

ALL THAT GLITTERS...

IS GOLD ANOTHER BUBBLE OR A WAY TO PRESERVE PURCHASING POWER?

BY RAY RYAN, CFA

John Maynard Keynes called it a “barbarous relic.” In the fifth century B.C., it was described as a “child of Zeus.” Gold. A currency. A mystery. An obsession. Peter Bernstein in his book, *The Power of Gold*, points out: “Gold is a mass of contradictions. People believe that gold is a refuge until it is taken seriously; then it becomes a curse.” Nations have fought wars over gold. Given its inherent beauty, gold has occupied a prominent place in history since nearly the beginning of time. Moses, in fact, was directed on Mount Sinai to decorate the tabernacle with gold.

Gold is amazing in that its perceived value has traversed centuries and eras. Gold has long served as a means of facilitating commerce. For much of the 20th century, nations used gold as a peg for their currencies. The use of gold in this regard, however, was always controversial. In fact, during a debate about the peg, President Hoover said to President-elect Roosevelt in 1933, “We have gold because we cannot trust governments.” Yet, in terms of practical uses, gold offers less value than steel and other metals – one would certainly not construct a building made entirely of gold.



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In August 1999, the price of gold finally found bottom at \$252/ounce following a two-decade-long decline from a peak of \$850. If one had invested \$10,000 in gold at this low price, it would be worth approximately \$61,000 today. Another way to think about this: In August 1999, \$10,000 could purchase nearly 40 ounces of gold. Today, \$10,000 can purchase only 6.5 ounces. By way of contrast, if one had instead invested the same \$10,000 in the S&P 500, it would be worth approximately \$9,800 today. Over that period, the price

of crude oil has risen from \$20/barrel to \$113/barrel. Whereas the price of oil reached its all-time high in 2008 and gold only recently achieved its pinnacle, it is clear that oil and gold have experienced equivalent price movements over the past 12 years. Therefore, if one could have redeemed gold to purchase oil over this period, purchasing power would have been effectively preserved.

It is widely acknowledged that the U.S. Dollar, when measured in an index against a basket of other currencies, has lost

considerable purchasing power. Using the Dollar Index, the “real” value of \$10,000 in August 1999 would be only \$7,207 today. In other words, it generally requires more dollars to purchase an equivalent amount of goods and services. A simple example: If the price per gallon of gasoline is \$1, then one can purchase one gallon with \$1. If the price per gallon rises to \$1.25, then one could purchase only 0.80 gallons with that \$1. Purchasing power has been reduced. In order to offset this negative impact, one needs to boost income either through wages or investments.

Has gold been the best hedge against a loss of purchasing power? Certainly not. For example, in August 1999, the price per share of Apple, Inc., was approximately \$15. If one had invested \$10,000 in shares of Apple, Inc., the investment would be worth approximately \$229,000 today. However, while Apple’s stock suffered during the two bear markets of the past decade, the price of gold has exhibited a steady, inexorable ascent to its recent all time high.

Is gold yet another asset bubble that will inevitably burst? The bear case argues that it offers no intrinsic value. There are limited industrial uses for the metal. Apart from jewelry, demand for gold is driven primarily by central banks for their currency reserves. For decades, central banks diversified away from the metal. The bears would also point out that the proliferation of exchange-traded funds (ETFs) has facilitated mass investment in this commodity. While this is welcome news in the sense that individuals can now own gold bullion through a mutual fund, concerns persist that ETFs introduce a speculative element that did not exist

to such a degree in the past. Yes, gold is a bubble that continues to inflate, they insist. So, “watch out,” the bears growl, as gold will eventually succumb to a collapse similar to all other bubbles and the one it experienced in the early 1980s.

The gold bulls (or “bugs”) are happy to point out that both China and India’s central banks have recently increased purchases of gold in an effort to diversify away from the U.S. Dollar. They argue that gold should be viewed as an alternate, tangible currency that has been able to hold its value for over 4,000 years. The central banks will continue to de-leverage through a monetization of their debt – otherwise known as currency debasements (i.e., print more of their own currencies). Monetary policy generally seeks to stimulate economic activity through a process known as reflation – the version practiced by our Federal Reserve is called “quantitative easing.” However,

it also applies downward pressure to the value of paper currencies by increasing the money supply. Given the fact that gold cannot be printed, it has proven to be an excellent hedge against the reflationary tactics of global central banks. Moreover, gold has performed well during periods of both extreme inflation and extreme deflation. Given all the uncertainties in the world, why would one not want to own some gold, they ask? The gold bugs see no near term ceiling on the price per

ounce of gold. To the extent paper (or “fiat”) currencies such as the U.S. Dollar continue to lose purchasing power, they believe gold should be an integral component of investors’ portfolios.

So when does gold’s bull run come to an end? Ironically, that day might not arrive until the Federal Reserve feels better about general economic conditions to warrant a tightening of monetary conditions. Thus, in order to remain bullish on gold, one should remain somewhat bearish on the economy. Gold has also exhibited an inverse correlation to the Dollar, but the strength of that correlation has varied over time. Nevertheless, strengthening of the Dollar would likely be viewed as a bearish signal for gold, and the Dollar is unlikely to strengthen while the Fed maintains an accommodative monetary policy. In an analysis from 2009, Credit Suisse pointed out that “gold is insurance against debt monetization ... The gold price tends to rise when the real Fed Funds rate is below two percent.”

All bull markets eventually end, and consequently, the price of gold will hit its peak someday. As with all markets these days, eyes remain fixated on the Fed as to when this lengthy period of zero interest rates finally terminates – the key to investment returns for many sectors over the near term. It is likely that rising interest rates, as pointed out by many analysts, could expose gold’s Achilles’ heel. **CS**

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