BULLION MANAGEMENT GROUP INC.

PRECIOUS METALS INVESTING

Gold vs. Bonds: Another Look

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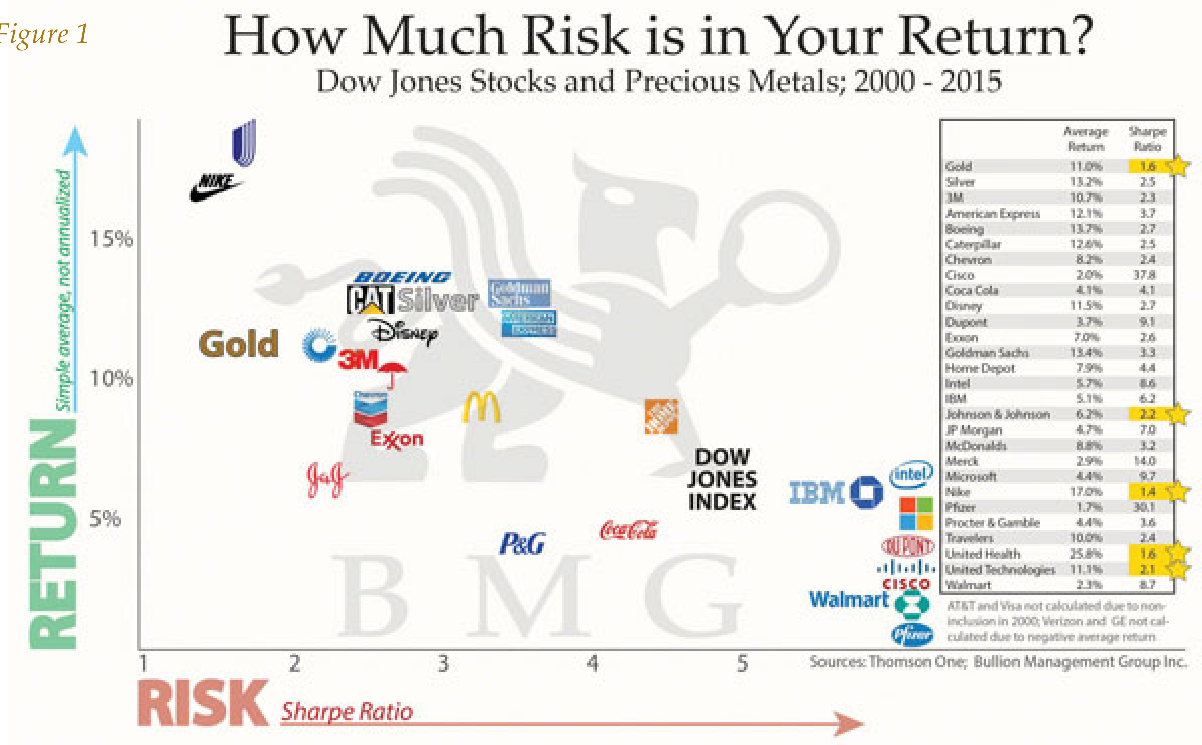
In the past, we have highlighted the advantages of using gold rather than bonds to protect portfolios against inflation; since then, it seems the issue of bonds has rarely been out of the headlines. The European sovereign debt problem has erupted, and Greece is on the precipice of default after years of bailouts, repayment delays and flawed negotiations with its Eurozone creditors. Greece's arrears are largely bond-denominated debts. If Greece were to return to the drachma, it would certainly devalue the currency and the struggling economy will crumble. Ukraine is also experiencing a debt crisis and national currency devaluation. Kiev may not be able to meet demands for repayment of its $15 billion debt to Russia, and the International Monetary Fund (IMF) will have to provide significant loans if the country is to avoid complete economic meltdown.

But it is not just Europe that is on the brink; in the US, the rate of municipal bond defaults reached record levels in 2014. Detroit declared bankruptcy in 2013, defaulting on its municipal bonds, and now Puerto Rico is barely able to

Figure 1



	Average Return	Sharpe Ratio
Gold	11.0%	1.6
Silver	13.2%	2.5
3M	10.7%	2.3
American Express	12.1%	3.7
Boeing	13.7%	2.7
Caterpillar	12.6%	2.5
Chevron	8.2%	2.4
Cisco	2.0%	37.8
Coca Cola	4.1%	4.1
Disney	11.5%	2.7
Dupont	3.7%	9.1
Exxon	7.0%	2.6
Goldman Sachs	13.4%	3.3
Home Depot	7.9%	4.4
Intel	5.7%	8.6
IBM	5.1%	6.2
Johnson & Johnson	6.2%	2.2
JP Morgan	4.7%	7.0
McDonalds	8.8%	3.2
Merck	2.9%	14.0
Microsoft	4.4%	9.7
Nike	17.0%	1.4
Pfizer	1.7%	30.1
Procter & Gamble	4.4%	3.6
Travelers	10.0%	2.4
United Health	25.8%	1.6
United Technologies	11.1%	2.1
Walmart	2.3%	8.7

AT&T and Visa not calculated due to non-inclusion in 2000; Verizon and GE not calculated due to negative average return

pay its debts. It is in the process of negotiating a debt moratorium with bondholders, asking US Congress to afford it bankruptcy protections.

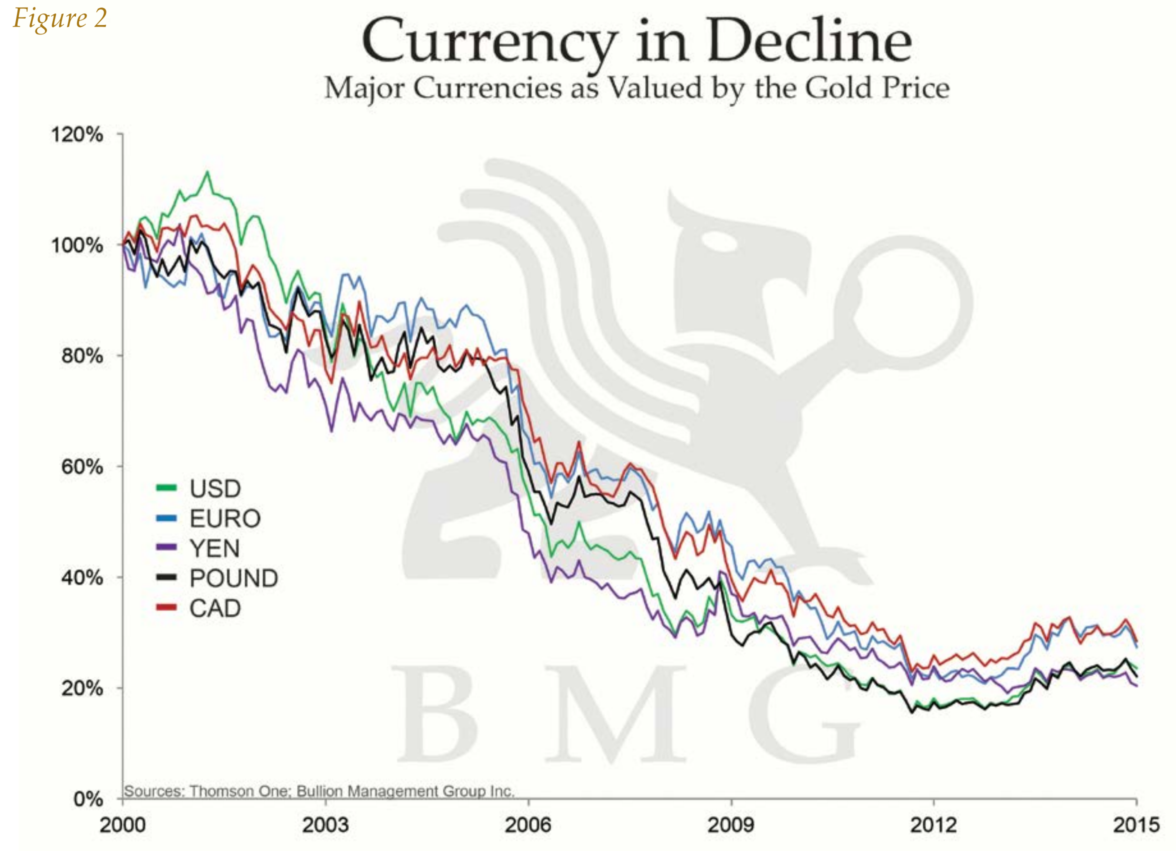
According to a 2013 article in the *Wall Street Journal*, "In 87 deals since 2006, Puerto Rico and its public agencies sold $61 billion of bonds, giving the tiny island more debt per capita than any U.S. state."

The *Wall Street Journal* recently reported that some Puerto Rico bonds are now trading between 64 and 70 cents on the dollar. The Puerto Rico Electric Power Authority (PREPA) barely avoided default in July 2015 by re-negotiating the repayment terms of its $8 billion in bonds.

Most investors have a deep-seated belief that bonds are a safe investment while gold is risky and volatile. This belief is further encouraged by advisors who are mandated by their compliance procedures to buy bonds for those who identify themselves as conservative investors. 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 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.

Figure 2



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

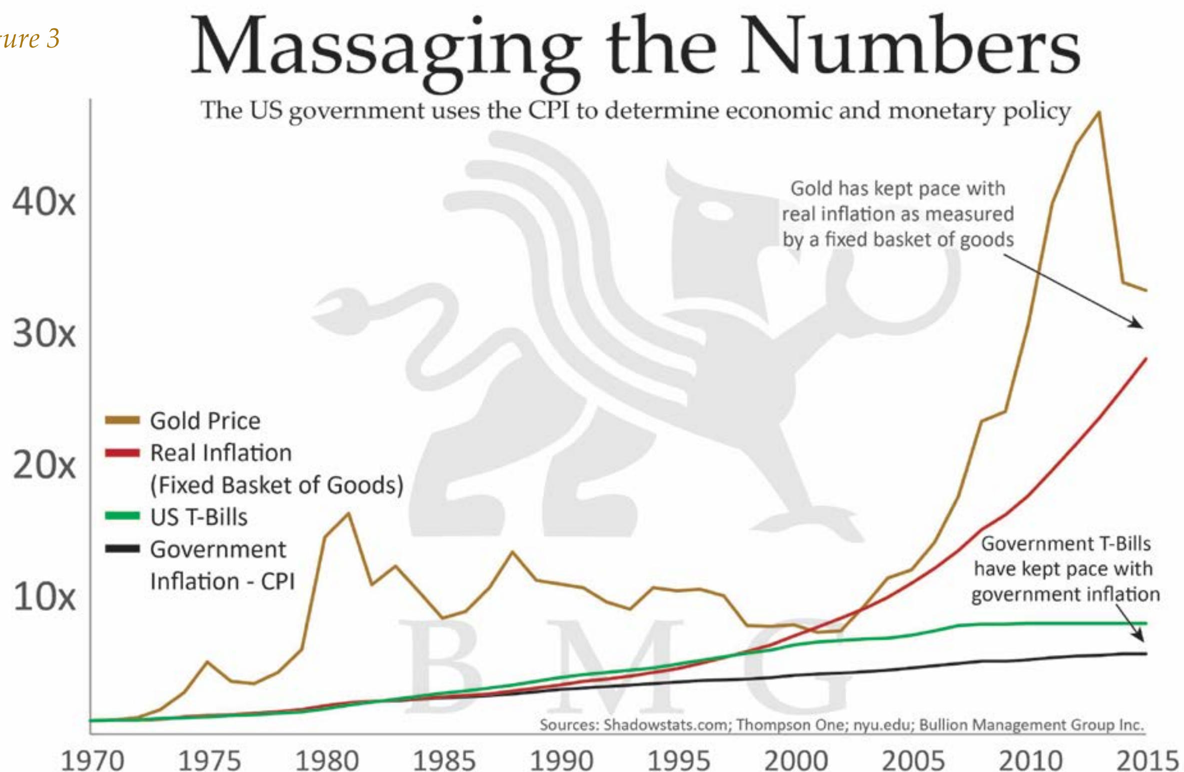
In addition, *Figure 2* shows how all major currencies have declined when valued in gold since the Gold Standard was cut in 1971.

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 have provided 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.

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 0.0 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

Figure 3



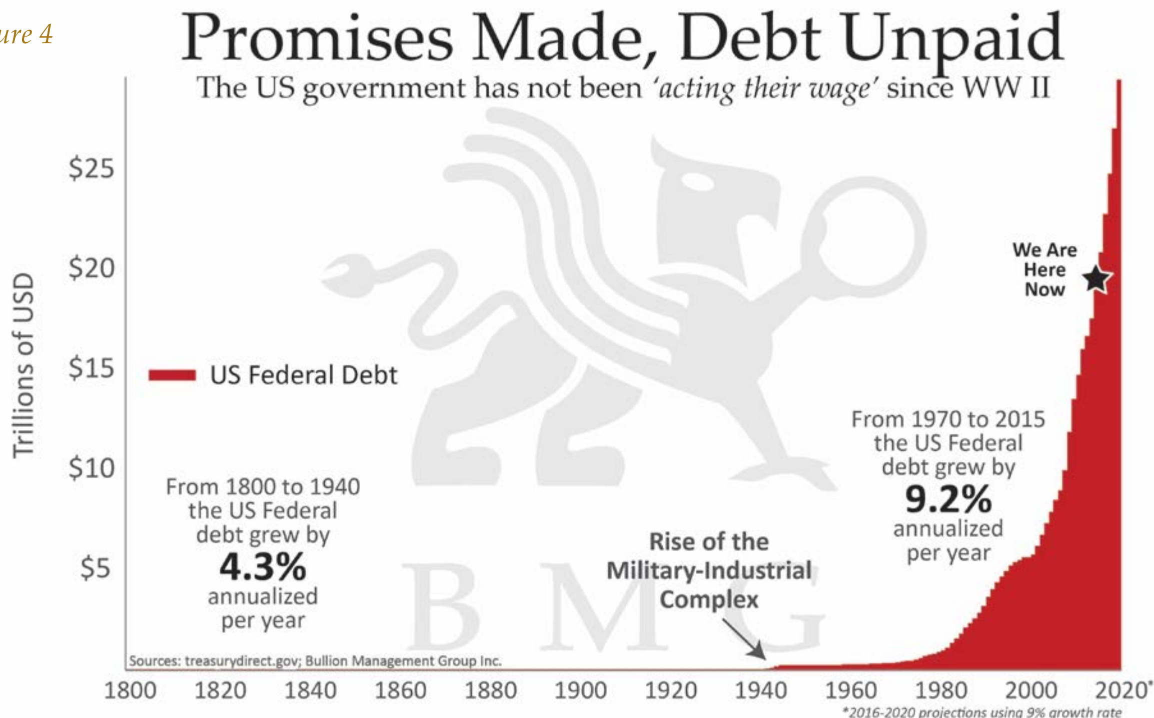
www.shadowstats.com calculates the CPI using the original methodology, as shown in *Figure 4*. From this, we can see that real inflation is closer to 7 percent and is poised to get much worse.

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. But with interest rates at record lows, there is no room to maneuver, and the increasing the money supply will lead to higher inflation.

The US raised the debt ceiling again this past March to accommodate its $18.298 trillion public debt is $18.298 trillion *(Figure 5)*, and growing at a rate of about $1 trillion per year. However, if we include unfunded liabilities such as Medicare obligations, Social Security obligations and military and civil servant pension obligations, the actual amount is over $156 trillion. It is not realistic to assume that the US can support or repay $156 trillion of debt with $3.141 trillion of revenue.

American 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

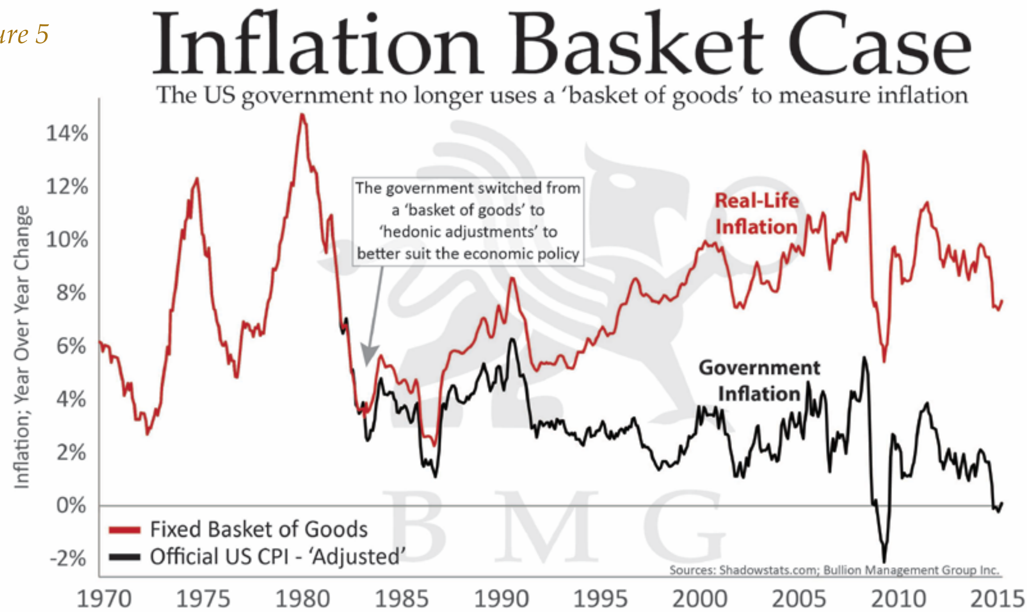
Figure 4



national debt. When 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 2015 are $3.141 trillion. Total outstanding 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

Figure 5



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 yield. With real inflation at 7 percent, bonds are not a safe investment; rather, they represent guaranteed annual losses of over 8 percent of purchasing power. According to the 2015 Incrementum report, bond mean return since 2001 is 13.06 percent (USD).

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.

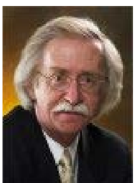
Bond yields are so minimal at present that it has given rise to a bond sector bubble, and investors will face losses if interest rates rise. This is perhaps a separate conversation, although it is common knowledge that feverish, inexplicable buying is the cornerstone of any bubble. With the negligible interest rates on bonds being wiped out by inflation, it is hard to understand the attraction. The appeal of bonds is further inflated by the mandates of compliance departments, and exacerbated by QE programs around the world.

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 that 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 holding physical gold bullion.



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