Why investors turn to gold amid debt-ceiling uncertainty

The price of gold went up $12.90 an ounce on Monday alone, closing at $1,614.40. But if the debt ceiling is raised, the gold price could come down over the short term.

An employee prepares gold bars for transport at a gold refiner in Switzerland. Fears that the US government might default on its debt have driven up the price of gold.

Arnd Wiegmann/Reuters/Files

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By Ron Scherer, *Staff writer* / July 25, 2011

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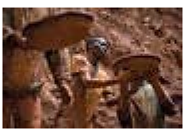
The debt-ceiling gridlock on the Potomac is making at least one group of investors giddy: people who own gold.



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Since the beginning of the year, the price of the precious metal is up 13.58 percent, closing at $1,614.40 an ounce on Monday. This includes an increase of $12.90 on Monday alone. By way of contrast, the stock market – as measured by the Dow Jones Industrial Average – is up about 8 percent for the year and down some 88 points on Monday.

Behind the rise in the gold price are fears that the US government might default on its payments on Aug. 2, the day the US Treasury says the government runs out of money. Although no one knows exactly what will happen if Uncle Sam can't raise his credit limit, most investment advisers don't think the stock market will take an actual default very well.

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With all the uncertainty, investors are turning to gold.

“Some gold makes sense, even though the metal is at record-high prices,” says Fred Dickson, chief investment strategist at D.A. Davidson & Co. in Lake Oswego, Ore. “But you have to bear in mind that gold can be a volatile commodity.”

Indeed, professional gold investors are issuing storm warnings over short-term investing at such high levels. One of those is Thomas Winmill, portfolio manager of the Midas Fund, which invests a portion of its assets in the stocks of gold-mining companies.

“We think it is highly likely the debt ceiling will be raised and the gold price will come down over the short term,” he says. “But over the longer term, we think the price will be driven up because Washington lacks fiscal discipline.”

Even though President Obama and the Republicans appear to be far from an agreement, that could change quickly, Mr. Dickson points out.

“Remember back in December when they were at odds over renewing the Bush tax cuts, all of a sudden they found a way to do it,” recalls Dickson. “Congress has a lot of ability when their back is pushed against a wall to get something done.”

Historically, governments have dealt with huge deficits by increasing inflation, making political promises that can’t be fulfilled, or increasing taxes, Mr. Winmill says. Since the US debt load is so high, he says, it’s impossible for the nation to tax its way out of the problem. “It has to be inflation,” he says.

Inflation decreases the real value of money, which makes repayment of debts easier. In the past, hard assets such as gold have risen in value during times of high inflation.

If Congress raises the debt ceiling but does not do a credible job of reducing the deficit, the government faces the possibility of a debt downgrade from AAA, the highest rating. “It’s hard to tell the fallout,” Dickson says.

If Standard & Poor’s and other bond rating agencies do downgrade the US government’s debt, gold may do well, says Axel Merk, president of Merk Investments, a firm in Palo Alto, Calif., that invests in gold and currencies such as Swiss francs and Japanese yen.

A lower debt rating for Treasury securities will give them a lesser value in bank portfolios, Mr. Merk reasons. Since banks carry the securities as assets, the banks will have less money to loan in the future. This will reduce economic activity, he reasons.

If the US economy falters, this may boost the price of gold.

However, gold will suffer if the economy starts to grow, businesses begin to hire more workers, and productivity improves, Winmill says. “The risk to gold is real economic growth,” he says. “It’s happened many times.”

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