

COVER STORY



Going for GOLD

The precious metal will continue to trend higher, as its appeal as a safe-haven asset rises on the back of ongoing uncertainties in Europe and turbulence in global financial markets, say experts

| BY KELVIN TAN |

With risk-aversion currently plaguing global financial markets, driven by fears over economic uncertainties in the debt-stricken eurozone as well as possible military conflicts involving North and South Korea, gold looks set to shine as a safe-haven asset in turbulent times. The metal is among a handful of assets — alongside US Treasuries — that are still turning in positive returns this year.

"Traditionally, gold has acted as a safe haven in times of economic uncertainty and stress in financial markets, with its attraction increasing as the degree of financial uncertainty rises," says Robert Adair, fund manager of United Gold & General Fund and United Global Resources Fund at UOB Asset Management (UOBAM). "The price of gold could potentially go higher, in the event of renewed financial market uncertainty," he predicts.

Of late, global investors have "questioned the credibility" of the recently announced US\$1 trillion (\$1.4 trillion) eurozone rescue package, as "it failed to address the issue of sovereign debt burdens", says Andrew Robinson, a market analyst at discount brokerage Saxo Capital Markets. "With French and German debt-to-GDP ratios at 78% and 73%, respectively, this bailout package is actually a case of the indebted bailing out the indebted," says Robinson, another gold fan, who believes the ongoing uncertainties in the eu-

rozone will continue to keep gold at the forefront of investors' and hedgers' minds.

The key reason for gold's appeal as insurance during market turmoil is that it tends to preserve its value better than other asset classes in an across-the-board slump. Indeed, gold is up 9.1% this year (as at May 26), while riskier assets like global equities and commodities, measured by the MSCI World Index and Reuters/Jefferies CRB Index of 19 commodities, are both currently down by more than 10%.

Besides gold's safe-haven characteristic, the current low interest rate environment around the world is also spurring demand for the metal. "Gold was often viewed as the investment of zero returns; it just sits there, shines, but does not earn an investor any interest. However, with the current low global interest rate environment, gold may no longer be seen as the 'costly' investment it used to be," says Robinson. With global interest rates likely to stay low in the foreseeable future, the lack of higher yields elsewhere will keep investors trading in gold, he adds. "We can therefore expect the current highs to remain supported in the long term."

Nevertheless, investors should treat gold as an insurance policy against unexpected market chaos, instead of using it as a profit-making asset, advises Christian Gattiker-Ericsson, global head of research at private bank Julius Baer. "[Though] overhyped, gold does act as an insurance for our clients' portfolios," says Gattiker-Ericsson, whose cli-



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ents' diversified investment portfolios tend to have a 5% exposure to the precious metal. "If you have the extremes [scenarios] in the market, with either heavy deflation or inflation, or if [the EU] really messes it up in Europe, then gold will compensate you," he points out, adding that the recent strong surge in gold price "tells you that the market is very concerned about policy errors of the EU leaders".

Volatile prices

For sure, it has been a topsy-turvy couple of weeks for gold, whose price has been extremely volatile of late. It hit an all-time high of US\$1,249.40 an ounce on May 14 as other asset classes — notably riskier ones like

equities and industrial commodities — slumped on concerns about the worsening eurozone debt crisis. The latest Chinese consumer-price numbers that show inflation in the country at an 18-month high fuelled more buying in gold, which is seen as an inflation hedge.

But, from that peak, gold subsequently slumped five straight days to as low as \$1,166.50 in the week ended May 21. That was its worst weekly performance in almost 15 months, as traders cashed in profits on expectations that demand for risky assets could see a pick-up and dampen the shine of the yellow metal.

The recent short-term slump could be due to "deteriorating equities forcing managers into selling their winners [namely accumulated gold gains] to meet their widening losses", observes Ashraf Laidi, a strategist at discount brokerage CMC Markets.

Last week, gold regained some of its glitter. Its price climbed above US\$1,200, after reports that North Korean leader Kim Jong Il was preparing his military forces for combat against its neighbour in the South, which is accusing the North of sinking one of its warships and killing 46 people. The global stock sell-off last Tuesday — spurred by fresh concerns that the European debt crisis may derail the global economic recovery — also helped revive demand for gold.

Although the gold price is currently 3.5% below its record set over a week ago, many gold experts, according to a recent Bloomberg survey of 23 traders, analysts and in-

vestors, still believe the metal could hit US\$1,500 an ounce by end-2010. Many market observers reckon that gold's recent slide is temporary and it is likely to trade in an upward-trending range going forward.

"We see gold prices edging closer to US\$1,300 by year-end, as long as we are able to hold position above US\$1,160," says Robinson of Saxo Capital Markets. "For long-term investors, gold remains a viable store of value. US\$1,330 is a possible target for year-end, but gold could also see a decline towards \$1,080 in the medium term," adds Laidi of CMC Markets.

Gold to hit US\$8,000 by 2015

Veteran "gold bug" James Turk, founder of online gold broker Gold Money, is predicting more upside for the precious metal — reaching \$1,800 to \$2,000 at end-2010. In a keynote address on the first day of the 2010 World Mining Investment Conference in London on May 18, Turk reaffirmed his bold forecast made at end-2009 that gold could reach US\$8,000 by 2015, based on past patterns of surges in price.

The trillion-dollar bailouts by the US and Europe will lead to high inflation over the long run, says Turk, who believes the purchasing power of many currencies will be devalued in a hyper-inflationary environment, as large volumes of fiat money are printed and pumped into the global market by developed economies in their respective bailout plans. The only "real money" that can preserve wealth over the long term is gold, he says.

Adair of UOBAM agrees. "Financial instability could manifest itself through an equity market sell-off, a crisis in the bond market or a loss of confidence in paper currencies. Of these three, gold is perhaps most attractive when viewed as an alternative to paper currencies, since an important characteristic of gold is that it does not depend on a particular national government for its value."

Fundamental drivers of gold

Indeed, gold has been rising against the currencies of most of the developed countries in recent years. Last year, prices surged 23.9% against the US dollar, marking the ninth consecutive year of gains versus the greenback.

Gold's bull run, which started in early 2002 when prices crossed US\$300 an ounce, is widely believed to have been primarily driven by the weakness in the US dollar. But, Adair of UOBAM points out that there are other fundamental reasons behind the price surge.

"We believe the price of gold is well-supported at current levels, given reduced selling by central banks, increased investment demand and constrained supply fundamentals," he says, observing that since 2002, private and institutional investors have started repositioning their portfolios by allocating a portion of their assets into gold. "We believe [investment demand] will continue to provide some support for the price of gold."

Global central banks and governments bought 425.4 tonnes of gold last year, the most since 1964, according to data by the World Gold Council (WGC), whose latest *Gold Investment Digest* (published on April 22) noted that strong jewellery demand in India and China, as well as sustained inflows from global investors, continued to support the gold price performance in 1Q2010.

"What becomes clear is that gold's continuing upward price trend is anchored in solid fundamentals," notes Juan Carlos Artigas, investment research manager at WGC, in a recent report. "A strong recovery in the Indian jewellery market from the low levels of demand experienced in early 2009... coupled with strong physical demand in China during the quarter, created positive support for gold," he observes. India is currently the world's biggest jewellery market for the precious metal.

Artigas also points out that gold could move higher, even when both the US dollar and global equities are rallying. "Given the proven role gold plays as a hedge against weakness in the US dollar and the fact that it typically exhibits a negative correlation with equities, it is often assumed that when equities or the US dollar rise, the price of gold suffers. [1Q's positive] price performance was achieved despite the US dollar rallying against weaker European currencies and despite an uptick in US and emerging market equities," he states.

Still, not everybody is a fan of gold. Among the big fund managers shunning bets on gold is Richard Lacaille, CIO of State Street Global Advisers, which manages assets of US\$1.9 trillion. The focus on gold is "difficult," because it is not easy to measure whether the metal is expensive or cheap, Lacaille tells *Personal Wealth*. "Gold doesn't have a yield or any [fundamental valuation gauge] you can get your arms around. When it rises, people tell a



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Laidi warns that a strengthening of the euro could lead to weaker gold prices against currencies and a broad sell-off

story about inflation or currency concerns, but they can tell the same story when gold is US\$2,000 or US\$1,000," he points out. "For that reason, I think making a bet on gold is something we don't like doing."

Without a doubt, Lacaille says a lot of his institutional clients own gold, as "the long-term inflation story hasn't yet gone away". But, he says, "gold isn't the only way of hedging inflation. The logical thing is to go for global [inflation protected bonds] or if you want to take more risk, go for a real asset portfolio like [a basket of] commodities or real estate that have a long-term inflation-link payoff."

Gold ETF and equities

Nevertheless, investment demand for the metal continues to be strong. According to data from the US Mint, sales of American Eagle one-ounce gold coins hit a year-high of 158,000 ounces up to May 25 for the month, exceeding 60,500 ounces for the whole of April. Meanwhile, physical gold holdings of the world's largest gold-backed exchange-traded fund (ETF), the SPDR Gold Trust, hit a record 1,236.89 tonnes on May 24, according to the company's figures.

Gold holdings in this ETF, a favourite among some of the world's most successful hedge fund managers, have grown 9% so far this year. Billionaire hedge fund manager John Paulson's New York-based Paulson & Co was the SPDR Gold Trust's largest investor in 1Q, with 31.5 million shares, or about 96 tonnes, according to a May 17 regulatory filing with the US Securities and Exchange Commission. Meanwhile, renowned hedge fund manager George Soros' Soros Fund Management was the sixth-biggest investor in 1Q, the filing shows.

Given that gold as an investment class is relatively small, compared with the total value of global stocks and bonds, continuing strong inflows from ETF investors could easily push gold prices sharply higher, Adair says.

Gold price over one year



"Total cumulative gold production is estimated at 158,000 tonnes. Assuming that all this gold is available for sale, this only equates to approximately US\$6.2 trillion. By comparison, total global bonds and equities are probably valued in the region of US\$120 trillion," he points out. "If sizeable amounts of investor money moved towards gold, the physical gold price and the share prices of gold-producing companies could react sharply."

Besides investing in gold ETFs, which track gold price performance, adventurous long-term investors who are positive on the metal and a leveraged play on it could consider gold stocks or a gold-equity mutual fund. Gold stocks are typically very sensitive to gold prices, both on the upside and downside, and they provide a "two-to-one leverage" on the underlying movement in the price of gold, says Adair.

"Gold equities are typically valued on a net present value basis with assumptions made for the expected price, future production and the cost of production. In aggregate, financial analysts estimate that for 1% increase in price, the net present value of gold equities increases by 2%. For this reason, we believe gold equities are an attractive leveraged way of investing in a forecast increase in the gold price," says Adair, who is invested in gold stocks such as **Barrick Gold**, **Goldcorp** and **Newmont Mining**. Last year, his United Gold & General Fund generated returns of 53.7%, which were more than double the price gain of physical gold in 2009.

Risk factor

Looking ahead, as long as volatility in the global financial markets remains high and equities continue to slump, gold will remain one of the preferred safe-haven assets alongside US Treasuries. Interestingly, the main short-term risk facing gold isn't the strength of the greenback but that of the battered euro, says Laidi of CMC Markets.

"The recent gold rally had initially emerged against the euro, owing to the eurozone sovereign woes, which led to multiple record highs in gold versus the euro before the metal finally hit new highs against the pound, yen and US dollar," the strategist observes. "Thus, any anticipation of coordinated intervention to support the euro" may similarly trigger a decline in gold against the European currency, leading to weaker gold prices versus other currencies, and eventually cause a broad sell-off in the metal, he warns.

Gold and its key price drivers

BY ATUL PRAKASH, JAN HARVEY & FRANK TANG |

Demand for gold is growing, as the debt crisis in the eurozone sparked the buying of the precious metal as a haven from risk. Gold broke its usual strong inverse correlation with the US dollar to rally in line with the greenback this year, as investors sought refuge from other markets in both assets. Following are key facts about the market and different ways to invest in the precious metal.

How do I invest in gold?

Spot market: Large buyers and institutional investors generally buy the metal from big banks. London is the hub of the global spot gold market, with some US\$18 billion (\$25 billion) in trades passing through London's clearing system each day. To avoid cost and security risks, bullion is not usually physically moved and deals are cleared through paper transfers. Other significant markets for physical gold are India, China, the Middle East, Singapore, Turkey, Italy and the US.

Futures markets: Investors can also enter the market via futures exchanges, where people trade in contracts to buy or sell a particular commodity at a fixed price on a certain future date. The COMEX division of the New York Mercantile Exchange is the world's largest gold futures market in terms of trading volume. The futures markets of Japan and Singapore are other important ones in Asia.

Exchange-traded funds: The wider media coverage of high gold prices has also attracted investments into ETFs, which issue securities backed by physical metal and allow people to gain exposure to the underlying gold prices without taking delivery of the metal itself. Gold held in SPDR Gold Trust, the largest gold-backed ETF, is equivalent to nearly half the global annual mine supply, and is worth more than US\$53 billion at today's prices. Other gold ETFs include iShares COMEX Gold Trust, ETF Securities' Gold Bullion Securities and ETFS Physical Gold.

Bars and coins: Retail investors can buy gold from banks and financial institutions selling bars and coins. They pay a small premium for investment products, of between 5% and 20% above spot price, depending on the size of the product and the weight of demand.

Key price drivers

Investors: Rising interest in commodities, including gold, from investment funds in recent years has been a major factor behind bullion's rally to historic highs. Gold's strong performance since the beginning of the 21st century has attracted more players and increased inflows of money into the overall market.

US Dollar: Despite the recent drop in the usual strong

correlation between gold and the euro-US dollar exchange rate, the currency market still plays a major long-term role in setting the direction of gold. Bullion prices typically move in the opposite direction to the US dollar, both because US dollar-priced assets become nominally more expensive as the US currency strengthens and because gold is a popular hedge against currency weakness.

Oil prices: Gold has historically had a strong correlation with crude oil prices, as the metal can be used as a hedge against oil-led inflation. Strength in crude prices also boosts interest in commodities as an asset class.

Fiscal and political tensions: The precious metal is widely considered a "safe haven", bought in a flight to quality during uncertain times. Financial market shocks, as seen in the aftermath of the collapse of Lehman Brothers in 2009 and more recently in the case of Greece's debt problems, tend to boost inflows to gold. Major geopolitical events, including bomb blasts, terror attacks and assassinations, can also induce price rises.

Central bank gold reserves: Central banks hold gold as part of their reserves. Buying or selling of the metal by the banks can influence prices. On Aug 7, 2009, a group of 19 European central banks agreed to renew a pact to limit gold sales. The pact was originally signed in 1999 and renewed for a further five years in 2004. Annual sales under the pact are limited to 400 tonnes, down from 500 tonnes in the second agreement, which expired in late September. Sales under the agreement have been low under the new pact, however.

Hedging: Several years ago, when gold prices were languishing around US\$300 an ounce, gold producers sold a part of their expected output with a promise to deliver the metal at a future date. But, when prices started rising, they suffered losses and there was a move to buy back their hedging positions to fully gain from higher market prices — a practice known as de-hedging. Significant producer de-hedging can boost market sentiment and support gold prices. However, the rate of de-hedging has slowed markedly in recent years as the outstanding global hedgebook shrank.

Supply/demand: Supply and demand fundamentals generally do not play a big role in determining gold prices because of huge above-ground stocks, now estimated at around 160,000 tonnes — more than 60 times annual mine production. Gold is not consumed like other commodities. Peak buying seasons in major consuming countries, such as India and China, exert some influence on the market, but others factors like the US dollar and oil prices carry more weight.

— Reuters