



### Appealing To Occam's Razor to Explain Gold Above \$500

On Wednesday, December 7, the London pm gold fix was \$515.40 per troy ounce – the highest dollar price of gold since April 6, 1981. The dollar price of gold began a noticeable ascent in 2002 as the foreign-exchange value of the dollar began a noticeable descent. From 2002 through 2004, while the *dollar* price of gold was rising, the foreign-currency price of gold was relatively stable. This year, the foreign-exchange value of the dollar has risen, but so, too, has the dollar price of gold. In other words, in 2005, the price of gold has risen not only in dollar terms, but in terms of most foreign currencies. Why?

Gold is a sterile asset. It pays no dividend or interest. Gold's appeal as an investment asset comes into play when central banks no longer provide for a positive inflation-adjusted return on short-term investments – that is, when the yield on the central bank's policy interest rate (or some related money market rate) is below the inflation rate. In this case, gold becomes a better store of value than short-term money market instruments denominated in fiat currencies. Gold soared to a record high price in 1980 after a number of years in the early 1970s of central banks keeping short-term interest rates below inflation rates. As the charts below show, history now is repeating itself, at least qualitatively. That is, the rate of wholesale price increases, which tend to be less hedonically-adjusted than the rate of consumer price increases, is far in excess of the level of central bank policy interest rates or related money market interest rates. Moreover, it is not clear that central banks are in a mood to rectify this situation. For example, although the ECB just raised its policy rate by 25 b.p. to 2.25%, it indicated that this could be a case of "one and done," probably because of political pressure. The Bank of Japan (BOJ) has recently been verbally signaling a 2006 rise in its policy rate. But the Japanese Ministry of Finance has simultaneously been verbally signaling a revocation of the BOJ's independence if it does raise rates. In the UK, with the economic growth decelerating, the debate seems to be more about when the Bank of England will cut interest rates again rather than will it will raise rates. And perhaps most importantly, the November 1 FOMC minutes hinted that the Fed is nearing the end of its tightening campaign. And, of course, the Fed seems fixated more on "core" concepts of price increases, which have been "better behaved" than more inclusive concepts.

So, we do not have to conjure up a lot of convoluted hypotheses as to why the price of gold is soaring against paper currencies. Rather, we can appeal to Occam's Razor (Google it) in coming up with an explanation – **global investors are losing faith in, as Jim Grant calls them, faith-based paper currencies as a store of value.**

Chart 1

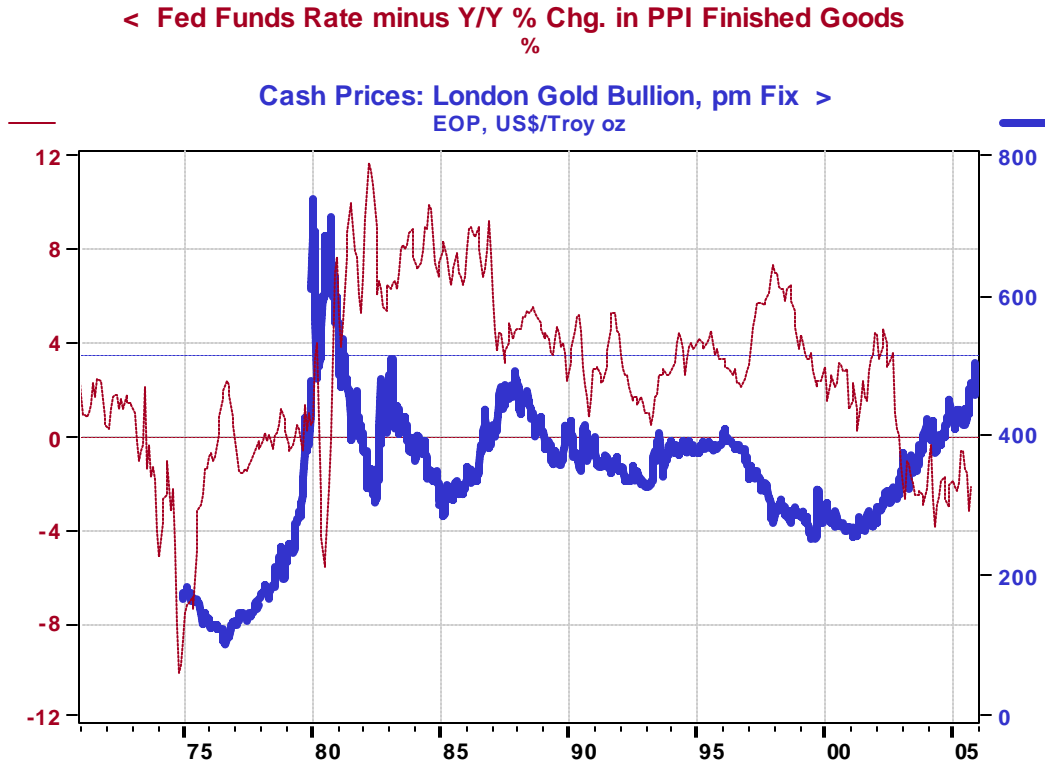
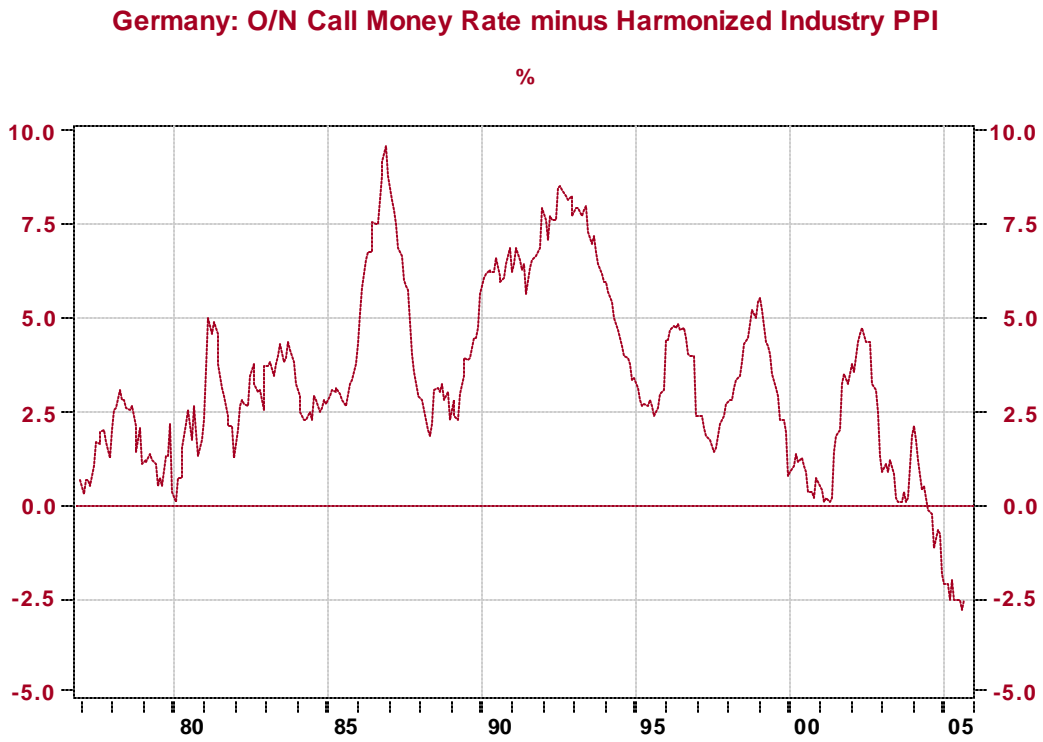


Chart 2



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Chart 3

**Japan: O/N Call Rate minus Y/Y % Chg. in Corporate WPI**

%

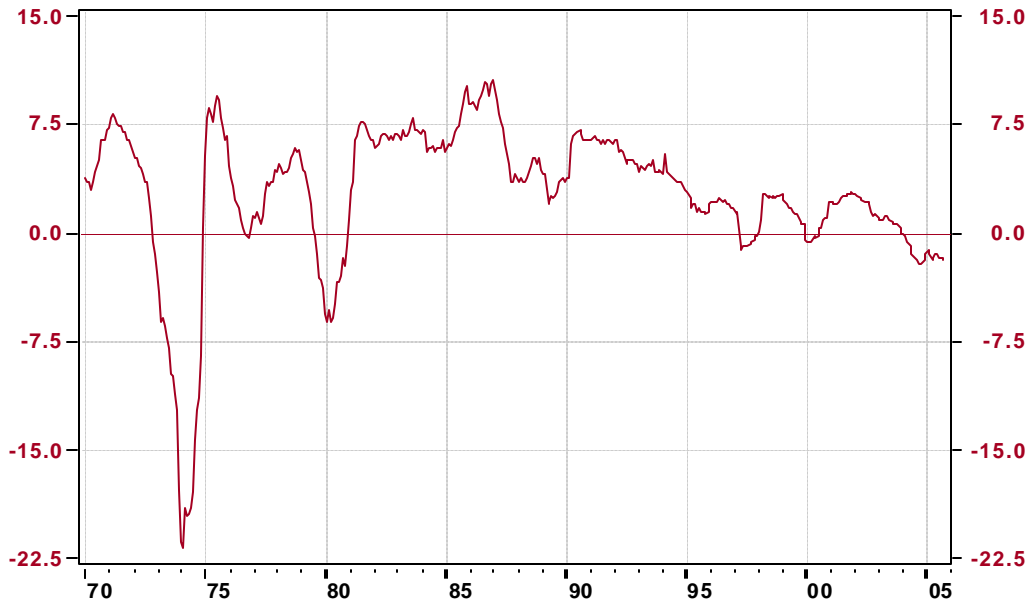


Chart 4

**UK: BOE Base Rate minus Y/Y% Chg. in Harmonized Industry PPI**

%



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