feature

The Ascent of Gold

A speculative bubble, or the currency of old?

Having produced gains in virtually all currencies, gold's impressive 10-year rise in value has not sheltered it from controversy. Some experts question gold's validity as an asset class and believe the precious metal is forming a speculative bubble. There have been plenty of bubbles throughout history. In the past decade alone, there have been two notorious frenzies: the tech mania and the U.S. real estate debacle.

A speculative bubble forms when asset prices rise far above a level justified by fundamentals. The common belief is that values will only continue to rise. It is human nature to chase returns, in order not to "miss out" on what everyone deems a profitable investment. As a result, massive amounts of money flow into the asset, thereby bidding its price up to unjustified and irrational levels.

BLOWING BUBBLES, OR SURPRISINGLY UNDER-OWNED?

From a monetary standpoint, gold does not pay any dividends or interest; similarly, after inflation, paper currencies do not pay any *real* returns either. While most of the gold that has been mined is still around in some form today, consider the overwhelming amount of paper currency that exists today, more than at any other time in history. Since the last recession alone, governments have created literally trillions of dollars out of thin air. These fiat currencies are actually a government liability – a promise-to-pay – funded by a government's authority to tax and its ability to print more money, when necessary.

Although gold's stellar performance is great conversation, the truth is that most people simply do not own it. Gold is surprisingly an under-owned asset, gathering far more media attention than it likely deserves.

In 1968, when U.S. dollars were still backed by the physical metal, gold represented roughly five per cent of global financial assets. Since then, gold's weighting has fallen and now represents approximately 0.7 per cent of financial assets. While this probably speaks more to the mass production of fiat currencies than it does to gold investment, at a trivial 0.7 per cent, gold is still dramatically under-owned.

Even if there were motivation to rebalance toward the five per cent level of 1968, this move would require six billion new ounces of gold. This is more than the amount of gold produced in the history of this planet, and four times the amount of known reserves.

At just over twice the size of the total U.S. economy, global pension assets are a massive $31 trillion. Less than one per cent of the average pension fund's assets are devoted to gold. Similarly, insurance companies, hedge funds and sovereign wealth funds together manage another $20 trillion, of which most are financial assets, with an underrepresentation in gold.

This past decade, $2.5 trillion was invested in U.S. mutual funds, but less than one

Mike Magreehan is an investment advisor, and Certified Financial Planner, with Canaccord Wealth Management in Waterloo, Ontario. Mike welcomes your comments and questions at 1-800-495-8071 or mike.magreehan@canaccord.com. Visit www.LM-wealth.com.

Michael S. Magreehan, CFP

per cent of those dollars made their way to precious metals equity funds. Gold companies raised $78 billion in equity financings this past decade, which is the same amount of equity raised by technology companies in the first three months of 2000.

CURRENCY OF OLD?

Gold has been recognized as currency for more than 4,000 years. That changed in 1971, when then-president Nixon closed the gold convertibility window, barring foreigners from exchanging their U.S. dollars for a fixed amount of physical gold. This gave the U.S. government a licence to print money, with no immediate concern for its consequences; namely, deficits, debt and inflation.

The Chinese perspective is interesting. As the world's largest gold producer, China is a massive gold importer and the world's largest creditor, with more than $3 trillion in foreign currency reserves. The Chinese government encourages their growing middle class to buy precious metals to protect purchasing power.

Since the Second World War, the global financial system agreed to price all commodities in U.S. dollars. As the world's reserve currency, the U.S. dollar was awarded a triple-A rating, providing a reference by which all other assets are valued. A triple-A rating is granted only to currencies with sound government, a strict adherence to the rule of law, prudent control of the printing press, little or no debt, and a stable, expanding economy.

The United States used to be the world's largest creditor nation, and is now the nation most in debt. As of spring 2011, U.S. Congress is embroiled in historical debate on whether to raise the country's debt ceiling, or face the risk of default. Although the S&P rating agency maintains its triple-A rating on U.S. sovereign debt, it has altered its long-term outlook to "negative."

Not only has the U.S. dollar been losing value compared to other major world currencies, but also it has been losing value versus commodities, including gold. Indeed, commodity prices have been increasing, but coupled with a weakening U.S. dollar, the value of commodities has exploded higher, and gold continues to make new highs.

Investment climates are riddled with question marks, clouded uncertainty and confused emotion. A prudent investor aims for profit, but wisely hedges to minimize negative shock. During the last recession, gold was one of the few investment classes that provided positive returns. This fact will not be forgotten during the next recession.

Despite all this talk of a gold bubble, the money flow paints a very different picture. Unlike fiat currency, gold is not a government liability. Investors should consider a five to 20 per cent investment weighting in hard assets, such as gold. •

Canaccord Wealth Management is a division of Canaccord Genuity Corp. member of CIPF. The views in this article are solely the work of the author, and not necessarily those of Canaccord. The information herein is drawn from sources believed to be reliable (Sprott Asset Management, RBC, CPM Gold Yearbook 2010, IMF, Thomson Reuters, BIS), but its accuracy and completeness is not guaranteed, nor in providing it does the author or Canaccord assume any liability.