The Wealth Advisor

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A Closer Look at Gold

Amid all the hype and euphoria, some history is worth remembering.

America's got gold fever. Internet headlines inform you that gold settled at another record close today. Nightly news segments show you footage of excited sellers and beaming commodities traders. Radio commercials remind you that gold has outperformed stocks in the last decade. How should you respond to all this?

There's no doubt that in recent history, the performance of gold is startling. Across the 2000s, gold gained 278.52% on the COMEX while the S&P 500 lost 24.10%. In 2010, the S&P 500 advanced 12.78% and gold notched a 29.76% gain.[1,2,3] So given these numbers, why doesn't everyone put every dollar they have into gold?

Recent price returns don't tell the whole story. Investing big in gold may seem like a no-brainer – until you take history and inflation into account. In 1980, gold prices were up around $850 an ounce – adjusted for inflation, that's the equivalent of about $2,300 an ounce today. Yet when 2008 ended, gold prices were at just $870 an ounce. When 2003 started, gold futures were trading at $343 per ounce.[4,5,6] Gold is often seen as a hedge against inflation – but from 1980-2002, annualized inflation averaged 3.55% and gold didn't exactly keep pace. So if you lengthen the window of historical performance, gold hasn't always trumped stocks.[6]

Remember, gold is a commodity. Since it tends to have little correlation with stocks and bonds, it can play a significant role in a diversification strategy. On the other hand, gold has no intrinsic value. It doesn't give you any cash flow. It doesn't pay you a dividend or earn interest. Gold is only worth what people are willing to pay for it.

Right now, people are willing to pay more than $1,500 an ounce for gold. Three big factors have driven this gold rush - a consistent global demand, an assumption that the dollar will stay weak and a whole lot of speculation.

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S&P Cuts U.S. Outlook

The credit rating agency sends up a flare and hopes for action on Capitol Hill.

Pessimism over America's ability to reduce its deficit. When one of the world's premier credit rating agencies issues a warning for America, global stock markets dip. On April 18, Standard & Poor's announced that its rating outlook for the United States was now "negative" instead of "stable". It was a landmark moment – S&P had never made such a declaration about America's fiscal profile.[1]

While the U.S. still has the preferred AAA credit rating from Standard & Poor's, S&P credit analyst Nikola G. Swann put the possibility of an actual rating downgrade at 33% by 2013.[1,2]

S&P more or less gave politicians a deadline. Swann's statement on behalf of Standard & Poor's put it this way: "In our macroeconomic forecast's optimistic scenario (assuming near 4% annual real growth), the [U.S.] fiscal deficit would fall to 4.6% of GDP by 2013, but the U.S.'s net general government debt would still rise to almost 80% of GDP by 2013. In our pessimistic scenario (a mild, one-year double-dip recession in 2012), the deficit would be 9.1%, while net debt would surpass 90% by 2013. Even in our optimistic scenario, we believe the U.S.'s fiscal profile would be less robust than those of other 'AAA' rated sovereigns by 2013. Our negative outlook on our rating on the U.S. sovereign signals that we believe there is at least a one-in-three likelihood that we could lower our long-term rating on the U.S. within two years."[2]

Translation: let's see some significant action, or we'll have no choice but to cut America's credit rating.

Moody's sees a "turning point" in the budget battle. An April 18 report from Moody's Investors Service sounded more optimistic. Moody's senior credit officer Steven Hess wrote in a note that considering the most recent budget proposals from the White House and the Republican leadership, the agency sees "the changed parameters of the debate, with broadly similar goals as to government debt levels, as a turning point that is positive for the long-term fiscal position of the U.S. federal government."[1]

Moody's currently ranks the U.S. credit rating at Aaa with a "stable" outlook, and Hess noted that "either the president's revised proposal or the Republican proposal would improve the U.S. government's creditworthiness."[1]

Geithner counters the S&P opinion. Shortly after the S&P report hit the streets, Treasury Secretary Timothy Geithner appeared on Bloomberg Television, remarking that he had "absolutely not" had to reassure any buyers of Treasuries about the creditworthiness of America. Of course, the real reassurance would be bona fide action – some compromise that will pare between the $4 trillion the White House wants cut over the next decade and the $6.2 trillion Republican leaders want cut in the coming ten years. Raising the federal borrowing limit in the near future seems a given, as without that move the federal government could default on its debt in early July.[3,4,5]

What would happen if the U.S. credit rating was cut? In a nutshell, the cause-and-effect would go like this. Global investors would regard Treasuries as riskier investments than they do now, and this would mean that the Treasury would be left paying higher interest rates on any freshly issued debt. That would imply higher interest costs for U.S. businesses and consumers – and food and energy prices are already strenuous enough as we speak.

S&P Cuts U.S. Outlook Continued...

Incidentally, along with its gloomy April 18 opinion on U.S. credit, S&P also revised its outlook from "stable" to "negative" for five insurers: New York Life, USAA, the Knights of Columbus, Northwestern Mutual and the Teachers Insurance & Annuity Association of America. The reason? These insurers are "are constrained by the sovereign rating on the U.S."[4]

Can a deal be brokered before 2012? Good question. After all, John Chambers, chairman of the sovereign ratings committee at Standard & Poor's Ratings Services, cited "political gridlock" as a core reason for S&P's change of outlook. Symbolically, it would be nice to have one before fiscal year 2012, which begins in October.[4]

This has happened before. Major nations have faced warnings about credit rating downgrades in the past. We have: Moody's cut its outlook for the U.S. in 1996, reversed its opinion once the federal debt ceiling was raised.[1]

In the last 22 years, S&P has changed its outlook to "negative" for five AAA-rated nations, including the United Kingdom in 2009. S&P's outlook on the U.K. returned to "stable" after an austerity plan was approved, and if we arrive at a plan to cut the deficit (a painful one, but a necessary one), our credit outlook may similarly improve.[4]

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Citations.

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A Closer Look at Gold Continued...

Bubbles can happen; bubbles have happened. Investors who bought gold at $560 an ounce at the start of 1980 had to wait until 4Q 2010 to break even in inflation-adjusted terms. Those who bought gold at $850 an ounce in 1980 won't effectively break even until gold prices top $2,300. Gold has performed astonishingly well in recent years – but past performance is no guarantee of future success.[2]

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