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Gold: Should you buy now?

by Jerry Marlow
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The world is in the throes of a financial crisis. As you watch the value of other investment assets plummet, you may ask yourself, "Should I invest in gold? Would gold protect me against inflation? Would gold protect me against devaluation of my home currency? Is gold really a good store of value?"

Gold hit nominal peak in March 2008

The price history of gold is different in different currencies. In most major currencies, the price of gold reached an all-time high earlier this year. On March 18, gold's U.S.-dollar price reached \$1,006.75 a troy ounce.

Several factors pushed gold to its dollar peak price in March. The U.S. dollar was down against major currencies. Against the yen, it was at its lowest level since 1995.

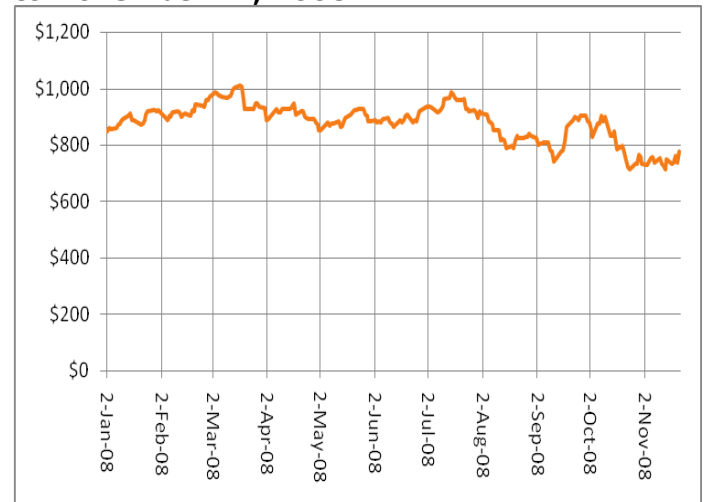
The U.S. Federal Reserve appeared to be more concerned with promoting growth than preventing inflation. Prices of oil and agricultural commodities were climbing. Investors who consider gold to be a hedge against inflation were buying.

Hedge funds that pursue trend-following strategies were betting that the price of gold would continue climbing. They were buying.

The financial system appeared to be becoming increasingly unstable. People who have greater faith in gold than in currencies backed merely by the full faith and credit of governments were buying.

Through exchange-traded funds (ETFs) gold had become easier to buy.

Gold's daily prices in U.S. dollar January 2008 to November 21, 2008.

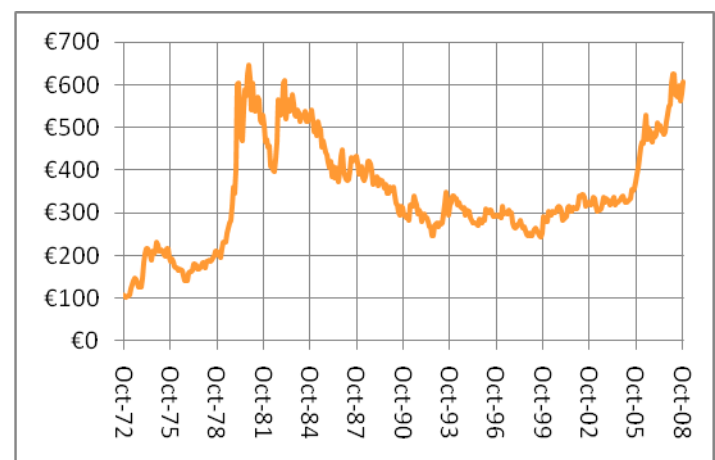


High price of \$1,006.75 on March 18, 2008.

Gold's monthly prices in selected currencies October 1972 to October 2008.



U.S. Dollar



Deutsche Mark → Euro

Before 1999, Deutsche Mark converted to euro at the irrevocable euro conversion rate.

Down by 23% since

Since its March peak, the U.S.-dollar price of gold has fallen by 23%. Why?

As the global crisis intensified, many investors in emerging markets shifted their investments to dollar-denominated investments. The dollar's six-year decline against the euro and some other leading currencies reversed itself.

Price climbs in oil and agricultural commodities turned around. The specter of inflation lessened.

The credit crunch and declining asset values forced many hedge funds to sell whatever they could. Some, no doubt, sold gold.

While the financial system continued to wobble and weave, the fear factor sparked by its new-found vulnerabilities may have begun to wear off.

What next?

The current price of gold represents the equilibrium point of investors' expectations about the future. As expectations change, prices will change.

Expectations about inflation are caught in the crosscurrents of two possibilities: A looming recession promises to reduce inflation and may even cause deflation. To fight the recession and financial crisis, governments are likely to run deficits and pump cheap money into their countries. Deficits and fresh supplies of cheap money often lead to increased inflation. If you expect recession fighting to produce inflation, buy gold.

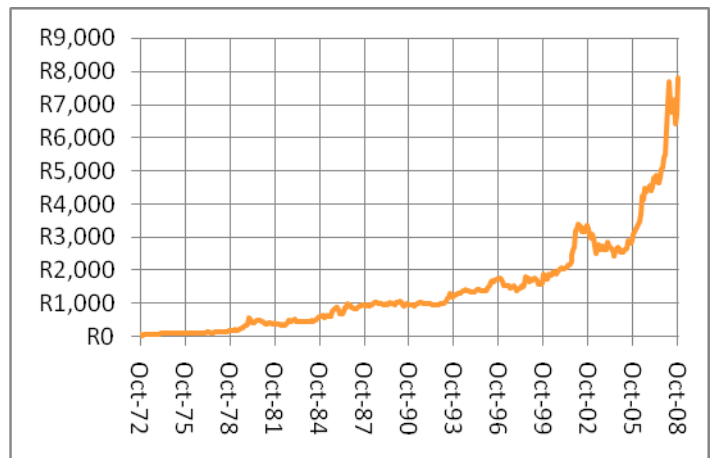
If global recession sets in, the currencies of commodity-producing countries could well weaken. The Australian and New Zealand dollars, which lost ground in 2008, may lose more in 2009.



Yen



UK Pound



South African Rand

In the midst of financial turmoil, the most vulnerable currencies are those of countries whose banks, companies and households owe large amounts of short-term debt denominated in foreign money. Witness the fate of the Icelandic krona.

If 2009 sees currencies crash, the dollar is unlikely to be one of them. If your home currency looks vulnerable, you may find some protection in gold.

On the internet and in bookstores you may encounter hysterical rhetoric that urges you to purchase gold bullion and coins to use as currency when the banking system collapses and paper money becomes worthless. If you estimate the probability of societies returning to barter to be one in a million, you may want to invest one-millionth of your wealth in gold coins. Store them in the vault in your bunker next to the cans of tuna fish.

If you think of gold as a long-term store of value, think again. After the 1980 peak in prices, the price of gold over the next two decades fell in nominal terms by two-thirds. Before you buy, figure out when to sell.

The price of gold is exposed to one risk that other assets are not. Many central banks hold large quantities of gold as part of their monetary reserves. Were one or more of the central banks to dump large quantities of gold onto the world market, the price of gold could plummet.

If you can't think of a rational reason to invest in gold but think others will buy for irrational reasons, then buying before they do may be the rational thing for you to do.



Australian Dollar

Source: World Gold Council