Pay No Attention To That Man Behind the Curtain

By Adrian Ash, Head of Research, BullionVault

Frank Baum published his original novel for children, The Wonderful Wizard of Oz, in 1900. Adult readers heard a satirical note in some of its 16 sequels, and they couldn’t miss the politics in many of Baum’s other fantasy stories and plays (an octopus takes offence, for instance, at being likened to the Standard Oil Company’s strangling monopoly). Yet it wasn’t until the mid-1960s that Henry Littlefield, a New York high school teacher, writing in the American Quarterly, highlighted the Wonderful Wizard’s “blatant satire” on turn-of-the-century monetary politics.

Baum himself claimed that Oz was “written solely for children”. His flight of whimsy certainly isn’t Animal Farm or Pilgrim’s Progress in trying to change opinion or morality. But like Littlefield five decades ago, literary professors and economic historians have since found relationships and analogies with events and characters from when Baum was writing that seem far too consistent to be coincidental. Put simply, the story pokes fun at the presidential election campaigns of 1896 and 1900, and the United States’ political battle over joining Great Britain and the rest of Europe in adopting a gold standard, rather than including more plentiful silver in its monetary system.

The Yellow Brick Road, Dorothy’s magic slippers (silver in the book, not ruby), the green glasses with golden bands everyone must wear in Emerald City, even the name of the fake wizard’s kingdom itself (‘oz’ is an abbreviation of Troy ounce, then as now the standard weight for bullion prices) together create what Littlefield called “a gentle and friendly Midwestern critique” of the late 19th century Populist movement. It campaigned for a return to silver against the “sound money” ticket of Republican William McKinley. His “gold bug” supporters often wore gold-coloured metal lapel badges in the shape of insects. The Populists backed William Jennings Bryan, some wearing “silver bug” badges to show their allegiance. Bryan secured the Democrat party’s 1896 candidacy with a fiery speech attacking the deflation in prices and wages that had followed the US abandoning silver coinage two decades earlier:

“Having behind us the producing masses of this nation and the world, supported by the commercial interests, the laboring interests, and the toilers everywhere, we will answer [the] demand for a gold standard by saying to them: ‘You shall not press down upon the brow of labor this crown of thorns; you shall not crucify mankind upon a cross of gold.” Says the Cowardly Lion: “I learned that if I roared very loudly, every living thing was frightened and got out of my way” – a trick that opponents now accuse both Democrat hopeful Bernie Sanders and likely Republican candidate Donald Trump of using in this year’s US presidential election campaign. The gold standard has also made an appearance on the 2016 hustings, but with the odd twist that tight money and higher interest rates now seem a populist promise, rather than an appeal to evil New York bankers (the Wicked Witch of the East keeps the little Munchkin people “in bondage...making them slave for her”, and her spells turn a hard-working woodcutter into the machine-like Tin Woodman).

There is something very nice about the gold standard,” Donald Trump said in March 2015, adding that “we used to have a very solid country because it was based on a gold standard”. Ted Cruz, Trump’s remaining competitor (at the time of writing) for the Republican nomination, has also said that the Federal Reserve “should get out of the business of trying to juice our economy, and simply be focused on sound money and monetary stability, ideally tied to gold”. Neither mentions returning to a gold standard anywhere on their campaign websites, but Cruz says that “a rules-based monetary system would restore stability to the dollar”, and his campaign has run a TV ad using footage of 1980-1988 US president Ronald Reagan speaking on gold-backed money, with the 2016 candidate vowing to “finish the Reagan Revolution”. 
Cruz’s advert doesn’t mention however that Reagan’s pro-gold commercial of 1979 – which blamed America’s then “rippling inflation” on the decision to “stop tying the value of the dollar to gold” taken by his (unnamed) fellow Republican Richard Nixon in 1971 – was never actually shown to voters. Reagan’s first manifesto didn’t mention the word “gold”, stressing instead how “the independence of the Federal Reserve System must be preserved”. Yes, the Gipper called in 1981 for the appointment of the Gold Commission already signed into law by his Democrat predecessor Jimmy Carter. But the final report published in 1982 found against returning to gold, and it was only in 1984 – after nearly four years of power and two deep recessions – that Reagan’s re-election platform said that “the gold standard may be a useful mechanism...to sustain price stability”, and only then because the record-high interest rates imposed by Fed chairman Paul Volcker were at that time “destabilizing actions (which) must stop”.

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Where would such double-dealing and opportunism in monetary politics leave gold (or silver) advocates today? Whatever Frank Baum’s intended joke in writing The Wonderful Wizard of Oz, the simplest monetary parable it offers in 2016 is that, if you follow the Yellow Brick Road, you will find there isn’t a great, powerful wizard at the end. Only an ordinary man, or woman, with no magical powers to put everything right. This insight is normally reserved for gold bugs, that dredged figure of fun for financial columnists who can’t understand why anyone would buy a little gold (or increasingly silver) as a store of value and a hedge against financial risk or political incompetence. Indeed, the then new 20-year low of May 1999 saw the New York Times ask: “Who needs gold when we have Alan Greenspan?” The fact was we all did, but with European central banks selling (and the Jubilee 2000 campaign urging the IMF to do likewise), the logic of rejecting gold was plain.

“If the demonetization of gold continues,” concluded Times columnist Floyd Norris, “the price is likely to keep falling as central bank sales more than offset any increase in demand from jewelers or industrial users. That could change if it turns out that central bankers are not the geniuses they are now deemed to be. But for now, the world believes in Mr. Greenspan and sees little need for gold.”

That nadir for gold marked the zenith of central banking’s reputation, and the harsh reality that no one is in charge (or at least, no one competent or trustworthy) has since dawned on people beyond the bug-o-sphere, albeit in fits and starts. It’s hard to think of a stronger advert for buying gold than Jim Cramer’s famous “They know nothing! NOTHING!” rant on CNBC about the US Fed in late 2008, when the celebrity fund manager banged his fists in sudden disillusionment with central bankers amid the failure of Lehman Brothers and the fast-worsening financial crisis. World investment demand for gold jumped by two-thirds that year from 2007, more than balancing the collapse in jewellery sales according to World Gold Council data. Central banks led by Washington then yanked the lever marked “Quantitative Easing” and turned the dial marked “Interest Rates” right down to zero. Including the surge in gold-backed exchange-traded trust funds (ETFs), those “extraordinary measures” saw net investment demand for gold total 175% of jewellery demand worldwide in Q1 2009, even as gold bar and jewellery holders in Asia and most notably India – traditionally solid buyers whatever the outlook – sold metal to take profits and raise cash amid the economic slump.

Professional wealth managers may not be wide-eyed innocents, but after confidence in central banking returned (and gold prices sank) from the peak panic of late-summer 2011, a few have suddenly found Janet Yellen, Mario Draghi and Haruhiko Kuroda as big a disappointment in 2016 as Judy Garland finds that clumsy old man behind the curtain in The Wizard of Oz. You might wonder what took them so long, but since the US Federal Reserve finally acted in December to raise rates off zero as promised throughout 2015, all but 17 of 112 central bank meetings worldwide have voted to hold or cut rates so far this year, with the European Central Bank cutting its refinancing rate – the key interest rate in the world’s single largest currency zone by GDP – to that zero level only just vacated by Janet Yellen’s team. The ECB has also boosted its monthly QE money creation to €80 billion, more than the US Fed conjured each month at its peak, while the world’s fourth-largest economy, Japan, has followed the ECB, Switzerland and Sweden into what many people find the frankly insane policy of paying negative deposit rates, charging commercial banks for holding excess reserves. More than two dozen countries now have key policy rates below zero, helping drive the yield offered by $8 trillion of government bonds below zero according to Bank of America-Merrill Lynch data.

The more desperate that central bankers become, the more they succeed in making gold bugs of us all. The brave new magic of sub-zero rates breaks has yet to juice corporate investment, consumer price inflation or GDP growth. But it breaks what central bankers previously feared was the ‘zero lower bound’ of interest-rate policy, and that makes rare, indestructible gold more attractive than many near-cash investments on cost alone. Negative deposit rates in the Eurozone and Japan are now approaching commercial storage charges on physical gold (BullionVault users pay 0.12% per annum), while Swiss interbank Libor rates and the Swedish Riksbank’s deposit rate already exceed even the higher fees of gold-backed ETFs. The cheapest, the iShares Gold Trust (NYSEArca:IAU), costs 0.25% per annum. The Fed’s wizards in Emerald City have in the meantime downgraded their US growth, inflation and interest-rate forecasts, spooking even the most trusting investors. Because if the Fed actually does know what it’s doing, rather than just making it up as it goes along, then it must be really scared about the economic outlook.

Gold’s sudden revival comes off a low base after four years of price falls. But sliding to seven-year lows at the end of 2015, the number of shares in issue from the giant SPDR Gold Trust (NYSEArca:GLD) jumped 25% in the first three months of this year, the fastest quarterly growth in the gold-backed fund since US quantitative easing and zero rates began at the start of 2009 (see Chart 1). This surge also erased the last two years of outflows from the GLD’s gold bullion backing, and while institutional ownership of the trust’s shares had fallen to just 22% by end-2015 from the 40% level reached at its peak size of 2012, it is a fair bet that money managers led the charge.

The bullish gold position amongst hedge funds and other money managers speculating in Comex futures and options has also turned sharply higher, growing at the fastest pace since the UK government and Bank of England flirted with turning the failure of Northern Rock into a full-blown banking run in late 2007. Retail
demand for physical bar and coin products has leapt as well in New Year 2016, but from a stronger level, because as prices fell ever lower over the last five years, the more that private investors built their holdings. Last year’s fresh turmoil in the euro, plus the currency zone’s move to QE and ever-more negative interest rates, saw the Austrian Mint’s gold sales rise 45% from 2014. Between January and March this year, the US Mint sold 12% more gold Eagle coins than the last half-decade’s Q1 average, and 18% more silver Eagles.

Mint figures don’t say whether retail distributors have yet sold all this stock to consumers. Like the raw ETF data, they also don’t say how much demand is coming from new buyers rather than from existing gold bugs already wise to the fact that central banking is really a “confidence game” (to quote the title of one detailed history of Western policy-making in the 1970s and 1980s). But our data at BullionVault do confirm a sharp jump in the number of private Western investors peeping behind the curtain (almost nine in ten of our 60,000 users live in North America or Western Europe), with new account openings rising 60% between January and March compared with last year’s quarterly average to reach a level not seen since spring 2013. Back then, gold prices suffered their worst-ever fall, dropping 25% against the US dollar and drawing a wave of ‘bargain hunting’ from investors buying gold at what were then the lowest prices in almost three years. Gold in February touched levels not seen since spring 2013 in contrast ended March this year 17% higher versus the dollar from the end of December, its strongest quarterly rise since Q3 1986.

A straw in the wind perhaps, but this year’s fresh demand suggests that a new wave of private investors is seeking shelter in physical gold. On the other side, however, existing investors held off making new purchases at gold’s sudden multi-month highs (priced in sterling, gold in February touched levels not seen in two-and-a-half years). Indeed, the number of BullionVault users choosing to sell gold leapt by two-thirds in Q1 from 2015’s four-quarter average. As these previous buyers cut losses or took profits, that capped our sentiment measure – the Gold Investor Index – at the highs of last autumn, when new price falls drove more bargain-hunting again (see Chart 2). Each month, this index tracks the number of net gold buyers over net sellers as a proportion of all existing holders, rebased so that a reading of 50.0 would signal a perfect balance.

More traditional retailers dealing in small bars and coin (both more difficult and costly for investors to resell than vaulted bullion traded online) don’t as yet report a rise in customers selling back. But based on revealed preference amongst the largest single pool of private bullion investors online, the Gold Investor Index offers an early indication of broader behaviour. After the bonanza of bargain-hunting gold bug demand since 2013, the wider retail gold investing industry – like central bankers – might want to note the example of Japan.

The developed world’s first joint real-estate and stockmarket bubble to burst, Japan was first to slip into deflation, and turned to QE and zero interest rates before Western central bankers did. Its private households also turned to gold ahead of North American and European savers, building large holdings before world prices bottomed and the bull market began in 2001. Higher prices then invited those owners to sell, especially from 2005, when gold broke above levels last seen when Tokyo’s property and financial crash began in 1989. Japanese savers have been net sellers of gold ever since (see Chart 3), with data published by major provider Tanaka Precious Metals suggesting that its clients bought 525 tonnes of gold over the last 15 years but sold 664 tonnes, running down the investment holdings built during the country’s first “lost decade”.

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Western households, in contrast, couldn’t reduce their investment holdings during the bull market of 2001-2011, because they hadn’t previously built any to sell, choosing instead to buy real estate, equities and bonds under the magic spell of central bank stability epitomised by ‘the Maestro’ himself, Alan Greenspan. Should this early 2016 rebound continue, Western households cannot repeat the rediscovery of gold they began a decade ago, and retail dealers expecting a repeat of the one-way flows of the last bull market could face a rude awakening. Because whether or not the retail gold investing business is over the rainbow yet, the fact is we’re not in Kansas anymore. At least some of the bargain-hunting stockpiles amassed on lower prices since the peak is very likely to come back to market, even as new investors and savers discover that there isn’t a wizard behind the curtain.

Adrian Ash is Head of Research at BullionVault, the physical gold and silver online exchange. Launched in 2005 and winner of two Queen’s Awards for Enterprise, it now cares for $2 billion of client property, all held in Good Delivery bars in the user’s choice of London, New York, Singapore, Toronto or Zurich. Adrian was formerly Editorial Chief at the UK’s largest publisher of regulated advice for private investors.