HEMISPHERE
CAPITAL MANAGEMENT

Reflections
August 2006

WHY WE OWN GOLD

An important, and sometimes misunderstood, item impacting investment returns is inflation. Investment returns require a common basis for measurement which in our case is the dollar. As a paper currency, the dollar has no fixed value except a promise by the government to pay you its current purchasing power. Throughout history, the "market value" or purchasing power of all currencies has declined (in many cases quite severely). Inflation is the measure of that decline in purchasing power or currency debasement. A 10% return is excellent if inflation is 2%, but poor if inflation is 9%.

Inflation is a function of the amount of paper currency and easy credit relative to the productive output of an economy. If the government managed supply of paper currency and credit exceeds the output of goods and services within an economy, inflation occurs.

Inflation is reflected through both the rising price of goods and services as well as rising asset values (e.g. house and stock prices). The consumer price index (CPI) is an attempt by governments to measure inflation relating to goods and services. Current annualized CPI statistics in North America are in the range of 2.5%. This level may be understated as the CPI only measures price levels of certain "core" goods and services and only in a particular manner. At present, the CPI appears to be missing items in the economy that have rising costs (i.e. plumbers, commodities, user fees, etc.). Despite this fact, goods and services inflation is low by recent historical standards.

So far this decade, North American inflation has shown up mainly in commodity prices and real estate valuations. With credit and capital-flow imbalances greater in the U.S. than Canada, one could conclude that "asset inflation" has been greater south of the border. The U.S. has both a massive Federal government deficit ($520 billion in 2005) and a ballooning trade deficit ($700 billion plus in 2005). Canada has both a Federal government and trade surplus. Our economy is also more resource based, thereby insulating Canada from commodity inflation. Regardless, there is substantial inflation throughout North America. Large debt balances within an economy require even more money for servicing that debt. In all economies one plus one still equals two - unsustainable distortions eventually show up somewhere. Excessive printing of paper currency and/or cheap and easy credit only produce a temporary illusion of wealth.

Thus, we buy gold as a direct hedge against inflation. Gold is an insurance policy against further currency debasement and the global woes this might create. After 20 years in the doldrums, gold prices have risen significantly in U.S. dollar terms since 2001. Think of this rise as a canary in a coal mine. Gold has a history of major moves in either duration or extent. So far, on an historic basis, the move in both has been relatively moderate.

The supply-demand situation for gold is also appealing. The global supply of gold will not grow in any meaningful way in the forseeable future. There have been few major discoveries of gold in this decade. Further, given the increasingly arduous task of securing permits, capital and equipment for a new mine virtually anywhere on the globe, even if a major discovery occurred tomorrow, it would be at least five (and probably ten) years before the discovery would translate to production.

Finally, gold has unique qualities as a financial asset. Unlike stocks or bonds, which generally represent paper promises of future cash flows, gold has intrinsic value and no default risk. This gives gold a "safety premium" that becomes especially prominent during uncertain times.