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Popular Delusions

A Minskian roadmap to the next gold mania

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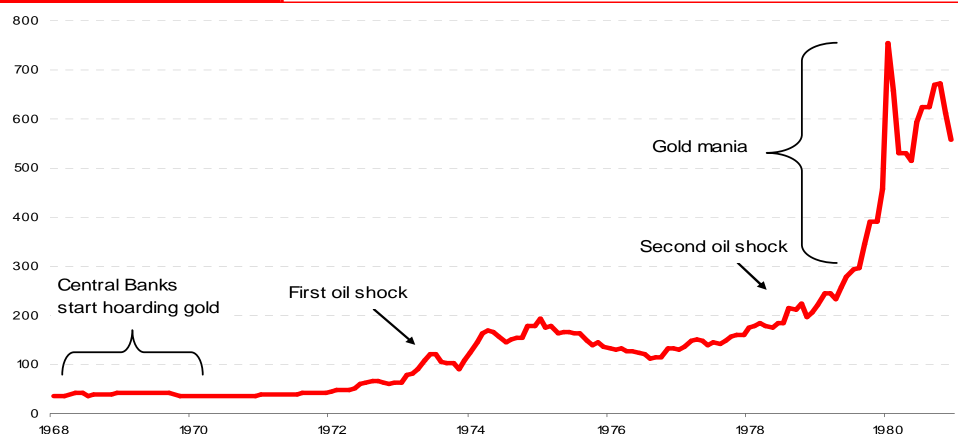
Central bank hoarding of gold in 1970 ushered in the famous gold bull market. With central banks likely to be net gold purchasers in H2 2009 for the first time since 1988 the same starting gun is ringing out today. The price at which the USD would be fully backed by gold (as it was during the peak of the 70s mania) is $6,300. So there is a case for gold being "cheap." Moreover, the 70s bull market was facilitated by tight energy markets, overly accommodative central banks and nervousness that policymakers had lost their way. Sound familiar?

- In 1965, concerned at the inflationary policies of the US and the attendant threat to their dollar reserves, the French central bank started converting their dollars into gold. This set in motion events which saw the central banks of Belgium, the Netherlands, Germany, and eventually Britain doing the same in 1970. By 1971, the Bretton-Woods system, by which all currencies were pegged to the dollar and the dollar effectively pegged to gold, had broken. The French had fired the starting gun for the great 1970s bull market in gold and silver.

- It's worth pointing this out because central banks aren't known for their investment acumen. Some commentators have mockingly suggested that the Reserve Bank of India's recent decision to buy 200m tonnes of IMF gold signals the top of the market in the way that heavy selling by the UK signalled the bottom in 1999.

- This is cute. But I think it's wrong. Like today, central banks weren't buying gold in the late 1960s to prop it up, they were *abandoning* attempts to prop up the dollar. Gold feels frothy today, but the Indian purchase of IMF gold eerily parallels the French purchases of the late 1960s. And ill policy winds are blowing in its favour. With the precious metals consultancy GFMS estimating that central banks will be net buyers of gold for the first time since 1988, have the Indians just sounded the same starting gun the French did in 1965?

The last time central banks hoarded gold ….



Source: SG Cross Asset Research

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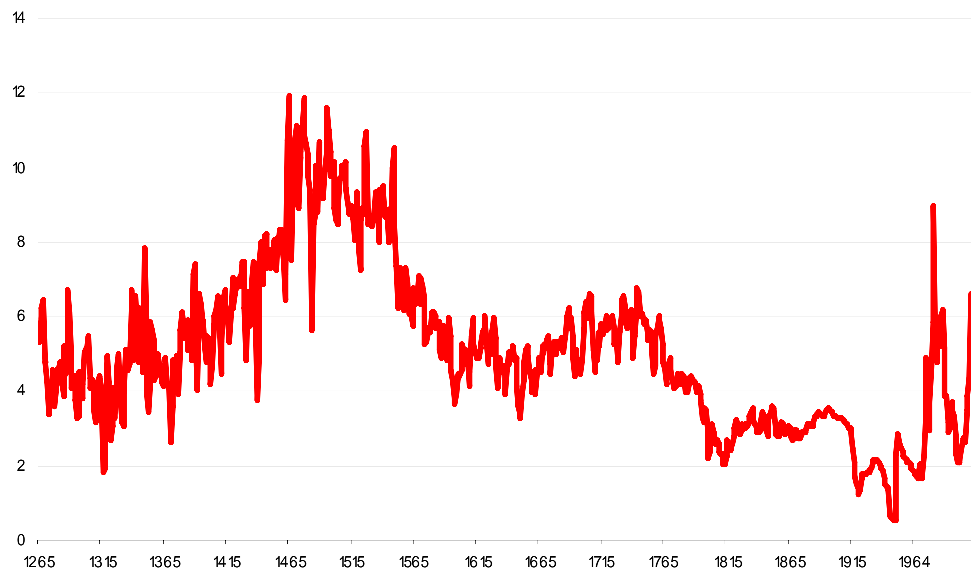
"Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Warren Buffett

The standard reply to Mr. Buffet might be that gold acts as a long-term store of value, the most commonly heard rationale for investing in gold. Indeed, the chart below shows the real UK gold price today to be similar to that prevailing in 1265.

But the same chart also shows how unreliable gold has been as a store of wealth. A 15th century gold bug who'd stored all of his wealth in bullion, bequeathed it to his children and required them to do the same would be more than a little miffed when gazing down from his celestial place of rest to see the real wealth of his lineage decline by nearly 90% over the next 500 years (though he might take comfort from the knowledge that his financial advisor would be burning in hell). More recently, had you bought at the peak of the last bull market in January 1980 for $850, you'd have suffered a nominal decline of 70% by the time it bottomed in 1999. On an annualised basis you'd have lost 6% pa nominal and 9% real.

Seven and a half centuries of real gold prices



Source: SG Cross Asset Research, www.measuringworth.org

So gold isn't intrinsically safer than any other asset. There is nothing mystical about it either. Like all other assets, it goes up and down according to its fundamental drivers.

But what are these fundamental drivers? How can something with no cashflow or earnings power be valued?

The simple answer is that it can't be. Intrinsically it is pretty much worthless. Indeed, when I tell people I buy gold the most common complaint I hear is that it has no real industrial use. Surely I'd be better at least buying a commodity that industry needs to make stuff with, like silver or platinum?

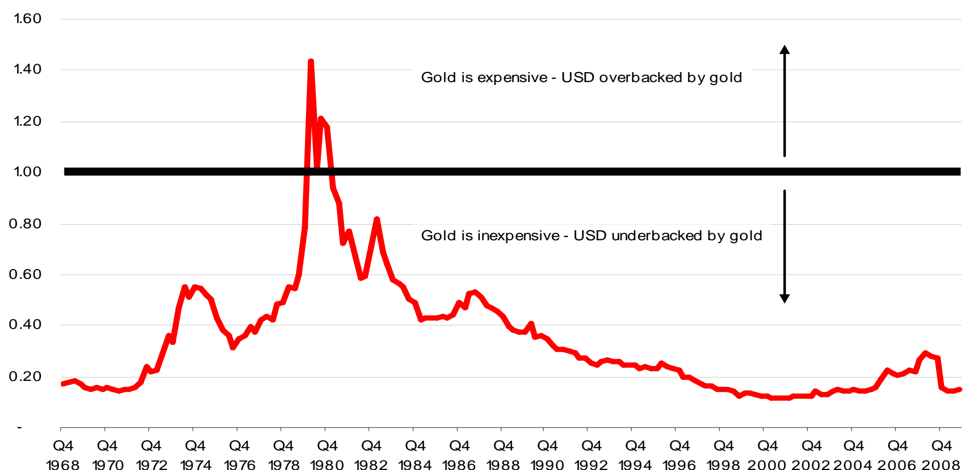
The more *verbose* answer is that this "uselessness" is exactly what gives gold its value because it makes it the perfect currency. If you own silver, a recession will cause the price (and therefore its purchasing power) to fall because industrial demand has fallen. The same is true for platinum or palladium. But the price of gold will be unaffected by any decline in industrial demand because there is no industrial demand!

To value gold it helps to understand that paper money was traditionally based on the stock of gold (and silver). Depositors of bullion would receive a receipt proving their holdings and it soon became easier to use those receipts for commerce than it did the physical gold. So while the use of paper money had become commonplace by the 18th century, that **paper was always redeemable into gold or silver. The money supply was always gold-backed.**

Full redeemability was increasingly watered down after WW1 so that by the time the Bretton Woods system was imposed following WW2, only central banks had the right to convert paper for gold. But when that broke in 1971 because dollar holders had become distrustful of US promises to restrain its dollar printing, the link between paper money and gold was severed completely. Since then, paper money has been backed by nothing more than central banks' promises to maintain the money supply at a stable level

So one way to value gold, therefore, is to ask at what gold price the value of outstanding central bank paper would be completely backed by gold. The US owns nearly 263m troy ounces of gold (the world's biggest holder) while the Fed's monetary base is $1.7 trillion. So the price of gold at which the US dollars would be fully gold-backed is currently around $6,300.

Gold is very cheap - at current prices, the USD is only 15% gold backed



Source: SG Cross Asset Research

The chart above shows the extent to which the USD has been gold backed since the late 1960s. It currently stands at 15%, close to the all-time low 12% reached in 2001 but far from the all-time high of 140% reached in early 1980. Interestingly, during that inflation panic the value of gold rose to such a level that the dollar became *over-backed* (the red line is higher than 1). The market value of gold held by the Fed was worth more than the paper money it had issued!

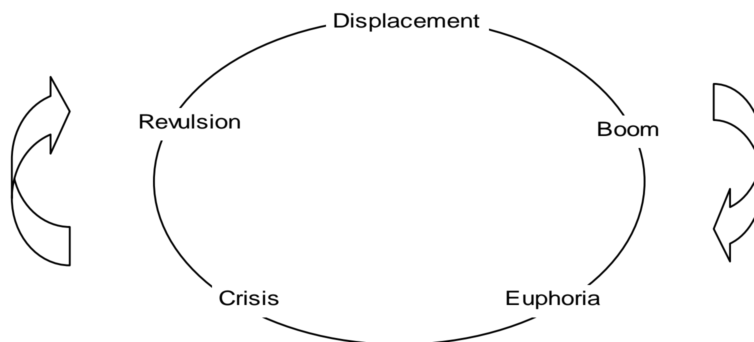
Gold has rallied considerably in recent years, but the monetary base has grown *even faster.* So a better response to Mr. Buffet might be that you should buy gold because it's cheap …

If my "valuation" of gold strikes you as a desperate attempt to value something which can't be valued, it's no different from metrics such as the "market cap to clicks" or "ARPU" ratios which were used in the late 1990s during the technology bubble when demand for bullish "valuation analysis" mushroomed. They seem crazy now but speculators bought into them during the tech craze. And there may well be a bubbly parallel ... Charles Kindleberger, drawing heavily on the work of Minsky, outlined the following "anatomy of a bubble".

Stage 1 sees "displacement". Frequently, this comes about through the introduction of a new disruptive technology (e.g. canals, railways, or the internet) although Kindleberger says it doesn't necessarily have to come from such an innovation. It can arise on the back of greater market liquidity through, for example, financial deregulation.

Stage 2 is the "boom." A convincing narrative gains traction (e.g. Asian economies are "miracle" Tiger economies; the Internet will change the world; sub-prime mortgages help financial institutions diversify risk). Price movements which seem to confirm the narrative are stoked by credit creation.

Anatomy of a bubble: the Kindleberger-Minsky model



Source: Kindleberger, SG Cross Asset Research

Stage 3 is "euphoria." In the words of Kindleberger, "there is nothing so disturbing to one's well-being and judgement as to see a friend get rich." This greed sucks people who wouldn't normally involve themselves in such practice into the mania. More and more people seek to become rich without understanding the process involved. Rationality becomes stretched and increasingly fanciful notions excuse what would ordinarily be considered irrational behaviour.

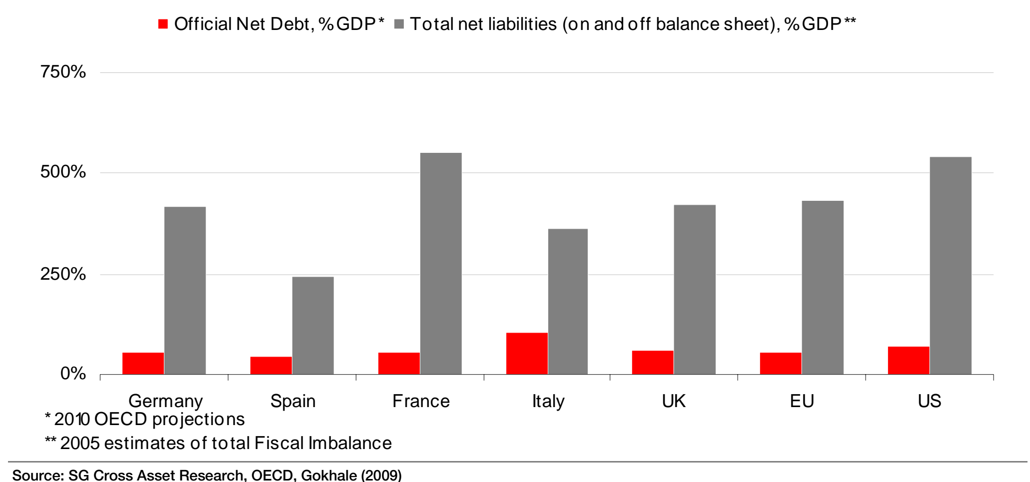
Stage 4 sees the "crisis." The insiders originally involved start to sell. Prices level off and begin to fall. Those who bought at the top find themselves pushed out first and their selling eventually cascades down through the remaining believers. Speculators realise prices can no longer rise and the rush to exit is on. To the extent that leverage was used to finance any purchases at irrationally overvalued prices, savage price declines put banks in trouble too. Stage 5 sees "revulsion" where prices likely overshoot fundamental values on the downside. Scams and frauds are uncovered. Scapegoats are found for the financial distress caused. The

object so richly desired as the bubble inflated becomes an object of ridicule and disgust, along with anyone or anything associated with it.

With this in mind, consider the parallels between the 1st and 2nd phase of the 1970s gold mania with the situation unfolding today. Then, the “displacement” was the collapse of the Bretton Woods system, precipitated by central banks, distrustful of inflationary US policies buying of gold. This is very similar to what we are seeing today. Then, the liquidity turning “displacement” to “boom” came from central bank accommodation of the oil shocks. Today, central banks are monetising government deficits to accommodate the recessionary effect of the credit crisis.

Then the convincing narrative was that with the Middle East controlling our energy from abroad and aggressive trade unions rampant at home, policymakers were no longer in control. Today, the perception of central bank infallibility has been permanently ruptured by their collective failure to see the 2008 crash coming. Nagging concern at their over-willingness to inflate, at the blurring of monetary and fiscal policy and over long-term government solvency (see chart below) gives traction to a similar narrative today.

Our governments are insolvent



Source: SG Cross Asset Research, OECD, Gokhale (2009)

On the Kindleberg-Minsky map as I’ve drawn it, therefore, we’ve had the “displacement” and are only now entering into the “boom” phase. The “mania phase” lies well ahead. Who knows what unknown unknowns might parallel the two oil shocks of the 1970s?

The top of the gold bubble occurred when politicians won a mandate in the late 1970s/early 1980s to take painful decisions, to take on the trade unions, and to raise interest rates to tackle inflation. Only then, during the “crisis phase” did scams such as the Hunt brothers’ attempted corner of the silver market come to light. The parallel today would be governments winning a mandate to take the difficult decisions ahead on health care and pension entitlement, or even climate change. And who knows what yet-to-be-conceived frauds await?

But that is a long way off. Governments only won such mandates because by the late 1970s, the “inflation fatigued” electorate was tired of lurching from one crisis to another. We’re several crises away from governments winning similar mandates. In the meantime, displacement has happened, liquidity is plentiful, and the compelling narrative is gaining traction. Oh, and gold is “cheap” ...

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