



# Ted Scott on the wire

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## Is it time to take profits in Gold?

### In Summary

- **The opportunity cost of holding gold is very low**
- **Almost all the gold ever mined still exists**
- **Hedge funds have big positions**
- **Gold still works as a store of value**
- **US Treasuries don't offer the security low yields imply**
- **Deflation and inflation both good news for gold**
- **India & China buy gold on currency concern**
- **Capital flows are restricted**
- **A good each way bet**

### Introduction

In September I wrote a note exploring the reasons behind the rise in the gold price and what it may be telling us about the global economy and asset markets. Since then the rally in global assets has continued implying that confidence about a sustained recovery from the global credit crunch has risen. This has generally been confirmed by a good third quarter earnings reporting season and solid economic data releases. Other things being equal, one would expect the price of gold to fall as it is usually viewed as a hedge against uncertainty (social and political as well as economic). However, in the intervening two months gold has soared towards \$1200 per oz from just under \$1000.

This note gives an update on an apparent paradox and considers whether we are in a bubble for bullion. In September we concluded that gold was "a good each way bet" but is this view still appropriate given the 20% rise in the price since then?

### Why the rise in the price of gold has accelerated

Once the gold price broke through the resistance level of \$1000 it was always likely there would be a decisive breakout. There was a period when the price oscillated around this psychologically important level but since breaking out it has been hitting new highs on an almost daily basis.

Unlike the last time we had a sustained bull market in gold in the 1970s and early '80s, it is now easier to get exposure to gold via both the equity market and, more importantly, Exchange Traded Funds (ETFs) and so this has added liquidity to the market. Furthermore, hedge funds have become more significant in the demand for and pricing of assets and some of the best known (including Paulson and co. and Greenlight Capital) have built big positions in the metal.

This all means that technically the gold price has had a strong tailwind behind it, even though it has become a very crowded trade with overwhelmingly positive sentiment. However, from a fundamental viewpoint with the price having risen so fast does it appear less appealing? Let us consider the most important factors that have been driving the price:

### 1. Industrial and jewellery demand for gold

This has not been a factor driving the gold price recently. Indeed with the price having appreciated so much in the last six months there is evidence that demand is slowing down, especially in the crucial Indian market where it is widely used in society. It has limited industrial use (unlike platinum an alternative precious metal), so demand from consumers and manufacturing does depend heavily on the jewellery market. The supply of gold is also not subject to depletion like other metals that are used industrially and almost all the stock of gold that has ever been mined is still in existence. Therefore, from an economic perspective reflecting the laws of supply and demand the price of gold should be weak reflecting its increasing availability. With evidence that some economies are growing faster again, especially in emerging markets, demand may pick up slightly but because the supply is continually incremental it does not reflect the swings in production and demand that other metals do.

### 2. Gold as a store of value

One of the main attractions of gold is as a store of value compared to paper based currencies. The supply of gold is by definition limited whereas currencies can be produced in infinite quantities. In this respect, gold is an alternative to currency and this was reflected in its history of backing the world's main currencies through the gold standard (the last vestige of the gold standard was abandoned with the collapse of the Bretton Woods system in 1971).





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The value of gold is not dependent on the creditworthiness of any particular issuer and with the financial crisis of 2007-8 leading to a global recession the attractions of gold as a reserve currency have once again been highlighted. The flip side of this is that the dollar, which has presided as the world's reserve currency since the Second World War, has been inversely weak with gold's strength. Doubts have increasingly been raised about the dollar's domination in the foreign exchange markets.

### 3. The dollar and the bond market

Although the US has now officially emerged from recession, the nature of its recovery is rightly regarded as fragile and fraught with risks. The Federal Reserve has implemented an ultra-loose monetary policy combining record low interest rates with the equivalent of the UK's quantitative easing (QE), called credit easing, by buying interest bearing assets and thus increasing the money supply in an effort to reflate the economy. The Fed will remain committed to this policy until it is convinced that the economy is on a stable and sustainable growth path and only last week the Chairman, Ben Bernanke, announced that interest rates would remain low for an "extended period".

The low yield on dollar assets has encouraged the so called carry trade whereby investors have been selling dollars and reinvesting in currencies with higher returns for little perceived risk. For commodities, and especially gold, the weakness of the dollar has helped fuel the large rise in commodity prices (see graph below for the close inverse correlation). Commodities are priced in dollars so a weak dollar equates to a higher commodity price.

Chart 1: Gold Price & Dollar Trade-Weighted Index



Source - Bloomberg

The record low interest rates are important because the opportunity cost of holding gold is the real interest rate as it does not pay a coupon. In normal economic conditions the yield on government bonds would provide an alternative 'safe' asset class but, to the surprise of many, the yield on bonds has remained low despite signs of economic recovery.

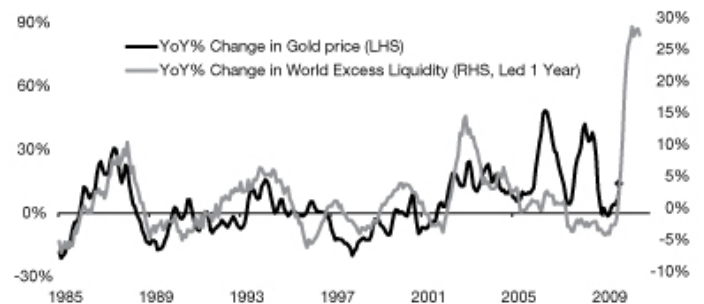
This means that the opportunity cost of holding gold is very low and with the prospect of rates, and therefore bond yields, remaining depressed for a while yet the relative attraction of holding gold will remain intact. The low opportunity cost has been and is a major reason for the strength of the gold price.

### 4. The US economy and future concerns

The nature of the US fiscal and especially monetary policy has led to increased uncertainty as to the longer-term consequences. The expansion of the money supply is regarded as potentially inflationary while the economic expansionary programme has led to a massive rise in the fiscal deficit. For the time being the credit easing policy is, like QE in the UK, helping to keep bond yields low but when it ends there is still going to be a large requirement to finance the deficit by further issuance of government bonds. This will probably lead to a sharp rise in yields and this implies that currently US Treasury bonds do not offer the security that the low yields would imply.

Much of the demand for government bonds has come from commercial banks who were previously large holders of the now infamous asset-backed securities. There is a risk that if and when bond yields increase it could lead to concerns about how the US can finance its deficit in a low growth environment. The gold market reflects the uncertainty and, like the opportunity cost of holding the metal, is a major reason for its recent ascent.

The world is a very uncertain place at present and gold thrives on uncertainty. Although the immediate threat of deflation has receded it has not been lanced and we are still in an era of falling prices in many developed nations. At the other extreme, the risk of inflation has significantly increased with the liquidity fuelled monetary policies of the authorities (see chart below showing the correlation between excess liquidity and the gold price). Deflation and inflation are two extremes but, paradoxically, strong arguments can be made in favour of both and either would be good for the gold price.



Source: Credit Suisse





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## 5. A potential currency crisis

The weakness of the dollar by no means represents a currency crisis and so long as its decline is orderly it should be of net benefit to the global economy because it will benefit the US, still by far the world's largest and most important economy. However, not everyone has been content with the decline of the dollar.

The US built up a large trade deficit through importing cheap goods, especially from China, in the years of economic growth leading up to the credit crunch and as a result those nations have large foreign exchange surpluses. Much of the surplus has been invested in US Treasuries that were seen as the securest form of investment but, as mentioned, that is less true now. Furthermore, the decline of the dollar has eroded the value of the US assets much to the chagrin of the Chinese and other surplus nations. If bond yields rise sharply there will be large capital losses as well.

The Chinese have remonstrated with the US about the weak dollar and are clearly worried it could turn into a full scale currency crisis. The authorities have bought gold to diversify China's foreign exchange reserves and were joined by India who recently purchased 200 tonnes from the IMF. Although the US policy makers are probably happy to see the dollar depreciate gently they would not want a rout, but to some extent it is outside their control. If the US has problems financing its deficit as the recovery stalls and the credit easing programme comes to an end, markets will quickly lose faith in the dollar.

The US (and this is true of the UK as well) can tackle its debt by one of three ways: it can default but this is very unlikely given the continuing importance and size of the US economy and the interested parties exposed to the value of the dollar. Secondly, it can attack the deficit in a conventional manner by cutting spending and raising taxes. There is not much sign of this yet except occasional rhetoric. In fact, the reverse has been true as taxes have been cut and State spending increased to boost recovery hopes. A conventional solution to the deficit via tax increases and spending cuts could come about if the economy embarked on a V shaped recovery and this would be negative for the gold price. However, this seems unlikely in my view (see previous notes) and therefore the currency concerns that follow on from the uncertain economic outlook appear entirely rational. The last way to remove the deficit is to monetise the debt. This is what the market fears with the ultra loose monetary policy. In effect, the US is debasing its currency by printing excess money that is monetising its debt. In extremis, this is what Germany did in the 1920s and that led to the complete collapse of the economy and the rise of Hitler.

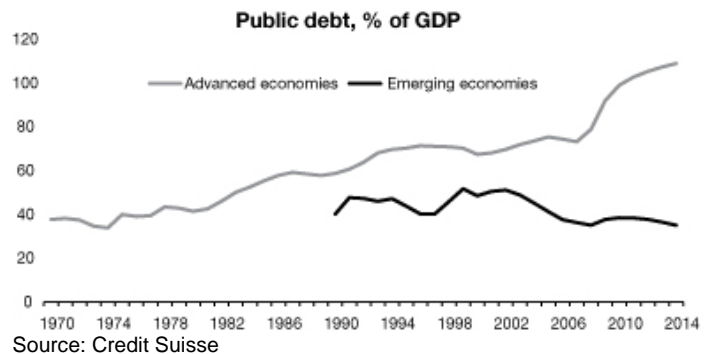
Today the Federal Reserve is so preoccupied with avoiding deflation that it is prepared to risk high inflation while growing what is already an enormous fiscal deficit. It can get away with a high risk and, arguably, irresponsible monetary policy partly because it is being financed by the credit easing programme. Also, commercial banks have been buyers of government bonds as they seek to strengthen their balance sheets. Until the risks of deflation and inflation become clearer, gold is likely to benefit from this uncertainty.

## 6. The global flow of capital

Linked to the heightened currency tension between trading partners there have been increased flows of capital relating to the perceived economic outlook of the respective countries. China, as the leading emerging nation, has been growing at about 8% GDP this year and has attracted large foreign capital inflows that have put upward pressure on its currency, the renminbi. As the Chinese economy is still heavily reliant on its export sector the authorities have had to intervene heavily in the foreign exchange market to prevent the RMB from appreciating. In Brazil, another commodity based emerging economy; the Government has gone even further to discourage capital into the country by imposing a 2% tax on inflows.

It is apparent there is a trend to try to limit the amount of capital going into fast growing emerging economies and therefore the holders of the capital will seek an alternative. Gold will therefore be a main beneficiary.

For the foreseeable future there will be a reluctance to invest capital into developed markets given the uncertainties and risks described. The chart below shows the respective public sector deficits of advanced and emerging economies and is a clear pointer to the financial risks of the respective countries. With constraints appearing to limit the inflows of money to emerging markets, gold will be a natural haven.





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### Conclusion

The above analysis shows there are many reasons for the recent strength of gold, aside from its traditional attractions as a hedge against risk and a store of value. Since the last note two months ago the price of the metal has risen about 20% and the consensus has become much more bullish. However, the case for holding gold remains compelling given the increasing uncertainty relating to the growing global imbalances as we emerge from the recession. Furthermore, the low interest rate environment, especially in developed economies, is set to remain for some time and therefore the opportunity cost of holding gold is low.

The only way that gold can underperform is if the US and other developed economies recover in a conventional way by cutting spending and raising taxes while at the same time embarking on a period of stable economic growth. This would prompt a strong and sustained rally in the dollar as confidence in the US economy rose together with bond yields and interest rates. Given the significant challenges ahead, a muted and fragile recovery appears more likely. With the likelihood that the world will take several more years to heal the wounds inflicted by the credit crunch an alternative asset like gold will remain attractive in such an uncertain environment.

The price of gold may have risen a long way recently but in real terms is still well below today's real price high of \$2300 achieved in 1980. It is over-bought and is likely to see a correction when the dollar has a technical rally. Beyond that, gold remains an attractive each way bet.

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