

Giving Gold Currency

By Anthony S Fell, Chairman, RBC Capital Markets

It's a commodity, to be sure.

But the recently more-precious

metal is better suited to a

brighter future as a currency

and store of value.

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Is gold a commodity, a currency or a store of value? Though the correct answer is all three, it is primarily a currency and a store of value and is a hedge against paper money and inflation: as a currency and a store of value, gold has stood the test of many centuries. As a commodity, gold has little intrinsic worth because of limited industrial use.

At Royal Bank of Canada, we trade gold bullion off our foreign exchange desks rather than our commodity desks because that's what it is — a global currency, the only one that is freely tradable and unencumbered by vast quantities of sovereign debt and prior obligations. It is also the one investment and long-term store of value that cannot be adversely impacted by corrupt corporate management or incompetent politicians — each of which is in ample supply on a global basis. Don't measure the dollar against the euro, or the euro against the yen, but measure all paper currencies against gold, because that's the ultimate test.

When reflecting on the long-term outlook for gold, it is important to fully appreciate that we now live in a world of fiat paper money. Since the US moved to fiat money in 1971, the dollar has lost 80% of its purchasing power. Since the Federal Reserve was established 93 years ago, the dollar has lost 98% of its purchasing power.

How much confidence do you have in politicians and central bankers to maintain the purchasing power of their currencies? In the United States, the Democrats tax and spend and the Republicans reduce taxes and spend. President Bush has not vetoed one spending

bill during his time in office. In recent years there has been absolutely no fiscal or monetary discipline in the US. When the crunch comes, unless you have a Paul Volcker, the record clearly shows that politicians will always opt for inflation over deflation.

Looking ahead, the pyramid of consumer and government debt that has accumulated in the US will force the Fed to respond very aggressively to any economic slowdown — or the slightest whiff of deflation. The watchword is, "a little inflation is a good thing." The problem is, as politicians come and go, you can't control it.

A Fistful of Troubles

I learned long ago that you couldn't forecast gold prices on a short-term basis. The important thing is to keep the big picture in mind.

So where are we now in the big picture? At the current level of about \$590, gold has risen 230% over the last five years. It is my view that gold is now in the very early stages of a long-term secular bull market that, due to several fundamentals, will carry it to much higher levels over the coming decade.

Notwithstanding a modest rally last year, the trade-weighted US dollar has been in a downtrend since February 2002, and the overall loss is now about 28%. After a decade of fiscal and monetary excess, I believe the broad sweep of the US dollar will be significantly lower for the coming five to ten years. The next stage of the decline could be gradual, like the last four years, or it could be precipitous — like the mid-1980s, when it fell 47% in the less than three years.

It is my view that the US economy is headed for a slowdown later this year, and there is better than a 50/50 chance of a recession, led by a housing slowdown, in 2007. A year from now the Fed will be reducing rates rather than increasing them. In a declining US rate environment, there is a real risk of a broad move out of dollar-based assets.

In the four years ended 2005, consumer spending in the US grew at about twice the rate of per capita income. This consumer boom has not been driven by rising incomes.

I believe it has been artificially stimulated by:

- The Bush tax cuts of 2001 and 2002
- Massive spending on two wars
- A prolonged period of record low interest rates in the US
- Two trillion dollars-plus of home equity financing
- A declining US personal savings rate from 6% to 8% of disposable income to less than zero last year
- A major build-up of fiscal deficits in the US, which now range between a quarter and half a trillion dollars
- An ongoing trade deficit exceeding three-quarters of a trillion dollars annually.

In aggregate, these factors spell big trouble for the dollar — though, in the face of them, the markets are in denial.

Over the past decade there has been significant debasement of the US currency, so that now there is a vast global surplus of dollars and liquidity. What has caused this? Apart from an escalating trade deficit, most of the credit must be given to the Fed, with the Bank of Japan in a strong supporting role.

For the past 15 years, every time there has been a financial or economic crisis around the world, the Fed — rather than let the disciplines of the market work and wring out excesses — has chosen both to inject large quantities of liquidity and credit and lower interest rates to bail out the system. This pattern began with the stock market crash in October 1987 and ended, most recently, with the breaking of the stock market bubble in 2001. At that point, the Fed reduced its funds rate 13 times — to a new record low of 1%.

For its part, the Bank of Japan has contributed greatly to this euphoric environment and global liquidity with its five-year program of pumping extra cash into the economy, keeping its benchmark lending rate near 0% — while at the same time accumulating hundreds of billions of US dollars and facilitating the yen carry trade.

Excess liquidity flowed into commodities and emerging markets, driving credit spreads to record lows. The current global glut of US dollars is the cumulative impact of all of these stimulative events. These injections of liquidity and low interest rates have been short-term fixes for long-term fundamental problems, and in my view the whole exercise will have a distinctly unhappy ending.

The US is overextended militarily and financially, its consumers are tapped out and there is a growing lack of confidence in its leadership. The centre of gravity of global economic and financial power is shifting steadily to Asia, and to China in particular. Global central bank foreign-exchange reserves now total \$4.4 trillion, of which an incredible 63% are held by ten Asian central banks.

The US annual trade deficit – now running at a rate of more than three-quarters of a trillion annually, or 6.3% of GDP – is a huge concern: it's not prudent for the country to depend on foreign bond buyers to finance domestic consumption. As Asian countries produce low-cost goods to be shipped to the US, the US ships dollars back to Asia – and then the Asians purchase US treasuries. I do not think this model is viable or sustainable: Asian central banks will not want to accumulate US dollars at the current rate.

The Dollar Option: Gold

For all these reasons, I believe the dollar's status as a store of value has been greatly diminished over the past decade. It will never regain the outstanding reputation it had 50 years ago. In light of this, gold bullion will gradually re-emerge as an accepted alternative asset and investment. It's worth noting that during the recent sell-off in the gold price, the seven exchange-traded funds have had net sales rather than net redemptions – quite extraordinary – and a portent of things to come.

There are now indications that some Asian central banks (and a few others as well, which have large reserves of US dollars) would like to diversify, but some of these holdings are so large that it is extremely difficult to do this in a meaningful way without causing major disruption. The only really viable paper currency alternative to the US dollar is the euro, and so I expect the euro, along with gold bullion, to play an increasingly important role in central bank reserve allocation.

Over the past five years some central banks have been selling bullion, and we should be grateful to them for affording us an opportunity to buy at bargain prices. At this time one wonders if some central banks wish they had not been sellers at less than half the current market price. As a result of sales over the past many years, the relative size of central bank holdings, which now stand at about one billion ounces worth \$590 billion, has declined dramatically over the decade. The

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market cap of Exxon and General Electric is substantially larger than all the gold reserves held by central banks.

Another factor in gold's favour is that I believe that over the past decade there has been a substantial increase in systemic risk in the global financial system, which has benefited greatly from an extended period of incredibly low interest rates and easy credit. History shows that such an environment can, and usually does, foster a degree of complacency.

There are perhaps 7,000 unregulated hedge funds around the world, with assets of approximately \$1 trillion, and there are most assuredly some time bombs waiting – like the Long Term Capital debacle. Hedge funds are great, but we should always remember the only perfect hedge is in the back garden of the Imperial Palace in Tokyo.

Supply – But is there Demand?

Supply statistics are compelling in favour of gold. Over the coming decade, while governments around the world continue to increase the money supply at a rapid rate, gold production will be static to declining. Annual gold production is now running at about 76 million ounces, which means that the aboveground stock of gold is increasing at about 1% per year. Major gold companies are not replacing reserves and new discoveries are extremely rare.

At most gold mines, you have to move 35 to 40 tonnes of dirt and rock just to get one ounce. On the other hand, fiat paper money can be, and usually is, printed at will by computer. Governments and central banks around the world are probably printing money and creating credit at the annual rate of 5 to 10% per annum. The Fed stopped publishing the M3 money supply numbers last February. At last report, M3 amounted to over \$10 trillion and was growing at an annualised rate of about 8%. Recently, China's money supply has been increasing at a rate of 18%.

Another point in gold's favour is that it acts as a hedge against inflation. I believe there is more inflation in the pipeline than is generally anticipated – perhaps quite a bit more – as a result of the excesses of the past 15 years. The reported inflation rate in the US is now in the range of 2.5 to 3%, but remember that the Consumer Price Index has been re-jigged many times over the past 30 years. Additions and deletions have been made and judgments with respect to the quality of products and services included in the index. A study recently estimated that if the CPI were calculated today exactly as it was in 1970, the rate of inflation would be running in the range of 8%.

There is a great deal of scepticism about the future of gold, which is another positive factor. The vast majority of investors are so short-term orientated that they just don't see the big picture unfolding.

When the price of crude oil bottomed out at \$10.70 a barrel on Christmas day in 1998 – and the front cover of the *Economist* was forecasting a glut and \$5.00 oil – you couldn't give oil or gas stocks away. Now – just six years later – with the price up by 700%, everyone loves oil at \$70.00 the barrel and you hear talk of \$100. As we celebrated the New Year in 1971, ten-year US Treasuries yielded 6%. Little did we know that a decade later they would yield 15.4%.

The markets just didn't see it coming – it happens all the time.

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It is my view that the past few years represent a major positive turning point in the fundamental long-term outlook for gold bullion. There is, at present, an unwarranted optimism that the business cycle is a thing of the past, that central bankers with infinite wisdom are in firm control and will be able to thread the needle between inflation and deflation, and that we will never again have another major global foreign exchange or financial crisis. Well, I don't believe it.

To some extent, I regret to say that all paper currencies are becoming somewhat suspect, and accordingly it is my view that gold bullion may well become the asset of choice for many investors over the coming decade. I have always been told to buy quality assets that are vastly undervalued and that have been ignored by the marketplace for a prolonged period. Notwithstanding the modest rise in gold prices over the past few years, that is where gold bullion is today and it represents a great opportunity. ■

Anthony S. Fell is chairman of RBC Capital Markets. He has been with the firm (and its predecessor, Dominion Securities) for 45 years, including 18 years as CEO. Previous roles include serving as deputy chairman of the Royal Bank of Canada, chairman of the Investment Dealers Association of Canada and governor of the Toronto Stock Exchange.

He currently holds several directorships – BCE Inc., Loblaw Companies and CAE Inc. – and is chairman of the Munich Reinsurance Company of Canada. In 2001 he was appointed an Officer of the Order of Canada.