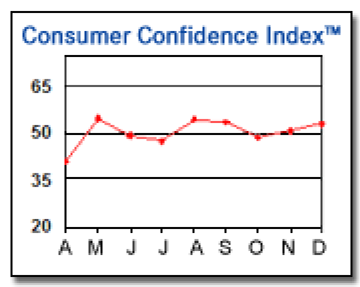
THE ILLUSION OF GOLD AND THE WALL STREET MELTDOWN

In early October, 2008, as the stock market was headed into oblivion, a client asked me why their gold fund had not skyrocketed during this Wall Street Meltdown this month. This was my answer:

The Gold Illusion: The reason gold wasn't rising is because the value of gold is an illusion. Only high demand for gold will make it skyrocket. But the only way to create high demand for gold is to create the illusion that it will bring security to someone who has great fear about the future. As the stock market crashes, and interest rates fall, people with money will speculate in gold. Therefore, it's *speculative* value may rise, then fall again as stocks rise and interest rates rise. Gold has no more utility today than it had last year. Gold is good for jewelry (limited demand, like diamonds), and for electrical contacts in computer systems (for which there are many substitutes). It's not really good for tooth fillings, so what good is it? One must look for "*intrinsic* value" not *speculative* value when investing in anything (Warren Buffet has a good sense of intrinsic value.) . If you play the speculative value game, watch it carefully, because it's a bubble that will burst eventually[i].

Consumer Confidence: Gold has become a classic hedge against uncertainty (a nice word for *fear*) and inflation. If the general public does not *trust* the economic future, this fear is reflected in the Consumer Confidence Index[1], which averages of two points of view: the Present Situation, and the Short Term Future. As of the end of the year 2009, the Consumer Confidence Index registered 53 (normal is about 100 +/- a few points). Of deep concern at the end of 2009 is:

> Present Situation Index, declined to 18.8 in December, 2009 from 21.2 in November. The index continued to lose ground and remains at a 26-year low (Index 17.5, Feb. 1983) Expectations for the short-term future increased to the highest level in two years (Index 75.8, Dec. 2007). Those claiming business conditions are "bad" increased to 46.6 percent from 44.5 percent, while those claiming conditions are "good" decreased to 7.0 percent from 8.1 percent. Those claiming jobs are "hard to get" decreased to 48.6 percent from 49.2 percent, while those claiming jobs are "plentiful" decreased to 2.9 percent from 3.1 percent."



With Consumer Confidence so low, the housing market in the pits, and government debt going through the roof (which will have to be repaid with inflated money to dig ourselves out of the hole), it's no wonder that the fear of inflation

[1] 5,000 households are surveyed each month from across the nation. Because 75% of the economy is driven by consumers, this statistic holds a lot of importance.

and economic uncertainty drove people to invest gold, driving the price higher in something that had the illusion of stability.

Speculative Fluctuation: Now, if everyone believes that gold is a valuable hedge against inflation and drives the demand up enormously, then the price will skyrocket, just as crude oil prices were driven up this summer by speculators who thought the limited supply and increasing demand would create a wild-cat rise in prices. Speculative artificial demand for oil futures drove the price up to $147/barrel on July 11th. Today (Oct 10th) it's $80/barrel and dropping. You can see how speculation (which is motivated by fear and greed) can artificially shift prices dramatically.

Wall Street Mentality: To understand the Wall Street Meltdown, one must first understand the mentality of the people on Wall Street, and every other major financial market in the world. Willie Sutton, the famous bank robber, was asked "Why do you rob banks?" "Because that's where the money is!" he responded. Thirty years ago I asked a number of my fellow alumni from Harvard Business School why they wanted a career on Wall Street. Behind all the articulate obfuscation, the bottom line: "To make money" (read: to get rich). So, if you were highly intelligent, ambitious, and wanted to get rich, Wall Street was your magnet.

Deregulation of Financial Markets: When Wall Street appealed to Congress for Deregulation, the real motive was: Take away the rules so I can Make More Money For Me (MMMFM). This opened wide the door for a den of foxes to raid the hen-house's jewels (401Ks, Pension Funds, Personal Investments) and create a plethora of subterfuge schemes (sub-prime mortgages, hedge funds, CDOs, short selling, derivatives, management fees, etc.) that use other people's money to feed Wall Street's greed.

How Some Financial Institutions Preyed upon People: The Sub-Prime Mortgage debacle was a greed vehicle gone unchecked. Mortgage lenders gave money to poor people to buy houses hoping they would make a boodle later on the adjustable rate. Giving more money to those who couldn't pay drove the demand for houses artificially high, which drove developers to build more houses. Speculators, looking to flip or to rent their houses further increased demand, even when there were no renters. Once the supply outstripped demand, the shell game was doomed, and the house of cards could not be sustained. When it came time to pay the piper, the poor and even the speculators defaulted in droves, being strapped with too much debt, compounded by the same tricks the banks used with credit cards. The bubble burst, as do all bubbles like this.

Wall Street Theft: Of course, Wall Street mavens were able to make tons of money by buying mortgages then selling them through investment portfolios. Ordinary people's 401Ks and Pension Funds soaked up the bad loans. So when the house of cards fell, Wall Street executives walked away from the meltdown with big bonuses and federal buyouts, while the little guy lost their retirement funds and home values. This is called "robber baron capitalism" that supposedly ended with Teddy and Franklin Roosevelt. But during the Clinton and Bush administrations, Wall Street successfully lobbied for deregulation, which opened the door for this mess. They even had the audacity to advocate shifting people's social security into stock investments! Imagine the mess we'd be in today had that happened. Look for a new spate of regulations, and the cycle will start anew. Unfortunately we live in the United States of Amnesia, and in 10-15 years we will have forgotten these lessons.

I hope this help explain your question about gold.

Robert Porter Lynch

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[i] Nelson Bunker and William Herbert Hunt were wealthy oil tycoon heirs In the early 1970's the family decided to buy silver as a hedge against inflation, and amassed it in great quantity. In the fall of 1979, the Hunt Brothers, along with some wealthy Arabs formed a silver buying pool and bought up 200 million ounces- the equivalent of half the world's deliverable supply. The price of silver had moved from $2 per ounce in 1973 to $5 per ounce in early 1979 and then rocketed as high as $54 in early 1980.

The officials at Commodity Exchange moved to check this cornering of the silver market by raising margin requirements. The highly leveraged Hunt Brothers were unable to meet their margin calls, and were forced to sell. The price of silver fell dramatically; on March 27th 1980 the price fell 50% in one day, from $21.62 to $10.80. The Hunt Brothers were forced to declare bankruptcy. Bache Group, which handled of the trades for the brothers, was financially ruined.

Be sure to see my other analysis "Historic Delusions About Free Markets"