

Will the gold rush continue?

Oliver's insights



Key points

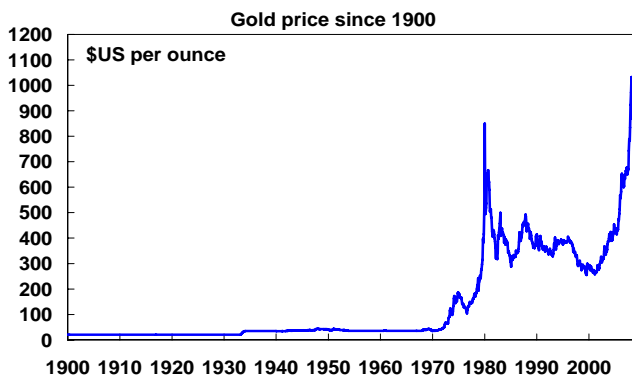
- Gold has been about the best performing investment this year. It's been driven by a combination of collapsing interest rates, concern that monetisation will drive inflation, fear of the collapse of the global financial system and general investor caution.
- A re-test of last year's high of \$US1032.7 an ounce looks very likely. In the short term, a period of volatility is likely in the gold price given that it's risen so far so fast and everyone seems to be jumping into it (which is negative from a contrarian perspective). However more upside is likely over the medium term.

Introduction

Through prehistoric to modern times, gold has been a source of fascination for mankind.¹ Some see it as the only truly safe way to store wealth and that the decision to break the link between gold and paper currencies (ie the gold standard under which the price of gold was fixed in paper currencies) was the undoing of the global economic system. Others see it as a barbarous relic with no intrinsic value apart from that deriving from its appearance and hence its use in jewellery. Right now though, gold is attracting a lot of interest. So far this year it's about the best performing 'asset'. Whereas shares have continued to slide, government bonds have fallen in value as yields have increased, oil and other commodity prices have fallen, gold is up 10% in US dollars and is up 18% in Australian dollars. Why all the interest and will it be sustained?

Gold over the long term

The chart below shows the price of gold since 1900.



Source: Global Financial Data, AMP Capital Investors

Up until the early 1970s the US dollar was fixed against gold, albeit subject to periodic devaluations such as in 1934. From the early 1970s to 1980 gold was in a secular upswing as investors turned to gold for protection against inflation. However, from 1980 to 1999 the secular trend was down as inflation was brought under control. This decade though has seen gold enter another secular upswing, much in line with other commodities. Last March the gold price rose to a record high of \$US1032.7 an ounce.

What's driving gold prices up?

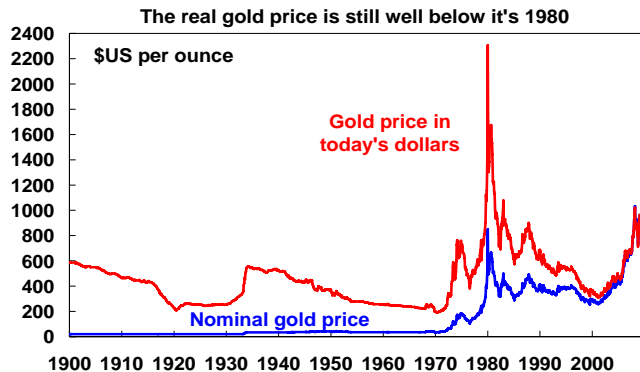
Following last year's record high the gold price fell by over 30% to around \$US700 an ounce as the \$US rebounded during the financial panic last October and fear of deflation became dominant. Since then, despite further weakness in other commodity prices and share markets the price of gold has rebounded, recently rising above \$US1000 an ounce. Several considerations are behind the surging gold price and most suggest the price could go higher over the medium term:

- Firstly, **investors are fearful that all the policy stimulus - both fiscal and monetary - being pumped into the global economy will generate inflation.** This would reduce the purchasing power of paper currencies (such as the \$US, euro, \$A, etc), so gold is in demand as a hedge against such an eventuality. Our view is that thanks to massive slump in global demand and surging levels of excess capacity, deflation is a greater threat right now than inflation. However if enough people are worried about inflation then it will certainly benefit gold.
- Secondly, **while there are fears about the future of the \$US, the outlook for other major currencies is not much better.** Europe's economy looks worse than the US and European banks are more highly leveraged than US banks, the strong Yen looks unsustainable given the damage it has already caused the Japanese economy and the Renminbi is not really an option as it's not convertible. So gold is seen as a good alternative to paper money.
- Thirdly, **some fear that fiscal and monetary policy stimulus will be ineffective with the end result being a collapse in the financial system, against which gold is seen as providing a hedge.**
- Fourthly, **the opportunity cost of holding gold as opposed to cash or government bonds as an alternative store of value has collapsed.** US and Japanese interest rates are effectively zero, with other key regions looking like they will converge on that. So

¹ The fascination with gold is evident in the James Bond films where three of the 22 "official" Bond films have gold in the title including the best, *The Man with the Golden Gun*.

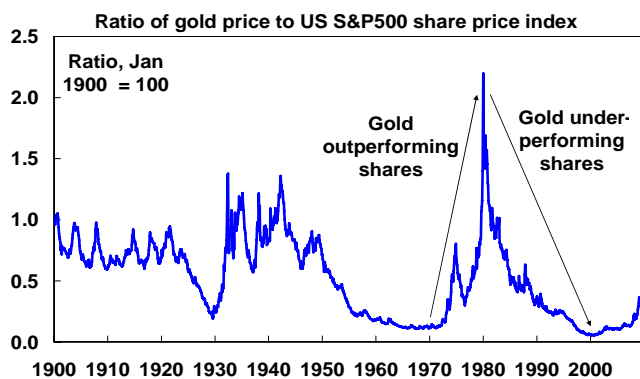
the yield on cash is rapidly disappearing. Similarly, government bond yields have fallen dramatically and are now averaging 4% or less. So with cash and bond yields falling towards zero the missed return from holding a non-income producing asset like gold (putting aside the potential yield achieved from rolling gold futures contracts over) is very low.

While gold has had a great run up over the last decade it still remains below its inflation adjusted peak in 1980, when gold was worth \$US2306 an ounce in today's prices.



Source: Global Financial Data, AMP Capital Investors

Finally, it's interesting to note that there is also something of a secular cycle in the relative performance of gold versus shares. The next chart shows the relative performance of gold versus the US S&P 500 share price index. Gold outperformed shares in the depression of the 1930s, underperformed during the post war years, outperformed in the high inflation 1970s and underperformed shares during the equity bull market of the 1980s and 1990s. On the basis of this chart, gold may be in the early stages of a secular out performance phase versus shares.

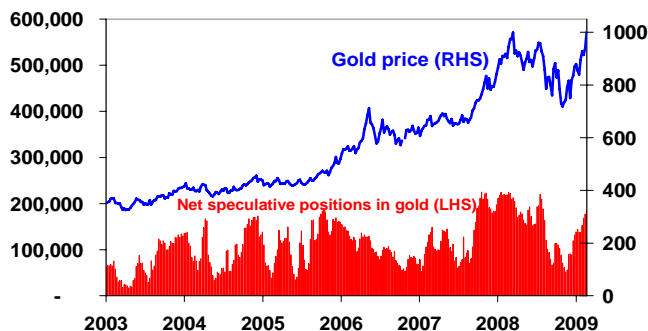


Source: Global Financial Data, AMP Capital Investors

Some risk of short term turbulence

The one problem with gold is that it seems that everyone right now is wanting to buy into it. New flows into gold exchange traded funds (funds that track the price of gold) have exceeded that of all of 2008. Net speculative positions in gold are pushing up towards previous extremes.

Speculative positions in gold are nearing past extremes



Source: Thompson Financial, AMP Capital Investors

From a contrarian perspective this all suggests there could well be a bout of short term volatility or correction in the price of gold. However, it's unlikely to be enough to derail the positive forces referred to in the previous section.

Investing in gold

There are several things to note about investing in gold. **Investors should realise that gold is highly speculative.** It's not grounded by an income stream like most shares, property, bonds and cash. As such there is no general agreement as to how it should be valued. Virtually all the gold that was ever produced still exists and can potentially come back on to the market. At the same time actual production and demand for jewellery and industrial use is trivial relative to the huge gold stock. As a result, 'animal spirits' can play a huge role in the determination of its price. In fact, its value is really seen in terms of alternatives such as the outlook for paper currencies such as the \$US and it's correlated to some degree with other commodity prices.

This can make for a volatile ride over time and suggests that gold should not be dominant in an investment portfolio.

There are numerous ways to get exposure to gold, all with their pros and cons:

- Buying physical gold, including coins and medallions. This quite clearly gives an exposure to gold but can be costly to store.
- Buying gold futures contracts. This doesn't come with the physical storage problems and can be a way to leverage up one's exposure but might be seen as too complicated for many investors given the need to roll the futures contracts over as they get close to expiry.
- Investing in gold exchange traded funds (ETFs) which are funds traded on stock exchanges offering exposure to gold (and which are backed by physical gold or gold futures exposure). This approach is highly liquid.
- Investing in gold shares. These will reflect the movement in gold prices but are also affected by the performance of the individual companies which in turn may be influenced by other factors including production, new discoveries, currency moves and management.
- Various gold funds are offered by fund managers and others that provide an exposure to gold.

Concluding comments

While gold may be vulnerable to a short term correction or bout of volatility, several considerations suggest that it may still have more upside on a medium term view.

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