

# Why Gold, Why Now

The disturbing trends affecting your financial future



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The ABCs of Gold Investing

How to Protect and Build Your Wealth With Gold

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# Why Gold, Why Now?

## Ominous bail, rescue print operations

"[E]normous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects. For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself."

-- Warren Buffett

Some might believe that we have reached a culmination of sorts for the financial crisis that began in 2008 and that from here things are going to get better. This study draws the opposite conclusion. The bail, rescue and print formula being employed by the federal government and central bank today is simply a continuation of policies that brought about the crisis in the first place. Only now, as you are about to read, they are being conducted on a far grander scale. The repercussions, I might add, are likely to arrive on a far grander scale as well.

From time to time I update this Disturbing Trends table which first appeared in my book, *The ABCs of Gold Investing: How to Protect and Build Your Wealth with Gold* (1997, 2004). The table's purpose is to isolate and monitor key economic data that have had an impact on gold demand in the past, and likely to affect it (and investor psychology) in the future. I use 1970 as a start date because that was the year just before the United

### Disturbing Trends

Item	1970	Present	Change
Population (a)	205 million	304 million	+48%
Median Income (b) [Annual, individual]	\$9,867.00	\$50,223.00	+509%
Fed Interest paid (d)	\$198.60	\$3,118.00	+1,570%
Fed Expenditures (c) [Annual]	\$16.20	\$412.00	+2,543%
Accumulated Fed Debt (e)	\$380.90	\$11,950.00	+3,137%
Additional to national debt (f) [one year]	\$14.40	\$1,826.00	+12,681%
Fed Debt Held by Foreigners (g)	\$12.40	\$3,267.00	+26,347%
Trade Deficit (g)	Balanced	\$696.00	
Consumer Price Index (h)	\$37.80	\$215.00	+569%
Adjusted monetary Base (i)	\$63.00	\$1,702.00	+2701%
Over-the-Counter Derivatives Positions [1995] (j)	\$47,530.00	\$592,000.00	+1,246%
Purchasing Power of Dollar (k)	\$1.00	\$0.17	-82.50%
DJIA (l)	744.1	9,310	+1,251%
Gold (m)	\$36.02	\$955.00	+2,651%
DJIA (one year thru 8/31/09)	11,517	9,310	-19.2%
Gold (one year thru 8/31/03)	\$822.00	\$955.00	+16.1%

Monetary figures in billions and rounded except as indicated. (a), (b) U.S. Census Bureau, (c) U.S. Department of Commerce [8/09], (d), (e), (f) U.S. Treasury Department [9/08], (g) St. Louis Federal Reserve, [12/08], (h), (k) Bureau of Labor Statistics, [5/09] (i) St. Louis Federal Reserve, [7/09], (j) Bank for International Settlements, [12/08], (l) (m) through 8/31/09

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States officially detached the dollar from gold and launched the new era of fiat currencies -- the era in which we still find ourselves today. From 1971 on, the monetary system behaved differently than it had under the gold standard. Simultaneously, individual investors began to include gold in their portfolio planning as a defense against the profligate policies that they feared would follow. As such, 1971 serves as something of a demarcation point for students of the contemporary gold market.

The numbers in the table above speak for themselves and do not require a great deal of embellishment. They describe a monetary and financial system in crisis. I last researched and prepared this table in 2007. Much has changed over the past two years, and I could not help but note that the numbers had begun to take on a distinctly Weimar-like\* feel.

- Foreign-held debt up 26,347%.
- One-year addition to the national debt up 12,681%.
- Adjusted monetary base up 2701%.
- A \$12 trillion national debt.
- \$592 trillion in derivatives positions.
- A nearly \$700 billion trade deficit.
- And, last but not least, a currency that has depreciated by 82%.

At the end of each one of those examples I could have added ". . .and counting!" This is not the kind of report card that generates a great deal of faith, or even sympathy, but rather some nagging questions about how it all happened.

Disturbing Trends is simultaneously one of the least and most popular pieces I have written. Whenever it is updated, I get numerous requests for reprint. I also get complaints about its bleak view of the future. As the saying goes though, the turtle never got anywhere by keeping his head in his shell. Likewise, today's saver/investor stands a greater chance of staying out of harm's way by understanding the problem rather than ignoring it. So bleak though this study may be, it also serves a positive purpose as an unambiguous call to action.

Please keep in mind that the first wave of investors who reacted to these Disturbing Trends paid in the \$300 per ounce range for their gold. These early buyers have emerged from the latest round in the on-going financial crisis with their wealth intact (assuming they achieved the recommended 10% to 30% diversification). Also, be aware that *none* of the conditions that induced those initial purchases has changed, except that they have decidedly worsened.

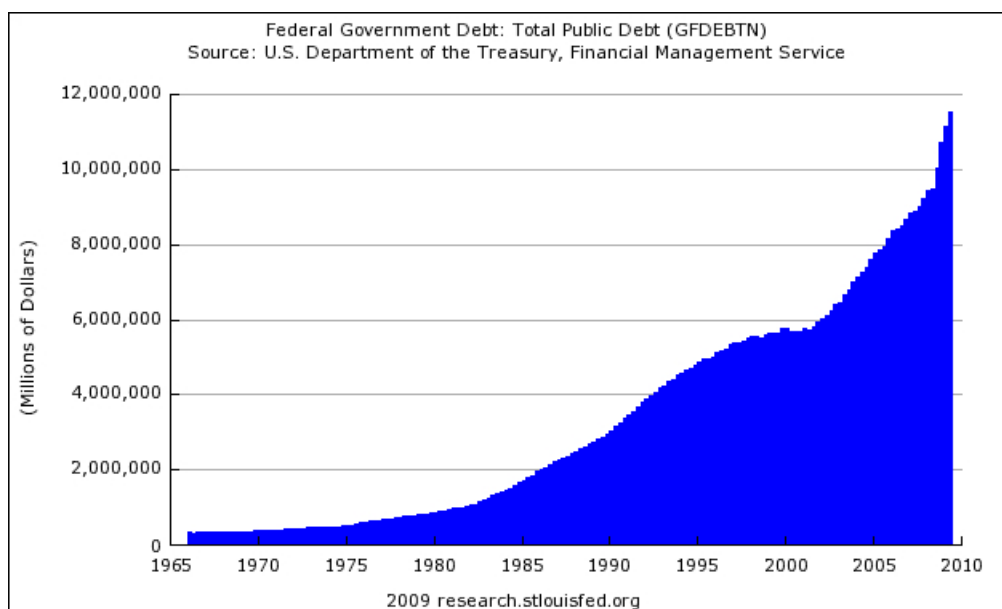
\*The Nightmare German Inflation (Weimar Republic, 1922-1923): "The many parallels between 1924 Germany and present-day United States are cause for concern. Though the U.S. has not yet reached the depths to which Germany descended in that era, few can look at the constant depreciation of the dollar since the early 1970's and fail to be alarmed. It seems contemporary America differs from 1924 Germany only in the duration between cause and effect. While the German experience was compressed over a few short years, the effects of the American inflation have been more drawn out."

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## Disturbing Trend #1

### The Alarming Growth of the U.S. National Debt

The federal government's fiscal year ends in September 2010 and, by that time, \$2 trillion will have been added to the national debt over the past 12 months -- the biggest jump in history and nearly four times the largest annual debt addition during the Bush years. It is not just the nominal growth that's alarming. (The national debt now exceeds the \$12 trillion mark -- almost \$40,000 per citizen, or \$160,000 for a family of four.) It is the rate of growth that has economists sitting on the edge of their chairs. The wars in Afghanistan and Iraq and rapidly increasing social spending had already taken their toll, but when the credit crisis hit, the federal government put the pedal to the metal. When you factor in the potential costs of the new national healthcare plan, we could see the deficit go into hyperdrive. The debt clock now ticks nonstop at the rate of nearly \$5.5 billion per day. The last time we published this study it was running at \$1.3 billion per day.



**Conclusion:** President Franklin Delano Roosevelt famously proclaimed that we shouldn't worry about the deficits because we owe them to ourselves. If the government pays interest, he said, we pay it to ourselves. There was a time when that argument might have held water, though to characterize government debt as benign is a bit specious. Things have changed. First, we no longer owe it just to ourselves. We owe nearly \$3.5 trillion of it to foreign creditors, primarily China and Japan. Second, the effect of the national debt is far from benign. It is the primary driving force behind higher taxes, inflation and the depreciating dollar. The Obama administration has predicted annual deficits of \$1 trillion per year for the coming decade. However, the "political" deficit, to which the president refers, is a piece of accounting fiction that includes borrowings from the social security fund. The real deficit is the actual yearly addition to the national debt, and for fiscal year 2009 that number went over the \$2

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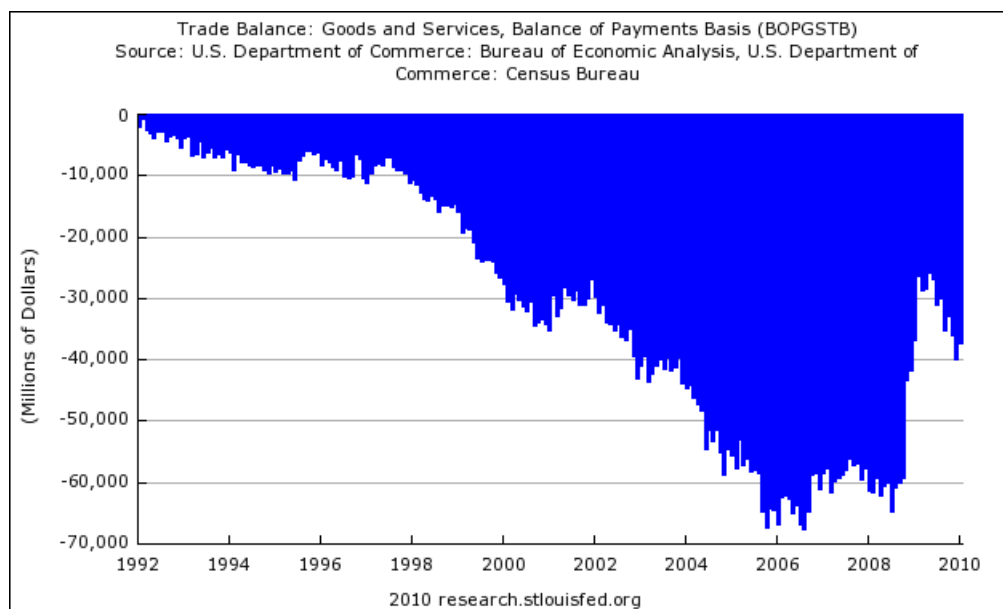
trillion mark -- an astonishing addition to the national debt load. Political deficits can be as much as half to one-third the real deficits. It is the *real* deficit, however, that inflicts *real* damage in the world of international finance.

**Recommendation:** Learn to live with the federal deficits and all that they portend. We aren't going to see a balanced budget anytime soon. When you blanch at the \$50 to \$75 it takes to fill your gas tank and suffer food prices running through the roof, think about the federal debt. When Congress inevitably raises the income tax, or the Federal Reserve prints money, think about the federal debt. When you hear about the dollar plummeting on foreign exchange markets, think about the federal debt. It is perhaps the most insidious, entrenched and debilitating of the disturbing trends threatening the nation and our economic well-being, and it isn't going to go away anytime soon.

### Disturbing Trend #2

#### The Alarming Growth of the Trade Deficit

U.S. exports and imports were roughly in balance in 1970. In 1992, the trade deficit ballooned to \$36.5 billion. By 1995, it had grown to \$105 billion. By 2000, it had mushroomed to the then-incredible \$378 billion. By 2008, the U.S. was importing \$700 billion more than it exported, thus surpassing even the most pessimistic expectations. Needless to say, this progression is not an encouraging trend. Few can remember the last time the United States ran a trade surplus (which was 1975), or a time when the United States did not rely on foreign suppliers for a long list of strategic materials including, most notably, oil. The United States now imports 60% of the oil it consumes, and oil, in turn, accounts for almost 15% of total U.S. imports.



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**Conclusion:** For a short time in 2009, it looked as if we might get a bit of reprieve on the rapidly deteriorating U.S. trade deficit. That turned out to be wishful thinking. When July's numbers came out, they showed the trade deficit surging by 16.3% over the previous month. Gold responded by pushing over the \$1000 mark and the dollar went into something of a tailspin. What had been a lone bright spot in the economic picture had suddenly been eclipsed by the old problem of America importing far more than it was exporting. That situation is unlikely to reverse itself anytime soon. Exporting nations have too much to lose by altering the current quid pro quo, and the United States is unlikely to effectively address its dependence on foreign oil and manufactured goods.

**Recommendation:** Expect the dollar to continue its seesaw, unpredictable performance. Occasionally it will show signs of strength against other currencies, but the long-term trend has been, and most likely will continue to be, steady depreciation against goods and services. If you have decided to reduce debt and bolster your savings, make sure you understand the danger inherent in saving only in the local currency. Be constantly aware of the real rate of return -- yield minus taxes and inflation. If your real rate of return is in the negative, your wealth is eroding even though your statements show a nominal gain.

### Disturbing Trend #3

#### The Explosive Growth of Derivatives

In 1995, the first year the Bank for International Settlements reported on derivative positions, their notional value was roughly \$47.5 trillion -- a somewhat manageable figure given what was to follow. "Notional" value is the face value of the private contracts between counterparties. This is in contrast to "at risk" value when one counterparty defaults on the contract. By 2006, the notional value had risen to \$415 trillion -- a nearly 875% increase. Today, derivative positions amount to \$592 trillion -- a staggering number posted after the spate of derivatives-based meltdowns in the financial sector. One would think that by now the ardor for derivatives might have dissipated, but it hasn't. When Lehman Brothers, Bear-Stearns and AIG collapsed, derivatives were largely to blame and the government and Federal Reserve stepped in with a more than \$13 trillion system-wide capital injection to keep the financial structure from collapsing. In order to give this statistic a degree of meaning, it nearly equals the \$14 trillion annual U.S. GDP (Gross Domestic Product).

**Conclusion:** Goldman Sachs chief executive Lloyd Blankfein once addressed the derivatives problem in the context of the general social welfare. "The industry," he said, "let the growth and complexity in new instruments outstrip their economic and social utility as well as the operational capacity to manage them." Mere mortals, it would seem, simply do not understand derivatives let alone how to properly apply them in every day use -- a point we emphasized in the 2007 issue of *Why Gold, Why Now*. Mr.

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Blankfein's contrition aside, it is important to keep in mind that the derivatives problem didn't go away when the credit crisis faded from financial page headlines. Financial engineering is alive and well on Wall Street, its practitioners believing that past failures were more a problem having to do with insufficient computer software and incomplete modeling platforms than the unpredictability of human nature. As long as that's the case, the dangers presented by derivatives trading will remain a major threat to the stability of the financial system.

**Recommendation:** When the Financial Times reported that some aspects of the financial crisis in Greece had its antecedents in derivatives deals with major U.S. investment banks, it drove home the message that we are hardly out of the woods when it comes to the relationship between derivatives trading and systemic breakdown. It was said that similar derivatives trading practices might surface in other European nation states, thus compounding the effect and creating an atmosphere of political and economic tension among European Union members. Concern runs heavy that more derivatives-related problems are likely to surface in Europe and elsewhere, ultimately creating a contagion effect that could fuel the next round of the on-going financial crisis. Derivatives remain a sword of Damocles hanging over the international financial system, and the polar opposite of gold coin and bullion ownership. Be acutely aware both of your own exposure (direct or indirect) to another derivatives' meltdown and the systemic risks they imply.

### Disturbing Trend #4

#### Foreign-Held Debt May Have Hit a Wall. What's Next?

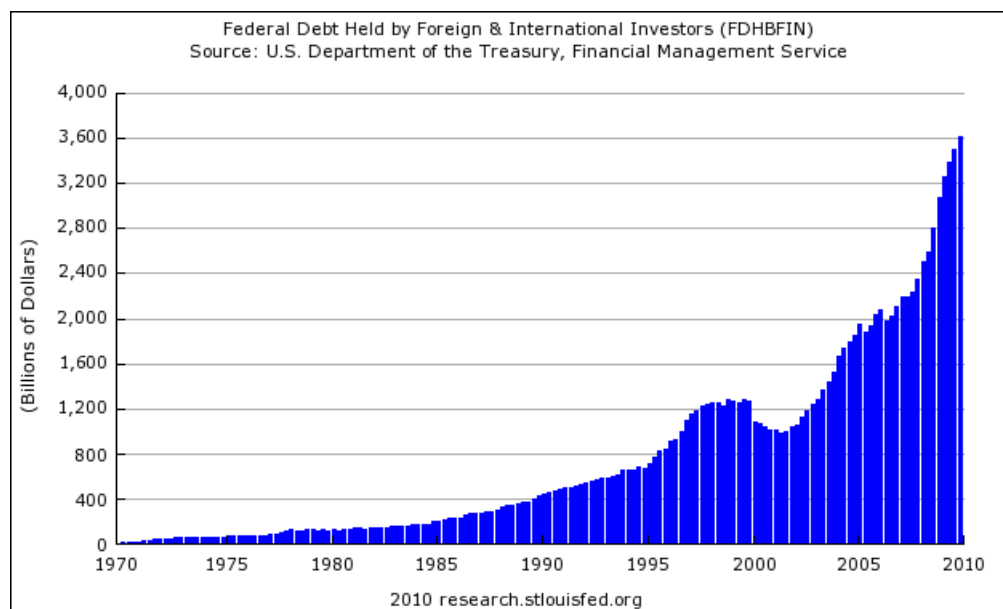
"If they [the United States] keep printing money to buy bonds, it will lead to inflation, and after a year or two the dollar will fall hard. Most of our foreign reserves are in US bonds and this is very difficult to change, so we will diversify incremental reserves into euros, yen, and other currencies."

- Cheng Siwei, former vice-chairman, China's Standing Committee

By 2009, the U.S. debt held by foreign investors and banks stood at just over \$3.25 trillion. The total has more than doubled in five short years, and tripled since 2001. Much of that increase has been shouldered by China which went from holding \$77.5 billion held in U.S. Treasuries in 2002 to an astronomical \$727 billion by the end of 2008. Similarly Japan went from \$381 billion in 2002 to \$616 billion in 2008. Over the past three years, and here is where things begin to get interesting, Japan, Uncle Sam's number two creditor, and Great Britain, number three, have either leveled, or reduced their overall commitments. China, for its part, has become very nervous about its dollar holdings and has repeatedly vocalized those concerns over the past few years. Recently it committed to purchasing \$50 billion in new International Monetary Fund paper as a diversification out of the dollar. It also has stated through various government and central bank spokesmen that it has a keen interest in buying gold whenever and wherever possible, as well as other national currencies, as Cheng Siwei warns in the quote

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above. In recent months, the void left by the Big Three (China, Japan and Great Britain) at U.S. Treasury auctions has been made up largely by the oil exporters as a group and the Caribbean banking centers which house the international processing operations for major banks and hedge funds. Though growth is likely to continue for the Caribbean banking centers, no one is looking to them as a replacement for the Big Three holders of U.S. debt. The oil exporters have by and large expressed concerns identical to those of China and have traditionally taken a cautious approach.



**Conclusion:** Trends proceed until they flatten out and finally reverse themselves. Foreign-held debt is the first of our disturbing trends to actually show signs of flattening. Americans will find little solace in such a transition simply because it represents the support mechanism at the heart of the dollar-based monetary system. Take it away and economic chaos might ensue. Watch for the term "dollar flight" to become a part of the financial vernacular. It is doubtful that the nation-states with large dollar reserves will suddenly start dumping the dollar. More likely, they will either reduce or completely halt their purchases of U.S. Treasuries and turn instead, as China has done, to other acquisitions -- most notably key, strategic commodities. That withdrawal would leave the U.S. with two options: It would be forced to finance the red ink either by covering its debt internally or by resorting to the printing press under the auspices of the ubiquitous Federal Reserve.

**Recommendation:** It was no great surprise when the Fed in 2008 announced a new policy to purchase \$300 billion of U.S. Treasury securities in the open market. Such purchases are known in the modern economic parlance as quantitative easing, but in the end they amount to simply printing money which the government then distributes

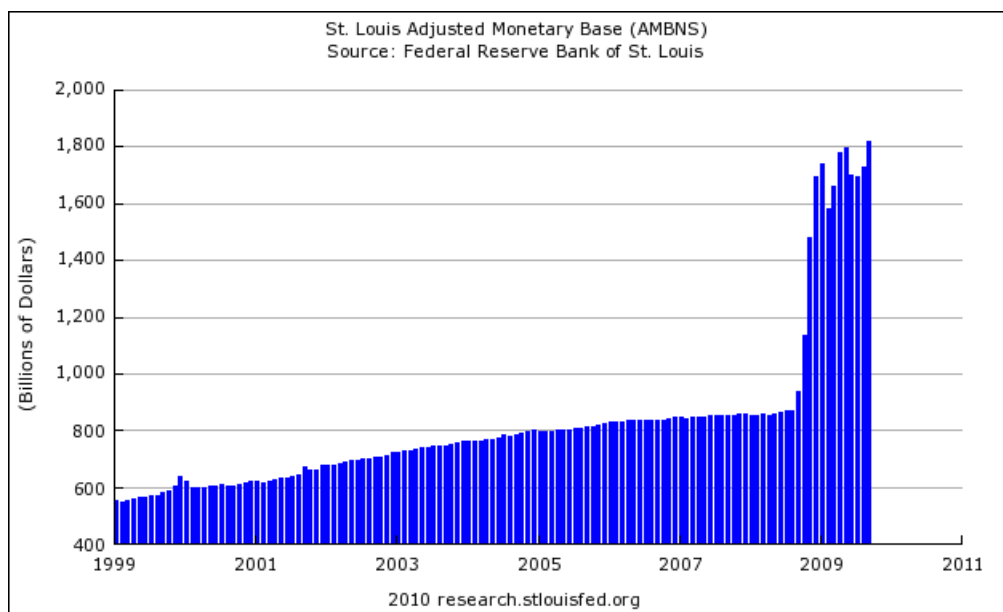
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through the course of its ordinary business. History has shown the correlation between deficits, printing money and inflation to be sacrosanct. Thus the pronouncements by Cheng Siwei featured above are justified. Look for the culmination of one disturbing trend (growth in foreign-held debt) to potentially give birth to another (debt monetization/money printing). Prepare for the possibility of a 1970s-style runaway stagflation which, if it tilts out of control, could lead to more serious consequences. (See Disturbing Trend #6 below.)

### Disturbing Trend #5

#### Unprecedented Growth in The Adjusted Monetary Base

The adjusted monetary base comprises currency in circulation plus bank reserves held at the Federal Reserve. According to the St. Louis Federal Reserve, "the adjusted monetary base has been widely monitored as an indicator of Federal Reserve quantitative monetary policy actions since its introduction in 1968. The adjusted monetary base is a valuable indicator of the stance of monetary policy because extended periods of rapid growth of the monetary base have often preceded accelerations of inflation in the United States and other countries." The accompanying chart in this respect speaks loud and clear.



**Conclusion:** The extraordinary growth depicted on the chart for 2008 and 2009 is directly related to the bail, rescue and print operations carried out by the Federal Reserve. It is interesting to note that gold, which is generally considered the essential hedge against inflation, has appreciated almost exactly the same percentage as the adjusted monetary base since 1970 (See table, page 2). In the past, the Federal Reserve would control monetary growth by simply selling U.S. Treasuries from its portfolio. Under the Fed's quantitative easing program, all sorts of debt paper has been purchased

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for the Fed balance sheet, some with a dubious lineage and limited liquidity. As a result, contracting the money supply could turn out to be a much more difficult policy than expanding it. To make a long story short, much of the liquidity the Fed has created over the past two years may be rattling around the economy for a long time to come.

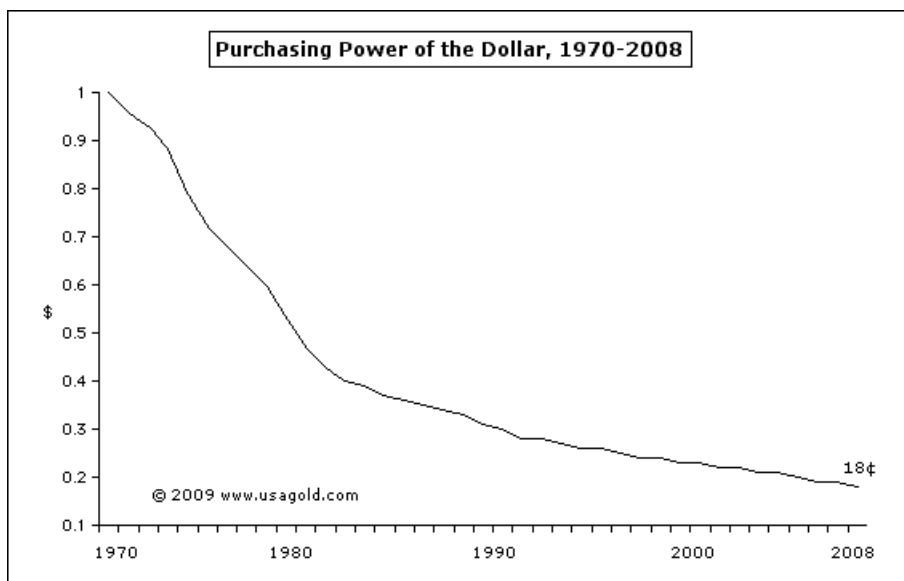
**Recommendation:** The Obama administration has already promised annual additions to the national debt of one trillion or more over the next decade. Also, the Federal Reserve under the chairmanship of Ben Bernanke is likely to continue its "accommodative" policy. Should another financial crisis emerge; and it is quite possible under the present circumstances, the Fed is likely to react as it has in the past with massive doses of credit and liquidity. Gold, if the correlation holds and I don't see any reason why it wouldn't, would likely trend much higher, not necessarily in tandem with adjusted monetary base, but over time. Monitor the monetary base for signs of where gold might be headed in the years to come.

(Available at [http://www.usagold.com/reference/monetary\\_data.html](http://www.usagold.com/reference/monetary_data.html))

### Disturbing Trend #6

#### The Long-Term Decline of the U.S. Dollar

The cumulative effect of the five disturbing trends outlined here has been to undermine the purchasing power of the dollar. Since 1971 when the United States severed the tie between gold and the dollar, the greenback has lost 82% of its purchasing power. The 1971 dollar, in other words, is worth 18¢. Put another way, what the consumer could purchase for a dollar in 1971 now costs \$5.54, and still another way if you earned \$50,000 in 1971, you would have needed to earn \$277,000 in 2009 just to keep pace with inflation.



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**Conclusion:** Dollar debasement has become as American as baseball and the Big Mac -- a fact of life with which each of us lives with on a daily basis. Keep in mind too that these figures are based on the Bureau of Labor Consumer Price Index -- a measuring stick the reliability of which has come under question in recent years. Shadow Government Statistics, for example, gauges the consumer inflation rate at a little under twice the BLS rate *using the same criteria the government utilized in 1990*. Needless to say, the long-term decline of the dollar represents probably the most troubling of our disturbing trends because currency depreciation can be technically infinite, or proceed until a final breakdown occurs. John Williams, the statistician who heads Shadow Government Statistics, voices a concern held by many:

"The U.S. economy is in an intensifying inflationary recession that eventually will evolve into a hyperinflationary great depression. Hyperinflation could be experienced as early as 2010, if not before, and likely no more than a decade down the road. . . The U.S. has no way of avoiding a financial Armageddon. Bankrupt sovereign states most commonly use the currency printing press as a solution to not having enough money to cover their obligations. The alternative would be for the U.S. to renege on its existing debt and obligations, a solution for modern sovereign states rarely seen outside of governments overthrown in revolution, and a solution with no happier ending than simply printing the needed money. With the creation of massive amounts of new fiat (not backed by gold) dollars will come the eventual complete collapse of the value of the U.S. dollar and related dollar-denominated paper assets."

**Recommendation:** Note that Williams is not predicting an outright hyperinflation, he warns of an "inflationary recession" evolving to a "hyperinflationary depression." Recent economic breakdowns -- Argentina, the Asian tiger economies and more recently in Zimbabwe -- hint that Williams might not be too far from the truth. When fiat money economies break down, inflationary and deflationary tendencies blend producing what appear to be conflicting symptoms. As someone once said, it doesn't matter the color of the cat. Black or white, it still catches the mouse. Similarly, your investment portfolio isn't going to care how economists describe the malady which undermines its value. In the end, when your financial history is written, the only thing that will matter is whether or not you acted to protect your assets.

### Final Note

#### Why Gold? Why Now?

One of the more intriguing line items in the Disturbing Trends table (See page 2) is the comparison between the stock market and gold since 1970. The Dow Jones Industrial Average is up 1251% over the period (ending August, 2009), and gold 2651%.

**Conclusion:** Those who took their cue from this study in years past and purchased

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gold have been amply rewarded. When *The ABCs of Gold Investing* and the original version of this study first hit the bookstores in 1997, gold hovered in the \$300 range. It has been in a steady upward pull ever since. As of this update, it has already surpassed the \$1000 mark on two occasions and, in recent months, stayed stubbornly above the \$1000 mark. In short, those who own gold have emerged from the economic meltdown relatively unscathed. Gold preserves wealth and remains as serviceable today for the average investor as it did when this study first made its appearance nearly fifteen years ago. Price is a secondary consideration when the real goal is to acquire portfolio insurance. The price might be higher now than it was in 1997, but the need is the same. Richard Russell, the dean of investment advisors, puts it succinctly: "I still sleep better at night knowing that I hold some gold. If or when everything else falls apart, gold will still be unquestioned wealth."

**Recommendation:** To protect your wealth, whatever its magnitude, buy gold coins and bullion for asset preservation purposes through a reputable gold brokerage-one that has a history of client service over a good many years.

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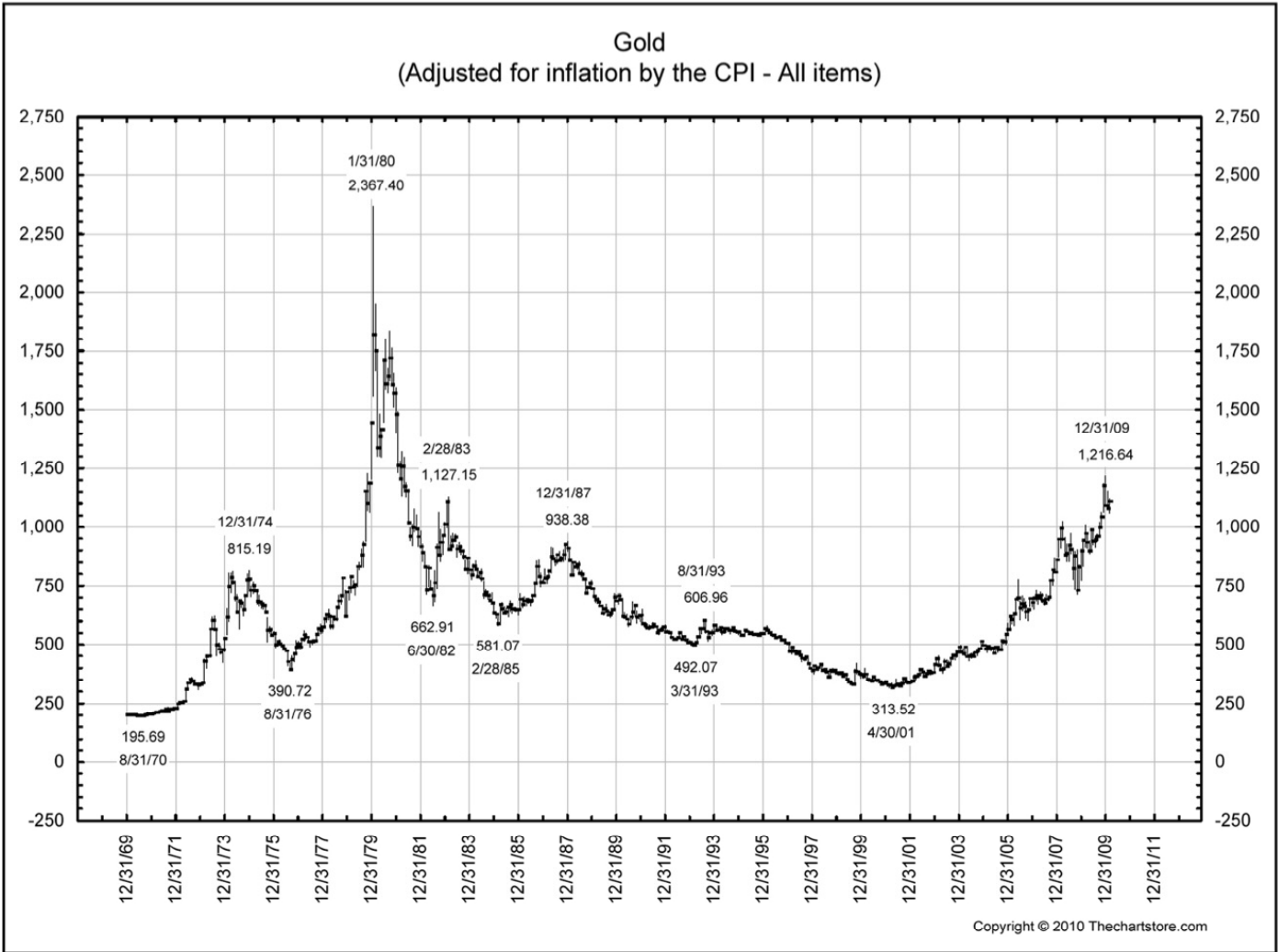
## Appendix - Key Long-Term Charts



This chart shows gold's price performance from 1970 to present. In 1971, the United States abandoned the Bretton Woods Agreement, devalued the dollar against gold and freed the dollar to float against world currencies. The United States would no longer honor the dollar as a fixed weight of gold in international transactions. Declaring "We are all Keynesians now," President Richard Nixon set the United States on a new economic course ushering in the era of fiat money.

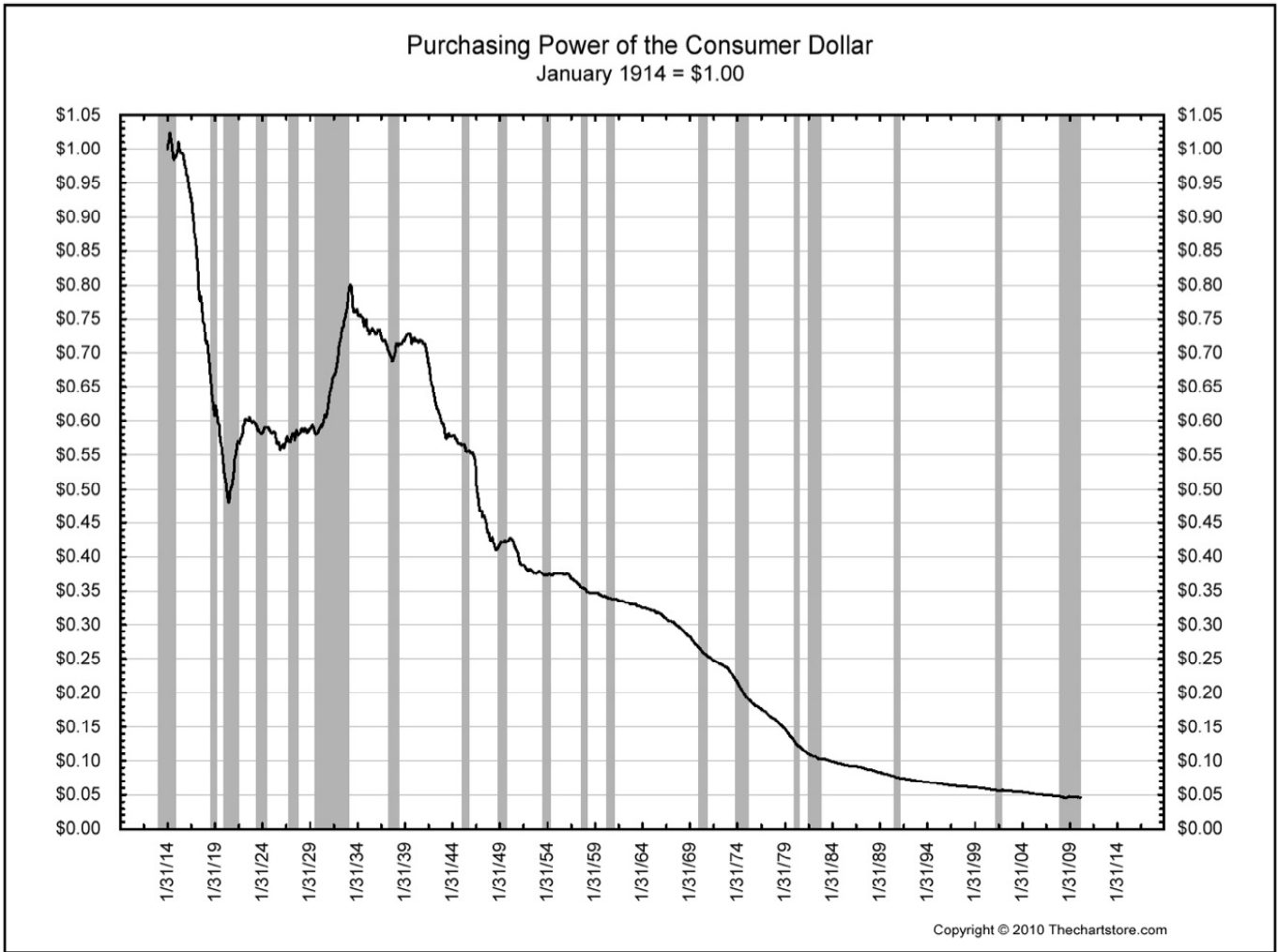
The case for gold ownership in the modern era rests on an important principle: In the absence of a gold standard, there is no discipline on the issue of paper money. As a result, individuals would be well-served to put themselves on the gold standard through the ownership of gold coins and bullion. This chart is a visual testament of gold's reaction to the Nixon administration's choice, and to the direct tie between the unrestricted issuance of money and the gold price over the long term.

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This chart is widely cited as an indicator where the price of gold could be going in the years ahead. By adjusting historic prices to growth in the consumer price index, the viewer is presented with a picture of where the price of gold would have been at various times, taking into account the rise in consumer prices. As you can see, if gold were to revisit its 1979-1980 peak, the price would need to reach \$2367. Please keep in mind that, during the significant price run-up of the 1970s, gold rose substantially over its inflation-adjusted price due to speculative interest. Though there may be corrections along the way, this chart serves as a handy reference for those interested in gold's upside potential.

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With the exception of the deflationary 1930s, the dollar has steadily declined in purchasing power since the founding of the Federal Reserve Bank in 1913. The 1913 dollar is now worth about 4¢. To put the same statistic another way, it now takes \$25 Federal Reserve Notes to purchase the same amount of goods it took one dollar to buy in 1913. Don't let the leveling in the trend line from 1980 to present fool you. It has more to do with the time span the chart covers than it does any meaningful change in direction. In fact, the 1980 dollar has lost more than two-thirds of its purchasing power over the last thirty years. As long as the United States government continues to spend beyond its means, run up debt and print money to cover it, the dollar is likely to continue losing purchasing power and gold is likely to continue its long-term rise.

(The grey bars indicate recessions/depressions.)

Appendix charts courtesy of the Thechartstore.com

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