

## MARKET UPDATE

# The Gold Bubble

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August 15, 2011

### The Modern Day “Gold Rush”

With the price of gold surging to record highs—recently breaching the \$1800 per ounce barrier for the first time—the beautiful, shiny yellow metal has grabbed the attention of many investors around the world. In this Quick Market Update, we discuss the popularity of this commodity, drivers of demand for it and our views on current market activity.

Let’s begin by discussing the popularity of gold. Here are some interesting anecdotes that underscore the popularity of the precious metal:

- In June and July, the Bank of Korea announced that it purchased 25 metric tons of gold, or over 800 thousand ounces, more than doubling its total gold holdings.
- The physical holdings of gold held by the wildly popular gold Exchange Traded Funds (ETFs) now total approximately 75 million ounces. Were it a central bank, the aggregate of these ETF gold holdings would make it the sixth largest central bank gold “reserves” in the world—even larger than the gold holdings of the central banks of China, Switzerland, Russia, and Japan.

### Gold, How Do Investors Love Thee? Let Us Count the Ways

Some of the more typical reasons that we hear from investors for their veneration of gold, include:

- *Past performance*, e.g. “The price of gold has gone up a lot already, therefore it likely will keep going up.”
- *Hedge against currency instability*, e.g. “I don’t have confidence in the stability of fiat currencies such as the U.S. Dollar, the euro, or the yen; therefore, I will buy gold.”
- *Historical store of monetary value*, e.g. as the television commercials tell us, “Since the time of the Pharaohs of Egypt gold has been recognized for its monetary qualities.”
- *Hedge against inflation*, e.g. “I will buy gold in case inflation sky-rockets.”
- *Hedge against societal calamity*, e.g. “If the world goes to ‘hell in a hand basket’, at least I will be able to buy things with gold.”
- *Flight-to-safety*, e.g. “Everywhere I look there seems to be risk. Gold is a safe harbor to ride out these storms.”

- *Low interest rates.* Many investors believe a positive impact on gold prices from the negative real interest rates (interest rates minus inflation) that we are currently experiencing with short to intermediate interest rates, will support gold over an extended period.
- *Declining value of the dollar.* Since gold is solely denominated in U.S. Dollars, if the dollar continues to move lower against other major world currencies, it will add further price support to commodities like gold.

### **We View Gold in Bubble Territory**

We believe that we have reached the point where we can confidently state that interest in gold investing has reached the level of a speculative bubble. Prudent investors should be very wary of having substantial investment exposure to this precious metal in their portfolios.

Wells Fargo has a rich history of trading, transporting, and safekeeping gold. However, we have seen the economic damage that other past speculative bubbles (e.g. housing bubble, Internet bubble, Nikkei bubble) have done in luring unsuspecting investors by the prospects of being “safe”, “stable”, and “sure things” and feel compelled to ring the warning bells. As with all bubbles, we know that we run the risk that our view may turn out to be wrong (“early” would be our preferred euphemism) in the short run; however, we believe that we will be proven right in the long run. Some will vehemently call us “crazy” and “naïve” for being unenlightened to gold’s zero gravity investment properties, but that will only help to steel our convictions (we similarly took our licks from critics in the past when we expressed concerns about speculative bubbles in technology stocks and housing).

### **Reasons Gold may be in Bubble Territory**

**Volatile Price Movements:** With very little warning, the bottom can drop out on gold prices very quickly. For example, during six short months in 2008, gold lost more than 30 percent of its value. In the 1980s, in a little more than two years, the price of gold dropped approximately 65 percent. When fear subsides, inflation doesn’t sky-rocket, and everything begins to return to “normal,” demand for gold can fade away quickly. Last week in response to rising volatility in gold prices the Chicago Mercantile Exchange (CME), the world’s largest futures market, raised the margin requirements for trading gold futures contracts by 22 percent. The CME has a history of raising margin requirements on futures contracts when price volatility increases as a way of further protecting investors’ interests.

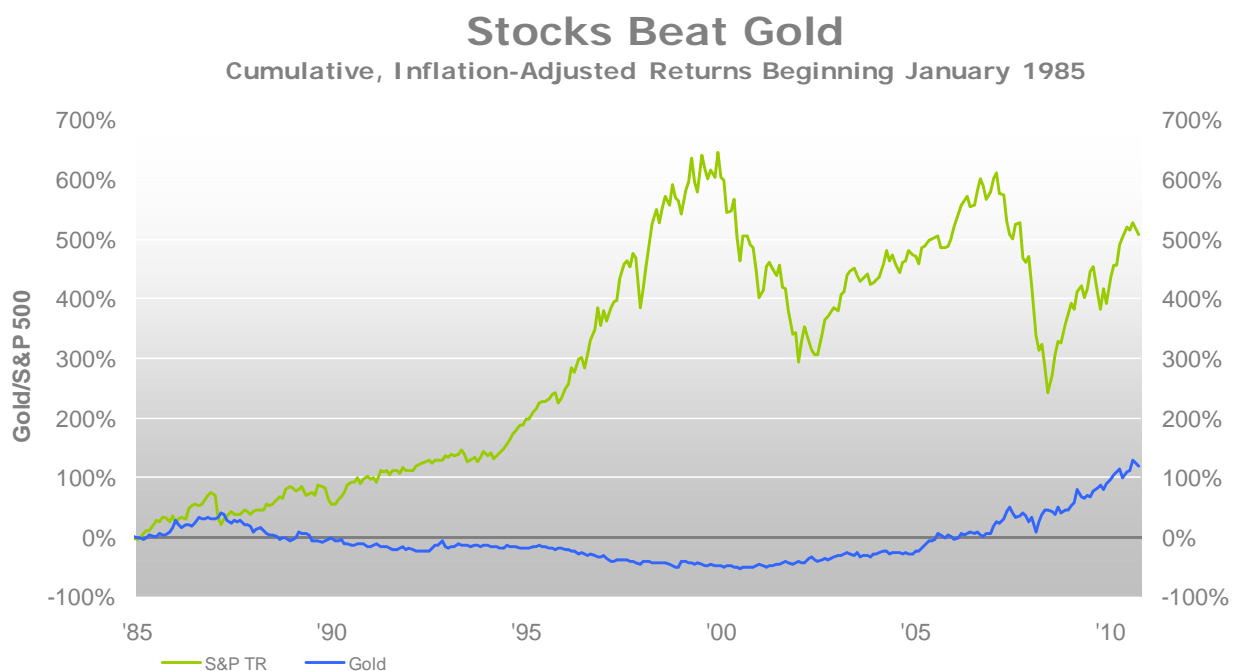
**No Income:** Most investments have some sort of cash flow potential: stocks have dividends, bonds have coupons, and real estate has rent. This flow creates intrinsic value. However, gold, like many other commodities, does not have any simple, inherent cash flow. In fact, when one factors the incumbent costs of ownership (transportation, storage, insurance, protection, assay

fees, etc.), gold, in its physical or derivative form, can actually be considered to have a negative yield.

**Greater Fool Dependence:** Because it has no inherent earnings power and little intrinsic value, investors in gold are hoping that other investors will come along to bid up their holdings in the future. While a common tactic of speculators, the “greater fool” approach is rarely a good long-term investment strategy. In fact, it was this strategy that led us to the recent housing market crisis. During that period, lenders, homeowners and real estate investors assumed that home prices would continue to climb into perpetuity.

**Central Bank Activity:** Lately, there has been a great deal of attention in the news about central bank purchases of gold. However, it is important to note that, in aggregate, the central banks of developed countries have been net sellers of gold in recent years. That trend may change since the political back-drop of future supply and demand dynamics of central banks is quite difficult to predict.

**Inflation Fighting Properties are Overstated:** The chart below challenges the idea that gold is an effective hedge against inflation, as it shows that stocks have experienced a far superior after-inflation-adjusted return over the past 25 years. This longer time-frame view of gold puts into perspective a more realistic time horizon for many investors.



Data Source: FactSet, June 30, 2011

**Warren Buffet's View on Gold Values:** In a recent interview on CNBC, the renowned investor Warren Buffett crystallized the concerns that prudent investors have with gold at current price levels:

*“. . .if you took all of the gold in the world it would roughly make a cube 67 feet on a side and that would be the whole thing. Now for that same cube of gold it would be worth at today's market prices about \$7 trillion. That's probably about a third of the value of all the stocks in the United States. So you could have a choice of owning a third of all the stocks in the United States or you could have a choice of owning that little block of gold, which can't do anything but kind of shine there and make you feel like Midas or Croesus or something of the sort.*

*Now, for \$7 trillion, there are roughly a billion of farm-acres of farmland in the United States. They're valued at about \$2 1/2 trillion. It's about half the continental United States, this farmland. You could have all the farmland in the United States, you could have about seven ExxonMobils, and you could have \$1 trillion of walking around money. And if you offered me the choice of looking at some 67-foot cube of gold and looking at it all day, you know, I mean touching it and fondling it occasionally, you know, and then saying, you know, `Do something for me,' and it says, `I don't do anything. I just stand here and look pretty.' And the alternative to that was to have all the farmland of the country, everything, cotton, corn, soybeans, seven ExxonMobils. Just think of that. Add \$1 trillion of walking around money. I, you know, maybe call me crazy but I'll take the farmland and the ExxonMobils.”*

**You Can't Eat Gold:** For all the talk of gold's antidotal properties vis-à-vis fiat currencies, beyond its few industrial and jewelry uses, it is hard to see that gold has much intrinsic value. Gold doesn't readily produce cash flow, doesn't provide shelter, can't be eaten, nor does it provide efficient clothing. There is certainly some intrinsic value, but, in our view, not \$1,800 per ounce worth of intrinsic value. Further, all sound investments provide some element of societal benefit. However, digging gold up out of the ground, refining it, forming it into bars, and then burying it back in the ground again—specifically in elaborate, highly-protected underground vaults—doesn't seem to provide substantive economic value to society, other than being a short-term speculative store of value.

### **Conclusion: Gold's Role in a Prudent Investment Strategy**

Given continued global economic uncertainty and recent volatility in capital markets, “hoarding” gold may seem like the safest bet in the near term. In our view, gold is a commodity that should be held as a part of a larger, diversified allocation to commodities that is frequently rebalanced. We do not believe that gold should be utilized as a cash-equivalent no matter how enticing the price returns have been in recent months.

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<sup>1</sup> Excerpt from CNBC Interview on March 2, 2011

While we recognize the potential benefits of investing in gold, we are definitively not in the “gold bug” camp (we’re not even “gold aphids”!). In fact, we think the current price of gold is a bubble that is poised to burst. Gold should be considered only as a part of a broader exposure to commodities, including other precious metals such as silver and platinum, industrial metals such as copper and aluminum, as well as agricultural and energy-related commodities. Commodity allocations should be coupled with real estate, such as Real Estate Investment Trusts (REITs), to ensure proper exposure to the real assets group. Real assets must be combined with the three other major asset groups (stocks, bonds, and complementary assets) to achieve a properly diversified portfolio within the Wells Fargo’s Asset Allocation-based investment strategy. Investors should maintain the appropriate allocation to gold, and understand how gold fits within a total portfolio strategy. We believe this offers a more prudent strategy to address economic uncertainty and inflation rather than succumbing to the pressure to jump on the gold bandwagon. Time will tell if we are right or just “early.”

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