
Shorting the Federal Reserve

"I've never let my guard down by saying, I do not need to be hedged" - Paul Singer

Preservation of clients' wealth is the most important fiduciary duty guiding investment managers. This obligation tends to be under-appreciated in the midst of financial asset bubbles when recency bias blunts the desire to sacrifice the potential for further gains in exchange for protection against losses. Inevitably, this is made painfully clear when a bubble pops and those once popular assets lose value and the manager's clientele suffer. 720 Global has repeatedly urged caution as valuations are currently stretched on the back of reckless Federal Reserve monetary policy and poor economic fundamentals. This article presents the case for an asset that can help managers protect their clients and uphold their fiduciary duty owed to them.

Gold - \ 'göld\ AU #79 - A heavy yellow elemental metal of great value

Gold is neither a claim on the promise of future earnings like a stock, nor a liability owed by a public institution or a private party like a bond. It also lacks the full faith and credit of most governments, like a currency. Gold serves little industrial purpose, unlike all other commodities and is most commonly revered as a shiny metal used in ornamental display or jewelry. It is precisely these failings that make gold a unique and valuable asset and one that can play an important role in portfolio construction.

Gold is one of the few stores of value that is limited in supply, transportable, globally appreciated and not contingent upon the faith and credit of any entity. It cannot be manufactured or debased. Gold is the only time honored currency or in the words of John Pierpont Morgan (J.P. Morgan), *"gold is money, everything else is credit"*.

History

Thousands of years ago trade between people began through a system of barter. This method of payment was effective but very limiting. Trade could not occur unless both parties had the goods or services demanded by the other. If a metalsmith, for example, did not need wheat, a farmer seeking a new sickle would have to find alternative goods or services to offer the metalsmith.

These stark limitations and the growing desires to conduct trade with parties over further distances required a more robust system. Accordingly, trade graduated from the barter system to that of a common currency. Aristotle stated the rationale for a common currency eloquently:

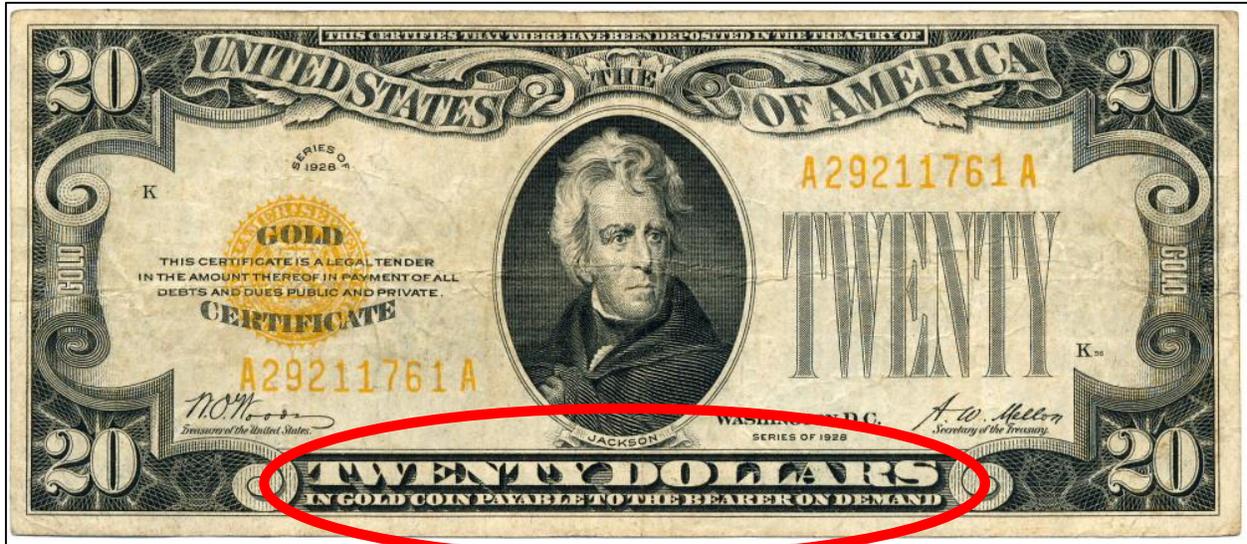
“When the inhabitants of one country became more dependent on those of another, and they imported what they needed, and exported what they had too much of, money necessarily came into use”. At first, in almost all cases, the currency was a commodity. While eliminating some of the problems associated with barter, this system presented new ones. Carrying gold or other commodities such as silver, grain, shells, or livestock can be cumbersome and difficult to properly measure for weight and purity. Dividing most commodities into fractions for ease of exchange produced additional difficulties. Paying for an acre of land with a quarter of a cow must have presented quite a quandary.



The next step in the advancement of currency was the use of sovereign issued, standardized currency typically made with gold, silver, copper and bronze. The first known instance of such a currency, the Greek drachma (pictured to the left) dates back to approximately 700BC. The benefit of this commonly accepted currency was that the supply of money became regulated and

standardized. Additionally, the limited availability of the metals made it hard to increase the supply of currency in any significant manner. These currencies held their value well as the worth of the coin was always tied to the weight and the price of the metal used. That said, there are instances where governments abused their authority by decreasing, or shaving, the metal used in each coin, temporarily unbeknownst to the public.

While coins were a big improvement from the days of barter, they could not fulfill the pressing monetary requirements of escalating global trade. To fill this need national banks introduced bank notes. Bank notes are essentially paper IOU's, as we have today. The dollar bill, for instance, is backed by the full faith and credit of the United States. However, prior to the last 50 years, full faith and credit was rarely acceptable and accordingly most bank notes were backed by a commodity, typically gold or silver. One holding a bank note backed by gold or silver could always exchange the note for a fixed amount of the metal backing the currency. In 1792 the Mint and Coinage act authorized the Bank of the United States to establish a fixed ratio of gold to the U.S. dollar. While the fixed rate fluctuated over time, there was always gold and silver backing the currencies. Below is a picture of a \$20 gold certificate.



On May 1st, 1933, President Roosevelt issued executive order 6102. This action ordered U.S. citizens to turn in their gold coins, gold bullion and gold certificates to the government. The order essentially made holding gold, in those forms, illegal for private citizens. The government set a rate of \$20.67 per ounce for anyone exchanging their gold for cash. Surprisingly, and still deeply entrenched in the memory of many, personal bank vaults were raided in search of gold. 7 months later, having accumulated a significant amount of gold, the Gold Reserve Act was passed which raised the fixed rate of gold per ounce to \$35.00. While rarely discussed in mainstream economic text books, this simple act was a massive devaluation of the dollar. With one swipe of a pen the amount of gold supporting the dollar was increased by 70%.

Roosevelt's actions highlight an important distinction in the gold debate. Most critics of a gold standard today argue there is not enough gold in existence to back the current monetary regime. **The truth is that the amount of gold is irrelevant, it is the price of gold that matters.**

While the gold standard no longer applied to U.S. citizens, foreign nations were still able to exchange U.S. currency for the gold or silver backing it. In 1971, President Nixon signed executive order 11615 which suspended this right of exchange. The act officially took the U.S. off of the gold standard. Most other nations have since taken similar actions.

It has only been the last 44 years where gold plays little to no role in the backing of any major currency. Although there is still gold stored in Fort Knox and other vaults, it only represents about 7% of our monetary base at current prices. The nouveau logic surrounding this fiat currency regime states that confidence and trust for a piece of paper backed by faith will always trump the desire for people to hold something tangible.

History is littered with financial crises and other disturbing events resulting from reckless monetary policies. Part II of this piece, soon to be released, will chronicle one example of the ills

of uncontrolled money printing, namely the actions that ultimately led to the French Revolution (1789-1799). This example is not as well-known as recent money printing schemes such as the Weimar Republic in 1923, Argentina in 1981 or Zimbabwe in 2008, but the lesson it provides is invaluable. The scale of money supply growth today is enormous but far from those achieved in the aforementioned countries. Nonetheless, all investors should have an appreciation for the path we are on and the fate that befell others that took similar paths.

The Era of Easy Money

Without a mandate for gold or silver to back a currency, most nations can freely increase or decrease the supply of money with few restrictions. The Federal Reserve (Fed) and many other central banks have done just that. Central banks now use their ability to manipulate the money supply to help them decrease interest rates, incent borrowing with the intent of spurring economic growth. Consider the stark differences in the annual growth of the money supply before and after Nixon's removal of the gold standard:

- Post WWII era (1950-1970): +3% annualized
- Removal of gold standard until the financial crisis (1971-2008): +19% annualized
- Period since financial crisis (2008-today): +29% annualized

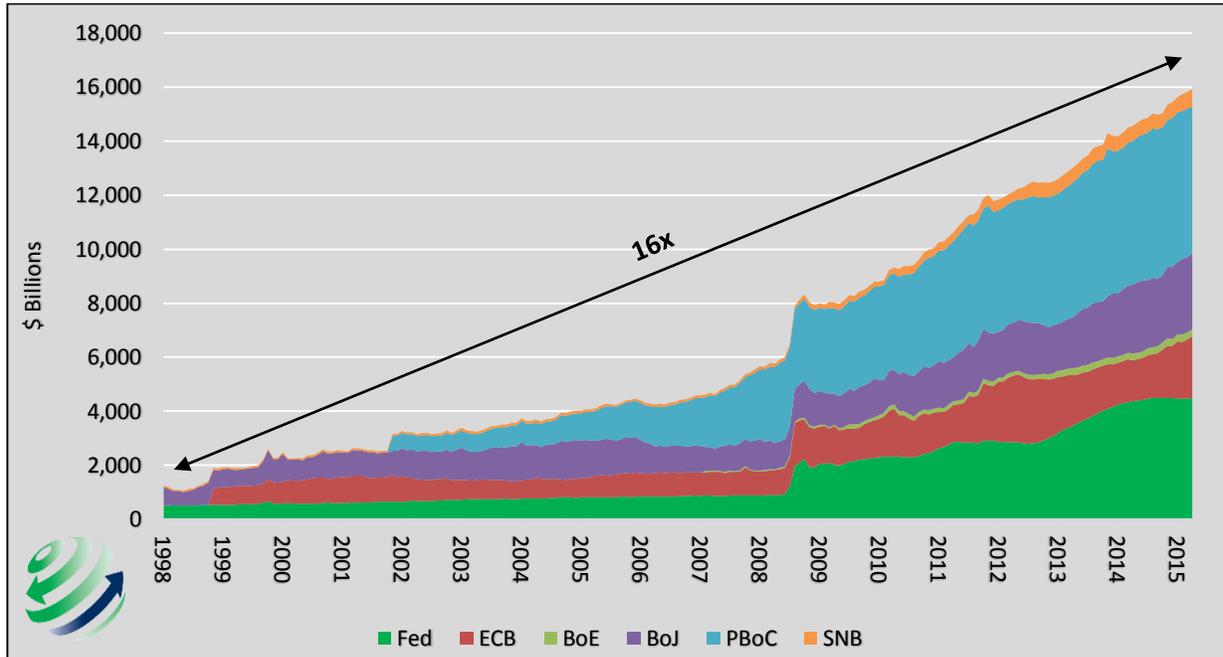
It is important to highlight that the Fed has quadrupled the money supply since 2008, dwarfing the 100% increase in the money supply during the great depression.

This "get rich quick" mentality generated limited shots of synthetic economic growth instead of fostering productivity to nurture and support lasting organic economic growth. This strategy is not without cost. In the words of Aldous Huxley: *"One can't have something for nothing"*. Laying in the wake of money printing and extraordinarily low interest rates is an unprecedented accumulation of public and private debt, the decline of productivity growth and a fragile economy. These costs have been mounting for years, requiring higher degrees of central bank intervention to avoid paying them.

It is becoming more and more apparent that the so called "era of easy money" is quickly coming to an end. Debt levels are at a point where they challenge the economy's ability to grow them, let alone service them. Interest rates have been lowered to zero with some countries now targeting negative rates. As stressed earlier, the U.S. money supply has quadrupled since 2008 and those of other economic powers have done likewise. Productivity growth has ground to a halt in the U.S. and is in decline in most major economies. To put the situation in blunt economic terms: the Minsky moment has arrived. The saying, derived from the works of Hyman Minsky, describes the sudden collapse of assets values which were driven higher by the gross misallocation of capital. Years of easy money and unregulated money printing has created this condition today.

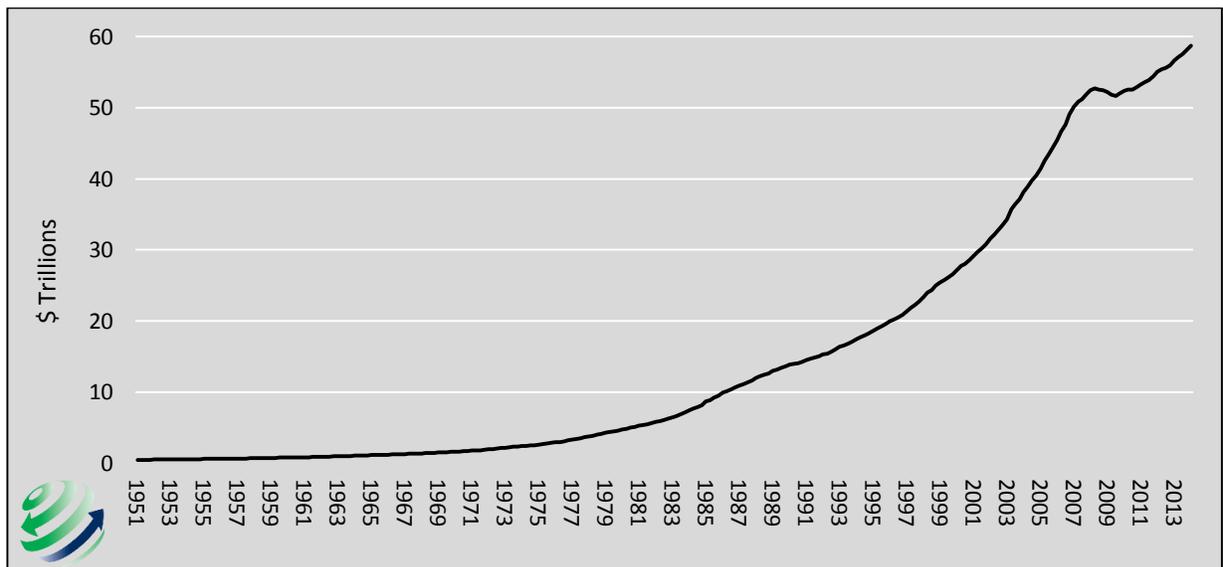
The graphs below help visualize the enormous growth of central bank balance sheets and total U.S. debt outstanding. The table following the graphs show the stunningly low current level of short term interest rates of selected major economic powers. 5 of the 7 countries in the table have interest rates below zero.

Growth of Central Bank Balance Sheets



Data Courtesy: Bloomberg

U.S. Total Debt Outstanding (Public and Private)



Data Courtesy: Federal Reserve Z.1 Release

Country	3 Month Sovereign Bill Yields
United States	-.01%
Germany	-.38%
Italy	-.04%
France	-.19%
Great Britain	.49%
Japan	-.01%
Canada	.39%
<i>Data Courtesy: Bloomberg</i>	

Why Gold

Gold is denominated in US dollars meaning it is quoted as the amount of dollars required to buy or sell one ounce of gold. The price of gold rises and falls with supply and demand for gold however a big determinant of its price is the value of the U.S. dollar.

Commonly, the U.S. dollar is quoted as an index or ratio. For example, the closely followed dollar index (DXY) is currently trading at 96.00 and the dollar's exchange rate versus the Euro is 1.12. These are valid price indicators, yet also misleading, as they solely describe the value of the U.S. dollar relative to other currencies. **If another country debases their currency more aggressively than the U.S., the dollar may rise in price but has it truly gained value? The exchange quotes and pundits may say yes but the answer is clearly no.**

The only proper measure of the value of a dollar is its purchasing power. In the 1950s, \$1 bought a couple a full meal at McDonalds including a burger, fries and a shake. Not only that, but the couple walked away with change. Today a similar meal at McDonalds would run the couple well over \$10. The easy conclusion from that example is that prices have increased. However, one could more accurately state the value of the dollar has diminished. Had one been able to preserve those burgers, fries and shakes for over 60 years they would have retained the original purchasing power of their dollar bill (currently \$10+ at McDonalds). Although storing food and most every product/commodity is fraught with risks and complication, one takes the additional chance that there may not be demand for such goods in the future. Had one bought \$1 worth of gold in the 1950s, they would have \$33 worth today.

Therein lies the value of gold. While theft of gold is a risk like anything else, gold doesn't spoil or rot, it is relatively compact and easy to store, and it is not easily destroyed. Most importantly though, one can have about as much confidence as this world offers that someone will be willing

to buy their gold in the future as has been the case throughout the history of civilized human existence.

Brazil and Turkey provide us with current examples of the virtues of owning gold. Year to date the Brazilian Real has dropped 25% and the Turkish Lira 30% versus the U.S. dollar. Despite the significant depreciation, Brazilians and Turks holding gold were able to retain their purchasing power. In both countries gold is trading at all-time highs offsetting the depreciating effects of their respective currencies.

This article should not be mistaken as advice to increase your allocation to gold to 100% and sell all financial assets. What it does imply is that in periods of economic strength, central bank credibility and dollar strength that the need to hold gold for protective purposes is minimal. Conversely, in times, like today, when debasement of currency is the Fed's last remaining policy tool of any significance, one should retain some protection. Holding gold is simply recognition that the Fed's actions over the last 30 years have potentially severe consequences that pose threats to the value of most financial assets, the almighty dollar and ultimately your clients' purchasing power. **Owning gold is in effect not only a short on the dollar and on the credibility of the Federal Reserve, but most importantly a one of a kind asset that protects wealth.**

"Gold, unlike all other commodities is a currency... and the major thrust in the demand for gold is not for jewelry. It is not for anything other than an escape from what is perceived to be a fiat money system, paper money that seems to be deteriorating." -Alan Greenspan 2011

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