The Equus Report

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WHY SHOULDN'T GOLD

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Why Shouldn't Gold?

In "All That Glitters," Howard Marks says that gold is impossible to value and that it is like religion: you're either a believer or you're not, and one can't ever convince the other.[1] In truth, there really isn't any analytical way to value an asset that doesn't produce a Cash Flow. But wouldn't this be true of almost any tangible asset, including raw land and art? Must we then exclude these from consideration when it comes to long-term asset allocation when everyone knows how much they have appreciated over the past 40 years?

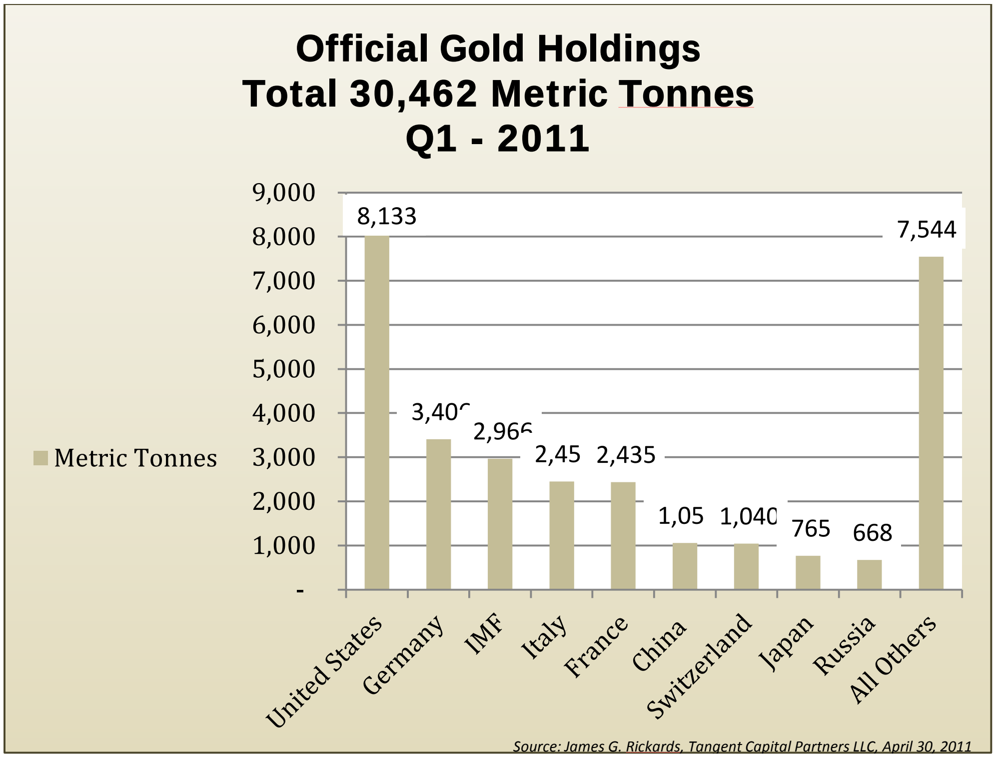
The fact is that gold has long been a reliable store of value and a hedge against inflation *and* deflation. It is a tangible asset of which one can take delivery and store and which is accepted worldwide. It is a finite resource that is becoming increasingly difficult to find, expensive to mine, and is not subject to dilution, debasement or government manipulation. And – for most of the past 5,000 years – it has served as a means of exchange in almost every civilization on every continent worldwide.

In 1971, however, President Nixon took the United States off the Gold Standard by closing the "window" to stop people from buying gold here and selling it abroad at higher prices and, ever since, it has been dropped from our country's curriculum. As a consequence, two generations of economists, including Ben Bernanke, have come to have little or no respect for it in their policy deliberations. This is understandable – in America. But things are quite different in the Middle East and Asia Pacific where gold, especially in the latter, is central to their value system. And it was when I noticed some years back that governments outside the United States and Europe were buying gold again for their own Reserves that I started buying it for clients and myself. China in particular has been buying, not only bullion, but entire gold mining companies – removing these companies from the grid and keeping 100% of their production for themselves to the point where nobody really knows how much gold China has any more.

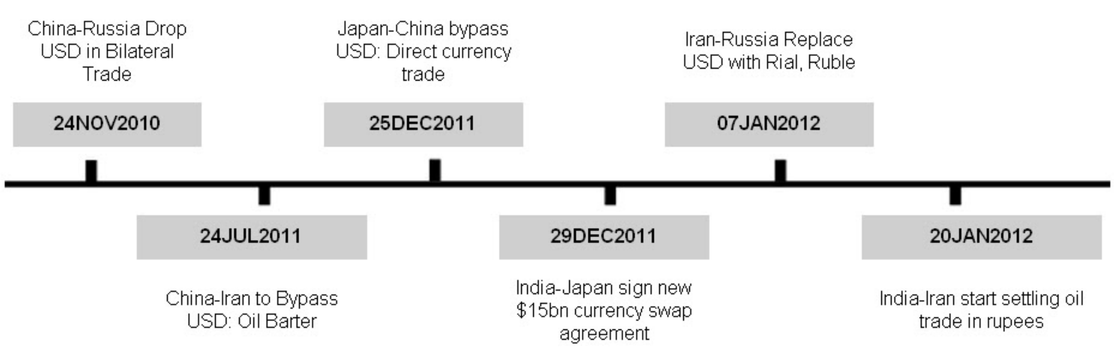
But we do know that China has replaced India as the largest consumer of gold and it is interesting how, despite our own Fed's disdain, the United States remains the world's largest holder with more than 8,000 tons and, since 1981, hasn't sold an ounce. If gold is, as John Maynard Keynes once said, such a "barbarous relic," why are we still holding on to it? And why have central banks outside the U.S. purchased 254 tons this year through mid-year alone? This is an increase of 62.9% from the first quarter 2012; a 137.9% increase over the second quarter

[1] "All That Glitters," Howard Marks, Oaktree Capital Management L.P., December 17, 2010

last year; and "at this rate," according to the World Gold Council, "we'll be looking at a record central bank year, higher than last year, which was a record since 1964."[2]



With regard to the dollar, it is important to note how, in recent years, China, India, Russia and Brazil have all publicly stated that, in their opinion, the Dollar no longer deserves to be treated as the world's Global Reserve Currency – and that the U.S. shouldn't be the only nation to benefit from the many economic advantages such status bestows. As a result, they have already begun bypassing the dollar and started trading with one another directly in each other's currencies and are now in the process of establishing their own World Bank.



2 "Gold Demand Trends Q2 2012," August 16, 2012

Should their efforts succeed, there will be serious consequences for our economy and, while I certainly do not wish this, I believe it is only a matter of time before the dollar is replaced, either by multiple Reserve currencies or, more likely, a basket of currencies through some sort of IMF-backed, Special Depository Receipt. And when this occurs – whether the ratio to money in circulation[3] is set at 20%, 40% or more – I believe these countries will choose to return to a Gold Standard in order to provide the new exchange mechanism a stable base and sense of legitimacy. Until then, the fact is, every one of these countries is accumulating gold as part of their reserves and we have held onto every ounce of ours since 1981.

Also in the interim, the U.S. clearing house for the Chicago Mercantile Exchange started accepting gold as collateral two years ago and, as of August 17th, so has its European arm. As of last May, Germany started asking for gold as collateral for Greek and other GIIPS[4] debt. By the end of this month, according to the Financial Times, China plans to launch an Interbank Gold Exchange that will allow their banks to trade bullion directly with one another as part of the country's overall financial reform.[5] And two Chinese firms are on the verge of launching gold ETFs that will trade on the Shanghai Stock Exchange.[6] The point of all this – contrary to many people's assertion that gold is not "money" – is seeing how more and more entities seem to be accepting it as such. And as China and other emerging markets grow in influence and become an increasingly bigger percentage of Global GDP, I have to ask why the laws of Supply & Demand should suddenly cease to exist in the case of gold alone? In other words, why should gold be the only exception to the world's long-term, rising price bias? It is true that gold has gone from $300 an ounce in 2003 to $1,600 today, but this was only after a twenty-year bear market. And, for those who feel gold has had its "run," I would note that it reached $1,900 last summer and has yet to reach its prior 1980, inflation-adjusted peak of $2,400 an ounce. Sadly, I know first-hand how prices for everything from jeans to automobiles have increased many times over what they cost me then and so I have to ask: Why Shouldn't Gold?

Howard Marks, again, says that "gold has no financial value other than that which people accord it" and I agree. But I don't see how this is any different than virtually every other asset class including stock. Price-earnings ratios expand in good times and contract in bad, so which is truly "fair value"? Fair value is whatever the market is willing to pay at a given point in time, in and of itself and relative to other asset classes. In the case of sovereign debt, its value is based on our belief and "faith" that a government will stand behind its debt and repay principle in full. We believe this because of their power to tax, perhaps, or because they own a printing press. But even without outright default – which, of course, we all know can and does happen – we need to take this term "in full" with a grain of salt. For every Dollar, Yuan, Real and Ruble governments print, it reduces the value of all their other, outstanding debt and enables them to repay that debt in cheaper Dollars, Rubles, Yen and Real. And I think we can all agree they aren't doing this out of ignorance or for altruistic purposes.

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[3] The choice of monetary base is an important consideration, but"M1" – which is defined as the amount of money in circulation – is considered the most liquid measure and contains all physical money, including cash and coins, that can quickly be converted to currency.
[4] Greece, Ireland, Italy, Portugal and Spain: I prefer this to the term "PIIGS."
[5] "China to Launch Interbank Gold Exchange," Leslie Hook, Beijing Financial Times, July 19, 2012
[6] "Chinese Gold ETFs Trigger for Fall Price Surge?" Peter Cooper, Resource Investor, August 21, 2012

Come to think of it, haven't we had this kind of argument before? With regard, both to politics and our current budget situation, things are pretty much where they were in 1948 when a self-effacing, Nebraska Congressman explained how, from 1930-1946, "your government went into the red every year and the debt steadily mounted. Various plans have been proposed to reverse this spiral of debt…but they are unrealistic under our paper money system [where] our finances will never be brought into order until Congress is compelled to do so." "The paper money disease," he said, "has been a pleasant habit thus far and will not be dropped voluntarily any more than a dope user will without a struggle give up narcotics. In each case the end of the road is not a desirable prospect."[7] These were the words of Warren Buffet's father, Howard, and in his opinion, the only way out of the country's fiscal dilemma was to return to a Gold Standard which would act "as a silent watchdog to prevent unlimited public spending." Then as now, politicians are constantly and, I imagine, unavoidably besieged by special interest groups upon whom they depend for their election and – until we limit each branch to a single term so they can be immune to such pressure and truly focus on what's good for *all* Americans – that Federal paycheck, once received, quickly becomes "vital" to their survival and, ultimately, a "right" to which they're forever entitled and for which they will do everything in their power to hold on to for dear life.

In the end, it turns out that there are a *lot* of reasons why gold deserves a place at the table. Based on a growing, global population that is increasingly influenced by Eastern values and culture; increased purchases by governments outside the United States; spiraling debt and paper currencies that, through constant printing, are actively being devalued on a global basis; a move away from the dollar as the world's Reserve Currency; widening acceptance of gold as collateral; new Interbank Gold Exchanges; increased allocation to tangible assets in general in portfolios; new gold ETFs being launched overseas; 5,000 years of history; and the simple laws of Supply & Demand, the price of gold should go much higher.

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[7] "Human Freedom Rests on Gold Redeemable Money."