QB | Asset Management Company

Late last week, Nouriel Roubini, the current go-to bubble diviner, published a report entitled, "The New Bubble in the Barbaric Relic that is Gold". The report is scheduled to be released to the general public tomorrow, December 15. We have read the report and we disagree with its conclusion. In fact, our ongoing analysis indicates gold's terminal value in this cycle will be multiples higher than current pricing.

We were eager to read the piece, hoping to find insights that would provide commercial applications. Instead, we found troubling lapses in logic seeking to link current monetarism to practical market applications. Many of the rationales justifying Dr. Roubini's conclusions lacked intellectual rigor, in our view. Additionally, we could not help but notice that his language tended towards provocative sound bites (e.g. "barbarous relic", "gold-bug bulls", "stock up on Spam"), which we feel could only have been used to elicit public attention among those predisposed to superficially accept his arguments as credible. Given the inconsistencies and apparent misunderstandings inherent in his arguments, we feel positioning assets based upon the logic in his report would be imprudent.

In short, we believe Dr. Roubini's misinterpretation of current data fooled him into putting his finger on exactly the wrong bubble. We believe the extraordinary growth rate in fiat currency supply of late better defines a "bubble". Thus, we would characterize gold as the "anti-bubble" (if such labels need be applied).

When recapping recent history, Dr. Roubini notes:

- NR: "Following the global financial meltdown following Lehman's collapse, investors were so concerned about safety of their financial assets -- including their deposits – that they preferred gold bars in a vault in Zurich to liquid assets in a bank."

  QB: Deposits backed by liquid assets in a bank? Gold rose (and will continue to rise) precisely because bank assets were (and remain) *illiquid*, rendering the banking and monetary systems vulnerable to more dilution.

- NR: "The economic scare was contained when the G7 committed to insure deposits more widely and to backstop the financial system."

  QB: And with what did G7 policymakers insure deposits? More deposits. And what are those deposits backed by? Even more deposits, if necessary. It's the money growth to date and threat of even more that makes comparatively scarce gold rise in price.

- **NR**: “Renewed concerns emerged that many sovereigns would not be able to backstop deposits and the financial system – that banks were too big to fail but also too big to be saved.”

  QB: Dr. Roubini does not seem to consider that there are no constraints on creating deposits, which means that no entity (under a fiat currency system) is too big to save. And again, he fails to see the connection linking increasing government-sponsored bank deposits and the process of diluting paper currency, which in turn increases the gold price.

- **NR**: “That panic subsided, (financial Armageddon) – and gold prices started to drift down again – after the U.S. conducted bank stress tests, began quantitative easing and further backstopped the financial system through a program to get rid of bad assets from banks’ balance sheets.”

  QB: Dr. Roubini seems to imply QE led to a downward shift in gold prices. This broad sweep makes no allowance for cause and effect (i.e. you sneezed in Caracas and I fainted in Boston therefore please sneeze tonight following Letterman’s monologue), time (i.e. buy the rumor, sell the news), or relative value. QE cannot facilitate declining nominal prices of a scarcer currency. In fact, it can ONLY facilitate the opposite.

- **NR**: “The pattern is clear: gold spikes when there are concerns either about inflation or about depression (with deflation). In both cases, gold is a good hedge against fat tails, black swan events and extreme event risks.”

  QB: This is a fundamental misinterpretation and is only partially true. As we are seeing, gold also spikes to reconcile years of monetary inflation at times when insufficient “risky asset” bubbles can be blown. Such bubbles (e.g. dot-com, housing, bank portfolio, etc.) are capable of acting as receptacles for a gross excess of currency, bank reserves and credit. However, the driver of these mini bubbles is a currency bubble.

  We would argue that the magnitude of past, current and potential money printing may be easily quantified by calculating a Shadow Gold Price (Monetary Base divided by official sovereign gold holdings). Presently, our SGP is multiples higher than the current nominal public gold price. To display “bubble-like” characteristics, gold would need to trade at a meaningful premium to the SGP, as it did at its speculative peak in 1980. At current levels, that price is multiples of the current spot price of gold. In fact, spot gold currently trades at approximately an 85% discount to the SGP which, we’d be remiss not to highlight, indicates forcefully that it is the US dollar and other fiat currencies that are currently a bubble.

Dr. Roubini also seems to misinterpret basic cause and effect:

- **NR**: “Deflation is still gripping the global economy as the slack in goods and labor markets persists at high levels.”

  QB: Dr. Roubini seems to mistaking nominal economic contraction for “deflation”. Slack is productive overcapacity that may lead to global economic contraction, yet it is not deflation. Deflation is a nebulous term which is being thrown about quite randomly these days. There are generically three types of deflation worth analyzing: 1) monetary deflation (which the Fed directly controls via its administration of the monetary base), 2) debt deflation (which is manifest in the banking system and the result of the whims of markets) and, 3) price deflation (which is a decline in the nominal or real price of any good, service or asset). Dr. Roubini seems to be referencing price deflation here resulting from economic slack. The truer chain of causality though is that economic contraction most likely will lead to *debt deflation* as asset prices deflate. Price deflation itself is an ambiguous dynamic as its effects on asset prices can be positive or negative (for instance, if input costs are declining at a more rapid rate than output costs, some “assets” will be prone to appreciation while others prone to depreciation).

  The global gold price responds to an increase/decrease in banking system reserves (monetary base), not debt deflation itself. The causality here is that in our modern system of central banking, private sector debt deflation is fiercely combated with monetary base inflation. Gold behaves in the markets as though it were the reserve asset “backing” the monetary base. As the monetary base expands and gold reserves do not, the nominal price of gold is biased to upward adjustment. Dr. Roubini’s argument might hold true for copper, oil or cattle – but not gold.

  Past credit inflation has led to today’s overcapacity. Today’s overcapacity is leading to today’s risky asset price deflation. Today’s risky asset price deflation is leading to private banking system debt deflation. Central bank monetary inflation is the popular prescription for combating private banking system debt deflation. Central bank monetary base inflation/deflation drives the gold price higher/lower. Alternatively, private banking system debt inflation correlates with risky asset inflation (and, correspondingly, debt deflation correlates with risky asset deflation).

- To bolster his point that the markets no longer expect inflation, Dr. Roubini used a graph of inflation expectations. We presume from the Y-axis on the graph that the underlying relationship used for inflation expectations was the relative yields of TIPs versus fixed-coupon Treasuries. While we do not dispute this graph may accurately represent the inflation expectations of dedicated Treasury investors, (most of whom are structurally motivated to be indifferent to *real* yields), we would argue that the absolute rate of monetary base inflation better reflects the current and future loss of a currency’s purchasing power. The Treasury market is not accurately discounting the rate of monetary inflation and its impact on future goods and service prices.

Therefore, we believe the gold price has nothing to do presently with coincident relationships of Treasury issues. In fact, we'd argue that global central banks are the marginal price-setters of the Treasury market (with relative-performance investors like PIMCO a distant second). Ergo, inflation expectations are no longer rationally represented by this metric. (Given that QE is the modern day method of monetary base expansion, one could rationally argue that lower Treasury yields are *symptomatic* of monetary inflation rather than being harbingers of lower price inflation. Yes, the mind boggles as we must continually discard our formal economics training and enter the murky realm of economic reality. That's a discussion for another day however.)

- NR: "But since gold has no intrinsic value, there are significant risks of downward correction in gold prices."

  QB: Gold has no less intrinsic value than paper money, except that paper money is currently sponsored by global governments (by fiat). The military, taxing and monetary powers of discrete governments do not make them global price setters of private goods, services and assets.

  Beyond this technical point there is a very real practical issue that argues against Dr. Roubini's assertion: the denominator of the gold price is the US dollar, which itself has no definable intrinsic value. Dividing an item with no intrinsic value by another with no intrinsic value is an exercise that cannot produce an intrinsic value. The *relative value* of the numerator to the denominator is the key, which, given the expanding supply of paper money vis-à-vis gold, argues for an increasing intrinsic gold value in US dollar terms. This has been the trend of this decade thus far in fact.

- NR: "But in practice it (sovereign credit risk) has weighed on the price of gold because it has increased investors' risk aversion and led to a rush into different (and more liquid) asset(s) than gold – e.g. the U.S. dollar – thus pushing gold prices down."

  QB: The dollar is not an *asset*. To be so, it must be a specified claim on something of value since it has no intrinsic value. Dr. Roubini's assertion must be incorrect in a world wherein no "prices" of which we are aware are "fixed" in USD terms (excepting certain FX rates). Alternatively, a contract denominated in USDs whereby future delivery of any good, service or asset is promised would indeed be an asset as its value is definable (putting issues of counter-party risk aside of course).

  We do sympathize with the argument made by some that the dollar is a claim on the assets of the Federal Reserve System's consolidated balance sheet, and that the assets of that balance sheet are the liabilities of other institutions. All that can be said then is that the dollar is a claim on a stream of liabilities of uncertain present and future exchange value. Gold too is a claim of uncertain present and future exchange value. It is not, however, someone else's liability. This is a key distinction.

The only metric we can cite that can logically define the relative intrinsic value between the dollar and gold is their respective costs of production. Gold is definably scarce and costly to produce. Dollars are infinitely printable at a direct cost approaching nil. In the end, sovereign debt is vulnerable to further debt deflation pressures, which will require the creation of even more bank reserves, which in turn should make gold even more relatively scarce against dollars. As we've noted many times in the past, sovereign debt denominated in its native fiat currency will always be "money good". You'll eventually be paid but, it will be in the form of "bad money".

- NR: "Thus the gold bugs are wrong – or at least very, very premature – in justifying buying gold as an attack on fiat currency. The velocity of money is still low or falling—the opposite of a currency crisis or run on the dollar. As a further indication of the collapse of credit/money multipliers, indicators of expected inflation are subdued or falling, despite governments printing money (excess reserves). The high inflation scenario may be constrained even if/when easy money gains too much traction, as the yield curve would steepen sharply, raising the discount rate for risky private sector debt and for corporate equity, limiting the speed of the recovery and hence the ability of states to impose inflation surprises in the context of shortening average debt maturities."

  QB: If, in the spectrum of "risk", "risk assets" lie to the right of holding dollars, then gold should lie to the left. To put gold in the "risk" bucket defies logic and understanding.

  Unlike "risky assets", the banking system's exposure to gold is a large and systemic net short position. The banking system's exposure to "risky assets", on the other hand, is a direct or indirect long exposure (via loan collateralization). The smattering of leveraged-long gold investors (kooky "gold bugs", if you must) is a drop in the bucket in terms of the massive financial system short. (For example, there has only been an estimated $60 billion in total new investment in commodity/gold funds and ETFs in 2009.)

  Put differently, if one might envision a systematic collapse of the aggregated balance sheet of the global banking system (whereby all assets are liquidated in order to satisfy all liabilities), "risky assets" would fall substantially in real terms and gold would rise aggressively. In a less than obvious sense then, the de-leveraging of the banking system is extremely bullish for gold.

  Dr. Roubini is not alone in thinking a rising gold price should come in anticipation of a nominal economic recovery that would lead to an expansion of total bank credit, commensurate with the expansion of the monetary base of the last 18 months. However, the bull case for gold is the exact opposite: gold anticipates contracting total bank credit (continued debt deflation), which requires further monetary inflation to be administered by central banks. This seems to be a common misunderstanding among economists, as well as high profile investors currently espousing negative AND positive views on the anticipated direction of the gold price.

- NR: "The only scenario where gold should rapidly rise in value is one where fiat currencies are rapidly debased via inflation."

  QB: This is precisely the world in which we live today. What other world could he be referencing?

- NR: "That scenario may eventually materialize if large and monetized fiscal deficits persist for a long period of time; but overall, today there are more deflationary than inflationary forces in the global economy, as the slack in goods and the labor market is still rising."

  QB: Slack in the goods and labor markets are harbingers of further risky asset deflation. Further risky asset deflation is a harbinger of further debt deflation. Further debt deflation is a harbinger of further monetary inflation. Further monetary inflation is a harbinger of higher gold prices. Such is the chain of causality we, and the global markets, recognize.

  NR: "Third, dollar funded carry trades and a more generalized portfolio allocation to non-dollar assets (especially EM assets) are pushing the U.S. dollar sharply down. There is an inverse relation between the value of the dollar and the dollar price of commodities: the lower the dollar the higher the dollar price of oil and other commodities, including gold. The rise of gold in euros has been much more muted."

  QB: If a "stronger" dollar is associated with weakening risk asset markets then Dr. Roubini should be arguing that the USD price of gold should rise, not fall. The stronger dollar is symptomatic of de-leveraging of USD-denominated bank and financial balance sheets. Lastly, Dr. Roubini's implication that gold is to be identified as a consumable commodity serves to contradict his earlier argument that it has no intrinsic value.

We have concluded that Dr. Roubini's views on the dynamics that drive the gold price are disturbingly off the mark for a man of his reputation and stature among market watchers. We feel he is guilty, like most contemporary economists, of viewing the dollar as an immutable unit of account. He does not recognize the dollar as a moving target that defiles all subsequent analysis predicated upon the assumption that its quantity is stable. The logic we found in this report neither supports nor refutes our prevailing views. (Indeed we're not sure what message it offers, except putting forth a baseless market call that seems to cleverly coincide with a healthy short term market correction.) We would view any weakness in the gold price derived from Dr. Roubini's report as a buying opportunity.

Our View of Gold

We come back to the basic model of fiat currencies as the fundamental driver of the gold price over time. When systemic credit *deflates* from very high levels (vis-à-vis income and output levels), we know that central banks will repeatedly dilute their fiat currencies to synthesize rising nominal asset prices, and to try to expand nominal output growth and employment. We want to own gold now because it has a long history of sustaining its purchasing power value (as real money should) when paper currencies are diluted. Paper currencies are being aggressively diluted as we write.

Ironically, the last 20 or so years have actually been the "inflationary boom" that some market analysts fear may be soon upon us. Financial assets – stocks and bonds – were continually re-priced higher over time because debt-to-sustainable equity ratios ballooned. This was a period of massive and persistent credit inflation. We are now in the early stages of the "deflationary credit bust". Money is scarce, by definition, in a deflationary credit bust and is prone to further future scarcity. This leg of the cycle doesn't run its course until asset prices in real terms reconcile with those of all else (e.g. wages, basic materials, consumptive essentials, etc.).

It seems obvious to us that economists like Nouriel Roubini and other market watchers have this backwards. Some are "worried" today about price inflation and/or deflation in *nominal terms* at a time when we are experiencing severe asset price deflation *in real terms*. There is no avoiding the inevitable reconciliation. All the Fed and Treasury can do is to continue to try to hide or delay economic reconciliation via inflationary policy prescriptions. Being long gold is nothing more than a bet on credit/debt deflation in a world of money-printing central banks.

Gold is a relatively scarce form of money. If the dollar were inherently scarce (unable to be created nor extinguished at the whim of central banks), we would look to be implicitly long cash by being outright short overpriced assets. Regrettably, the dollar is not scarce and markets are treating it that way. The only way to be long cash *in real terms* then is to be long gold. Gold offers the opportunity to profit because the dollar can be (and currently is being) inflated administratively to maintain banking system solvency. We believe the magnitude of the nominal price appreciation in gold will be determined not by investor whim but, rather, by whatever nominal price is necessary to provide holders with positive *real* returns.

Being overweight consumable commodities would be the play if one were to think that central banks are going to get way ahead of the curve AND that the *real* economy is going to expand. (In a period characterized by *monetary inflation* AND real economic growth, we would generally look to overweight consumable commodities -- not a "monetary commodity" like gold. There are also other plays to consider if one wants to get into the business of predicting and/or recognizing bubbles early. Intelligent use of leverage is usually rewarded during a debt-induced inflation, as recent history has shown.) Perhaps Dr. Roubini and others mistake nominal growth for real growth? Real growth may eventually materialize, but we do not think we are fully there yet. Hence, we think scaling into certain consumable commodity plays to a lesser degree than gold makes sense presently.

The pure arbitrage play then, should one anticipate an economic recovery in real terms, would be to own commodities and to be short over-valued assets. (The long leg could also conceivably be long wage rates, but global demographics would argue against that with *Asian enlightenment* enticing the masses to leave their traditional lives of subsistence and enter the competitive global labor pool. We expect over-valued assets to be ultimately reconciled either through substantially higher interest rates or via substantially higher wage rates and commodity prices or, most likely, some combination of the two.)

As we have discussed, gold is not a consumable commodity and, based on relative valuations, there appears to be no reason yet to reduce its weight in favor of them. The popular misunderstanding of its price drivers does not change the gross disequilibrium presently separating its substantial relative undervaluation from past and current (and future?) monetary excesses. There simply remains too much bad debt that needs to be chopped through before central banks can take a break at the beach.

All in all, maintaining a long gold position is NOT an "inflation play", as is popularly expressed (apologies to the marketing groups of high profile investment managers launching gold funds). A long gold position is a long MONEY play in an environment where paper money, posing as a store of value, can be infinitely supplied at virtually no explicit cost. Above all else, being long gold is a short fiat currency play, or, borrowing from Dr. Roubini's tone, a way to bet explicitly against "the bubble of the century".

Lee Quaintance (lquaint@qbamco.com) Paul Brodsky pbrodsky@qbamco.com