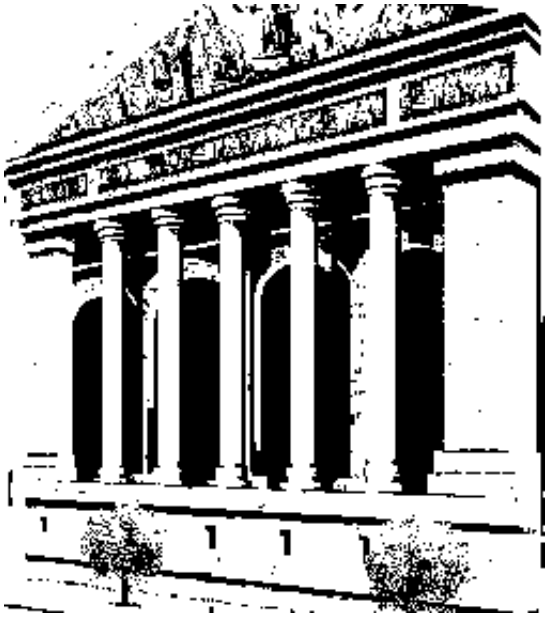

In Gold We Trust

James Grant on Gold

Includes
Charles DeGaulle's
"Gold Criterion Speech"

Foreword by Michael J. Kosares
The ABCs of Gold Investing: How to Protect and Build Your Wealth with Gold

Gold Classics Series

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Published by
USAGOLD-Centennial Precious Metals, Inc.
P.O. Box 460009
Denver, Colorado
80246-0009

1-800-869-5115

since 1973

Foreword

by Michael J. Kosares
Author of "The ABCs of Gold Investing: How to Protect and Build Your Wealth with Gold," President, USAGOLD - Centennial Precious Metals, Inc.

James Grant has long been viewed as one of Wall Street's most gifted commentators. Well-known for an incisive, cutting-edge view of the financial markets, his private investment letter, *Grant's Interest Rate Observer*, enjoys a wide following among some of the most sophisticated investors and fund managers in the world. In the following three essays (one is actually a speech) Grant tells why gold remains an important portfolio holding for the modern investor. From the fiscal consequences of the struggle in Iraq and terrorism to monetary instability (inflation, hyperinflation, disinflation, deflation, et al) as the legacy of the "pure paper standard system," Grant skillfully makes the case for gold ownership in the 21st century,

Gold, Grant says, is not an everyday speculation like cotton, soybeans, copper or even the stock market, but a bulwark against unpleasant and unforeseen developments--a precious metal that acts as a hedge and insurance for the holder. Therefore, it should be a part of every portfolio. In this group of essays, he breathes new life into the old maxim "In Gold We Trust" and tells *why* probably better than anyone on the contemporary scene.

In the keystone essay in this series, *Where We Came In*, Grant takes us through the modern history of gold and how it has performed in past war economies -- economies which usually spawn an inflationary consequence. Toward the end, he invokes the Last Great Frenchman, Charles DeGaulle, whose attachment to gold is the stuff of legend. DeGaulle believed that gold should play the same role for nation states that it does for individuals, i.e., as the ultimate asset of last resort. To supplement Grant's argument,we include DeGaulle's famous Gold Criterion Speech as a final note to the essay.

So, what is it about gold that allows it to faithfully serve this function as a safety net?

"Only gold," says Grant, "is beautiful to look at and not replicable on a high-speed printing press."

All the gold ever mined (a 60 foot cube) could fit comfortably within the baseball diamond at Grant's native Yankee stadium *and* with plenty of room to spare. The U.S. gold reserve, the largest in the world, would fill not even half a tennis court and carries a roughly $100 billion value at $400 per ounce--that against a more than $7 trillion national debt and another estimated $45 trillion in future social security and other generational debt obligations.

The Federal Reserve estimates that it cost roughly $300 to produce an ounce of gold on the average. Conversely, printed with the right number of zeros, an ounce of paper dollars could amount to millions, even billions -- as anyone who has has ever examined a worthless pile of 1924 German marks would readily attest -- and cost next to nothing to produce. Though Americans have yet to drain their savings accounts to buy a cup of coffee (as actually happened in 1924 Germany) few, once the consequences are understood, can watch the current trends in public finance and the trade imbalances without concern.

"There are many differences between physics and economics," he says, "but the greatest of these is that particles aren't people. Participating in a monetary system, clever people will exploit the rules in such a way as eventually to bring the system down. The system in place subsidizes and encourages risk taking and borrowing. Accordingly, leveraged financial structures and colossal debts abound. The gold standard failed by reason of its structure (perceived as rigid). The pure paper standard is failing on account of its lack of structure. Anticipating the end of the dominance of the paper dollar, we have cast around for an alternative. The answer we keep coming up with is the one you already know."

When taken as a whole, the three essays you are about to read comprise the thinking man's rationale for gold ownership. We will now move aside and allow Mr. Grant make the case for gold ownership as only he can.

GRANT'S
INTEREST RATE OBSERVER
Two Wall Street, New York, New York 10005 • www.grantspub.com

For Real Money

First published, Winter, 2001

So accommodating is Alan Greenspan that the federal funds rate is lower than the inflation rate. Growth in the broad money supply is running strong, and bond yields are head and shoulders above bill rates. Wartime fiscal policy is beginning to be put in place.

A gold price of less than $290 an ounce in such a world speaks volumes about gold: It remains orphaned and marginalized. Such a price is similarly expressive about the world. Recent surveys have found that more Americans trust their government than at any time since 1966. Monetary polls, conducted daily at the Comex division of the New York Mercantile Exchange, find that savers overwhelmingly trust the government's money.

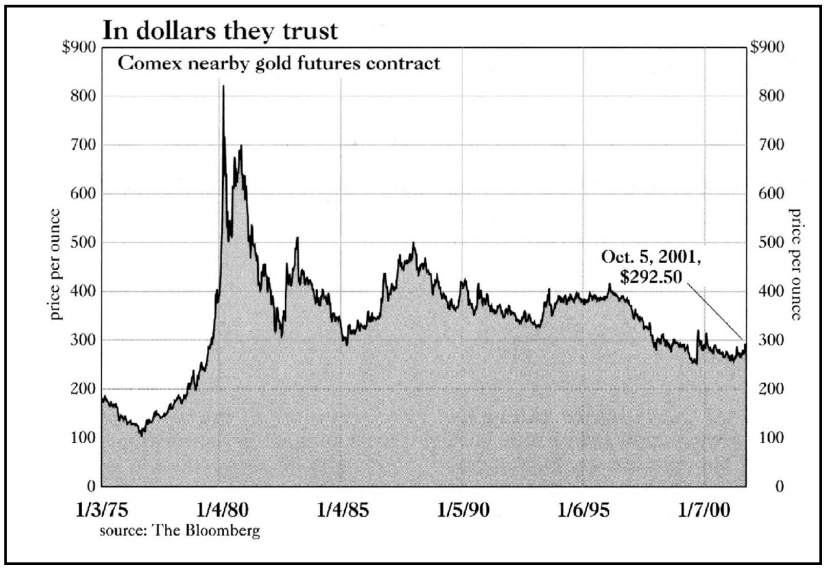
Grant's now embarks on a return trip to the land of gold, with emphasis on the monetary and interest-rate attractions (and the interesting views of Jean-Marie Eveillard, surviving gold-stock portfolio manager). In preview--constant readers won't believe their eyes--we are bullish. The Fed is ramping up the pace of credit creation, the dollar exchange rate is hostage to continued foreign devotion to U.S. financial assets and the fiscal position of the U.S. government has, overnight, gone from ostensibly perfect to visibly imperfect.

As proposed elsewhere in these pages, a new bull market in risk aversion is under way. An economy so indebted as this one may prove hard to stimulate through monetary means, which boil down to the creation of credit on top of credit. However, the confluence of recession, war and bear market may cause dollar holders to take precautionary measures. They should, in our opinion.

Grant's was bullish on gold long before Al Qaeda started getting its name in the papers, and we were bullish for the right reasons. Regrettably, the right reasons were just as unprofitable as the wrong reasons. In the mid- and late-1990s, the U.S. economy was growing and the stock market was booming and consumer price inflation was only creeping. For these blessings, the Federal Reserve was popularly credited. Unique were the chairman's powers of foresight, many said. Doubting this, we advocated some diversification out of dollars. Following the roll-up of the European currencies, only four basic monetary alternatives present themselves: euros, yen, Swiss francs, gold. Of these, only gold is beautiful to look at and not replicable on a high-speed printing press.

For the longest time in America, what could go right, did. Then the stock market peaked, the economy went into reverse and the dollar exchange rate weakened. All of these changes in trend antedated September 11. The bear-market low in the gold price, $253.20 per ounce, was set in July 1999.

The succinct bull argument for gold today is that, for the first time in a quarter-century, all the world's major economies are in recession together. Trying to lift them out of it, governments and



central banks will err on the side of doing too much. The question before the gold market, the bond market and every other pit, bourse and exchange on earth is whether the anticipated intervention will have the intended elevating effect. August Arace, longtime monetary observer, likens the central banks' efforts to the act of pouring water into a sieve. Riddled with debts, says Arace, the financial system no longer retains liquidity. We concede that this might be correct. However, we believe there would be an investment role for gold even in a leaky, or deflationary, world.

Like any other government regulator, the Fed can fix the supply or the price of the commodity it regulates, but not both at once. It has elected to fix the price, i.e., the interest rate. So choosing, it has relinquished direct control over the size and growth of its balance sheet. Whatever the supply of funds required to impose its target rate, that is the supply provided. The Fed creates new dollars through a variety of methods: by buying securities, extending loans, acquiring foreign currency, tolerating increases in the volume of float in the banking system. Each method adds credit where none had existed. Central banking is the ultimate in scalable businesses. No extra increment of production is needed to supply an extra infusion of credit.

In conditions distinctly suboptimal, the Fed created upwards of $90 billion at the tail end of the banking week ended September 12. The other major central banks performed similar stimulatory feats, a coordinated effort that, according to the Financial Times, forestalled a global financial panic. Whatever else this intervention accomplished, it provoked a question: If paper money is so easily duplicated, what is it worth?

Down through history, the answer has usually been, "less and less." It is easy to forget that the modern monetary system is unique. Not until the early 1970s were all the currencies of all the major financial centers simultaneously unanchored--i.e., undefined as a measure of gold or silver. The U.S. stopped exchanging dollars for gold at $35 per ounce in 1971. Most observers would judge the subsequent 30-year experiment in paper money and all its political apparatus, including the partial socialization of credit risk, to be an unqualified success. We have no such confidence, observing, to start with, that no monetary system of any description since the 1880s has remained intact for more than a generation. All met their maker: the international gold standard (1880-1914), the gold exchange standard (c. 1920-44) and Bretton Woods (1945-71). What mainly distinguishes the current system from its gold-based predecessors is its lack of structure. This flexibility has sustained it through periodic crises while serving to foster the conditions that contribute to new crises.

Contradictions, imbalances and wars closed out the histories of earlier systems. Whereas the war on terrorism may not swing much monetary weight, there are contradictions and imbalances galore in 2001. Under the pure paper standard, the world has piled up unprecedented debts, including the cumulating U.S. external deficit. Sustaining the confidence of lenders and borrowers has been the U.S. government's alacrity to hang wallpaper over financial cracks.

The handiest wallpaper index is the Fed's own balance sheet. Just as in the private sector, this document consists of assets and liabilities (you can read it, form H.4.1, every Thursday at 4:30 p.m., Eastern time, at the Fed's Web site, www.federal reserve.gov). Assets comprise government securities, loans, foreign exchange and float. Liabilities are mainly currency and reserve accounts, i.e., the dollars deposited by banks to satisfy legal requirements. The sum total of the Fed's assets is known as Reserve Bank credit, or Fed credit.

Currency plus bank reserves is called the monetary base. The faster the growth of these magnitudes, other things being the same, the more inflationary the Fed's policy.

Other things are frequently not the same because the Fed only proposes. It does not unilaterally dispose. It sends monetary signals to banks, consumers, government-sponsored enterprises and financial markets, foreign and domestic. However, the power of these impulses depends on the capacity of the market to receive and act on them. Debts clog the markets' receptors.

It is worthwhile to consider what the Fed does and how it does it. To start, we can imagine a world without banks and central banks. In this unspoiled place, what we call the federal funds rate would be set in the open. It would be determined by the demand for savings in relation to the supply of savings. Savings are money. The best definition for money we know is contained in a Laura Ingalls Wilder book (the title escapes us at the moment). Money, says a farmer or other non-economist, is distilled work.

Now introduce banks and central banks. Complexities ensue. No longer is the rate set by savings alone. It is significantly influenced by the demand for, and supply of, credit. Credit is not money. It is the promise to pay money. Because credit is easily created, the federal funds rate can be easily manipulated.

The Fed takes the lead in credit creation, and therefore in money-market manipulation. It manipulates the funds rate by varying the pace at which it creates credit (and by playing with the mind of the market, which is another story). Sometimes the interest rate imposed is too high, higher than it would be in the absence of intervention. At other times, the rate is too low, lower than it would be if it were set in a free market for savings. In the collective opinion of a nation of debtors, lower is better. When the Fed creates enough credit to push the funds rate below what might be called the natural rate, a train of expansionary events begins. Low interest rates induce more lending and borrowing than would otherwise take place. They promote a steeper yield curve than would otherwise obtain. They lead to higher money supply growth, and bigger profits for banks and brokerage houses, than would occur in a state of nature.

Consult the graph that plots the funds rate vs. the growth of the monetary base. To impose a high interest rate, the Fed prints less money; to make a low rate stick, more. In 1993, the central plan-

ners at the central bank targeted a 3% funds rate. You will remember that the banking system had had a brush with disaster between the late 1980s and the early 1990s. The 1990-91 recession was mild, but recovery was slow to materialize. To hasten the upturn, the Fed acted. The track of its credit creation is visible in the growth of its balance sheet, up by more than 10% in 1993. It was no coincidence, we think, that the gold price also climbed, to more than $400 an ounce in July from less than $330 in March. At last report, the monetary base was growing by 8.1% (thank you, Fred D. Kalkstein). On form, more credit will be needed to push the funds rate to 21/2% and keep it there. How much more will depend on the demand for credit in a weak, and weakening, world economy. Whatever the volume, the Fed can be expected to furnish it.

Possibly, the Fed today faces the Japanese predicament of striking a match but lighting no fire. The residue of the great American boom includes heavy debts and surplus production capacity. Even before September 11, it featured mounting risk aversion. In Japan, ultra-low interest rates and heavy-handed credit creation elicited no pickup in monetary growth and no substantial economic recovery. The Japanese banking system is incapacitated.

No such paralysis characterizes the U.S. banking system, and a partly socialized mortgage market continues to churn out immense volumes of paper. Altogether, we think, the Fed is pushing on something more than a string. If so, a very low funds rate will be established only with a potentially inflationary volume of central bank credit. Observing this operation, worldwide dollar holders may begin to hedge their exposures. And if they give the matter their undivided attention, they may conclude that it is wise to diversify outside of the handful of currencies that, like the dollar, are under the management of governments and central banks determined to fend off recession at any price. Thinking these thoughts, they may lay in a few tons of gold.

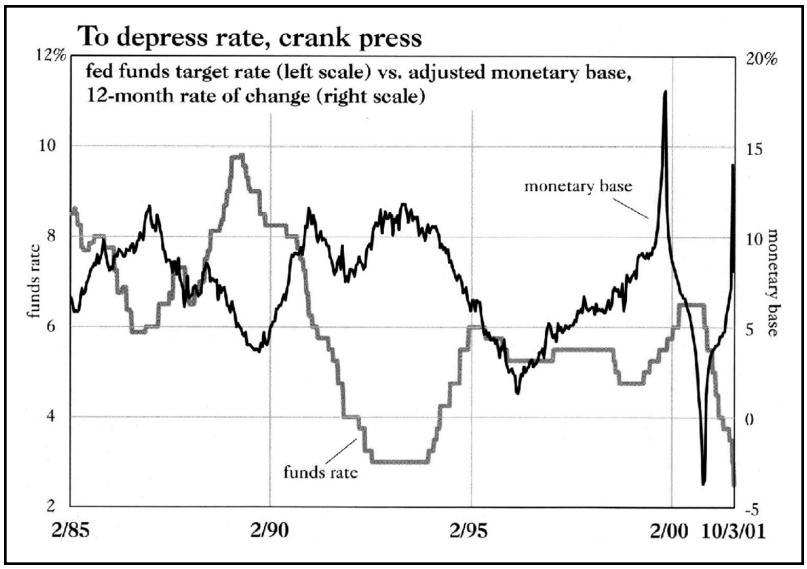
The last issue of Grant's presented a bullish argument for the Treasury's inflation-protected securities (TIPS). No inflation forecast accompanied the analysis because none seemed necessary. We contended that TIPS were cheap precisely because CPI inflation was dormant. Noting that TIPS were priced to reflect an implicit CPI inflation forecast of 1.6% a year for the next 10 years, we observed that, since 1970, the CPI has never come in at less than 1.9% (on a three-year, five-year or 10-year rolling basis). At the price, we concluded, TIPS were a bargain. Two weeks later, they are a bigger bargain, with a break-even inflation rate on the 10-year maturity of 1.4%.

Gold, a harder analytical nut than TIPS, has no earning capacity, yield or maturity date. There's no margin of safety in even a very low gold price: Who's to say it can't go lower? Gold is money. It was an inferior kind of money, people judged when the new economy was new, as it occupied physical space and reliably depreciated against interest-bearing paper. The up-and-coming generation of central bankers couldn't figure out how so much of it got into their vaults in the first place. They were more than willing to lend the dust-gathering ingots to those who, like mining companies, would turn around and sell them. Sellers borrowed gold, paying a lease rate of, say, 11/2%. They invested the proceeds of the sales in money-market instruments at, say, 4%. As long as the borrowing cost was lower than the investment yield, the gold-selling business prospered. More and more mining companies turned to mining interest rates.

Rising equity prices brought forth a mutual fund industry. Falling gold prices conjured a gold short-selling industry (bullion banks, mining companies, central banks and their minions). Bullishness is institutionalized in the stock market, bearishness in the gold market.

We believe that a new gold bull market is under way. We observe--in our capacity as a global authority on bearishness--that the gold price seems to be climbing a wall of worry. "Worry," in this case, is the belief that the inflation rate is on its way to zero, or less. "Even before The Attack," counseled ISI on Monday, "inflation had started to plunge. The consumption price deflator over six months through August had increased at only a 0.6% annual rate, a record low! Now, after The Attack, there have been waves of price cuts, e.g., hotels, airfares and autos. In addition, the GSCI has declined at a record pace over the past 15 trading days, and DRAM prices have declined another 7.3% over the past two weeks. Even wages are being cut in a few instances. Perhaps stimulative policies and/or dollar weakness will lift inflation in 2003, but for 2002, inflation is likely to be much lower than expected and deflation is a possibility."

However, a sinking price level would stymie consumption, impair creditworthiness, retard corporate profit growth and (as we suppose) shrink P/E multiples, low Treasury yields notwithstanding. Not a small source of the dollar bull market has been the sense that Alan Greenspan could improve the future before it came to pass. The onset of deflation would prove that monetary



policy had lost its effectiveness, to say nothing of its foresight.

Gold, although it tends to appeal to conservative investors, defies conservative appraisal methods. Not only does conventional security analysis not apply, but neither does conventional commodity analysis. Every year, more gold is demanded than is dug out of the ground, but the deficit is readily filled by sales of aboveground stocks. Central banks obligingly lend what the market needs.

The plunge in short-term interest rates has had two (not one) bullish effects on the gold market. First, it has reduced the opportunity cost of holding a sterile asset. Second, it has lowered the profit in forward selling. The cost of borrowing gold hasn't changed, observes John Doody, editor of the monthly *Gold Stock Analyst*. It's still in the vicinity of 1% to 2%. What has moved adversely is the other critical portion of the interest-rate equation. The rate at which a seller can invest has slumped to 3% or so in the wake of the Fed's massive easing. A differential of only one or two percentage points between the cost of borrowing and the yield on investment, Doody notes, is too small to justify "the price risk from selling gold short or going long bonds that could give a higher return." Interest-rate mining is today a business in decline.

These bullish developments have not gone unnoticed in the shrunken gold investment community. Commodity funds are said to own as much of the metal as they prudently can. Market Vane, which monitors speculative sentiment, recently found that more than 70% of the advisers it polls are bullish. In another sign of the times, the October issue of Doody's newsletter identifies four overpriced mining stocks (Agnico-Eagle, Glamis, Goldcorp, Meridian). "Investors are either playing them as momentum stocks," Doody writes disapprovingly, "betting someone will pay a higher price tomorrow, or they're thinking the ongoing industry consolidation will see these miners gobbled up. GSA views the former [as] a variation of the 'greater fool' theory of investing that doomed the dot.com players, and the latter [as] very unlikely, as the high current stock prices of all four make it impossible for any to be acquired and be accretive to the buyer."

Value investors must swallow hard to buy this asset without a cash flow, as pretty as it is. They must swallow just as hard to buy the stocks of the mining companies, valued as most of them are at Nasdaq-like multiples. Jean-Marie Eveillard, who manages what has become a very small gold stock mutual fund, is one such value investor. Eveillard is the portfolio manager of a handful of funds worth a cumulative $2.3 billion, of which the largest is the First Eagle SoGen Global Fund. The smallest, at $13 million, is the First Eagle SoGen Gold Fund. At its peak, it was worth $50 million.

"We had considered shutting the [gold] fund in the spring and summer of 1998," Eveillard tells colleague Jay Diamond. "I started making some public noises to the effect that. . . maybe I should write a letter to every shareholder apologizing and suggesting they move on. I think what I found most disappointing was that, in 1993, when I started the fund, I thought the downside was limited." In that year, as UBS Warburg points out, mine production totaled 2,291 tons, about 1,000 tons less than aggregate demand. Such a gap should have been more than adequate to support the price, Eveillard reasoned, but he reasoned without 464 tons of net official liquidation, 116 tons of forward sales and 576 tons of previously owned bullion, or scrap. "That imbalance was more than made up for," Eveillard reflects.

"And then in the fall of 1998," he goes on, "there was the Russian crisis and the bailout of Long-Term Capital Management, and I said, 'I'm not going to shut this fund down if the financial system is so fragile that the Federal Reserve has to arrange the bailout of a hedge fund.' So we didn't."

In the year through Friday, Eveillard's gold fund was up by 37%; in the past two weeks, an additional $1 million was subscribed to it. Though not quite yet the Magellan Fund, First Eagle has won a stay of execution. "And also, Eveillard says, "I have warmed up to the idea of an insurance policy. For a while it was hard to put this idea across, because who needs insurance if the business cycle has been abolished? But now--the bubble

A short history of gold
(in tonnes)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(e)
Mine Production	2237	2291	2282	2276	2361	2479	2538	2568	2575	2393
Old Gold Scrap	488	576	647	625	641	629	4097	636	611	612
Hedging	174	116	163	535	125	472	97	306	- 10	100
Net Offical Sales	622	464	81	173	275	376	374	464	471	500
Total Supply	3521	3447	3143	3609	3402	3956	7106	4154	3645	3807
Fabrication Demand	3206	3041	3074	3294	3336	3905	3725	3745	3738	3740
Identified Bar Hoarding	282	162	231	306	182	323	173	240	198	200
Total Demand	3488	3203	3305	3600	3518	4228	3898	3985	3936	3940
Average Gold Price	$344	$360	$384	$384	$388	$331	$294	$279	$279	$267

has burst, the American economy has weakened, the events of September 11--the argument for an insurance policy is stronger."

On September 12, we are reminded by Robert J.A. Irwin, chairman of ASA Ltd., the Bank of England hammered down 20 tons of gold in its regular bi-monthly auction. The winning bid was $280 an ounce, which betrayed no flight out of dollars, either panicky or calculated. Hours later, with still less panic in the air, the price was back to $276.

Eveillard, who has just launched a U.S. value fund, would assuredly not touch some of the companies in his mining portfolio if they did anything else for a living but mine gold. "The shares of gold mining securities are very seldom, if ever, cheap in traditional terms," he notes. "Because the price of gold has been so low and the cost of taking gold out of the ground has been quite high, the margins are low. The companies are barely profitable, so you are looking at high multiples on depressed profits.

"Newmont, Gold Fields, Harmony," he goes on, ticking off the names of some of his portfolio companies. "There are weaknesses there. Some of those weaknesses would become strengths if the price of gold were to have a sustained rise. For instance, the fact that there is quite a bit of debt on the balance sheet of Newmont Mining would help the price of the stock if the price of gold were to sustain a rise."

Some contend that the gold price is under the thumb of a conspiracy led by governments and their tools. Exponents of this doctrine assert that a gold price significantly higher than the one now prevailing would be as a stench in the nostrils of the world monetary establishment. It would constitute an indictment of the monetary policy of the leading central banks and a threat to the stock-market economy of the United States. It is for these reasons, the argument continues, that the conspirators have suppressed the price through forward sales, covert and overt. For Eveillard (as for Grant's), the allegations are unproven. However, says Eveillard, ruling out nothing, such a scheme could not succeed in the long run. The London Gold Pool was established by central banks to hold the line at $35 an ounce during the dollar crises of the 1960s. By 1968, it had surrendered to the forces of supply and demand. In the 1970s, the U.S. government and the International Monetary Fund tried again to cap a rising gold price. The only cap imposed was the blow-off top made in January 1980, at $850 an ounce.

"What continues to puzzle me," Eveillard reflects, "is that even though central banks acknowledge freely that now and then they intervene in foreign exchange, why do they not acknowledge that they probably intervene in the gold market?" Sitting as they do on 30,000 tons, Eveillard goes on, the central banks undoubtedly have their ways to influence gold-price dynamics--"not to push the price down, but to keep it going up sharply and quickly." He adds that he is not upset by this because, when the time is right, the price will go where it will. Market forces will overwhelm any new gold pool, "and central banks don't want to be in a position of saying they are down to their last few thousand ounces."

When Eveillard started his fund in 1993, the gold bear market was already 13 years old. Little did he (or, for that matter, we) imagine that the downtrend would achieve the New York state drinking age. Many we know would be happy if the bear market lasted for another 21 years, as gold, in their view, is the relic of an ignorant age. Shortly after passage of the Gold Standard Act of 1900, which defined the dollar as a weight of bullion ($20.67 to the ounce), the British Association for the Advancement of Science convened in Glasgow. The scientists listened to one of their colleagues discuss the question, "Are atoms real entities?" The learned speaker held up as ideas of equivalent merit (a) the atomic theory of matter and (b) the theory of the existence of ether (an "all-pervading subtle medium").

One century later, physical science has definitively chosen atoms over ether and seems unlikely to change its mind. No such progress can be traced in monetary theory. Whereas many would regard the close of the gold standard as a triumph of modernity over superstition, at least one Nobel Prize winner in economics, Robert Mundell, has taken the other side of the argument.

There are many differences between physics and economics, but the greatest of these is that particles aren't people. Participating in a monetary system, clever people will exploit the rules in such a way as eventually to bring the system down. The system in place subsidizes and encourages risk taking and borrowing. Accordingly, leveraged financial structures and colossal debts abound. The gold standard failed by reason of its structure (perceived as rigid). The pure paper standard is failing on account of its lack of structure.

Anticipating the end of the dominance of the paper dollar, we have cast around for an alternative. The answer we keep coming up with is the one you already know. •••

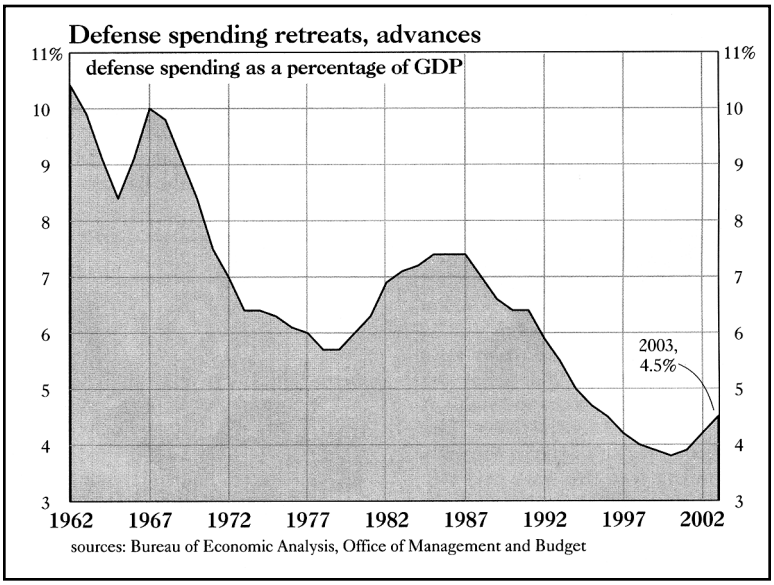
Where We Came In

First published in April, 2004

Every loyal Republican is enjoined from comparing the wars in Vietnam and Iraq, because, it is said, there is nothing to compare. However, the arbiters of Republican thought reckon without finance. In 1965, as in 2004, interest rates were low, the dollar exchange rate was under pressure and fiscal policy was stimulative. And then, as now, signs of inflation went mainly unheeded by a nation long accustomed to stable consumer prices. After Vietnam came the Great Inflation of the 1970s and the towering interest rates of the early 1980s. Now unfolding is an apolitical exploration of the potential financial and economic consequences of the struggle in Iraq.

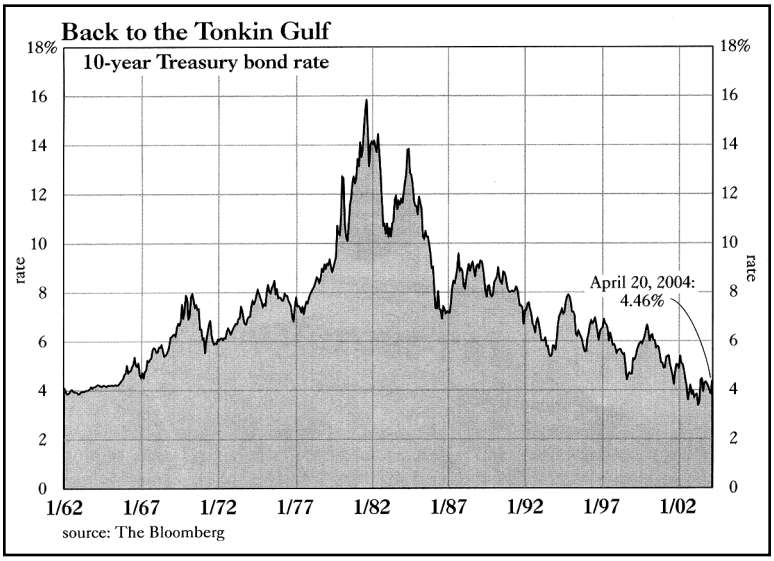
Just or unjust, wars cost money. Usually, the money is printed. Much of the money to finance the operations in Iraq is printed, but with a twist. At the margin, the central banks running the presses belong to America's Asian creditors, not to the Federal Reserve. The Iraq operation is unusual in several respects. It is, for openers, the first American war in a century to be waged in a mainly deregulated financial environment. And it is the first American war since the Revolution to be waged with foreign capital accounting for a significant portion of overall government borrowing. What these facts may mean for interest rates, the dollar and inflation is the subject under discussion.

If a time-traveling bond trader were transported back to 1965, he or she would recognize the prices and yields, if not the faces and institutions. The benchmark Treasury issue in the early Vietnam era was the 4 1/4s of 1992. However, there was no financial futures market, no securitized mortgage market, no swaps market and no CNBC. Pending the invention of the Bloomberg terminal, buyers and sellers of fixed-income securities derived prices and yields from basis books preserved on clay tablets.



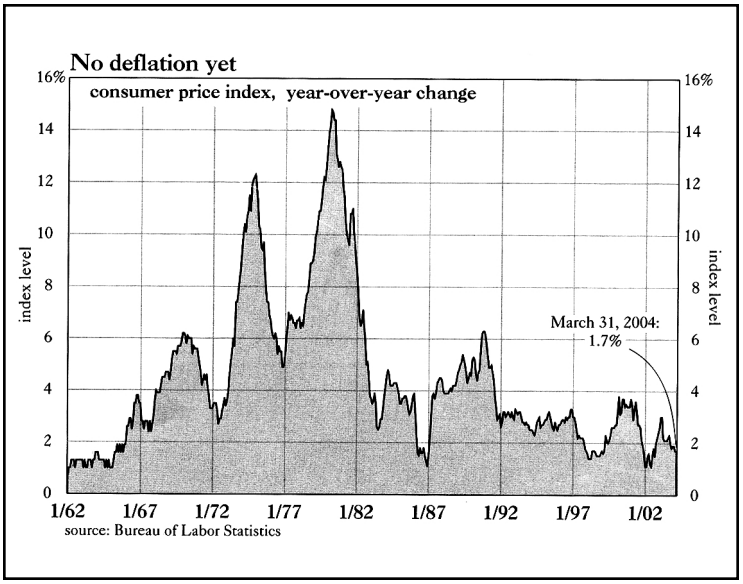
In the mid-1960s, American finance was organized under two great principles, each of which tended to check the production of dollars and the extension of credit. The first was the idea of convertibility. On demand, a foreign holder of dollars could present $35 to the U.S. Treasury and receive an ounce of gold. By this convention, growth in the stock of money was constrained by the growth in the stock of collateral behind it.

The second great organizing principle of the mid-1960's was the Legacy of Sorrow. Regulated like public utilities, banks were denied the power to set deposit rates or enter into the securities business or open branches across state lines. They had had these privileges in the 1920's, had abused them and had landed the country in, or near, the Great Depression. The regulatory apparatus in place was the one devised in the 1930's to save capitalism from the capitalists and the depositors from the bankers.



The powers denied the banks were ceded to the central bank. Not only did the Fed control open-market rates, but it also set deposit rates. By pushing the former above the latter, it could--and, in 1966, did--drain the savings banks of incremental deposits. It thereby deflated the housing market and slowed the national economy. The banking system was the dog at the end of the Fed's leash. On command, it would sit up, shake hands or play dead.

American finance at the millennium is organized under a pair of contrary principles. First, that the dollar is convertible into nothing. Like every other currency in the world, the greenback is faith-based. Second, that the banking business is a business like any other: It should be free to evolve as the market directs. If the consequence of this regulatory laissez-faire is that J.P. Morgan Chase winds up with $36.8 trillion in notional



value of derivatives contracts and 1.5 million separate and distinct securities positions with 240,000 different pricing series (as it did at the end of the fourth quarter), so be it.

The close of World War II approximately marks the beginning of a generational bear market in bonds. It spanned 1946 to 1981, or from 21/4% to 15% at the long end of the government yield curve. The Gulf of Tonkin incident exactly marks the beginning of the final phase of that protracted washout. In August 1964, in separate actions, U.S. destroyers reportedly clashed with North Vietnamese vessels in international waters. In that month, the CPI was rising by only 1% a year. The federal funds rate was quoted at 31/2%— except for a one-month wonder (a 3.29% reading in February 1972), it would be the lowest funds rate until 1992. The 10-year Treasury was quoted at 4.19%—it would be the lowest 10- year yield until 2002. The U.S.S. Maddox and U.S.S. Turner Joy may or may not have been in harm's way, but the bond market took a significant hit below the water line.

The U.S. invaded Iraq in March 2003. U.S. bond yields made their lows three months later, in June, with the 10- year Treasury quoted at 3.11%. It's a fair bet, we believe, that that yield will stand as the lowest for many years to come—that a long-term bond bear market got under way around the time of the fall of Baghdad. It was a coincidence that the Gulf of Tonkin incident marked a long-term low in U.S. interest rates, and it would be a double coincidence if the opening phase of the Iraq war marked a second major low in U.S. interest rates. But behind the coincidences (actual and potential), there is a possible train of causation.

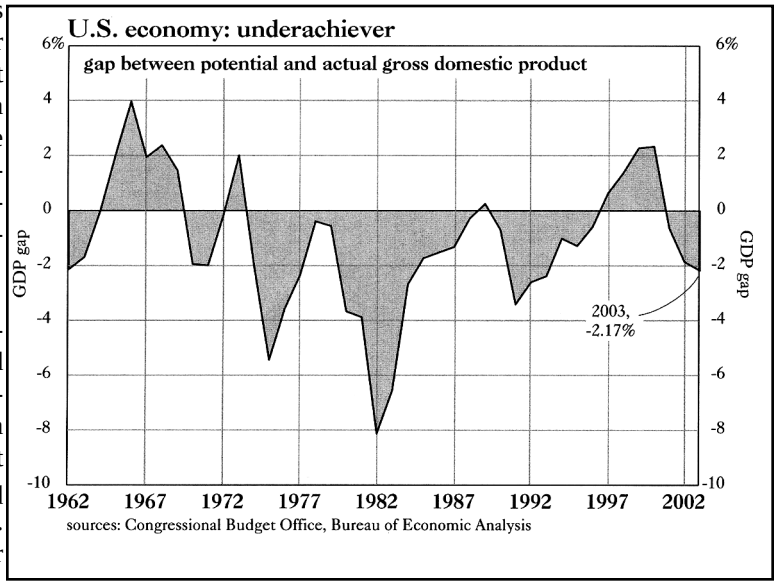
War is bearish for bonds because war finance is usually inflationary. War is specifically bearish for the bonds of the United States because war tends to undermine the standing of the dollar, the world's reserve currency. In the Vietnam era, it was a loss of faith in the capacity of the U.S. government to pay out gold for dollars that precipitated rising interest rates. In the Iraq era, it will be the world's loss of faith in the capacity of the U.S. government to finance its external deficit that throws a spanner in the financial works.

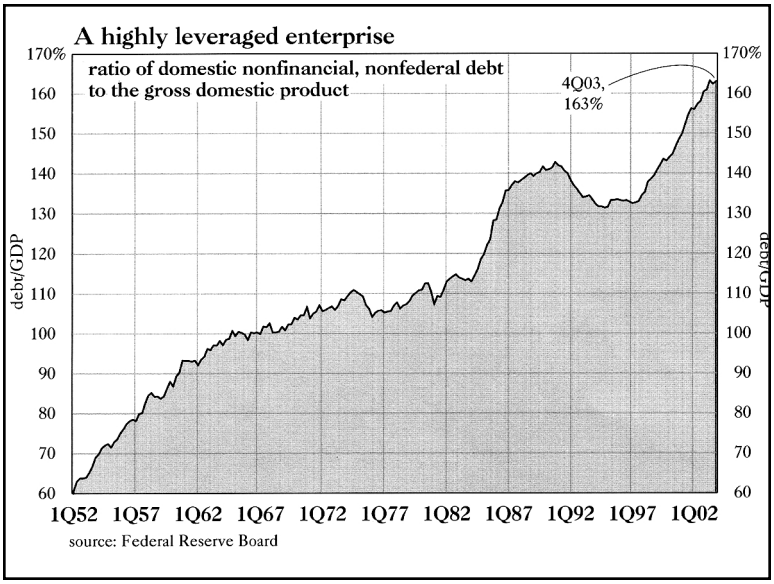
Not all wars are equally inflationary. The Cold War, of which Vietnam was a red-hot battle, was, financially, a war of wars. In 1964, defense spending amounted to 42% of federal outlays and 9% of GDP, about double the levels of today. It might be supposed that, with inherently unproductive government spending running high, inflation would have been a constant scourge around the time of the British Invasion. Yet, month by month in the four years ended January 1966, the year-over-year rise in the CPI was never more than 1.9%. As for the bond market, Sidney Homer describes 1961-65 as "the most unusual period of stability in the postwar period. Prime corporate bond yields remained close to 4.5% for five years." Following which came guns and butter.

Guns and butter hold no fear for the bond bulls of 2004, because, in the first place, they say, the Iraqi struggle is financially insignificant. In the second place, as one put it, there is a "vast reservoir of output that could easily meet any increase in final demand." Because, in the modern world, supply will forever outpace demand, prices of tradable goods and services will forever weaken. Interest rates, ditto.

This, of course, is the language of the "output gap," a measure of the difference between the economy's actual growth and potential growth. It takes a fine story to seduce a saver into buying low-yielding securities denominated in inflation-prone paper, but the output gap fills the bill. To derive the economy's potential growth, the Congressional Budget Office forecasts growth in two variables: the labor force and productivity. The labor force calculation is a snap. Productivity is harder.

Productivity is defined as output divided by hours worked, and the apparently simple number has only two problems: the numerator and the denominator. How long do people work in the 24/7 rat race? Longer than they admit to, or used to, say the skeptics (of whom we are one). And what is a unit of output? It is not the thing on Best Buy's shelf, but something greater than that. A unit of





output is, or can be, a statistical construct. If a 2004 computer runs twice as fast as the 2003 model, but the price of the new and improved machine hasn't gone up from 2003, how much computer is the 2004 buyer buying? A lot more computer than last year, reply the econometricians, who have developed methods to adjust output for perceived improvements in product quality. Suffice it to say that such "hedonic adjustments" tend to flatter the statistical profile of a digital economy. Faster computers, merely by being faster, do not generate incomes. But they do—statistically—tend to generate higher output. They do so because the government's econometric models say so.

Naturally, the faster the forecast rate of productivity growth, the greater the economy's potential growth. What the graph shows is that the output gap is now negative, i.e., the economy is hitting on fewer cylinders than it is capable of hitting on. The output gap was negative in the early 1960s, too. It was not until 1965 that the GDP excelled itself, growing beyond its estimated potential. The excellent Caroline Baum, writing for Bloomberg, neatly describes the analytical problem associated with these hypothetical calculations. "Academic economists may disagree on whether it's the level of the output gap or the change that matters," Baum writes. "They don't challenge the theoretical basis, which is odd since there are so many real-world examples that do. The 1970s witnessed lots of slack and lots of inflation. The late 1990s witnessed no slack and low inflation."

The early and mid-1960s were, in many particulars, times like our own. Technological progress was fast and furious, the measured inflation rate was low and stable, and a resurgent Asian economy was presenting American manufacturers with unwanted low wage competition (the name of that competitor was Japan). The Cold War was on, but Vietnam was a cloud the size of a man's hand.

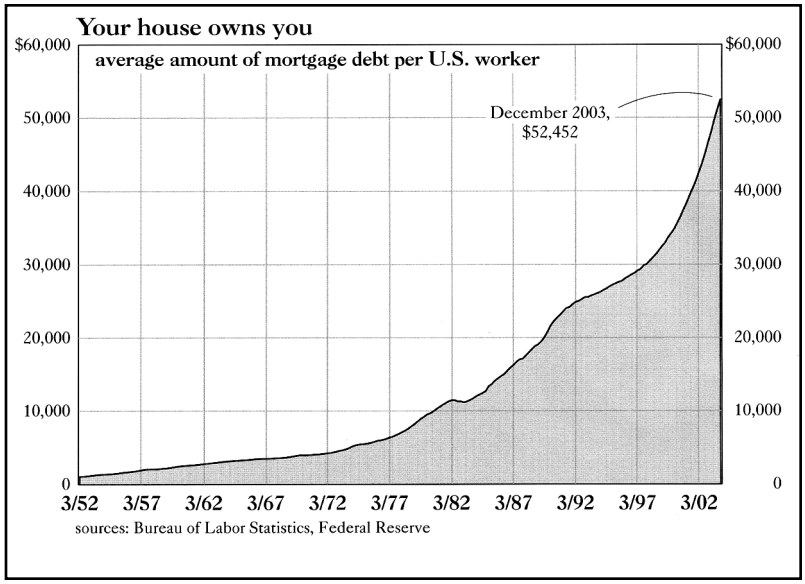
There was no inflation to speak of in America in the early 1960s: The government provided assurances. Yet, there was a chronic shortage of coin, and a persistent loss of monetary gold. Both were the leading indicators of the inflation that would presently burst forth in splendor.

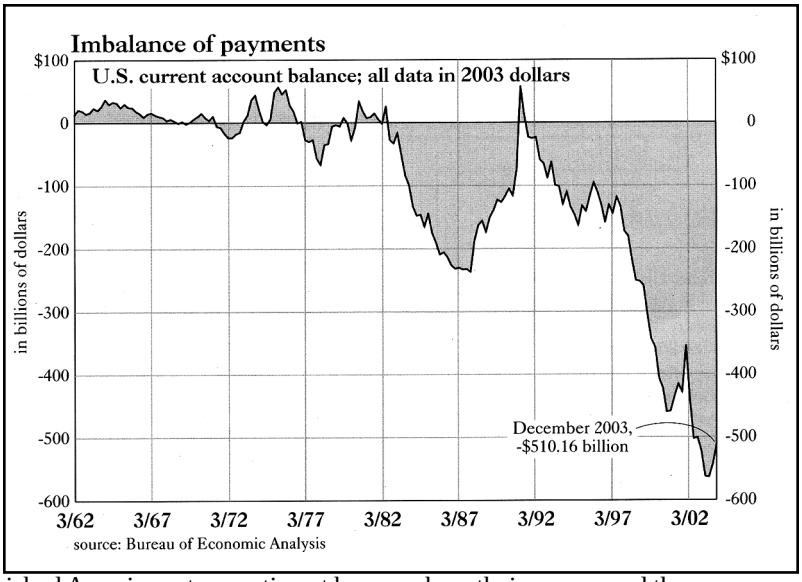
William F. Rickenbacker's "Wooden Nickels: Or, the Decline and Fall of Silver Coins" (Arlington House, 1966), tells the story: "The banking system first felt a pinch on coins in 1962. The Federal Reserve Bank of New York received from general circulation slightly less small change than it had received in 1961. As with almost every monetary experience, there has been not only an acceleration towards the end, but an acceleration in the rate of acceleration. In 1963 the New York Federal Reserve Bank received 20% less small change from general circulation than it had in 1962. In 1964 it received 63% less than in 1963." In 1965, the Chase Manhattan Bank made its customers the kind of offer that more and more Americans found they could easily refuse. "Break that piggy bank," the Chase urged. "Open that fat jar of pennies. And bring your coins to the Bank. . . . We'll then swap you even for crisp new bills (we've got plenty of them). Sound fair?"

No surprise to Gresham, silver dollars had long since disappeared into the nation's piggy banks and fat jars. From year-end 1954 through March 1964, the stock of silver dollars at the Treasury had plunged to 2.9 million from 267.6 million. The silver content was greater than the coins' stated purchasing power.

The dollar was then a kind of derivative, its value being derived from the collateral available to back it. And the law required that 25 cents of every dollar in circulation in the United States and on deposit at the Federal Reserve be backed by gold. American citizens were prohibited by law from owning the barbarous relic, but foreign dollar holders could exchange their paper for gold at the official $35-per-ounce rate. In 1959, there was enough gold to back every foreign-held dollar; but in 1960, there were 20.9 billion foreign-held dollars and only $17.8 billion in gold (making no allowance for the domestic gold cover requirement).

The persistent loss of gold and silver implied that there were too many dollars or that there was too little collateral. Refusing to raise the gold price (i.e., devalue the dollar), successive U.S. administrations attacked the monetary problem with palliatives. They borrowed abroad in foreign currencies, joined in a bankers' pool to suppress the rising free-market price of gold or admon-





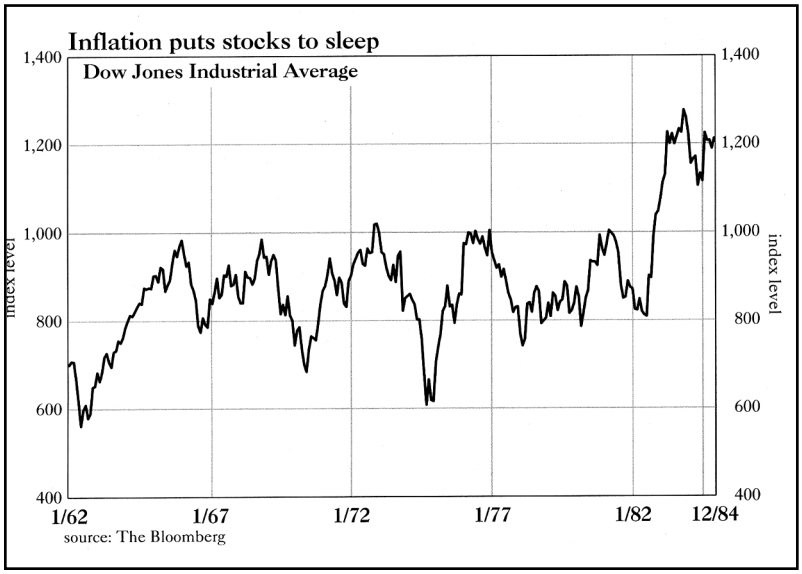
ished Americans to vacation at home, where their money and they belonged. In 1964, the Johnson administration imposed an "interest equalization tax" on domestic buyers of foreign securities to discourage the unpatriotic movement of dollars offshore. On March 25, 1964, some five months before Tonkin Gulf, the Treasury Department announced it would stop paying out what few silver dollars it had left, a decision that foreshadowed by seven years a culminating act of dollar devaluation. It was not lost on the French that, while gold steadily left Fort Knox, none seemed to arrive there. In this, the dollar reminded them of another devaluation- prone reserve currency, the formerly lofty, then-lowly pound sterling, famously devalued in 1931. To protect themselves against another Anglo-Saxon debasement, the French announced, in January 1965, that they would begin to exchange more of their dollars for gold. "Yes, gold," declared the president of France, Charles de Gaulle, "which does not change in nature, which can be made into either bars, ingots, or coins, which has no nationality, which is considered, in all places and in all times, the immutable and fiduciary value par excellence."

It wasn't America's Vietnam policy to which de Gaulle objected, but the monetary system by which the United States was uniquely favored. "[W]hat the United States owes to foreign countries it pays—at least in part—with dollars it can simply issue if it chooses to." Yet, de Gaulle went on, "the supreme law, the golden rule . . . is the duty to balance, from one monetary area to another, by effective inflows and outflows of gold, the balance of payments resulting from their exchanges." This so-called duty, the United States refused to acknowledge then or later. The difference is that, later, almost nobody else acknowledges it, either. "The balance of payments," as a sine qua non of international finance, is a dead letter. In its place is one of the mightiest edifices of debt ever built.

To those who, like Rickenbacker, watched the stacks of silver dollars vanish, the Great Inflation was preordained. It did not seem so to the average bond buyer. In 1965, guns and butter and a 4% handle on long-dated Treasurys were still market-clearing ideas. The Federal Reserve had an inkling about the war, according to Milton Gilbert in his "Quest for World Monetary Order" (Wiley, 1980). William McChesney Martin, the Fed chairman, "knew from previous experience that excess demand pressures expected, and he had information from contacts in industry that bottlenecks were already developing. The administration, however, considered that his fears were premature so that months slipped by without any restraining measures being taken. It was only in December [1965] that the discount rate and the ceilings on deposit rates, fixed under Regulation Q, were raised."

The late Daniel Patrick Moynihan bewailed "dumbing deviancy down." The drift in monetary policy might be similarly condemned. In the month that Martin raised the discount rate, to 41/2% from 4%, the CPI was rising just 1.9% from the prior December. The current account balance was running slightly positive and the 10-year Treasury was fetching 45/8%. The federal budget deficit was on the way to totaling all of $1.4 billion. True, as measured by the output gap, the economy was running at more than 100%, but President Johnson took no notice of that. Instead, he rebuked the Fed for tightening while appealing to housewives to "get out their lead pencil and put on their glasses and look at some of those price lists and see where these shortages are occurring, and see where prices are advancing, and say, 'goodbye to those products that insist on going up and up.'"

Looking backward, posterity sees that Martin did not tighten enough. Under cover of an apparent benign inflation rate, inflation was eating away at the timbers of the U.S. economy. Reading the newspapers in 2004, Iraq era fixed-income investors see no cause for alarm; the inflation rate the government announces is, to most of them, the inflation rate that is. Thus, in 2003, when the CPI was registering year over-year gains of as much as 3%, the Federal Reserve not only did not tighten, but also mounted a well-advertised offensive against deflation. Governor Ben S. Bernanke walked point. At the time, the economy was performing at less than potential (according to output-gap calculations), but the fed-



eral deficit and the current account deficit were both exploding, and the dollar exchange rate was weakening. The gold price was rising.

The Fed's persistent expressed concern over deflation is—on its face—a mystery. Under the monetary arrangements now in place, the Federal Reserve can create all the dollars it wants. The aforementioned law stipulating a 25% gold cover for currency in domestic circulation and deposits at the Federal Reserve banks was relaxed in 1965 and erased in 1968. "Removal of this requirement," testified Chairman Martin on the occasion of repeal, "would in no way reduce our determination to preserve the soundness of the dollar."

Inflation is an increase in the supply of money not offset by an increase in the demand for money: The ancients—von Mises and Keynes—said so. It is money printing, not the effects of money printing in the marketplace. By the classical definition, one would suppose that the Iraq war would be more prolific of inflation than the Vietnam War. And so it is, and will be, we believe. By definition, there's no predicting through which set of channels the surplus money will enter the economic bloodstream. The point of contact might be consumer prices, asset prices or—as came to light in Saturday's New York Times—New York City taxicab medallion prices ($712,101 for a pair in the latest auction).

As noted, paper money and financial deregulation are the hallmarks of American finance in 2004, so different from the precepts of 1965. Set free to lend and borrow, Americans have gone to town. In 1965, private debt and GDP were running neck and neck, with a ratio of debt to GDP of 1:1. Today, the ratio of debt to GDP is 1.63:1 (for the record, that's "credit market debt owed by domestic, nonfinancial, nonfederal sectors"). In 1965, there was about $3,300 in mortgage debt for every employed American. Today—holding the value of the dollar constant—there is more than $52,000.

So the Fed, to the accompaniment of a falling dollar exchange rate and a widening current-account deficit, expresses concern over the loss of zip in the measured inflation rate. Many commend the officials for their worry. The slow-rising CPI constitutes prima facie evidence that the United States has become, in effect, inflation-proof, they say. If a 1% funds rate and a big federal budget deficit (equivalent to 3.4% of GDP) can't make Wal-Mart put up prices, what can?

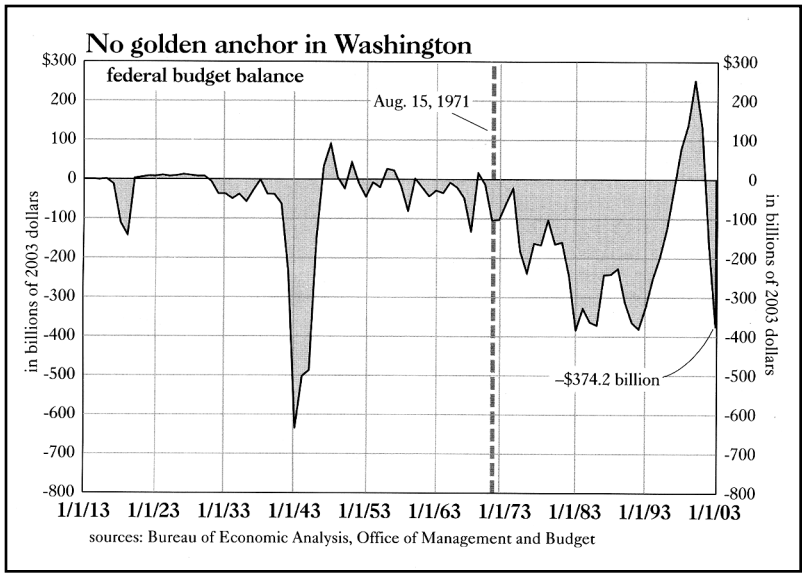
"[I]f China changes its monetary policy and revalues the yuan significantly," replies David Hale, eponymous voice of Hale Advisors, Chicago, in his April 19 advisory, "Wal-Mart could be forced to raise prices 20%-30% on half of its merchandise." The Fed has preached patience concerning the 1% funds rate. In like fashion, we counsel patience to those who wait for the visible fruits of inflation. There was no rushing the bond bear market in the Vietnam era. Just how long the measured inflation rate remained in the low single digits in the 1960s is a fact that amazes and astounds. "Why Workers Don't Mind a Little Inflation" was the subject of a U.S. News & World Report investigation in October 1965; at the time, the CPI was rising by 1.9% a year. In the year of the "credit crunch," 1966, consumer price inflation soared above 3%. Did Wall Street rejoice at this deliverance from the jaws of deflation? It did not. The Dow Jones Industrial Average peaked on Feb. 9, 1966, at 995.14 and moved sideways or down for the next 16 years.

It gradually dawned on the bond market that the Age of Aquarius was also the Age of Inflation. Astute observers noticed that, although the federal funds rate was rising, so, too, was the pace of central bank credit creation; at the end of 1967, the Fed's portfolio of government securities was 10.8% larger than it had been a year before. In June 1967, Illinois Bell Telephone borrowed at 6.04%, the highest such yield since 1921.

The formerly deflation-fearing Greenspan Fed could do worse than to bone up on its modern American financial history. In the late 1960s and early 1970s, inflation rates of 4% and 5%—i.e., the rates indicated by the March 2004 CPI report—sent shock waves through Wall Street. In May 1969, Institutional Investor put a dinosaur on its cover and speculated on the coming extinction of the bond market. In a setting of 51/2% CPI growth, the funds rate was quoted at 8.67% and the 10-year Treasury fetched 6.32%. They were the highest interest rates of the 20th century up until that time.

The output gap was negative in 1970 and 1971, but the bond market's attention was directed elsewhere. The widening war in Vietnam and the dwindling reserves at Fort Knox were undermining the value of the dollar. In the summer of 1971, the free-market gold price reached $41 an ounce, $6 over the official price, and Martin's successor at the Federal Reserve Board, Arthur Burns, was warning about a wage-price spiral. Foreshadowing a devaluation, Treasury Secretary John Connally emphatically pledged not to devalue.

On August 15, President Nixon said goodbye to all that, snipping the last tethers between the dollar and gold. At the same time, the

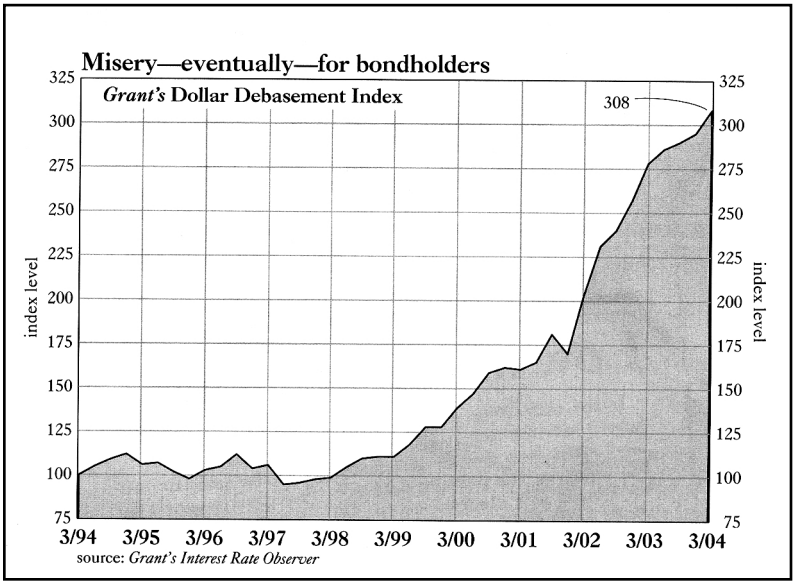


administration imposed a three-month freeze on and prices, pledged a reduction in federal spending and slapped a 10% tax on imports. Here were emergency measures. Where was the emergency? The current-account deficit in the second half of 1971 was running at an annual rate of $4 billion and the CPI was rising by 4.5% a year. Yet the dollar was under attack by foreigners who preferred sterile gold to interest-bearing paper (in August 1971, the funds rate was 5.5%). in billions of dollars

Posterity smiles at these petty crises. Nixon set the Fed free to seed bigger ones. In the 121/2 years preceding the revolution of Aug. 15, 1971, M-2 grew at a compound annual rate of 7.1%; in the 121/2 years following, it grew at a compound annual rate of 9.6%. Consuming much more than they produce, Americans discharge their debts in dollars, the currency that only they may lawfully produce. Data on the United States current account, the broadest measure of American international payments, begin in the first quarter of 1962. From that time until the third quarter of 1971, the current account, annualized, ranged between a surplus of $36.9 billion (first quarter of 1964) and a deficit of $7.9 billion (third quarter of 1971). Post-August 1971, the deficit has deepened at a compound annual rate of 11.2%. At last report, in constant dollars, it had reached $510.2 billion.

The breakdown of the old monetary rules has had a liberating effect on fiscal policy, too. From 1914 to 1971, the median federal budget deficit was $13.5 billion, in constant 2003 dollars; since 1971, the median federal budget deficit has ballooned to $190 billion, also in constant 2003 dollars. As for interest rates, not only have they been higher since the Nixon monetary revolution, but they also have been more volatile. Thus, between April 1953 and August 1971, the median yield on a constant maturity 20-year Treasury bond was 4.1%; after the great divide, the median rate was elevated to 7.3%. The standard deviation of the yield also took flight, from 116 basis points before August 1971 to 227 basis points afterward.

"Old news!" some may cry. Inflation was yesterday's problem and it may be tomorrow's, but it certainly isn't today's. Besides, an American might add, the world has arrived at the happiest division of labor available in mortal life. Asia produces and the United States consumes; we absorb their merchandise, they our dollars.



But the apportionment of work and privilege is destined not to last. To acquire American dollars, Japan and China must print more of their own currencies. Spending yen or renminbi (or yuan), they get dollars and invest them in Treasurys or agency securities. For all intents and purposes, the dollars so acquired never leave the 50 states. It is a thing of beauty, as America sees it. Yet, come the day when Japan or China fears a rising inflation rate, the creation of yen or renminbi will sharply decelerate, leaving the Treasury and agency markets in need of major new customers. For China, apparently, that inflation-fighting day is fast approaching.

The pre-Aug. 15, 1971, monetary system was designed to promote timely adjustments between debtors and creditors. The successor system is built to postpone them. However, no system can engineer the perpetual postponement of enormous imbalances. The cumulative effect of America's deficits on its current account is stamped on the net international investment position of the United States. At last report, the difference between U.S.-owned assets abroad and foreign-owned assets in the U.S. was minus $2.6 trillion, with a "t." The world's only superpower does double duty as the world's greatest debtor.

It may be asked, why should a debtor object if his creditors don't? And the answer is that the creditors will. "The fact that America offers interest rates of only 1% while having the lowest savings rate and largest current account deficit in the world has encouraged a significant decline in the dollar exchange rate," economist Hale observes. The 1% funds rate has done more than that, he goes on, distorting patterns of trade and investment and promoting sunbursts of speculation in all four corners of the earth. Junk bonds, emerging markets debt and residential real estate have all received a monetary lift, of course. But, Hale proceeds, "America's monetary policy is also producing great distortions on the periphery of the world economy. The most outstanding example is South Africa's currency market," the biggest in the developing world. What has a 1% dollar interest rate got to do with 9%-10% South African rand rates? The former finances speculation in the latter. Trading volumes in the South African rand amount to 24% of South African GDP, Hale relates, compared to 4% in the case of Mexico and 9% for Poland. "South Africa also has a swap market nearly three times as large as the country's GDP," he writes. "The large size of South Africa's currency market and swap market is a by product of surplus global liquidity seeking high yields….

"Low interest rates in America, Europe and Japan have also encouraged a large carry trade in other commonwealth currencies," Hale goes on. "The volume of currency trading in Australia and New Zealand is 35% of GDP compared to 27% for the U.S. and 18% for Europe. As with South Africa, investors have flocked to the currencies of the South Pacific in search of higher yield. The currencies of South Africa and the

dominions have become global casino chips, not just a means of payment."

During the Cold War, the U.S. dollar was not merely the leading global monetary brand but also the currency of the nation that kept the Soviets at bay. As the gold-dollar crisis came to a boil in 1968, Milton Gilbert relates, representatives of the leading central banks met in Washington to decide on a course of action. Many favored a boost in the official $35 price, but the United States stoutly refused. What emerged was a two-tier gold price, a non-solution that only postponed until 1971 the admission that the U.S. was running out of monetary collateral. Significantly, Gilbert reports, the central bankers who disagreed with U.S. policy bit their tongues, geopolitical considerations trumping financial ones. "In fact," writes Gilbert, "a majority of the governors of the Group of Ten and Switzerland had been for some time in favor of raising the gold price, although they were not free to say so publicly and, as far as I knew, did not press their views on the United States, even confidentially."

Thirty-six years later, many things have changed. Cut loose from its golden anchor, the dollar has propagated wonderfully. Freed from Depression-era regulation, some big banks have evolved into federally protected hedge funds. Emboldened by its experiments in interest-rate fixing and crisis management, the Fed is trying to manage the unemployment rate, the inflation rate and the GDP growth rate all at the same time.

And this, too, has changed: In the dollar crisis of the Vietnam War, the United States could count on its allies to lend a hand (at least with their silence). The Iraq war, too, will bring a dollar crisis, we predict. And if it does, who would lend a hand? Not "Old Europe." But wait, France just may surprise. On April 14, the Bank of France dropped a bombshell. For the first time since Napoléon, it said, it is planning to become a seller of gold, perhaps as much as 16% of its hoard. The bank observed that gold pays no interest (when did it find out?). It would, it said, convert some of this bullion "into a more lucrative investment." What might this investment be? Dollar balances yielding 1%? Yen at zero? Euros at 2%? For ourselves, we intend to implement a French pairs trade: Fade the Bank of France, go long the memory of Charles de Gaulle. •••

The Gold Criterion Speech

by Charles DeGaulle

For all these reasons, France is in favour of the system being changed. We know that France said this, in particular, at the Tokyo Monetary Conference. Given the universal jolt that a crisis in this field would probably cause, we have every reason to hope that the steps to avoid it are taken in time. We therefore believe it to be necessary for international exchanges to be established, as was the case before the world's great misfortunes, on an unquestionable monetary basis, that does not carry the mark of any particular country.

What basis? Indeed, we cannot see that, in this respect, there can be any other criterion, any other standard, than gold. Oh, yes! Gold, which never changes its nature, which can be shaped into bars, ingots or coins, which has no nationality and which is eternally and universally- accepted as the unalterable fiduciary value par excellence. Moreover, despite everything that could be imagined, said, written, done, as huge events happened, it is a fact that there is still today no currency that can compare, either by a direct or an indirect relationship, real or imagined, with gold. Without doubt, we could think of imposing on each country the way it should behave within its borders. But the supreme law, the golden rule - we can truly say that should be reapplied, with honour, to international economic relationships, is an obligation to make up, between one monetary zone and the next, by effective deliveries and withdrawals of precious metals, the balance of payments resulting from their foreign exchanges.

Indeed the end of the sharp jolts of the "Gold Exchange Standard", the restoration of the gold standard, and the additional transition measures that could be essential, particularly as far as the organisation of international credit on this new basis is concerned, should be jointly arranged carefully among the countries, particularly those whose economic and financial capacity gives them a particular responsibility.

Moreover, there are already frameworks in which it would be normal for such studies and negotiations to be carried out. The International Monetary Fund, set up to ensure, as far as is possible, mutual responsibility for currencies, would provide all the countries with an appropriate meeting place, as soon as it was contemplated not to perpetuate the "Gold Exchange Standard", but rather to replace it. The "Committee of Ten", which groups together, alongside the United States and England, on the one hand, France, Germany, Italy, Holland and Belgium, and on the other hand, Japan, Sweden and Canada, would prepare the proposals for the creation of a European economic community, to work out between them and to represent them outside the solid system that good sense recommends and which provides an answer to the renascent power of Europe.

Excerpted from a press conference at the Palais de l'Élysée, February 4, 1965

Value Hedge

First published September, 2003

On Monday, the editor of Grant's gave a talk at the New York Institutional Gold Conference. An expanded version of his remarks follows:

My name is Jim. I'm a value investor, and I own a stock with a 53 P/E ratio. In addition, I hold a long position in a certain precious metal, in the company of a record number of self-avowed "speculators." These are the things I have to live with.

In the S&P 500, only 72 stocks have a higher P/E than the one I just mentioned. Probably, many of you own it, too. It is Newmont Mining, a leading producer of the metal that brings us together today. In the non-gold portion of his mind, the thoughtful gold bull knows what usually happens to a stock quoted at such a rarefied valuation as Newmont's. It stars on CNBC and its P/E strains even higher. Then, one fine day, the critical marginal buyer decides to pass up the opportunity to make an investment that (holding everything constant) would make him whole again—in this example, in 53 years. As this would-be buyer steps aside, the high-P/E stock begins the long journey that may, one day, deliver it into the outstretched arms of the value investors.

My mission today is to try to reconcile gold and value, and it won't be easy. With hindsight, all can agree that gold was a rank speculation at $850 to the ounce in January 1980. Similarly, we can see that it made a fine investment at $252 to the ounce in August 1999. Yet, at both extremes of price, a shiny Krugerrand generated the same earnings and paid the same dividend as a 1999-vintage Internet stock.

"Value investing," according to author and investment practitioner Seth A. Klarman, "is the discipline of buying securities at a significant discount from their current underlying values and holding them until their value is realized. The element of the bargain is the key to the process."

Gold, therefore, is no investment "bargain." It can't be one and it won't be one. It's a fact to bear in mind come the day CNBC launches "Gold Week," with Louis Rukeyser, or when Pierre Lassonde, president of Newmont, is made a Knight of the British Empire. Gold can't be an investment bargain because it has no "current underlying value" to sell at a discount to. Nor would it be a bargain even if it were quoted in the market at less than the cash cost of producing it (in the case of Newmont, about $200 an ounce). The reason why is the very reason that gold is the legacy monetary asset. It is scarce and indestructible. So large are above-ground stocks in relation to any one year's production that the "gold supply" is relatively stable. In this it has a clear edge on the "money supply."

If gold isn't a bargain, what is it? It is a hedge. However, in my opinion, it is a hedge bargain. The value of a hedge should vary according to the cost and imminence of the risks being hedged against. In the case of gold, the risks are monetary. They are potentially very costly, and they are more than imminent. They are upon us in the shape of burgeoning deficits and a radically reflationary policy stance. Owning gold, you are insuring not against what may be but against what already is.

When George Bush, on a swing through the Pacific Northwest in August, said, "I am more concerned about somebody finding a job than I am about a number on paper," he was talking about the federal budget deficit, now closing in on $500 billion. And when, at a Labor Day speech in Ohio, the president declared, "We have a responsibility that when somebody hurts, government has got to move," he was talking about the value of the dollar, which, against the renminbi, the administration judges too high. As for the Fed's contribution to fashionable thought, on May 6, the Federal Open Market Committee for the first time expressed concern about the inflation rate falling too low.

The price of fire insurance would be out of reach if the homeowner started shopping for it after his house was billowing smoke. Yet, in my opinion, the price of monetary insurance is still reasonable in view of the risks posed to the purchasing power of the dollar by the dollar's own stewards. In one sense, gold is a hedge against what could go wrong. But it is also, nowadays, a hedge against what could go right, as U.S. policy makers use the word "right."

In the language of the electrical transmission system, gold is off-grid, independent of the global power system of banks and central banks. The Krugerrands in my safe deposit box are my asset and nobody's liability. By the way, it's a telling comment on the unevolved state of gold investment that, pending the advent of the World Gold Council's exchange-traded fund, the metal is so hard to buy. The quarter-century equity bull market, 1975-2000, led to the development of a thriving mutual fund industry. Similarly, the 20-odd-year gold bear market brought forth an elaborate gold-selling industry (gold mining companies borrowed metal they hadn't produced, sold it forward and invested the proceeds). For me, the purchase of a few thousand dollars' worth of Krugerrands entails a trip to the coin dealer and a ride home on the subway. Then there's a second trip to the bank where, with luck, Rosemary, the nice lady who watches over the safe deposit boxes, won't be on break. It must be like buying stocks in 1947.

You must be wondering where the price of gold is going. The sophisticated analyst is not at a loss for an answer. We start with a venerable rule of thumb I will ever associate with the late, redoubtable Harry Bingham, who for years worked for the Van Eck group of funds. Gold's principal monetary characteristic is the long-term stability of its purchasing power, Harry would say. And as an example, he would posit that an ounce of gold has tended to command the purchasing power to buy one good-quality man's suit. Research shows that at Brooks Brothers this fall, prices start at $598. Ergo, on this count, gold may be judged "market outperform."

The analyst next turns to interest rates. Down through time, money has competed with credit. In most phases of the cycle, credit has the edge, as money pays no interest. The owner of gold thus forgoes a stream of income and all the wonders of compounding. The elder J.P. Morgan counseled his son never to sell America short or he would surely go broke. He might have added, just as emphatically, never to sell short the compound interest

table, either. Late in the 1990s, when the stock of Alan Greenspan was quoted at an exorbitant premium to the chairman's personal book value, and when interest rates were much higher than they are today, the opportunity cost of holding gold was judged prohibitive. Now that yields have plunged and the chairman's stock is off its highs (though still at an outsized premium to net worth), the opportunity cost of holding gold has plunged. If we are talking about money-market rates, the opportunity cost is essentially nothing. William V. Sullivan Jr., ace money-market economist at Morgan Stanley, notes that some $6 trillion is invested at real interest rates either a little higher, or a little lower, than zero. That is in the U.S. Add in Japan, and the equivalent of many more trillions of dollars is lying fallow. For perspective, and to stoke delusions of grandeur among Newmont owners, the market cap of all the gold in existence is probably less than $1.5 trillion.

The analyst, finally, will attempt to answer the question: What is the cost of not owning gold? To frame an answer requires some brainstorming. One must ask, What are the chances of a monetary accident? I was about to say monetary "failure," but the risk to the holder of dollars is not that the Federal Reserve will fail to achieve a slightly higher inflation rate or that the Treasury will fail to achieve a selectively lower dollar exchange rate. The risk to the holder of dollars is that the policy makers will succeed beyond their wildest dreams. Similar risks confront the holders of Japanese yen and even of Chinese renminbi, a currency I believe is destined to appreciate against the dollar. Gold is the hedge against the "success" of currency-manipulating and deflation-fighting monetary institutions everywhere.

You will be no richer for knowing that I am bullish on gold. I have been bullish at long, unprofitable intervals during the gold bear market that began before the birth of Britney Spears. I wake up every morning in the belief that the international monetary system is one day closer to breakdown. I am certain that posterity will look back at this episode in monetary history with a mixture of mirth and amazement.

It would be unnecessary to observe that these are not the views of the investment mainstream. Gold has its enemies as well as its friends, an odd thing considering its enemies' principal knock. If gold is an atavism, as they say, why do they hate it? Do they despise their useless appendixes?

I have just reread portions of Martin Mayer's excellent study, "The Fed" (The Free Press, 2001). In it, Mayer chronicles the evolution of our central bank, not neglecting the episodes of market intervention that have come to characterize the Greenspan watch. The book leads off with a dramatic account of the surprise, 25-basis-point cut in the federal funds rate implemented on Oct. 15, 1998, to mitigate the fallout from the explosion of Long-Term Capital Management. You may remember that that October 15 was an options-expiration day, and that the Fed pulled those 25 basis points out of its hat four minutes after the bond futures had settled and 56 minutes before the New York Stock Exchange closing bell would ring. In that speculatively charged interval, Mayer relates, the nation's stock market capitalization leapt by a cool $1 trillion. Well do I remember the day. With this "coup de théâtre," as Mayer puts it, the Fed shattered the morale of the remnant of bears who were still playing the stock market for a well-deserved fall. When the speculative peak finally came, in March 2000, the Dow was 42% higher and the Nasdaq Composite 212% higher than on the day Alan Greenspan elected to save the free market from itself.

Greenspan and gold go way back together. I expect most of you know about the 1966 essay of his that lavished praise on the classical gold standard (Mayer calls this work a "truly nutty screed"). Now, in a sense, Greenspan is the anti-gold standard. If the gold standard was the rule of law applied to monetary affairs, the present-day setup is the rule of discretion. As long as discretion seemed to deliver the goods, the gold price languished. As discretion has faltered, the gold price has rallied.

Discretion is no match for the arithmetic of the deteriorating United States external financial position. You know this country is privileged to consume more of the world's goods than it produces and to finance the deficit with dollars. International finance can be a difficult subject, but there is nothing abstract in the piles of empty shipping containers rising at America's deep-water ports or in the mounds of dollar-denominated securities accumulating in the monetary warehouses of foreign, mainly Asian, governments. The containers stack up in America because this country imports much more than it exports. The securities accumulate abroad because the supply of dollars is greater than the private demand for dollars. Holdings of Treasurys and federal agencies by foreign central banks and international institutions stand at $953 billion, up 18.1% from a year ago. It takes no feat of curiosity to wonder when these foreign holders might choose to diversify out of dollars. They could add euros and yen, but the political sponsors of neither currency would welcome a higher exchange rate. Gold is, to me, an obvious portfolio diversifier. Among its other merits, there is no Government of Gold to protest the appreciation in its value.

There is a school of thought that sovereign governments hold down the gold price through covert intervention (by nefarious means separate and distinct from the overt sales by central banks). I have never believed it. I have never believed that, in this country, at least, ranking public officials care enough about gold to risk their careers by participating in a conspiracy to do it harm. For the same reason, I can't imagine them scheming to do it good, either.

I am an assiduous reader of the speeches of our high monetary officials, and there are no stronger props under the gold price. The Ph.D. economists on the staff of the Federal Reserve Board, however, I except from this generalization, because I have no idea what they're talking about. When talking to each other—the only people with whom they seem to talk shop—they can make Greenspan sound lucid. For example, Vincent Reinhart, director of the Division of Monetary Affairs, Board of Governors of the Federal Reserve System, recently had this to say: "[E]ven if the central bank and market participants share

the same view as to the likely outcomes for the economy, they may differ as to how to characterize the risks associated with those outcomes. For example, the possibility of a significant adverse tail event that might trigger pernicious and nonlinear dynamics could require weighing that possibility more heavily in policy choice than an equally likely (or unlikely) outcome that had more predictable consequences for the economy." Roger that.

Reinhart was speaking at the annual Federal Reserve camp-out in Jackson Hole, Wyo., where this year, as is customary, Alan Greenspan gave the keynote address. The chairman's talk, entitled "Monetary Policy Under Uncertainty," was a defense of policy making by the seat of his own pants. Greenspan argued that central banks shouldn't be bound by rules because the world economy is too complex. They should, instead, be free to make it up as they go along. The chairman is pleased to call this technique "risk management."

Greenspan is increasingly isolated in this point of view. The conservatives attack him, as they usually do. But so, more respectfully, do the monetary academics. "Inflation targeting" is the hot concept in central banking. Bernanke, late of Princeton, was an academic exponent of it, and his former colleague, Princeton economist Michael Woodford, is out with a new book on the subject, "Interest & Prices" (Princeton University Press, 2003). In 785 pages of equation-packed text, Woodford tries to show that, in the absence of such familiar policy touchstones as a gold standard or a set of money-supply targets, central banks can get along by adhering to a set of explicit rules, the nature of which Reinhart might possibly understand. You may understand them, too, if the "intertemporal equilibrium modeling, taking full account of the endogenity of private-sector expectations" is a phrase that means anything to you. "Price stability," Woodford goes on, is a goal that the well-managed central bank can and should attain (proofs of the propositions advanced in the text are available in the 112 pages of mathematical appendixes).

Greenspan, too, is a devout stabilizer, but he is unwilling to say just what prices he wants to hold still or how he would pin them down. Woodford is crystal clear—on that, at least. He wouldn't target so-called asset prices, e.g., stocks and real estate. He would aim, instead, for a measure of core inflation. Readers of Grant's may remember a discussion in these pages of the intellectual battle between the price stabilizers and their opponents during the 1920s and 1930s. The stabilizers, sounding a lot like modern Federal Reserve Board governors, shut their eyes to the risk that, by making a certain kind of price index walk a straight line, a central bank could inflate another kind of index—the Dow Jones Industrial Average, for instance. Woodford seems not to acknowledge this risk, or even the history of the controversy. Neither does Greenspan.

Maybe Woodford wasn't paying attention when the Fed lit a fuse under the stock market in 1998, and he very well may not be a student of the capital markets. Greenspan was there, and his description of that critical act of manipulation is either disingenuous or oblivious. "At times," the chairman intoned at Jackson Hole, "policy practitioners operating under a risk-management paradigm may be led to undertake actions intended to provide some insurance against the emergence of adverse outcomes. For example, following the Russian debt default in the fall of 1998, the Federal Open Market Committee eased policy despite our perception that the economy was expanding at a satisfactory pace and that, even without a policy initiative, was likely to continue to do so. We eased policy because we were concerned about the low-probability risk that the default might severely disrupt domestic and international financial markets, with outsized adverse feedback to the performance of the U.S. economy."

I would describe the ensuing equity boom and bust as feedback of greater-than-outsized proportions. And I would characterize the refusal of the Greenspan Fed to acknowledge its complicity in this cyclical error as ominous for the future of monetary policy. In the pursuit of "risk management" and "price stability," the Fed is likely to continue to ladle out the credit, with consequences that the chairman will not only not anticipate, but also not seem to notice even after they play out. The salient feature of the millennial economy is not, as claimed by Greenspan, its complexity, but rather the determination of the Federal Reserve to forestall bad things through money printing.

The rich old speculator Bernard M. Baruch forehandedly bought gold and gold shares after the 1929 Crash. Years later, a suspicious Treasury Secretary asked him why. Because, Baruch replied, he was "commencing to have doubts about the currency." Many are beginning to doubt the strength of the dollar today, as well they might. Following Baruch's example, they should lay in some gold as a hedge. And they should follow the great Baruch in another particular as well. They should not forget to sell too soon. •••

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