PRECIOUS METALS INVESTING

Gold vs. Bonds: A Second Look

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by Nick Barisheff

Last year we highlighted the advantages of using gold rather than bonds to protect portfolios against inflation; since then, it seems the issue of bonds has rarely been out of the headlines. A European sovereign debt problem has erupted and Greece, which received a massive bailout last year, is seeking another in order to avoid defaulting on its largely bond-denominated debt. The rest of the PIIGS nations (Portugal, Italy, Ireland, Greece and Spain) are also on the edge of a financial meltdown. But it is not just Europe that is on the brink; in the US, the municipal bonds of several states are in danger of default. Respected banking analyst Meredith Whitney recently told CBS's "60 Minutes" that "there's not a doubt in my mind that you will see a spate of municipal-bond defaults."

Most investors have a deep-seated belief that bonds are a safe investment while gold is risky and volatile. If we explore this belief with an open mind, however, we will find that gold, not bonds, offers vastly superior wealth protection.

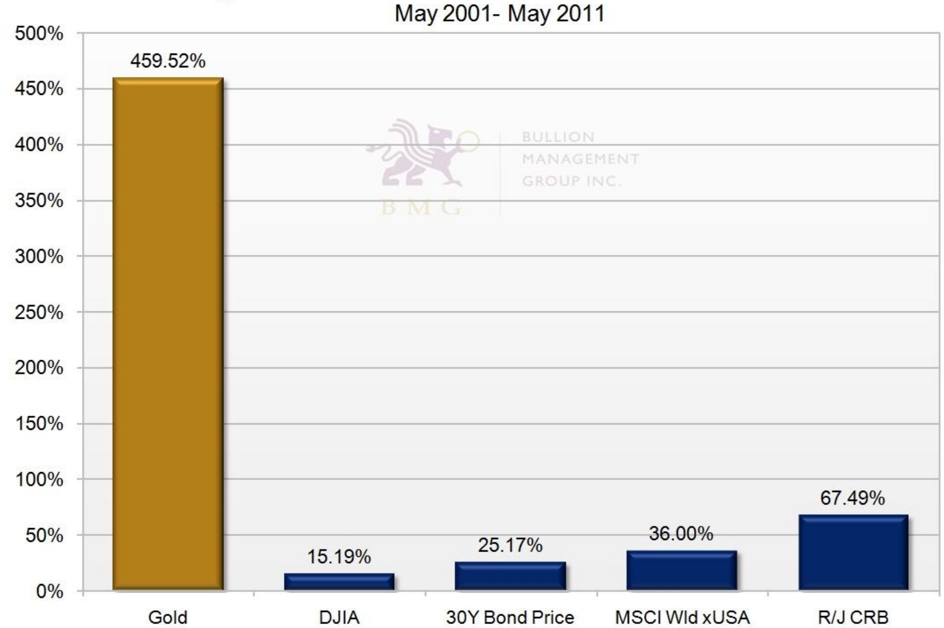
The 2008 financial crisis saw an unprecedented move out of equities and into bonds as investors looked for a safe haven, one that would protect their portfolios. Relatively few investors chose to move into gold. This is curious because gold, unlike bonds, is an asset class that has a negative correlation to financial assets, thus providing the greatest diversification as well as protection from inflation and currency crises.

This is illustrated in *Figure 1*, which shows how gold has outperformed all major asset classes.

In addition, Figure 2 shows how all major currencies have declined when valued in gold since the Gold Standard was cut in 1971.

Figure 1: Gold vs. Investment Indices Performance

May 2001- May 2011



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The US government's response to the 2008 financial crisis was to embark on and continue with policies of extreme stimulus and bailout packages. These policies will provide only a temporary reprieve, a Band-Aid solution to America's dire situation. Since the financial crisis was caused by excess debt, issuing more debt can hardly be the cure. The US Treasury, with help from the Federal Reserve, essentially flooded the economy with excess dollars, driving the money supply to unparalleled levels and inviting the serious threat of future inflation.

Figure 2: Currency Decline

Major Currencies as Valued by Gold Price January 1, 1971 - May 31, 2011[1]

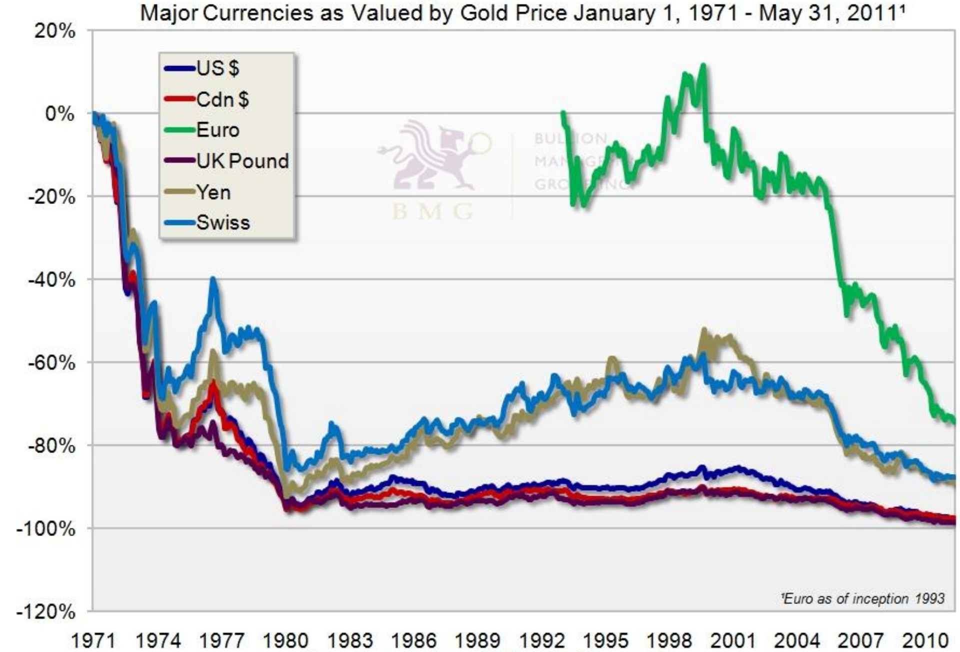

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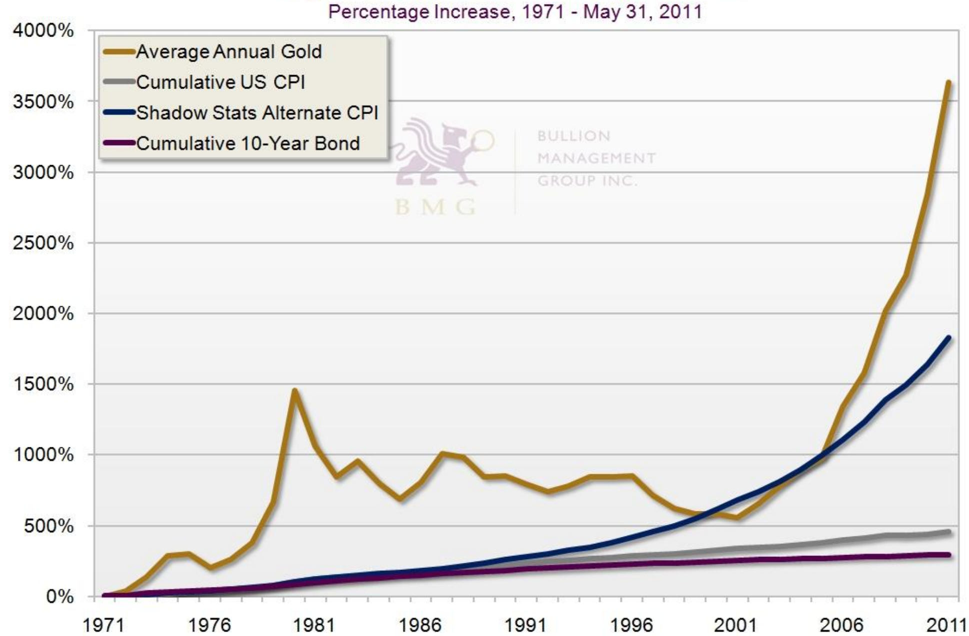
Figure 3: Inflation vs. Gold and Bonds

Percentage Increase, 1971 - May 31, 2011



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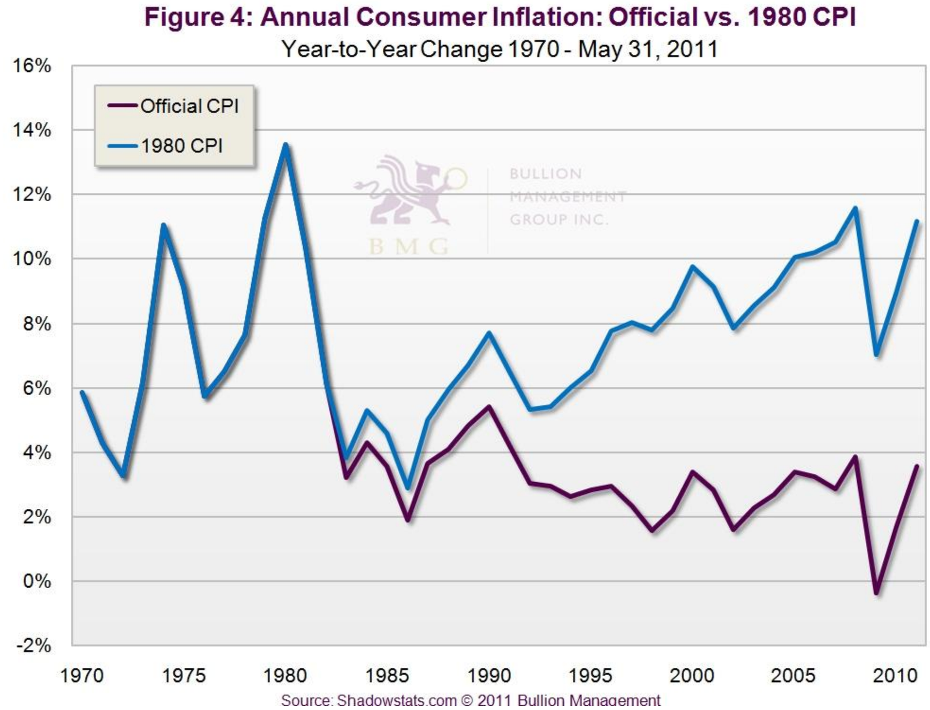
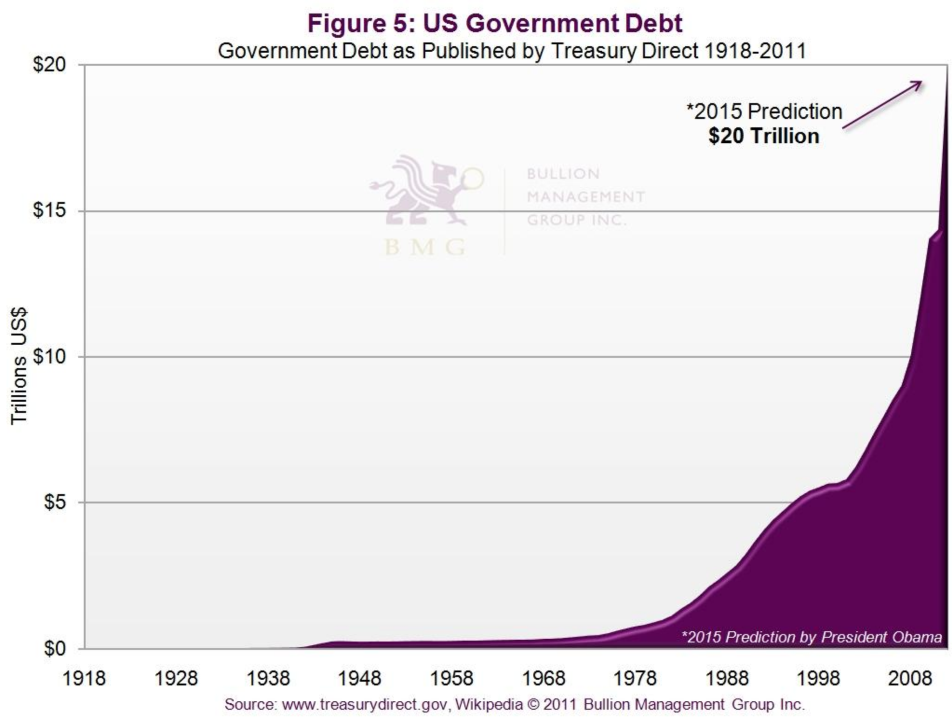
In *Figure 3*, we see gold offering another distinct advantage over bonds; historically, it performs well during periods of inflation. Bonds, however, are severely hurt by inflation, which wipes out the purchasing power of the principal balance as well as the purchasing power of the bond yield.

When considering inflation, it is important to use accurate, honest data.

Currently, the official Consumer Price Index (CPI) stands at a modest 3.5 percent. However, the methodology for calculating the CPI was changed in the early 1980s. Instead of using a fixed basket of goods that represented a certain standard of living, today's methodology uses substitution, hedonic adjustments and geometric weighting to understate the CPI. John Williams of www.shadowstats.com calculates the CPI using the original methodology, as shown in *Figure 4*. From this, we can see that real inflation is already at 11.15 percent and is poised to get much worse.



The US government is attempting to keep interest rates artificially low by having the Federal Reserve issue new money with which to purchase US Treasury debt. With interest rates at record lows there is no room to maneuver, except with further quantitative easing, which Fed Chairman Ben Bernanke has already stated he will continue to use. This will only serve to increase the money supply and lead to higher inflation.



The US has officially reached its $14.294 trillion borrowing limit. As Congress debates raising the limit, which is undoubtedly a formality, the bigger picture is being missed. America's financial debt situation has become unsustainable. Estimated US federal revenues for 2011 are $2.57 trillion. Total outstanding public debt is $14.3 trillion *(Figure 5)* and growing at a rate that nearly equals revenues. However, if we include unfunded liabilities such as Medicare obligations, Social Security obligations and military and civil servant pension obligations, the actual total amount is over $120 trillion. It is not realistic to assume that the US can support or repay $120 trillion of debt with $2.5 trillion of revenue.

US policies of aggressive quantitative easing - or, to put it bluntly, currency creation - endless debt and reckless spending will most certainly continue to devalue the US dollar, further eroding the real value of bonds and boosting the prices of precious metals prices and other commodities.

Critics of gold as an investment will argue that the yellow metal does not pay any interest. While it is true that gold held in a vault does not pay interest, it also has no counterparty risk and cannot decline to zero. Bonds are subject to credit rating downgrades as well as defaults, as became clear in the 2008 crisis, and can become worthless.

With interest rates much lower than inflation we can see that, in relative terms, it is bonds that are not providing any returns. With real inflation at 11.15 percent, bonds are not a safe investment; rather, they represent guaranteed annual losses of over 8 percent of purchasing power. At this rate, bond principal will be halved after 8 years. Gold, however, has generated annual compounded rates of return of 19.1 percent.

Gold investors who require cash flow can simply liquidate part of their gold gains in order to generate such cash flow. To match the after-tax cash flow from bond interest payments, investors need only liquidate part of their capital gain; the remaining gain would be enough to keep the purchasing power of the principal from declining.

Bond returns are so minimal at present that it has given rise to the serious question of whether the bond sector is in a bubble and subject to losses if interest rates rise. This is perhaps a separate conversation, although it is common knowledge that feverish, inexplicable buying is the cornerstone of any bubble; with the negligible interest rates on bonds being wiped out by inflation, it is hard to understand the attraction.
While the Federal Reserve can control short-term interest rates, when bond investors around the world lose confidence in the US economy and its currency, bond yields will rise and bond values will fall. In addition, there will be day-to-day inflationary losses.

Finally, it is worth noting that bonds, like equities, are a financial instrument, someone else’s liability; a holding of physical gold bullion is not. A bondholder gives up their money and risks a loss of principal for a certain period of time in return for a yield. A holder of physical bullion could lease out their gold and generate income, but they seldom choose to do so as it is precisely the safety of preserving wealth in real terms without risk to capital that savvy investors seek in uncertain times.

Given the current economic climate and the fiscally irresponsible policies, including competitive currency devaluation, which governments in the US and indeed around the world are implementing, it is no wonder that investors are desperately seeking ways to protect their wealth.

As explained above, however, moving from equities into bonds is like jumping from the frying pan into the fire. The smart move for wealth preservation is to a physical holding of gold bullion.

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