



PLIMSOLL MARK CAPITAL

GOLD: Barbarous relic, store of value, or investment opportunity?

Gold has endured from the beginning of recorded history, yet it remains a controversial subject. It provided a stable monetary base that sustained the Byzantine Empire for a millennium, yet its detractors say it is only a commodity with no intrinsic value – it provides no yield, has no significant commercial use, and is not a depleting asset.

Lord Keynes coined the “barbarous relic” term to gain support for monetary expansion and deficit spending – a policy that was not possible under the gold standard. In fact we have “enjoyed” a paper currency standard in the U.S. since President Roosevelt took the country off the strict gold standard in 1933. In the intervening 76 years, the purchasing power of the U.S. dollar has declined by over 90%.

Gold is a monetary metal. It has maintained purchasing power and served as a store of monetary value through out history. However, this argument for holding gold is not sufficient, at least not in a country governed by rule of law. Common stocks have outperformed gold, providing purchasing power growth of about 5% a year over the longer term.

Yet, as we have recently experienced, equity returns can be volatile. In the worst case, when productive assets are destroyed through war, terrorism, or natural disaster, equities offer no sure return at all. Gold offers purchasing power protection through thick and thin, and some investors accept the prospect of little or no purchasing power growth as the price to pay for this comfort.

Today there is also a powerful cyclical argument for holding gold. We are in uncharted monetary territory. The U.S. monetary base has more than doubled – that’s 100% growth – since the financial crisis began. If the Fed’s reflation efforts are successful, money supply growth could accelerate as monetary velocity picks up, resulting in an inflationary mix of rising prices, rising asset values, and further currency decline.

Of these, currency weakness is the most concerning. Pressure on the dollar comes not only from excess money creation but also from a growing budget deficit. Will foreign capital continue to support deficit financing as our government’s credit worthiness deteriorates? Will the dollar eventually lose its position as the world’s reserve paper currency? As a sign of the times, there was a recent report in the British press suggesting Russia and China are holding secret discussions to establish a new currency basket that would replace the U.S. dollar for dealings in oil.

Our government does not yet seem overly concerned about a weak dollar. After all, a weak dollar reduces the cost of exports and increases the cost of imports, improving our balance of trade. In effect, weak currency trades off current income for wealth – more of the former and less of the latter. The classic (and usually ineffective) monetary response to a weak currency is an increase in short term interest rates, but the government does not have this political luxury at current levels of unemployment. Barring an unlikely precipitous currency drop, which would require more drastic policy response, there appears little to change the current course of monetary expansion, fiscal expansion, and gradual currency weakness.

While equities of U.S. multinational corporations with substantial international revenue offer protec-

tion against a weak dollar, we believe that the hedge that provides the most immediate protection is gold. By recently rising above \$1,000 an ounce, gold is already responding to dollar weakness and the growing inflation risk. Gold first reached that level in March, 2008, challenging the \$1,000 an ounce ceiling various times before finally breaking out this October.

How high could gold go? That depends on the extent and duration of deficit financing, money supply growth, and currency depreciation. Gold last peaked in 1980 at about \$850 an ounce, driven by speculation in the gold futures market. Adjusted for inflation, that would be about \$2,200 an ounce in 2009 dollars. The action today is in gold Exchange Traded Funds, the largest of which is listed on the NYSE under the symbol GLD.

This Fund, sponsored by State Street Global Advisors, buys and sells physical gold, stored mainly in London, to meet purchase or sale demand for its shares. As GLD is a trust, the IRS assumes each investor holds an interest in the underlying gold bullion. For tax purposes this is treated as a “collectable,” with a maximum federal capital gains rate of 28%. For this reason, gold may be an appropriate investment in tax exempt retirement accounts. (Please consult your tax advisor).

Gold can be volatile, and that volatility will increase as more money pours into the gold market through Exchange Traded Funds. A short term dollar rally would lead to a sharp gold sell off. Investors must be prepared for this possibility and take a longer term view of the holding.

In summary, we believe gold offers a real time hedge against currency depreciation and monetary inflation. With cash yields close to zero, the opportunity cost of holding gold is minimal. For clients concerned about the risk of inflation and currency depreciation, a gold holding of at least 5% of liquid assets appears reasonable.

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Bruce Lueck, Member
Plimsoll Mark Global Investment Committee