THE GLOBAL SPECULATOR

1 March 2011

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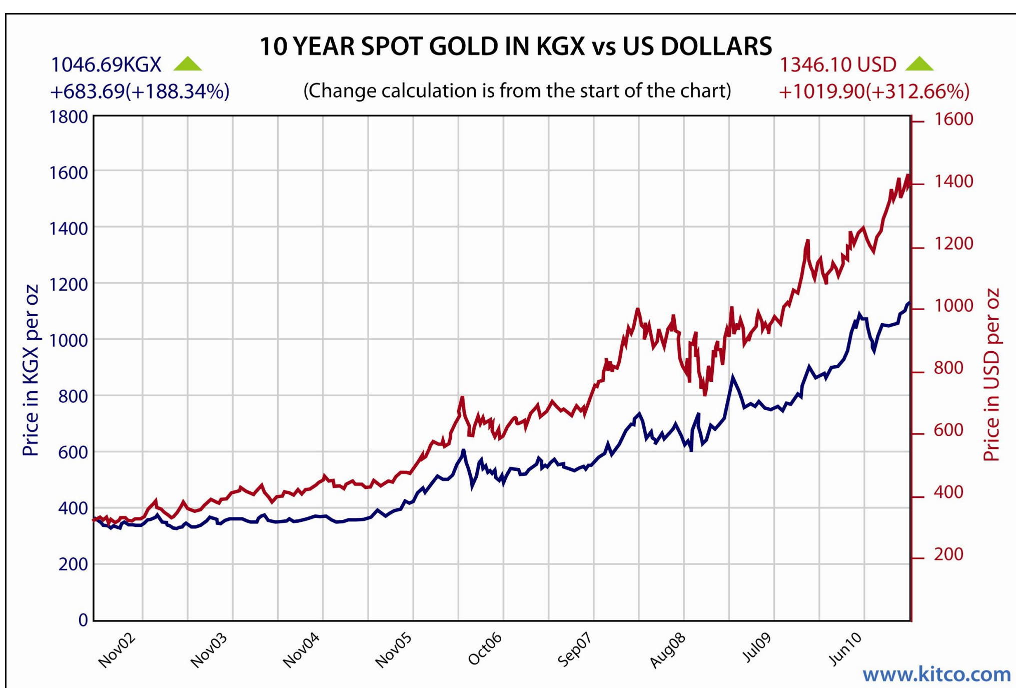
GOLD: THE MONEY OF LAST RESORT

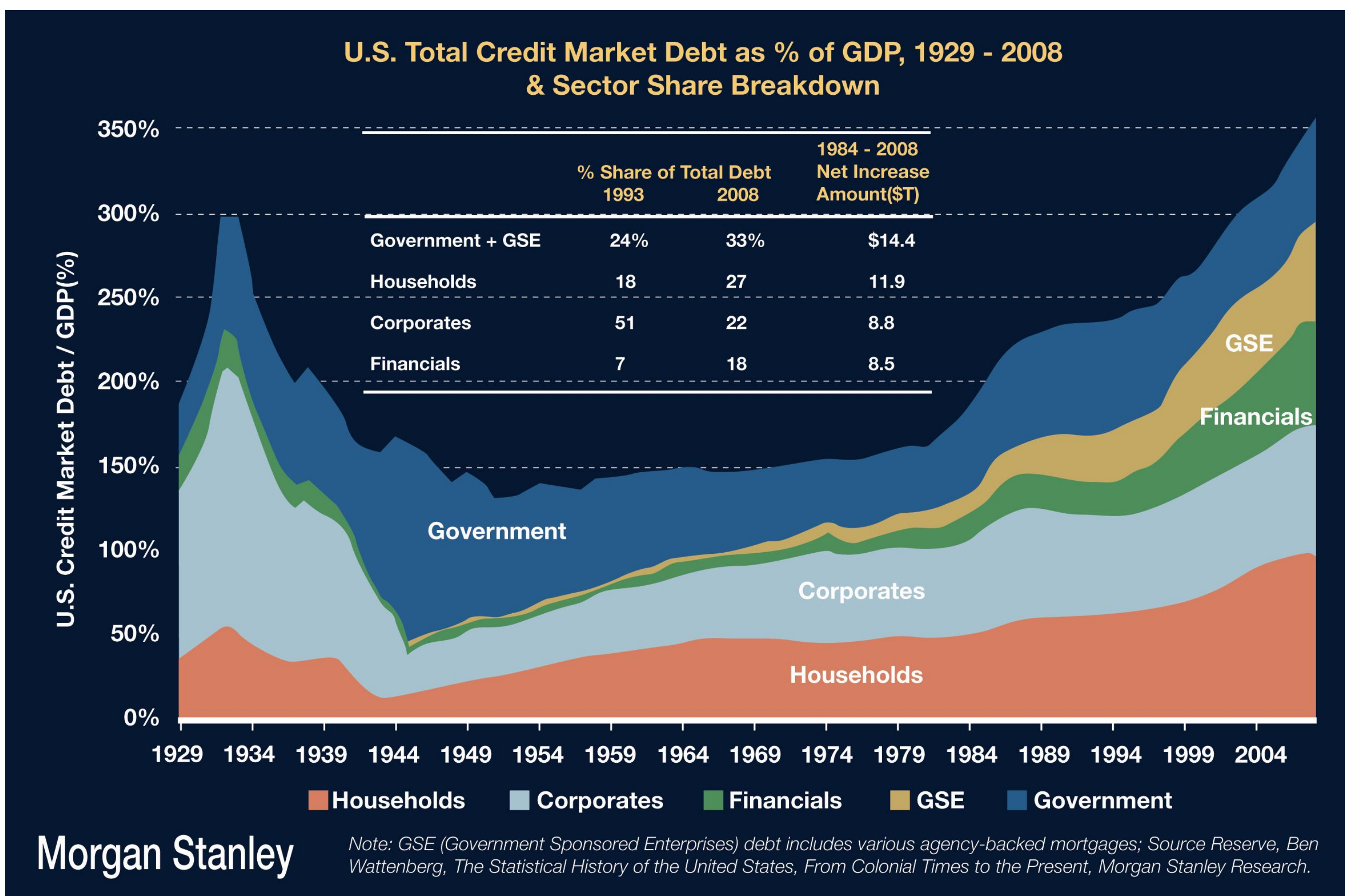
As published in the March 2011 issue of Australian Resource and Investment Magazine. For anyone wanting access to a great mining publication (online version is free) I encourage you to register at: www.australianresourcesandinvestment.com.au

When writing an article on a commodity such as gold and the outlook for 2011, it is tempting to write about the usual annual demand and supply fundamentals. Will production and overall supply increase? Will higher prices negatively impact on jewelry demand (50% plus of annual consumption)? Will a sustainable recovery in the global economy lead to safe haven liquidation? These are all the traditional factors we have no doubt seen and read about ad nauseam. As it happens, they are all, to varying degrees, irrelevant. Gold is unlike any other commodity. Where the likes of copper, zinc and nickel are produced and then largely consumed, most of the gold ever mined still exists today. Gold has played the role of money for centuries. To get a better idea of what the price is likely to do, we need to focus on what the largest holders of gold are doing. What they do is largely contingent on how major governments and central bankers around the world manage their respective activities and the impact this has on currencies.

The outlook for gold in 2011 and beyond is therefore more likely to be dependant on the monetary and fiscal policies adopted by the USA. The US dollar still remains the world's reserve currency. The US Federal Reserve seems committed to inflation, irrespective of the cost. Quantitative Easing (QE) has been the buzzword post the Global Financial Crisis (GFC). The collateral damage of printing money is a declining currency. Other major economic players conduct a large quantity of their transactions in US dollars. They have a preference for maintaining a stable exchange rate for trade purposes. This is especially the case with China which maintains a currency peg with the US dollar. The monetary policy adopted by the US therefore invariably sets the trend for all currencies. This fact is made all too clear when you look at a comparison of the gold price in US dollars versus that of the gold price in an index of other major currencies (KGX index).



The gold price is rising in all currencies. In other words all currencies are falling together. The obvious question for investors then is will this trend continue? To answer this, we need to ask: **Why are the US and other countries so committed to inflation and hence currency devaluation?** The answer becomes more apparent when you look at the US Total Credit Market Debt to GDP ratio on a historical basis.



We haven't seen credit levels such as these since the commencement of the Great Depression in the early 1930s. The common school of thought has been that this astronomical credit to GDP ratio needn't be a problem, provided the US economy (GDP) continues to grow. Over the last decade, the US has increasingly been achieving GDP growth via inflationary measures (note the explosion in Household credit). Interest rates have been progressively cut to the bone. Credit, for the most part, is simply future consumption brought forward. The economic day of reckoning inevitably comes when credit expansion is exhausted and debt has to be re-paid or is simply defaulted on. The last time this occurred was during the Great Depression. We can see from the chart above that it was largely corporations and households that sustained much of the pain during the 1930s. Mountains of debt simply went bad. In essence, these are the deflationary forces the US Federal Reserve is presently fighting doggedly against. Unlike the Great Depression, we are no longer on a gold standard (a gold backed currency system). Theoretically, there is no limit as to how much QE (money printing) the US Federal Reserve and other central banks can employ in an attempt to stave off deflation. An

investment in gold is simply a bet on the continuation of this policy. The political fall out and social unrest caused by another depression would be immeasurable. When we look at the public backlash from recently announced austerity measures in Europe, one get's the impression we will see more widespread QE and government spending programs in the months and years ahead. Governments around the world have effectively snatched the credit batten from increasingly cautious households and corporations (the private sector). If we cast our eye back to the 1930s and early 1940s, we see it was no different then. Corporate and household credit shrunk as government debt increased (note the debt explosion in the latter years was due to World War 2).

How high can the gold price go from here and how can one gain exposure? The more pertinent question is actually how much further currencies will be debased? When you have large quantities of debt/credit, it pays to debase your currency (inflate) all be it in a measured way. The strategy is to maintain economic growth and to pay your creditors back in a currency worth significantly less. Gold should be viewed as an insurance policy and a store of wealth in the likelihood this trend continues. Major holders of gold (such as central banks) are net buyers as opposed to net sellers at present for this simple reason. The remaining upside is hard to predict but may still be quite significant (multiples of the current level). There are numerous ways you can invest in gold.

The safest way is to buy physical bullion from a dealer and store it yourself. If, like many, you are uncomfortable doing this, you can also gain exposure via an intermediary such as an Exchange Traded Fund (ETF). ETFs are a popular, easy and convenient way to gain exposure to the gold price. The downside is you are dealing with two parties. One is the ETF itself and the second is the vault they are presumably storing the gold in. The rule of thumb is the more parties you deal with, the bigger the default risk. A nice compromise is perhaps the Perth Mint. Here you can invest in an allocated or unallocated position of gold. An allocated account incurs storage fees as the gold is stored and registered in your name as the legal owner. Unallocated accounts provide holders with a share in the working inventory of gold at the mint. No storage fees are incurred, but account holders are essentially unsecured creditors, should the mint default on its obligations. Whether you are an allocated or unallocated account holder, you do have the advantage of dealing with one party which is backed by the Western Australian Government. Another investment alternative for the less risk-averse investor is gold stocks. This does require some working knowledge in the sector but the leverage to a rising/falling gold price is significantly greater (typically 2 or 3 to 1). Most investors in the gold sector have a combination of physical metal and shares in producing gold mining companies.

Troy Schwensen

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Troy Schwensen has invested in the precious metals sector for a living since 2002. He is one of the founding members of www.goldnerds.com.au and also writes a free financial newsletter at www.globalspeculator.com.au