Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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Has Gold Lost its Luster?

Gold enjoyed a tremendous run over the last 15 years. From December 1999 to October 2012 the price of an ounce of gold rose from a sleepy $300/ounce to over $1800, averaging better than 15% in annual returns.

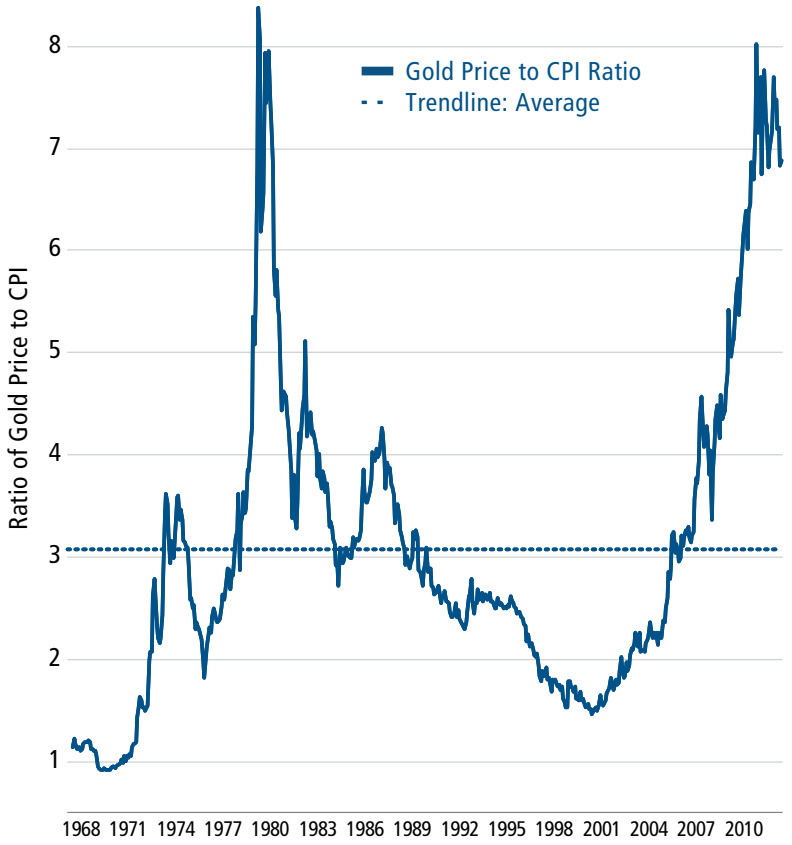
More recently though that upward momentum faltered. Since touching nearly $1,800 in October 2012 (and $1,900 in Sept. 2011), gold prices drifted lower over the last six months. Talk of "tapering QE," a slowdown in Chinese growth and rumors that peripheral euro area central banks would sell gold holdings to fund bailouts: whatever the "real" reason, the general downtrend in prices was underway.

Two weeks ago prices lurched lower, descending from $1561 to $1,348 (including the single largest daily decline since 15 April 1977). What should investors make of the recent price volatility in gold? Has gold lost its luster?

To answer this question, we must examine three myths surrounding the gold story:

Myth 1. Global Central Banks' "Money Printing" Sets the Stage for Rapid Inflation - Many analysts labeled "quantitative easing" (QE) as "money printing" and foretold an inflationary (for some, a *hyper* inflationary) future. While not advocates of QE, we do recommend an understanding of monetary mechanics. QE is an asset swap. The central bank exchanges interest-bearing bank reserves for interest-bearing Treasuries. The size and composition of the central bank's balance sheet changes, but not the broad money supply. Actual "money printing" occurred most recently in Zimbabwe, but most famously occurred in Weimar Germany when the government printed paper currency to pay public employees. The newly printed currency immediately entered the money supply, and the abundance of money lifted the prices of goods purchased.

Chart 1 - TWIN PEAKS: THE REAL PRICE OF GOLD IS EXTRAORDINARILY HIGH



Sources: BLS, Reuters *©FactSet Research Systems*

Returning to today, recent data have not borne out the ominous predictions of the inflation hawks. In fact, the average rate of inflation across all advanced economies *decreased* since 2008 - dropping to an annual rate of 1.6% from 2.2% over the previous decade.

Reality: the relationship between central bank balance sheets and inflation is more complicated than our textbooks or our gold bug friends suggest.

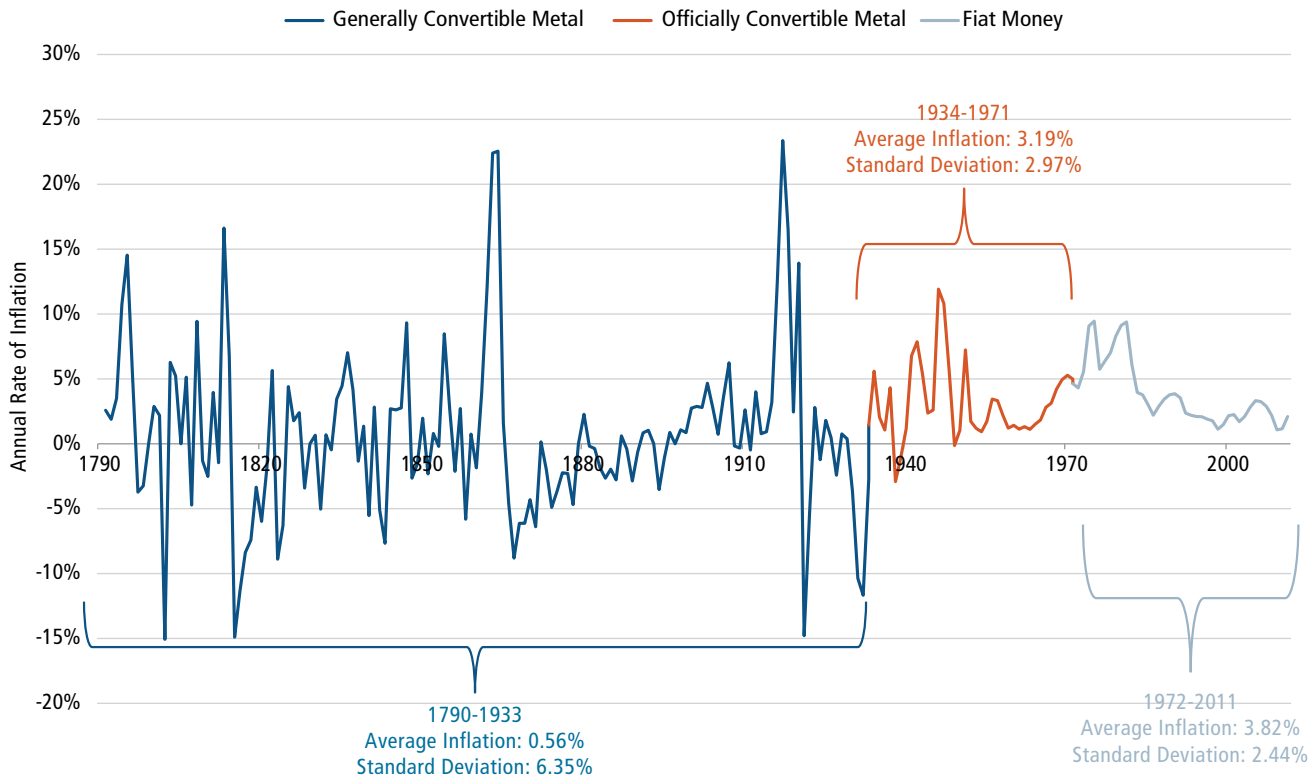
Myth 2. Gold is an Effective Inflation Hedge - Even if Myth #1 above were accurate, *gold is not a good inflation hedge.* Contrary to popular belief, since 1975, no correlation exists between unexpected spikes in inflation ("inflation shocks") and the price of gold. Research suggests that commodities in general may benefit in the short-run from an inflation shock, but not necessarily over the long run.

For example, in the US, as inflation spiked in the late 1970s and early 1980s, gold prices marched higher. However, with the regime switch at the Fed at the start of the "Volcker era" gold took a hit and posted negative returns on average of -5% per year from 1980 to 1990. Meanwhile, the average annual rate of inflation during the 1980s? +5.6%. Finally, research suggests that if US inflation was the primary driver of the gold price, the price of gold would actually be much lower, closer to $800/ounce - not the $1400 we see on the screens today.

Reality: as shown in Chart 1, relative to the consumer price index, gold prices remain near all-time highs, even though inflation has been subdued.

Myth 3. In an Era of Euros and Bitcoins, Gold is the Only Real Money. We Must Return to the Stability of the Gold Standard – Many insist that gold is the only "real money" and will provide superior protection against economic instability. History, however, tells another story. Under previous currency regimes the *average rate of inflation* was indeed lower, but wild instability characterized the financial system (see Chart 2). Given that the last 30 years accommodated unprecedented growth in world trade, investment and economic activity, we prefer our so-called "paper money standard." Rather than thinking a return to the gold standard is our hope for stability, the last few weeks reminded us that liquidity and stability go hand-in-hand with safety. While no asset (gold included) has intrinsic value, only the value given to it in trade for goods and services, the dollar and US Treasuries remain sources of safety and liquidity.

Chart 2 - "HARD" CURRENCY PROMOTES STABILITY? NOPE.



Source: Louis Johnston and Samuel H. Williamson, "What Was the U.S. GDP Then?" MeasuringWorth, 2011.

Reality: a by-gone era where gold paved the path to financial stability is an historical illusion.

Our view: The run-up in gold prices over the last 15 years will not likely recur. As investors recognize that the yellow metal is a poor hedge for many of the risks from which it supposedly provides shelter, demand for gold may wobble. History instructs that when the real price of gold is extremely high, future gold returns disappoint.

Where could we be wrong? For one, the global supply of gold is limited and most investors remain underinvested. If global investors significantly shift portfolio allocations, upside price pressure on the precious metal could result. Of course, this is true of any asset class and we continue to believe the anticipated benefits of gold have been overestimated by the myths surrounding the yellow metal.

Caveat emptor!

Sources:

Claude B. Erb and Campbell R. Harvey, "The Golden Dilemma." National Bureau of Economic Research Working Paper.

Alexander P Attie and Shaun K Roache, "Inflation Hedging For Long-Term Investors," International Monetary Fund Working Paper, April 2009.