Classical Insights

Global Equity Research Based on the Classical Economic Model

Monthly Portfolio & Themes:
Thinking about the gold-to-suit ratio

Mike Churchill *April 27, 2010*

Remember the old adage that an ounce of gold should buy a good man's suit? Well, these days an ounce of gold will buy you 3.6 suits. The average price of a suit at Syms is now $320, including tailoring and tax. (I've excluded a couple of crummier brands from the table below, which would have pushed the average lower.) If one goes strictly with Brooks Brothers, the average would be $498 per suit (as per their website), or about $600 with tax and minor alterations. That would be just under 2 suits per gold ounce.

Syms suit prices

Calvin Klein	$259	Jones NY	$199	Michael Kors	$199
Hart Schaffner & Marx	$299	Joseph Abboud	$299	Nautica	$159
Hickey Freeman	$499	Kenneth Cole	$199	Perry Ellis	$159
Hugo Boss	$399	Ralph Lauren	$219	Average	$262
				+ tailor & tax (22%)	*$58*
				Total	$320
				Suits per gold oz	**3.6**

Why are suits so cheap relative to gold now? And what implications does this have for CPI generally? Here are some thoughts on the matter:

a) In a monetary inflation the gold price rises first and other prices follow – at widely varying rates of speed. Items with a high commodity content (copper) adjust quickly, while items with a lower commodity component (clothing) adjust more slowly:

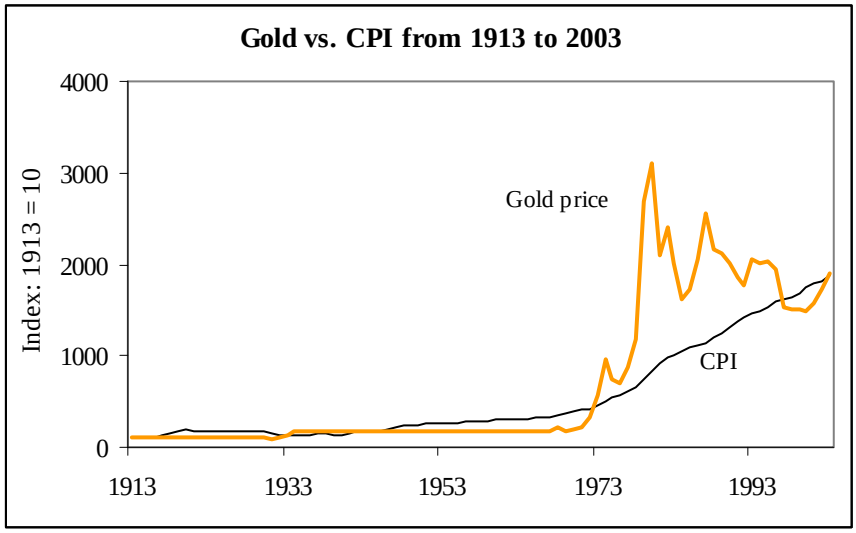
How changes in the value of money flow through the price stream

Adjustment time	Item	Comments
Instant	**Gold**	*A gold move is a change in money's value.*
	↓	
3-12 months	**Copper, oil & gas**	*Dug straight from ground and sold on spot.*
	↓	
6-36 months	**Steel, chemicals, aluminum, lumber, coal, iron**	*Only one layer of inputs. Little or no branding. Spot or short contract. Demand elastic.*
	↓	
3-15 years	**Paper, railroad freight rates**	*Longer contracts (rails), inelastic demand (paper).*
	↓	
4-18 years	**Autos & parts, trucks, capital goods**	*Some branding, many inputs, elastic demand.*
	↓	
5-30 years	**Ketchup, cereal, shampoo, beverages, clothing**	*Heavy branding, many inputs, inelastic demand.*
	↓	
7-30 years	**Regulated electricity and water prices**	*Pricing fixed close to CPI, inelastic demand.*

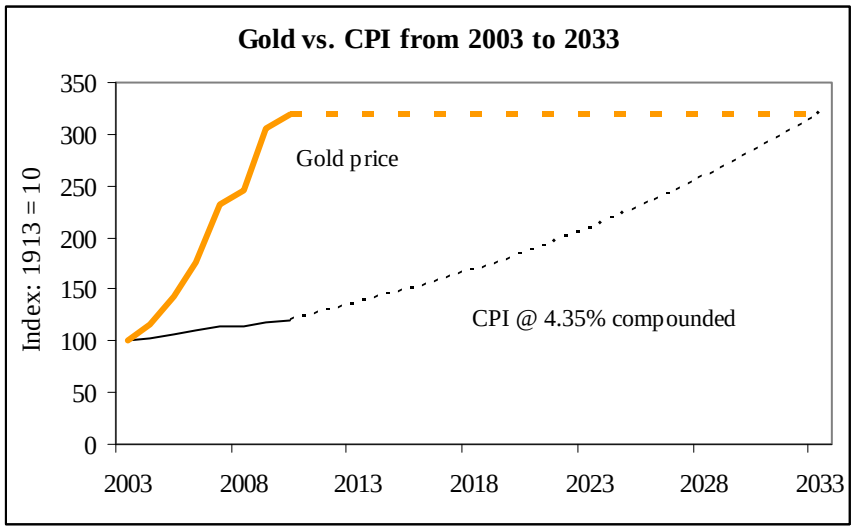
Source: Churchill Research estimates

b) Central bankers are getting a free pass right now. Dollar devaluation isn't translating into sharply-rising CPI now due to the aforementioned time-lag effect, economic weakness (which is now ending) and the impact of big efficiency gains from computerization and global sourcing of inputs. (More on this below.)

c) The free pass can't last forever. History shows that CPI eventually adjusts for big gold-price advances, though it takes many years. Here is a chart of CPI vs. gold back to 1913, with each indexed to 100. The two series returned to parity in 2003 – at a level 1780% above where they had been 90 years before:



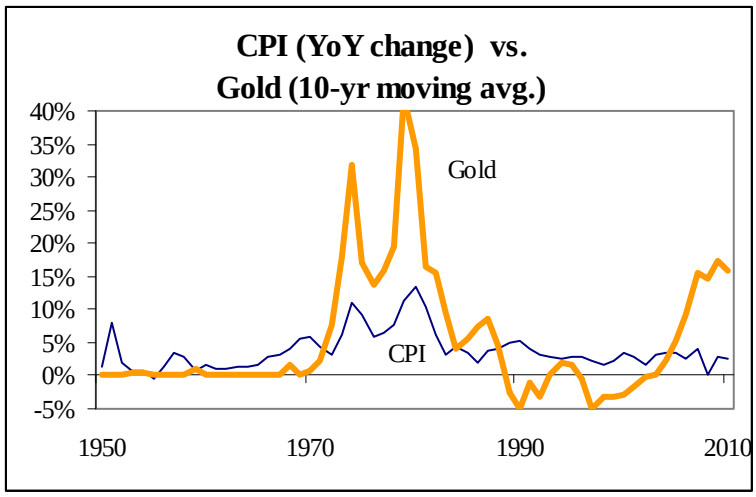
d) Street prices should catch up to gold again by the year 2033. In general it takes about 30 years for a change in the value of money to flow all the way through the price stream. That would imply a 4.35% annual CPI rate over the next 23 years:



e) One caveat here is that the big efficiency gains from computerization and global sourcing won't be reversed. Thus, we might say that the overall price level has experienced a *real* (i.e. gold-adjusted) downward price adjustment. For the sake of

argument, let's call that price adjustment 10%. That's 10 percentage points that CPI will not have to adjust for over the next 30 years. If we apply this reduction to the above chart, the forward CPI rate would fall to 3.9%.

f) A second caveat is that if gold rises fast enough, CPI adjustments can be front-loaded. Back in the '70s and early '80s, CPI got above 10% a couple of years. The current devaluation is smaller than the '70s deval in percentage terms, but gold is still on a rising tack. If gold continues advancing at its recent rate, CPI could start to climb at 5%+ YoY.



g) What does all this mean for the gold price itself? In principle, the implications of the above points are positive for gold. Here is the logic:

- Assume a 4.3% CPI rate from 2011 onward;
- Assume that, in order to make gold fall, the real Fed funds rate has to be at least 3 points above CPI;
- On this basis, gold would not start declining until the nominal Fed funds rate had been increased to 7.3% (i.e. 4.3% plus 3%);
- Realistically, that's not going to happen until 2012 at the absolute earliest;
- In theory, then, gold could keep climbing steadily for the next 2+ years;

This rosy scenario for gold contains two main risks. First, the core assumption (that the real funds rate needs to be 3%+ for gold to fall) may be wrong. There's no science behind that number. It's just my observation based on history. Second, once the Fed starts raising interest rates (probably later this year) investors may do some of the Fed's work for it, bidding up the dollar in anticipation of higher rates to come. Historically, that has not actually happened to any meaningful degree, but that doesn't preclude a pop in the dollar upon news of the first rate hike.