THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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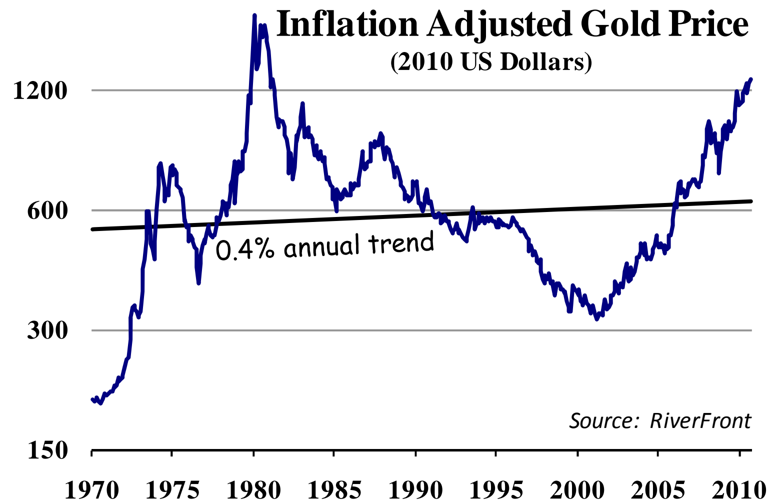
Gold Still Glitters

- Gold reached a record high of $1275 per ounce last week, up 400% from its 20-year low of $255 made in 2001. Gold's annualized trend growth rate from 2001 has been 18% (and 15% on an inflation-adjusted basis). While this strong trend shows no sign of slowing down, history shows that such growth is ultimately unsustainable and RiverFront's Price Matters[SM] analysis suggests that, from current levels, five- to ten-year returns will be disappointing. Despite this, after initiating a 1% position in gold in August, we increased exposure last week and now have a 2% weighting in our portfolios. We did this to help hedge our exposure to risk assets — reducing overall portfolio risk — rather than raising cash. Adding to inversely correlated assets like gold — whose value tends to rise when risk assets fall — should offer more downside protection per dollar than cash. Moreover, in the current global monetary policy environment, we believe gold can enhance our portfolios' returns.

- Gold is something of an enigma. Its intrinsic value is hard to calculate, it pays no interest, and yet it has a track record as a store of value that has kept pace with inflation for more than 700 years (see *Weekly View*, 11/23/09). Strategically, we acknowledge the risks of buying any asset so far above trend, but tactically we see fundamental and technical reasons for the price to go higher. Adjusted for inflation, gold is about 30% below its 1980 high, which would be around $1850 in today's dollars (see chart on right), an achievable target in our view. To manage the strategic risk, we think it is important to have an exit strategy. For us, at this time we would regard a break below $1160 as a signal to begin risk managing our gold position. This is approximately the level of the 200-day moving average, the 50% retracement of the rally from the February 2010 low, and also a level that served as support last July and overhead resistance last April.

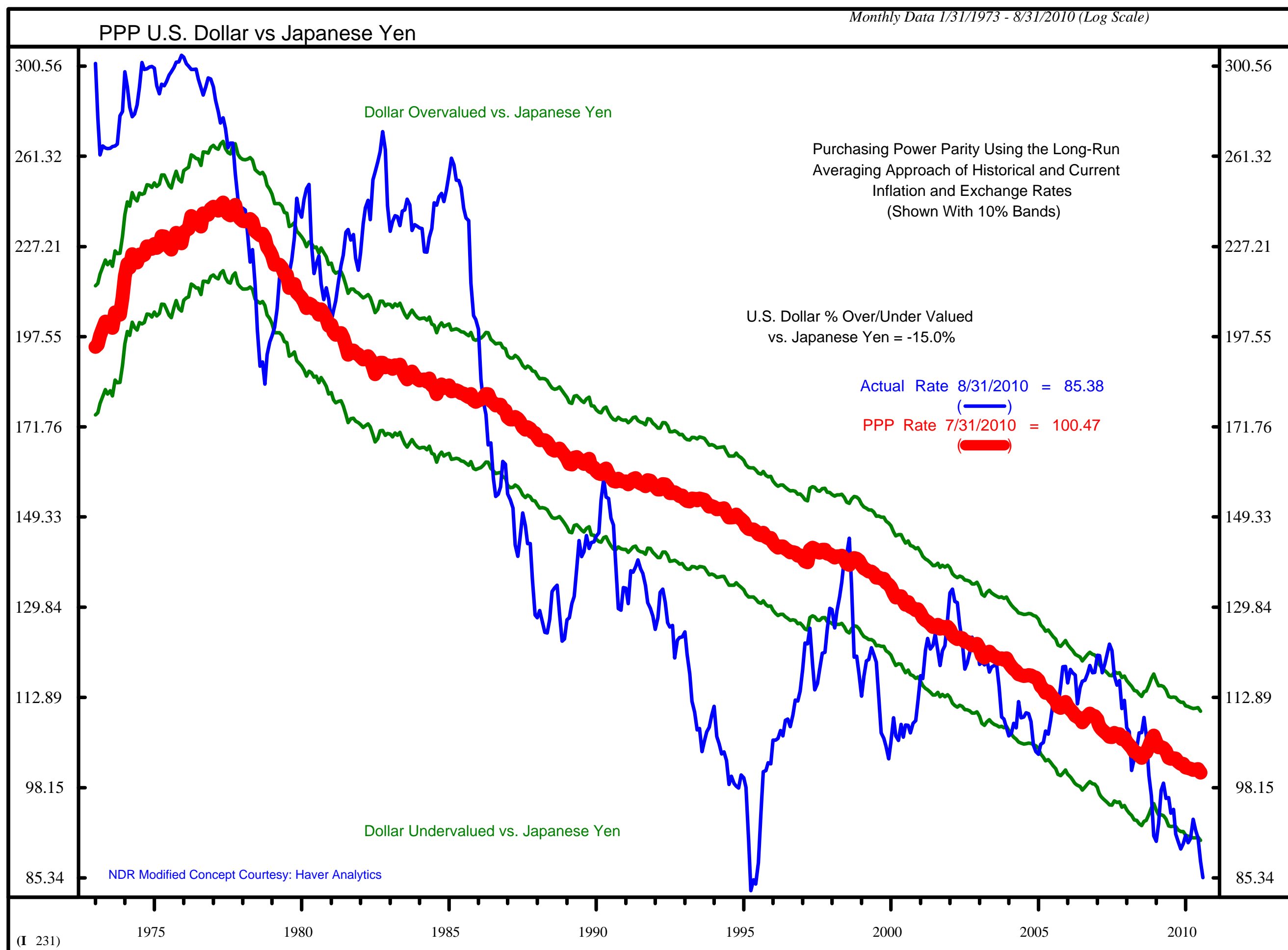


- The global monetary environment is the main fundamental driver for gold in our view. Interest rates are below the level of inflation throughout much of the developed world as well as in major emerging markets such as India and China. This makes holding money in cash vehicles less attractive and so has historically been a bullish condition for gold. Furthermore, in the absence of fiscal stimulus, the Federal Reserve appears increasingly willing to utilize its balance sheet to revive growth and counteract the ongoing deflationary impact of household deleveraging. Thus, in effect, the Fed is actually trying to raise inflation expectations (from low levels), which is bullish for gold in our view.

- Japan intervened in the currency markets last week, lowering the yen's exchange rate by about 3.3% versus the dollar. The degree of policymakers' resolve to devalue the yen is still unclear — it may be merely a political move to placate the country's exporters — and there appears to be little international support for yen devaluation. However, Japanese intervention does raise the prospects for another round of currency devaluations among the myriad of countries attempting to boost their exports, the US included. We believe the potential for such competitive currency devaluations is another factor driving investors to gold, since it remains the non-fiat 'other currency' against which government-backed paper currencies can be measured. In other words, gold is increasingly playing its historical and *de facto* role as a global (non-national) monetary standard of value, especially as faith in governments wane.

- Japan has justification for its intervention based on the yen's purchasing power parity (PPP). PPP suggests that a comparable basket of products cost 15% more in Japan than in the US, after adjusting for currency translation. By the same measure, China's yuan is as much as 50% *undervalued*. Hence we believe Japanese actions are defensible at present levels around 85 yen per dollar, when 'fair' value based on PPP is 100 (see chart below). From a long-term perspective however, the trend suggests the yen will likely continue to appreciate against the dollar.
- Finally, in addition to the many economic reasons supporting gold, we think there is also a political angle. With the recent ramping up of bipartisan protectionist rhetoric against China, and amid increasing pressure to 'do something' about the economy (ahead of elections), our concerns over competitive devaluation risks have grown. So far China has allowed the yuan to appreciate marginally versus the dollar, suggesting some willingness to respond to political pressure, but the pace is frustratingly slow in our opinion. Our worry is that 'slippery slope' political arguments end up trumping fundamental economic rationales for currency levels, leading to unilateral devaluations. To offset this risk, we think a growing number of countries around the world could increase gold holdings as the value of their currency reserves — a large part of which are held in foreign-denominated assets — decline due to competitive currency devaluations.

The Weekly Chart: Japanese yen overvalued relative to US$



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