The Real Deal

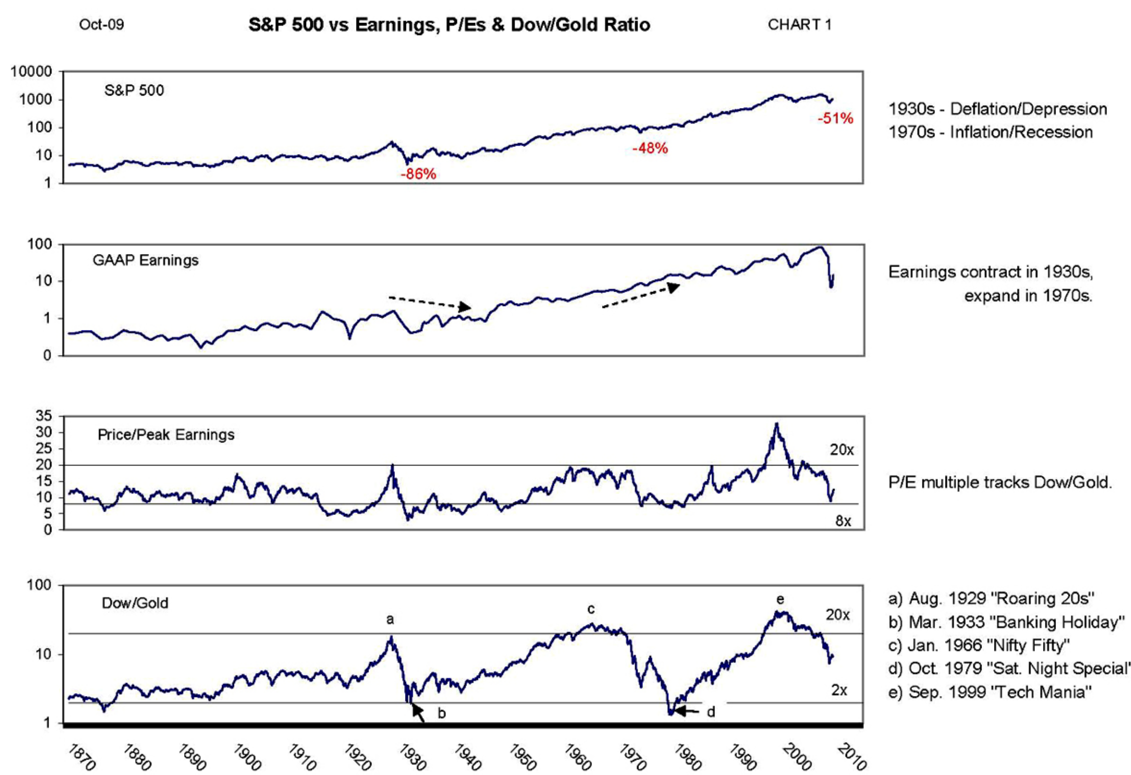
Dean LeBaron, CFA, Walter Deemer and Mark Ungewitter

”What is fascinating is the extent to which gold still holds reign over the financial system as the ultimate source of payment.”

-Alan Greenspan, Sept. 9, 2009

Introduction

In November 2008, we issued a research paper entitled “A Way Forward,” which examined historic booms and busts from a variety of perspectives, including an analysis of inflation-adjusted equity prices. [1] For this we utilized a classic inter-market study, the Dow/Gold ratio. We noted that equities in gold terms have essentially moved sideways over the centuries, with Dow and gold attaining near-parity every 40-50 years. We also noted a strong connection between Dow/Gold and P/E multiples. Chart 1 reproduces and updates our original study.



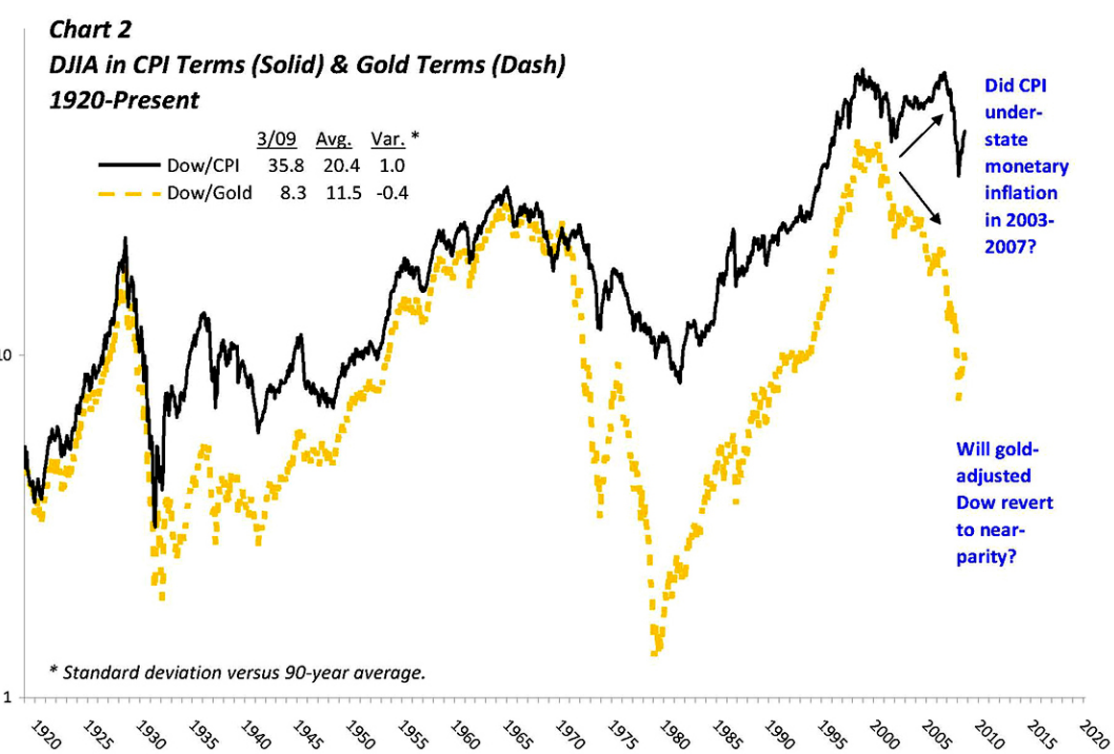
[1] *The Journal of Wealth Management*, Summer 2009, Vol. 12, No. 1: pp. 10-16. Also see www.walterdeemer.com/forum/viewforum.php?f=2

Which Inflation?

An early criticism of "A Way Forward" concerned our choice of gold as equity deflator. Why did we not use CPI, as our scholarly reviewer suggested? After careful consideration, we chose gold for the following reasons:

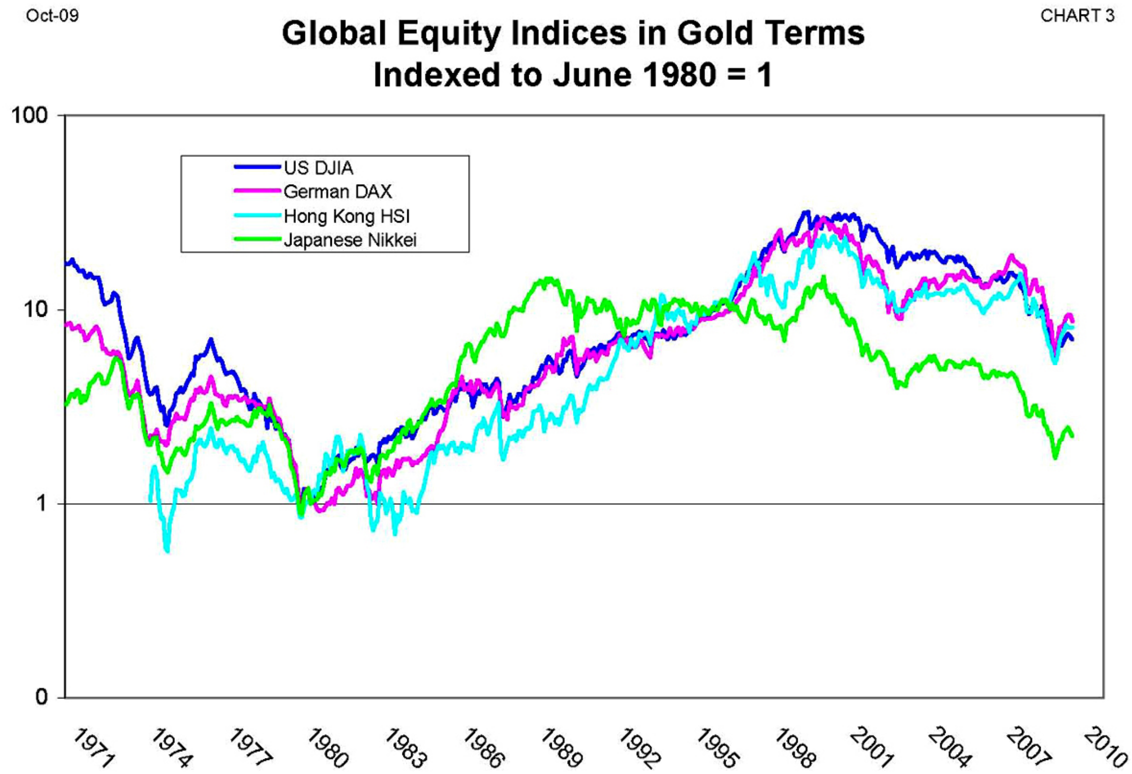
1. Gold has a longer history than CPI;
2. CPI methodology has changed over the years;
3. Dow/Gold has better mean reversion qualities than Dow/CPI; and
4. Gold provides a global yardstick independent of national CPI methodologies.

Chart 2 examines the relationship between Dow/Gold and Dow/CPI since the inception of CPI data in 1920. The two series are in broad agreement most of the time. Dow/Gold, however, exhibits better mean reversion qualities, especially in the post-Bretton-Woods era. We note that the two series diverged sharply from 2003-2007, and question whether CPI understated monetary inflation during that period. We believe that, while both series are worth watching, the market-derived Dow/Gold ratio provides a better indication of valuation extremes.



Global Dow/Gold

New York, of course, is not the only city on earth. If we are on the right track, our logic should extend to other markets as well. Chart 3 presents global equity indices in gold terms. Here, we deflate the Chinese, German, Japanese and US markets by the price of gold in local currency. We then index to a base period of June 1980 (the prior real bottom).



By this measure, all markets topped in 1999, though New York and Hong Kong made new nominal highs in 2007. We note that Chinese, German and US markets were more overvalued in 1999 than was Japan in 1989, and that Japan is now the cheapest market relative to the 1980 bottom.

"Clever charts," you say. But why should a golden denominator tell us anything at all? Isn't gold a barbarous relic that was fully demonetized in 1971? Yes, but there remains an old controversy over nominalism; that is, whether money is what the state decrees or what the market dictates:

> *[A] critical point of monetary theory that has gone out of textbooks as of little modern relevance (mistakenly in my judgment) – [is] the difference between the Knapp state theory of money (that money is what the state declares it to be and designates as legal tender for debts public and private) and nominalism (that money is what the market uses to fulfill the purposes of money). States may propose, but markets dispose.* [2]

We suspect that gold retains *partial* functionality as money. While it is no longer an official medium of exchange, it may still act as a store of value, especially in times of financial mismanagement. To the savvy observer, it may also function as unit of account, revealing a historic range of equity valuation and helping to identify secular trend.

So, what if we're wrong? Perhaps CPI is the more accurate measure of inflation. In this view, the rising slope of Dow in CPI terms is simply a measure of corporate progress. The apparent

[2] Charles P. Kindleberger, "A Financial History of Western Europe," Oxford University Press, 1993, p. 22.

mean-reversion quality of equities in gold terms might only reflect gold's propensity to overshoot as suggested by the old saying, "There's no fever like gold fever."

Whatever the case, whether gold retains monetary functionality or not, we find its long-wave behavior of considerable interest. In statistical work, one can never accept a hypothesis; one can only not reject it. The notion that Dow/Gold will revert to near-parity is no exception, especially in light of the limited number of historic observations. On the other hand, only a myopic observer would conclude that residual claims on corporate wealth are not subject to mean reversion, and that the price of gold is of no relevance to the issue of inflation.

The definition of inflation has also changed over time, as acknowledged by this interesting comment from a Federal Reserve Bank economist:

> *For many years, the word "inflation" was not a statement about prices but a condition of paper money – a specific description of a monetary policy. Today, "inflation" is synonymous with a rise in prices, and its connection to money is often overlooked…. What was once a word that described a monetary cause now describes a price outcome.*[3]

Inflation, then, is a complex subject bridging cause and effect. It should not – in our opinion – be reduced to the simple notion of "generally rising prices," a premise upon which many questionable arguments are built.

We like to think of the Dow/Gold ratio as an alternative lens on market history. By shifting our denominator from the increasingly elastic US dollar to a quasi-monetary unit in relatively fixed supply, we hope to learn more about the effect of monetary inflation on equity valuation.

<u>What's Next?</u>

In March 2009, US equities approached secular cheapness. Price-to-peak-earnings reached a multiple of 8.9x versus prior lows of 7.4x in 1974 and 3.0x in 1932. The Dow/Gold ratio, however, remained well above historic lows. See chart 1.

While there is no rule that history must repeat, we expect it will continue to rhyme. In this regard, we observe the following:

1. Secular bottoms are a process, not an event. In the past, price-to-peak-earnings multiples have tended to retest their initial lows over a period of five to ten years.
2. In the post-Bretton-Woods era, real versus nominal bottoms and tops have occurred several years apart. In dollar terms, for example, US equities bottomed in 1974. Their real low, in CPI or gold terms, came six years later, in 1980.
3. The most recent Dow/Gold top occurred in 1999, implying that we are now ten years into a structural decline. In the past, such declines have lasted thirteen or more years before a secular bull phase has emerged.

---

[3] "On The Origin and Evolution of the Word *Inflation*", Michael F. Bryan, Federal Reserve Bank of Cleveland (www.clevelandfed.org/research/Commentary/1997/1015.pdf).

4. The rally from 2003-2007 was a nominal affair, not evidenced in gold or P/E terms. It was supported by an artificially low Fed funds rate that sustained and encouraged global imbalances.

All of this suggests that, at best, we will now experience a long basing period before a new secular bull market will emerge. Government "solutions" that rely upon devaluation are likely to foment new secular lows, at least in gold terms.

Conclusion

Milton Friedman famously taught that inflation is always and everywhere a monetary phenomenon. In other words, prices don't inflate, money devalues.

Most investors rely on CPI to gauge monetary conditions. Yet CPI is only one measure of inflation. While consumer prices are undoubtedly influenced by monetary phenomenon, they are also influenced by real factors such as globalization and technology.

Gold, on the other hand, is essentially non-consumable. Aside from jewelry demand (which doubles as investment demand) and negligible industrial consumption, the price of gold in local currency is driven entirely by monetary phenomenon. Gold is a "dumb rock" that attains value from even dumber government policies.

The Dow/Gold ratio compares residual claims on corporate wealth to a quasi-monetary unit in relatively fixed supply. In the past, it has provided a useful guide to secular trend and valuation extremes. Gold is the only major world asset to have attained new secular highs in 2009. Its historic message is deserving of our attention.

***

About the authors: Dean LeBaron, CFA, is an author, contrarian thinker, and founder of Batterymarch Financial Management (www.deanlebaron.com/dlbio.html). Walter Deemer is a principal of DTR, Inc., an institutional investment advisory service; a former head of market analysis at Putnam Investments; and a founding member and past president of the Market Technicians Association (www.walterdeemer.com/bio.htm). Mark Ungewitter is a portfolio manager at Charter Trust Company.(www.chartertrust.com).

Special thanks to John Budden and Marilyn Pitchford.

For further discussion and analysis please see *A Way Forward Forum*, www.walterdeemer.com/forum

---