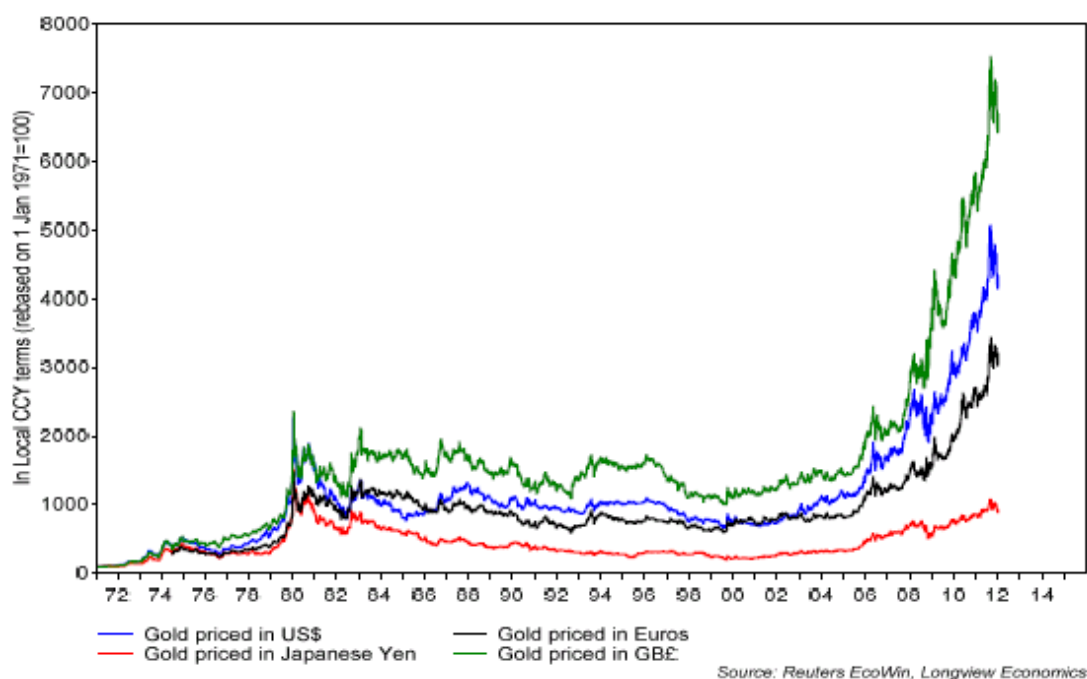


GOLD: IS IT TIME TO SELL YET?

Introduction

Keynes famously described gold as a 'barbarous relic'. He was referring to its outdated status compared to paper based money and, with the demise of the gold standard, discrediting the use of gold as real money or a proxy for real money in today's world. Although gold has not regained its status as the world's official reserve currency it has enjoyed a significant rise in price since 2001 as it has regained its lustre as an investment safe haven and store of value. Gold attained a new all time high in 2011 (over \$1900 per ounce) and although it has given back some of those gains many investors and analysts are wondering if the bull run is now over.



This note explores the reasons for gold's recent strength and poses the question: is it time to sell?

Why has gold done so well?

Gold tends to do well in times of economic and financial stress reflecting its safe haven status and this is clearly a factor contributing to its strength over the last several years. However, there is a lot more to it than this and below we will look at the main factors that have driven the price up and why it would be premature to take profits now.

The looming failure of fiat paper money currencies

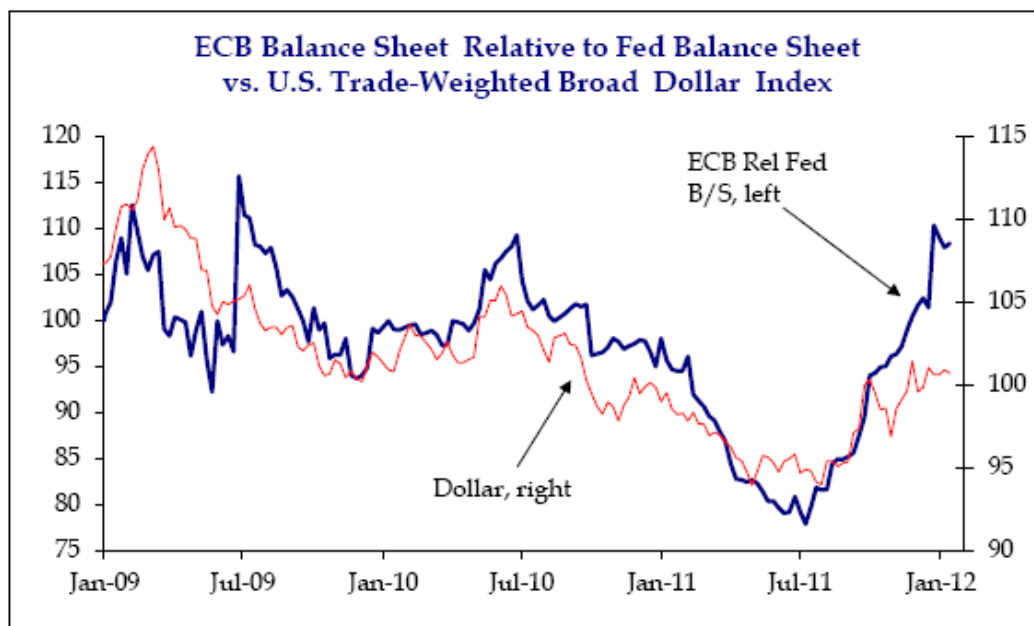
This is the most important reason for gold's rise and why it should continue to do well. The term fiat money is defined as "any money declared by a government to be legal tender". Since governments have a monopoly on the issue of money (via bank notes printed by the central bank) there have been times in history when currencies have become unstable due to the excessive issuance of paper money. This usually comes at a time of excessive debt of which the most infamous was the Weimar Republic in Germany between the 2 world wars that led directly to hyperinflation.

A fiat money system can operate effectively and with confidence under the conditions of sound money. This means that governments pledge to retain the value of the paper money by refraining from excessive issuance of it. In modern days these principles have been enshrined

in the beliefs and the constitution of the German Bundesbank (partly as a reaction to the hyperinflation of the 1930's) and more latterly the ECB that was founded on the tenets of the German central bank (although these principles have recently been compromised by the three year LTRO programme announced in December). The economic doctrine of monetarism that was popular in the era of Reagan and Thatcher also advocated a control of the money supply as a prerequisite for containing inflation. Put simply, too much money chasing too few goods will result in higher prices that will result in increased demand for an asset that retains its value of high inflation, like gold.

With the debt crisis proving so difficult to resolve the temptation to abandon the principles of sound money has correspondingly increased. Since 2008, when Lehman Brothers went bust and triggered the global recession that followed, policy makers have grappled with various strategies to counter the deflationary effects of paying down debts. The result has been an anaemic recovery in most developed economies, which is well below trend for this stage of the economic cycle, while the burden of debt has partly been transferred from the private to the public sector. Most obviously this has been manifested in the Eurozone that has witnessed the creation of a major sovereign debt crisis which has been exacerbated by the policy of self-imposed fiscal restraint and austerity on the afflicted periphery states.

Over the last three years central banks have loosened the purse strings and flooded the financial world with liquidity in, as yet, a vain attempt to restore economic growth and provide a solution to the debt crisis. As interest rates had already been cut to near zero there was little monetary ammunition for central banks to deploy other than to print money. Both the Federal Reserve in the US and the Bank of England implemented quantitative easing (QE) programmes in 2009 and they have subsequently announced second tranches in response to the continued slow economic growth outlook. More recently, the ECB has injected almost €500bn of liquidity into the Eurozone banking system through its LTRO programme with the promise of more to come in February. Although the President of the ECB has rejected appeals for QE, the actions of the Bank are tantamount to the creation of new money as the funds borrowed by the commercial banks are not sterilised (i.e. there is no offsetting measure to ensure the money supply does not grow, as is the case with the ECB's securities market programme when it buys Eurozone sovereign bonds and then sterilises the purchases). Anyone who doubts that the ECB has not aggressively expanded its balance sheet in the same way as the Fed and Bank of England should reflect over the chart below, which illustrates that over last 6 months the ECB's monetary base has grown substantially faster than its US counterpart.



Therefore, at least in developed markets, there is a coordinated response to tackle the debt crisis through the creation of new money, whether directly like the Fed and the Bank of England or indirectly like the ECB. In effect, debt is being monetised with the attendant risk of high inflation and the debasement of the paper money system. In more normal times, growth will return to economies that have suffered a recession but, as the CEO of Paulson christened it, the 'new normal' is likely to be one of slow or declining growth for many years to come. Mindful of what Japan has experienced over the last 20 years policy makers where 'debt-deflation' has taken hold, today's politicians and central bankers have resolved to avoid the policy mistakes of Japan in the 1980's and 90's through aggressive monetary policy.

Although there has been some modest improvement in economic data in recent months, especially in the US, the level of growth has been very disappointing and the UK and Europe face the real prospect of relapsing into recession this year, despite the enormous liquidity creation by the respective central banks. The response is likely to be even more printing of money meaning the risk of eventual high inflation and currency debasement will grow accordingly. All this will add to the lustre of gold as an asset because it is the only major asset that does not represent somebody's obligation to pay. There is a finite supply of gold in the world where the supply is only growing at a small rate as new stock is mined each year. This means that it cannot be debased like a paper currency where the potential supply is limitless.

Gold as a reserve currency

Gold has a long and distinguished history as a reserve currency and its' supporters credit gold with a financial discipline that produced decades of price stability, only interrupted by large scale wars which tended to result in temporary bursts of sharply rising inflation. Indeed, it was the massive debts associated with the spending from the First World War that led to the breakdown of the Gold Standard that had anchored the global monetary system for so long. However, it was not until the suspension of the Bretton Woods system when the US unilaterally terminated convertibility into gold that its role in international finance was formally ended. On that date (August 15th, 1971) the dollar officially became a reserve currency only backed by the promise of the US government.

One of the reasons for today's central banks being so loose with their monetary policy is that the adherence to the gold standard was widely blamed as a major reason for the Great Depression of the inter war years. Countries that remained on the Gold Standard were restricted in their ability to expand the money supply and lower interest rates. It is certainly true that those countries, such as Great Britain, that left the Gold Standard first recovered earlier than those which remained. However, much of the broader recovery that followed was due to the increased expenditure associated with programmes such as the New Deal in the US as well as rearmament ahead of the Second World War and the huge spending associated with the war itself.

For this reason, the gold standard was partly discredited following the Second World War and policy makers were determined not to repeat the mistakes of the First World War where the combination of fixed exchange rates and austerity measures (similar to the Eurozone today) resulted in the Depression. The new Bretton Woods system pegged currencies to the dollar that in turn was convertible to gold at a fixed price but this only lasted from 1946 to 1971 which effectively ended gold's role for anchoring the global monetary mechanism.

The prosperity of western economies following the Second World War, in contrast to the hardship that followed the First World War, led to a growing view that the gold standard was a major policy mistake that sowed the seeds for the Great Depression. In the 1930's Keynes developed his economic theories that demonstrated that economies did not trend towards full employment and that fiscal stimulus was necessary to boost aggregate demand when the economy was weak. Keynesian economics remained in vogue until the oil induced inflation shock of the 1970's but even this did not lead to a demand for the return to the gold standard.

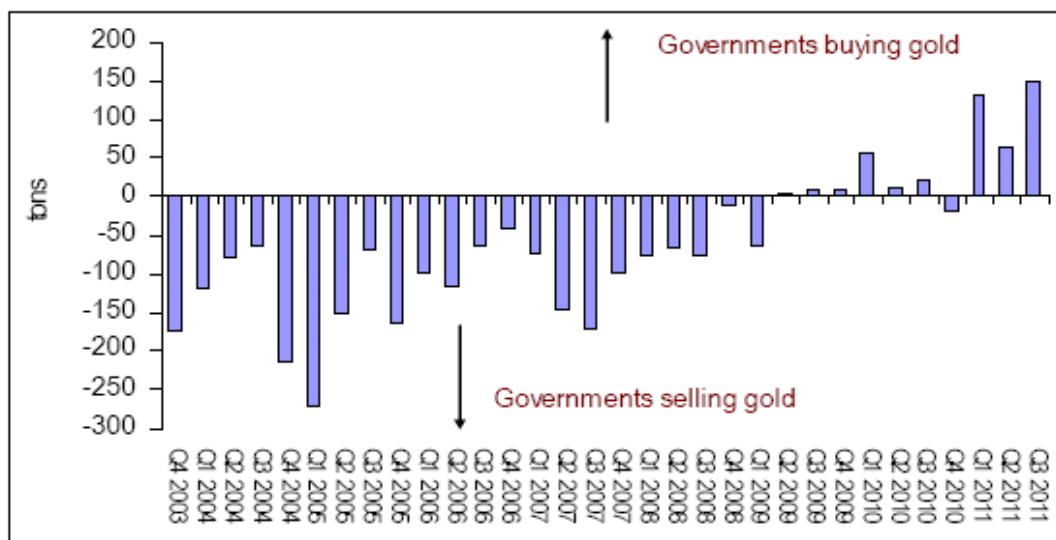
What the current debt crisis has highlighted is that without the discipline of gold as an anchor of the global monetary policy there has been no check on government deficit spending as there is no limit on the amount of debt that can be issued. As there is only a limited amount of gold it means that governments cannot create unlimited amounts of money. Central banks are

now adopting the strategy of printing money ostensibly to provide a necessary stimulus for economic growth but in reality to discharge debts (buying government bonds and other interest bearing assets) and to erode away the value of those debts through inflation.

For these reasons gold has returned as an asset of choice for governments and central banks seeking to diversify their foreign exchange reserves away from paper currencies, especially the US dollar. There have even been calls for a return to the gold standard although this is very unlikely to happen, especially in the light of the lamentable failure of the Euro as a fixed currency regime. However, the secular devaluation of the US dollar that is the world's only reserve currency has led to demands for an alternative asset to fulfil that role. At present, there is no obvious alternative currency to the dollar: the Euro has been discredited and the ECB liquidity programme is also contributing to its recent devaluation that could mirror what has happened to the dollar over the last few years whilst the Chinese Renminbi, which could become a global reserve currency at a later date, is in the early stages of becoming fully convertible from an international perspective.

In recent months the increased demand for gold as an international reserve currency has become apparent not only in the purchase of gold itself by central banks (see bar chart below) but, just as significantly, by the sale of dollar assets at the same time. The official holdings in gold at central banks only amounts to the equivalent of \$1.58trillion compared to foreign exchange reserves of \$10.2trillion and 2/3rds of the reserves are held by EM and developing nations. Indeed, China and Japan own a combined 43% of the world's forex reserves but only 3% of the gold reserves. The former has frequently expressed its hostility towards the US monetary policy that it believes is debasing the currency in which it has invested so much of its surplus. The Chinese central bank has stated that "no asset is safe now. The only choice is to hold hard currency – gold". Backing up its words with actions the PBOC has become a net seller of US Treasury bonds, even as the price has soared reflecting its safe haven status and some of the proceeds have been reinvested in gold. Russia has reportedly increased its gold reserves for 56 consecutive months.

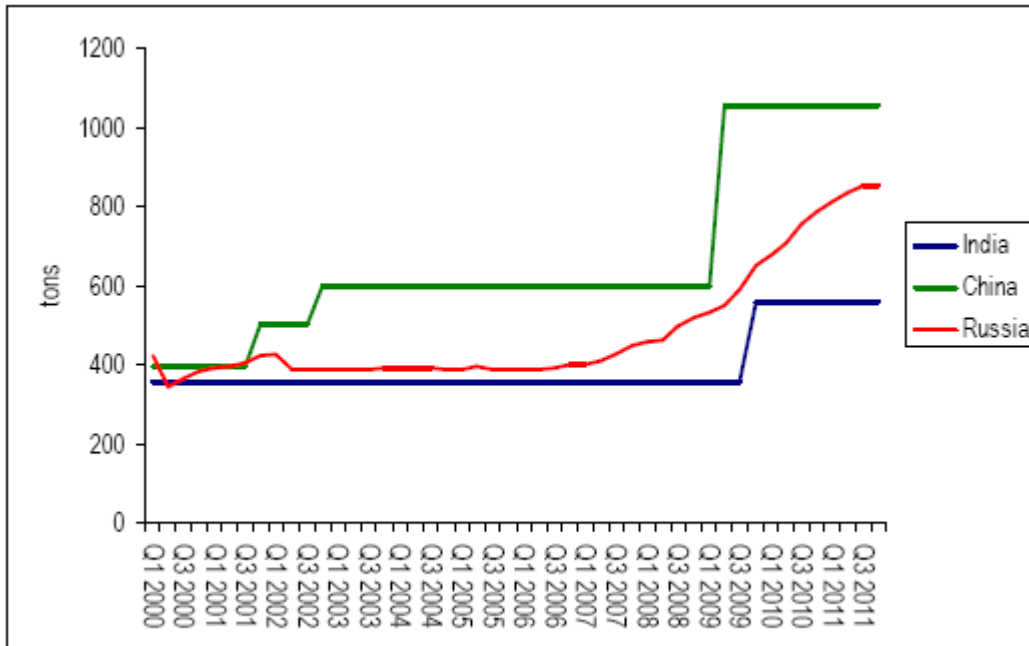
Net purchases of gold by central banks



Source: Lonaview Economics. World Gold Council. GFMS

The trend for increased holdings of gold as part of foreign exchange reserves is one that is likely to have a lot further to go, especially for EM countries. As it becomes evident that the trend towards currency debasement through increased printing of money is likely to continue the demand for gold as a reserve asset should accelerate.

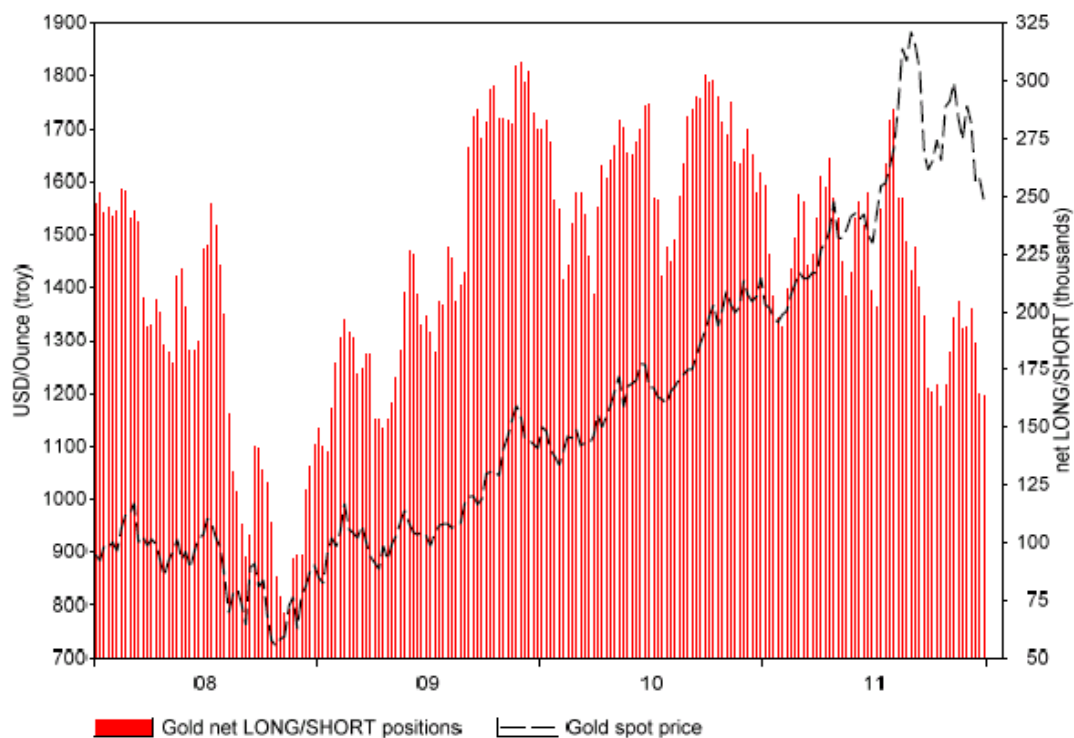
Purchases of gold by EM nations in recent quarters



Source: Longview Economics, World Gold Council, GFMS

What does the recent sell off tell us?

Gold fell sharply in September, when it reached a peak of \$1921 per ounce, to December with a fall of over \$300. It still finished 2011 with gains of 10.2% (better than the large majority of assets) and has rallied further during the first month of the New Year. What has been noticeable is that the volatility of the gold price has increased in recent years and when the price has fallen the declines have been sharp and sudden. This reflects the way gold is traded today and the amount of financial interest in the asset, especially through Exchange Traded Funds (ETF). The sharp falls in the price are often associated with the liquidation of futures positions suggesting it is linked to short term selling, something that is a relatively recent phenomenon. The graph below shows the net long/short futures positions in gold and reveals that the sell off in H2 of 2011 correlated with a fall in the net longs that is now the lowest since 2009. More fundamentally, the decline in late 2011 was partly due to the liquidation of a large holding by Paulson & Co. in the SPDR Gold Trust (an ETF). A further factor is that some confidence has returned to the US dollar as a safe haven as confidence has been further eroded in the Euro due to the recent actions of the ECB in raising liquidity and following better than expected economic data in the US.



Source: Reuters EcoWin

In times of extreme stress there is a valid argument that gold will not act as a safe haven because holders are forced to raise liquidity to meet liabilities elsewhere. This was reflected in the large percentage fall in the gold price after the collapse of Lehman's in September 2008 that precipitated the global credit crisis. However, the weakness is likely to prove only temporary, especially if the reasons for the period of extreme stress are not quickly resolved, as has been the case since 2008. If there was another financial catastrophe as a result of a breakdown of the Eurozone it is probable that gold would fall for similar reasons but it would also make it even more likely that policy makers would increase liquidity still further until it had the effect of creating the necessary inflation to erode away the value of the debt. The only way that savers can protect themselves would be to invest in a real asset like gold.

Therefore, the recent sell off in December and the periodic corrections prior to that are partly technical although no asset goes up in a straight line. By the late summer of 2011 (see chart) gold had become a very crowded trade and was extremely overbought so the weakness in the second half of that year was also fundamentally justified. Against other assets it is difficult to ascribe a value to gold as it does not have a coupon or produce earnings. Obviously, it has outperformed most other assets strongly during the last decade but this followed a long period of under-performance. The relative weakness of other assets such as some sovereign bonds, equities and real estate reflects the burden of debt that lies behind the current financial crisis and is supportive of gold.

The two major swing factors affecting the price of gold are the actions of central banks and investment demand. As discussed above investment demand is increasingly volatile depending on factors such as margin requirements and short selling that have little to do with the underlying trend of the asset price. In contrast, central banks have transformed from being net suppliers (remember Gordon Brown sold a large percentage of the UK's gold reserves near the bottom) of up to 12% of the global market to becoming a source of mounting demand. In the first half of 2011 official sector net purchases were 164% higher than in 2010 and are likely to be higher still this year.

Conclusion

The rise in the gold price has been driven by a confluence of weak economic growth, massive monetary expansion (that the ECB has recently added to) and fears of a breakdown in the global financial system. Gold is gradually regaining its role as a traditional safe haven that had been partially lost following the ending of the Bretton Woods system in 1971 that severed the dollar-gold link. That meant that cash could no longer be represented by gold and the main safe haven became US Treasury bonds where most central banks invested large amounts of foreign exchange reserves. With the debt crisis becoming so difficult to resolve and central banks threatening to debase their currencies via the excessive issuance of paper money it has not only increased the attraction of gold as a safe haven but undermined that of the US Treasury bonds. Indeed, the credit rating of US debt was downgraded last year reflecting the weak fiscal position of the US. Although US Treasury yields have continued to fall this reflects their greater liquidity and the currency they are traded in rather than any great optimism that the US government debt will rapidly diminish (US total debt to GDP peaked at about 370% in 2008 and is still over 350%).

If one believes the actions of the central banks will be successful in restoring economic growth while reducing the debt burden to manageable levels while not generating excessive inflation, then gold will fall sharply. The more likely scenario is that the deleveraging process for both the private and public sectors has much further to go and in the meantime central banks will continue to pump the financial system with more liquidity. As it becomes clear that the risk of currency debasement is rising the attraction of real assets will grow and within that category gold remains the best play. It should continue to be an integral part of a diversified portfolio.

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Director, Global Strategy
26 January 2012

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