Part One

THE LOGIC OF HARD MONEY IN THE NEW INVESTMENT WORLD

Chapter 1

Gold Driver 1: The Increasing Likelihood of Fiscal Crises in Major Economies of the World

Adopting the euro is effectively irreversible. Leaving would require lengthy preparations, which, given the anticipated devaluation, would trigger the mother of all financial crises.

—Barry Eichengreen, professor of economics, University of California, Berkeley and former senior policy adviser, International Monetary Fund[1]

Following banking crises, we usually see a bunch of sovereign defaults, say in a few years. I predict we will again . . . . It's very, very hard to call the timing, but it will happen.

—Kenneth Rogoff, professor of economics at Harvard University and member of the Group of Thirty, February 23, 2010[2]

"Will sovereign debt be the new subprime?" was a stunning question posed by one of the editors of the *Financial Times* in late 2009.[3] He was comparing the bonds issued by national governments to the subprime bonds linked to the U.S. residential market that sparked the global credit crisis of 2008, the worst since the Great Depression. But subprime real estate bonds were a very small part of the then $22 trillion U.S. mortgage market, and a minuscule fraction of the total global financial asset market that existed in 2007. Sovereign bonds, such as the ones issued by the U.S. Treasury, are in a different category altogether for four important reasons that should make the potential for a sovereign crisis a key driver of gold investment in the years ahead.

First, sovereign bonds (which include U.S. Treasury bonds) represent the largest part of the $83 trillion global bond market, the largest market of any kind in the world. (See Table 1.1, which shows bonds issued domestically) Total global government-issued bonds outstanding in 2009 amounted to over $30 trillion, twice the size of the United States economy. (See the Public column in Table 1.1.) The whale's share of that amount is concentrated among the 10 largest economies, and the United States and Japan have issued more than half of the world's total sovereign debt outstanding today. The emergence of at least one government debt crisis is relatively common from decade to decade in smaller economies, like Argentina and Iceland in the one that just ended, and invariably warnings about unsustainable deficits and debt came years

Table 1.1 Domestic Bond Market by Nationality of Issuer (in Billions)

	Total	Public	Financial	Corporate
United States	24,622	7,888	13,819	2,914
Japan	11,077	9,113	1,197	767
Italy	3,262	1,780	1,055	427
France	2,921	1,437	1,160	324
Germany	2,593	1,364	929	300
Spain	1,746	540	543	663
United Kingdom	1,223	827	378	19
Canada	1,035	670	254	110
Belgium	553	373	144	36
Others	10,634	5,795	3,795	1,045
World	**59,666**	**29,787**	**23,274**	**6,605**

SOURCES: Bank for International Settlements, International Financial Services London.

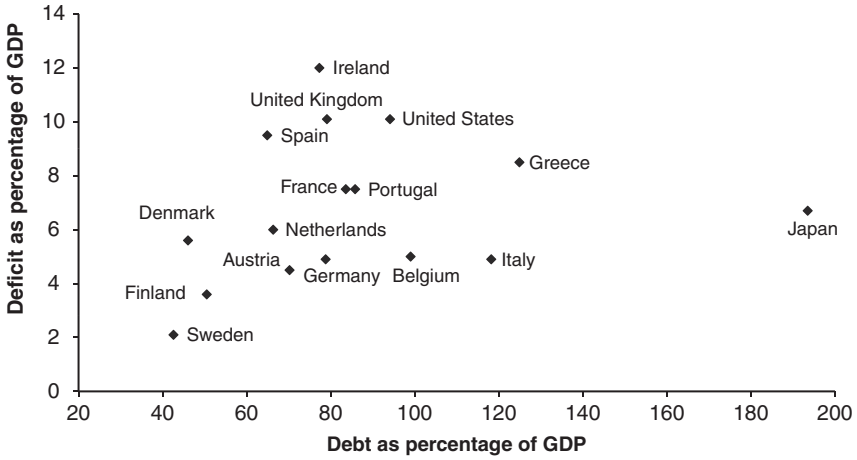

Figure 1.1 General Government Debt and Deficits as Percentage of GDP, 2010
SOURCES: European Commission, Credit Suisse.

ahead of eventual crashes. But the surge in truly alarming public sector leverage among the largest economies is a fairly new phenomenon, at least during peacetime.

The word *unsustainable* is increasingly being attached to the deficits and national debts of the United States, Japan, and the United Kingdom—countries that collectively account for almost half the world's GDP—and economists today frequently express great concern and for good reason. Figure 1.1 presents countries on a chart that positions them based on the sizes of their deficits and debts relative to the size of their economies. The United States, in particular, is shown to be very near Greece, a country in financial crisis: The American deficit and national debt are extremely high, and yet they do not include the weight of massive unfunded liabilities that will also need to be dealt with in the future.

If there is a problem in the sovereign debt arena, perhaps the credit crisis of 2008 was merely the introduction to something far more severe in scale. Following years of tremendous bond issuance (Figure 1.2), most of the major economies listed in Table 1.1 have serious debt challenges today. The United States, for one, will borrow 40 cents out of every dollar it spends in 2010. But its financing requirements are so large that it needs to fund a large portion of its obligations in foreign markets. In fact, most of the U.S. Treasuries bonds in circulation today are owned outside the country's borders, making the United States hugely dependent on other

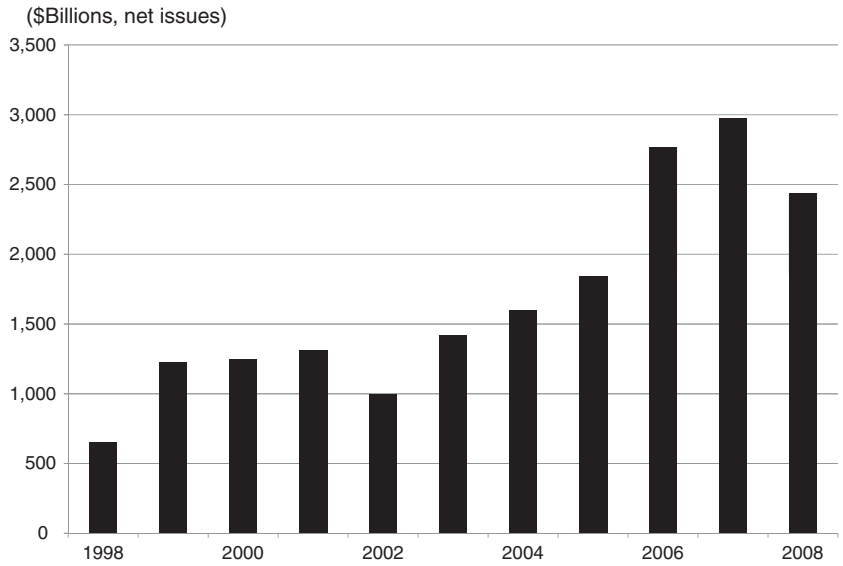

Figure 1.2 Soaring Bond Supply: International Bond Market Issuance, 1998–2008
Sources: Bank for International Settlements, International Financial Services London.

nations. But perhaps Japan is facing the most challenging situation. Its $9 trillion in government bonds outstanding is larger than the amount of U.S. Treasuries outstanding, but Japan's economy is about a third the size of the American one. This makes Japan's debt as a percentage of its GDP the largest of any developed economy, placing it to the far right in Figure 1.1. Furthermore, its borrowing rates, at well below 2 percent for a 10-year bond, cannot realistically go much lower, so the clear risk is that rates will climb—making Japan's debt burden even more painful–unless it is able to constrain its debt levels.

This leads to the second reason to fear a government debt problem: Sovereign bonds are the obligations issued to finance the operations of governments everywhere, which would make a sovereign crisis a crisis of government. If Wal-Mart, the world's largest retailer, defaulted on a bond—or all its bonds outstanding—it's unlikely this would be disruptive to the world economy or even the United States. If it ceased to operate, people could buy goods at alternative retailers and Wal-Mart would probably reopen with different owners—its creditors. But if, say,

Greece defaulted on its bonds and was unable to fund its daily operations without external help, this would cause a national economic and banking crisis. The Greek government has millions of employees and a substantial part of the country's banking assets are held in government bonds, which would be falling sharply in value and impairing capital in the financial system. It would be a national catastrophe and foreign assistance would have to come from European governments or agencies like the International Monetary Fund (IMF) to prevent an economic catastrophe. However, if a sovereign crisis emerged in a significantly larger economy—one, like the United Kingdom, which is also a major international financial center—the catastrophe would extend beyond its borders and it would be difficult for relatively limited agencies—like the IMF, which mostly works with smaller economies—to help.

Third, sovereign bonds, as an asset class, are widely regarded today as the ultimate portfolio insurance. (As discussed in the Introduction, gold is not regarded as a major investable asset in modern professional asset management.) The quality of bonds issued by the world's leading economies has not been questioned for decades. To the contrary: investment advisors today invariably recommend that conservative clients aiming to protect their investments lend money to the government: "Buy bonds." Government bonds—particularly those of the U.S. Treasury, which has never defaulted—are *risk-free* by definition, a core holding at any major pension fund or insurance company. They are seen as the unquestionable rock-solid asset to cling to when the stock market gets rocky. Corporate bonds sink during bad depressions, and the 2008 crisis was no exception. However, government bonds rose in value, as they normally do.

But the perennial "no-brainer" recommendation that you should buy Treasuries "if you need 100 percent safety" may finally require use of a brain. What if, due to the continuing sluggish economy and need for even more government spending, deficits remain elevated and government debts climb even higher? This is actually what most economists *are expecting will happen*, mostly because there are large expenditures blowing from the future due to the coming retirement of large segments of the populations of the United States, Japan, and the United Kingdom. The safety of government bonds would come under even greater scrutiny and, should they begin to fall in value, would start to threaten the balance sheets of global pension funds and insurance companies. Consider that

pension funds around the world hold $24 trillion and insurance companies $19 trillion in assets. And there are hundreds, if not thousands of bond funds in the world that manage trillions more, a great many of which are large sovereign bondholders.

Finally, there is the risk that trouble in the bond market could harm the valuation of other bonds, as well as stocks and other asset classes. The so-called risk-free interest rate is one of the key components of the Capital Asset Pricing Model (CAPM). Although not without its problems, CAPM is the widely accepted theoretical underpinning for the valuation of all major financial assets, since it provides the discount rate to determine *valuation*, what stocks and other financial assets are actually worth. Strictly speaking, the risk-free rate, as the name implies, is the yield on a bond whose issuer will never default, which for the United States is the 10-year bond issued by the U.S. Treasury Department. However, considering the importance of the U.S. dollar in the global monetary system as well as the perceived stability of its government finances, the U.S. 10-year Treasury bond yield is also the foundational rate used to value most of the bonds in the world: When a Brazilian or Korean 10-year bond is issued, its price is generally determined in reference to the U.S. equivalent. But the U.S. 10-year Treasury bond yield is also the risk-free rate metric used in many valuation models for stocks, real estate, and many other types of financial assets in many countries. Consequently, if the risk-free rate began to rise, as a result of investors dumping U.S. bonds, it would harm the valuation of a great many assets in the world today.

The U.S. government's freedom from risk was severely undermined by the 2008 financial crisis. In what Morgan Stanley's chief global strategist called "the Great Swap," the U.S. government was forced not only to spend as consumers moved to save; it also had to swap its quality assets (Treasury obligations) for malodorous mortgage-backed securities and other assets of extremely poor quality to help banks cleanse their balance sheets and be able to lend again. Due to the severity of the credit crisis, the U.S. government was forced to undermine the quality of its balance sheet, which put the risk-free interest rate into question. Unfortunately, the crisis arrived just as government spending was about to begin to surge: On January 1, 2008, the first of 78 million Americans, members of the baby boom generation, began to retire and Social Security,

Medicare, and Medicaid expenditures are beginning to expand dramatically. As our leaders deal with these tremendous challenges, which present investment risks to U.S. Treasury bondholders, it is probable that some part of the trillions the world has invested in U.S. Treasury obligations will begin to move into gold.

Notes

1. Barry Eichengreen, "The Euro: Love It or Leave It?" voxeu.org, May 4, 2010.
2. Aki Ito, "Harvard's Rogoff Sees 'Bunch' of Sovereign Defaults," *Bloomberg*, February 23, 2010. The Group of Thirty is a panel of central bankers, finance officials, and academics headed by former Federal Reserve Chairman Paul Volker.
3. Gillian Tett, "Will Sovereign Debt Be the New Subprime?" *Financial Times*, November 23, 2009.