The Case for Gold: Invest in the Ultimate Currency?

Introduction
Gold has been used as a standard medium of exchange and store of value throughout history and across countries around the world. It has been coveted for its beauty, scarcity, durability, divisibility, and transportability, these key attributes having made it a sought-after commodity and suitable form of money. We consider these characteristics underpin gold’s value and its importance within an investment portfolio. Moreover, we find that a gold allocation may provide significant advantages from an investment standpoint, enhancing a portfolio’s risk-adjusted return profile. Indeed, our analysis finds that investors may create more optimal portfolio combinations by incorporating gold into their investment allocation process. The case for investing in gold now may be as compelling as ever given the heightened risk of inflation in the U.S. and the uncertainties surrounding the global economy and financial markets.

“Gold: a currency, a commodity, an investment.”

This white paper specifically focuses on the two key reasons investors typically cite as critical decision-making factors supporting an investment in gold: as a form of protection against inflation and as a safe haven investment. In the context of the current economic environment, we put forth arguments supporting both of these investment theses. We show how expectations for future inflation have become elevated, and are likely to remain so, given a backdrop of easy monetary policies the world over. Additionally, we propose that continued leverage throughout the economy is likely to result in ongoing heightened levels of volatility, while a large degree of uncertainty remains over the future trajectory of the global economy. These dynamics may continue to vindicate an investment in gold as a protection against inflation and as a safe haven investment. In turn, we believe these trends are likely to underpin continued strength in the price of gold over the foreseeable future.

We would also propose that an equally important, and complementary reason, for an allocation in gold is from a portfolio diversification standpoint. In a follow-up white paper, we analyze the portfolio benefits of adding gold to an investment portfolio. Notably, gold may help to contain downside movements in the value of an overall portfolio, reduce overall volatility, and enhance returns. As such, the addition of gold may help to significantly enhance a portfolio’s overall risk-adjusted performance. Specifically, we find that incorporating a gold allocation into an investment portfolio produces optimal results based upon efficient frontier analysis.

“Complementary reasons to invest in gold: inflation hedge, safe haven and portfolio diversification.”

Gold as Protection Against Inflation
Investors typically cite risks surrounding future inflation as a leading contributor to their decision to invest in gold. Importantly, it is the risk to future inflation levels and not the current level of inflation that drives this investment decision. Future inflation levels can be calculated using economic principles, and are generally referred to as implied inflation...
“Future inflation expectations elevated.”

expectations. Indeed, implied inflationary expectations are a key metric used by the U.S. Federal Reserve (Fed) in gauging the risks to future inflation. Implied inflation expectations are typically calculated by assessing the difference in yields between Treasury Inflation Protected Securities (TIPS) and equivalent maturity Treasuries. TIPS are designed to provide investors with protection against the level of inflation, as measured by the consumer price index (CPI); as such, when using the above two securities, one can solve for the implied level of inflation over various time periods. Notably, the definition of CPI and the calculation methodology has changed over time. In fact, using the 1980’s measure of CPI, today’s inflation levels would be much higher than reported.

A common implied inflation expectations metric is known as the Five-Year Forward, five-year inflation expectation. This measure shows the expectations for the average annual inflation rate over a five-year period beginning five years from today. Figure 1 outlines recent movements in the future inflation expectations metric over time.

Note that there is an amount of “noise” surrounding the above calculated inflation expectations. For instance, differences in liquidity between the two markets (TIPS and Treasuries) may cause one security to price-in a higher liquidity premium. We would also argue that the monetary policies of the Fed, such as “Operation Twist,” have manipulated the underlying Treasury yields used to calculate future inflation expectations, which we discuss in greater detail below. Nonetheless, the general movement in perceptions for future inflation is clear from Figure 1.

Monetary Policy Fanning Inflation Concerns
It should not be too surprising that the present expectations for future inflation are elevated. With central bankers around the world evermore dedicated to keeping the world awash with freshly minted currency, the case for an investment in gold based upon inflationary concerns may be strong. From the Bank of Japan and the People’s Bank of China to the European Central Bank (ECB), the Bank of England (BoE) and the Fed, central bankers are either putting their money where their mouth is (quite literally) or strongly insinuating that continued, ongoing easing policies are needed to prevent another significant downturn in global economic activity. In many respects, Bernanke et al., are providing a backstop to the financial markets in much the same way Greenspan did during the “Goldilocks” years. Commonly referred to as the “Greenspan Put.” Today’s central bankers have been quite straightforward in communicating their stance: they appear willing to step in with more liquidity should the global economy show signs of further weakness.

It should be noted that central bankers have already been quite profligate regarding the expansion of their respective balance sheets. We consider the change in a central bank’s balance sheet to be a proxy for the additional money that central bank has created. Figure 2 clearly outlines the trajectory of changes in the central bank balance sheets of the Fed, the BoE and the ECB, since the latter half of 2008, a period when the threat of a global financial catastrophe analogous to the Great Depression was omnipresent.

“Central bankers have already been profligate regarding expansion of balance sheets.”
While all the excess printed money may or may not have the desired effect of stimulating the respective central banks’ economies, the money does find its way somewhere; unfortunately, most central bankers appear to fail to realize that they simply cannot control where that money ends up. Case in point: Fed Chair Bernanke’s Achilles’ heel since the onset of the financial crisis has been the housing sector. It’s no surprise that the Fed bought over a trillion dollars worth of Mortgage Backed Securities (MBS) and recently announced another open-ended buying program under “QE3”; the intention appears clear: to re-inflate home prices and in so doing, bail out all those underwater with their mortgages.

In our assessment, much of the freshly printed money only serves to inflate the value of assets that exhibit the greatest level of monetary sensitivity: commodities and natural resources. Such commodities and resources are essential in the manufacture and production of goods and services purchased by U.S. consumers on a daily basis. As such, inflated commodity and resources prices ultimately pressure consumer price inflation, as the consumer’s “everyday basket of goods” becomes evermore expensive.

Figure 3 depicts the relationship between the change in the Fed’s balance sheet total assets, with movements in the price of a basket of commodities and the price of oil, since December 2008.

Next, we depict a similar chart (Figure 4), which focuses on the change in the size of the ECB’s total assets compared to the price of oil (as measured by Brent crude, a more commonly used reference price for Europe) and an index composed of a basket of commodities. Note that the ECB’s total assets, oil and the commodity basket are denominated in euros, to depict the relationship between a central bank’s total assets and the local price of commodities and natural resources.
Weak U.S. Dollar Creates Inflation Pressure

The decline in the U.S. dollar over time, particularly against Asian currencies and currencies of commodity-producing countries, has been compounding the inflationary pressure brought about by natural resource and commodity price increases. The U.S. imports a great deal from abroad; every time the dollar depreciates against a currency of a country from which the U.S. imports, the price of those imports rises. Many high profile American importers, such as Walmart, have noted price pressures in goods sourced out of Asia in particular. All of which puts upward pressure on the price of goods and services consumed in the U.S., creating inflationary strains.

Readers might ask why the dollar has held up relatively well, as measured by the U.S. Dollar Index. The answer largely lies in that index’s oversized weighting (57.6%) to the euro. The euro has underperformed other currencies recently, primarily due to the concerns surrounding the long-term sustainability of Eurozone members’ public finances. Indeed, many other currencies have strengthened considerably against the U.S. dollar. The following chart depicts the cumulative change in the value of commodity currencies – the Australian dollar, Canadian dollar, New Zealand dollar and the Norwegian krone – versus the U.S. dollar, since the end of 2008 through the end of September 2012. (During this timeframe the U.S. Dollar Index appreciated approximately 1.7% cumulatively) A positively sloped line represents commodity currency strength and U.S. dollar weakness. As depicted in Figure 5, the trend is quite noticeable across all currencies analyzed.

The same trend is also clearly evident within Asian currencies, illustrated in Figure 6, over the same timeframe. Note that Asian currency exchange rates are typically more closely managed vis-à-vis the U.S. dollar than the commodity currencies presented above. Notwithstanding, Asian currencies have tended to strengthen relative to the U.S. dollar over time. The U.S. dollar has weakened against many Asian currencies.

Gold: the Ultimate Hard Currency

In light of the depreciation of the U.S. dollar and the inflationary implications, we would be remiss not to touch upon gold from a currency perspective. Gold has long been used as money and we consider it to
"U.S. dollar weakness vs foreign currencies an inflation threat?"

be the ultimate hard currency. Historically gold has demonstrated value both as a commodity, primarily for its desirability as jewelry, and as money, a role for which it is naturally suited due to its unique attributes: namely its scarcity, durability, divisibility, and transportability. Unlike fiat currencies, gold has a limited supply that cannot be easily influenced and an underlying commodity value, which allows gold to retain its purchasing power over time. Production of gold is very hard to ramp up, whereas the creation of new fiat currency takes a simple stroke of a keyboard. As noted above, central bank keyboards have been working overtime of late, which has arguably deteriorated confidence in fiat currencies. As a result, gold may become an ever more attractive alternative to holding investment wealth in one's domestic currency. These dynamics may underpin ongoing appreciation in the price of gold over the coming years. In a follow-up gold report we will cover the dynamics of gold as a currency in more depth.

Gold as a Safe Haven Investment

The performance of gold during broad market downturns and periods of heightened uncertainty underpins gold’s safe haven value. Looking ahead, holding gold in this capacity may once again be validated. Global economic activity remains at risk and appears to be slowing. The U.S. economy has not yet recovered from the financial crisis, as the unemployment rate still hovers at historically high levels. Unemployment globally continues to be elevated. Consumer spending remains constrained, as consumer sentiment is once again reaching lows and many retailers – both high-end and low-end – have cut their sales outlooks, as have many transportation companies. There is a fiscal cliff on the horizon, both at the national and state level. The housing market remains weak. Europe continues to weigh on the minds of investors the world over. Japan’s aging population and fiscal largess has resulted in a worse fiscal situation than the U.S. and most of Europe (“gulp”). It appears China’s rapid economic expansion of years past may be waning.

All of these headlines are enough to heighten investors’ cumulative heartbeat, and unfortunately we don’t consider the risks to global growth will disappear anytime soon; rather, we believe financial markets will continue to exhibit heightened levels of volatility for an extended period of time, in large part due to the ongoing high levels of leverage throughout the global economy. See Figure 7.
Leverage Causing Ongoing Volatility

With the total debt of developed nations at unprecedented levels, there remains a great deal of leverage throughout the globe. As any investor who has utilized leverage knows, it is great while the going is good, but when the tide turns, it can be extremely painful. Leverage in this sense is a dangerous double-edged sword. We consider that through current monetary policy, policy makers are discouraging consumers from deleveraging (through ultra low interest rates, for instance), thus incentivizing ongoing high levels of consumer leverage. Despite recent improvements, these high levels of leverage are likely to contribute to the ongoing sluggishness of the U.S. consumer and disappointing headlines. Over the past five years, average implied daily market volatility has risen by over 50% compared to the level witnessed during the preceding five-year period, to 26.3%, substantially higher than historic norms. We believe the high level of leverage throughout the global economy was a leading contributor to the heightened levels of volatility and consider that ongoing high levels of leverage are likely to continue to underpin uncertainty going forward, thus validating an investment in gold from a safe haven standpoint.

“Continued leverage throughout the economy raises the likelihood of heightened market volatility, validating gold as a safe haven.”

Worrying Levels of Government Debt

Ominously, the use of leverage has spread from individual consumers and private businesses to national governments. While government debt is nothing new, we consider the levels seen today are reason for serious concern. Gross general government debt in the G-7 nations has exceeded 100% of GDP, and Japan’s public debt is already over 200% of GDP. Unfortunately, when the tide turns against governments, financial catastrophes can ensue. Greece is a prime example. As we elaborate in Figure 8, problems may extend to many developed economies.

Compounding matters are the rising interest rates quite rightly being imposed on profligate governments, as investors the world over realize the long term fiscal positions of many nations may become untenable. Such rising interest rate environments make it increasingly difficult for nations to service their expanded debt levels, thus threatening a vicious cycle of indebtedness. Europe has already been the focal point for some time, where policy makers continue to rush to the aid of weaker nations in the hope of avoiding disaster. In the U.S., markets have yet to impose such fiscal oversight on the U.S. government, where Treasury yields remain close to historic lows. We consider these dynamics to be less of a commentary on the current U.S. fiscal situation, but rather believe it has been brought about by a combination of the Fed’s actions (see Figure 9) and the fact that a suitable substitute for the depth and breadth of the U.S. Treasury market is yet to be found globally. Nonetheless, the probability of a U.S. fiscal catastrophe increases each day while nothing meaningful is done to address the situation.

Increased levels of national debt cause heightened levels of uncertainty over the future fiscal positions of nations around

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2 Data source: IMF World Economic Outlook Database, April 2012.
The risks to future government expenditures and raises question marks over future tax policies. We consider these various uncertainties to be key factors in holding back business investment and thus the economy in the U.S. Especially worrying is the paralysis in Washington regarding the looming fiscal cliff. It is clear to all observers that something needs to be done, either by cutting government expenditure or by increasing government revenues (likely through taxes), or a combination of the two. Current federal deficit levels are simply unsustainable.

We would argue that the longer it takes to come to an agreement on a sustainable fiscal solution, the greater the risk to the economy. Not only does the risk of fiscal catastrophe increase with the associated rise in yields not dissimilar to what has occurred in parts of Europe) but also business investment is negatively impacted, causing detriment to the economy. For businesses to make an investment decision, they must forecast future expected revenues and expenses for a given project. When there is uncertainty surrounding future government-imposed costs, such as tax or health care expenses, investment risks increase, pushing higher the required return on investment. This reduces the number of investment projects undertaken. The problem is more acute for a business that contracts with the government. These businesses know that future revenue streams are at risk, because their businesses may be directly impacted if government expenditures are cut. Thus, these businesses are unlikely to undertake any substantial business investment over the near-term, until such issues are resolved. The longer nothing is done to address the long-term fiscal sustainability issue, the more damaging the impact on the economy and the greater the uncertainty to the markets.

In many respects, the U.S. faces a lot of the same challenges Europe does. According to the Congressional Budget Office’s (CBO) projections, if nothing is done to address the looming fiscal cliff, the U.S. annual budget deficit is expected to be approximately 5% of GDP through the year 2022. Even if meaningful policies were enacted to address the situation, which would broadly equate to European style austerity measures, it is hard to foresee the U.S. fiscal deficit turning to a surplus over the medium term, especially when factoring in a slowdown in economic growth as a result of the measures. However, one point of difference does seem apparent: the Fed may be more willing to deploy the printing press than the ECB, which we believe may be positive for the price of gold over the medium term.

Monetary Policy also Creating Uncertainties
Despite the best of intentions, we consider monetary policy is inherently increasing financial market risk. Fed Chair Bernanke believes that the Fed’s non-standard policies since 2008 may have helped lower 10-year Treasury yields by over 1.5%. While readers may agree or disagree with any substantial business investment over the near-term, until such issues are resolved. The longer nothing is done to address the long-term fiscal sustainability issue, the more damaging the impact on the economy and the greater the uncertainty to the markets.

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![Figure 9: Federal Surplus or Deficit](Source: Merk Investments, Federal Reserve © Merk Investments, LLC)

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3 Under the CBO’s “Alternative Scenario,” in which some changes specified in current law would not occur and many tax and spending policies that have been in effect in recent years would continue.

the policies put in place, one thing is clear, the Fed has taken away a key metric in gauging the economy and thus setting appropriate monetary policy: free market interest rates. Historically, the Fed has relied in part on long-term yields, such as the 10-year and 30-year Treasury yield, as part of its assessment of the overall health of the economy. In manipulating those same yields, as Bernanke has stated the Fed has done, the Fed can no longer rely upon them to provide valuable information on the health and trajectory of the economy. In other words, the more the Fed meddles in the market through non-standard measures, the more the Fed is in the dark regarding the appropriateness of monetary policy. Such a situation inherently creates an additional level of uncertainty over the economy.

Additionally, the Fed has provided vast amounts of liquidity via its quantitative easing programs, which at some point will have to be reined in. This may create massive headaches down the road. Whether the need to rein in liquidity will be due to inflationary pressures or a sustainable recovery, only time will tell. However, given the ongoing high level of leverage employed in the economy, such monetary tightening runs the risk of undermining any economic recovery and potentially causing it to crash back down, as the likelihood of it negatively affecting consumer spending is high. With a still-leveraged consumer, rising rates may be overly painful, dramatically slowing consumer spending and, in turn, the economy. Such dynamics may have an outsized impact on the U.S. economy, given consumer spending makes up approximately 70% of U.S. GDP.

All of which underpins our view that the risks to the Fed getting monetary policy wrong have risen dramatically. Obviously, this could have dire economic consequences and increases the likelihood of ongoing volatility, as well as the risks to inflation, over the foreseeable future.

**U.S. Economic Outlook Murky**

A picture is worth a thousand words, and we believe the Figure 10 presents a telling depiction of the severity of the recession that began in 2007. It tracks the trend and recovery in unemployment and contrasts the rapidity of improvement against all other recessions stretching back to 1960. As is clear in the Figure 10, the current U.S. economy is yet to regain the level of employment experienced prior to recession; indeed, it remains a full 3.4
percentage points below that level 55 months after the recession began. In comparison, the median recession took just 21 months to recovery to pre-recessionary levels of employment. Moreover, the depth of the recession and length of the current recovery significantly trails even the harshest monthly post-recession change for the previous 10 post-war recessions. See Figure 11.

Quite clearly, there remains a lot of risk surrounding the future trajectory of the present recovery, especially given a backdrop of still too much indebtedness at both the consumer and government levels (Figure 12). Some have propositioned that we may be in for an extended period of sub-par growth, not dissimilar to that experienced in Japan, for the past 20 years. See Figure 13.

It is evident that significant risks remain regarding the strength of the economic recovery. We consider that the high levels of government debt, not just in the U.S., but the world over, are likely to contribute to elevated levels of volatility in financial markets for years to come. Monetary policy, too, has increased the risks to financial markets and the economy. In turn, ongoing heightened levels of volatility may underpin strength in the price of gold, as investors increasingly seek safe haven investments, potentially as substitutes for government debt, such as U.S. Treasuries.

**Conclusion**

We have discussed the two key reasons most typically cited for an investment in gold – as a protection against expected future inflation and as a safe haven investment – and have shown that there are ongoing economic dynamics supporting such investment theses over the foreseeable future. We demonstrated that expectations for future inflation have become elevated, likely due to the extraordinary monetary policies being employed and/or signaled by central banks around the world. For instance, the Fed’s recent announcement of open-ended quantitative easing clearly indicates that easy monetary policies will be in place for sometime yet. Continued weakness in the U.S. dollar vs. foreign currencies and heightened commodity and natural resource prices are only likely to compound inflationary pressures going forward. Monetary policies are also inherently creating increased financial market risk, through the Fed’s manipulation of the yield curve. With still too much leverage in the economy, the fiscal cliff imminent, and the outlook for the global recovery unclear, ongoing

“Ongoing heightened levels of volatility may underpin strength in the price of gold as a safe haven.”
market volatility may remain high. Such dynamics should help underpin strength in the price of gold going forward, as gold may become an ever more attractive alternative to holding investment wealth in one’s domestic currency.

To Learn about the potential portfolio benefits of adding gold and other hard currencies to your investment portfolio, please sign up to our newsletter, Merk Insights at www.merkinvestments.com/newsletter

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