Forbes

Rick Ferri, Contributor
I cover low-cost index fund and ETF investing.

PERSONAL FINANCE | 4/22/2013 @ 10:00AM | 2,505 views

Gold Bugs Swatted Again

Being a gold bug is painful. I'm not one, but they have my sympathy. Just when they think they're going to make a killing because they see the world's financial order beginning to crumbling, markets turn around and they get walloped.

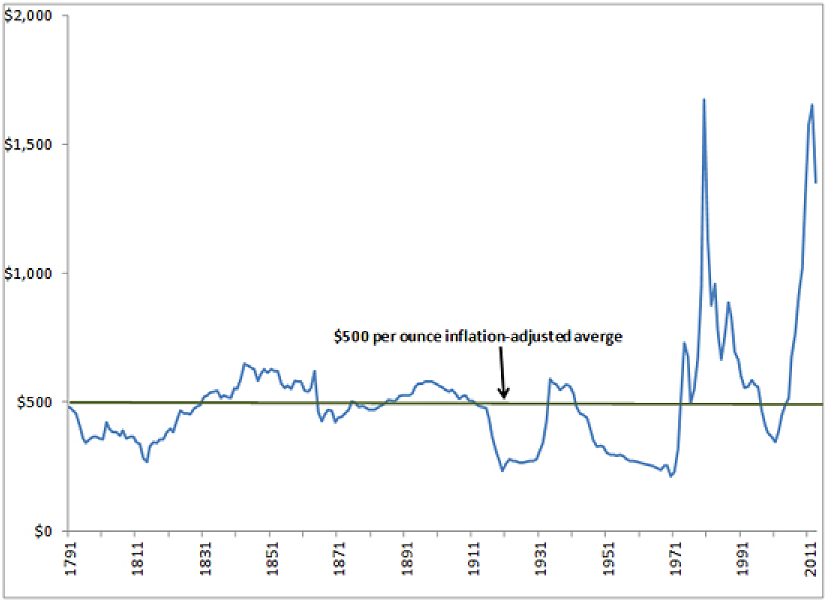
Gold has never been on my buy list because I'm a cash-flow and real-return investor. I like investments that pay dividends or interest, and those that grow in value over the inflation rate. Gold doesn't fit into either of these categories. A bar of gold produces no income and never grows into two bars of gold. In fact, it costs money to own gold due to trading cost, storage costs, insurance and possibly management fees.

Over its long history, every academic who has studied gold agrees that prices move with inflation over time. Gold appears to have started its fall back to its inflation-adjusted average price. That's about $600 per ounce in nominal dollars assuming there is some inflation on the way down.

The Shekel, a coin originally weighing 11.3 grams of gold, became a standard unit of measure in the Middle East in 1500 BC and took its place as the recognized standard medium of exchange for international trade. The amount of goods that one gram of gold bought thousands of years ago is still about the same it bought just a few years ago before the recent spike in price.

Figure 1 illustrates the long-term inflation adjusted price of gold based on 2011 dollars. It highlights the average $500 per ounce price over the 220 year period, which was passed through many times.

Figure 1: Long-Term Inflation-Adjusted Price of Gold and Average Price



Source: MeasuringWorth.com

The average price per ounce of gold is about $500 adjusted for inflation from 1790 through today. June 2005 was the last time gold was at its inflation-adjusted average price. By January 2011, gold prices had risen by 350 percent while inflation increased only 17 percent. A huge spike in price had happened a few decades ago, although for different reasons than the recent surge.

Inflation adjusted gold prices peaked in January 1980 and demand was driven by high inflation, which was caused in part by the country dropping gold as a currency peg in 1974. The Consumer Price Index (CPI) increased by 14 percent on a year-over-year basis the month gold hit its peak. Monetary policy became very restrictive shortly thereafter and this caused inflation to tumble to 3 percent by 1983. In turn, gold crashed back down and ultimately fell to its long-term $500 inflation-adjusted average price.

The figure illustrates the inflation-adjusted price of gold from April 1975 to April 2013. The $2,451 high price is based on a 2011 inflation adjustment and it has yet to be breached.

Figure 2: Recent Inflation-Adjusted Gold Price and Average Range (in 2011 dollars)

Source: Federal Reserve Economic Data (FRED)

Like all commodities, gold has a supply and demand equilibrium price. More demand with the same supply causes prices to rise temporarily until either demand lessens or supply increases. Since 2005, the demand for gold accelerated for several reasons: growth in China, India and other emerging markets where people store their wealth in gold; the banking crisis that began in 2007; the European debt crisis that followed; and unprecedented Central Bank balance sheet expansions that resulted.

At the same time, a new way to buy gold was becoming popular in the US and abroad. SPDR Gold Shares (ticker: GLD) allowed investors to own gold through their brokerage accounts as easy as buying stock. GLD went from a fledging new idea in 2004 to holding more than 1000 tons of gold today. That's more gold than the reserves of a large government including Japan, Russia, China and Switzerland.

New demand for gold fed by fear of hyperinflation quickly outstripped supply and caused a large price spike seen in Figure 2. The interesting aspect of this surge is the large number of investors who bought gold because they *anticipated* hyperinflation rather than waiting to observe a rise in prices. These fears are gradually subsiding as inflation remains low, the banking sector becomes stronger, and asset prices are recovering in stocks and real estate.

Like all demand-driven gold spikes, the latest one is gradually being worked off. I anticipate gold prices will continue a descent until eventually reaching its inflation-adjusted long-term average. It's probable that this contraction may stall temporarily if inflation does become a problem, but I don't see another spike in prices forming because gold is already at a high level.

I recommend a working paper titled The Golden Dilemma by Claude B. Erb and Campbell R. Harvey for in-depth information on gold and why the current market is overpriced. Also see The Power of Gold: The History of an Obsession by the late Peter Bernstein for a long-term view.

This article is available online at:

http://www.forbes.com/sites/rickferri/2013/04/22/gold-bugs-swatted-again/