Week 79 - Gold vs. Financial Repression

Situation: Three weeks ago (see Week 76), we explained how Financial Repression forces investors to allocate more funds to stocks. This step has to be taken to counter (hedge) the main result of Financial Repression, which is to inflate values of all financial instruments by ~1.8%. In other words, you can't come out ahead of inflation by putting your money in a historically safe place like Treasury Notes. You will have to put it in a less safe place, and that means investing in stocks (becoming a trader), local real estate (becoming a landlord), a small business (becoming an employer), or the education needed to land a better job. Our goal was to show you some stocks that are better (and arguably safer) places to put your money than Treasury Notes. By investing in those "hedge stocks" you would be doing something counter-intuitive, i.e., using stocks to hedge against bond losses.

Financial Repression is basically ***a tax on all your assets***. The Federal Reserve levies that tax by removing Treasury Notes and mortgage-backed securities (MBS) from circulation, currently at a rate of $85 Billion/mo. Treasuries and MBS that remain on the market become so high in price that their interest rates may fall lower than the rate of inflation. This is done to drive mortgage interest so low that all of the expensive mortgages taken out in 2005-2008 can be refinanced to inexpensive mortgages, and new buyers looking for a home can get an affordable mortgage. In other words, a recession caused by a real estate crash can only be reversed by restoring home values.

We get that part of the equation but what about the other part--expansion of the Federal debt? What does Financial Repression do for the Federal Reserve and the banking system? Let's focus on the big issue, the one ***driving investors into gold***. Financial Repression makes it very cheap for overly indebted governments to borrow money. When the Federal Reserve drives down interest rates to reduce the cost of borrowing, investors (and even economists) will often conclude that Financial Repression represents *debasement of the currency.* That makes gold (a currency that cannot be debased) more expensive. Gold shouldn't be an investment asset because it produces no income to offset its costs (commissions, storage fees, insurance, and a high tax rate on any capital gains). But when the Federal Reserve is giving away money at a cost to its balance sheet of $1.14 Billion/yr, TV commentators say "the Fed is printing money" and TV viewers go out and buy gold. The Fed isn't printing more money. It is actually printing less than it was because relatively few people can put it to use unless the cost of borrowing is next to nothing. The Fed simply tilts the ebb and flow of money through the banking system toward more flow, which allows banks to make money available at very low interest rates. The goal is to ***reflate an economy that is under threat of deflation****.* (Up until recently, the main purchasers of that cheap money have been the Chief Financial Officers of solvent corporations who have figured they will be able to use it when demand for their products finally returns.)

When Financial Repression works and deflation is prevented, gold is a great asset to own because Financial Repression usually takes a long time to work its magic. But if deflation happens because Financial Repression is applied too late or too timidly, gold is a terrible asset to own. In 2008, when the Fed was still keeping interest rates high and the "bailout" had not yet kicked in, the exchange-traded fund (ETF) for large gold-mining stocks (**GDX**) fell in price from $56.87 (in 3/08) to $15.83 (in 10/08) for a 72% loss. Over that same 9 month period, a highly-regarded low-cost/no-load natural resources mutual fund (**PRNEX)** fell 51% and Vanguard's lowest-cost S&P 500 fund (**VFIAX**) fell 35%. Investors who thought a 1930s-style depression was in the offing fled from gold. Once it became clear that a depression had been prevented by the prompt application of robust monetary and fiscal policies, investors returned to gold seeking to reap the benefits of Financial Repression. But most will disappear when and if the economy is reflated without incident. Why? Because, at that point, the Fed will be withdrawing money from circulation to prevent inflation thus driving up interest rates. That will make the trading commissions, storage costs, insurance premiums, and capital gains taxes on gold unaffordable. Gold is only a reasonable long-term investment when the government is over-spending in its role as lender of last resort *and* driving up ***debt per capita.*** Once debt per capita is falling, the economy is okay: the currency isn't being debased. Right now, debt per capita is increasing and the currency is being (temporarily?) debased. This means gold is a reasonable investment now provided that holding costs continue to remain low and gold isn't overpriced.

In summary, you need to answer two questions before investing in gold:
1) can you afford the holding costs?
2) Is gold overpriced?

Question #1 is easy to answer because you can own gold bullion through an exchange-traded fund (**GLD**) at a cost of less than 0.5%/yr after paying the trading commission. That expense ratio will increase when Financial Repression ends. In other words, storage fees and insurance premiums will rise in tandem with rising interest rates. Question #2 is harder to answer because no one knows quite how to price gold. It has some tangible value (industrial uses) and a lot of intangible value (jewelry), which is why profits from its sale are taxed at the highest rate as though it were a collectible similar to art.

Doing the math, we'll start with best estimates. An ounce of gold has historically been said to have the same value as a very good suit of clothes. Most of us aren't prepared to shell out $1600+ when we shop for a good suit. But financial reporters keep trying to pin down gold's value by asking tailors how much they charge to make a very good suit from very good fabric. Tailors think that's an easy question and over the past few years have answered ~$1000. Another way is to look up the prices of gold mining stocks (see the attached **Table**). Those reflect the cost of extracting & milling the mine's most easily accessed ore in order to market its next ounce of gold: $1200/oz (http://online.wsj.com/article/SB10001424052702304821304577438633632102346.html?mod=WSJ_qtoverview_wsjlatest) to $1300/oz (http://online.wsj.com/article/SB10001424127887323316804578161230254371890.html?mod=WSJ_qtoverview_wsjlatest#).

What have we learned? At $1660 (the price of gold on 12/31/12), gold is overvalued and could fall out of favor with investors. Those are the very people who have been buying up **half** the annual production of gold over the past 5 yrs. Without the eagerness of those investors, the only tangible value gold has is the price paid for the 12% of annual production that is used for industrial applications--the rest being used for jewelry, which is another intangible like art. (Central Banks also buy and sell gold but don't move the needle much from year to year.)

Let's try harder to come up with gold's value **to an investor**. An investor wants to own gold as a hedge against the hyperinflation that will arise **if the currency is *unremittingly* debased.** So an investor will want to know how efficiently decreases in the purchasing power of the dollar (inflation) have been compensated for by increases in the price of gold. To answer this question, we need a reliable way of measuring the true value of the dollar. Since gold, always and everywhere, is an easily transported medium of exchange, we need a benchmark that is available always and everywhere. In other words, we need ***a benchmark that measures the true value of every currency relative to the true value of every other currency***. In business school, the choice of a reasonable benchmark by which to value different currencies is called arriving at *purchasing power parity (PPP)*.

It sounds silly but that benchmark is the price of a Big Mac hamburger. Go out and buy an issue of a British business magazine called The Economist if you doubt whether this is the global way to measure PPP. McDonald's has established restaurants in 190 countries so Big Macs are ubiquitous--always made the same way, always on the menu, and always marked up the same in local currency. It is easy to find the price of a Big Mac in the currency of any country on the planet (just Google it). So let's establish PPP for gold in US dollars relative to a Big Mac. In 1975, the average price of gold was $161.25 and the average price of a Big Mac was $0.75. In 2012, the average price of gold was $1766 and the average price of a Big Mac was $4.33. So gold went up 10.95 times in price while Big Macs were going up 5.77 times. The Consumer Price Index (CPI) only went up 4.28 times over that 38 year period so McDonald's is a strong brand that bestows considerable pricing power. If gold bullion had enjoyed the same pricing power as a Big Mac, it would have had an average price in 2012 of $930.41 (161.25 x 5.77), instead of $1766. Therefore, in 2012 the average price of an ounce of gold represented at least $836 (1766 minus 930) of intangible value vs. a Big Mac, which already has considerable intangible value vs. the CPI.

Let's be clear about intangible value. When a company is bought by a private equity fund, the amount paid over and above tangible book value is called *intangible book value*. Intangible value is the price paid for the brand and the talent that went into building it: The pricing power of that brand is worth only what the buyer is willing to pay. Gold bullion is a great brand that currently enjoys enormous pricing power. Whenever you sell it at a profit, you'll pay a lot of tax because the IRS is onto your game: The IRS considers the *entire* value of your gold to be intangible and therefore taxable as a work of art: You bought a votive object, plain and simple, then profited from its sale.

Bottom Line: In the event that the Federal Reserve and Congress are able to bring the country out of Financial Repression, which now seems likely to occur within 5 years, gold bullion is going to lose value. How much and how fast? Rationally, that depends on the rate at which the nation's debt *per capita* decreases. The government's debt will keep growing but not as fast as the population. Irrationally, you have to ask yourself what price investors will pay for gold after currency debasement has ended. This will depend on sentiment. If you are a *gold bug,* you'll never sell. But if you're *not* wedded to the gold coins buried in your backyard, you'll sell and sell quickly because the price will be falling fast (herd instinct). If you own a well-chosen gold mining stock (**Table**), you'll still take a hit--but not from the IRS since gold mining stocks are taxed like any other corporate stock. You'll just end up wishing you'd invested in the mining industry rather than gold mining *per se,* perhaps through a diversified mining stock like Rio Tinto (**RIO**) or a mining equipment stock like Caterpillar (**CAT**). Both are shown in the **Table**.

Risk Rating for gold mining stocks is a 10. No asset class fell faster or farther during the 9 months in 2008 when major economies appeared to be falling into a 1930s-style depression.