

Gold

October 7, 2009

Over the last few weeks there has been a great deal of talk about the price of gold. From the beginning of the year gold is up over 18% and recently made an historic new high price (non-inflation adjusted) of \$1049. While this is truly an impressive move, we want our clients to know **why** this is happening.

The common belief is that gold is used as a hedge against inflation. The fact is that inflation averaged only 2.8% per year since 1994 and so far in 2009 we are in a **deflationary** environment. (Inflation is negative 3.8%). The price of gold since 1994, however, has averaged over 6% annualized return with 18% returns so far this year.

As it turns out, the price of gold is a reaction to an unstable environment and a weak dollar. **Chart 1** below is the price of gold vs. the U.S. dollar index since 1994. As you can see they are mirror images of each other. During this time inflation was never above 3.85% and as mentioned, averaged only 2.8%.

If we just look at this decade gold is up over a total of 285% (18% annualized) yet inflation has been extremely low. However, the dollar is down a total of 37%, we've had two severe bear markets (and two recessions), a terrorist attack on U.S. soil, a credit crisis, real estate crisis, a banking crisis and rising unemployment.

Charts 2,3 and 4 are the price of gold in dollars, euros and yen. While gold did rise considerably in all three currencies, **it is actually down 10% from the high prices in 2008** when it's based in euros and yen.

Make no mistake, the possibility of inflation exists. The Fed is pumping tremendous amounts of dollars into the system but these dollars are not circulating. Banks are sitting on a lot of money, not lending it out, thereby keeping the velocity of money very low. This is the key component to possible high inflation. If the Federal Reserve orchestrates the recovery properly, they will drain reserves from the system before we get the hyperinflation that some are expecting. If this happens we will look at this price action as just another asset bubble from the decade of asset bubbles.

When the dollar begins to turn around we will see the price of gold come back down, but not until then.

Chart 1

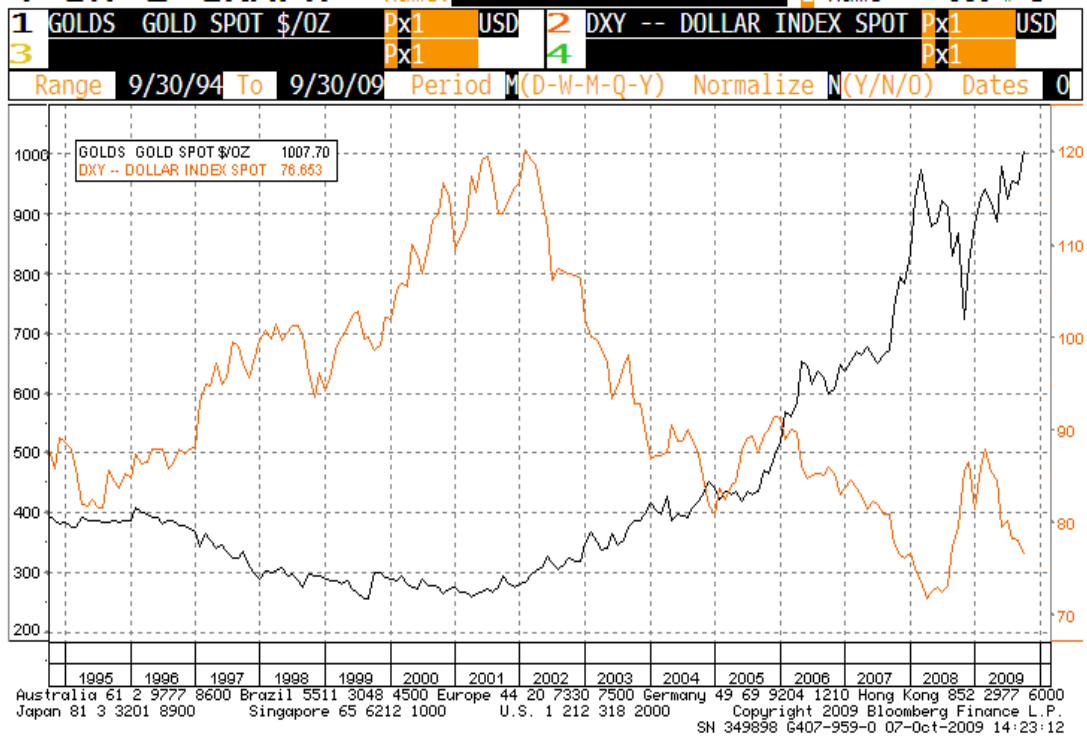


Chart 2



Chart 3



Chart 4

