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All that glitters

May 4, 2011

It is hard to find anything in the current financial landscape that has caught investors' attention as much as gold. We were proponents of gold at times over the past decade. However, the rationale for investing in gold has changed in the last three years. The story was once a fundamental one, but today's general enthusiasm seems more emotionally-based. Gold prices might rise further, but we prefer to sit out the current rally in favor of more fundamentally-based investments that tend to perform well during periods of sizeable nominal growth.

The gold/dollar relationship seems increasingly odd

We were big fans of gold during the period when the US dollar was falling precipitously. Strangely, few people seemed overly concerned about the dollar during that period. Now that the decline of the dollar (despite the fact that it is trading near its 2008 lows) has slowed, investors suddenly seem terribly worried about the pace of that decline, despite the fact that the dollar has been remarkably stable over the past three years.

The following table divides the past decade into two periods. Gold appreciated at an annualized compound rate of 20% from the July 2001 peak in the dollar index (DXY) to the index's trough in April 2008. The dollar fell during those years at about 7% per year. The second period is from the April 2008 trough in the DXY to the recent levels. The DXY actually appreciated about 1% per year over the past several years, but gold has nonetheless appreciated at 18% per year. In other words, gold has significantly appreciated over the past three years despite the fact that the US dollar stabilized.

These data (i.e., appreciation of gold during the last three years when the dollar was relatively stable) clearly suggest that the recent run-up in gold has become more speculative than fundamentally based. We are quite sympathetic to the investment strategy of buying gold when the US dollar is weak, but the recent popularity in gold would suggest that the dollar has resumed its freefall from earlier in the decade, and that clearly has not been the case.

Table 1:

Dollar Index (DXY) From 2001 to Present

		Gold	DXY
Peak	7/5/2001	265.35	120.9
Trough	4/22/2008	915.90	71.3
% Return		245%	-41%
Annualized Return		20%	-7%
Trough	4/22/2008	915.90	71.3
Current	4/26/2011	1506.30	73.8
% Return		64%	4%
Annualized Return		18%	1%

Source: Richard Bernstein Advisors LLC, Bloomberg
* For index descriptors, see "Index Descriptions" at end of document.

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What about inflation?

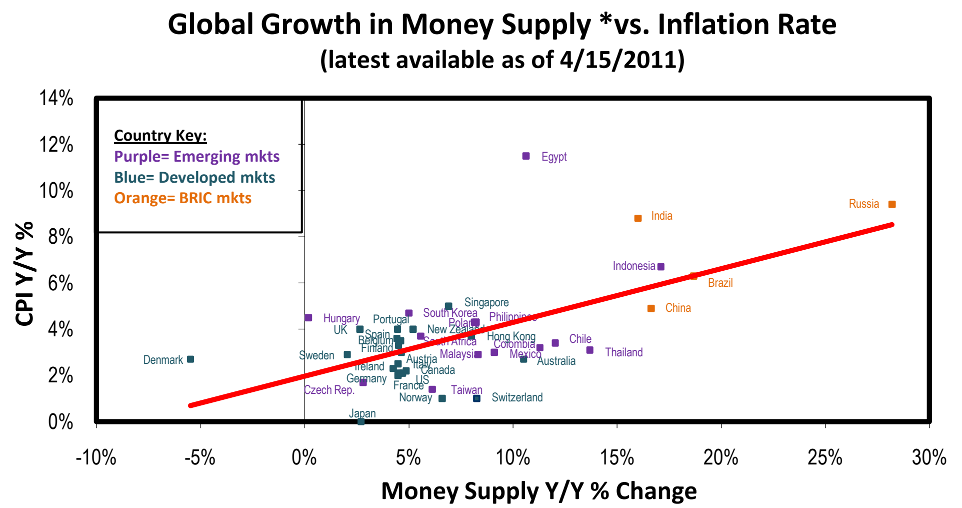
"Printing money" is today's derogatory description of what was once simply called "monetary stimulus". Some observers, distorting basic monetary theory, argue that monetary stimulus itself causes inflation. In fact, it is only the combustible combination of printing money *and creating credit* that stokes inflationary fires. With credit growth in the US still moribund, its M2 money supply growth is currently less than 5%.

Monetary theory states that an economy cannot sustain an abnormally high inflation rate without abnormally high credit growth that stimulates abnormal demand. Consider the recent housing bubble. Abnormal growth in housing-related credit caused abnormal demand for housing, which in turn caused abnormal inflation in home prices. The US might experience some normal, cyclical pricing pressures (indeed, the trough in US headline CPI occurred nearly two years ago), but sustained above-normal inflation seems unlikely unless credit growth begins to rapidly expand to stimulate demand beyond available supply.

It is easy to blame the Fed for the recent increase in US inflation, but analysis suggests that investors may be faulting the wrong central bank. Whether they realize it or not, US investors' current inflation fears are more closely related to emerging markets' loose monetary policies and resulting strong local-market credit growth than to the Fed's policies and US domestic credit growth.

Abnormal credit and money-supply growth in the major emerging markets have been spurring abnormal inflation exactly as monetary theory would suggest. Monetary growth over the past 12 months in Brazil, Russia, India and China now ranges between 15% and 30%. These are the highest monetary growth rates among the major economies. Very loose credit conditions have boosted excess demand, which has led to significant and rising rates of inflation. In fact, the BRIC countries now have among the world's highest inflation rates. Consistent with theory, high rates of credit growth have overstimulated demand, which has led to high rates of inflation (see Chart 1).

Chart 1:



Source: Richard Bernstein Advisors LLC, The Economist, Bloomberg
*Money Supply defined as M2 (or M3, if M2 not available, or IMF Currency Issued by Monetary Authority in National Currency, for EMU countries).

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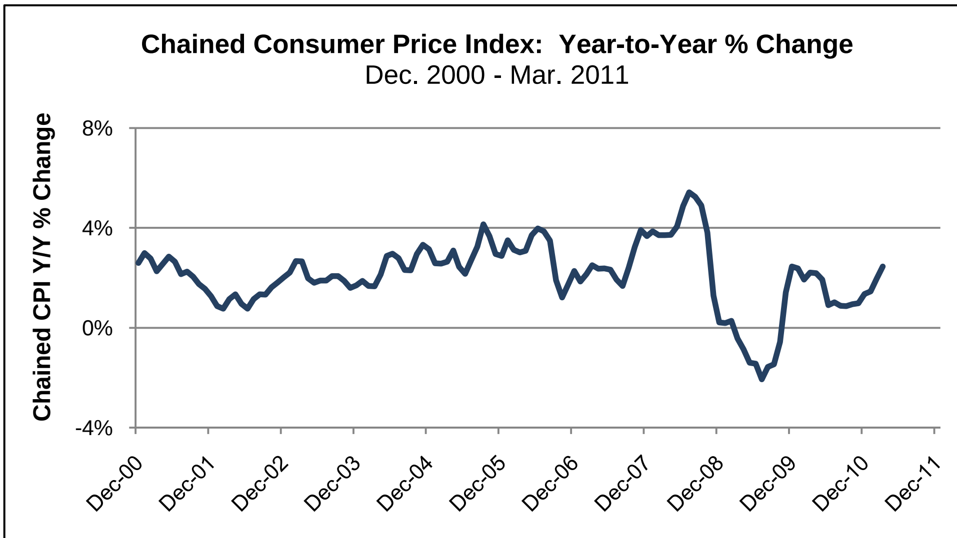
Is the CPI wrong?

It has also become popular to suggest that the CPI grossly mismeasures the rate of inflation in the US. We find these arguments off-base. Beyond the CPI, there are no measures of inflation that are showing a run-up in inflation that would warrant such an explosive rally in gold.

For example, Chart 2 shows the Chained CPI for all items. This is a measure of inflation in which component weights change depending on buying patterns. Items that are more frequently purchased at any point in time receive a larger weight than do those that are rarely purchased. Inflation using this measure is 2.5% on a year-to-year basis. The traditional headline CPI currently shows 2.7%. When adjusting for how purchasing patterns change through time, inflation is actually lower! The chained deflator for personal consumption expenditures (which is calculated separately from the CPI, but is similarly adjusted for spending patterns) currently shows only 1.8% inflation.

All inflation gauges show an increase in inflation. That is normal within the context of an improving economy. However, no measures that we can find suggest that US inflation is accelerating enough to justify gold's recent rally.

Chart 2:



Source: Richard Bernstein Advisors LLC, BLS, Bloomberg

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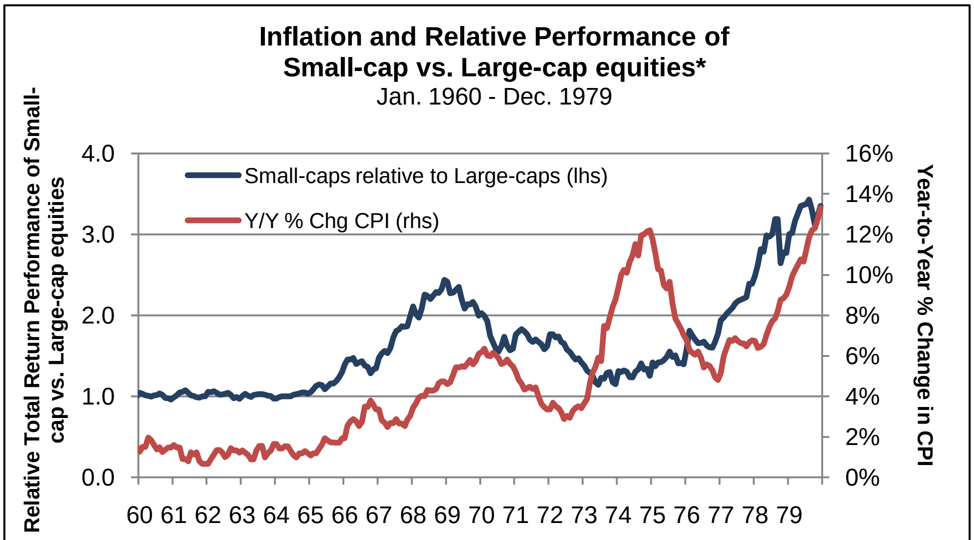
Why not small caps and munis?

Most of all, we remain puzzled why investors are so unwilling to look at other investments that tend to perform well during periods of rising inflation, such as small-cap stocks. We also think municipal bonds have some characteristics during this cycle that might make them particularly attractive in a strong nominal growth environment.

"Junk stocks" and "junk bonds" tend to perform better during periods of stronger nominal growth because it is more difficult for their issuers to go bankrupt during such cycles. Although certainly not all small-cap stocks should be classified as "junk", many studies have shown that smaller-capitalization companies tend to be of lower quality than larger-capitalization ones, and that the former have tended to outperform the latter during periods in which nominal growth accelerates.

Chart 3 shows that smaller-capitalization stocks outperformed larger-capitalization stocks by a factor of three during the severe inflation periods of the 1970s.

Chart 3:



Source: Richard Bernstein Advisors LLC, BLS, Ibbotson, Standard and Poor's
* For index descriptors, see "Index Descriptions" at end of document.

For similar reasons, junk bonds tend to outperform higher-quality bonds during periods of accelerating nominal growth. Traditional junk bonds have not actually been acting like junk bonds during this cycle. Corporate balance sheets are stronger than normal and, as a result, junk bond spreads are narrower than normal. Municipal bonds, however, are acting like junk bonds. Municipal bond spreads are quite wide for this part of the cycle, despite the general improvement in state and local finances. Munis appear to be playing the role of the junk bond for this cycle. Accordingly, munis would likely outperform during a period of strong nominal growth because of increases in income, sales, and corporate tax revenues that typically occur as nominal growth expands.

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Blinded by the glitter

Gold continues to appreciate, despite the fact that such appreciation doesn't appear justified by the depreciation in the dollar or by the rate of inflation. Investors prefer to argue that the data are wrong, rather than sell an overvalued asset. Historically, that has never been a good strategy.

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

Indices are not available for direct investment.

Small-caps: Ibbotson Small-cap Index. The Ibbotson Small-cap Index is a market-capitalization-weighted index that measures the performance of a broad cross-section of U.S. small-cap stocks.

Large-caps: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity. The Gold Spot price is quoted as US Dollars per Troy Ounce.

DXY Index: InterContinentalExchange (ICE) US Dollar Index. The ICE US Dollar Index, indicating the general international value of the USD, averages the exchange rates between the USD and six major world currencies, using rates supplied by some 500 banks.

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