PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

17 September 2010

# The golden ratio

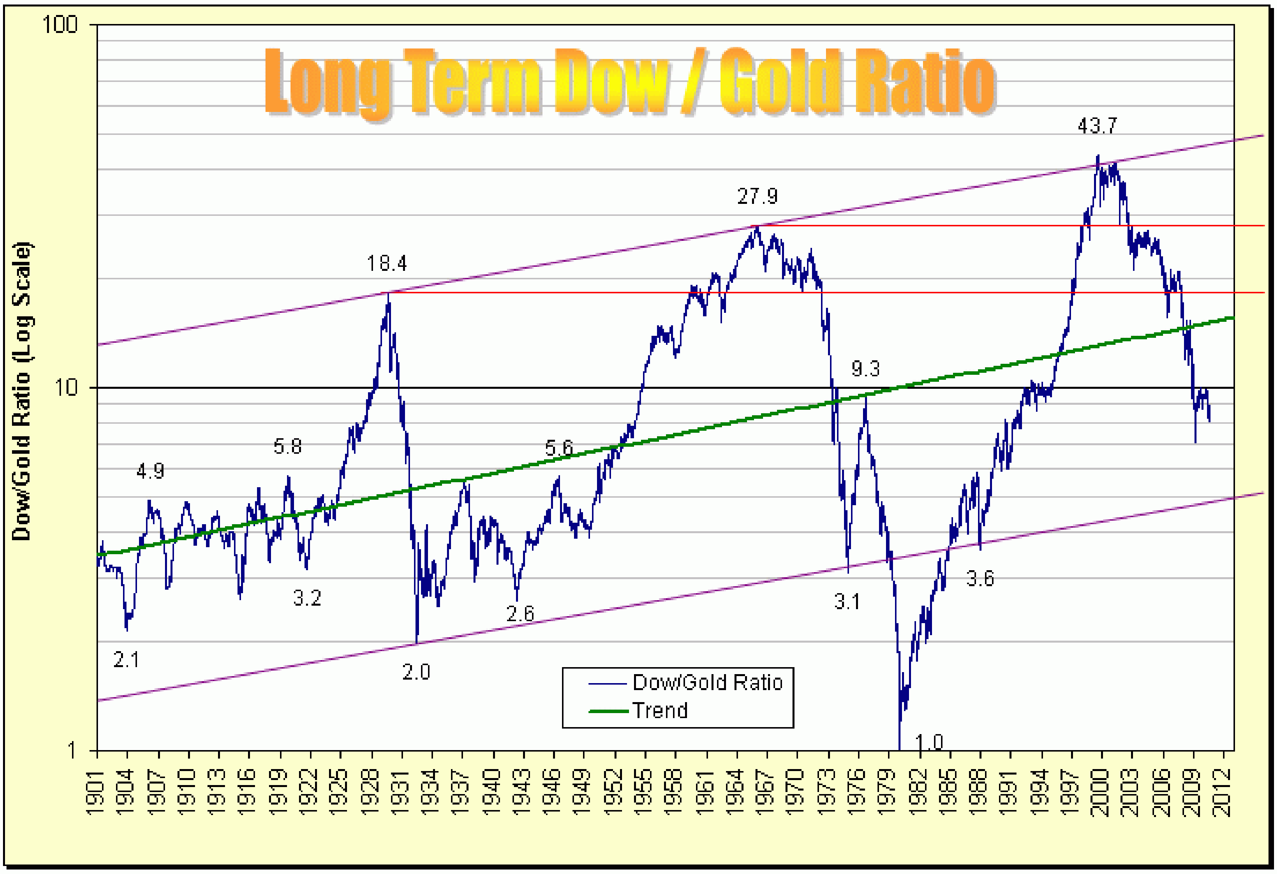
"Greece rules out possibility of default"

- FT headline, 16.9.2010.

**There's probably merit** in seeing the markets through fresh eyes. But after a couple of weeks away, not much seems to have really changed. Stocks have been more resilient than we might have thought – but only a little. Even after the recent rally, the S&P 500 is showing year-to-date gains of less than 1%; the FTSE 100, of just over 2%; the MSCI World Index, of just over 1%; and the year is almost three quarters over. This is not exciting stuff, given the theoretical boost to stocks from interest rates effectively at zero. These markets look simply tired. But the stock market is, in any event, a fickle and rumour-driven sideshow by comparison to the main event, which is a global credit market drowning in government debt. Much of that debt is no longer worth buying, if it ever was. That this market hasn't collapsed under its own weight like some form of paper neutron star is remarkable. What its failure to collapse means is open to debate. Sceptics point to a bubble in bonds. Deflationists, a number in which we are content to be counted, point instead to the widespread investor terror of investing into anything else at a time when most of the world is engaged in deleveraging and balance sheet reconstruction. At some point, the inherent insanity of buying government debt issued by the most heavily indebted entities in the world will become apparent, and the price evolution of those putatively risk-free assets will become an interesting learning experience for anyone unlucky enough to be holding them. But between now and then, whenever *then* turns out to be, government bond yields can continue to fall. Japan has shown the way. Suffice to say, we maintain that the only government bond markets worth investing into are those where the governments in question have the resources to pay you back. That effectively excludes most of the developed world, and certainly most of the G8.

And the gold rally continues. Indeed it is now, astonishingly, into its eleventh year. Sceptics would hold that any financial instrument that has seen its price rise over such an extended period of time is a) now overvalued and b) ripe for correction. We absolutely disagree with the first contention, and are agnostic as to the second. The flaw with this 'overvaluation' view is that it is putting the cart before the horse. The inherent problem with gold is trying to value an asset denominated in a fundamentally valueless currency, namely paper. Instead, let us consider an alternative means of valuation, namely the Dow / gold ratio, or the number of ounces of gold required to buy one share of the Dow Jones Industrial Average.

The following (log) chart, as its title implies, shows the long term relationship between the Dow and gold:




(Source: Fred's Intelligent Bear Site / Sharefin)

At the bottom of previous equity bear markets / gold bull markets, the Dow / gold ratio has reached 2.1 (c. 1904); 2.0 (c. 1932); 3.1 (c. 1975) and 1.0 (c. 1981). It currently sits at around 8.3. The trillion dollar question is: how low can it go ? (Notice that we don't phrase this question as 'how high can it go'. We do not envisage stocks outperforming gold. We are not fantasists.) And of course, the ratio could reach a temporary equilibrium level between 8 and say 1 from three separate scenarios:

1) Gold prices remain close to current levels and equity markets continue to fall

2) Equity prices remain close to current levels and gold prices continue to rise

3) Gold prices continue to rally; equity markets continue to fall; and both markets meet each other somewhere in the middle. This would be our 'base case' scenario.

But ***why*** is gold rallying ? We have written continually about gold over the past three years so our views should be well known by now. Nevertheless.. we are living through a period in finance that is likely to enter the history books, and not in a good way. Since Nixon took the US dollar off the gold standard in 1971, world currencies have been backed by nothing more substantial than the promises of politicians. While this makes the perceived value of one currency versus another somewhat subjective, it also makes the generalised trend of fiat currencies per se somewhat predictable: they will all tend to depreciate over time against harder assets, as fiscal rigour and tough economic choices typically get bypassed in favour of bribery, corruption and lies. Which is where the bankers and central bankers come in. The *first* leg of the bull market in gold was a purely political one, courtesy of the end of the Bretton Woods currency system. The *second* and current leg of the bull market in gold has been driven by market developments, as financiers overleveraged themselves and their institutions while the regulators looked the other way. Seeking to shore up the financial system has meant governments taking on the liabilities and malinvestments of the banks. Since these liabilities and malinvestments dwarf the amount of money in circulation, government guarantees have effectively bankrupted the governments forced to undertake them. These governments were already buckling under the weight of their own indebtedness, but the scale of their new liabilities essentially gives them no option now but to try and impose panic austerity and (perhaps not so quietly) to try and inflate their problems away. So the fiat currency backdrop was already problematic pre-crisis, but now it looks fraught. Whether or not we end up charred by inflationary fire or entombed in deflationary ice, gold (and now silver) is acting exactly as one would expect, as an early warning device signalling what in extremis could turn out to be the wholesale restructuring of the global monetary order. A knee jerk warning of simple inflation this is not.

But again, the fundamental problem comes down to debt. There is too much of it, and much of the existing store of debt clogging the financial world's arteries will never ultimately be refinanced. Not all of us are going to make it out of this room alive. How did we get into this mess ? Readers are advised to read and enjoy Michael Lewis' latest piece for Vanity Fair, 'Beware of Greeks bearing bonds'. An excerpt may suffice to hint at the succulence of the meat:

"..beyond a $1.2 trillion debt (roughly a quarter-million dollars for each working adult), there is a more frightening deficit. After systematically looting their own treasury, in a breathtaking binge of tax evasion, bribery, and creative accounting spurred on by Goldman Sachs, Greeks are sure of one thing: they can't trust their fellow Greeks."

And this is the sadder aspect of the crisis. The Greeks aren't alone. Here in the UK, the austerity measures still remain more hypothetical than real, and already union leaders in denial are setting the scene for a battle royal with the part of the economy that inhabits the real world. At least the two weeks away from the markets were nice.

Tim Price
Director of Investment
PFP Wealth Management
17th September 2010.

Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com