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Gold: The Currency of *First* Resort

Aurophobia is defined by Webster's dictionary as an abnormal fear of everything gold; but it might be more aptly defined as '*the pathological and almost hysterical fear of owning gold, as espoused by the mainstream media*'. The mainstream financial media seem to be falling prey to this malaise at an alarming rate. With gold rising seemingly in perpetuity not only in dollar terms but in a plethora of free-floating paper currencies, the antagonists are out in full force, their fear and loathing of gold for all to see.

Gold seems to engender all manner of emotions, and there appears to be no middle ground. The mere mention of the word can induce comments more on a par with those of Marmite. People either 'love it or hate it', as the advert for the nation's most divisive breakfast spread chimes. Indeed the skew of hate from most media gets more pronounced at every new high. Indeed, every interim peak in gold's price over the last few years has been accompanied by a cacophony of voices proclaiming it to be overvalued. The inevitable retreats that have followed have been short-lived, briefly silencing the critics. However much to these critics' consternation gold keeps making new highs, and with it their strident chorus of disbelief echoes out even more fervently.

The recent highs have prompted the usual critiques of gold: it has little practical use, it pays no interest, generates no income, it is volatile, and it is hard to value. In short it is considered an anachronism, more suited to a bygone era. The recent WSJ editorial (*http://online.wsj.com/article/SB10001424052748704032704575268462477689760.html*) concurs it is a "currency substitute" but still that "it's useless". It acknowledges it is a hard asset but that so are "land, bags of rice and even bottled water". To top it all the author even proclaims physical gold to be a "Ponzi scheme", because people hoard it. He encapsulates in his piece precisely the fundamental misunderstanding of gold that is commonly held, and one that we will try to rectify here.

One of the primary errors those who argue against gold make is to view it as a commodity, like oil, copper, bags of rice or bottled water. Gold, it is argued, is largely not consumed. To paraphrase Warren Buffet, it is dug up from the ground in Africa, then melted down, sold on and finally buried back in the ground somewhere else in the world, only to be watched over by armed guards. Indeed, the argument goes, as it is not consumed in any great quantities, cannot be destroyed, and comes out of the ground at a fairly constant rate, this should be fundamentally bearish for gold. Yes it would be - if gold were just another commodity. But, for most of recorded history, gold has acted principally as a monetary asset. Gold was 'stable' money. Rarely do we question what money is and how it came to be. By understanding the evolution from a barter system to a modern financial system utilising electronic credits in exchange for goods and services, we can best understand what constitutes stable money and why gold is undervalued.

Before coinage and paper (‘fiat’) money there was barter. This system of direct exchange had limitations. For a start for somebody to buy something he wanted he had to find somebody who wanted precisely what he had available for exchange. A second issue was one of divisibility or indivisibility. How could a seller divide larger goods into lesser units in exchange for other smaller goods? For instance how could a person sell his house in return for horses, cars or even a fridge? They could not divide the house up into units; this is not practical. Society needed a means of indirect exchange whereby a good is used not merely for its own sake, but whereby it is used by everyone for exchange for all other goods. In other words every commodity or good is priced only in terms of one commodity. If one good is more marketable than another—if everyone is confident that it will be more readily sold—then it will come into greater demand because it will be used as a medium of exchange. It will be the medium through which one person can exchange his product for the goods of others. When a commodity is used as a medium for most or all exchanges, that commodity is defined as being *money*. Herein lies the confusion for most, as a commodity became money. That commodity was gold.

Society did not pick the medium of exchange out of thin air. Individuals chose a commodity heavy in demand, highly divisible, and as it had to be easily portable, it had to have a high value per unit weight. To have such a property, requires a good which is not only in great demand but also relatively scarce; as such a combination would yield a high price, or high value per unit weight. Importantly the ‘money commodity’ should be highly durable, so as to maintain itself as a store of value for a long time. Gold has no utility and this precisely why it is good to use as money, as its supply is unimpeded by the usual industrial commodity needs. A key quality for money is its integrity, its soundness. By this we mean something that cannot be destroyed, or easily debased by a sudden increase in supply. Furthermore, money that is produced naturally at a rate similar to the long term average rate of population growth furthers its role as a stable asset relative to numbers of people and goods produced. Gold fits that remit and was the natural choice over time to fulfil this role.

Without sound ‘money’ –without a general medium of exchange – there could be no lasting real specialization, no advancement of the economy above a bare and primitive level of existence. Money has helped an elaborate structure of production develop, with land, labour and capital goods interacting to advance the production of goods and services, whilst receiving payment in money. The world could not operate without a widely accepted medium of exchange. Yet this existence of a common and widely accepted medium of exchange rests on a single convention – faith. Our whole monetary and thus financial system rests solely on the mutual acceptance or faith of this medium, as payment or exchange for goods and services. This faith is no fragile concept. Even under the greatest provocation of the medium’s validity, the value of having a common money is so great that individuals will stick to this faith.

Only in the last few decades did gold come to be almost completely de-monetised. When Nixon broke the Bretton Woods gold exchange standard in 1971 gold ceased to be money as deemed by government. In truth the gold exchange standard was just a bastardisation of a true specie gold standard that enabled the US to create more dollars under the guise of the fixed gold oz peg - $35 to a troy oz. The subtle accumulation of extra dollars to help fund the Korean and Vietnamese Wars did not go unnoticed by France's President De Gaulle. He called for payment of trade goods with gold not dollars; at that time each was interchangeable as payment. Nixon declined such a request and closed the gold window - the biggest testimony in history of gold's true worth. Since that time gold has risen in real terms (adjusted for inflation). Note: one of the WSJ premises for not trusting gold was that it has not been a store of wealth since the 1970s. We have shown this to be incorrect in previous presentations on the website www.hindecapital.com. Sadly most have not benefited as governments decreed gold not to be money and thus have not owned material amounts.

The stark reality is that the free market money, gold and silver, has been usurped by government decree, throughout history. The emergence of money not only spawned a boon in prosperity and higher living standards but it also opened a subtle route for the government expropriation of resources under the guise of 'nation building'. Such expropriation or seizure was and is called 'taxation'. However taxation is often very unpopular. To obtain such taxation, fiat ('by order') money or pieces of paper were issued and would be accepted as payment of taxes. In fact it was decreed by legal tender laws that fiat currency must be used/accepted for all payments of debt, public or private. So in essence all government debt is money and the faith in money (if it is not gold) must rest in the belief that government can receive enough future tax revenue to repay all its debts.

Excessive taxation we know is unpopular so governments will engage in a more subtle means of meeting its obligations. To balance the books under a fiat money system the temptation is too great not to issue more money. Government merely puts ink to more pieces of paper, or nowadays just increases electronic money at the banks. They may even in extremis take their own bonds, or foreign government bonds, and convert this money they owe (after all a government bond is merely an IOU) into new money. This is an insidious form of taxation, which reduces the effectiveness of a unit of money, is the true reality of inflation. Inflation is merely a confiscation of your wealth over time, as the purchasing power of your money dwindles.

The value of money, then, is just the effectiveness of a monetary unit (or unit of weight). It is its purchasing power. If asked, most people will say I want more money. However what they really want are more effective units of money (higher purchasing power). They want a greater command of goods and services for same amount of money. Under a gold money system, this faith would not waiver. Gold is homogenous. An ounce of pure gold is exactly that - an ounce of pure gold, equal the world over. Gold and silver would be exchanged directly as 'grams' or 'ounces'. However the proliferation of currency has been so vast that gold has struggled to maintain its worth is against the rate of growth in global monetary bases (money supply to you and me). Remember it takes a lot to break a person's faith in the construct of money, and trust in government not to pervert its value. Most are trusting and law-abiding citizens.

If you increase the supply of money, you dilute its purchasing power. Whilst we see that any increase in supply of any good or money lowers it price, the increase offers no social value whatsoever. Initially we may feel rich as we have 'more money', but as we rush out and spend our surplus money, prices will rise. The last person to spend will be the worst off. Just like a counterfeiter, whether it is the government or an individual introducing more money into the economy, the first to benefit are the counterfeiters (whilst prices are still low). Yes, if the government increases the money supply, they will benefit first. If one understands this truism one can begin to comprehend to what extent what we call money today is not money.

In a world of highly liquid, and electronically accessible credit that became the vast source of 'substitute money', gold, frankly began to look obsolete. Now the environment has changed. The unsustainable growth in paper money and credit seemingly ended. Or has it? The implosion of the financial system that grew via self-enfranchisement of the right to lend without limit led to public-led bailouts of an unprecedented size. If ever there was a Ponzi scheme this was it - layer upon layer of borrowed money with no collateral or principal as downpayment. The amount of substitute money, mainly in the form of derivate contracts, shrunk at lightening pace, leaving the financial system on the edge of the abyss.

Governments and their abetting central banks resorted to their usual playbook as we outlined earlier - inflation of the money supply. They stepped in with yet more borrowed money to take the place of this substitute money whose flow had abruptly stopped. The only way to generate so much money so fast was to issue more government debt, but there was no one to pay for it, except the central banks. So they monetised the new debt in full. They effectively printed new money. By now readers will know, if they have not already worked it out - when you increase the money supply you decrease the value of your money and with it you erode the value of a day's labour.

"*The most important thing about money is to maintain its stability...You have to chose between trusting the natural stability of gold and the honesty and intelligence of members of the government. With due respect for these gentlemen, I advise you, as long as the capitalist system lasts, to vote for gold*."

George Bernard Shaw, 1928

There is no doubt that the individuals (savers) are beginning to question their faith in our current monetary system The unquestionable belief in fiat/paper money is wavering as it looks less like a store of value. The synchronicity of problems across the world, however, mean that most currencies are being created at an accelerating rate, whether it be yen, yuan, euros, sterling or the reserve currency dollars. So in such circumstances what currency does one turn to? The universal currency - gold. What we are witnessing today is the incremental reversion of gold to monetary status, as dictated by the people, ie what is coined the 'free market'. As such, its value is increasing. It is here where the gold sceptics get themselves into a twist. Mainstream writers and TV pundits are the main culprits, by what motivation is not wholly clear to us. They say gold has gone too far, too fast, its price is stretched; in sum that is a bubble.

They are right, insofar as they have identified a bubble - it's just not in gold. Rather it is paper money, in which gold happens to be priced, that is the bubble. It is not so much that gold is making new highs, rather, paper money everywhere is making new lows against gold. If alchemy became a reality, and the supply of gold were suddenly to vastly increase, then most people would naturally assume the price of gold would reduce. So why, if the mechanism is reversed, and it is the supply of paper money that suddenly expands at a furious rate, shouldn't the opposite be true?

It should be noted that there is potentially an *unlimited* supply of paper money, and with it the rise in the value in gold is potentially unlimited. Although gold supply is a misnomer as it is not destroyed or consumed. It lasts forever and does not degrade. Almost all the alleged 160,000 tonnes of gold mined (almost the size of a tennis court cubed) exists in some form, jewellery, bullion, coins, ancient Egyptian artefacts or scrap. At $1200 an ounce this cube is worth some $6 trillion, a mere 3.3% of the $180 trillion pool of available financial assets. Half of this cube is comprised of national and artistic treasures, religious artefacts, heirlooms and treasured possessions that will never come back onto the ‘market’ - ie the area of exchange – so gold only comprises a derisory 1.6% of the pool of financial assets. The market capitalisation of gold producers is also a paltry $300 billion and they can only produce gold annually at close to 2.5% of the existing world supply. This falls far short of the increases of money supply that runs into double digits for most leading countries.

Governments have by and large managed to nullify the impact of gold's fiduciary value in the mindset of society (mostly the 'developed' world). But now that individuals begin to obsess about the validity of the current capitalist structure, the weight of trillions upon trillions of printed money will eventually overwhelm a small and ultimately finite supply of gold (and silver). Government will not want to relinquish control of money, because under a gold backed currency it cannot be increased, with which to 'confiscate' goods and assets. However the free market is once again dictating gold is money. This will ultimately overwhelm any governmental suppression. Since 1971 gold has had a 9% annualised return and throughout that time government has had the will and gold with which to hold back its ascent to fair value. Now western central banks are running low of gold whilst others wish to increase their holdings against the potential devaluation of their dollar currency reserves. Remember there are many governments in the world today who will ultimately pursue their own interests. It's the nature of the beast – man is his own worst enemy. If they do not buy gold the man in the street will begin to. Gold is a *universal* currency, it is not an investment it is *money*. It is undervalued, under-owned and mis(understood). It is not only advisable to own gold, it is a must.

Again we emphasise that consternation and confusion arises when the issue is viewed through the prism of gold as a regular commodity. A change of mindset is enough to reveal the true bubble; it is not in gold.

Finally to all you savers out there. We sincerely hope we have dissuaded you from taking heed of the ill informed financial journalism. We also would like to dissuade you from making potentially risky investments in "substitute gold" products. The proliferation of ETFs has almost been as excessive as global money creation itself. The most well known gold and silver backed ETFs, the GLD and SLV, have attracted growing amounts of retirement savings. This greatly troubles us at Hinde. We are not alone in our misgivings. These ETFs provide a seemingly easy way to own physical gold but without all the storage and delivery hassles. One click of a button and like a share you appear to own the real stuff. The WSJ journalist is right about one thing: owning "gold is dangerous". Unfortunately he did not realise he meant *paper* gold, ie pieces of paper purchased with an alleged ability to take ownership of the gold each piece backs.

The recent Ponzi scheme of " substitute money" was based on unregulated pools of credit. The enormous, complex and overvalued mortgage related investment products which were the undoing of "too big to fail" banks and insurance companies, exhibited the same lack of transparency and disclosure that ETFs do. ETFs straddle two different investing arenas - securities and commodities. The needs of shareholders are not necessarily addressed by the issues in the commodity market. There is not full disclosure and proper alignment of regulation between commodities and securities markets. It is not outlined that there is a conflict of interest. The two largest custodians, JPM and HSBC, hold significant OTC gold and silver derivatives as well as significant short positions on the paper gold and silver futures on the COMEX exchange. In theory for every short in a commodity, the seller should be able to 'cover' the position by holding or borrowing actual inventories. It would be fair to say such custodial holdings would prove tempting a source of gold. This may be a moot point. So significant are these shorts, that the CFTC has been undertaken to investigate talk of market manipulation. Allegations, if proved to be founded, on ETFs would be detrimental for ETF holders. This all should be disclosed to participants. Should it also not be disclosed the relationship between such entities and the Federal Reserve System and in particular the Federal Bank of New York and how it acts as a depository for the US government and Exchange Stabilisation Fund?

We believe that a new Ponzi scheme is potentially growing in the gold and silver ETF market. The ETFs' purported gold and silver inventories appear to be more than the amount of available supply of the physical metals in existence, particularly silver. In fact there is great debate on the actual numbers. This certainly raises some questions. Such inconsistency is more reflective of a classic Ponzi scheme. New investors are enticed to invest based on a perceived return or in this case investment in something perceived to be real; in this case physical, allocated gold. The scheme is perpetuated by each new investor's proceeds securing the investment. Although in this case investors will only truly know the validity of their investment if all decide to take delivery into a vault, separate from the custodian banks. Then there would be no question of double accounting. The unpalatable truth is savers have not been given a clear picture of what they are purchasing when investing in GLD and SLV, and full disclosure of the issues confronting the commodity element of the investment also.

Once you have understood what gold is, you will understand that investing in the physical bullion via a regulated fund that stores allocated (named gold) bullion for part of your savings will provide you with protection of your purchasing power, while offering capital appreciation as a second priority. All great family dynasties have survived by converting large amounts of their paper money into gold. What will your family do?