Australian Gold Fund Economic Commentary

Deciphering the Mystery of Gold, Inflation and Purchasing Power in Australia

21st November 2019

Key Points

- Over the 1990-2019 period, Australia has largely been a lucky country that dodged the devastation of several financial crises, but central bank policy of low interest has led to inflation and rising property prices.
- The low interest rate environment encouraged more borrowing and increased spending, leading to the impression that households have improved their living standards as they can afford to buy more goods and services.
- Average earnings have been dwarfed by property price increases, which provided a "wealth effect" for those who purchased early but confounded those who want to purchase properties later on to need to rely more on debt.
- The silent inflation of rising costs of necessities and home prices, especially in Sydney (and likely in major Australian cities), has been largely unnoticed. Necessity goods and services have increased more than discretionary items, giving people the impression that they can afford more luxuries.
- In the midst of the silent inflation, the gold price has been catching up substantially since the mid-2000 and those invested in gold would have seen their purchasing power increase especially in the last five years.
- Gold is not only an effective hedge for inflation but as a standard measure for wealth, it provides a clearer picture of what is happening in the economy and also assist in financial decision-making since it is a more reliable measure.

Almost Thirty Years of Silent Inflation

Australia is a lucky country by many standards in that in the last 29 years, we have been able to boast that we have dodged the fallout of several financial crises and market crashes and have been able to emerge still standing. However, one thing is certain, Australia has taken many body blows and while we have been bruised but not taken down, we have sustained some massive internal bleeding and it is starting to manifest itself in the recent five years. For one, the Reserve Bank of Australia has cut the 24-Hour Cash Rate three times in 2019, and within four months to a record low of 0.75%. At its peak in early 2008, this rate was 7.25%. The low interest rate is in conjunction with the last cylinder in our Australian economic motor, that of the residential property market, starting to splutter and choke. When Australia entered into the 1990's, our economy was reliant on primary producers (agricultural products and minerals), manufacturing, tourism, clothing and heavy industries. Major cities would have factories, warehouses and workshops that produced goods to sell locally and also some being exported.

However, over time, we began to squander away our opportunities as a result of rising labour costs, production inefficiencies and also our inability to protect our export industries against the Asian powerhouse. Globalisation brought with it the positives of financial and informational integration, but at the cost of Pareto efficiency of comparative advantage on steroids where capital intensive countries lost their manufacturing industries to countries that employs cheaper labour.

The result of this was Australia becoming more a service-based economy and one reliant on imports. We also began to rely more on debt as the interest rates set by central banks around the world fell with each successive economic crisis or recession, both domestically and overseas. People consumed more than the nation produced and over time, household debt began to rise. To boost consumer confidence whenever economic indicators rings an alarm that recession is at the door, interest rates fell and more liquidity was injected into the economy. Households slowly realised that they needed a dual income household to maintain their living standards and credit cards and loans became the way to keep everything running. Soon enough, people would grace the streets looking like they have it all – a brand new luxury car, branded clothing, fine dining, manicures and holidays that make their friends jealous but behind closed doors, they sweat over their bills, bicker over who made the purchase that busted their credit card limit and ponder over whether they need to refinance their homes.

What happened?

Prices, Inflation and Purchasing Power

Since the decoupling of the US dollar from gold as a result of the 37th US President Richard Nixon on 15th August 1971 when he closed the convertibility of US dollars into gold, the entire financial system began to adopt the US dollar as the unit measure of wealth. Prior to this, the US dollar and hence other currencies of the world was fixed to gold and hence one could use gold as the standard measure of wealth (hence why this was called "the gold standard"). When we refer to the price of something, we naturally quote it in terms of our domestic currency. However, this is actually misleading.

Central banks around the world have been creating currencies on behalf of their governments to cover for budget deficits, repaying debt or to stimulate the economy by boosting consumer liquidity. This leads to the growth in the currency supply. Currency is a means of exchange used for purchasing goods, services and assets. Productivity is the creation of goods, services and assets. The economic definition of inflation is the increase in the price of goods and services in the economy, with the Consumer Price Index (or the Average Weekly Earnings) acting as proxies. However, a purer economic definition of inflation is simply the excess in the growth of currency (the means of exchange) to the growth of productivity (what currency or money is used in transactions).

We can all agree that a $10 note will remain as a $10 and that a ceramic drinking cup will remain the same over time. However, both can be created and the relative price of the note to the cup is dependent on the relative supply and demand. The scarcer the availability of cash relative to the goods or services, the lower the price (deflation) while the price increases (inflation), vice versa.

This concept is not difficult to understand but what we have a problem with is that of optics – the appearance of reality.

You see, central banks have created so much currency in recent times, especially in the last ten years, that we see prices rise but we do not easily notice that goods and services are less affordable. Throw into the deal the availability of cheap credit (thanks to low interest rates, also a natural follow-on of increasing supply of currency) and we think "no problem, no worries". However, reality soon strikes as our debt mounts and interest payments take up a bigger portion of our weekly budget. Thus, we soon realise we can afford less, even as our income may continue to grow with annual salary increases (if you are lucky!)

At this point, the all-important and neglected purchasing power makes itself known. Most likely you are receiving higher salaries or wages than you did five, ten, twenty or thirty years ago, assuming you have not reduced your work hours or changed to a different career path requiring you to start all over. However, prices of most things have been rising in the meantime. Remember the good old days in the early 1990's when you would buy a trolley full of groceries with a $50 note? Today, $50 will probably get you much less, or you are buying the budget brand. That's inflation though. Purchasing power is how much can your pay-check afford, and how many hours you need to work to get the same good or service.

Remember these rules when evaluating purchasing power:

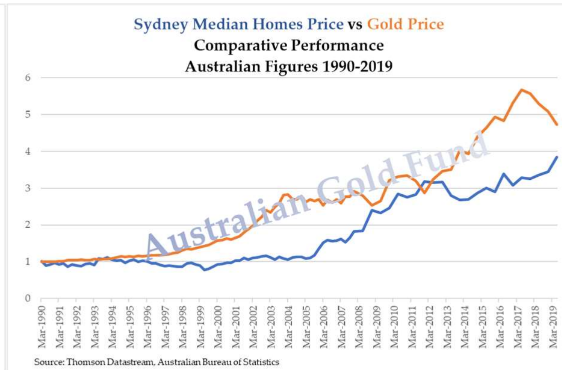
1. Apples to apples, oranges to oranges. The good or service must be the same in terms of quality and quantity. This gets tricky because manufacturers do change their packaging and ingredients.
2. Purchasing power is not simply about price rises, but about how much more you can afford with what you have.
3. If you increasingly rely on debt to maintain your living standard and consumption patterns, your purchasing power is decreasing.

Gold, a Misunderstood Asset and an Unloved Investment

Ask a typical person in the streets what is the best investment in Sydney in the last thirty years and you will likely hear them say "residential property". A few young upstarts will promote cryptocurrencies, even though these have only existed for a decade and began to get mainstream attention for over half a decade. Very few will talk about gold and precious metals, because it does not earn any income and for much of the last thirty years, it delivered little or no price increase and only started surging in the second half of the previous decade and then fell significantly in 2012-2013. Furthermore, gold seems old-fashioned and has been constantly referred to by central bankers, economists and the media as being a barbarous relic or a pet rock.

However, if one held gold from 1990 till now, they would enjoy a total return of 324% or an annual return of approximately 5% p.a. During the same time, the ASX All Ordinaries

Accumulation Index (stocks plus reinvested dividends) would yield from May 1992 to now a total return of 1 110%, or an annual return of approximately 8.7% p.a. Residential properties in Sydney have appreciated in price by approximately 400% or an annual return of approximately 5.5% p.a. Assuming no mortgage (unrealistic, of course) and adding net rental yield of around 2.5% p.a. and they would see a unlevered return of around 8% p.a. Below are two figures that show the performance of gold against stocks and Sydney residential properties:



One may argue that from the findings above, gold is indeed not worth considering because the annualised return is dwarfed by stocks and residential property. However, if one considers an alternative perspective on gold – that of a measurement of wealth and for preserving purchasing power, then we could be talking about a different story altogether.

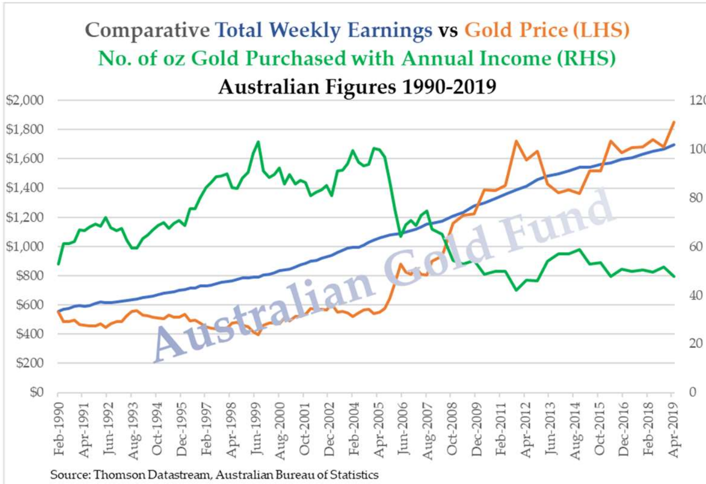
Gold was, is, and will always be gold, period. The lump of pure gold unearthed thousands of years ago will remain the same if left alone and untouched. It will not tarnish, break or disappear. The quality is assured. This cannot be said for most other physical materials in our universe. Moreover, gold is one of the rarest materials on earth. Its scarcity is the reason why mankind over the course of history valued gold. Being an element that has little practical use or is substituted by other materials that can do just a good a job, gold became a storage and measure of wealth, used as a symbol of power and prosperity. One can measure how much other goods are worth in units of gold. Given its longstanding status and also the intuitive appeal, we will return to the gold standard in our study of purchasing power and measuring wealth.

Addressing Common Misconceptions

#1 We Earn More Nowadays so We are Better Off

People often think in nominal terms. In fact, many people may not even know why we would bother with the term *nominal* because they cannot discern that from *real* terms. In nominal terms, we indeed earn more dollars on average than folks in the past, with the Australian Bureau of Statistics reporting hat average individual earnings increasing monotonically over the last 29 years (and longer going back, but our study focuses on 1990-2019).

However, while the average earnings are rising, we need to consider the purchasing power or what this pay-check is able to afford. Using the gold standard, we compare how many ounces of gold the average Australian's total annual gross earnings can be purchased over the period. The figure below shows this:



The average weekly income for an Australian was around $550 in early 1990 and the gold price was just under $550. Thus, an Australian could purchase almost 53oz of gold at that time. Over the next 15 years, the gold price generally remained rangebound between $400-$600/oz while earnings rose steadily at around 2% p.a. and thus be able to purchase more gold. In mid-1999 and early 2005, an average Australian could purchase over 100oz of gold with their earnings. In today's terms, this would imply the average Australian's annual earnings would be $215 000! However, back to reality, the current average annual earnings is around $88 000.

Of course, the gold price did dip during this period as a result of central banks selling gold reserves into the market to control inflation. However, what they did to suppress the gold price came back to haunt them in the last ten years. As the gold price made its significant climb in early 2007 and continuing till early-2012, the purchasing power of the average Australian fell some 50% in the space of five years. This may have not been felt too sharply by the Australian household as they saw the property price increase and also interest rates falling, allowing them to gain access to cheaper debt. Also, the bait and switch approach of using currency as a measure for wealth and cost meant that many Australians (including the author of this article, at least up to 2013) missed out on the opportunity to build up wealth easily some ten years ago when gold was more affordable. And in the recent half a year, as the Australian dollar further fell in value against the US dollar, the gold price broke the historical record and went above $2 000/oz. This sudden surge in the gold price meant that the average Australian's earnings has slightly less purchasing power today (at around 48oz of gold) than in early 1990!

But, how many would even notice it now?

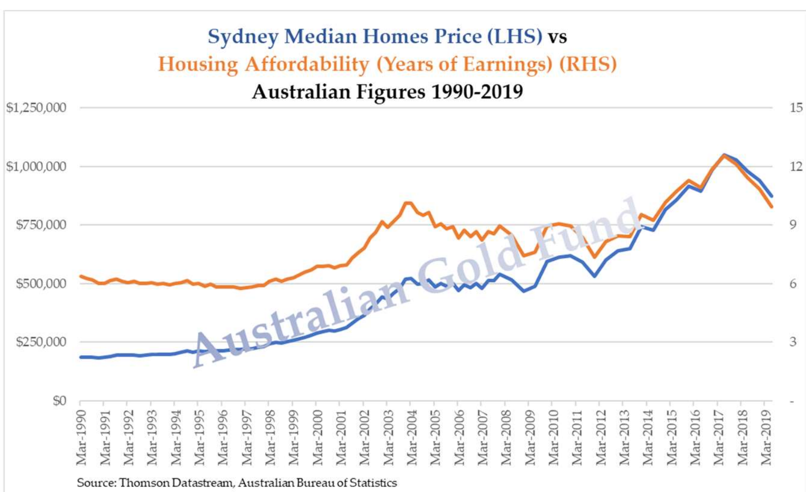
#2 Property Investments Will Increase Wealth, Don't Worry About Gold

Without a doubt, when you are in a gathering and people talk about how to build wealth, they will say that property investment is almost a sure-win. And in the era of cheap debt and negative gearing, people will talk about getting a mortgage and just buy and hold these properties and watch their wealth grow.

However, this may have worked back in the day as the central banks could cut the interest rate and thus boost prices. But too much of a good thing and repeating the same trick may not work as well anymore. As interest rates fell to almost 0% in the last thirty years, the marginal impact of each rate cut has run its course. Furthermore, as household debt increases to eye-popping proportions and housing affordability fell, the growing worry is on whether banks can weather the storm of bad debts and households can cover their mortgage repayments. Throw into the deal the level of residential property constructions in the recent five years in Sydney and Melbourne, and we are witnessing the making of a mess that may be hard to reverse or avoid.

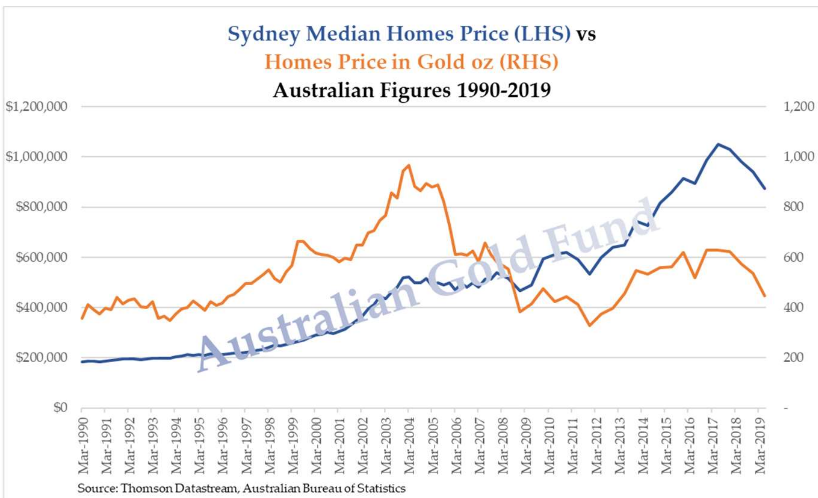
In early 1990, Sydney median home price was $185 000. Prices began to gain pace in early 2002 to 2004 when it moved from $300 000 to $500 000. The subprime crisis did not hit the property market too hard, although there were two minor dips in 2008 and 2011, before it made its legendary rise from $550 000 in late 2011 to $1 050 000 in mid-2017 when it peaked. Since then, it has fallen to $870 000 in mid-2019 although signs are showing that prices are beginning to turn upwards again in the second half of 2019. We do not have the data available to us yet at the writing of this report as there is a three-month lag from the ABS.

While some look simply at the home prices and see that increase, one has to also consider the affordability of homes over the same period. One useful measure is the number of years of average income required to purchase an average home. Below is the figure showing the changes in the median home price and the housing affordability from 1990-2019:



During the 1990-1998 period, an average home in Sydney would require 6 years of average income to purchase. At the turn of the millennium, housing affordability began to decline quickly as a result of lower interest rates as well as increasing immigration leading to rising demand. The housing affordability reached its first trough in around 2004 when an average home would cost almost 10 years of average income. As our economy continued to heat up in the next four years due to the mining boom, the RBA raised interest rates and caused the property market to take a pause, leading to increasing housing affordability, though not by much. The subprime crisis temporarily pushed Sydney homes prices below $500 000 in early to mid-2009 before resuming its rise. The RBA raised interest rates temporarily in 2011 and the property prices took a dip, but as the RBA reversed course and continued to reduce interest rates, the property prices resumed its surge. Housing affordability declined from 7.5 years of average income in late 2008 to 12.6 years in mid-2017 when it peaked. With increasing supply of properties and a weakening economy, the Sydney property prices fell around 15% and housing affordability improved such that the average home is just under 10 years of average income. Despite the fall, Sydney is among the top 5 most expensive city for property.

If one looks at the property prices in terms of the gold price, the property market is not looking as crash hot as it is made out to be. The figure below shows the Sydney homes prices in gold ounces:



In terms of gold ounces, the property market surged from 1990-2004 when the gold price was range-bound, and even retreated at one stage. A Sydney home could be purchased with around 410oz of gold in 1990, rising to 965oz in early 2004. However, the property market actually has become more affordable in gold terms over the 2004-2012 period, took a pause for five years as the Sydney homes price rallied strongly, reducing to 329oz of gold in late 2011 when gold came off of the record high. Since the mid-2017 property peak, the property price in gold terms resumed its decline from just over 600oz of gold to 447oz. Looking at the big picture, the property market in gold terms is at the same level as around 1996.

#3 Living Standards Have Been Improving So We are Better Off

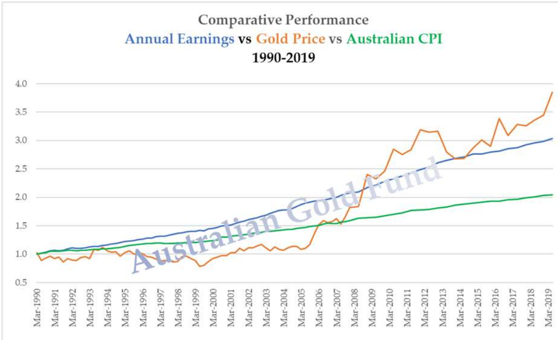
This statement is partly true, except the cause behind improved living standards is not due to one's earning capability or their accumulated wealth, but due to debt and consumerism. Based on the Consumer Price Index and Total Earnings data from the ABS, the following table summarises the annualised change in price levels for different categories of goods we have considered in our study:

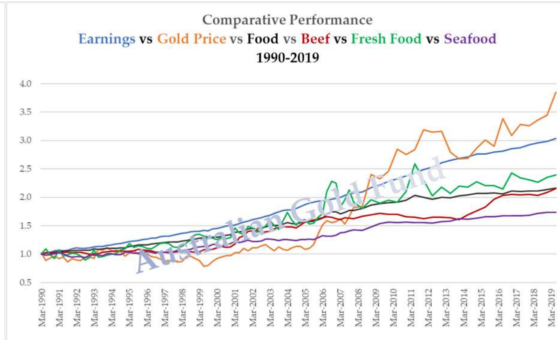
Estimated Change in Prices 1990-2019	
	Annualised Change (%)
Average Total Earnings	3.87%
Gold Price	4.95%
Australian CPI	2.47%
Sydney CPI	2.50%
Food and Drinks	2.66%
Drinks	2.96%
Fruits and Vegetables	3.02%
Beef	2.66%
Fish and Seafood	1.91%
Restaurant Dining	2.99%
Clothes and Footwear	0.11%
Rent	2.79%
Utilities	4.58%
Electricity	4.63%
Major Electrical Appliances	-0.19%
Public Transport	2.09%
Motor Vehicles	-0.44%
Fuel	3.12%

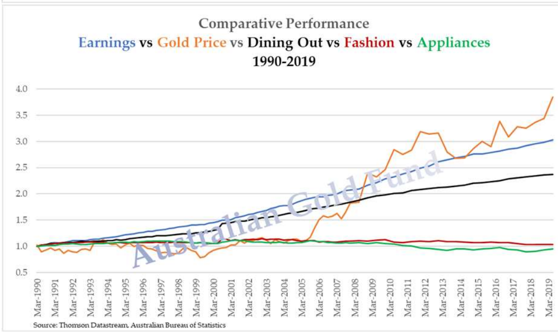
Source: Thomson Datastream, Australian Bureau of Statistics

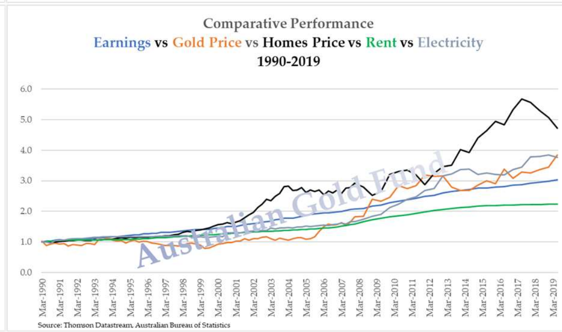
The author holds some reservation about the data especially due to the opaque and questionable nature of CPI measurement. Notwithstanding that, what is worth noting is that food, rent (or housing), petrol, utilities and electricity saw higher price increases than the CPI, and these are necessities. Discretionary items such as clothing, electrical appliances and motor vehicles have indeed declined or witnessed a minor increase. With lower cost of borrowing, households can use their earnings to cover the increasing cost of necessities and then pad out their lifestyle with cheap credit. This gives an illusion that they are living it up, but they are effectively digging themselves a hole that becomes increasingly difficult to climb out of, especially thanks to the power of compound interest.

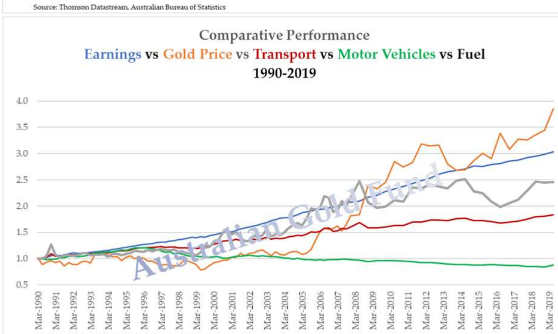
On the other hand, if one's household saves partly in gold, they will be able to maintain and increase their purchasing power over this period, albeit slipping behind the mainstream from 1990-2002 when the gold price lingered (and even went backwards). The following diagrams show the change in the CPI, various costs against total earnings and the gold price:











As the diagrams show, the gold price is only exceeded by the Sydney homes price, and the latter is in a declining trend since mid-2017. Average total earnings have been reported to increase steadily over this period and is only exceeded by electricity prices. What should not be missed is that the prices of necessities have increased by almost 3% p.a. Also, one should note that these items also are not likely to have changed over time and thus they rise in price faster as a result of the devaluation of the Australian dollar that has increased in supply substantially over this period. One may wonder why fashion, major appliances and motor vehicles have not increased as much. This is because mass production, reduction in quality and importing from low cost manufacturers in Asia and even South America have pushed prices down. Obsolescence of these discretionary items also can feed through the price measures through delay in adjusting the items being considered in the index. To illustrate, a flat-screen TV or a desktop computer from last decade would be a small fraction of the price now simply because the technology and functionality have improved so dramatically. This may be an exaggeration, but even within the space of a year, electronic goods will see no less than one model upgrade, leading to the previous model being worth much less.

In summary, living standards may have increased for the typical Australian household today because they have more creature comforts and have been consuming more than those in the

1990's. However, this is financed more from debt even as their income has been reported to increase more than most of the items they need to purchase. Rising property prices have also provided a "wealth effect" and many used their own homes and investment properties as a reserve account to draw down to fund their luxury spending. While gold would have provided them with greater purchasing power, this has been largely forgotten or misunderstood as the first 15 years of the study period saw gold underperforming. However, the same could be said for property prices that only began to see accelerated growth commencing at the turn of the millennium.

Conclusion

The overall picture for the Australian economy is not too flattering or reassuring for the average household given that property prices are looking to fall, cost of necessities is rising beyond the CPI and the average worker's earnings will be unlikely to suddenly accelerate beyond the trend seen over the last thirty years or so. As household debt continues to accumulate and the RBA looks to try to cut interest rates further to prevent the collapse of the property market, it is increasingly hard to save without taking extra risk to generate better investment returns. Businesses similarly will be hesitant to deploy their capital in such periods or take excessive risk and thus face the prospect of destroying capital. In the midst of all this, gold has been forgotten and neglected. Once a standard measure of wealth and for pricing goods and services, gold has not lost this capability. Moreover, gold offers a better basis for evaluating the state of the economy, gauging purchasing power and inflation as well as delivering returns to investors who can preserve and even increase their purchasing power.