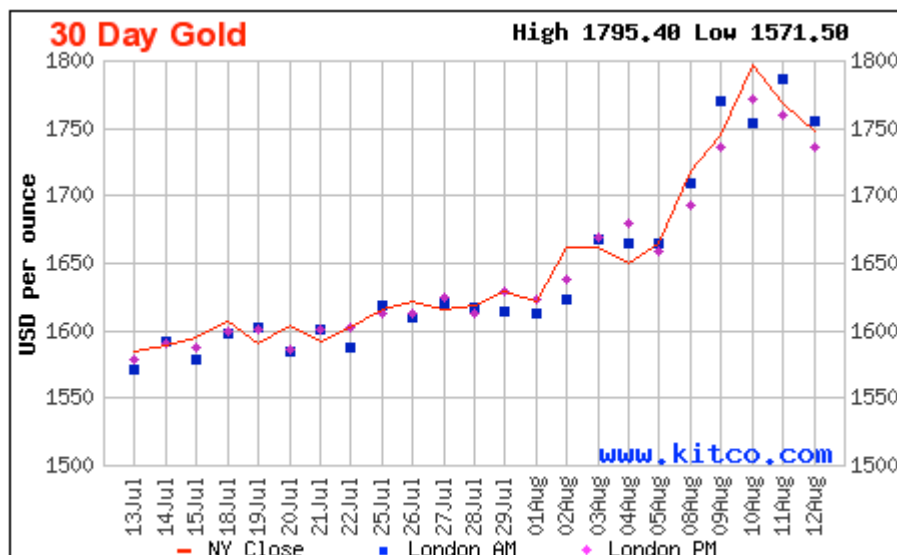


What is Bad for the Dollar is Good for Gold

By Chris Gan

Gold had an amazing run-up early August, immediate-delivery bullion, reached an all-time high of \$1,814.95 per oz on Aug. 11, before retreating a little to trade above \$1700 per ounce. Spot gold had been trading around \$1600 to \$1650 per oz leading up to the Aug 2 deadline, when the U.S had to raise its debt ceiling of \$14.1 trillion to avert a disastrous default on its debt obligation. Although President Obama and Congress managed to cobble up a “band-aid” agreement just in the nick of time, it did not help to restore investors’ confidence in the strength of the U.S dollar and its economic outlook. One of the key drivers of the meteoric rise in the price of gold was rating agency, S&P’s downgrade of the United States of America’s debt from its top rating of AAA, to AA+ on 5 August. The credit agency made the move because the deficit reduction plan passed by Congress did not go far enough to stabilize the country’s debt situation and that the policymaking was not stable or effective as needed to address the current economic challenge. The U.S has held this coveted status of the world’s safest, investment grade debt since 1917 (94 years to be exact), and along with it the U.S dollar as the world’s *de facto* reserve currency.

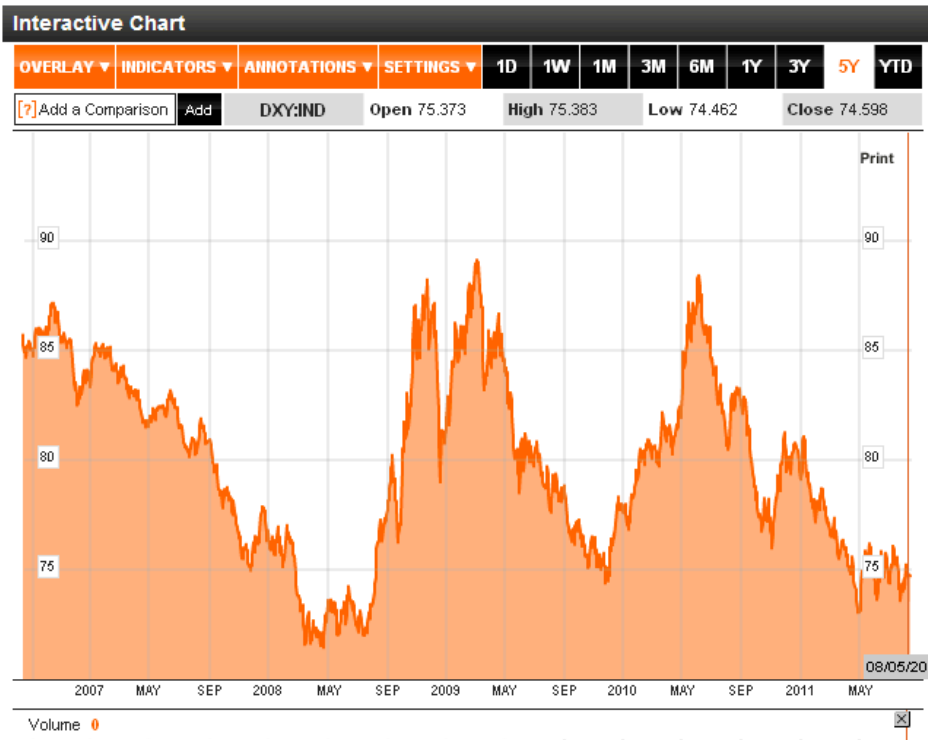
Gold’s meteoric rise on the back of historic US debt downgrade by S&P



Investors’ negative reaction to the downgrade was swift, wiping out about \$5.4 trillion in global equities since July 2011. The S&P500 index posted one of its biggest one-day fall in

recent history while the US dollar also declined significantly as investors seek safe havens like in the Swiss Franc and gold. What further exacerbated this massive shift in risk appetite was also the weak outlook for the US economy’s growth rate going forward. Moody’s Analytics has downwardly revised its U.S. economic forecast for 2011. Real GDP is now expected to expand at an annualized rate near 2% during the second half of 2011, and just over 3% next year. Previously, it had projected GDP growth at 3.5% during the second half of this year and through 2012. Consumer sentiments in the US remain weak while unemployment remains stubbornly high at 9.1% in July (having edged down slightly from 9.2% in June 11).

US Dollar Index (DXY): fallen back close to pre-08 financial crisis levels



Source: www.bloomberg.com

The US Dollar Index (DXY) which measures the US dollar against a basket of 6 major currencies like the Yen, Euro and others which has fallen back close to 2008 financial crisis levels now will likely to continue to weaken. It didn’t take S&P’s downgrade to convince investors on what they already know – that the US dollar is not the safe haven that it used to be. It is definitely not – “good as gold”. In fact since the end of World War II, the US Dollar has lost almost 97% of its value; the moment the Feds started to print paper money instead of being backed by gold, marked the start of this historic decline. The founding fathers of the U.S were smart enough to realize the important of gold - in that it was enshrined in its

constitution that only *in specie* or “real money” i.e. gold and to lesser extend silver, could be counted as money. But, all this changed when President Roosevelt under the Gold Reserve Act of 1934 ordered the confiscation of gold in the U.S, created the Federal Reserve, and in turn issued paper currency (the Dollar) which was convertible to \$35/ ounce. Overnight, the dollar was devalued by 69.3% and the American people were thereby conned out of \$3bn. And from that point on, the government could issue as much fiat currency as it wanted and borrowed as much as it needed, backed by the ability of the country to repay its debt in due course. The US dollar has continued to lose its value and the American people through the effects of inflation – have ended up owing more and having less¹.

The Swiss franc on the other hand has appreciated significantly in the wake of the US downgrade: the OECD estimates that it is 41% overvalued against the Euro putting more pressure on prices in Switzerland. The franc, considered a haven in times of turmoil, has appreciated 10 percent versus the Euro this year, reaching a record 1.0075 on Aug. 9. Against the dollar, the currency traded at around 79.98 centimes, down from an all-time high of 70.71 centimes earlier this month. If you buy a Big Mac at a Swiss McDonald’s it will cost you 128 percent more than one from a U.S diner, up from a 72 percent premium a year ago, according to a Bloomberg index that measures burger prices in dollars. The government is contemplating measure to restrain the runaway currency which it says is creating a massive problem for its industries, as higher prices make its exports uncompetitive while creating havoc with prices internally, emanating from cheaper imports. The world is running out of safe haven options it seems, which takes us to probably the only reasonable solution – gold.

One of the 5 key reasons to invest in gold is as a hedge against US dollar weakness. *The World Gold Council March 2008 Report* states that there is a negative correlation of between -0.4 to -0.6 between gold and US dollar. A 1% depreciation in the US dollar is likely to cause gold price to appreciate between 0.4 to 0.6%. Hence given the current scenario, it thus makes sense for investors to put / convert more of their fiat currency especially US dollars into gold.

¹ US debt now stands at \$14.1 trillion before Congress passed bill to increase this by \$2.1tr. Inflation was 3.6% in June 2011. From 1914 until 2010, the average inflation rate in United States was 3.38 percent reaching an historical high of 23.70 percent in June of 1920 and a record low of -15.80 percent in June of 1921. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. (www.tradingeconomics.com)

Gold as a hedge vs. US dollar weakness

Gold – hedge against US\$ weakness

GLD vs. US Dollar Index (5 yrs to 19 /01/2011)



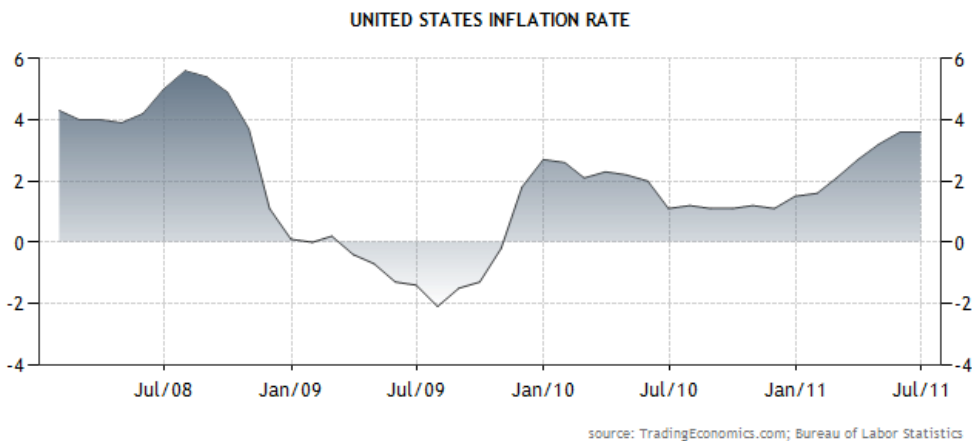
- GLD = SPDR, world's largest gold exchange traded fund (ETF)

- DXY = USD Index measures the performance of the US Dollar against a basket of major currencies: EUR, JPY, GBP, CAD, CHF and SEK

Rising inflation is another key driver of the higher gold prices today and necessitates investors to seriously consider hedging against this phenomenon, which effectively reduces their purchasing power and in the long run, their wealth. Inflation in the classical terms is defined as a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation also reflects an erosion in the purchasing power of money - a loss of real value in the internal medium of exchange and unit of account in the economy (www.wikipedia.com) It is generally argued by economists that inflation is a result of excessive growth in money supply and credit.

But, is it really the increase in supply of money that causes inflation? Does having more money results in a person spending and investing more? This is the Keynesian view. But the Austrian school of thought looks at the value of money more closely – a person is only motivated to part with his/her money (fiat currency) only when he or she perceives that its value will fall, in relation to what it can be exchanged for (otherwise, he may just decide to keep the abundance of money under his bed!). At this point, more money is exchanged for goods and services available – as a result, an increase in general prices occurs, hence inflationary pressures build up. Today, we are starting to feel the effects of not only too much money (being generated by the QE 1, QE 2 and other stimulus) but also a realization that the

real value of money (especially US dollars) is not what it seems. The downgrading of its debt by S&P is only a confirmation to what most American's and investors already know – the US dollar is losing its value, and rapidly. Inflation has been eroding their wealth for a long time: just like a balloon slowly losing air from a small leak. But, it had been propped up by huge government borrowings and decades of cheap money. Long living beyond their means, it is now time to pay the price. And, for those that have woken up to this reality – exchanging their dollars for “real” goods is possibly the best option to hedge against its further erosion. Higher inflation is inevitable.



Inflation is not only a phenomenon that is happening in U.S. It is also happening elsewhere and with grave consequences. In China inflation rose to a 3 year high of 6.5% in July prompting some stock brokers to increase their full year CPI forecast to 5.4% from 4.9%. Its no wonder that this is happening in the world's second largest economy – they are also the U.S' biggest creditor, holding about a \$1 trillion worth of Treasuries which have recently been downgraded. China's reserve of over \$3.4tr is held in currencies predominantly US dollars – only 1.6% is held in gold.

On the news of US debt rating downgrade, the Shanghai Composite Index declined drastically, down 3.8 percent on Aug. 8, capping a 20 percent drop from a November high. The Chinese central bank had raised interest rates five times and ordered lenders to set aside more cash as deposit reserves 12 times since the start of 2010 to contain inflation that quickened to the fastest pace in three years last month.

Inflation is also wrecking havoc in the UK. The Bank of England's recession-busting policy of buying up billions of pounds of bonds – may have contributed to recent social unrest and riots by exacerbating inequality, according to one City economist. As the Bank of England considers unleashing a fresh round of QE, some argue that the approach of creating electronic money pushes up share prices and profits without feeding through to wages. The money ends up in corporate profits and not to wages, and the man-on-the-street; that causes income inequality and social tensions. The fact is that real wages – adjusted for inflation – have fallen in both the US and UK, where QE has been a key tool for boosting growth. In Germany, meanwhile, where there has been no quantitative easing, real wages have risen. And as governments happily spend their artificially created money mostly on government bonds, the price of many assets especially real asset like commodities and gold are driven up.

So how do we protect our wealth given that we know that the US dollar is likely to further decline and that higher inflation which erodes our wealth is inevitable? **Gold and silver.** What else is there? Even the Governments are looking to buy more. Recently, the Bank of Korea announced it has bought 25 tonnes of gold over the past two months. The stake is valued at \$1.24 billion, or roughly \$1,550 per ounce, and it marks the country's first gold purchase since 1998². Central banks tend to buy gold when they need to diversify or increase their holdings as mandated by the government and are not necessarily market timers, but they do buy as a long-term investment. The purchase brings Korea's total gold holdings to almost 40 tonnes, still a fraction of the bank's total reserves compared to the U.S. or Portugal, which hold 74% and 84% of their reserves in gold, respectively, according to the World Gold Council.

The news does underscore the fact that central banks have become net buyers of gold, however, adding a huge floor under the gold market and reminding investors that countries are purchasing large quantities. Official sector buying in the first quarter was 129 tonnes, according to the World Gold Council's Gold Demand Trends report, led by Mexico which bought 93 tonnes. U.S is the largest holder of gold with roughly 8,000 tonnes with China at 6th spot with just over 1,000 tonnes of gold in its reserve.

In summary, gold has rallied up significantly – it may be a little overheated as investors clamored out of stocks and US dollar looking for safe havens. Other safe havens like Swiss

² During the 1997-98 Asian financial crisis, patriotic Koreans collected the precious metal as part of a campaign to boost the country's foreign reserves, when it was on the verge of a sovereign default.

franc have not been spared from this investors' scramble to protect their wealth, rising significantly in value versus Euro and USD. But, it should be kept in perspective – is the latest round of increase in gold prices driven by too little gold or too much paper money, which is quickly losing its “good as gold” status? Money that is having not much value. And, which is driving investors to part with their cash stash into real assets and real money (i.e. gold), that can at least protect their wealth? If the answer is the latter, then the strategy of converting fiat currency into gold remains as relevant today as it was before the ratings downgrade, and resulting turmoil in the stock markets. Investors may have over-reacted, and driven gold prices up to quickly. But, gold prices currently are showing signs of retreat – such price pull-backs, possibly to \$1650 per ounce would provide an excellent opportunity to accumulate more gold.

The information, opinions and financial data presented are for educational purposes only and are not intended as investment advice. No guarantees are made as to the accuracy of the information provided herein. Any links provided to other server sites are offered as a matter of convenience and in no way are meant to imply that Auruma International endorses, sponsors, promotes or is affiliated with the owners of or participants in those sites, or endorses any information contained on those sites, unless expressly stated Insert disclaimers.

AURUMA INTERNATIONAL

All copyrights reserved