

**November 2010: On Gold, the Dollar and Politics****By John Goltermann, CFA, CPA***(Updated 11/08/11)*

We want to address a question that clients have been asking in recent weeks: With gold's huge outperformance, is it time to reduce its allocation? Normally, when an investment has had a run similar to that of the precious metals, it is indeed prudent to pause and re-evaluate. Nothing, after all, grows to the sky. But before we conclude that gold's run is over, it is important to reflect on what caused its outperformance and whether those factors still apply.

Gold is difficult to value. It is inert, it has limited application and it throws off no cash. Admittedly, it's hard to admire gold's investment merits as it conjures images of dubious characters peddling coins on television commercials and it brings the disdain of progressive economists. Gold's highest and best use is as money. Its value is in its rarity and fungibility. Whether we like it or not, gold is the inverse to the creditworthiness of the U.S. Treasury and market perception of government policies.

Over the past several years, Obermeyer Asset Management has targeted between 10% and 20% allocation to gold and gold mining companies in equity portfolios. We first invested in this asset class in 2002, when gold was largely unpopular, because we viewed it as undervalued. Thus far, this contrarian strategy has worked well. While no one can predict with absolute certainty that the price of gold will continue to rise, we view it as an important hedge against the possibility of global markets balking at extremely expansionary U.S. fiscal and monetary policies, which are a function of political motivations. Furthermore, since we have a U.S. Treasury market that is manipulated by statements and actions of the Federal Reserve, the investment case for gold continues to be strong.<sup>1</sup>

The reasons we maintain an exposure to gold are nicely summarized by John Hathaway of Tocqueville Asset Management:

The global economic system has become fatally dependent on the issuance of sovereign debt to finance the livelihood of government employees and the multiple dependencies of

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<sup>1</sup> As way of background, I strongly recommend reading "Night of the Living Fed" by Jeremy Grantham of Grantham, Mayo, van Otterloo. This piece can be accessed at <http://www.gmo.com/America/> after you register your name on the home page. It gives great background and commentary, describing how Fed policy has effectively debased the banking system and sound money policy by consistently under-pricing credit to fuel a housing bubble.

entitlements and transfer payments. Income created by political largesse has become a cornerstone of economic activity. Unwinding longstanding patrimonies to restore the fiscal credibility of government promises to be a challenging task. Those who question the feasibility of such a restoration will continue to find gold attractive.

At its heart, paper money is a political instrument. Because of excessive total debt-to-GDP ratios in the U.S. and the unwillingness of politicians and the electorate to face hard choices, the government (through the Fed) currently has no choice but to print money if it wishes to try to prevent asset markets from falling. As Bernanke himself stated in 2002, “the U.S. government has a technology called a printing press...that allows it to produce as many U.S. dollars as it wishes at essentially no cost.” At the moment, the Fed sees every incentive to do just this.

In a levered economy such as ours, when asset markets decline, bank equity gets squeezed, pension solvency is impaired, confidence wanes, lending and economic activity slow and asset prices continue to feel downward pressure. This in turn necessitates more money printing – a dangerous spiral. Money printing (a.k.a. quantitative easing) stems from a political desire to preserve domestic tranquility, encourage economic activity, decrease total debt-to-GDP and enable consumption. In fact, money printing may be the only politically achievable way to purge excessive debt because it enables the debtors to pay back their loans with cheaper dollars – and it is bullish for gold.

When you cheapen dollars by expanding the supply of them, assets with finite supply (whose prices are based on supply/demand fundamentals, including agricultural commodities, energy products, industrial metals and precious metals such as gold) will appear to rise in dollar terms. But it is in fact, actually the dollars that are *declining* in value. Moreover, newly printed dollars (created by the Fed through asset purchases and the offsetting expansion in large banks’ reserves) will seek the highest return for the least amount of perceived risk. Currently, these dollars are finding their way into emerging markets, and productivity within their economies is rising rapidly. When capital flows into emerging markets, their asset prices and incomes rise, in turn further increasing their demand for commodities as living standards improve.

When you print more dollars, they become less attractive as a store of value and there is no monetary anchor that binds the dollar. Since 1971, when Nixon unanchored the dollar from gold, their value is faith-based. Unfortunately their issuer, the Federal Reserve, has significantly expanded its balance sheet to now include toxic mortgage pools (purchased at par) on top of increasing amounts of Treasuries (bills, notes and bonds). The dollars in circulation and in bank reserves are its liabilities.

Treasuries are issued to fund liabilities created by Congress. The creditworthiness and value of those Treasuries is tied to a belief in future fiscal surpluses and/or continued refinancability of the U.S. government – a big leap of faith at present. Last year the Federal government ran a \$1.4 trillion deficit, but this doesn’t tell the whole story. The government reports its deficit numbers

on a cash basis. On a U.S. GAAP accrual basis, the 2009 deficit was actually \$4.3 trillion. These figures don't even include the Freddie and Fannie guarantees or any increases in FDIC or Pension Benefit Guaranty Corporation liabilities.<sup>2</sup> Foreign interests currently own nearly 50% of Treasuries. If foreign creditors become reluctant to lend to our government because they are concerned about a weakening dollar, interest rates must rise to compensate them for their risk. They have not *yet* risen because the Fed has signaled to markets that it will be buying massive amounts of Treasuries in the near future (another \$600 billion we know about) and speculators have already front-run that trade. In fact, in the short run the Fed doesn't even have to actually buy Treasuries – it just has to *say* that it will. But at some point, it actually *will* have to buy them lest they risk a massive selloff and commensurate interest rate increase.

But the Fed can't keep this up forever. The fact that the Fed is the buyer at the margin of new Treasury issuance is unsustainable: for every Treasury bond it buys now, it devalues the currency with which it will have to buy more Treasuries in the future to hold the same line. This risks an exponentially accelerating spiral of greater and greater money printing as markets expect more and more. As such, the Fed risks a loss of credibility and/or a concurrent dollar crisis. Like the government's grand experiment to see what percentage of U.S. households it could encourage to be homeowners (without causing a financial crisis), we are about to embark on a new experiment to see what percentage of new Treasury issuance the Fed can purchase (without causing a dollar crisis). We don't want to know the answer to that question.

On the fiscal side, if interest rates increase (because the Fed can't hold the line) then interest payments will take up an ever-increasing proportion of total government expenditures. Other expenditures and entitlements will therefore likely get squeezed. They're going to get squeezed anyway, but they'll get squeezed even sooner. The first expenditure to be trimmed will likely be the military. The global role of the U.S. military contributes to the dollar's reserve currency status – a status that should not be taken for granted.

The Federal Reserve's zero-rate policy also robs savings from the aging and risk-averse. It forces a reallocation of savings to speculation and risk-seeking as savers attempt to recapture the rising costs of living (near a 10% rate year-over-year if properly measured). This is a terrible policy because most people don't speculate well. Technology stocks and residential real estate are two obvious examples where a bill of goods was sold by Wall Street firms to the American public, and they bought it and it ended badly for most.

Much of the problem comes from an extreme level of big bank and hedge fund self-interested influence in Congress. That there is limited outrage over the fact that banks and large funds are being allowed to be re-liquefied and re-constituted at the expense of the American public is frightening. For more on this, I recommend reading an essay called "The Quiet Coup" by Simon Johnson. It can be accessed on The Atlantic's web site: [www.theatlantic.com](http://www.theatlantic.com).

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<sup>2</sup> U.S. Department of the Treasury

I was fortunate to have dinner with Ken Rogoff in San Francisco a few weeks ago. Ken, a knowledgeable, amiable and highly educated fellow, is a Harvard professor and a former chief economist of the IMF. Because I was curious, I asked him what the risk was of a dollar crisis and he said “zero.” The level of confidence in his answer concerned me. Even if one thinks the possibility of a disorderly decline in the dollar is *remote*, the probability is never truly “zero.”

The probability of a dollar crisis is rising rapidly. Rogoff’s answer reminded me of Fed Chairman Ben Bernanke’s 2007 declaration with respect to the subprime crisis: “Importantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market; troubled lenders, for the most part, have not been institutions with federally insured deposits.” One year later, all hell broke loose and our entire system of credit would have collapsed were it not for the taxpayers.

It is for this reason that we will view certain predictive statements of policymakers and academics skeptically and will continue to perform our own analysis. We will also respect the certainty of unintended consequences of extreme policy intervention and the short-term unpredictability of capital flows through financial markets.

The negative effects of money printing are not just higher commodity prices, but also higher costs of general consumer goods and services (i.e., plumbing services, theater tickets, airline travel and health care). As we all know, individuals currently aren’t able to recapture cost of living increases through real estate gains – it has to be recaptured through the gold market or direct investment in quality firms that can pass through increasing costs. In this type of environment, it will be extremely difficult to beat inflation in the dollar-denominated bond market or in bank deposits. The obvious political incentives of cheapening the dollar and the heightened risk of an unintended dollar crisis therefore continue to necessitate a gold allocation.

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