CHAPTER 12

A Look at Commodities, Gold, and Other Real Assets —
“What Really Moves Gold Prices”
It is impossible to write a book about currency wars and a Code Red world without writing about the price of gold. And no matter what we write, we’re going to make a lot of people mad. Gold is like a religion: people either believe in it or they don’t. We’re going to get hate mail. (Please direct all letters to our publisher so they can shred them. The exception to that policy is if your letter is particularly colorful. We enjoy fun reads just as much as the next guy!)

The world is divided into two kinds of people. On one side you have gold bugs, who think that money can only be honest and pure if it is backed by gold. They still pine for the days of the gold standard. They think one of the greatest tragedies ever was the move to paper money that is backed only by a government’s good faith and credit.

On the other side you have the people who scorn gold bugs and cannot see any use for the “barbarous relic.” Neither side likes the other at all. (A friend who is a journalist at one of the world’s major financial newspapers told us that articles on gold consistently generate the most comments and the most shares via Twitter and Facebook. Almost no one has a moderate opinion about gold.)

Gold can seem like a ridiculous investment. Warren Buffett once said, “Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again, and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.”

Buffett’s comment is too clever by half. You could make a similar observation about money: “Trees get cut down in Oregon, or someplace. Then we pulp them, turn them into dollar bills, put them in ATMs, and trade them. They have no utility.” Money itself has no utility, but it functions as a means of exchange, a store of value, and a unit of account. Money is valuable only insofar as you can trade it for something else of value. Gold may be irrational, but there is a fundamental need for a medium of exchange. Early civilizations used pebbles or shells. Prisoners have used cigarettes. And for thousands of years societies have used gold. But today we use dollars, euros, and yen. Gold has value only insofar as you can trade it for something else of value. If you can trade your gold for companies that will grow and produce cash, all the better.

In a world of Code Red policies and currency wars, we like to think that gold is effectively a form of “central bank insurance.” We have health insurance, fire insurance, life insurance, and so on. We dearly hope we never have to use any of them. But we keep buying insurance anyway, because we don’t know the future. In a perfect world, gold would be a collector’s item, shiny jewelry, or an industrial metal. But this is not a perfect world. Central banks can print money and debase currencies. Gold rises and falls in relation to any given currency, in line with general concerns about the long-term viability of the obligations of the government issuing the currency. If you are in the United States, you might want only a small portion of your portfolio in gold. If we were in Japan right now, we would be buying gold or dollars or anything not denominated in yen. If you are a trader, buying gold in terms of yen might make a great deal of sense. If you live in Argentina, owning anything that is not physical pesos makes sense.

What drives the price of gold? The best predictor of the price of gold is the change in the real interest rate you can earn on your savings. As an investor, you have the choice every day as to whether to keep your money in cash or own a shiny metal. What influences that decision is whether you are getting any real return on your savings. If you are, you’re unlikely to buy something like gold that gives you no yield and pays you nothing. However, if inflation is higher than the going interest rate, then you’re earning a negative return by keeping your money in cash. Owning a real asset like gold suddenly doesn’t seem so dumb.

This very clear relationship between real interest rates and the price of gold has held for the past few decades. There is a simple rule of thumb called Gibson’s Paradox. Investors expect a real return on their cash of 2 percent. The rule states that for every percentage point the real interest rate is below 2 percent, gold returns 8 percent year-on-year times that multiple. So if real rates were 4 percent, then gold would decline by 16 percent. If real interest rates were 0 percent, then gold would rise by 16 percent. This rule has held true for over 40 years. Figure 12.6 shows the very tight correlation between real interest rates and the price of gold.

As we write this, gold has fallen over 30 percent from the highs it reached in the summer of 2011. It is worth asking whether the bull market in gold is over. Many investors have been spooked by the fall in the gold price.
Within less than a year, traders have gone from being wildly optimistic about gold’s potential to incredibly negative. Speculators are now shorting gold futures. However, while gold futures have fallen, the demand for physical gold has been extremely strong. According to GFMS in its 2012 “Gold Survey,” net official central bank gold purchases were the highest in almost 50 years. Many emerging-market countries have been doubling their gold holdings. Also, all across the world, even as gold futures fell, buyers of physical gold hoarded gold coins and bars. Almost all government mints ran out of coins. Many investors are confused — what are they to think about these conflicting developments?

“The bottom line is that as long as real interest rates are negative, gold will continue to go up. If we had to bet, we would say it is highly likely gold will keep appreciating. Central bankers...” (CONTINUED)
have already told us they plan to keep real interest rates negative for the foreseeable future. As our friend Christopher Wood at CLSA has written, “Central banks worldwide continue to compete to become even more unconventional. Under such a scenario, gold is indeed the purest form of ‘money' available, not contaminated by the current fiat paper system.”

His target for the price of gold in a few years is $3,500. Before you shudder, consider that Wood is one of the most highly regarded macro strategists, and he was far ahead of everyone in warning about the subprime and banking crises, before any central bankers even knew what a subprime mortgage was.

**Gold has gone down, but nothing goes up in a straight line. Even big bubbles where prices went up over 10 times in a decade had major corrections.** For example, the Nasdaq went from 400 to 5,000 in the 1990s. However, in 1998, it declined almost 40 percent before then rising almost five times. You can see that in **Figure 12.8**.

Another bubble that had an almost 40 percent correction was oil when it declined from $80 in 2006 to $50 in 2007. Everyone thought the bull market in oil was over, but it then rallied from $50 to $148. It is highly likely gold has had a major, significant correction that will lead to a bigger boom ahead. Gold will probably be like Nasdaq in 1998 and oil in 2006.