

The Performance of Gold during Inflation and Deflation

A thing long expected takes the form of the unexpected when at last it comes.

Mark Twain

INTRODUCTION

In the course of the year, I meet numerous very well informed hedge fund and traditional fund managers, strategists, and economists. Naturally, most of these people have a business self-interest. They only reluctantly have their clients withdraw funds, even if market conditions or poor performance warrant such action. Moreover, no matter how large these financial institutions have become, they continually look for new clients in order to enlarge their assets under management. So, what these financial people are saying publicly is often somewhat different from what they themselves really believe. In private, most of the fund managers and investment advisers I talk to express the view that the current imbalances in the global economy — and, in particular, the external imbalances of the United States — are not sustainable forever. With the exception of the incorrigible optimists, most financial observers know that at some point the excessive credit creation in the US will backfire and lead to some sort of a crisis. But that is where our knowledge stops. We don't know what might be the catalyst for the crisis, when it might happen and in what form it will manifest itself.

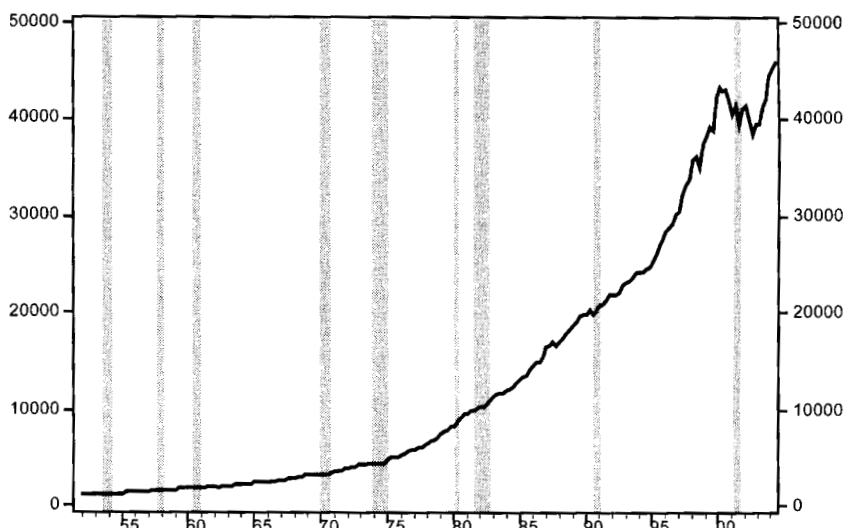
Moreover, as I have just

indicated, there are some unconcerned observers who believe that all is well in Dr Greenspan's wonderland. In a recent *Wall Street Journal* article, entitled "America is Not Running on Empty" (March 28, 2005), David Malpass, Bear Stearns' chief economist, makes the case that

... the reality is that the U.S. has the world's biggest accumulation of savings and investments. The U.S. household sector, the world's largest net creditor, is favorably positioned for higher rates due to large liquid assets and the generally fixed-rate U.S. mortgage structure.... Not only is the U.S. not running out of household savings, it is growing fast both in terms of the annual additions and the cumulative buildup of American-owned savings. U.S. household net

worth, one good measure of savings, reached \$48.5 trillion in 2004 [see Figure 1]. Time deposits and savings accounts alone total a staggering \$4.3 trillion, versus slow-growing credit-card debt of \$800 billion. True the U.S. is the world's biggest debtor, but it is building assets faster than debt.... According to the U.S. Federal Reserve's flow of funds data, the 2004 additions to American household financial assets were a net \$590 billion. This was 6.8% of personal disposable income, providing a meaningful measure of the cash going into new financial savings. This increased American households' financial net worth to \$26.1 trillion, way above any other country's savings and plenty to fund profitable domestic investments. If the 2004 appreciation in the value of U.S.

Figure 1 Household Net Worth (US\$ billion), 1950–2004



Source: Merrill Lynch, *The Market Economist*, November 19, 2004

homes and equities were counted, the 2004 saving rate was 46% of disposable income. Foreign savings invested in the U.S., the counterpart of the widely criticized current account deficit, is additive to America's own large store of savings. Rather than a "dependence" on foreign savings, the U.S. is an effective user of it, profiting by growing faster than the interest cost of foreign saving. The combination of large domestic and foreign savings allows heavy investments in the U.S. decade after decade, part of the explanation for its fast growth and the world's highest employment levels. Meanwhile, foreigners are actually losing ownership share in the U.S. despite the \$2.6 trillion net debtor position, since U.S. assets are growing faster than foreign savings in the U.S.

IS AMERICA REALLY NOT RUNNING ON EMPTY?

I would not have quoted David Malpass were his optimistic views not also echoed by other respected economists, including my friend Ed Yardeni, who take comfort in the fact that household net worth is at an all-time high (see Figure 1). According to these economists, this record-high household net worth is proof that the US consumer is in great shape and that high consumption gains can therefore be sustained for the foreseeable future. The 19th-century economist Frederic Bastiat demonstrated that it isn't easy to rebut well-formulated economic sophism. And while some points made by Malpass are certainly valid, it is important to distinguish between an economy's balance sheet and its income statements.

First, it should be understood that in an economic system money can be created, leading to additional debts, which then boost asset prices by a larger amount than the debt that was created. For example, in a system where household net worth amounts to, say, \$10 trillion, an additional credit creation of \$100 billion could

easily lead to household net worth jumping to \$10.5 trillion. The extent of the asset inflation when additional money and credit is being created will largely depend on the willingness of existing asset holders to part with their assets. Just think of a company that has a market capitalisation of \$10 billion. A new buyer comes into the market and wants to acquire \$100 million of this company's shares. If there are only few sellers, it is entirely conceivable that as a result of the additional buying the shares would jump by 10%, which would then increase the market value by \$1 billion to \$11 billion. This would be particularly true of the real estate market, where the inconvenience and costs associated with selling a house and moving to another one will require the prospective buyer to pay to an existing owner a substantial premium over the existing owner's acquisition cost.

There is a further problem with focusing on rising household net worth as an indicator of the consumer's ability to keep up his spending habits. Wealth is unevenly distributed. Rising asset values (stocks and real estate) have made "a few people" mega-rich, while the majority of the population is struggling to make ends meet. (See also pages 10–11 below, where reference is made to the money shufflers.) The top 1% of households earns 20% of all incomes and owns 34.4% of all net worth. The average compensation of the top 100 chief executives amounts to US\$37.5 million, which is 1,000 times the pay of an average worker. (According to compensation consultants Pearl Meyer & Partners, the chief executives at 179 large companies that had filed proxies by late March, and hadn't changed leaders since last year, were paid about US\$9.84 million on average in 2004, up 12% from 2003.) In addition, if throughout the economy savings were as understated as David Malpass claims, why would nearly half of California's home buyers in 2004 have used **interest-only loans** to finance their purchases (up from

almost none in 2001)? (Interest-only loans are used by home buyers who have no money at all for a down-payment.)

Finally, focusing on the balance sheet of an economy might lead to wrong conclusions, since the balance sheet shows only a snapshot of an economy at a given time and says nothing about past and future trends. In 1989, at the peak of the Japanese real estate and stock market bubble, the net worth of Japanese households was also likely at a record level. I suppose that Mr Malpass could have concluded that, based on the rising net worth of Japanese households during the 1980s, consumption and the economy would continue to perform well in the 1990s. (After 1990, Japanese retail sales contracted and real estate prices fell for 14 years in a row.)

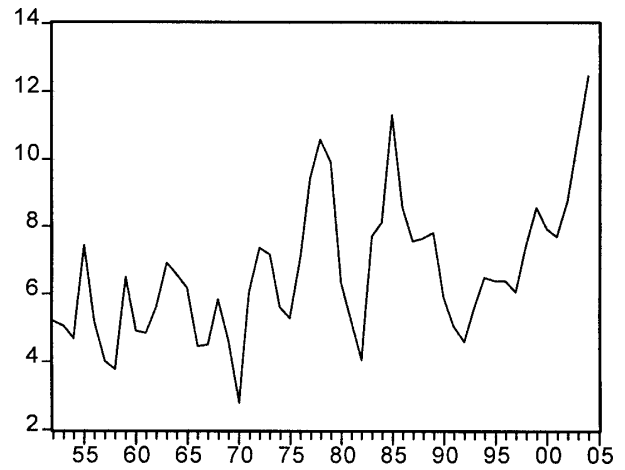
So, what is more important to analyse are the *causes* of rising household net worth. Are households becoming richer because of net capital formation, employment, and wage gains, the traditional drivers of the economy, or is the increased household net worth largely a function of easy money policies which have led to a rapid credit expansion? In this respect, Paul Kasriel, the chief economist of Northern Trust, rebuffed the views of David Malpass in a piece entitled "Households — *Still Running on Empty*", in which he argues that this "is one of those rare cases when the conventional wisdom is correct — that is, households are saving very little to the detriment of their *future* standard of living". Kasriel starts out by asking the rhetorical question: In recent years, has household borrowing (a flow concept) risen relative to household spending (also a flow concept)? According to Kasriel, "the answer is unequivocally 'yes'". Figure 2 (courtesy of Paul Kasriel) shows "the dollar-value *change* in total household liabilities (from Federal Reserve flow-of-funds data) as a percent of the dollar-value of total household spending.... In 2004, households' total borrowing represented 12.5% of their total spending — the highest percentage

since the 1952 start of the series. If households' incomes are so underestimated, why are they borrowing so much relative to their spending?"

Kasriel then suggests that another way to look at the alleged underestimated after-tax income and savings rate is to look at households' net acquisition of financial assets — stocks, bonds, deposits, pension fund reserves, etc. — compared to their net acquisition of liabilities (in other words, borrowings). Since the Fed provides the relevant data, it is possible to precisely determine whether households are saving or dissaving. Kasriel then shows two figures that plot the net acquisition of financial assets and households' net acquisition of liabilities, or household borrowing (see Figure 3). Evidentially, the change in household liabilities significantly exceeds the net acquisition of financial assets. Figure 4 shows that starting in 1999 household borrowing began to exceed households' net acquisition of financial assets. Kasriel concludes that, "starting in 1999, and continuing through 2004, households' cash outlays on goods, services and tangible assets have exceeded their cash incomes. From 1952, the beginning of these data series, through 1998, this phenomenon of households spending more than they were taking in had never occurred. If spending more than you take in is evidence of a strong propensity to save, then perhaps George Orwell's Ministry of Truth has actually come into existence and is being run by Chapman and Malpass." (Kasriel refers here also to an article by Marc Chandler in the *Financial Times*, dated March 8, 2005, in which Chandler makes the point that American savings are understated by most conventional measures.)

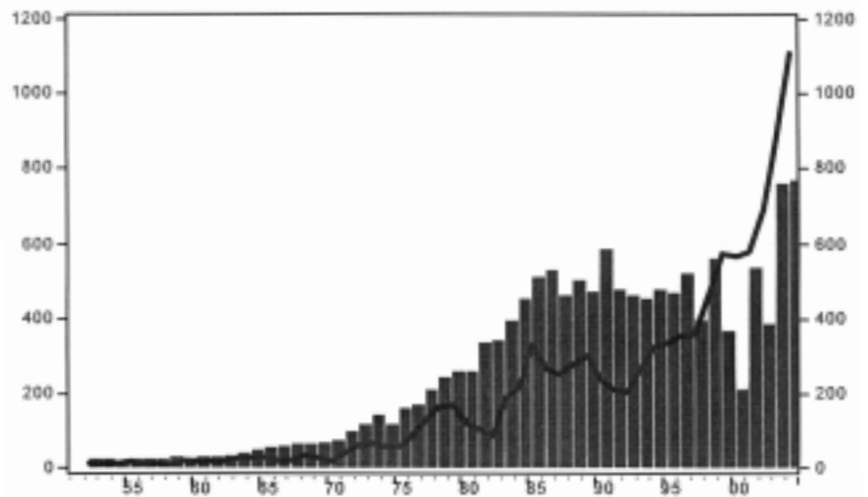
David Rosenberg, chief economist of Merrill Lynch, reasons along similar lines to Paul Kasriel. In a piece entitled "Living on 'Borrowed' Time" (*Merrill Lynch Economic Commentary*, dated April 1, 2005), Rosenberg produces two figures that

Figure 2
Households:
Change in
Liabilities (\$) as a
percentage of Total
Spending* (\$),
1952–2004



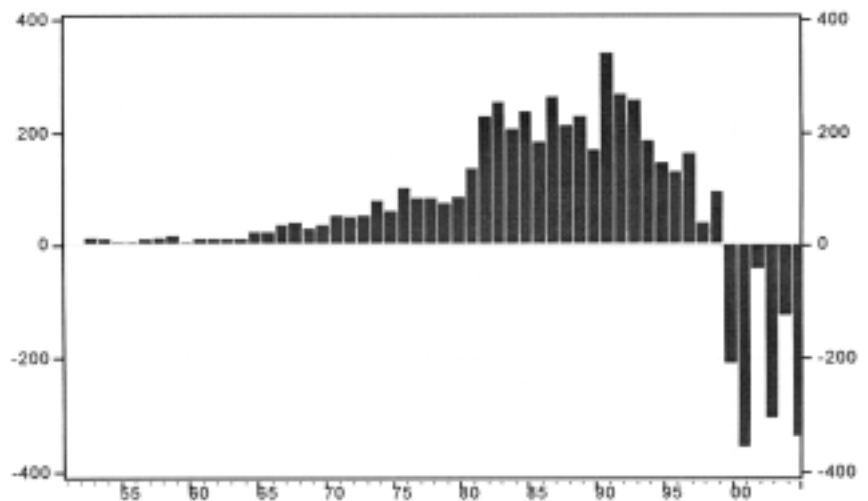
* Sum of personal consumption and private residential investment expenditures
Source: Paul Kasriel, The Northern Trust Company

Figure 3 **Households: Net Acquisition of Financial Assets; Change in Total Liabilities (SAAR, Bil.\$), 1952–2004**



Sources: Federal Reserve Board/Haver Analytics; Paul Kasriel, The Northern Trust Company

Figure 4 **Households: Net Acquisition of Financial Assets minus Net Increase in Liabilities (SAAR, Bil.\$), 1952–2004**



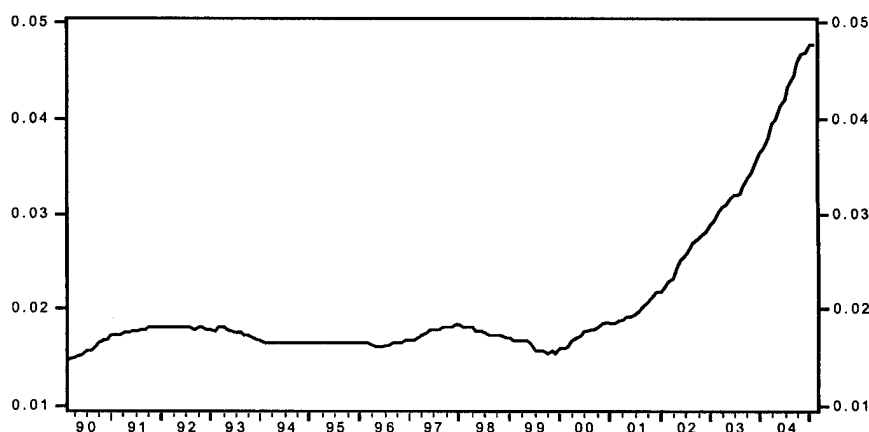
Sources: Federal Reserve Board/Haver Analytics; Paul Kasriel, The Northern Trust Company

show the ratio of revolving home equity lines of credit to consumption (see Figure 5) and the ratio of the 12-month change in both (see Figure 6). As can be seen from the figures, what was a stable relationship between revolving home equity loans and consumption has moved asymmetrically north since 1999. According to Rosenberg,

[W]hile there is no doubt that years of tax relief and the better tone to the employment backdrop have helped bolster consumer spending, it does not explain how household expenditures have basically continued to grow very close to a 4% clip in real terms over the past year. A key source of stimulus has been the ability to tap into one's house as if it were an instant banking machine. Over the past year, households drew down their home equity lines of credit by an unprecedented \$110 billion and this helped finance the \$450 billion worth of consumption. [Rosenberg refers to consumption growth — ed. note] In other words, just about one-quarter of that consumer spending binge can be traced to the boom in real-estate-credit-card usage (just in case you were wondering why the personal saving rate is sitting at a puny 1%). Consider for a moment that the 37% run-up in revolving home-equity loans over the past twelve months has outstripped growth in wage-based income by a factor of six. Who needs a pay raise when you can instantly crystallize the rising notional value of your home and go buy that speedboat you always wanted?

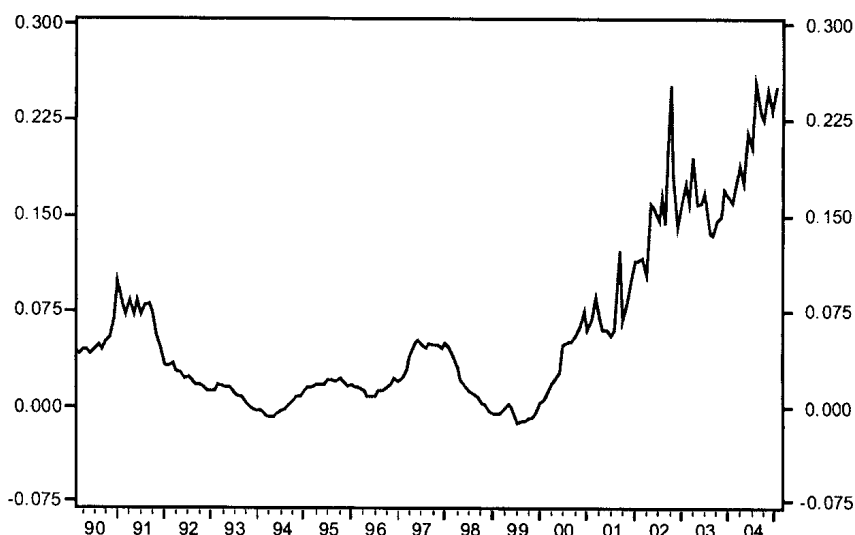
I have pointed out before that inflating asset values, such as rising home prices, lead to an illusion of wealth (see GBD report of February 28, 2005, entitled "Prepare Yourself for Some Big Changes"). Kasriel concedes that "holding period gains increase one's net worth today. [Kasriel refers to capital gains on already existing assets such as

Figure 5 **Ratio of Revolving Home Equity Loans to Consumer Spending, 1990–2004**



Sources: Federal Reserve Board; Bureau of Economic Analysis; David Rosenberg, Merrill Lynch

Figure 6 **Home Equity Loans/Personal Consumption Expenditures (12-month change: ratio), 1990–2004**



Sources: Federal Reserve Board; Bureau of Economic Analysis; David Rosenberg, Merrill Lynch

stocks, bonds, and real estate — ed. note] But are these holding period gains *saving* in the economic sense? That is do these holding period gains represent the building up of capital — both human and inanimate — that will enable goods and services to be produced at a *faster rate* in the future? Does the increase in the price of an existing house represent an increase in the amount of *real* shelter services provided by that house? Evidently not."

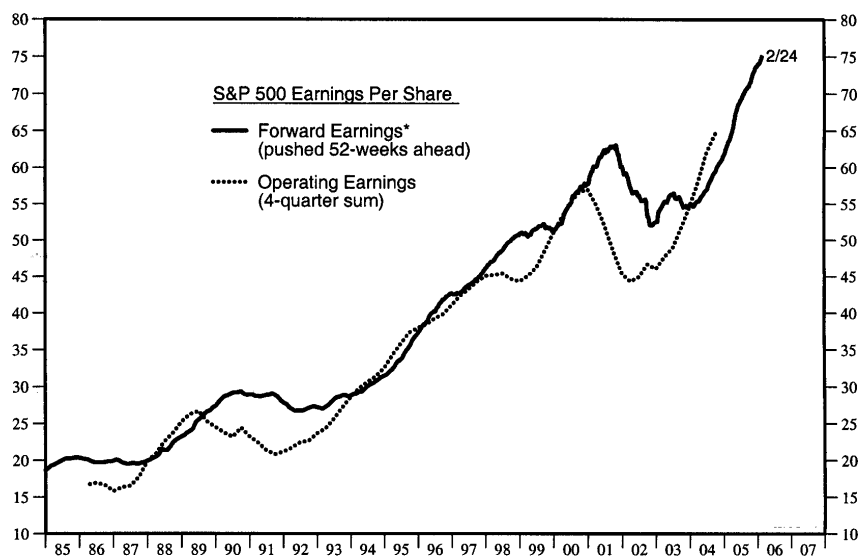
To be fair to David Malpass, I do concede that he has one valid point.

Household net worth is at an all-time high. Rising household net worth has been and can still be a driver of consumption for some time. However, for our purpose, which is to analyse the investment implications of this record household net worth, it is important to determine how sustainable is the increase in household wealth, under what conditions it can continue, and whether it could actually decline, as it did briefly after 2000 when equity values plunged (see Figure 1). Let us first analyse why, since the early

1980s, household net worth has increased so strongly. Obviously, a significant contributor to increased wealth was, in addition to rising corporate profits (see Figure 7) and an expanding economy, the decline in interest rates and the expansion of total credit market debt as a percentage of GDP, which rose from around 120% in 1980 to over 300% at present. Rising corporate profits and declining interest rates boosted the value of equities as price-to-earnings ratios expanded. (It should be added that declining interest rates were a major contributor to the corporate earnings expansion.) After 2000, however, equities no longer contributed to rising household wealth. Instead, it was the value of homes that led to the spike in wealth after 2002 (see Figures 1 and 8). From Figure 8, we can clearly see that household net worth increased after 2002, to a small extent because of a recovery in equity prices after October 2002, but far more importantly because of strong gains in the value of household real estate. Driving strong home price inflation were negative real interest rates, which led to refinancing activity, a rapid expansion of home mortgage borrowings, and in some areas wild speculation. So, whereas home mortgage borrowings averaged annually about US\$270 billion in the 1990s, recently home mortgage borrowings were running at an annual rate of almost US\$900 billion (see Figure 9).

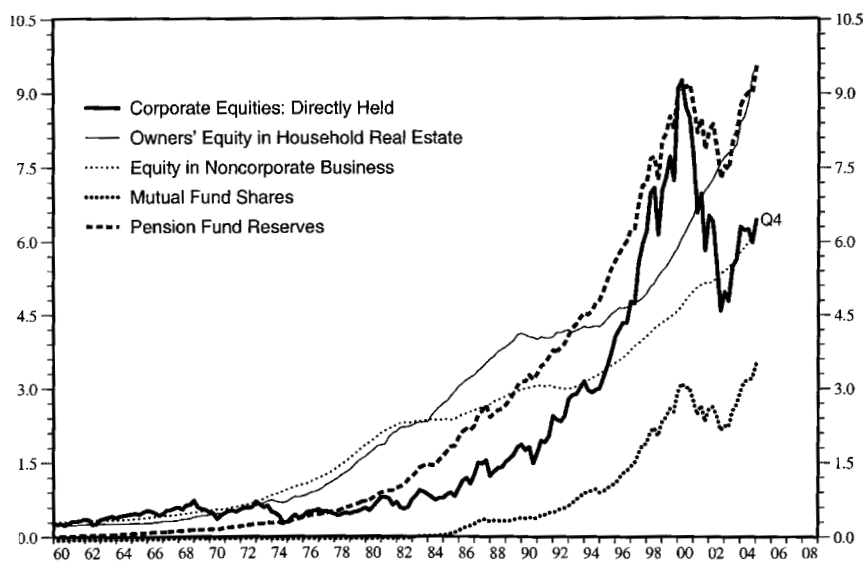
Now, whereas both David Malpass and Paul Kasriel agree that rising household wealth has been a major contributor to the economic expansion that has occurred over the last 15 years or so, they disagree on the durability of the rising wealth that is sustaining that economic expansion. If continuously rising asset prices (stocks and real estate) can be sustained, then there should be little to worry about the economy and corporate profits. Conversely, if household net worth stalls or declines meaningfully, as the deflationists maintain, then consumption and the economy would suffer — possibly very badly.

Figure 7 S&P 500 Earnings per Share: Forward & Actual (dollars), 1985–2005



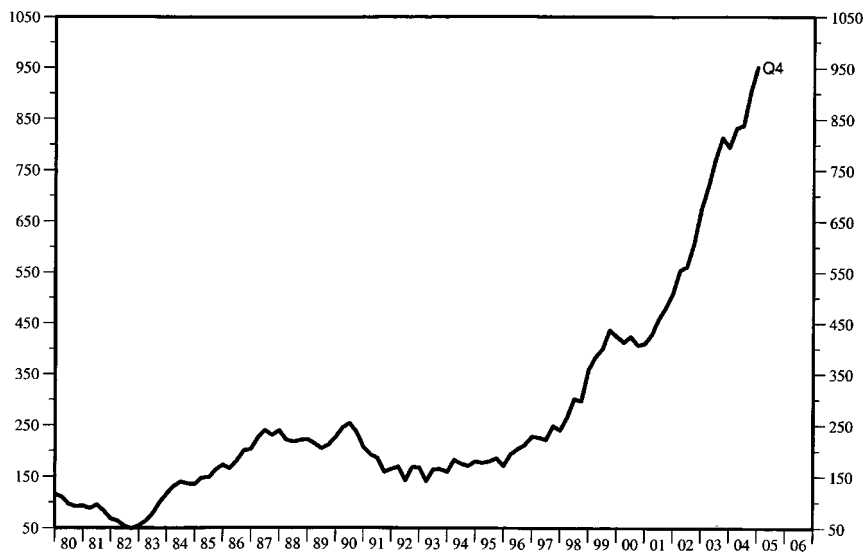
* 52-week forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates. Monthly through April 1994; weekly thereafter.
Source: Ed Yardeni, www.yardeni.com

Figure 8 Assets of Households (trillion dollars outstanding), 1960–2004



Sources: Federal Reserve Board Flow of Funds Accounts; Ed Yardeni, www.yardeni.com

Figure 9 **Home Mortgage Borrowing (4-quarter sum, billion dollars), 1980–2004**



Sources: Federal Reserve Board Flow of Funds Accounts; Ed Yardeni, www.yardeni.com

ARE CONTINUOUSLY RISING US ASSET PRICES SUSTAINABLE?

While it is unlikely that Mr Bernanke will ever drop dollar bills from a helicopter, since it would instantly lead to a nationwide civil war with people fighting with their guns for the raining dollar bills, the supply of money can be increased ad infinitum in an economic system. Therefore, on first sight, it would seem that easy money and credit can sustain asset inflation for a very long time, or at the very least prevent a serious asset deflation. A closer analysis, however, reveals that in the same way that corporate profits cannot grow in excess of nominal GDP in the long run, asset markets cannot appreciate at a higher rate than nominal GDP for very long. Let me explain.

Money supply growth in excess of real economic growth leads to inflation, which may manifest itself in rising wages or in rising consumer prices, commodities, equities, or real estate. The beauty — or the viciousness — of inflation is that it doesn't occur in all asset markets and in the prices for goods, services, and commodities at the same time. Very broadly speaking, we could argue that

rising consumer good prices are bad for asset markets, whereas a declining rate of increase in consumer prices (disinflation, such as we had since 1981) or an absolute decline in consumer prices (deflation) tend to be favourable for asset markets. The reason for this diverging performance of inflation in consumer prices and asset prices is that declining commodity and consumer prices allow for interest rates to decline, which boosts the value of assets such as stocks, bonds, and real estate. Rising commodity and consumer prices, on the other hand, lead to rising interest rates, which then depress asset markets (P/E contraction). Moreover, rising consumer prices lead to rising wages. It should be easy to understand that if consumer prices increase by 10% per annum, wages cannot increase for long by, say, only 3% per annum, since negative real wage gains would lead to a loss of purchasing power, diminished spending, and a recession. Similarly, wage increases in excess of productivity gains will lead to some inflation in the system (rising consumer prices, or rising asset prices). This is the easy part to understand about inflation.

Where inflation becomes tricky and vicious is at turning points.

Obviously, consumer prices and wages cannot rise forever without at some point bringing some asset inflation into the equation. This is so, even if monetary conditions never become tight, as was the case under Fed chairman Volcker in the early 1980s, when tight money brought about disinflation for consumer prices after 1981. Similarly, asset prices cannot increase forever without consumer price inflation manifesting itself in some form or another, leading then also to rising wage inflation. Accelerating consumer price and wage inflation will inevitably lead to asset inflation, when people lose faith in paper money as a store of value. They will then switch from bonds and cash into hard assets such as real estate, precious metals, or equities, which benefit from rising prices (oil and mining companies in the 1970s). Similarly, it is inconceivable that asset prices could appreciate forever in excess of consumer prices, wages, and interest rates. Why? If asset prices rise for very long at a much faster clip than interest rates, people will, as in the case of accelerating consumer price inflation, lose faith in cash and bonds as a store of value. They will then, as in the case of consumer price inflation, shift their cash into real estate and commodities and all sorts of collectibles. As asset prices rise, more and more people will be drawn into the asset appreciation game. Jobs will migrate from productive industries such as manufacturing to jobs related to the asset appreciation game, where the annual capital gains far exceed the returns that can be achieved from the manufacturing of goods and the provision of productive services. Rising asset prices and the neglect of manufacturing will then lead to a loss of international competitiveness, which will be reflected in rising trade and current account deficits. Initially, these rising trade and current account deficits will not be perceived as negative by the investment community. Some smart economist will write an article for the *Wall Street Journal* in which he

explains that the rising trade and current account deficits are a sign of economic strength and the appreciating asset values are some sort of savings.

Eventually, however, the market will become concerned about the total loss of international competitiveness as a result of the inflated price level and reflected in ballooning trade and current account deficits. The currency of the country with the high asset inflation will then weaken. Commodities will increase in price — expressed in the depreciating currency of the country with high asset inflation — and put upward pressure on consumer prices. In countries with a stable currency, commodity prices will remain stable or rise far less than in the country with high asset inflation and the depreciating currency. Should the country with the high asset inflation happen to be a large net importer of commodities, this situation of weak currency and rising commodity prices is likely to exacerbate the trade and current account deficits and lead to additional weakness in the exchange rate. And once the currency of the asset-inflating country falls in earnest, import prices will begin to increase rapidly and lead to consumer price inflation and rising interest rates. **At this point, the asset inflation is gradually replaced by commodity, consumer and wage inflation, for two principal reasons.**

Rising interest rates affect the inflated value of equities, bonds, and real estate negatively, since a huge credit expansion was responsible for the asset inflation in the first place. Therefore, some leveraged players faced with rising interest rates default and the supply of assets increases. But probably more importantly, while the public is brainwashed into believing that the asset inflation is based on sound economic fundamentals, the smart money notices that the asset inflation in local currency does not offset the depreciation of the currency. The result is that the smart money, which became immensely rich as a result of the asset inflation, bails out of local assets and shifts its funds overseas into assets that are

relatively inexpensive compared to the inflated domestic assets. The result is additional currency weakness and consumer price increases brought about by rising import prices, which begin to exceed the rate of increase of the appreciating assets. The leveraged consumer faced with rising interest rates, and wages that initially will lag behind the consumer price inflation because of international competition, is squeezed, and the accelerating consumer price inflation is likely to be accompanied by a very nasty recession.

Because of rising interest rates, asset price inflation, which may still continue but at a lower rate than consumer price increases, will no longer support increasing consumption, which the asset inflation did for as long as it was higher than consumer price increases. At the same time, negative real wage growth will bring about a decline in aggregate demand.

So far, I have tried to explain that there is only one type of inflation, and that this is an increase in the quantity of money in excess of real economic growth, but that this inflation can manifest itself in one of two ways: **rising consumer prices** or **rising asset prices**. Of the two types of inflation, rising consumer prices is far less dangerous. When consumer prices increase rapidly, the public at large will support the monetary authorities' attempt to bring down the rate of price increases through tight monetary measures since the majority of the population, notably the housewives, will suffer from rising consumer prices. In asset inflation, however, the illusion of wealth keeps the public happy for quite some time. How much more enjoyable is it to see one's stock portfolio or home equity appreciate by between \$50,000 and \$100,000 — or, for the rich, by millions of dollars — every year, than to work hard in a manufacturing plant or in one's own business? So, for a very long time the public — and especially the smart money, which benefits the most from the asset inflation — will support accommodating monetary policies by the central bank.

THE FOUR PHASES OF ASSET INFLATION

The **first** of the four phases of asset inflation is the soundest one. Once the monetary authorities move to curtail the accelerating commodity, wage, and consumer price inflation with tight monetary and credit policies (high real interest rates), commodity prices begin to decline and consumer price inflation to decelerate (disinflation). Usually, a recession will accompany the tight monetary policies. Once recovery gets under way, asset values — in particular, bonds and equities, which became very depressed as a result of the earlier high consumer price inflation, which was followed by tight monetary policies and a recession — begin to rally sharply as interest rates begin to decline and corporate profits to expand, thanks to the ongoing disinflation. In the United States, I would put the beginning of this phase in 1981/1982.

We can say that in the first asset inflation phase, financial assets recover from very depressed levels in celebration of the economic policymakers' victory over consumer price inflation. It is not unusual to have heavy foreign participation in this phase, since, at its onset, assets were extremely depressed — especially in foreign currency terms, since the exchange rate obviously collapsed during the preceding phase of high consumer price inflation. In the first phase of the asset inflation, policymakers, investors, and economists still worry about consumer price inflation — not understanding that inflation has shifted from commodities, wages, and consumer prices to assets.

Towards the end of phase one, excessive speculation becomes evident, some inflationary pressures develop, and the monetary authorities overreact and tighten money excessively, which then leads to a big setback for asset markets (in the US, real estate after 1986, and equities in 1987). Since the setback in asset markets threatens to bring about another recession, monetary conditions are quickly loosened again

and asset markets begin to recover in **phase two** of the asset inflation cycle. In the early part of phase two, foreigners are largely absent since they were burned badly when phase one of the asset inflation experienced a serious setback. The additional liquidity injection that gets phase two in motion then brings about additional asset inflation and, through the illusion of wealth, strong consumer confidence and general financial contentment, complacency, and happiness.

Phase two of asset inflation is facilitated by still-declining commodity prices and diminishing consumer price inflation, and increasingly begins to be perceived as resting on sound economic fundamentals. In this phase of the asset inflation, the loss of international competitiveness begins to show up in rising trade and current account deficits. However, asset markets continue to perform well because foreigners are drawn to the asset inflation party and become active participants once again (in the US, in the late 1990s). Forgotten are the pains from the losses incurred at the end of phase one; and, having missed out on the early stage of phase two, when assets recovered from the losses incurred earlier at the end of phase one, foreigners rush into the inflating asset markets in order to reap some “quick gains”. In this phase the incoming liquidity from foreign investors will even strengthen the currency and lead to declining import prices. This condition provides additional confidence to the monetary authorities and the public, who come to believe that their economy and their monetary policy are fundamentally sound. Otherwise, why would foreigners shift their assets into a country with high asset inflation?

Phase two of asset inflation usually ends in a wild orgy of stock market and often also real estate speculation. Prices become grossly overvalued, and when investors’ expectations are disappointed the markets collapse. Before the collapse, the financial markets, which expanded at a much faster clip than

GDP in phase two of the asset inflation cycle, become disproportionately large in terms of their size relative to GDP. The collapse of financial assets worries the monetary authorities who, up to now, have feared a recurrence of consumer price inflation. Suddenly they change their mindset and begin to believe that declining financial asset prices could seriously damage the economy, and that deflation could become a problem (the US after 2001). Through a massive injection of liquidity and, frequently, direct purchases of equities, the policymakers support the market. This leads to **phase three** of asset inflation, the most unhealthy phase.

In the early part of this phase, consumer price inflation remains low despite negative real interest rates, because the system suffers from excess capacities that came about from a capital spending boom at the end of phase two. However, the smart money begins to realise that asset inflation erodes the purchasing power of money in the same way that consumer price inflation does. Since excessive liquidity injection prevents financial asset prices from becoming truly inexpensive, money begins to shift into hard assets, such as real estate, commodities, and foreign currencies. The public, who just lost a ton of money when the equity markets broke down and who are desperate to make up for their losses, then follow and boost the hard asset markets to lofty levels. For a while, all assets become grossly inflated. There is simply too much money chasing too few assets. Speculation becomes rampant in all asset classes.

In the meantime, the productive economy doesn’t perform particularly well and, due to the artificially inflated price level brought about by negative real interest rates, becomes totally uncompetitive. But the public, brainwashed by the media and the monetary authorities, believe that asset prices are rising due to sound economic fundamentals and a solidly recovering economy. At some point in this third phase of asset inflation, consumer prices begin to rise more than was expected. **At this point, the**

most crucial time in the whole asset inflation cycle occurs. If the monetary authorities are alert — which is an unrealistic assumption — they would tighten monetary conditions resolutely. But their response will be to do so only reluctantly and timidly. Having gone from fearing consumer price inflation for as long as it wasn’t a problem (in the case of the US, for 20 years or more right up to the year 2000), to fearing deflation, the monetary authorities (who are usually several miles behind market events) will argue that the rise in commodity and consumer prices is only temporary. Nevertheless, the market will perceive the modest tightening as a measure to contain inflationary pressures, and the asset markets will begin to stall or decline moderately while the foreign exchange rate improves temporarily. However, when consumer price inflation does accelerate, which is inevitable in an environment of negative real interest rates, rising commodity and basic material prices, and renewed serious foreign exchange weakness, the market will push up interest rates through a bond market collapse.

It is important to understand that, in phase three of the asset inflation cycle, there is an inflection point that leads to asset deflation. This is brought about either by tight monetary policies or by consumer prices beginning to increase at a faster pace than asset prices, which is exacerbated by a collapse in the foreign exchange rate as the smart money and foreigners — even central bankers with a huge time lag — lose faith in the currency of the asset inflating country.

How ugly **phase four** of the asset inflation cycle becomes will largely depend on how high the asset markets were pushed by the easy money policies of the central bank during phases one to three and how the downturn is brought about. If asset prices became grossly inflated in phase three (the US in 1929, Latin America in 1980, Japan in 1989), the downturn in asset markets can be severe and long lasting. Moreover, if the downturn is brought about by

monetary tightening measures by the central bank, the result is likely to be a severe deflationary asset market decline in local currency. Conversely, if during phase three the central bank failed to increase interest rates in an attempt to curtail the emerging inflationary pressures in consumer prices — for fear of popping the asset bubble it itself created — the deflationary process is more likely to be through the exchange rate mechanism. In this instance, the asset markets may only decline moderately in local currency terms (down only by 30–50%) but collapse against strong currencies. If at this juncture no strong paper currencies exist, the asset deflation occurs against gold and silver! (See also Fred Sheehan's report below.)

The important point to remember is that there is a continuous process in economic development that leads to alternating phases of **consumer price inflation** and **asset price inflation**. At times, asset prices rise more strongly than consumer prices; at other times, consumer prices rise much faster than asset prices. I admit that my analysis of the alternating consumer and asset price inflation cycles is an oversimplification of economic conditions. If consumer prices rise strongly, not all asset markets suffer to the same extent. For example, in the 1970s bonds performed miserably, while real estate had its fair share of a collapse in 1974 but then recovered strongly. Similarly, in periods of asset inflation, not all consumer price increases decelerate. High asset inflation will increase the wealth of rich people more than that of poor people; therefore, prices of certain luxury goods (caviar, very high end luxury cars, prestigious premium wines, etc.) continue to rise strongly. But these imperfections don't alter the fact that the best time for asset markets is in the Kondratieff downward wave, during which commodity prices and interest rates decline. (All the major financial manias in the last 200 years coincided with declining commodity prices.) Conversely, during the Kondratieff upward wave, during

which commodity prices and interest rates rise, asset markets don't perform spectacularly well. Again, I concede that there are exceptions to this general rule. If at the onset of the consumer price and interest rate upswing (the early stage of the Kondratieff upward wave) asset markets were terribly depressed as a result of a massive debt liquidation, such as was the case in the US in the 1940s, then asset markets can perform superbly in an environment of rising consumer price inflation and rising interest rates (see Figure 10). In fact, I would like our readers to reflect on Figure 10 and fully understand that, whereas in the 1940s and early 1950s the asset markets were low (as was, at that time, total debt) as a percentage of GDP, today the asset markets are as badly inflated as total outstanding credit market debt. David Malpass should perhaps consider that the rise in household net worth in recent years (see Figure 1) may have had something to do with the rapid credit growth we have recently experienced. (Total credit is up by approximately US\$10 trillion in the last four years.)

IN WHAT PHASE OF THE INFLATION CYCLE ARE WE NOW?

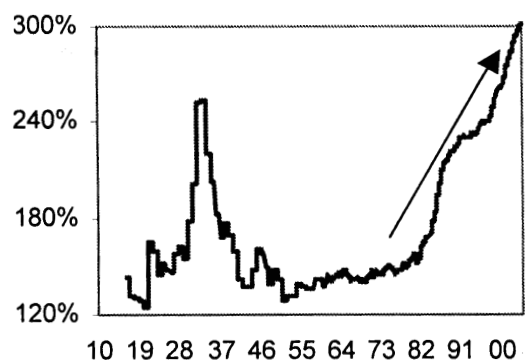
In economics it is always difficult to know precisely what stage of a price, business, or speculation cycle one finds oneself to be in. However, we know that consumer price increases have been moderating since 1980 and that interest rates have been declining since 1981. At the same time, asset markets have been rising since 1982, although equities

experienced a serious downturn after 2000. **Therefore, it is easy to determine that we are not at the beginning of consumer price disinflation and an asset inflation cycle. Rather, we are likely to be in either phase two of the asset inflation cycle or, even more likely, in the third phase where the inflection point from asset inflation to consumer price inflation is reached.**

Why do I think so? Unless a business downturn occurs, interest rates in the US cannot decline any further. A business downturn, however, would not be good for asset markets, as affordability of the inflated assets would become a serious issue. If, however, the economy continues to expand, inflation to accelerate, and interest rates to rise, then it would seem to me that even modest interest rate increases brought about by the Fed, or by the market if the Fed doesn't take any action, would cool, or more likely depress, various highly leveraged investment or asset markets. This, as mentioned above, would occur in the US through either deflation of asset prices in dollar terms or a depreciating dollar. The combination of the two is very probable, as was the case in Latin America in the early 1980s and during the Asian crisis in 1997/1998.

Characteristic of phase three of the asset inflation cycle is the rapid increase in the price of commodities. Now, I am aware that some observers maintain that, in today's economy, rising commodity prices have little impact on consumer prices. But rather than pay attention to these new theories, I look at a figure

Figure 10
Total Debt as a percentage of GDP, 1910–2004



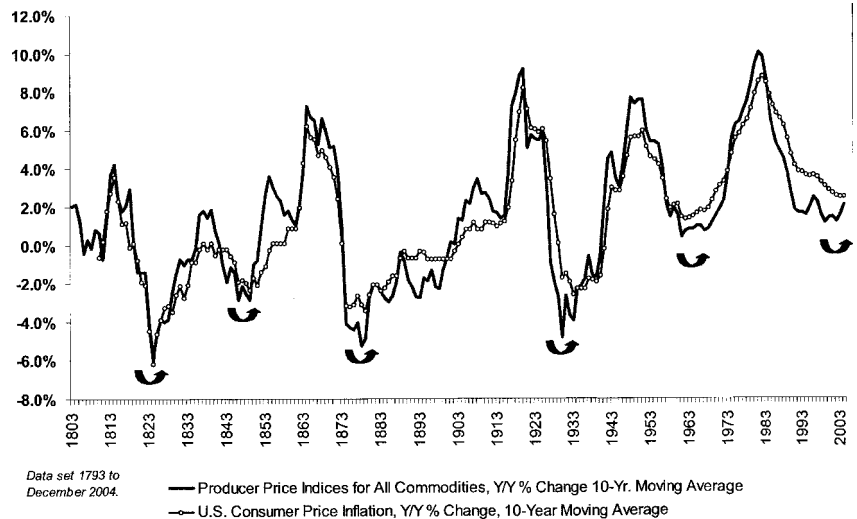
Source: Bridgewater Associates

provided by Barry Bannister of Legg Mason (BBBannister@LMUS. LeggMason.com), which shows a very close correlation between commodity and consumer price inflation over the last 200 years (see Figure 11). (Note how long the commodity and consumer price inflation cycles last.) So, until proven differently, I suppose that rising commodity prices do have the tendency to increase consumer prices. I may add once again that it is very likely the CPI in the US is understating the rate of inflation for the average household, which, I estimate, is running at least at 5% per annum. In addition, if we look at the producer price index for intermediate materials, which is rising at an annual rate of over 8%, it is most likely that the producer price index for finished goods will soon begin to rise at a faster clip — that is, unless there is an immediate collapse in commodity prices (see Figure 12).

Also pointing to the US economy having reached the third phase of the asset inflation cycle is the fact that it is internationally no longer competitive, which is reflected in the large trade and current account deficits. I must point out that in the case of both high consumer price inflation and high asset inflation, a country loses out on competitiveness and will have rising trade and current account deficits. In both cases, either tight money policies by the central bank (high real interest rates), which curbs domestic demand and leads to disinflation and sometime even deflation, or the market mechanism, will eventually make the adjustments through a collapse in the bond market and the currency.

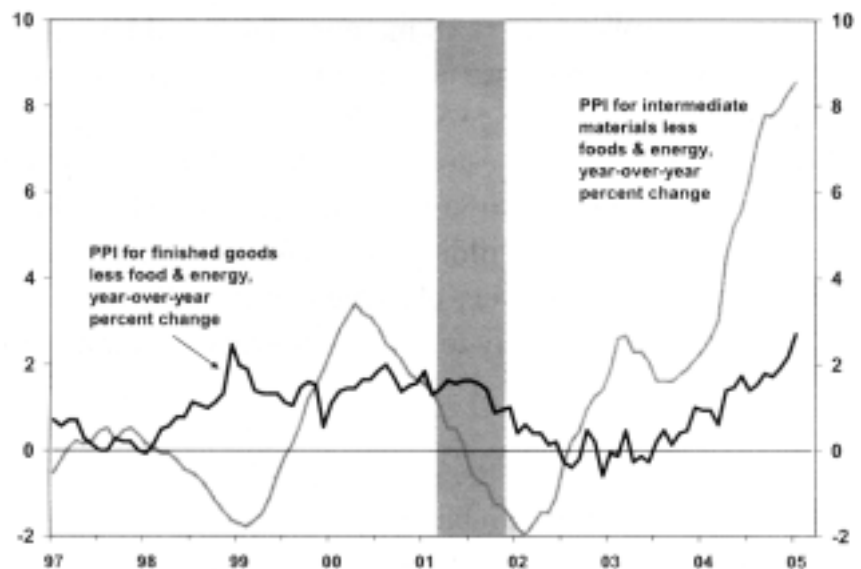
Then there is another point to consider. During commodity and consumer price inflation phases, speculation focuses on commodities and resource shares, while the financial sector performs miserably. (In the 1970s, a large number of brokerage firms closed down or were taken over.) During the asset inflation cycle, however, the financial sector performs superbly. Last September, Ray Dalio and Amit Srivastava of Bridgewater Associates published a report entitled “The Money Shuffler’s

Figure 11 **PPI All Commodities Index and US Consumer Price Inflation (Y/Y % change), 1793–2004**



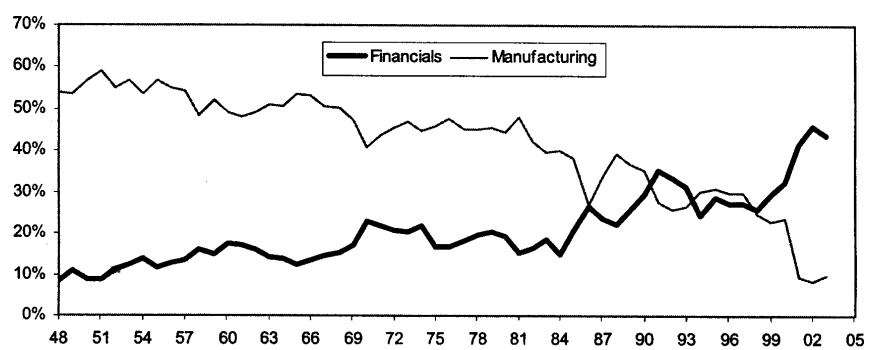
Source: Barry Bannister, Legg Mason

Figure 12 **PPI for Intermediate Materials and PPI for Finished Goods, 1997–2005**



Sources: Bureau of Labor Statistics; Richard Berner, Morgan Stanley

Figure 13 **US Profits Breakdown by Major Sector, 1948–2004**



Source: Bridgewater Associates

Vig” (see *Bridgewater Daily Observation* of September 22, 2004), in which the author wrote that “the money that’s made from manufacturing stuff is a pittance in comparison to the amount of money made from shuffling money around; 44% of all corporate profits in the U.S. come from the financial sector compared with only 10% from the manufacturing sector” (see Figure 13). Until the onset of the asset inflation phase in the early 1980s, the manufacturing sector’s profits always accounted for more than 40% of total profits while the financial sector never accounted for more than 20%. (In the 1950s and 1960s, the manufacturing sector accounted for about 50% of profits.) Moreover, it would appear that the 44% figure for the financial sector’s share of total profits is significantly understating financial profits, since they are unlikely to include financial earnings from industrial companies such as GE Capital and General Motors’ financial subsidiaries, and the profits earned by large multinationals from their treasury activities, which resemble hedge fund-type financial transactions. The Bridgewater piece is actually quite humorous and comments on this shift in profit contribution from industry to finance as follows:

We see it anecdotally — e.g. by who lives in the big houses in the expensive neighborhoods or who shops at the expensive stores. While in decades past it used to be the captains of industry, now it’s the money shufflers — the folks who handle OPM (other people’s money) and earn their vig of it. From low to high on the hierarchy, the money shufflers at or near the peak are a) bankers, b) investment bankers and investment managers, and then c) the 2 and 20 crowd (hedge funds, private equity firms, etc.). Now, the notion of one’s child wanting to be a doctor sends chills of fear down parents’ spines, engineers gravitate to plying their craft on money instead of real stuff, and the \$600/hour lawyers are depressed (to the point of

either padding their accounts or working nearly 24/7) in their failed attempts to stop falling behind.

According to Bridgewater, the growth in the money shufflers’ profits as a percentage of GDP has partially come because financial assets and liabilities as a percentage of GDP have risen rapidly (see also Figure 10) and because “the average money shuffler’s profit per dollar shuffled has gone up (largely because those with the big bucks, particularly institutional investors, have gone from investing in the .25% to .75% fee stuff to investing more in the 2% and 20% stuff)”. Cynically, Ray Dalio and Amit Srivastava note:

[T]he only thing that has been a slight drag on the otherwise rapid growth in the profitability per money shuffler has been the big increase in the number of them. That’s one of the great things of capitalism — it allocates resources so efficiently. So, rather than turning out doctors, engineers, teachers, architects, and others who are involved with the old economy, our system has met the increased demand for money

shufflers (like me and you) via an increased supply.

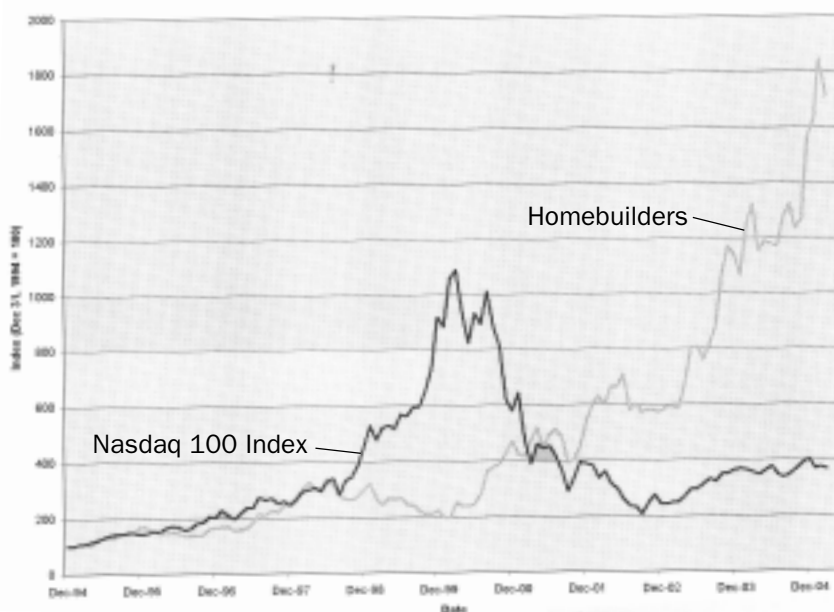
So, even if David Malpass has a point about the economy not running on “empty”, it certainly runs on plenty of money shufflers!

INVESTMENT IMPLICATIONS

Unless the economy weakens sharply (not to be ruled out), consumer price inflation is bound to accelerate. Interest rates will therefore rise and put pressure on asset markets. Conversely, if the economy begins to weaken, asset markets would likely be in trouble also, as affordability would not support the inflated home prices. Corporate profits would disappoint and put weight on the pricy stock market, while weakening demand would depress commodity prices.

In the environment I expect, where interest rates are likely to rise, the most vulnerable assets would be the ones that became the most inflated. In particular, rising interest rates or a recession would put immense pressure on the housing industry (see also GBD of March 29, 2005, entitled “The Beginning of the End”). Therefore, a basket of homebuilders, including Centex

Figure 14 **2000 Technology Bubble vs. 2005 Housing Bubble Bearing Credit Bubble Index, 1994–2005**



Source: Bearing Asset Management LLC

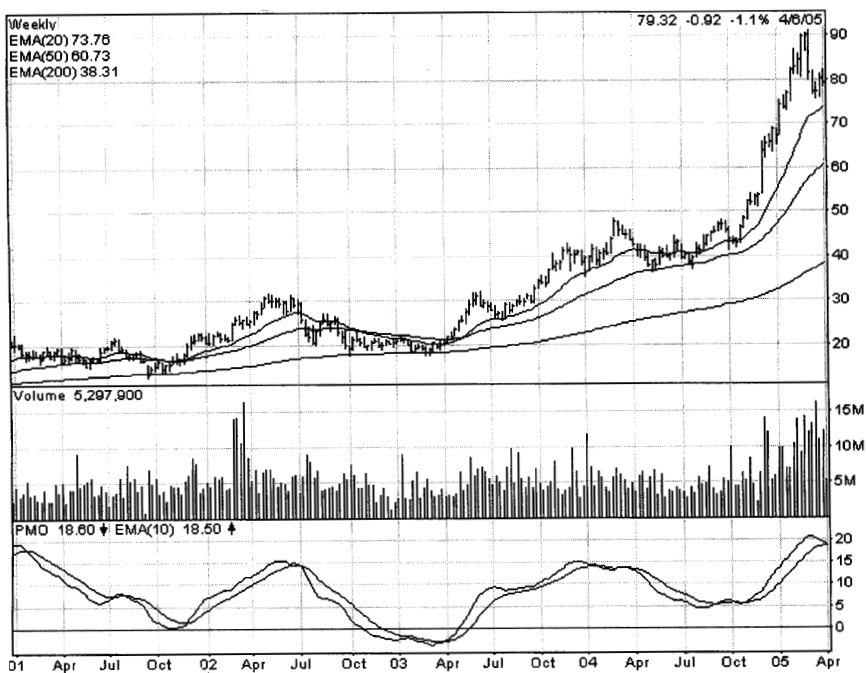
Corp (CTX), KB Home (KBH), Pulte Homes (PHM), Standard Pacific (SPF), Ryland Group (RYL), Hovnanian Enterprises (HOV), and Toll Brothers (TOL), should be avoided, or sold short by aggressive investors (see Figures 14 and 15).

Although the money shufflers are doing well, the market seems to have some doubts about how well they will do in future. The NYSE Financial Index (see Figure 16) has declined below its January low, and Fannie Mae and AIG have recently broken down and are approaching their March 2003 lows. Sub-prime lenders and banks (including Citicorp) have also broken down, which has to be regarded as a big negative for an economy that runs on rapid credit growth. In fact, we would use any strength in financials, including mortgage, credit card and sub-prime lenders, and providers of financial guarantee products such as Capital One Financial (COF), Countrywide Financial (CFC), Accredited Home Lenders (LEND — see Figure 17), New Century Financial Corp (NEW), MBIA Inc. (MBI), MBNA (KRB), and banks, as a selling or shorting opportunity. Still, I should point out that **April tends to be a month of seasonal strength for equity markets**, particularly if March was weak. Therefore, better selling or shorting opportunities may arise later in the month.

Regarding the high net worth of households and the consumer's ability to continue his spending binge, the stock market does not entirely share the view of David Malpass. Just look at the performance of General Motors, whose auto business is already running on empty, or at the breakdown of retailers such as Best Buy (BBY) and Wal-Mart (WMT — see Figure 18). Add to their weakness the recent decline of Starbucks and Budweiser and one doesn't get the impression that the consumer is in great shape but, rather, that he is about to retrench.

If we are indeed in phase three of the asset inflation cycle, and consumer price inflation is about to turn up, it is likely that lower valuations of the stock market will

Figure 15 Toll Brothers, Inc. (TOL), 2001–2005



Source: www.decisionpoint.com

Figure 16 Financial Index — NYSE (\$NYK), 2004–2005



Source: www.decisionpoint.com

Figure 17
**Accredited
 Home Lenders
 Holding Co.
 (LEND),
 2003-2005**

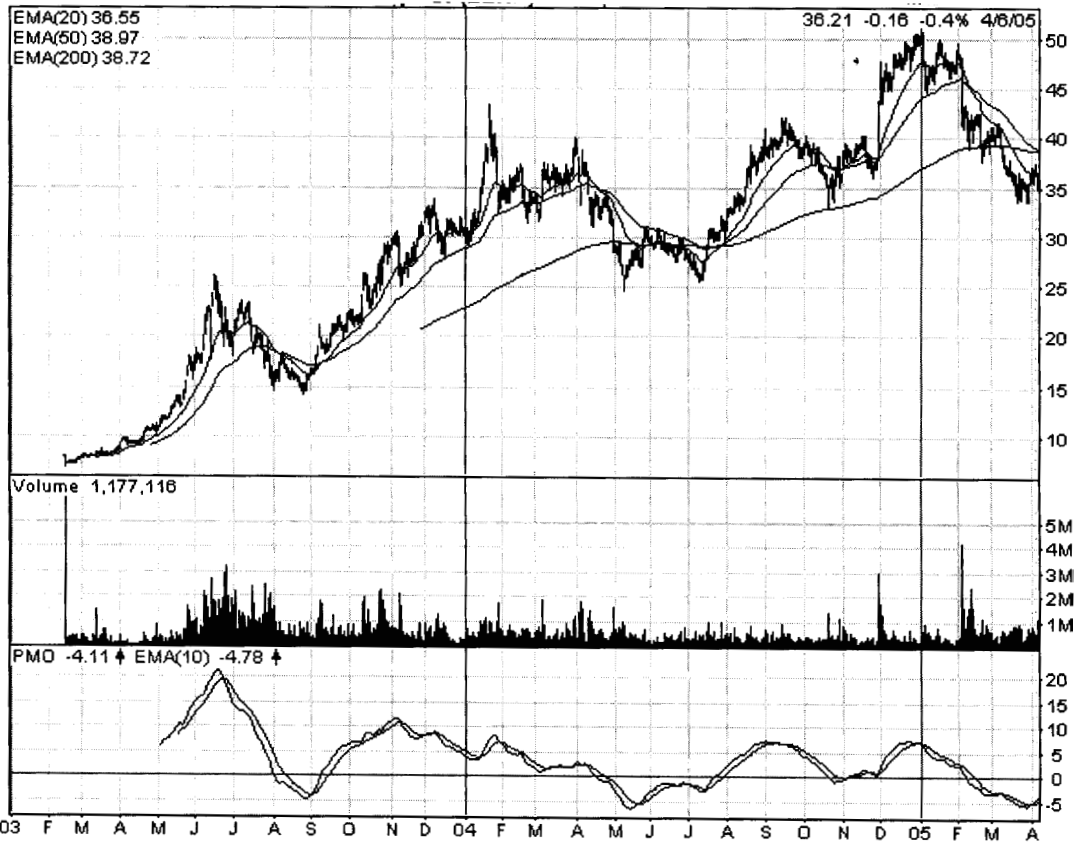
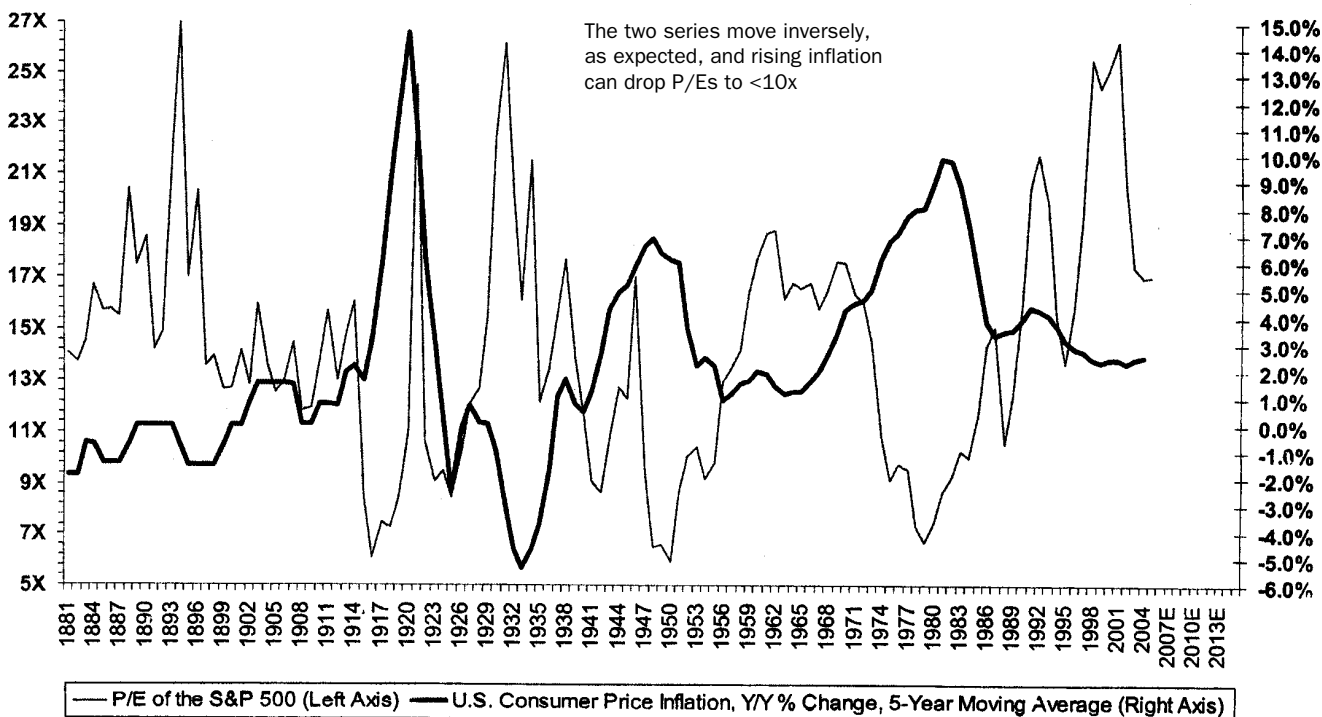


Figure 18
**Wal-Mart
 Stores, Inc.
 (WMT),
 2003-2004**



Figure 19 US Consumer Inflation 5-yr Smoothed vs. S&P 500 P/E, 1881 to Present



Source: Barry Bannister, Legg Mason

follow. From Figure 19, it is visible that when consumer price inflation accelerates, the stock market's price-to-earnings ratio contracts — frequently to a single digit. Now, in view of this, someone might question why consumer prices would turn up if the economy were to weaken. I suppose that economic weakness would induce the Fed once again to turn on the money spigot, except that this time inflation would likely shift from asset markets to consumer prices for the reasons explained above, including the likely collapse of the dollar if the money printing press is turned on again.

What about commodities? As pointed out in last month's GBD report, **the growth rate of foreign official dollar reserves has been slowing down, and this is usually accompanied by weakness in industrial commodity prices, including oil.** If one compares the price of oil to gold, it would seem that either gold is very undervalued against oil, or oil is significantly overvalued compared to gold (see Figure 20). Even more undervalued against oil are the agricultural

commodities, which are at their lowest level in 200 years, compared to oil (see Figure 21).

Therefore, I would consider shorting oil and going long gold and the grains. I may add that oil shares didn't confirm the recent new high in oil prices. Such divergence isn't a favourable omen for oil prices. In fact, I would also consider taking profits on oil stocks despite the long-term favourable fundamentals for the energy sector. As an aside, I should mention an even worse omen for oil prices that occurred recently. On the question of how high oil prices could rise, a CNBC commentator in the US said, in a moment of remarkable wisdom (by CNBC standards): "For oil prices to fall, demand would have to decrease or supplies to increase" (To be fair to CNBC, its quality in Europe and Asia is far superior to the US outfit.) Excessive speculation also occurred in the steel, copper, shipping, and iron ore sector. In my opinion, stocks in these sectors should also be avoided.

Recently, numerous **emerging markets** have sold off and are down by more than 10% from their recent

peak. A period of tightening global liquidity is very unfavourable for emerging economies and we would wait for a better entry point to initiate new positions. In my opinion, emerging markets, especially those that performed superbly over the last 12 to 18 months (Eastern European markets) and were beneficiaries of rising commodity prices (Latin American markets), should be avoided for now.

In an environment of tightening liquidity, the US dollar should hold and move up against the Euro and especially against the currencies of resource producers such as South Africa, Australia, and New Zealand.

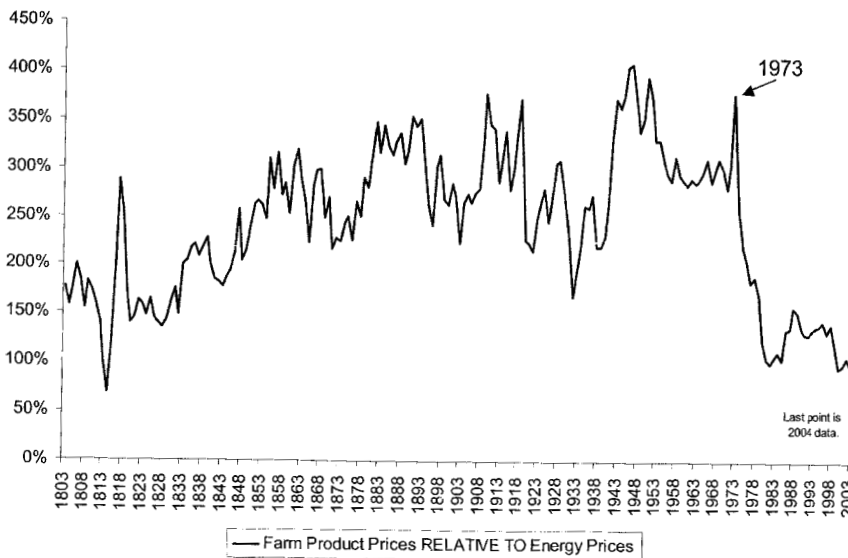
There is one further issue we need to address. **What if the deflationists are correct and a major asset deflation comes about as a result of tight money or a total debt collapse?** I have to say that this major deflation is not very likely to occur in dollar terms. If we look again at Figures 1 and 10, we are left with the impression that with the inflated household net worth and a colossal debt as a percentage of GDP, the American Fed, which created this

Figure 20 **Number of Barrels of Oil Required to Buy One Ounce of Gold, 1987–2005**



Source: Bloomberg

Figure 21 **Farm Product Prices Relative to Energy Prices, 1803–2004**



Source: Barry Bannister, Legg Mason

mess, will have no option other than to put the Bernanke & Co. money printing press in charge of a massive re-liquefaction of the system. Such extraordinary monetary interventions usually lead to extreme currency weakness, very high inflation and interest rates, a collapse of the bond market, and, at a later stage, to a collapse of society and the entire economic system. It is likely that in such an environment some sort of relative deflation of asset prices would occur, as consumer inflation and interest rates would rise and the smart money would move their funds out of the US.

Finally, **what about gold** in an environment of poorly performing assets or even in an environment of deflation? My friend Fred Sheehan, who has written for this report in the past, has some interesting observations to make on this topic based on extensive research carried out by Roy Jastram (see “Gold and the ‘Flations””, below).

I would like to leave our readers with one final thought. In the early 1980s, when the economy was ravaged by consumer price inflation and the great asset inflation was born, investors remained convinced that a resurgence of inflation was just around the corner. Moreover, hardly anyone realised that the rules of the game had changed and that **asset inflation was in the process of replacing consumer price inflation**. Now, more than 20 years later, could investors make the same mistake by counting on continuous **asset inflation**, when in fact they should be becoming concerned about **consumer price inflation**?

Gold and the 'Flations

Fred Sheehan, Tel: 1-617-572 4562; Fax: 1-617-572 4508; E-mail: fsheehan@jhancock.com

The rule-of-thumb goes that gold will appreciate during an inflation and lose value in a deflation. Empirical evidence shows quite the opposite — but the problem may lie in the question being answered. Is the question one of absolute return, or of the purchasing power of the metal over a period of 'flation? Absolute return does not exist. We quote the price of gold against dollars or Euros or Yen. Yet a portfolio manager, or even Aunt Matilda, is likely to consider its potential absolute contribution — “What will it contribute to my total return?” — some mixture of stocks, bonds, real estate, livestock, and gold. The manager is likely to concentrate on his portfolio return during 2005 (and on outperforming a relative benchmark, but that's a different topic). If inflation races out of control, gold is probably the place to be. In a deflation this may not be the time to own gold, if for no other reason than everyone else who is buying and selling *knows* the price of gold collapses in a deflation (and that it goes up in an inflation).

But life continues after Morningstar calculates the winners and losers. In the end, money's presence is only useful to numismatists and cashiers. This is not so apparent now in an age of credit and asset inflation. It becomes acutely obvious when the standard measurement for buying and selling the world's wares — oh, let's call it the US dollar — either challenges the 1923 Reichmark for the world championship in redundancy (i.e., prolonged inflation) or when wages slip, debts rise, and prices of goods fall (i.e., prolonged deflation).

One historical study stands tall. Roy Jastram spent many years collecting and interpreting data of the historical relationship between gold and prices in England and the United States. Elaboration shall follow the distillation of his labour:

- England, inflationary periods — the purchasing power of gold: 1623–1658: –34%, 1675–1695: –21%, 1702–1723: –22%, 1752–1776: –21%, 1793–1813: –27%, 1897–1920: –67%, 1933–1975: –25%.

- England, deflationary periods — the purchasing power of gold: 1658–1669: +42%, 1813–1851: +70%, 1873–1896: +82%, 1920–1933: +251%

The raw numbers are not worth much, to the investor or to the preserver of capital. Gold has been a much better hedge against inflation than is shown above. For instance, during the inflationary period of 1933–1976, gold lost 25% of its purchasing power but prices rose 1,434%. (As to what might have kept pace with inflation, “crime” comes to mind, which was the conclusion of many a corporate boardroom and trading desk.)

Jastram produced two historical studies of the monetary desks sitting at the periodic table, *Silver: The Restless Metal* (1981) and *The Golden Constant* (1978). The methodology employed was identical, as was the purpose. They are “quantitative stud[ies] of the economic history of England [1560–1976] and the United States [1800–1976].” He approached this excursion into economic history as a statistician: “I do not presume to take on the role of an economic historian or a monetary economist as well.” (He was an economics professor at the University of California, Berkeley.) Nonetheless, patterns of monetary behaviour under analogous historical events do repeat themselves. The purpose here is not to prophesise the continued relationships between gold and the 'flations, but to establish its historical existence, to apply as one sees fit to our circumstances as they unfold.

Jastram spends a good portion of the book explaining how he constructed his price tables. His purpose for doing so follows:

To construct a unified series of the price of gold since 1560 utilizing market prices, Bank of England buying prices, and Mint prices.

To construct a unified series representing the level of wholesale commodity prices in every year since 1560. [Jastram devotes chapters to explaining the full list of sources for prices, for classification of specific years when business expanded or contracted, and the methodology he employed.]

To determine the statistical relationship between the first two series in such a way as to measure the purchasing power of gold (operational wealth) since 1560.

To discover the behavior of the purchasing power of gold in the periods of inflation and deflation. [Deflationary periods were not so hard to come by as recent experience might lead us to believe. For instance, in England there were 74 years of deflation and 78 years of inflation after 1800.]

To judge the extent to which gold has served as an inflationary hedge in history and a conservator of operational wealth in periods of price recession. [On the term “operational wealth”: Jastram steers clear of “real wealth” and “real income” because “the opportunities for confusion are too great for those readers who may consider gold to be the only *real* wealth, in contrast to paper money.”]

To read Jastram today is to first acknowledge that his time series ceases when we tottered on the precipice of the most disruptive price fluctuations in Western history. On the other hand, the gold standard had been abandoned a half-decade back (and only half-heartedly supported during wars and various monarchical and republican escapades). The last few years of his

study was the most chaotic period of monetary mayhem — until the period that followed his study. (It is worth considering the four-century chart. Note that, prior to the 20th century, through continental wars; periods of fiat, printing-press currency; revolutions and of deep deflations — how comparatively mild were the oscillations around the mean. If it weren't for the last quarter century of this 416-year chart, there would be no need for a logarithmic scale. As it is, gold and commodity prices shoot off the top of the chart in the early 1970s. It is during the 20th century, and on into the 21st, that we see the portrait of modern anxiety, angst, alienation, social destruction and dislocation; a neurological chart of man's "progress" from an agricultural economy through an industrial period on into the current financial economy in which our bearings are as loosely anchored as is the construction of the latest "Russian doll" CDO tethered to its funeral-home receivables. Contemporary artists, please note.)

Jastram certainly had a taste of what was to come but his conclusions could not have anticipated a world with \$250 trillion in derivative contracts; a coordinated, worldwide land and house inflation; the ability of the US to amass a trade deficit that was financed, in 2004, by sucking in 80% of the world's savings; and the Euro and its potential to unseat the dollar as the reserve currency. Yet, the country is still considered (for the most part) the model of productivity, prosperity, and getting what you want.

Jastram chose "England [as] a country for which data are available over unusually long spans of time. She represents an economy with constant political boundaries for many centuries [not true of Germany, Italy and France]. England has not been invaded by a foreign power since 1066.... From the Norman Conquest until the change to decimal coinage in 1971, English money has consisted of pounds, shillings, and pence, always with 20 shillings to the pound and 12 pence to the shilling.

For about 700 years, there was no break between the money of one year to the next. The coinage and the money of account never parted company." Conveniently, "the English are a nation of record keepers." This includes *Prices and Wages in England from the Twelfth to the Twentieth Century*, published in 1939. Jastram "cannot recommend too highly this remarkable achievement".

He recognises that the United States cannot "match all of the attributes cited earlier for the choice of England" but "it is fully justified by its great importance both as a national economy and as an economic influence on the rest of the world". Also, "economic institutions are common to the two and similar motivations and traditions influence their commerce and finance".

To definitions: Jastram describes inflation and deflation as "any period of rapidly rising [or falling] prices". The author knows that he cannot define such subjective opinions as to "how fast is rapid; how precipitous is swift?" And, "this open question has to be related to the length of the time period which is descriptively designated as inflationary or deflationary." Since Jastram cannot satisfy everyone, he simplifies matters by satisfying himself: "I simply adopt an arbitrary schema and state my considered selection of terminal dates for periods of inflation or deflation."

To convention: Jastram sets 1930 as the starting point. Gold, the consumer price index, and the purchasing power of gold equal 100 in that year. For example: the purchasing power of gold in 1650 is 97.6, meaning the same amount of gold would buy 97.6 pots in 1650 and 100 pots in 1930.

Jastram is not interested in "transient swings" but with "fundamental changes in price levels over substantial durations". Periods of 20 to 30 years are more useful than longer periods. The composition of prices is relatively closer, as is the quality of the goods.

Jastram's conclusions:

- Gold is a poor hedge against major inflations.

- Gold appreciates in operational wealth in major deflations.

- Gold is an ineffective hedge against yearly commodity price increases.

- Gold does maintain its purchasing power over long periods of time. "The intriguing aspect of this conclusion is that *it is not because gold moves towards commodity prices but because commodity prices return to gold.*" [Jastram's emphasis, as are all future italicised words in quotations.]

I add two more summations:

(1) forget about the 'flations, gold has conserved operational wealth during periods of currency destruction; and (2) nobody has pursued Jastram's work after 1976, but, to the extent the "retrieval phenomenon" (as Jastram calls it) is still valid, the surge in gold will chase the Dow Jones Industrial Average for best in show. On the first, Jastram only devotes one page to what he calls "The Attila Effect". That is: "...historically, gold has served as a financial refuge in political, economic, and personal catastrophes.... [E]xamples are legion." Jastram apologises for what he considers the liberty of stating this. His intention was to record the history of gold's relationship with purchasing power. He did not study the change in gold's value when Attila showed up in the pantry. In response to that question he would probably say "priceless". He did write: "Anyone who fears the collapse of his country's currency is acting rationally when he shelters his assets in gold." Why bother with a quantitative study to describe that?

The retrieval phenomenon has demonstrated consistency. Examples include "three distinct cycles of the commodity price level *between* the beginning and the end. These were, bottom to bottom, 1700 to 1737, 1737 to 1752, and 1752 to 1779.... The amazing feature of these three cycles is that at the midpoints of each the three statistical series involved converged on each other at a value they were to attain again almost 200 years later, in 1930."

With book in hand, the reader can better judge the suitability of

Jastram's research in different circumstances. Without the reference, we will make do with Jastram's verbal description of this chase across the centuries:

As early as 1650, commodity prices had risen to equate with gold. They passed down through the gold parity level in 1660 and lay below that line until they rose to touch gold again in 1695.

Again, commodity prices dipped below gold, until in 1710 commodity prices moved up to meet the more stable gold price index. They remained in constant relation to each other until 1720 when commodity prices fell sharply away from gold, not to return until 1740.

The next disparity developed shortly after 1745, when commodity prices again fell away from gold levels, always the more stable of the two. But by 1765 the retrieval phenomenon had reasserted itself, and commodity prices rose to meet the level of gold.

Between 1765 and 1793 commodity prices again fell generally below gold levels but (to put it anthropologically) seemed to be striving constantly up to reach gold, witness 1771, 1776, 1782, 1790. Commodity prices broke through the gold level in 1793 and stayed above until they fell back down to meet gold in 1815.

After the Napoleonic disturbance, gold resumed its prewar index level in 1820 and commodity prices fell to join it in 1822. Thereafter through 1875 commodity prices arced above and below the constant level of gold but always returned to the latter.

After 1875 (when they stood at 99.0 and 99.8, respectively) a divergence developed until 1915, when characteristically, commodity prices finally moved upward to meet gold. Commodity prices continued to climb past gold until they peaked in 1920. In the decline that followed they homed in again on gold until the

two index numbers necessarily were equated in the common base year 1930 = 100. [In other words, all of the price changes through the entire period needed to start together at a certain point. Jastram chose 1930.]

The imagery here is that for nearly three centuries the level of gold was the loadstone for commodity prices. The latter traced a pattern falling and rising around the gold price level but always returning to it before wandering off again.

Why might this be? Jastram suggests:

If it is settled national policy that the price of gold will be constant, then there will be times when, for various reasons, commodity prices will fall below or above the constant level. When either of these swings becomes severe enough, monetary authorities will intervene and adjust the monetary supply to reverse the process. This will tend to return the commodity price level toward the constant price of gold. Not primarily because it is *gold*, but because it is *constant*.

Why, then, are “gold” and “inflation hedge” so bound together? Probably because that is what we remember. The only exception, in which gold chased commodity prices, was in the United States between 1951 and 1976. Jastram postulates this was due to the price fixing of gold before the London Gold Pool fell apart in 1968. We may, or may not, live amidst a similar price suppression today. (Similar or dissimilar — in the sense of whether the unwinding will chase the same path today.) England, by the way, would have joined the US as an exception during its final leg (1933–1976), if not for poor timing. Through 1974, gold stood at a 1.5% advantage to prices. After 1976, only two years later, gold had lost 25% of its operational wealth since 1933, a 44-year period.

This is an example of how the 20th century stands apart in his

study. Violent movements of price changes are concentrated in the last three generations. This observation comes up time and again: “[T]he annual rates of inflation were not at all severe until the twentieth century.” Regarding English deflations: “The most recent deflation [1930–1933] was by far the worst.”

Gold's ability to hedge during deflations begs to be charted in the New Era. As Jastram states: “[T]he historical capacity of gold as a hedge against deflation may be contingent on the willingness of government to maintain a stable gold price.” The government's willingness to maintain a stable anything in troubled times is always suspect; today it is certainly absent. But then, the alternative (chaotic, bombastic pontificating on a difficult subject which not five legislators in Washington possess the capacity to understand) may be money madness, a good time to stuff something solid into the safe.

ORGANIC CURRENCIES

It may be useful to apply *The Golden Constant* to a pair of contemporary topics — the future of the Euro and the reintroduction of a gold standard. The gestation of a currency was described by Carl Menger as a “medium of exchange. It is something that men acquire as a means of acquiring something else. It enables people to avoid the inconvenience of direct exchange, or barter, and engage in a more convenient indirect exchange.” Money “is a social institution, the unintended result, the unplanned outcome, of individual efforts of members of a society”.

The slow evolution of gold as an accepted means of exchange fills this description. It is commonly assumed that the gold standard was a law of the land, of many lands, decreed from on high. In both countries under discussion, the gold standard was accepted “as a social institution” long before it was written into law. Jastram notes: “The remedy [to hyper-irresponsibility] was the prevalent silver coins of those days [circa 1717]

and was not made to apply to the rarer gold.... The odd thing is that England did not establish the gold standard by any design or deliberate act. The proclamation of 1717 brought the golden guinea down to 21 shillings. [Shillings were silver pieces.] The 1717 Act made the value of 21 shillings in money tied to the value of *gold* in a guinea and not to the value of *silver* in 21 shilling pieces." It was only at the conclusion of the Napoleonic Wars, in 1816, "with Lord Liverpool's Act [that established] gold as the sole standard. But a full century earlier one of the greatest currencies of all time had quietly eased onto the gold standard at a price of 3 pounds, 17 shillings, 10.5 pence per standard ounce." Through the 19th century, other countries locked their currencies in terms of fixed quantities of gold. This was quite unlike the wholesale European conversion into the Euro a couple of years back.

The US established a bimetallic system in 1792. "It worked reasonably well" until its suspension on December 30, 1861. The government printing presses issued "legal-tender notes" (no backing other than the government's good word, which was not good enough to forestall an immediate inflation.) Specie payment was not resumed until 1879 when the US reverted to a specie standard, that standard being gold. According to Jastram, silver was discarded by oversight in legislation (in 1873), though he mentions opposing views of those who believe the act was more than absent-mindedness. In any case, there was no meaningful debate about the adoption of gold (as the sole standard) in Congress or the Senate, buffering his contention that the US eased its way on to the gold standard. Even then, it was the Gold Standard Act of 1900 "which provided legal recognition of what had been in operation since January 1, 1879".

We have the Euro today. It came into being as a negotiated piece of legislation. It is a paper currency that is not convertible. It is certainly giving the dollar its comeuppance, but it has not been tested by plague,

war, famine, or a 20% unemployment rate.

Proponents of a new gold standard may find that a widespread institution of such is not the best route even if the world's financial architecture crumbles (besides the practical problem of nobody speaking to one another). An analogy might be to the League of Nations or the United Nations. Both operations were launched with great fanfare and promise. The first disappeared, and the second is an incoherent mess, 60 years after its launch. Maybe they promised too much or maybe they were always castles in the sky. Maybe the United Nations could have made practical contributions if it had restricted membership to a dozen countries. Whatever the case, a couple of hundred voting countries is an impossible collage of interests and any future monetary standard with teeth should start out as a small, natural evolution.

THE GOLDEN CONSTANT: POST-JASTRAM

Jastram's work moves across time from an agricultural economy and into the industrial age. The final 25 years of his study gestated the financial economy, but finance did not control economic activity until well after Jastram's time. Nor did he witness the worldwide asset inflation propagated by the US central bank. He tracked consumer prices, not financial assets. How to incorporate this change into an extrapolated study is for a better mind: How does one adjust Jastram's calculations of relative prices during a period in which billions of dollars worth of US home mortgages are being bought by the Chinese central bank and recycled (thus inflating) the Chinese economy? The researcher who relies on the methods that produced *Prices and Wages in England from the Twelfth to the Twentieth Century* may fall short.

On the other hand, the shift from an agricultural to an industrial economy altered the role of finance in a way that touched every hearth and home:

There were bad times and good as long as economic history has been set down.... But until the nineteenth century, these events were largely accounted for by crop failures, epidemics, wars, civil disorders, political struggles, deviant fiscal finances...in respect to crises and depression, and by good harvests, prolonged peace, enlightened rule on the side of revival and prosperity.... It was not until a large part of the populace was receiving and spending money incomes, producing goods for large markets, organizing enterprises with few employers and many employees, and using credit instruments in support of all this that economic fluctuations took on the character of business cycles.

This economic change swept large portions of the population into a consciousness of money. That Jastram's study applied equally well on either side of that divide may foreshadow the financialisation of the American mind as equally inconsequential to future patterns. (One sign of that mind: In a 1979 poll, fewer than 10% of Americans knew who the Federal Reserve chairman was. Today, the percentage would be higher in Zanzibar.)

Another critical distinction that crept up and then pounced on Jastram's back is the era of democracy for all, liberty for none. Without democratic pressures, would the US have jettisoned the gold (demi)-standard in 1971? The Johnson and Nixon administrations were afraid to do what governments from centuries past had been forced to exact — tribute from the people when fighting a war. The current Bush administration is equally neglectful (and queasy) in this regard. Looking at the current Chinese government's thwarted efforts to rein in a recklessly credit-defaulting society, the era of mass democracy can be just as exacting in a communist country. Twenty million Chinese, wandering from country to city — and often back again — looking for a wage-earning position, leave this

communist government in a position somewhat analogous to the court of Louis XVI. We could bounce conjectures against theories and tackle the empiricists as to whether the leaders of the communist country mentioned have fallen prey to the unlimited credit pouring out of democracies, or whether China's recycling of redundant dollars into bad credit is a product of its participation in globalisation. There are several modern tendencies that have swept the two forms of government into similar dilemmas (one of which is that they are not so different as the categorisation suggests).

Anyone who knows anything worth knowing understands that the financial economy will come a cropper. The proportion of profits from financial operations at Ford,

General Motors, and the industrial heavies does not make for a functioning economy. What comes next? The industrial age is gone. Given the rising overcapacity in Asia, it might not last long there, either. We had a run at "the service economy", and it was anything but. Jastram's successor has his hands full, not to mention the rest of us along for the ride. An initial recognition might be the consistency of the golden constant over 400 years, and that, during the waning days of Jastram's study, gold and commodities were racing off the chart, in alternate sequence (England vs. the US), but nonetheless, both heading in the same, near-vertical trajectory. A final question: Was the 1980 spike in gold to US\$850 an ounce a demonstration of Jastramian wandering, which called for the long, bear market in gold?

About the book: *The Golden Constant* is not easy to find. Reg Howe and Bob Landis, custodians and editors of the Golden Sextant website (www.goldensexant.com), have posted the tables and charts referred to above. For the charts, go to "Library", then see "Roy W. Jastram: 'Remarks to the Securities Analysts Society of San Francisco'". The charts are at the end of the speech. For the tables, go to "Speeches", then see "Gold is Money, Deal with It!" by Bob Landis (RKL). The tables are set out in footnotes 7 through 9. Landis briefly discusses the book in the text accompanying the footnotes.

THE GLOOM, BOOM & DOOM REPORT

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