Hedging the worst-case scenario

How gold performs in periods of deflation, disinflation, stagflation and hyperinflation

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The ABCs of Gold Investing

How to Protect and Build Your Wealth With Gold

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Introduction

> "The global economy is in crisis. . .This crisis is structural, not cyclical. . .Governments around the world are borrowing, printing and spending on an unprecedented scale to absorb the global excess capacity (and to prevent asset prices from deflating), but these measures cannot continue indefinitely. The structure of the global economy is unstable and unsustainable. A catastrophic economic breakdown may be unavoidable."
>
> -- Richard Duncan, chief economist, Blackhorse Asset Management

The economy has gotten progressively worse over the past three years and threatens, so says the popular consensus, to remain in poor health for some time to come. The most dangerous outcome for investors, however, is not that current conditions might persist; it is that they might decidedly worsen, along the lines noted economist Richard Duncan suggests above.

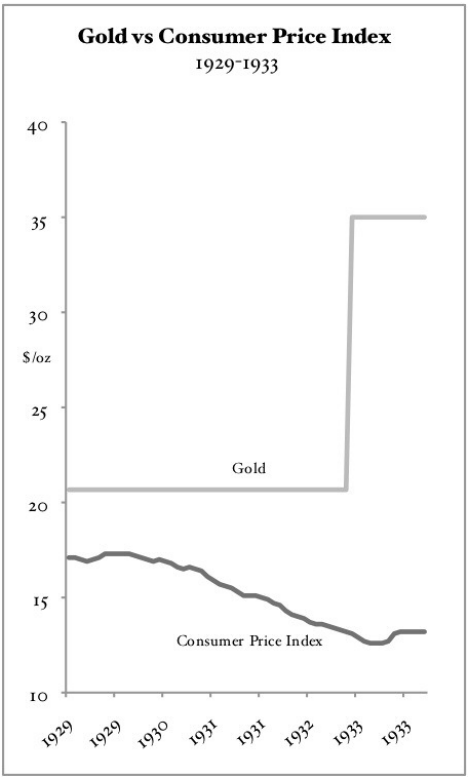
In recent months, the number of prospective gold owners contacting this firm about hedging a worst-case scenario has increased markedly. Most express a concern about either a deflationary or hyperinflationary breakdown, but these are not the only scenarios that could wreak havoc on the average portfolio. A runaway stagflation or severe disinflation could cause as much financial damage as either of their more infamous brethren.

This booklet examines how gold performed during past visitations of the four maladies just mentioned. If history is indeed the best teacher, the important lesson about gold coins and bullion being the most versatile and reliable store of value under a variety of breakdown scenarios will not be lost on the contemporary reader.

Gold as a deflation hedge

(United States, 1933)

Webster defines deflation as "a decline in the volume of available money and credit that results in a general decline in prices." Typically deflations occur in gold standard economies when the state is deprived of its ability to conduct bailouts, run deficits and print money. Characterized by high unemployment, bankruptcies, government austerity measures and bank runs, a deflationary economic environment is usually accompanied by a stock and bond market collapse and general financial panic -- an altogether unpleasant set of circumstances. The Great Depression of the 1930s serves as a workable example of the degree to which gold protects its owners under deflationary circumstances *in a gold standard economy*.



First, because the price of gold was fixed at $20.67 per ounce, it gained purchasing power as the general price level fell. Later, when the U.S. government raised the price of gold to $35 per ounce in an effort to reflate the economy by devaluing the dollar, gold gained even more purchasing power. The accompanying graph illustrates those gains, and the gap between consumer prices and the gold price.

Second, since gold acts as a stand-alone asset that is not another's liability, it played an effective store of value role for those who either converted a portion of their capital to gold bullion or

withdrew their savings from the banking system in the form of gold coins before the crisis struck. Those who did not have gold as part of their savings plan found themselves at the mercy of events when the stock market crashed and the banks closed their doors (many of which had been bankrupted overnight).

Economists who make the deflationary argument within the context of a fiat money economy usually use the analogy of the central bank "pushing on a string." It wants to inflate, but no matter how hard it tries the public refuses to borrow and spend. (If this all sounds familiar, it should. This is precisely the situation in which the Federal Reserve finds itself today.) In the end, so goes the deflationist argument, the central bank fails in its efforts and the economy rolls over from recession to a full-blown deflationary depression.

During a deflation, even one under a fiat money system, the general price level would be falling by definition. How the authorities might decide to treat gold under such circumstances is an open question. If subjected to price or currency-style controls, gold would likely perform the same function it did under the 1930's deflation as described above. It would gain in purchasing power as the price level fell. If free to float (the more likely scenario), the price would most likely rise as a result of increased demand from investors hedging systemic risks and financial market instability, as was the case globally during the 2008 financial sector meltdown.

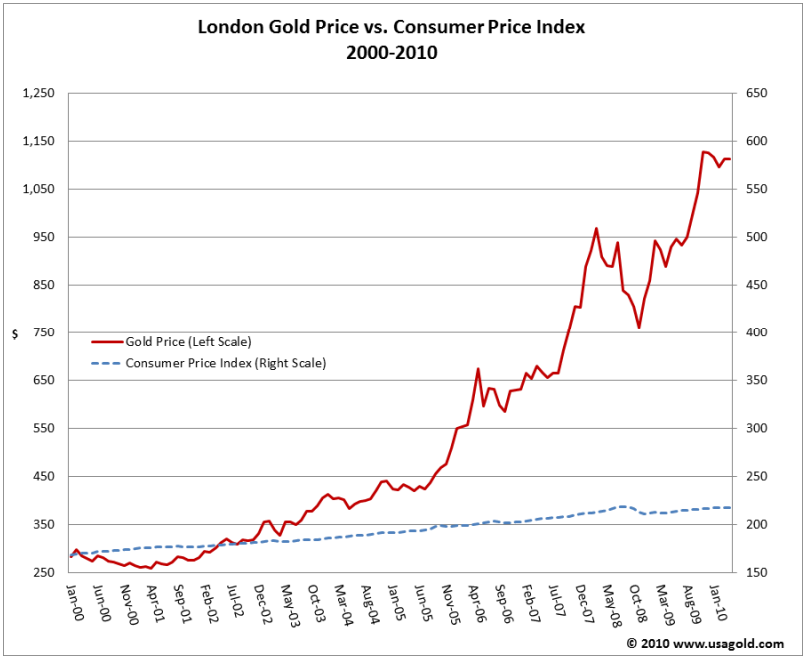
The disinflationary period leading up to and following the events of late 2008 (covered in the next section) serves as a good example of how the process just described might unfold. In terms of the effect on the average investment portfolio, the disinflationary economy is a close cousin to deflation. As a result, it provides some solid clues as to what we might expect from gold under a full deflationary breakdown.

Gold as a disinflation hedge

(United States, 2008)

Just as the 1970s reinforced gold's efficiency as a stagflation (combination of economic stagnation and inflation) hedge, the 2000's decade solidly established gold's credentials as a disinflation hedge. Disinflation is defined as a decrease in the inflation rate over time, and should not be confused with deflation, which is an actual drop in the price level. Disinflations, as pointed out above, are close cousins to deflations and can evolve to that if the central bank fails, for whatever reasons, in its stimulus program. Central banks today are activist by design. To think that a modern central bank would sit back during a disinflation and let the chips fall where they may is to misunderstand its role. It *will* attempt to stimulate the economy by one means or another. The only question is whether or not it will succeed.

Up until the "double oughts," the manual on gold read that it performed well under inflationary and deflationary circumstances, but not much else. However, as the decade of asset bubbles, financial institution failures, and



global systemic risk progressed, and gold continued its march to higher ground one year after the next, it became increasingly clear that the metal was capable of delivering the goods under disinflationary circumstances as well. The fact of the matter is that, during the 2000s even as the inflation rate remained relatively calm, gold managed to rise from just under $300 per ounce in January, 2000 and rise to well over $1000 per ounce by December, 2009 -- a rise of 333% over the ten-year period.

Following the collapses of Bear Stearns, AIG and Lehman Brothers in 2008, gold rose to record levels and firmly established itself in the public consciousness as perhaps the ultimate asset of last resort. As the economy flirted with a tumble into the deflationary abyss, it encouraged the kind of behavior among investors that one might have expected in the early days of a full deflationary breakdown with all the elements of a financial panic. Stocks tumbled. Banks teetered. Unemployment rose. Mortgages went into foreclosure. And so on.

In the process, gold came under accumulation by investors concerned with a major financial sector breakdown. In 2009, U.S. Gold Eagle sales broke all records, as investors clamored to protect themselves against a Wall Street calamity potentially on the scale of 1929. Gold demand was so strong that at one juncture bullion coins simply could not be purchased. The national mints globally could not keep up with demand.

As for price performance, in September, 2008 when the crisis began, gold was trading at the $750 level. As 2010 drew to a close, it crossed the $1400 mark as investors reacted to an announcement by the Federal Reserve that it would begin a second round of quantitative easing (i.e., money printing) to deal with the very same crisis that began in 2008. All in all, gold proved to be among the most reliable, if not the most reliable, of assets under very stubborn and trying disinflationary conditions.

Gold as a hyperinflation hedge

(France, 1790s)

Andrew Dickson White ends his classic historical essay on hyperinflation, "Fiat Money Inflation in France," with one of the more famous lines in economic literature: "There is a lesson in all this which it behooves every thinking man to ponder." The lesson that there is a connection between government over-issuance of paper money, inflation and the destruction of its citizens' savings has been routinely ignored in the modern era. Though politicians and their advisors talk the talk of fiscal and monetary prudence, they fail to walk the walk. So much so, that enlightened savers the world over wonder if public officials will ever learn the lessons drawn from the inflationary nightmares of the past.

White's essay tells the story of how good men -- with nothing but the noblest of intentions -- can drag a nation into monetary chaos in service to a political end. Still, there is something else in White's essay -- something perhaps even more profound. Democratic institutions, he reminds us, well-meaning though they might be, have a fateful, almost predestined inclination to print money when backed against the wall by unpleasant circumstances.

Episodes of hyperinflation ranging from the first (Ghenghis Khan's complete debasement of the very first paper currency) through the most recent (the debacle in Zimbabwe) all start modestly and progress almost quietly until something takes hold in the public consciousness that unleashes the pent-up price inflation with all its fury. Frederich Kessler, a Berkeley law professor who experienced the 1920's nightmare German Inflation firsthand, gave this description some years later during an interview published in Ralph Foster's book, "Fiat Paper Money: The History and Evolution of Our Currency" (2008):

> "It was horrible. Horrible! Like lightning it struck. No one was prepared. You cannot imagine the rapidity with which the whole thing happened. The shelves in the grocery stores were empty. You could buy nothing with your paper money."

Towards the end of "Fiat Money Inflation in France," White sketches the price performance of the roughly one-fifth ounce Louis d' Or gold coin during that infamous 1790s inflationary episode:

> "The louis d'or [a French gold coin .1867 net fine ounces] stood in the market as a monitor, noting each day, with unerring fidelity, the decline in value of the assignat; a monitor not to be bribed, not to be scared. As well might the National Convention try to bribe or scare away the polarity of the mariner's compass. On August 1, 1795, this gold louis of 25 francs was worth in paper, 920 francs; on September 1st, 1,200 francs; on November 1st, 2,600 francs; on December 1st, 3,050 francs. In February, 1796, it was worth 7,200 francs or one franc in gold was worth 288 francs in paper. Prices of all commodities went up nearly in proportion. . ."

That short paragraph speaks volumes of gold's safe-haven status during a hyperinflationary episode. The question becomes how likely is a hyperinflation in the United States today? According to an International Monetary Fund study by Stanley Fischer, Ratna Sahay and Carlos Veigh (2002), "the link with the French revolution supports the view that hyperinflations are modern phenomena related to printing paper money in order to finance large fiscal deficits caused by wars, revolutions, the end of empires and the establishment of new states."

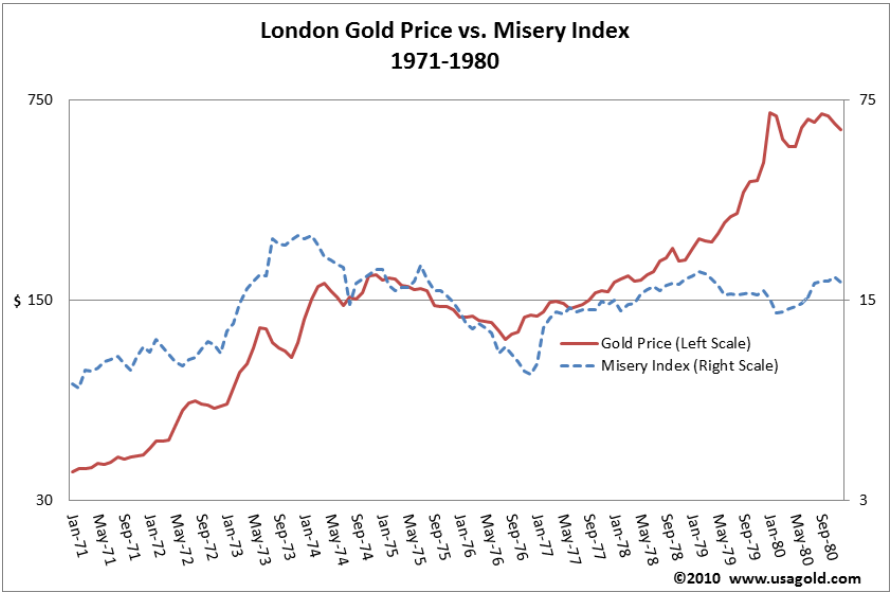
How many Americans would read those words without some degree of apprehension? In this era of free-wheeling quantitative easing as a palliative to uncontrolled fiscal deficits, hyperinflation cannot be ruled out, in fact, some analysts view it as inevitable.

Gold as a runaway stagflation hedge

(United States, 1970s)

In the contemporary global monetary system, when an economy goes into a major tailspin, both the unemployment and inflation rates tend to move higher in tandem. The word "stagflation" is a combination of the words "stagnation" and "inflation." To illustrate the effects of stagflation, President Ronald Reagan famously added unemployment and inflation together in describing the economy of the 1970s and called it the Misery Index. As the Misery Index moved higher throughout the decade so did the price of gold, as shown in the graph immediately below.

At a glance, the chart tells the story of gold as a runaway inflation/stagflation hedge. The Misery Index more than tripled in that ten-year period, but gold rose by nearly 16 times. Much of that rise has been attributed to pent-up pressure resulting from many years of price suppression during the gold standard years when gold was fixed by government mandate. Even after accounting for the fixed price, it would be difficult to argue that gold did not respond readily and directly to the Misery Index during the stagflationary



1970s. In fact by the end of that stagflationary episode, gold significantly outperformed the index.

In a certain sense, the U. S. experience in that period was the first of the runaway stagflationary breakdowns that have cropped up since the gold standard was abandoned in 1971. Argentina (late 1990s) comes to mind as another example, as does the Asian Contagion (1997), and Mexico (1986). In what could be considered probably the most extreme example of runaway stagflation on record, as of 2009 Zimbabwe's unemployment rate stood at 95% and its inflation rate measured an incredible 11.2 million per cent (late 2008). In each instance, as the Misery Index in those countries rose, the investor who took shelter in gold preserved his or her assets as the crisis moved with increasing urgency from one stage to the next.

Fortunately, the 1970's experience in the United States was relatively moderate by historical standards in that the situation fell short of dissolving into a runaway stagflationary nightmare -- a circumstance most attribute to the dollar's strategic role as the world's primary reserve currency. With that role now diminishing, any signs of the Misery Index returning to financial headlines should be greeted with a great deal of caution. The next runaway stagflation in the United States could flare out of control.

Even though some economists tend to view stagflation as a lesser event when compared to a depression or hyperinflation, it is difficult to classify stagflations of any size and duration as insignificant to the middle class. Few of us would gain comfort from the fact that the Misery Index we were experiencing failed to transcend the 100% per annum threshold or failed to escalate to a state of hyperinflation. On a practical level, just the specter of a double-digit Misery Index is enough to provoke some judicious portfolio hedging.

Gold: The ideal portfolio inclusion for the times

I would like to close with this thoughtful rationale for gold ownership from a UK parliamentarian, Sir Peter Tapsell. Delivered before the House of Commons in 1999, Tapsell spoke these words in opposition to then Chancellor of the Exchequer Gordon Brown's plan to liquidate a substantial portion of Britain's gold reserve:

> "The whole point about gold and the quality that makes it so special and almost mystical in its appeal, is that it is universal, eternal and almost indestructible. The Minister will agree that it is also beautiful. The most enduring brand slogan of all time is, 'As good as gold.' The scientists can clone sheep, and may soon be able to clone humans, but they are still a long way from being able to clone gold, although they have been trying to do so for 10,000 years. The Chancellor [Gordon Brown] may think that he has discovered a new Labour version of the alchemist's stone, but his dollars, yen and euros will not always glitter in a storm and they will never be mistaken for gold."

These words are profound. They capture the essential nature of gold ownership. His reference to "dollars, yen and euros" has to do with the British treasury's proposal to sell a significant portion of its gold reserve and convert the proceeds to "interest bearing" instruments denominated in those currencies. Though he was addressing gold's function with respect to the reserve of a nation-state, he could have just as easily been talking about gold's role for the private investor. Nation-states, in fact, look to derive the very same safeguards from gold that the private investor does.

Ultimately, the British government did sell over one-half its gold -- a policy which earned the description, Brown's Folly. Over the ensuing decade, gold went from $300 per ounce to over $1400 per ounce as the world economy moved through the first stages of a major financial breakdown. The "dollars, yen and euros" that the Bank of England received in place of the gold have only continued to erode in purchasing power while paying a negligible to

non-existent return. Most certainly they have not glittered in the storm nor were they mistaken for gold, as Sir Peter Tapsell predicted.

As for the seemingly endless argument over which of the four maladies described in this booklet is likely to occur next, gold renders that discussion purely academic, i.e., it protects against any and all of these economic calamities no matter their order of appearance. If we have learned anything at all from the past two years of economic upheaval, it should have been to expect the unexpected. Gold's utility, and *versatility*, as a safeguard against the range of breakdown scenarios, makes it perhaps the ideal portfolio inclusion for the times.

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