

Bridgewater®

Daily Observations

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Gold is a Currency

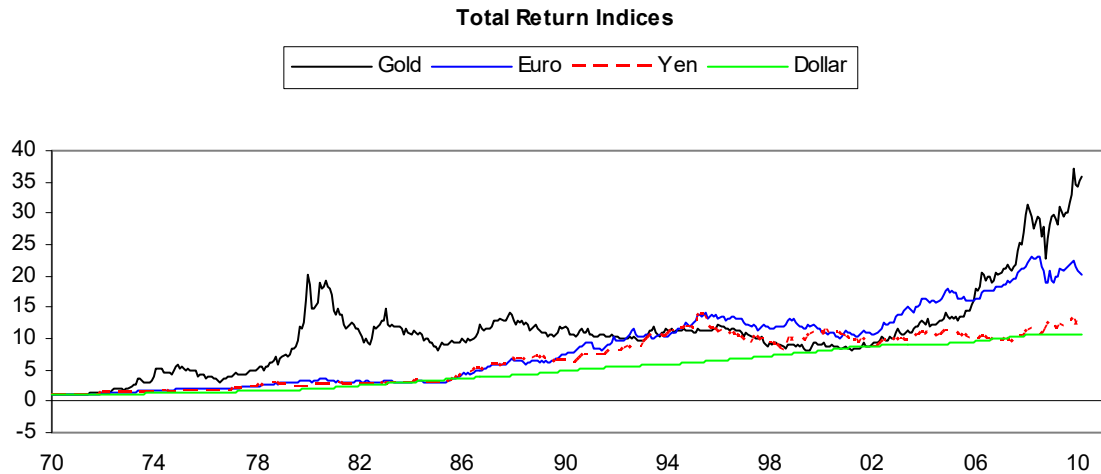
There seems to be some confusion about what gold is. It is not a commodity, nor an investment asset, as much as it is a currency. In fact, it can be said that it is the most fundamental currency because it is the oldest, the most widely accepted and the most basic currency through time. Gold has been a storehold of wealth and a medium of exchange for thousands of years, and in virtually all civilizations over the world, even with people in places that never had contact with each other. For example when the Spaniards conquered the Aztecs they both considered gold their most valued storehold of wealth. Not long ago (up until 1971) paper currency was considered to have no more intrinsic value than the checks in one's checkbook have -- i.e. like the checks, the currency's only value arose because it could be turned in to get the "real money", which was gold. Unlike other commodities, but like other currencies, its primary purpose is to be held as a storehold of wealth. Like other currencies, it is an effective medium of exchange because it can easily be carried in the form of coins and it is widely recognized and accepted for transactions. Unlike most investment assets, but like cash, it is not part of the capital formation process that benefits from increased productivity over time, so it has an expected long term return that is less than typical investment assets and is similar to cash.

But it is a different type of currency in that it can't be printed by central banks and it doesn't offer an interest rate. In fact paper currencies compete with gold by using interest rates to compensate holders of them for their depreciating values. Paper currencies depreciate in value faster than gold depreciates because paper currency supplies increase faster than supplies of gold increase. In fact, it would be more accurate to say that gold is much more stable in value than paper (and practically everything else in existence), though it doesn't appear that way because we measure the value of gold in terms of paper currency rather than measuring the value of paper money in terms of gold. But gold has been more stable in value than other currencies and just about anything else over time. For example, though gold's buying power was roughly similar to what it was during the times of the Old Testament and the Egyptian pharaohs (to the extent that we can judge the value of such things), there are not many currencies or companies now that even existed 50 or 100 years ago, let alone that have similar values to what they were way back then.

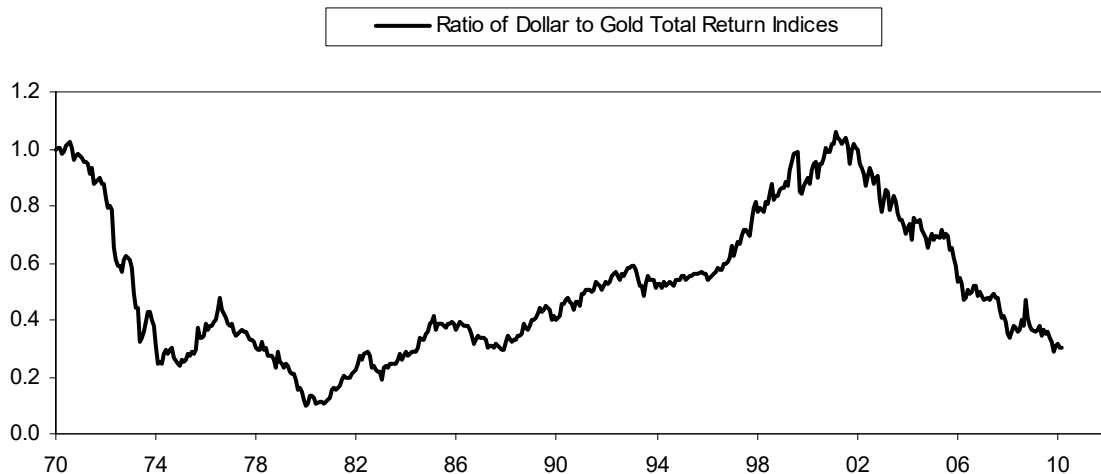
While central banks like to own gold, they don't like their citizens to want to own it because investors storing their wealth in gold makes capital formation more difficult. That perceived risk has been especially true when central banks needed to increase the supply of money in order to offset the effects of reduced credit during deleveragings -- and it was especially true when currencies were gold backed. When currencies were gold backed and deleveragings occurred, central banks always reneged on their commitments to convert money to gold because they needed to print more money which the link to gold would prevent (because the money would be turned in for gold). However, more recently -- i.e. since around 1980 -- as investors became more used to fiat currencies and more removed from gold, and gold seemed to be a less attractive form of money to central bankers, there has been no worry that gold would attract money away from other financial assets. So, this potential concern of central bankers has not been an issue.

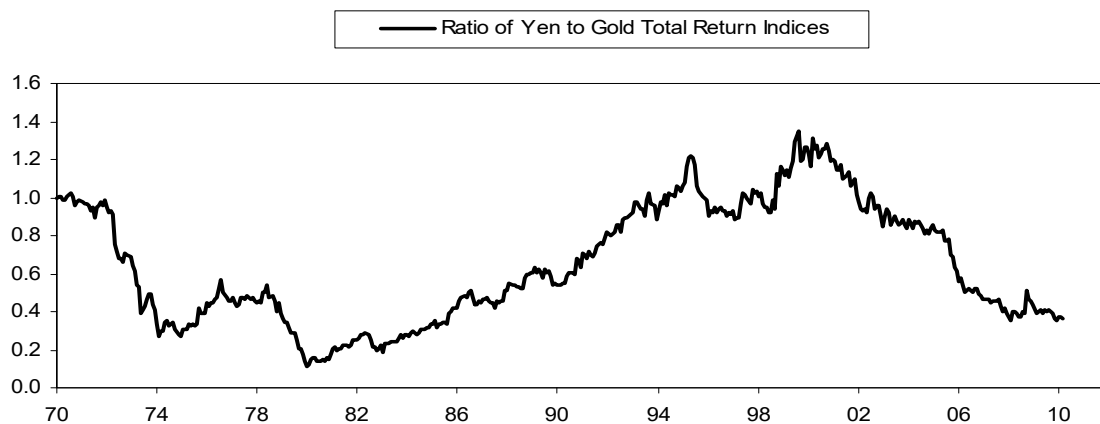
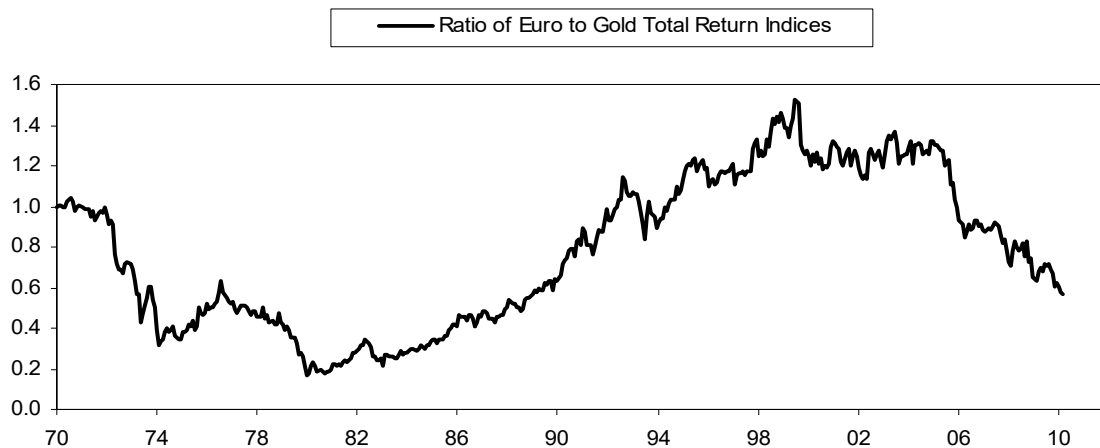
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Right now there are four major currencies -- the dollar, the euro, the yen and gold. The chart below shows their values through time. For the euro, which was formed in 1999 we derived its estimated value in earlier years by creating a weighted average of the currencies that made up the Euro at the outset. As shown, during this period, which was a fiat monetary environment, gold outperformed the other currencies, though there were long periods of time that it underperformed as well as outperformed.

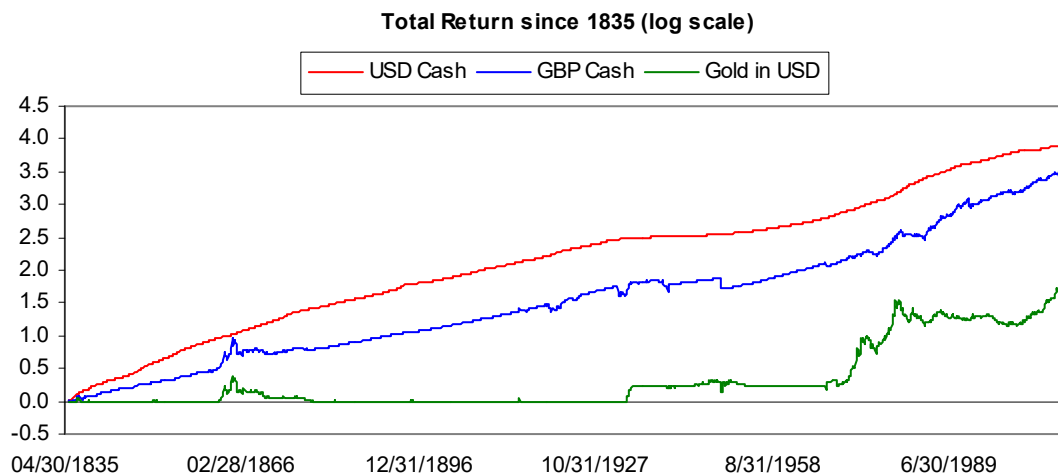


As shown in the next three charts, the value of the other currencies when measured in gold (or vice versa) is both variable and highly correlated. In other words, the value of all of the major currencies relative to gold tends to rise and fall both significantly and together. The periods of falling currency values are characterized by rapid money creation, low real interest rates and weak capital formation while the periods of rising currency values are characterized by slow money creation, high real interest rates and strong capital formation.



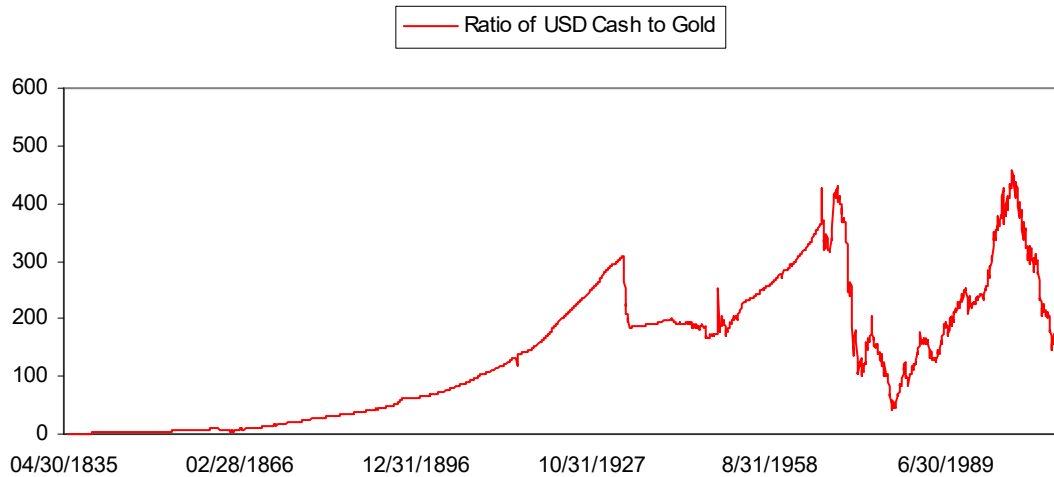


Though the value of gold outperformed the value of other currencies since 1970 (i.e. since there was a fiat monetary system) this wasn't always the case and should not be assumed to necessarily be the case. However, the values of the major currencies relative to each other tend to be correlated because their conditions are correlated and because their competition for trade and capital limits the extent to which the traditional currencies can deviate from each other without producing unacceptable consequences. The chart below shows the cumulative values of the dollar, sterling and gold going back to 1835.

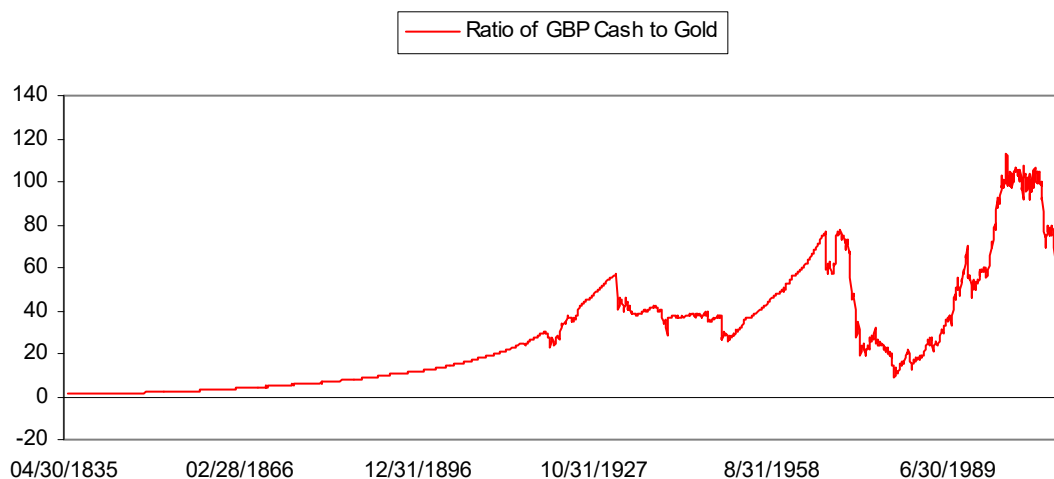


Source: Global Financial Data

The next two charts shows the value of dollars and sterling in gold terms since 1835.



Source: Global Financial Data



Source: Global Financial Data

Because the expected return of gold is about the same as the expected return of cash over long time horizons at the same time as gold is an effective diversifier against the depreciation of other currencies, we think that a significant amount of one's cash portfolio should be allocated to gold for strategic asset allocation reasons (i.e. tactical views aside). On this basis, we believe that gold is significantly under-owned. Concerning whether one should be tactically over or under weighted to gold, that primarily depends on what one expects the rates of money creation, real interest rates and capital formation to do. Said differently, the tactical allocations that one should make to other currencies relative to cash should be based on how attractive one considers these other currencies to be on the basis of these criteria. Currently, and probably for some time, we do not find the fundamentals of any of the major or minor developed country currencies to be attractive.

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