Investment Outlook

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GOLD & DOLLARS:

Reasons that cause Gold (& Silver) prices to go up:

1) Inflation Expectations.
2) Fear of Sovereign Currencies.
3) Supply/Demand.
4) Speculation.

So the question that gets asked constantly of a portfolio manager in today's investment climate is: "Why don't we own gold (silver)?" or in other circumstances: "Shouldn't we buy gold (silver) now?"

Besides making the obvious point of buying assets prior to the price tripling, the question is best answered with a question: "Is gold really going up, or is our currency going down?"

To understand what has happened to gold prices, and most every commodity in general, one has to understand what makes the prices or values move. Precious metals: gold, silver, and platinum are both industrial commodities and, unique among commodities, seen as a store of value. They trade both on fundamental supply/demand and on faith in fiat currencies plus inflation expectations.

To understand why gold has moved and likely will continue its speculative ascent, one merely can look to the four bullet points above. Gold is being moved by all potential factors and strongly so. But the greatest factor, other than speculative momentum, is the fear of underlying fiat currencies as a store of value.

"As a fiat currency which is NOT a store of value, but rather a ubiquitous unit of credit, the dollar can only have "value" in the context of an economic transaction whether it be a good or service. Therefore when one speaks about the value of the dollar, it is a nonsensical characterization unless it is measured in the amount required to purchase something." *

With debt levels rising across the developed world, deep concern regarding the values of all fiat currencies has grown. The reflection of this can be seen not just in precious metals (stores of value), but in virtually all commodities. In fact over the last 10 years, all commodities, except natural gas, have appreciated significantly.

This may signal one of two things, either a rising demand for static or declining resources or falling purchasing power of currencies.

"How can it be that the markets do not fully understand that the next Great Inflation has already happened?" *

DOLLARS, YEN & EUROS

Years ago, famed portfolio manager Marty Zweig came up with the easiest mental pictorial of how to understand currency markets. Simply draw a triangle. Label each leg with 1 of the 3 major currencies (Dollar, Yen, Euro)**. Now, no matter how you turn the triangle, for 1 or 2 currencies to be up, then another must be down. Simple as it seems, the currency markets really work this way.

Rumors of the US Dollar losing its reserve currency status are likely wildly unfounded.

Simply put, the dollar is the best house in a bad neighborhood. Reserve currencies, or where other nations seek to put their monetary reserves, require two basic elements: Stability and Float (Size).

No matter how stable for example the economy of Burundi might well become, its currency and economy are not big enough for China to invest its excess currency to any significant amount. So the size of the economy and float of the currency limit reserve currency status to only the largest economies.

No matter how large Argentina may well become, it was actually the largest economy in North and South America at one time, its history of political and economic stability will never allow it to become a reserve currency. Constant revaluations of currency, excessive borrowings, and a history of economic booms and busts make it not the destination to stash monetary surpluses and expect purchasing power to be preserved.

The contention that the Chinese Renminbi or Yuan may replace the dollar as the world's reserve currency is possible, but not currently probable. First the currency is pegged to the dollar hence it has never been allowed to float freely nor be traded in world markets. The economy is a planned economy, albeit emerging as a capitalistic economy in early stages, controlled by a Communist government. So though the Chinese economy is large in size, its currency does not currently have the float, nor is its modern history long enough to give assurance of stability.

So as the most stable and largest currencies, the Dollar, Yen and Euro will continue their dominance for the foreseeable future. The Dollar is not threatened long term by a currency whose government debt is in excess of 250% of GDP like Japan. Nor by a currency like the Euro which is backed by profligate countries such as Greece, Spain, Italy and Ireland.

CONCLUSION

The debt levels and demographic state of the largest developed economies are not positive. There are basically only three ways out of the high debt situation faced by the developed world: raise taxes, reduce spending, or monetize the debt through the creation or printing of money. Commodity prices, especially gold and silver, reflect that faith is lost in fiat currencies and that monetizing debt with the creation of more currency has happened and will continue to happen.

This is not evident by looking to currency markets where fiat currency is traded against fiat currency. There is no need to fear that the dollar will become worthless versus other currencies. The fear should be that all currencies will depreciate against the cost of real assets as reflected in the rise commodity prices, such as gold.

* *Mark LaPolla, Knight Research*

** *Ironically the triangle example at the time consisted of the US Dollar, Japanese Yen and the German Mark. Today the strength of the Euro is likely resolutely in the strength of the German economy and to a lesser extant the French economy. So even though the currency name has changed, the fundamentals remain the same.*

If you have questions or would like to set up a meeting with our team,
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