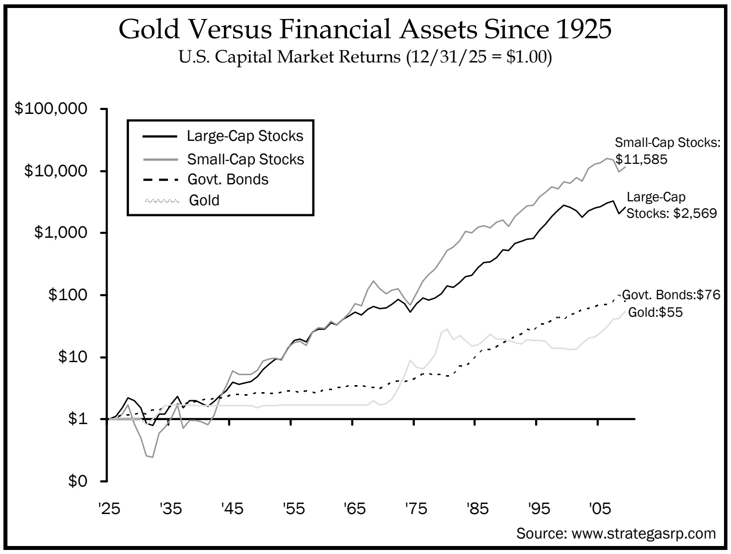
There is perhaps no commodity that inspires the passions of mortals like gold. Money, especially the paper kind, is a strange thing. It is important to note that minus the gold standard, our pure paper dollar is only 38-years-old. On or about the birth of our nation's founding monetary legislation, we went so far as to reserve the death penalty for officials who fraudulently debauched our bank notes.[3]

It's no secret that gold has been soaring of late. The financial press has been flush with articles on this subject, and the airwaves filled with offerings to both buy *and* sell the yellow metal. With this missive, we plan to take a forthright look at this somewhat controversial subject, examine both sides of the coin, and render our considered opinion.

We live in a world of fiat, or faith-based currency systems. Fiat currencies are wasting assets. That is, over time ... like the corrosive action of water dripping on a stone … they will slowly and inexorably lose value. It's sobering to think that our dollar is backed by nothing more than the *U.S. Congress*. For most of our nation's history, paper dollars were in fact convertible into gold or even silver. After 1933, only foreign central banks could demand gold for their paper dollars and in 1971, Richard Nixon suspended this convertibility altogether.[3] Perhaps most importantly, with more than half of all outstanding greenbacks in the possession of foreigners, we are indeed more dependent on the kindness of strangers than ever before.

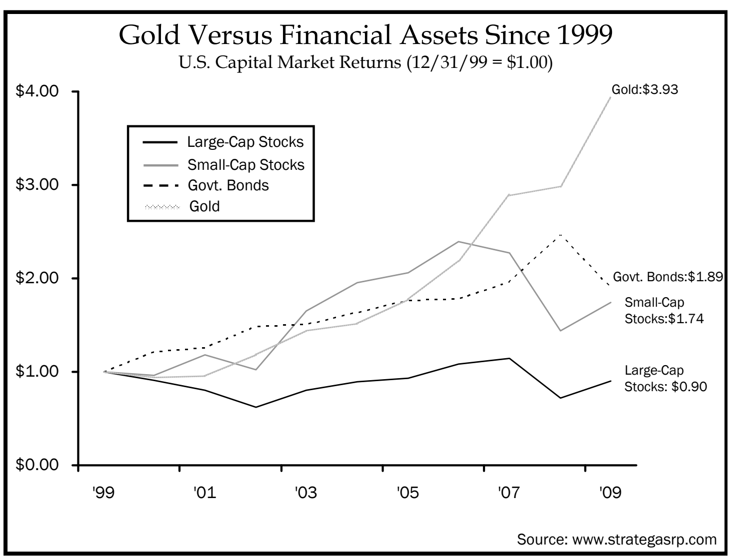
The weaknesses of gold as an investment are many and well founded. It has no yield and it's expensive to store, handle, and trade. While it's a great store of value, it's a lousy medium of exchange. In all but the worst of circumstances, one would most likely need to sell their gold to obtain sufficient (fiat) paper dollars to satisfy a debt or pay their taxes. On the other hand, gold is permanent, natural money; the antithesis of money made from nothing. And unlike other commodities, gold is produced for *accumulation* not consumption. More than 99 percent of all of the gold ever produced is still above ground and sitting somewhere.

There are times when gold becomes very desirable as a hedge against financial instability or worse. Surprisingly, it has served its owners well, primarily during periods of ... *deflation*. The seminal work in this area was done by Professor Roy Jastram, who concluded that over long periods of time, (he studied over 400 years of history from 1560 to 1976) gold lost purchasing power during periods of inflation and gained during periods of deflation. His work showed that while gold does not match industrial commodity prices in their cyclical swings; over the longer run, it does hold its purchasing power remarkably well. He concluded that gold prices do not chase after commodities, but rather that commodity prices return to the index level of gold, over and over. Hence the title of his landmark book, *The Golden Constant*.[4, 5]



Interestingly and importantly, there was only one exception to the patterns he observed over some 400 years. This was in the U.S. from 1951 to 1976.

Although gold behaved in line with the typical pattern up until 1970, the price level of gold rose sharply after 1970. This had never happened before, and coincided with hyperinflation in the U.S. Since this contemporary experience is still reasonably fresh in our 50-year-old minds, our first-hand experience belies the very lengthy historical record. While he had a variety of theories about why this experience was different (chiefly the collapse of the London Gold Pool in 1968, which held the dollar price of gold at an artificially low level), Professor Jastram's most important conclusion was that gold is historically an excellent hedge against the profligate use of the printing press by our elected officials and monetary disorder in general.[4, 5]



But where are we now? More recently the gold price move has been parabolic. Over the last decade the price of gold has risen about fourfold, more than four times the gain in U.S. Treasuries. Stocks (the S&P 500) have been flat over this same time period. On the other hand, gold would need to almost double in price from current levels to eclipse the inflation adjusted previous peak in price nearly 30 years ago. Investors who paid $850 an ounce back then (1980), earned 44 percent as gold reached a record $1,226.56 on December 3, 2009 in London. Over that same time frame, the S&P 500 produced a twenty-two-fold return with dividends reinvested, Treasuries rose elevenfold and cash in the average U.S. checking account rose at least 92 percent.[6, 7]

It would be a reasonable best guess that investors are equally concerned about both the prospects for more near-term deflation and longer-term inflation. What is undeniable; however, is that we have most certainly experienced monetary disorder that has been both global in scope and significant in size. It would seem that investors have been following the advice of the good professor, and using gold as a hedge against currency debasement. That would make sense in our view, but we're in at least the middle innings now, and gold prices have already moved sharply higher. Is there an investment case to be made for gold at current levels?

Frankly, the attention that gold has been getting of late is, at least from a contrarian's point of view is somewhat disturbing. Undiscovered clearly it is not. The SPDR Gold Trust, the largest exchange-traded fund backed by gold bullion, has amassed more metal than Switzerland's central bank. The U.S. Mint suspended production of some American Eagle coins due to depleted inventories. Central banks, which hold 18 percent of all the gold ever mined, will become net *buyers* of gold this year for the first time since 1988. Notably, gold fell 15 percent that year, and it took another 15 years to trade again at the same price as central banks reversed course and subsequently *cut* their holdings. Clearly, central bankers have not been the best traders in the yellow metal. More recently, India bought 200 metric tons of gold from the International Monetary Fund in October, which was the largest central bank purchase in over 30 years. The last major central bank *sale* was the so-called "Brown Bottom" referring to Gordon Brown, the then UK finance minister (now prime minister), who chose to sell gold, equivalent in size to two London Taxis for $296/oz, very close to the decade low gold price.[6, 7]

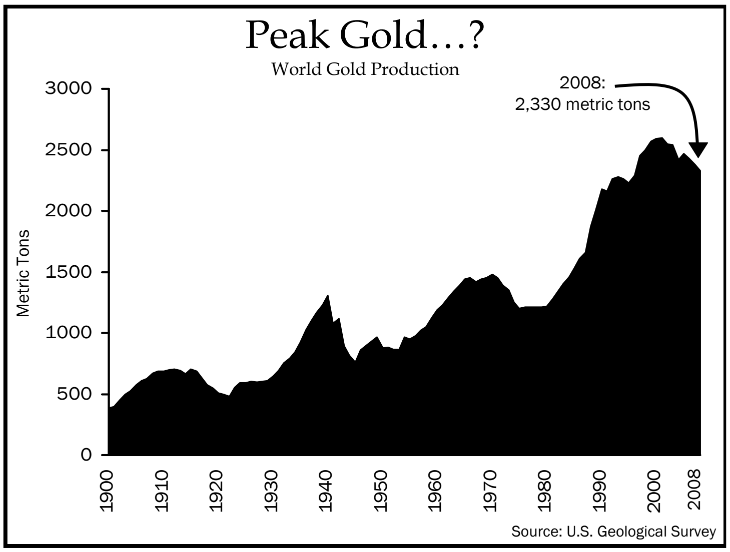
Our sense is that although the standard disclaimer "past performance is no guarantee of future results" is certainly advisable here, the bull market for gold has not fully run its course. There are some important, more long-lived contemporary reasons why a reasonably firm bid might remain in place. If we solve for price in our supply/demand equation, it seems that the bias will remain to the upside. This gold bull market could be quite durable.

In any commodity market, it is the marginal buyer who sets the price. It seems to us that a new marginal buyer exists, and its collective impact on the price of gold (and commodities in general) will be increasingly significant. We have previously discussed in these pages the impact of the developing world on a variety of commodities. Growth in the developing world is not going away. The Indians, for example, lacking a modern financial system, have always salted away their savings in gold. India now holds some 20,000 metric tons of gold, equal roughly to two thirds of the gold locked in the world's central banks. More importantly, the list of developing countries adding to their reserves is a long one indeed. Additionally, we expect *developed* countries to continue to add to their positions, as they diversify away from fiat based currencies like the U.S. dollar, Japanese yen, and the Euro. An exercise in the collateralization of paper claims appears to be very much in force.

Recently we came upon some well-founded research from *Grant's Interest Rate Observer* that did a very good job of quantifying the potential for both Asian and the emerging world's central bank demand for gold reserves. The metric they explored was the relationship between gold holdings and foreign exchange reserves. Ian McCulley of *Grant's*: " *… Western central banks own a significant amount of gold relative to their foreign exchange reserves, while Asian central banks reserve portfolios comprise a lot of paper and little gold …* " In fact, if you look at the U.S., Germany, France, and Italy, gold reserves range from about 67 percent to 77 percent of foreign exchange reserves. The Chinese, on the other hand have total gold reserves equal to only 2 percent of their foreign exchange reserves. Even after their recent 200 metric ton purchase from the International Monetary Fund, India has only 7.5 percent exposure to gold as a percent of foreign exchange reserves.[8]

Says Ian McCulley of *Grant's*, *"Consider the nine foreign exchange reserve holders in the world that are currently 'underweight' gold, as the market has come to define underweight. The list would include Brazil,* *Russia, India and China, the so-called BRICs, along with a handful of wealthier Asian countries, including Japan. If the nine got it into their heads to boost their gold holdings to 10 percent of reserves, they would need to acquire 11,174 metric tons, to 25 percent, they would need 33,254 metric tons. For perspective, existing official holdings currently sum to 29,634 metric tons, or 20 percent of the 150,000 metric tons of total above ground gold. You could talk yourself into some fancy bullion prices."*[8]

The aforementioned numbers are even more intriguing when viewed through the prism of gold supply. We are always suspect of "peak" claims for commodities, and how interesting is it that the best cure for a high price seems to always be ... *a high price*. That said, world gold production peaked about 10 years ago at about 2,600 metric tons per year. World production is now only about 2,330 metric tons. At $1,100 per ounce, all the world's gold represents only about 2.5 percent of all global financial assets. Over the last ten years, world GDP has doubled. This supply demand dynamic would appear to be a positive for gold longer term.



By now we hope to have convinced you of at least a few things. Gold is a unique commodity. Gold is an excellent store of value, but a very poor and unwieldy medium of exchange. It is a very good hedge against monetary disorder. The weaker the faith in the skills of global central bankers, the stronger the bid for gold. The supply of gold, for all intents and purposes, is fixed in the short term. The global supply-demand regime for gold appears to be positive. Timing is key in buying gold, and it can go both in-favor and out-of-favor for decades.

If you're reading this and you're a client of Ferguson Wellman, you'll know that earlier this year we established a new asset class that we call *Tactical Assets*. This broad-based classification is intended to hold a variety of low correlation assets and hedges, including gold or other precious metals like silver or platinum. Our conclusion is that gold does indeed have a place in a long-term asset allocation, and it is our intent to begin building a position in this hedge in 2010. After the recent sharp run-up in prices, we would hope to buy any reasonably meaningful correction in prices.

Sources and Footnotes:

[1] "Gold as a Reserve Asset: Alan Greenspan, Testimony before the U.S. House Banking Committee," *World Gold Council*, May 20, 1999.

[2] Alan Greenspan, "Gold and Economic Freedom," in *Ayn Rand's Capitalism, The Unknown Ideal*, 1966.

[3] James Grant, "Requiem for the Dollar," *The Wall Street Weekend Journal*, December 5 and 6, 2009.

[4] Robert K. Landis, "Gold is Money ~ Deal with It!" (presented to the Association of Mining Analysts, London, England), October 2, 2003.

[5] Roy W. Jastrom, "The Golden Constant - The English and American Experience 1560 – 1976," *John Wiley & Sons, Inc.*, 1977.

[6] *Bloomberg Wires*, "Gold buying by Central Banks May Send Signal to Sell," December 16, 2009.

[7] *Bloomberg Wires*, "Gold Can't Beat Checking Accounts 30 Years After Peak," December 7, 2009.

[8] James Grant, and others, "Cool Thoughts on a Molten Metal," *Grant's Interest Rate Observer*, November 27, 2009.