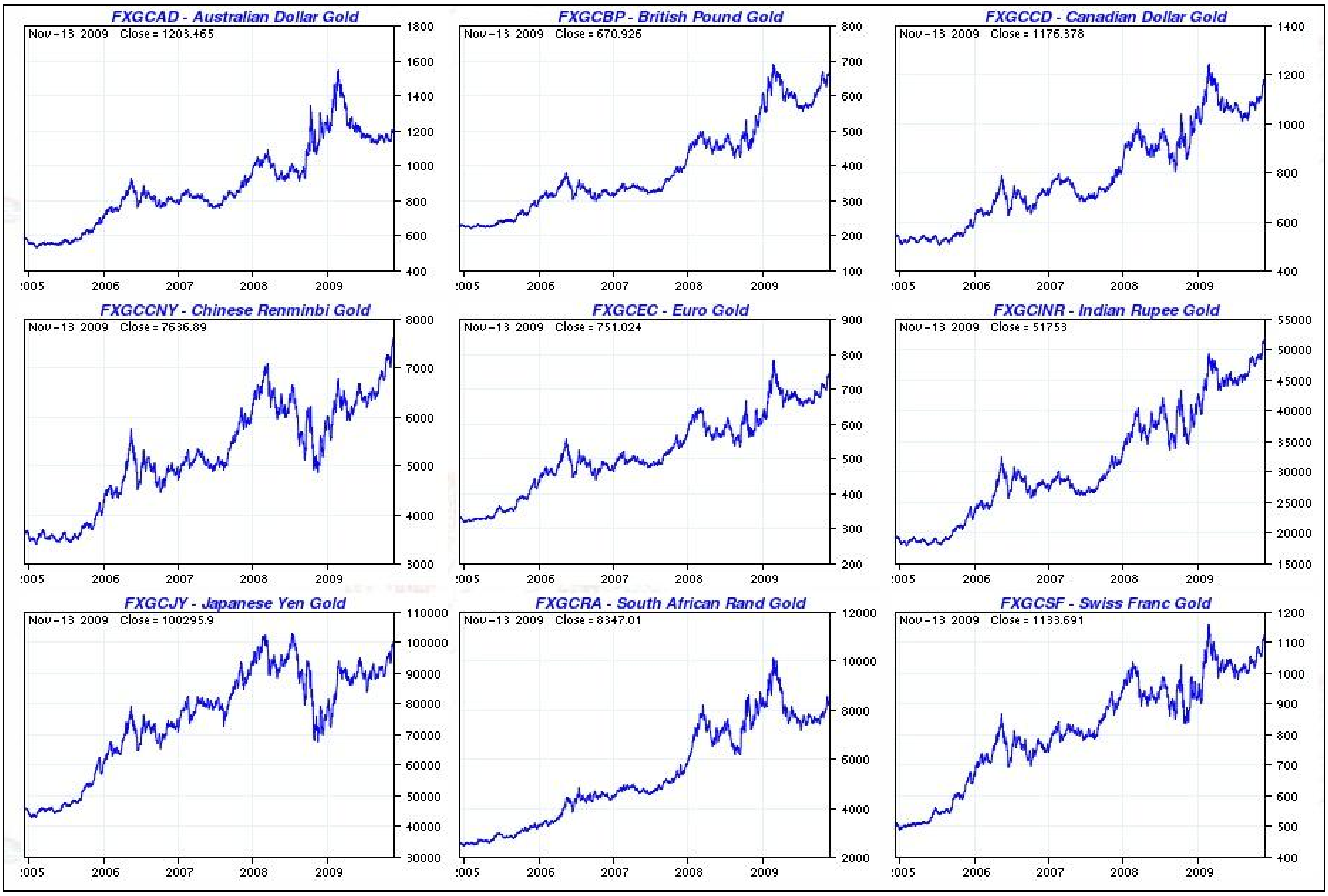
GOLD AND AUSTRALIA'S MONETARY INFLATION DELUSION

In 2009, many asset classes have recovered strongly after a frightening second half to 2008. In nominal terms, both the stock and property markets here in Australia remain seemingly sound. As we enter 2010, the media talk is that Australia's already expensive property market is set for yet another bumper year, as tight supply and increasing demand pushes prices higher. First home buyers, listening to these predictions on current affairs programs and reading about them in newspapers, feel an overwhelming uneasiness. If they don't get in now, they will miss out as house prices rise to even more unaffordable levels, never to return! Even worse is the unenviable social stigma associated with renting or moving back in with the parents! They are being told that rents are set to increase by at least 10% in 2010 as tight supply, increasing government taxes and rising interest rate levels will leave landlords no choice but to lift their rents. Economists continue to be bullish on the economic outlook for Australia and largely underpin their forecasts on China's continued growth. They are forecasting another strong year for the stock market and very few seem willing to challenge this optimism.

I continue to watch Australia's economy with great interest. Today I will attempt to put a few things into perspective. I want to start by looking at the performance of different asset classes in real terms. This is important. In the highly inflationary global economy we presently live in, all currencies are in a race to the bottom. When comparing their performances using cross rates, this becomes much less obvious. For the most part, currencies fluctuate both up and down against each other. This in turn poses the obvious question: How do we know that they are all in a race to the bottom? The answer: You measure their performance using an honest universal unit of currency which is of course gold. A look at the charts below shows the major devaluation which has been accelerating over the last 5 years. This seems set to continue into the future as governments around the world desperately attempt to re-inflate their respective economies, with Australia being no exception.

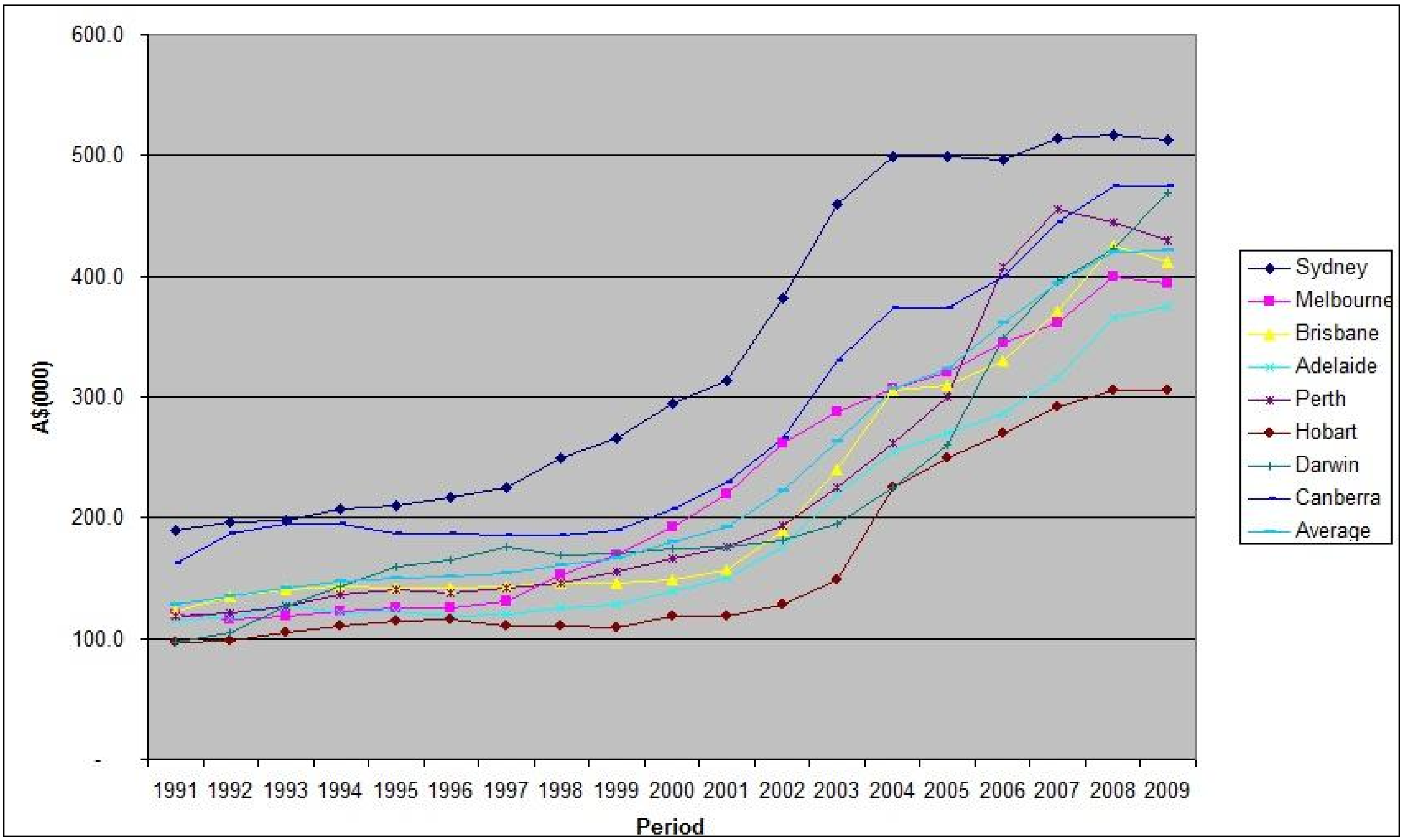
Gold Price Trends (in various currencies)



Source: www.goldchartsrus.com

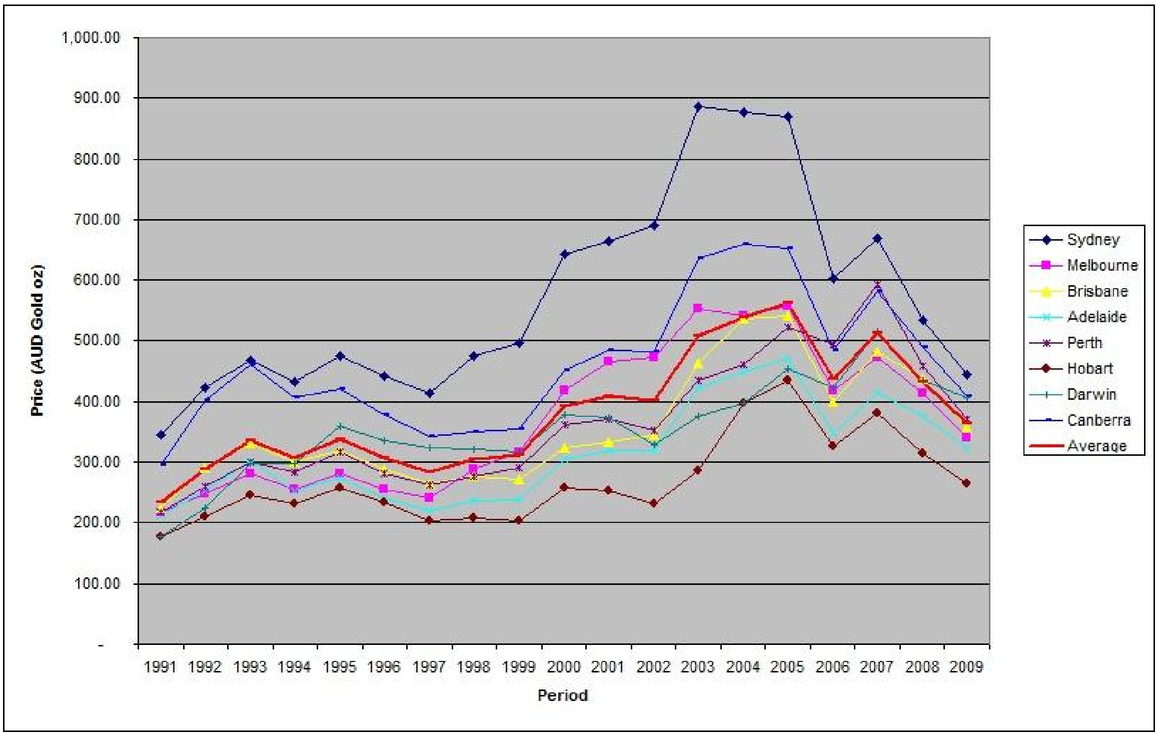
A look at these charts gives you an appreciation for how rapidly money has been loosing its purchasing power globally. What problems does a depreciating currency pose? First and foremost it means that the price of "things" generally becomes more expensive. This includes the price of commodities both hard and soft. It also includes investment asset prices which have been major beneficiaries of monetary inflation here in Australia for quite some time now. One of the biggest problems associated with monetary inflation is the inability to gauge just how well a specific market is actually performing. It can very often create the illusion that a market is performing better than it really is. Let's look at the Australian property market for a moment. In nominal terms, Australia's property market has risen very strongly over the last decade and has recently become the envy of other western nations given its relative stability.

Australian Capital City Median Property Prices in Nominal Terms



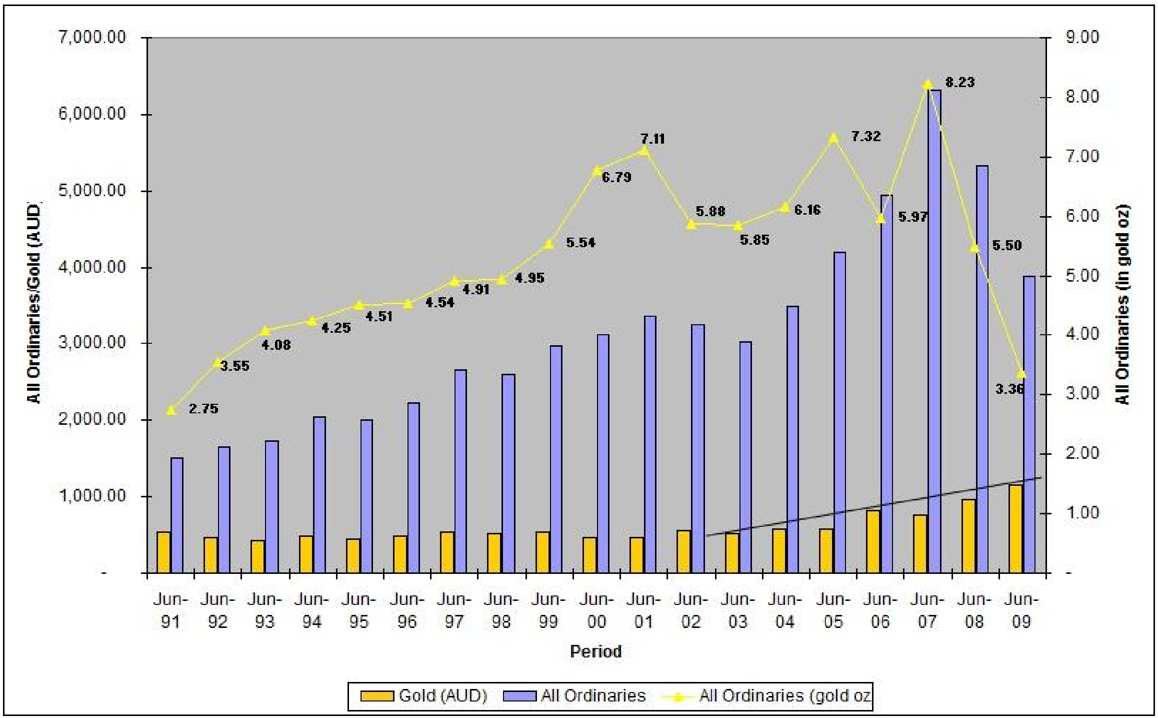
It's not until you look at property prices in real terms (in gold oz) on the following chart below that we start to see Australian property has actually been falling since late 2005. The chart below indicates property on average has fallen back to pre-2000 levels. This should have first home buyers celebrating right? Well no, not really, because most people keep their savings in bank accounts earning little more than 4-5% annually in interest. They have been conned into believing that inflation is low and that these paltry interest rate levels have adequately protected them against the decline in the purchasing power of their money. Depreciating currency? What depreciating currency? The newspaper tells them that the Aussie dollar is at historical highs against both the British pound and US dollar. We have a strong currency not a weak currency don't we? Yes, but look at the performance of the currencies we are getting our relativity from! Take another look at our earlier gold price charts in key currencies. I repeat. Gold is the best benchmark for assessing the true performance of various markets including currencies. By using gold, you are measuring performance on the basis of a unit of currency that has historically preserved its purchasing power. This is vital. If you assess performance in nominal terms using depreciating currencies and the likes as your base, chances are you will fall victim to the illusory force that is monetary inflation.

Australian Capital City Median Property Prices (in gold oz)



Let's take a look at another example. The Australian stock market's All Ordinaries Index.

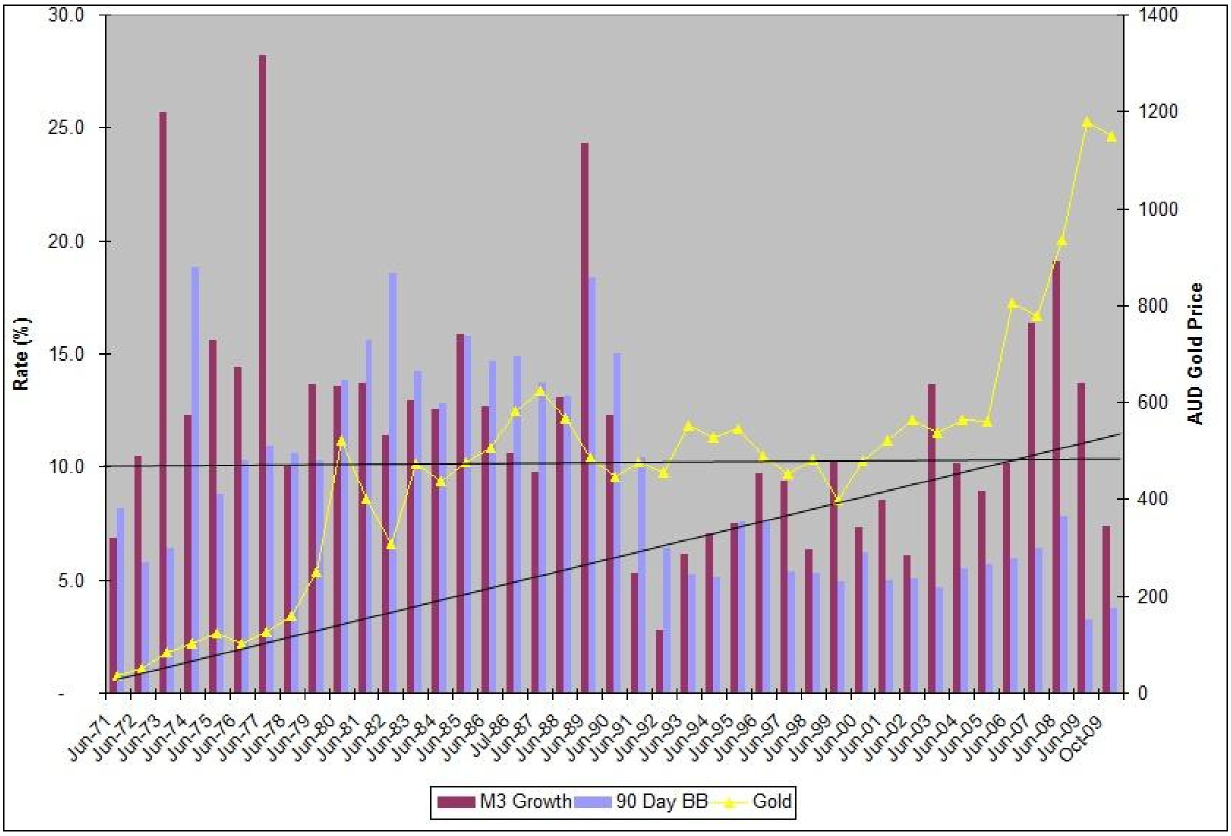
Australian All Ordinaries Index (in Gold oz)



Looking at the chart above, there can be no doubt the Australian All Ordinaries index has performed strongly in nominal terms since the last recession back in 1990/91. We can see in terms of gold oz that this growth peaked in June 2007 at 8.23 (yellow line graph). We have since fallen to early 1990 levels as the gold price has accelerated higher and the All Ordinaries Index has fallen. What does this mean? Well, as at 30 June 2009 (dividends aside), the gold price in Australian dollars has outperformed the All Ordinaries index since about 1993. The All Ordinaries has since recovered to 4,727 and the ratio is 3.87 at the time of writing.

In concluding, it is important to note that the gold price outperforms other asset classes when monetary inflation is high (generally over 10% annually) and or interest rates are at insufficient levels to offer investors the necessary protection. We can see in the chart below that the gold price, over the last 40 years, has performed the strongest when M3 growth has typically been above 10% and interest rate levels have failed to keep up. It then stabilizes during periods where interest rates exceed M3 growth rates and or the M3 annual growth rates fall below 10%. If you cast your eye over the last 5 years, you can see that the gap between the M3 annual growth rate and the 90 day bank bill rate has been significant. M3 is largely driven by credit creation and the major beneficiaries of this excessive lending in recent times have been the stock and property markets. Asset inflation is not recognized by government agencies in determining official inflation rates. This is why the gold price is a far superior gauge of inflation and should be closely considered when looking at the true performance of different asset classes. If an asset class is becoming increasingly dependant on excessive debt to grow or at least maintain present levels, one must ask the valid question. What happens when this liquidity inevitably dries up? I believe Australian investors are only just beginning to learn the cruel answer to this question which investors in many other countries are now all too aware. The coming 12-18 months will have even more nasty surprises despite economists' optimistic predictions.

M3 Growth versus Gold Price (Last 40 years)



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