

Gold – can it keep going higher?

Investment insights

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Key points

- The gold price has continued to reach new record highs. The key drivers are worries about the value of major paper currencies and the continuing fall in the opportunity cost of holding gold.
- While positioning in gold is high, implying the risk of a short term correction, more upside is likely over the medium term as major countries continue to debase their currencies.
- There is a case for gold in investment portfolios, but its speculative nature suggests only a modest exposure.

Introduction

Gold is one asset that has come through recent turmoil pretty well. But why is it doing so well? Is it a forewarning of inflation to come, or is it telling us something much more serious? Can it be sustained? Is it something investors should have in their portfolios?

Why the historical fascination with gold?

Gold has long been a source of fascination for mankind. The interest in gold dates back thousands of years to when advances in farming led to surplus food, and eventually the growth of prosperous civilisations. Around this time gold became valued as a medium of exchange, as a store of value, and as a display of power and status. Over the centuries it has acquired a status beyond its industrial use (which is now trivial) because it is attractive, malleable, ductile, resistant to corrosion, a conductor of heat and electricity, fungible, scarce and dense. This range of properties has helped drive demand for it as jewellery, as a medium of exchange or money and as a store of value. Today some see it as the only truly safe way to store wealth as it is highly liquid, portable, accepted globally and lacks any credit or counterparty risk. Further, some see the decision to break the link between gold and paper currencies as being the undoing of the global economic system. By contrast it's seen by others as a barbarous relic with no real value beyond its beauty and use in jewellery.

A long term perspective

The following chart shows the price of gold since 1900, both in nominal and real terms. Until the early 1970s, the US dollar was fixed against gold. This was 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, gold was in a secular

downtrend as inflation was brought under control. This decade has seen gold enter another secular upswing in line with other commodities. While the gold price has reached a new record high in nominal terms, in real terms it is yet to surpass its 1980 peak of US\$2467 in today's prices (although it was just a one week spike). But it has been getting there fast.



Source: Global Financial Data, AMP Capital Investors

What's driving the gold price higher?

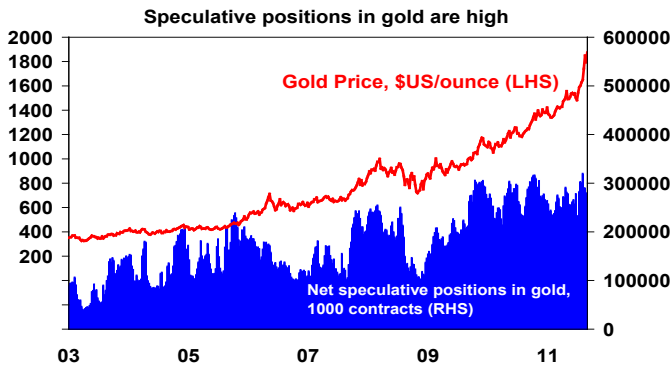
Gold has benefited from the general rise in commodity prices over the last decade, driven by rapid emerging world industrialisation, constrained commodity supply and a fall in the US dollar (which benefits commodities as they are mostly priced in US dollars). However, a range of specific factors have also been at play in the case of gold:

- First, **some have been buying gold as a hedge against inflation** on the basis that quantitative easing in the US and elsewhere (which involves printing money to buy financial assets – notably government bonds) will generate higher consumer price inflation.
- Second, **gold is seen as a good alternative to major currencies which are at risk thanks to high public debt levels and quantitative easing.** While the focus has been on the US dollar, where the supply of dollars is increasing thanks to quantitative easing, the outlook for other major currencies is not much better. Europe's economy looks worse than the US and its debt problems are threatening to tear it apart. The Bank of England looks likely to also engage in another round of quantitative easing. The Bank of Japan is likely to intervene further to stop the yen rising. Switzerland is already doing the same. The Chinese renminbi is not really an option as it's not convertible and China is limiting its rate of appreciation. This leaves the commodity currencies such as the New Zealand dollar and the Australian dollar (which is a separate story) and gold as potential safe havens.
- Third, **central banks in emerging countries are buyers of gold** as part of a strategy to diversify their foreign exchange reserves away from the US dollar.
- Fourth, **fears of another financial meltdown on the back of European debt problems have increased, and some see gold as a hedge against this risk.**
- Finally, **the opportunity cost of holding gold versus cash or government bonds as an alternative store of value is continuing to collapse.** The US Federal Reserve (Fed) has signalled US interest rates will stay near zero into 2013, no increase is on

the horizon in the UK and the European Central Bank (ECB) will likely cut its short term interest rates to near zero. Government bond yields in developed countries are averaging around 2% or less. So with cash and bond yields so low the missed income from holding a non-income producing asset like gold is very low.

Can it continue?

First, the negatives. After having risen around 30% this year to reach US\$1900 an ounce, gold has become technically overbought and due for a pullback. Adding to the risk, investor interest in gold is very high - evident in net speculative positions in gold running at high levels, which is negative from a contrarian perspective. (Bear in mind speculative positions in gold have been high for two years and it hasn't stopped the gold price rising to record highs.)



Source: Thomson Financial, AMP Capital Investors

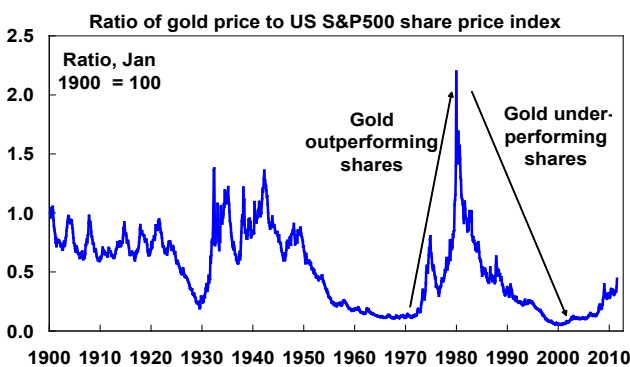
Also, I do not believe inflation is about to take off – there is too much spare capacity in the US, Europe and Japan, and too little pricing power. And while narrow money measures have surged in the US, until banks lend this out and spending returns to normal, inflation won't be a problem.

What's more, the gold price is trading well above its normal margin above its cash cost of production. A normal margin would imply a price of just below US\$1000 an ounce.

Finally, there is also a risk that in the event of another global financial meltdown, the gold price could fall as investors are forced to sell their liquid assets to cover losses elsewhere – as occurred in the second half of 2008.

However, the medium term picture remains positive for gold. Global interest rates look set to either remain low or go even lower keeping the opportunity cost of holding gold down. The outlook for the US dollar and other major currencies remains bleak given the prospect of more quantitative easing and ongoing debt problems in Europe. And of course as long as monetary policy remains easy, demand for gold as an inflation hedge will likely persist.

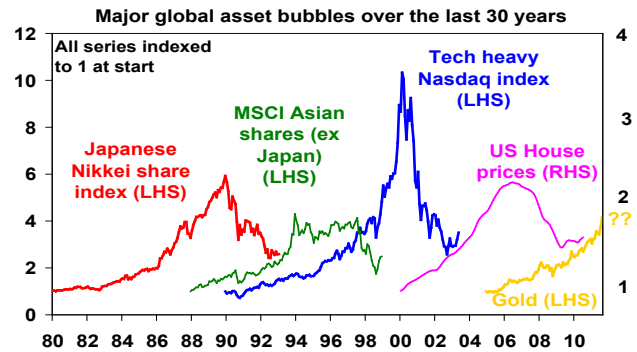
The next chart shows the relative performance of gold versus the US S&P 500 share price index.



Source: Global Financial Data, AMP Capital Investors

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, the outperformance of gold versus shares may have further to go, particularly as the macroeconomic backdrop is likely to remain weak and volatile.

For some time we have seen gold as a prime bubble candidate, and this seems to be unfolding thanks to a loss of confidence in major paper currencies, the low opportunity cost of holding gold and the ease of access to investing in it thanks to gold exchange traded funds (vehicles listed on share markets that buy exposure to gold). This likely has further to go in the years ahead as major countries continue to debase their currencies. But if gold does go on to become a bubble, like all bubbles it will eventually burst.



Source: Thomson Reuters, AMP Capital Investors

Investing in gold

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

- Physical gold – gives pure exposure but costly to store.
- Gold futures – no storage problem and easy to leverage up but need to roll futures contracts over as they expire.
- Gold exchange traded funds – these are highly liquid but do involve counterparty risk.
- Gold shares – these reflect the movement in gold prices but are also affected by the performance of the individual companies.
- Gold funds are offered by fund managers that provide an exposure to gold – these may reflect a combination of the above.

It's worth stressing that gold is highly speculative. It's not grounded by an income stream like most shares, property, bonds and cash. Virtually all the gold 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 the gold price. This can make for a volatile ride over time. History has shown that just as the gold price goes through long term upswings, it can also go through long downswings. So, overall we think there is a role for gold in investors' portfolios as a hedge against major currency weakness and financial turmoil, but it should be limited to maybe no more than 5% (depending on an investor's circumstances).

Concluding comments

Gold is vulnerable to a correction but the trend is likely to remain up as global interest rates remain low and scepticism about paper currencies remains high.

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