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King Dollar or Court Jester?

By W. Michael McBride, J.D.

With apologies to television pundits who sing the praises of the U.S. Dollar (USD) in any environment, a serious look at the Dollar as a currency is warranted. Investment strategy and performance needs to be measured not only in nominal currency terms, but in real purchasing power terms. After all, the goal is what your investments can buy, not what they represent in Dollars. The health of the currency that you save, invest and spend in is critical to your future standard of living. The financial events of the last couple months and the unprecedented actions taken by the U.S. Treasury and the Federal Reserve are all the more reason to visit this issue.

That said, what tools are available to help us measure whether we are at least maintaining purchasing power in our investment strategies? Measuring the USD in terms of other currencies such as the Euro, Pound or Yen can be helpful. Yet they, like the USD, are all “fiat-soft” paper money currencies, and are inherently flawed.

Traditional “hard” currencies such as gold and silver have been used to varying degrees as money for a couple thousand years. Let’s look at what gold might be telling us in economic monetary terms.

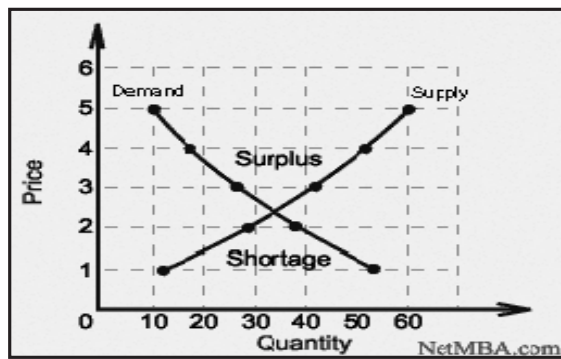
First let’s tackle some of the criticisms of gold as a currency barometer. When gold soared past \$1,000 per troy oz earlier this year, critics of the metal sprang from every corner and crevice of the conventional financial community. They dismissed individuals who pointed to the move in gold price as a concern. They called them hucksters, or Neanderthals clinging to a barbarous relic of the past.

Before we get to the potential core economic message that gold and the value of the USD may be saying, let’s tackle the critics’ updated grouching of gold.

The supply and demand factors are against gold

Below is your standard supply and demand chart from any Economics 101 textbook. Simply stated, raise the price high enough and you either choke off demand or encourage the production of new supply, thereby bringing down the price.

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Therefore, gold is no different than any other widget in the world and these high prices will bring lower demand and/or new supply to bring prices down, right? Well, that assumes that there is a massive supply of gold just waiting for a higher price before it decides to hit the market. There is quite a bit of gold still held by Central Banks around the world that at anytime can put a lot of gold on the market for sale. These are the same folks who sold in the \$300 range remember? Since most Central Bankers are government bureaucrats in nice suits, I would anticipate they would do precisely the wrong thing and probably buy gold at price levels that are multiples of where they sold it!

The danger of a large holder or number of holders of any asset selling it en masse; thereby putting negative price pressures on your holdings is a risk that exists in virtually every asset you own whether it is stocks, bonds or houses.

But there is another supply threat out there that some critics of gold are now resurrecting. It turns out, (you need to sit down for this one), if an economical method for extracting gold from sea water can be found it could easily dump a million tonnes of gold on the market. Just think how that could ruin the supply demand chart above. For those of you, like me, who had the proclivity to occasionally nap in the physical sciences classes in school, it turns out that sea water has a great deal of gold in the solution. It has something to do with bacteria concentrating gold around their cell membranes to form dense agglomerations of a hollow gold microtubule. Google “gold from seawater” and you will find lots of information. I started to read a few articles on it and began to nod off. (Old habits) To suggest that a potential massive supply of gold looms on the horizon is absurd, and smacks of desperation to find arguments against it. Does it theoretically exist? Sure, but it misses completely the point of gold and the role it plays. First it defies the economics of the proposition. Why spend time and money to develop a technology that could extract a now valuable resource that would become as valuable as dirt as a result of your new technology. It’s an inherently self-defeating proposition. Second, gold is valuable because it is limited in supply. If it became unlimited in supply, something else as a currency barometer would take its place and gold investors would migrate to that something else.

There is virtually no chance of double digit inflation in the foreseeable future thereby negating the reason to own gold or use it as a measurement tool.

The argument assumes that government and Central banks are smarter now and won’t make the same mistakes they made in the 1970’s or the 1930’s for that matter. First, I doubt they are smarter and second it doesn’t prevent them from making new mistakes ending in similar results.

In addition, just who’s definition of inflation shall we accept? Our previous articles discussed the manipulation of the Consumer Price Index (CPI) figures by the government. Those of us living in

the real world versus the land of government statistics know that inflation is becoming a real threat to our purchasing power, no matter what their “official” numbers indicate. If the “official government weatherman” says its sunny and 80 degrees outside and I open up the front door and see a tornado bearing down on me, I’ll probably cancel the picnic.

In fact as asset prices decline for all things financial and real estate, we are hearing conventional voices scream of deflation fears. This fundamentally confuses the issue of the effects of massive credit de-leveraging and true monetary deflation.

Gold has been a lousy long-term investment and indicator. If you bought gold at the end of 1979 and held it today your return is less than 100 percent for the almost 30 years.

How are those 1999 internet stocks working out for folks? The point is that, this is another absurd argument. There are times to enter and exit every asset class. Buying any asset at the peak of its price run inherently creates disappointments. Residential real estate rings a bell.

While all these arguments against gold are mildly amusing, they miss the broader point. Gold is money. Notice I did not say currency, but money. It has been for thousands of years. It is a basic economic tenet that if you flood the market with a large supply of anything, then each successive unit must fall in value. Right now, Central Banks around the world, led by our own Federal Reserve Bank, are creating massive amounts of currency. They may call it “liquidity injections in to the financial system,” but at the end of the day it is currency creation. Leverage in the financial system is coming apart and the betting is the Central Banks will provide whatever liquidity (create more money) is necessary to hold it together. The price action of gold suggests there will be no mass epiphany of wisdom by governments and Central Bankers around the world. If gold is just a commodity then so are currencies produced by countries. It is estimated that less than 1.5 percent of world liquid assets are in gold. If the world decided tomorrow to change that number to 5 percent, which is the standard conventional counsel for hedged asset diversification, there isn’t enough gold to make it feasible. How is that supply-demand chart looking now?

The chart below provides a long term view of the USD as measured by the Dollar index which is a weighted average of six major nations’ currencies. In 1973 the index started with a base of 100 for the USD. This means that since 1973, the USD has decreased in value approximately 20 percent against those six flawed currencies.

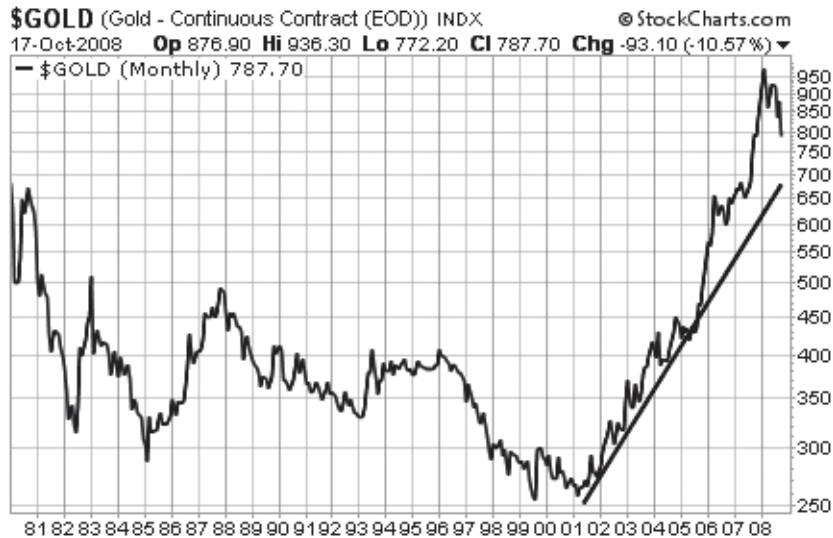
Charts courtesy of StockCharts.com





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At the beginning of 1973 the dollar price of gold was \$65.30. In gold terms the U.S. Dollar has lost approximately 92% of purchasing power over last 35 years. Purchasing power of your savings and investments is what really counts.



Gold is the proverbial canary in the monetary coal mine and it smells trouble. Someone is bound to rattle the cages to see who is still breathing properly.

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