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Debunking Gold

Brian Chang

No investment today is subject to more fallacies, misconceptions, and half-truths than gold. This is no surprise. Since its removal as the cornerstone of the global monetary system in the mid-1970s, gold has largely been eliminated from mainstream investment publications and banished from the teachings of academia. This has resulted in upwards of three generations of investors who have received virtually no formal education in gold and is largely to blame for the continuous and unending stream of inaccuracies being propagated by self-proclaimed gold-bugs and other special interests.

The central fallacy among these inaccuracies is the fallacy that during times of economic crisis, "gold always wins". Gold, we are told, is the perfect portfolio hedge against financial calamity of any sort, regardless of its cause or origin. We are assured that gold, and gold alone, offers investors the ultimate protection against the dangers of both inflation and deflation, and is to be bought indiscriminately as insurance against both depression-era outcomes and the spectre of runaway hyperinflation.

It is this logical absurdity – that it is somehow possible for gold to act as a hedge against one economic outcome while simultaneously acting as a hedge against the exact opposite economic outcome – that we will concern ourselves with today.

Recessions And Deflation

No economic subject is so critical to the understanding of gold's role in a modern-day investment portfolio than the concept of "cash hoarding" during periods of financial turmoil. As a response to the uncertainty accompanying recessions and times of economic crisis, the public moves at once to curtail excessive consumption and risk-taking while attempting to grow cash reserves and increase overall financial liquidity.

As people move to strengthen their financial positions in an increasingly uncertain world, cash provides them with the widest range of possible future choices and the surest way to instantly meet future contingencies as they unexpectedly arise. This hoarding of cash is driven by what economists call "uncertainty aversion", and during times of recession, the greater a person's cash reserves, the greater their uncertainty is alleviated.

As the public now attempts to counteract their economic fears through the raising of cash balances, they consequently increase the demand for money relative to all other goods and services, which is the same thing as saying that the purchasing power of money has increased, and the price of goods and services has decreased. Cash, as an asset class, increases in value relative to both consumer goods and financial assets and becomes the preeminent investment of choice during periods of economic turmoil. Deflation – the decline in overall prices – is the natural outcome of the public's desire to decrease uncertainty through the accumulation of cash and is the central trait of a recession unencumbered by government interference.

Gold And Deflation

If it is true that money becomes the investment of choice during deflationary periods of economic crisis, why then is it constantly argued that gold instead offers investors the ultimate salvation against depression-era outcomes? Gold's advocates repeatedly point to gold's high returns during the period of the Great Depression as justification for their misguided belief in gold's value as the ultimate deflation hedge, but what they fail to realize is that while gold certainly performed well during the deflationary period of the Great Depression, it did so precisely because, at the time, gold was money.

During the period of the Great Depression, gold was tied to a fixed exchange rate against the dollar and as such

represented liquidity and official money of the land. Gold coins circulated freely and could be traded for dollars at a known exchange, while dollars could similarly be exchanged for gold at a pre-determined price. Purchases could be made in gold, debts could be serviced in gold, and all taxes could be remitted in gold if so desired. Under the monetary system of the Great Depression, gold's value increased in lockstep with that of the dollar and functioned exactly as money should have – as an uncertainty hedge against economic crisis.

The monetary landscape today, however, is far different than the one that existed during the Great Depression. Today, gold is no longer official money of the land and is not readily used as a means of exchange in modern-day transactions. It does not represent the most readily salable good and the most liquid commodity in circulation and as such does not serve as the default uncertainty hedge during times of financial upheaval. In the monetary system of today, this function lies almost exclusively with money, and is the reason that cash, not gold, will benefit most during deflationary economic conditions. Far from being the last refuge of investors during both recessions and depressions, gold is far more likely to be sold en masse by investors as they scramble for true liquidity and the uncertainty hedge that only cash, as official money, can provide.

...why, given the abundance of government inflation over the last decade, has gold's response been so muted and subdued...

Gold And Inflation

We have so far seen that in cases where the public is able to alleviate economic uncertainty through the hoarding of cash, it is money, not gold, that becomes the safe haven asset class of choice. In today's economic climate, however, governments have come to resort almost exclusively to inflationary policies designed to prevent the hoarding of cash during economic recessions. Their primary means for achieving this goal is through a persistent policy of currency devaluation driven by a widespread increase in the money supply.

As the public attempts to hedge against the uncertainty of recessions through the hoarding of cash and the stockpiling of future purchasing power, government efforts to devalue this purchasing power results in the desired level of protection never being achieved and the hoarding continuing in perpetuity. Government economists often decry this hoarding of cash as intractable and self-perpetuating and needing to be "fixed" by government, but what they fail to realize is that were it not for the interference of government inflationary policies themselves, the hoarding of cash would quickly come to an end once the public's desired level of cash reserves had at last been reached.

The human desire to acquire protection against financial uncertainty is naturally occurring and, more importantly, it is enduring. The artificial mechanics of government monetary policy cannot alter this behaviour – it can only influence the medium that the public chooses to store their economic safety net. Government inflationary policies enacted in response to recession drive the public away from money as a means of protection and towards other commodities and currencies that are perceived to have superior store-of-value characteristics while also fulfilling the desire for liquidity.

While not directly exchangeable for goods and services in a modern economy, gold's unique history as money, its widespread salability, and its perceived store-of-value characteristics make it a form of quasi-money when the value of official money becomes suspect. When the public comes to view the economic crisis as intractable and the inflationary response by government as unending, it is gold, not cash, that becomes the uncertainty hedge of choice and will serve as the key driver of returns in a diversified portfolio.

Gold As A Safe Haven

We can see that when the public desires to save as a means of protection from economic crisis but is unable to do so in the official medium of exchange due to government inflation, it is gold that serves as the primary beneficiary. The reader then will be left wondering why, given the abundance of government inflation over the last decade, has gold's response been so muted and subdued. This is because, contrary to the claims of gold-bugs and other special interests, gold's investment performance cannot be predicted in real time wholly from mechanical factors such as the quantity of money in circulation – it is derived from the fickle phenomenon of investor psychology.

Annuities Offer Income For Life

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1. Male Single Life Prescribed Annuity ages 65, 70, 75 and 80

Male age at purchase	Annual income	Annual Taxable Amount
65	$5,970	$1,044
70	$6,852	$970
75	$7,766	$765
80	$8,936	$822

2. Female Single Life Prescribed Annuity ages 65, 70, 75 and 80

Female age at purchase	Annual income	Annual Taxable Amount
65	$5,600	$1,180
70	$6,343	$1,024
75	$7,240	$747
80	$8,374	$624

3. Joint Life Prescribed Annuity Male/Female ages 65, 70, 75 and 80.

Joint age at purchase	Annual income	Annual Taxable Amount
65	$5,118	$1,300
70	$5,735	$1,147
75	$6,574	$961
80	$7,751	$859

Annuity income values were obtained from highly rated Canadian insurers and are for illustration purposes only.

Annuity rates change daily. Income and tax rate will depend when the annuity contract is issued.

Rino Racanelli, *independent annuity advisor*
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While it is true that governments today respond to virtually every financial crisis through the reckless printing of money, it is also true that the public has tended not to view the subsequent currency devaluation as problematic so long as it raises the prices of financial assets. This is because when money printing causes prices to rise for investments such stocks, bonds, or real estate, the public comes to view this increase in price as a wealth-generating blessing rather than a wealth-destroying curse. It is only when inflation seeps through to consumer prices does the public begin to perceive a problem with their purchasing power and begin to flee to cash-like alternatives en masse.

We are today at the crossroads where underlying economic conditions have so deteriorated based on past money printing schemes that a significant economic crisis is all but baked into the cake (see *Inflation, the Disease of Money*, from the January 2018 edition of *Canadian MoneySaver*). If the government of the day chooses to step back and allow the coming recession to unfold free from interference, widespread deflation will take hold and investors will take flight towards the perceived safety and liquidity of cash.

If, on the other hand, governments resort to their old inflationary tricks to "fight" the recession, they run the risk that the general public will finally realize that further government inflation could not possibly be the answer to a crisis which is itself born from past inflation. If such a change in investor psychology takes place while inflation begins to manifest itself in general consumer prices, the public's desire to hedge against economic crisis and uncertainty will lead them away from their newly-devalued reserves of cash and instead towards the money-like alternative of gold.

All of this is to say that gold is not an investment that can be purchased as a hedge against both deflationary and inflationary outcomes simultaneously. For investors who are agnostic as to which of these scenarios seems most likely to play out in today's political climate, the safest portfolio would theoretically be one that is evenly split between both cash and gold. For those investors, on the other hand, who are understandably skeptical as to whether outright deflation will ever be allowed to unfold uncontested by the government of the day, holding at least some small portion of their portfolio in an inflation-hedge such as gold seems not only defensible, but prudent.

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