Why Gold?

Introduction

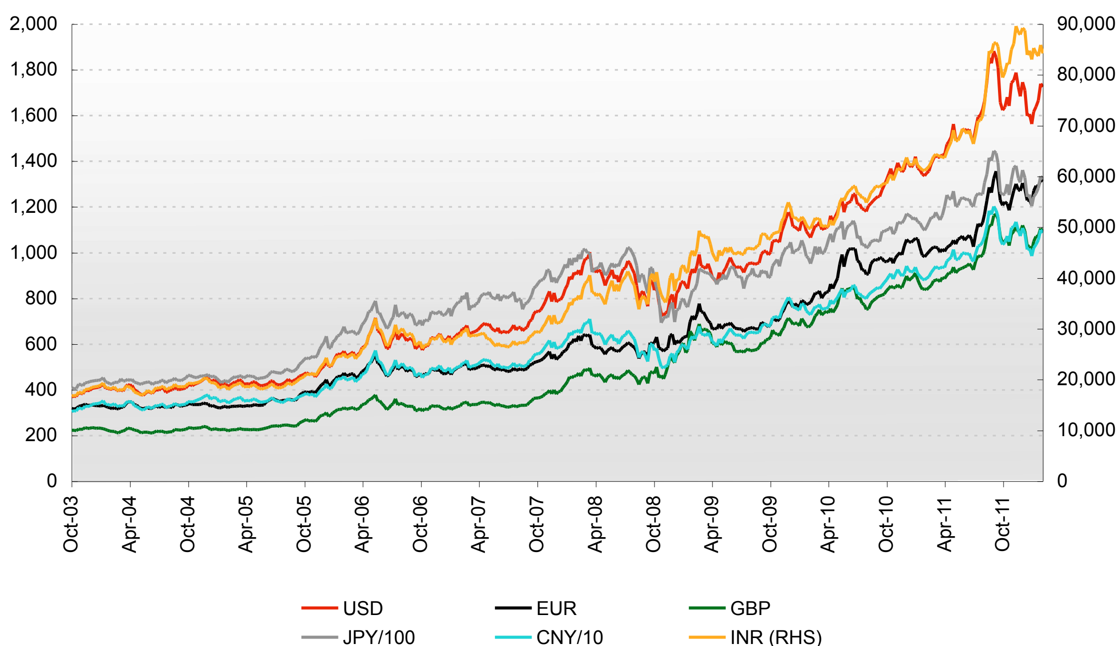
A GOLDEN REBIRTH

Gold is enjoying a renaissance, outperforming most other assets this millennium. The last few years have seen unprecedented economic upheaval, overhauling what was considered to be a new regime of steady, increasing returns in equities and bonds, accompanied by low, benign inflation. Times have changed.

The collateral value of paper currencies and complex derivatives has been comprehensively re-evaluated, and the reserve status of the US dollar itself has been called into question.

In this new turbulent climate, gold is experiencing a renewed level of demand unseen for many years. It is experiencing a rebirth, based on a universal change of attitude.

GOLD IN MAJOR CURRENCIES



GOLD – CHANGING ATTITUDES

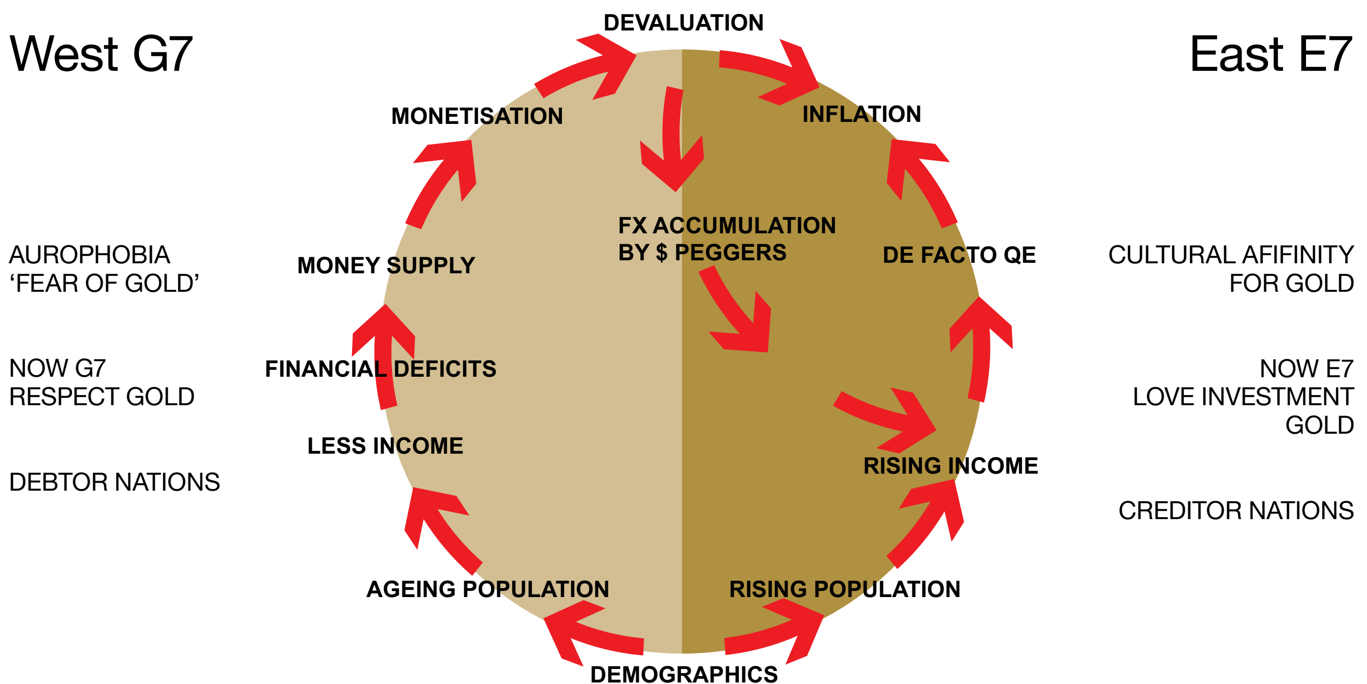
Gold attitudes have changed across the globe. This generalized shift in gold psychology is cultural, and manifests itself differently in the East from how it does so in the West.

The Great Financial Crisis engendered a mistrust of paper money and replaced it with a newfound respect for gold. In many ways, the gold story is a demographic one. Poor demographics in the West - aging populations and lower workforce participation - are exacerbating government deficits. A shortfall in tax revenues and an increase in government expenditures led to central bank monetisation of Western deficits. Put simply, central banks became wards of the state as they printed money to staunch the wound of their government's spiralling deficits.

In the East, on the other hand, positive demographics - large proportions of the population who are at the age when they are saving for their retirements - have fed a seemingly insatiable desire for gold. Of course, those in the East have always had a cultural attachment to gold, but primarily through jewellery ownership. Today these same cultures still perceive gold as a store of value. Yet, more and more, they are buying it in the form of physical bars and coins for the simple purpose of investment.

Nonetheless, there are some clouds on the horizon in the East. FX reserve accumulation, where emerging market central banks are forced to buy dollars and euros to help keep the value of their domestic currencies down, has accelerated as loose monetary policy in the West, in the form of quantitative easing, has been transmitted via dollar pegs. Countries are locked in a race to the bottom as they drive their currencies farther and farther down. As inflation rises due to the influx of fiat money churned out by the Fed, ECB, Bank of England and the Bank of Japan, this has led to widespread mistrust of local currencies in the East. Gold is now not seen as just an adornment in the Orient, but as a necessity to protect one's wealth.

GOLD ATTITUDE: DISTRUST OF PAPER MONEY



Yet, despite gold's renaissance in popularity, it remains largely misunderstood. Investors are still happy to invest large sums in equities, bonds and property, regardless of the torrid time these assets have had over the last few years. Little convincing is often needed, as such assets continue to be considered 'sound' investments. Gold, however, is different.

Most people need to be convinced as to why they should own a precious metal that has little apparent utility. There are three main reasons.

1 GOLD IS INSURANCE Owning gold is a prudent and intelligent idea to help protect oneself from the most extreme economic and geopolitical uncertainty we have faced for generations.

2 GOLD IS UNDERVALUED AND UNDEROWNED Despite gold's steady move higher over much of the last decade, it still remains undervalued, and largely underowned.

3 GOLD IS IN DEMAND Central banks are net buyers after being net sellers for many years, and savers in the East use gold to protect their wealth.

Gold is Insurance

"The time to purchase insurance is before your house catches fire"

The financial crisis, which began in the US housing sector in 2007, has now morphed into a full-blown sovereign debt crisis. Government borrowing surged to pay for bank bailouts and to cover the yawning gap between tax revenues and public sector expenditures.

The crisis exposed the economic imbalances in Europe. Greece has partially defaulted on its obligations, and there is a high likelihood Portugal will follow. Spain, Italy and Ireland may not be far behind. The very existence of the euro is at stake. The potential for a huge financial upset – far greater than after the Lehman bankruptcy – is real.

In such volatile times, owning gold is an excellent form of insurance. As a real, tangible asset it cannot become worthless overnight, as was the case with the complex derivatives that were so instrumental in inflating the US housing bubble. Nor can it be systematically devalued, in the way fiat 'paper' money can be, as governments worldwide debase their currencies by printing more of them in unprecedented amounts. Gold - as a scarce resource which is mined at a steady, but slow, rate - cannot be printed.

Governments' increased indebtedness brings risks for everybody's prosperity. The temptation for sovereigns to try to inflate away their debt will become irresistible. The cardinal risk of money printing is the arch enemy of wealth itself: inflation. If too much money starts to chase too few goods, prices have to rise to re-attain equilibrium. The paper money in your wallet – known as 'fiat' money – starts to lose its worth faster than you can spend it. Your purchasing power is eroded; your wealth, decimated.

Gold is a rare and beautiful asset that protects one's purchasing power over the long run. It is not just another commodity: it was once money. It is neither consumed nor destroyed, and it has stood the test of time, outlasting political ideologies, governments, nations and empires. As a store of value over lifetimes and across generations, it is peerless.

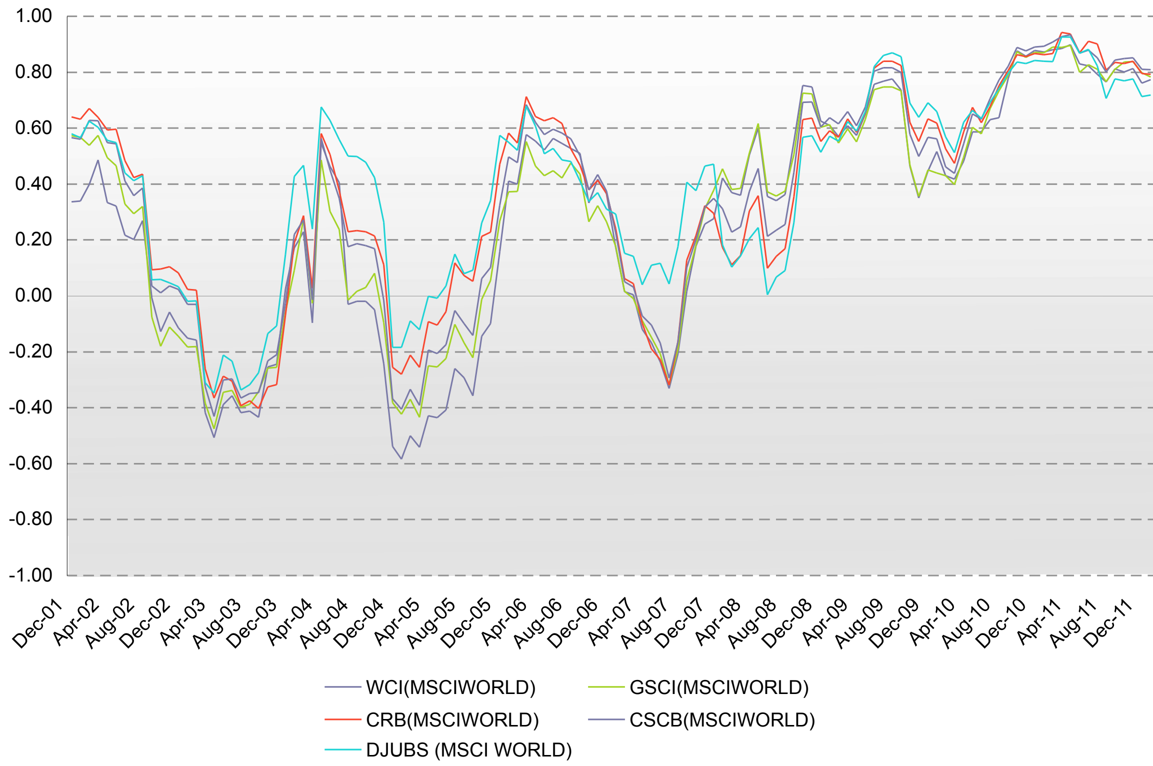
PORTFOLIO DIVERSIFICATION

Not only is gold an insurance against the stability of the financial system, it is also an excellent way to diversify your portfolio.

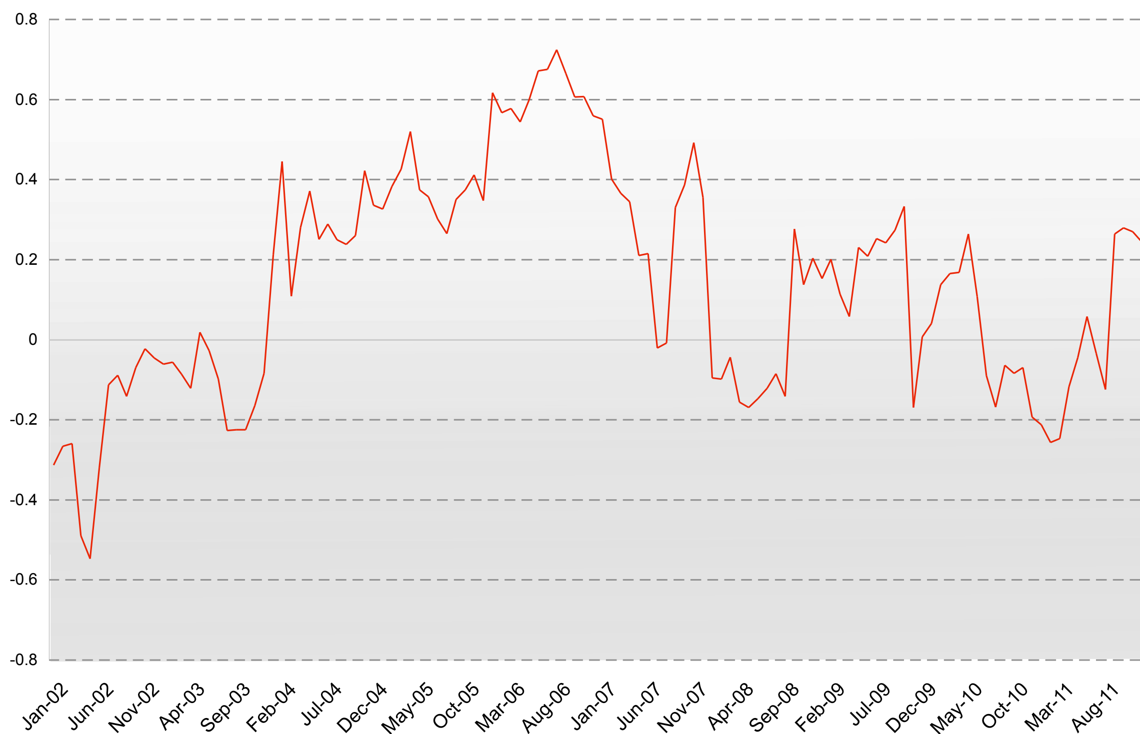
Commodities in general are often viewed as a way to diversify equity portfolios. Yet, given the huge reliance emerging economies like China have on raw commodities to fuel their recent surges in growth, owning a basket of commodities actually adds risk to emerging market equity portfolios.

Gold, on the other hand, shows a lower correlation to equities and as such adds true diversification to an emerging or global equity portfolio.

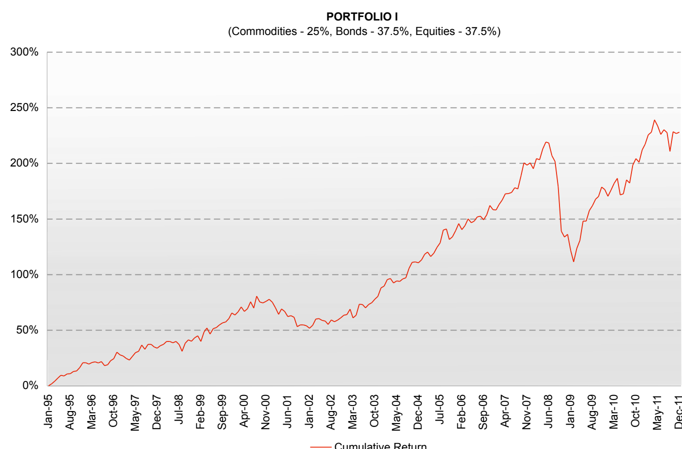
CORRELATION WITH MSCI WORLD

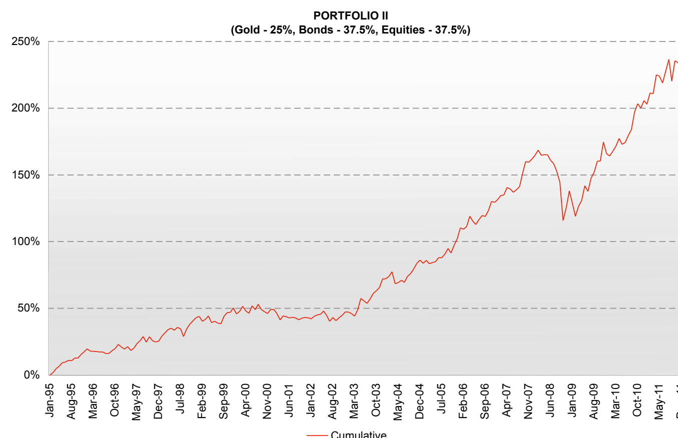


CORRELATION (MSCI WORLD / GOLD)

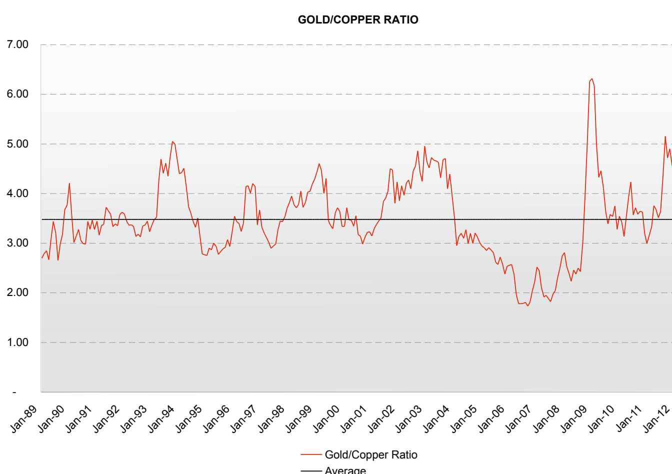


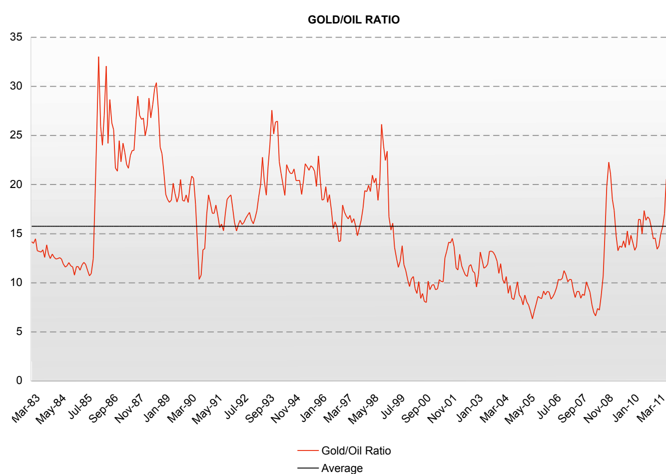
Furthermore, in recent years gold has also provided a better return than an investment in most commodity indices. A portfolio of 1/4 gold, 3/8ths equities and 3/8ths bonds would have performed almost 40% points better over the last decade than the same portfolio with the gold allocation substituted for a basket of commodities.





Gold is an excellent substitute for the commodity component of an investment portfolio. As a superior store of value over the long term, it is no surprise the ratio of the price of many commodities to the price of gold mean reverts. Thus an ounce of gold will buy you the same amount of, for instance, copper or oil today as it would have 20 or 30 years ago.





The years leading up to the financial crisis were unusual due to positive real interest rates. As central banks steadily brought down their interest rates from double-digit levels and inflation remained benign and under control, real interest rates stayed modestly positive.

This proved to be a sweet spot for bonds and equities, enjoying as they did stable and positive returns. Real interest rates are now firmly negative and are likely to stay that way for the foreseeable future as central banks are forced to keep rates nailed at zero, while inflation drifts higher. Such an environment, however, is very beneficial for gold.

With real rates currently lodged around -3% (and this would be a lot lower if unofficial, and likely more accurate, measures of inflation were used), the chart below makes it abundantly plain what this means for gold returns in the coming years.

Thus not only is the backdrop for gold returns very favourable, we have shown owning gold ensures at least part of your portfolio has its purchasing power secured, at the same time smoothing its losses when other assets – bonds and equities – face challenging environments.

Gold is Undervalued

There are several ways in which gold is undervalued.

1. GOLD VERSUS GLOBAL MONEY SUPPLY
2. GOLD VERSUS EQUITIES
3. GOLD ADJUSTED FOR INFLATION

1. GOLD VERSUS GLOBAL MONEY SUPPLY

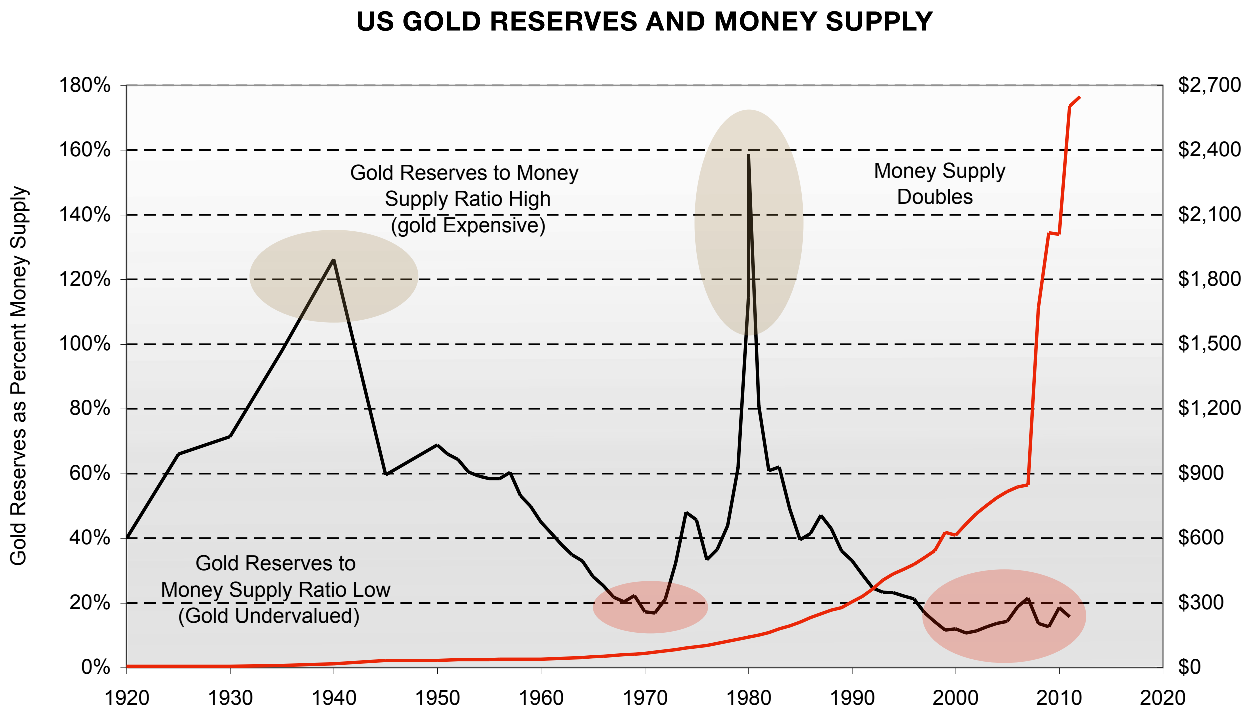
"Like gold, US dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology called a printing press (or, today its electronic equivalent) that allows it to produce as many dollars as it wishes at essentially no cost. By increasing the number of US dollars… the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services.

"We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

Ben Bernanke, 21st November 2002

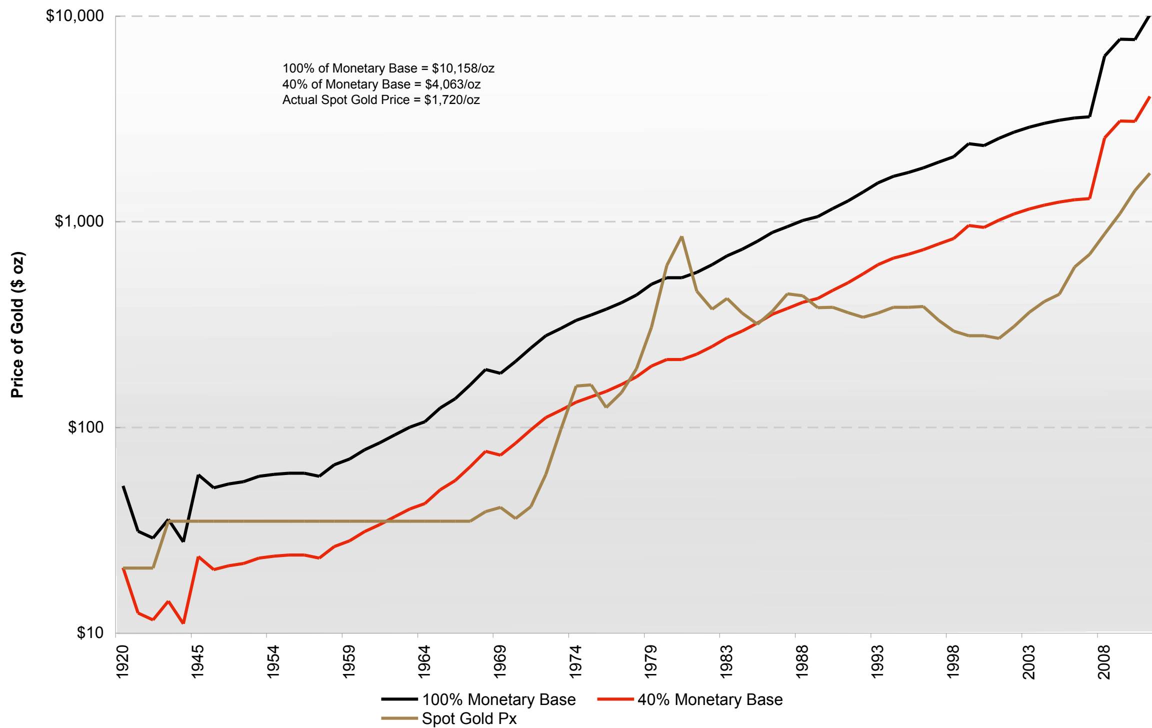
If anyone has any lingering doubts about the intentions of central bankers when faced with the risk of deflation, the above quote should dispel them in an instant. This is an explicit admission from the now governor of the Federal Reserve he will debauch the dollar to avoid even the slightest chance of falling prices.

The following chart is a stark illustration of how the new money printed in recent years has dwarfed the value of US gold reserves. The unavoidable implication is that gold's value will continue to rise due to its growing scarcity relative to printed currency.



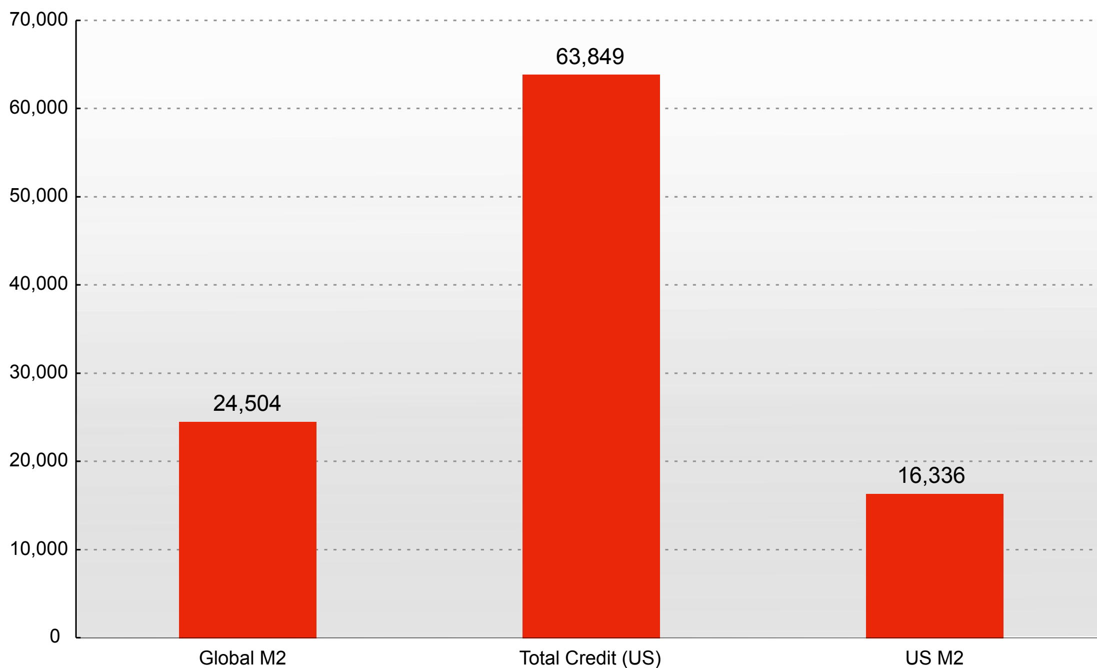
Today the US monetary base is only 15% backed by gold. This is the same level as in 1971 when gold was also highly undervalued. If gold was to back the US monetary base by 40% (the official reserve requirement stipulated under the 1914 Federal Reserve Act), then gold would have to be revalued to over $4,000 an ounce.

US GOLD RESERVES AND GOLD PRICE



If we apply this 40% reserve requirement to the total outstanding US credit, as the chart below shows, this would imply a gold price of over $63,000. This makes the $4,000 valuation for gold look an exceedingly conservative estimate.

IMPLIED GOLD PRICE IN USD ASSUMING 40% BACKING OF MONEY SUPPLY

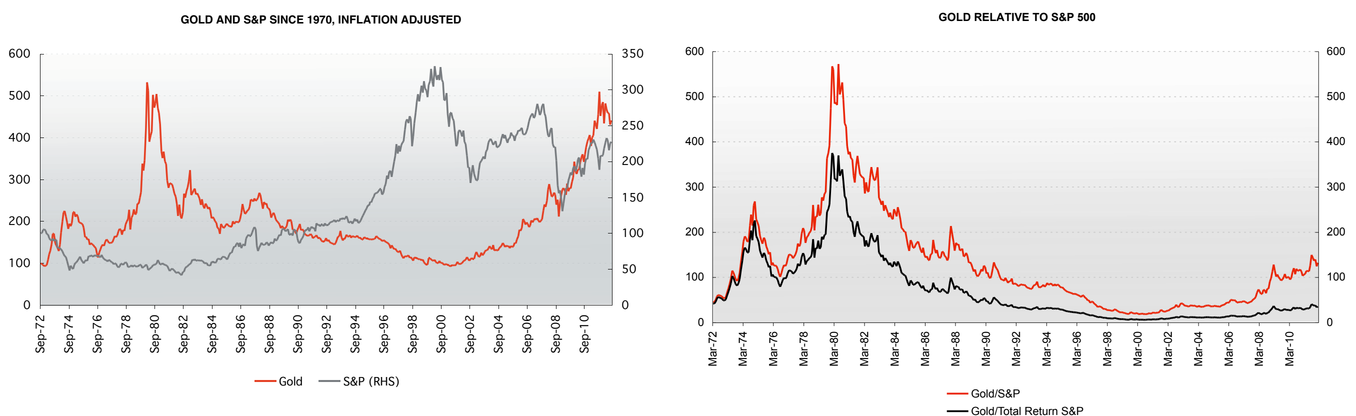


2. GOLD VERSUS EQUITIES

2009 marks the year gold prices began to substantially outperform equity prices both in real and nominal terms. Despite this transition, the two charts below clearly explain why gold continues to hugely underperform when compared to equities.

The ratio of gold to the S&P500 is currently around 1.3. From a historical perspective this is incredibly low. As gold surged in the early 1980s, the ratio reached as high as 6. Thus gold could outperform equities by a long way before it got anywhere near being overvalued.

In the period 1971-1980 we had the first post-Bretton Woods gold bull market. The end of Bretton Woods marked the end of the dollar's link to gold, and thus all the countries of the world became unpegged from gold. During the period 1973 to 1980 the gold price moved ahead of the price of the S&P. This was the beginning of almost 7 years of a powerful price rise in gold, it moving up six-fold in inflation-adjusted terms.



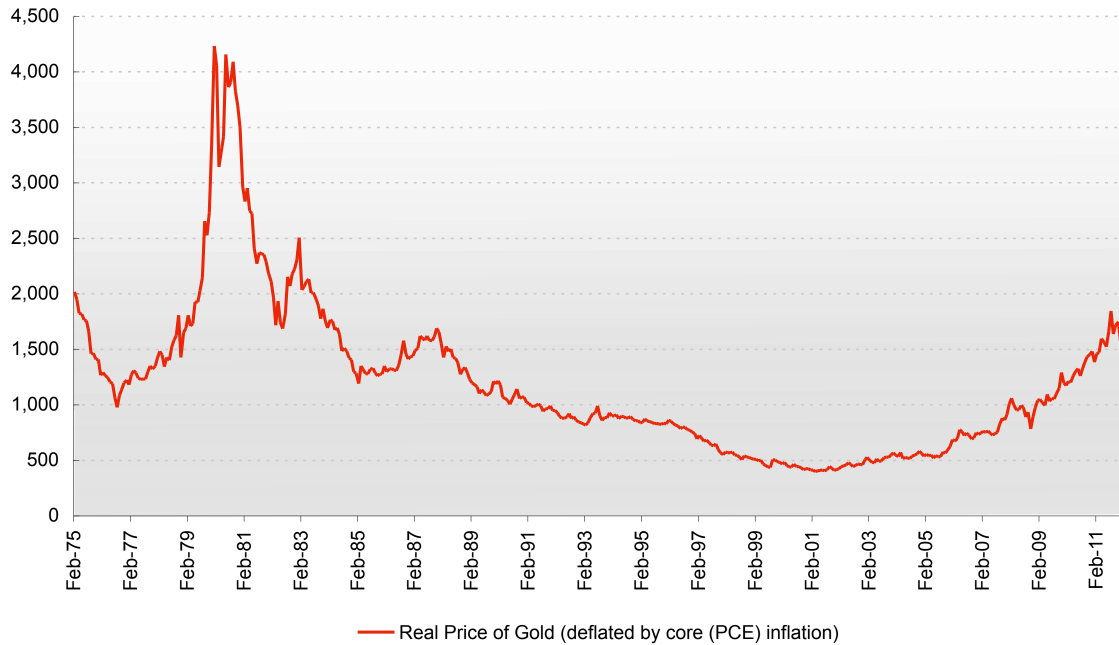
In 2008 the gold price moved ahead of the S&P price for the first time since the 1970s. What does this mean for gold? If the pattern plays out as in the 1970s, a 600% rise in gold would target a price in the region of $6,000. Gold has enormous potential.

3. GOLD ADJUSTED FOR INFLATION

Gold in inflation adjusted terms is still a long way off its peak. Looked at in this way, gold reached a peak of $2,400 in early 1980 (adjusting for inflation using US core PCE inflation). The chart below shows that gold today is far from the peak it reached 30 years ago.

To us, this shows gold is still out of favour as a monetary asset. However, this is beginning to change. Recent price moves are a testament to this incremental change in attitudes.

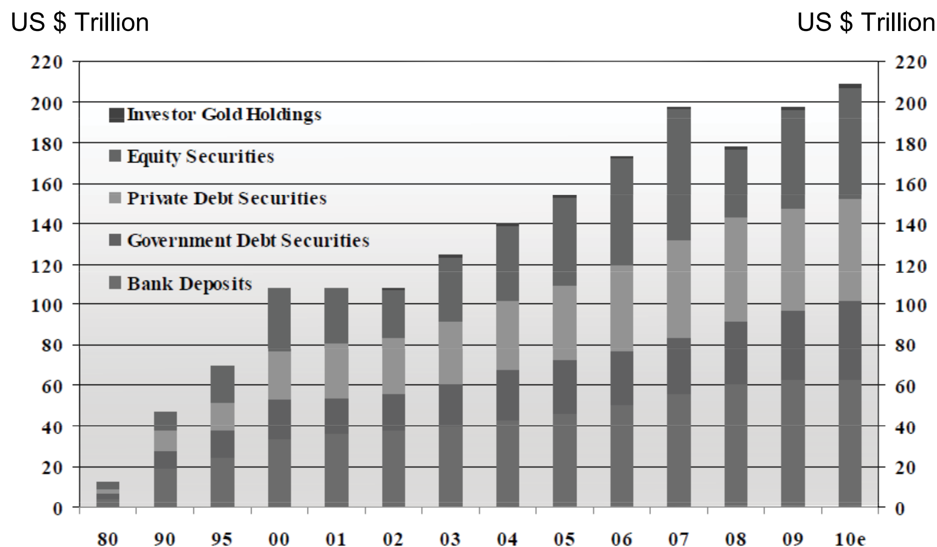
GOLD IN CURRENT DOLLARS



GOLD IS UNDERUWNED

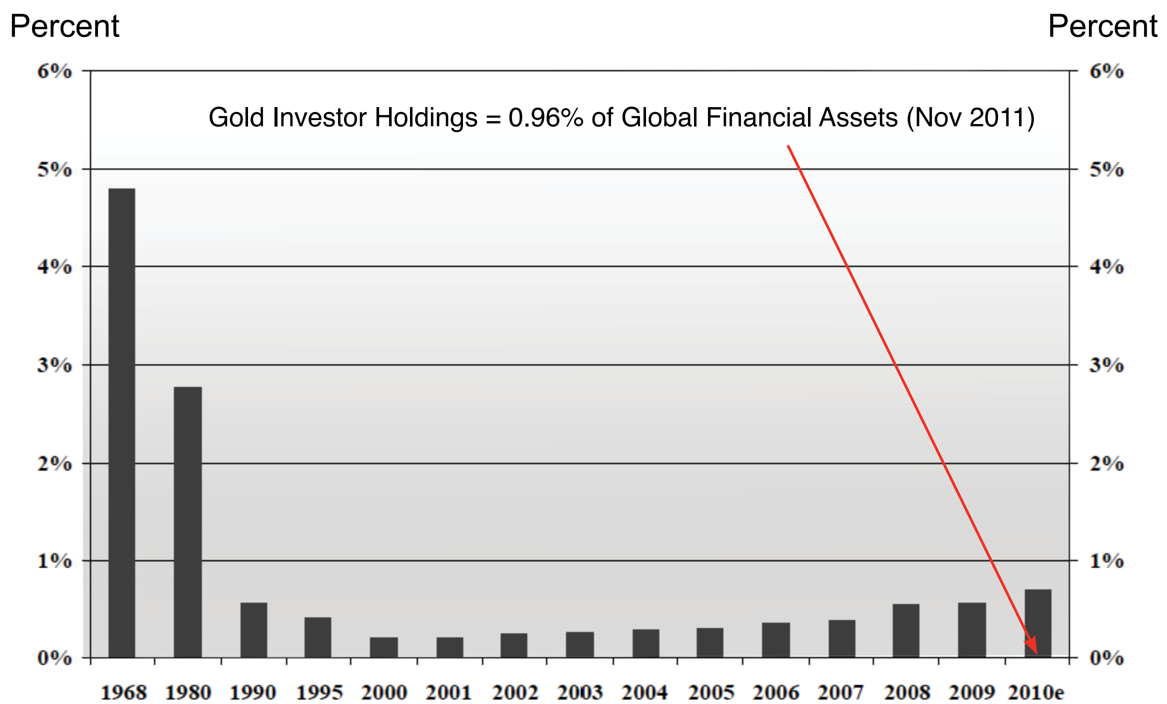
As the gold 'story' seems to be so well known now – even by those who would have considered themselves sceptics a few years ago – the corollary is often that most people who would buy gold as an investment have already done so. Therefore, the reasoning goes, the gold bull market is close to an end as few people are left to buy in. This is not the case.

Gold has not nearly kept pace with the vertiginous growth in financial assets across the globe. These have risen 17-fold over the last 3 decades, from $12 trillion to nearly $210 trillion. The dollar increase in the total value of gold above ground since the 1980s is significantly less than this.



Source: World Federation of Exchanges, The Economist, IMF and CPM group

Let's indulge in a little mathematics. Gold investor holdings today stand at $2 trillion, this is little less than 1% of global financial assets. In 2000, gold holdings were worth $227 billion, or 0.2% of all financial assets, but this isn't the whole story.



Source: World Federation of Exchanges, The Economist, McKinsey, IMF and CPM Group, as of end of Dec. 2010

$227 billion of gold at today's price of around $1,800 per ounce would be worth about $1.5 trillion, or 0.7% of today's global financial assets. This means only $0.5 trillion of the $2 trillion of gold today has come from new investment in gold, equivalent to 0.25% of today's assets.

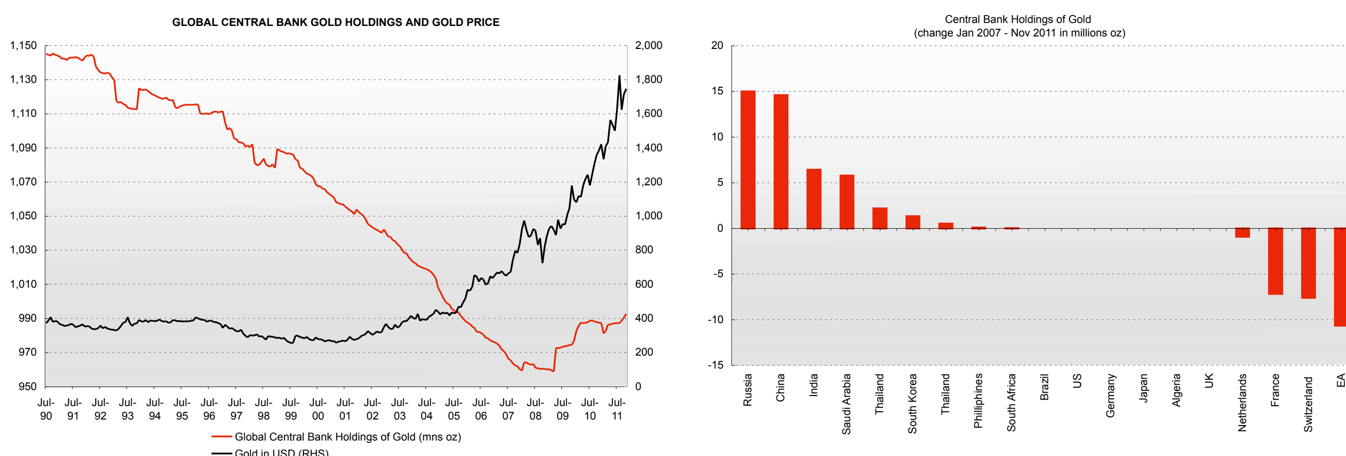
In the late 1960s, gold holdings were more like 5% of total reserve assets. This is $10.4 trillion today. With gold at $1,800 per ounce, this is a huge 5.8 billion ounces of gold, or 1.2 times all the gold ever produced. Indeed, it is 3.6 times of all known gold reserves (based on US Geological Survey data).

So not only is public ownership of gold miniscule, official sector holdings (central banks) are way below previous levels. To return to the holdings that were typical in the 1970s would require much more gold than today's prices could handle. This transfer of gold would have to take place at much higher prices.

Gold is in Demand

Central banks are net buyers of gold after being net sellers for many years. Demand for gold from central banks will likely rise to 1970 levels and this will overwhelm dwindling supply, as already discussed. Fundamentals for gold revolve around mine production and scrap sales on the supply side, and jewellery consumption, industrial and dental needs, as well as for investment, on the demand side.

CENTRAL BANK DEMAND
Central bank demand for gold is subject to structural trends. From 1990 to 2007 central banks were net sellers of gold every year. However, this changed after the financial crisis as fiat currency debasement across the globe has intensified.



From 1990 to 2007 central banks unburdened themselves of 176 million ounces of gold, but since then they have added 24 million ounces. The addition of gold reserves, however, is not even across global central banks. Europe is still a net seller, while India, China and Russia make up the main share of the net demand.

Let us indulge in a little more maths to illustrate how much gold central banks may need to buy. Reserve assets are what central banks hold on their balance sheets. They are made up of foreign currencies and gold. The total value of reserve assets worldwide currently stands at $10 trillion, of which 17% is made up of gold reserves. This ratio used to be much higher

Say central banks reverted to holding on average 34% of their reserve assets in gold, double the current 17%. This could happen in two ways (assuming the total value of reserve assets remained constant). The price of gold would have to double, or central banks would have to double their purchases of gold.

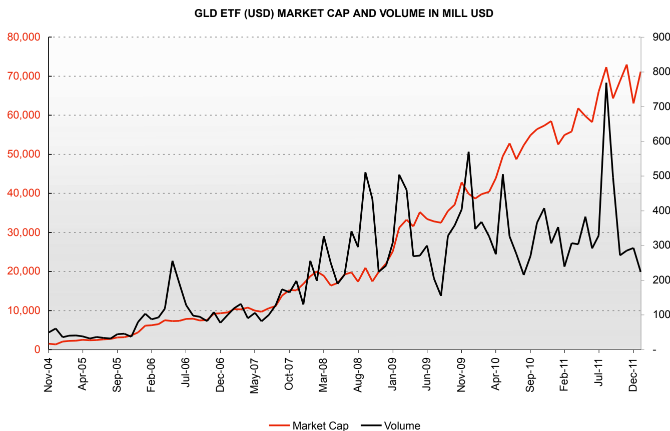
A doubling of central bank gold holdings would imply purchases in the region of one billion ounces of gold at current prices. However, this number is likely to underestimate the true dynamics. Central banks are rapidly expanding their balance sheets – through unconventional monetary policy such as quantitative easing – leading to the creation of more fiat currency, and thus further dilution of the gold component of their reserve assets.

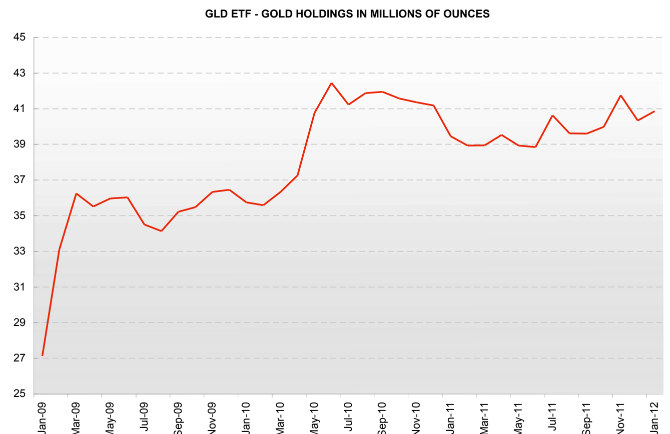
This implies that the value and/or quantity of gold needed to reach 34% is substantially higher than one billion extra ounces. Nevertheless, assuming a worldwide production of gold in the region of 2500 tonnes per year, 1 billion ounces would equal over 12 years of total global mine production.

Needless to say, central banks, even if they try only to increase their gold reserves by a modest amount, will have to buy at much higher prices than today’s.

INVESTMENT DEMAND

The strong performance of gold has attracted much investment attention. Exchange traded funds (ETFs) with exposure to gold have seen strong inflows over the past few years. The total market cap of ETFs has increased substantially in the past decade and, in conjunction with the bull market in gold, this has prompted a huge influx of investors to the product.





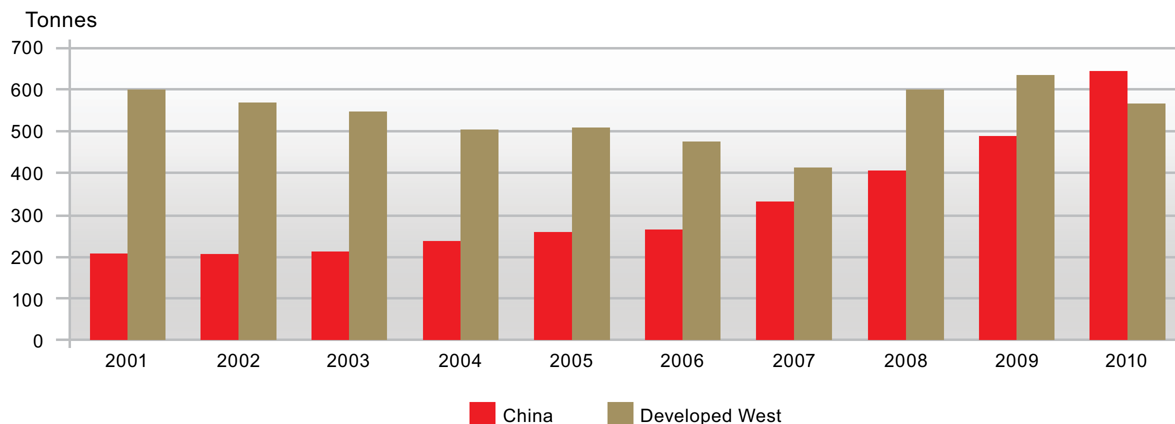
Gold ETFs are now one of the world's largest holders of gold, compared to a decade ago where they held next to none. But investor interest in gold ETFs has recently shown signs of waning. As the chart above right shows, the GLD – the largest physically-backed gold ETF – has struggled to re-attain its previous peak level of holdings. Investors are beginning to show a preference for holding physical gold, rather than a more opaque derivative product such as an ETF.

Indeed, we must point out that we are not advocates of gold ETFs and related products (we explain this in more detail in our other investor publications). We believe that there is unrealised credit risk and investors could find themselves without the exposure they thought they had, when they need it most.

Investment demand for gold is also going to be driven more by demographics going forward. This will be especially prevalent in the big Asian emerging economies where demand for gold is structurally much higher than in the developed world.

Chinese investment demand since 2008 has risen 277% from 2.2 million to 8.3 million ounces (2011) while fabrication demand rose only 26% from 11.3 million to 14.3 million ounces.

CHINA'S GOLD DEMAND OVERTAKES DEVELOPED WORLD



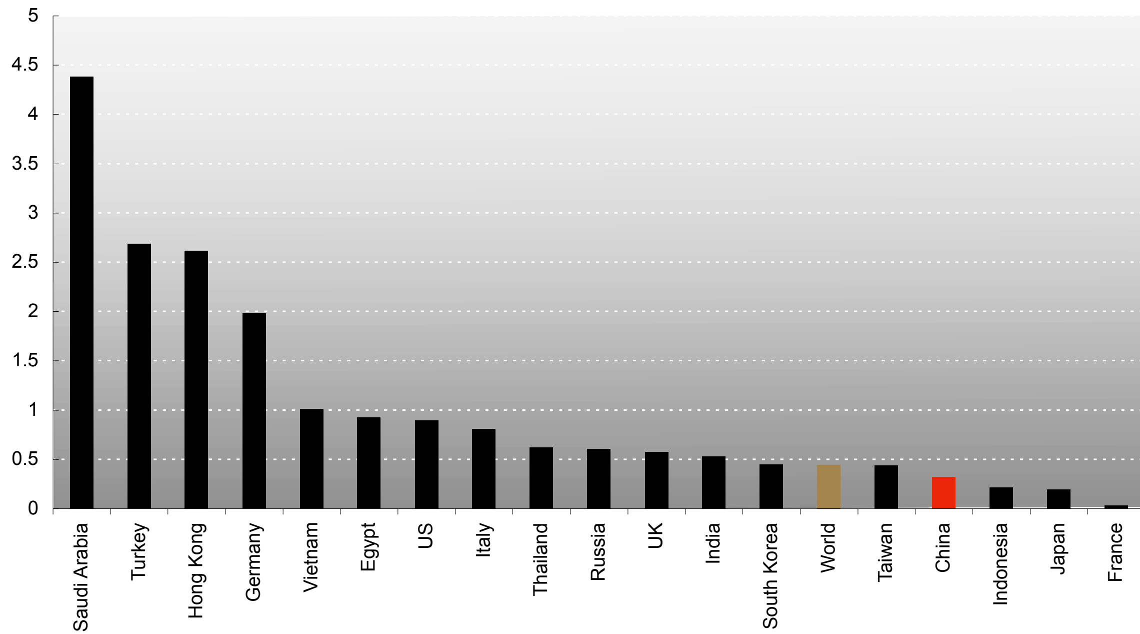
Note: Demand includes gold jewelry and bar and coin demand only. Gold colour represents Q1 2011.
•Developed West includes U.S., France, Germany, Italy, Switzerland, UK and other Europe
Source: GMX World Gold Council

Source: US Global Investors, WGC, CPM group

As a consequence total demand for gold in China has surpassed that of total Western demand.

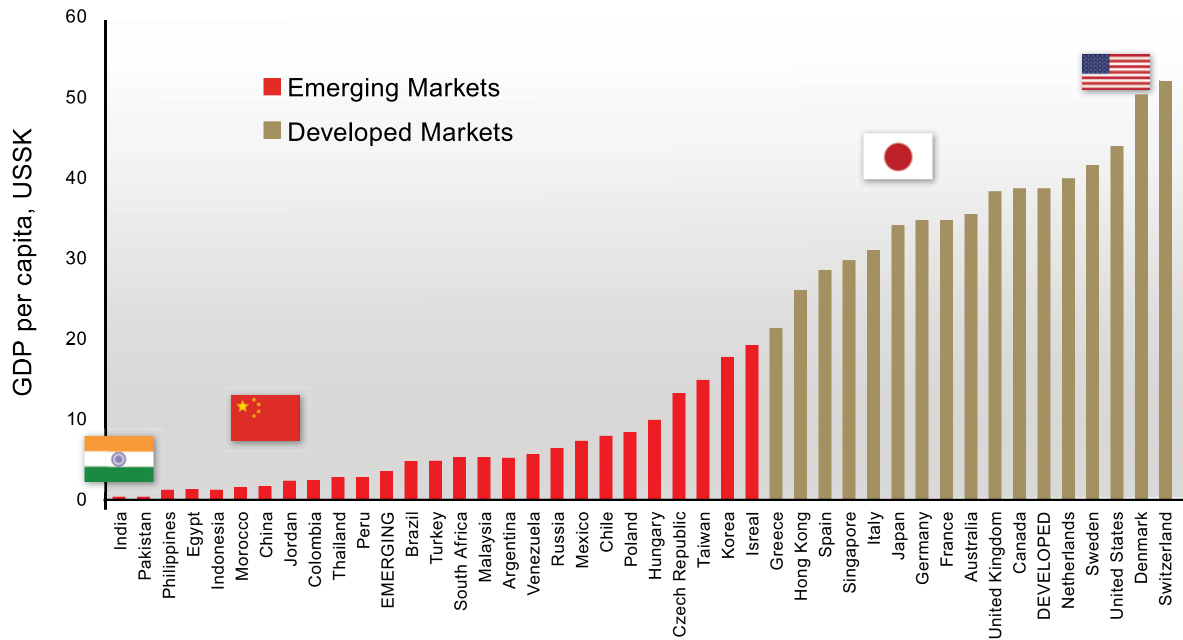
Moreover, on a per capita basis, China and India own much less gold than many other countries, as well as below the world average. This is noteworthy for two gold loving countries.

GOLD DEMAND (GRAMS PER CAPITA)



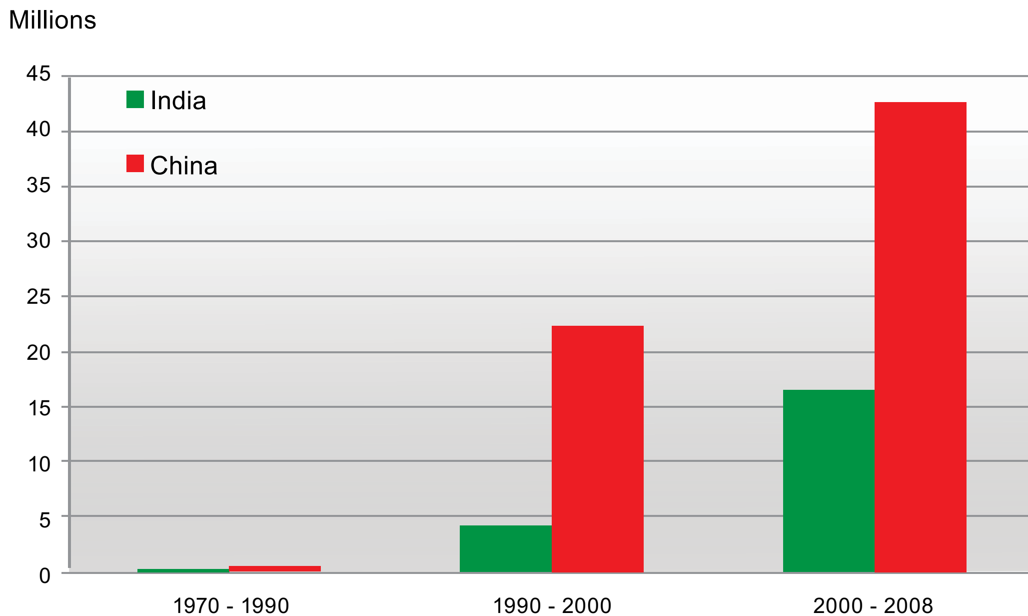
Source: UN, WGC

Asian incomes are set to rise strongly. Emerging market annual GDP per capita is under $4,000 versus over $40,000 for developed countries. Since 2000, China's per capita real income has risen from $3,000 to $7,000. This leaves twice as much to spend or save. Furthermore, the numbers of middle-class people with disposable income and the wherewithal to save some of their income is also increasing.



Source: IMF, US Global Funds

AVERAGE ANNUAL GROWTH IN MIDDLE CLASS + POPULATION



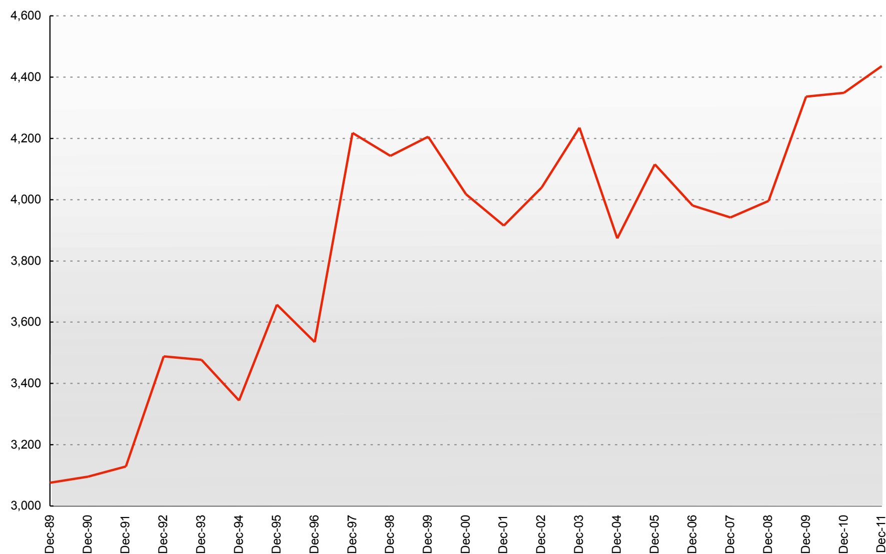
A rise in median incomes and a burgeoning middle class in countries with a cultural affinity for gold is very bullish going forward.

GOLD SUPPLY

We have shown several potent sources of demand for gold, from central banks to emerging market savers, but what about the other side of the coin – supply?

Global mine supply was stationary at about 2500 tonnes a year from 1997 to 2008 but has risen in the past two years to an annual production of about 2800 tonnes.

GLOBAL GOLD MINE DEMAND DATA



Source: CPM group

However, gold mine production is likely to fall short of demand going forward which will be bullish for prices. Demand is so strong that, despite technological advances, miners are unlikely to be able to get gold out of the ground to replace existing reserves and production. The economically mineable gold has declined in recent years mainly due to geological scarcity, geopolitical sensitivities, environmental hurdles and growing input costs. The dynamics again favour higher gold prices.

THE GOLDEN TRUTH

The 25 years leading up to the financial crisis were highly unusual. A secular decline in interest rates from their double-digit highs in the early 1980s, combined with central banks' willingness to respond to each crisis with a further loosening twist on the monetary tap, led to an exceptionally benign environment for equities and bonds. Many fell in to the trap of believing things really had changed for good.

The financial crisis exposed this chimera for what it was. Investors will have to work harder to get the sort of returns they got used to in recent decades. Economic volatility will increase; buy-and-hold for equities and bonds will no longer be a viable strategy. There is also the ever-present threat of a "sudden stop" event from a sovereign default or a major bank failure.

Owning physical gold, outright, in such a climate confers peace of mind. Furthermore, as long as central banks have ultra-low rates and are engaged in 'unconventional' policies such as quantitative easing, gold will continue to perform well.

Yet many individuals still do not have gold as part of their portfolio. Every successful family dynasty has always held a portion of their wealth in gold, passed down from generation to generation. Gold is unique in providing bona fide insurance from a collapse of the financial system; it is primed to do well in an environment of exceptionally loose monetary policy; and it provides true diversification to a portfolio, mitigating risks, not amplifying them.

Owning gold is a recognition that it should always be part of your portfolio. Any investment class can perform well or poorly. equities, bonds, property, cash, commodities, agriculture all have their periods in the sun. this is gold's.