# The Investment Demand for Gold

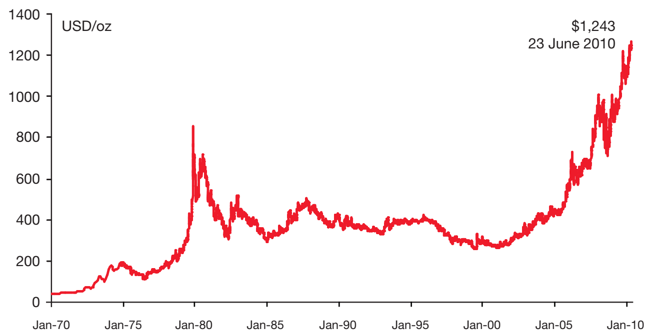

*The price of gold hit record levels in the second quarter of 2010, rising above US$1,200/oz. In addition, record prices have reached not only in US dollar but in other major currencies. An important catalyst behind Gold's performance has been the strong investment demand, with investors increasingly concerned about sovereign risk and the value of their currencies.*

**Decade-long gold rally**

The current rally in the gold price started in April 2001, when the price bottomed at US$255/oz, after a period of uncoordinated selling by central banks. In recent history, the only comparable period of sustained rising price is the 1970s. That decade saw important developments in global currency markets; President Nixon's decision to take the US dollar off the gold standard in 1971 being the most notable.

Under the gold standard, the expansion of the money supply by central banks was limited by the amount of gold they held. With the end of the gold standard, the US dollar ceased to be backed by any tangible asset and became a "fiat" currency backed by the faith that trade partners and investors have in the US economy and US government.

Gold since the end of Bretton Woods

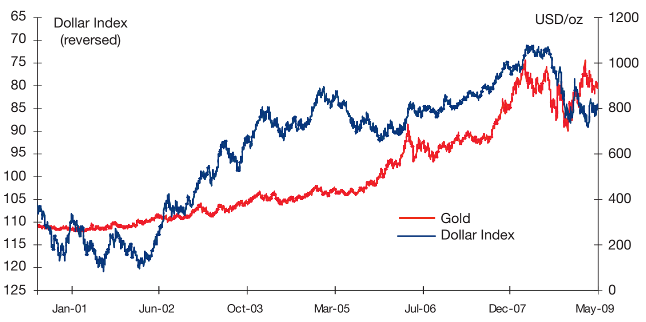



Source: Bloomberg, 23 June 2010

### Weak US dollar drove first stage of rally

There have been two stages to the current gold price rally. The first stage covered the 2001 to 2008 period, with gold price benefiting from significant monetary liquidity. The burst of the Internet bubble in 2000 resulted in the US Federal Reserve slashing policy interest rates from 6.5% to 1%[1] in an effort to reflate the US economy. Low interest rates and a growing current account prompted a period of significant weakness for the US dollar.

Gold and Dollar Index




Source: Bloomberg, 23 June 2010

Low US interest rates also boosted liquidity in Emerging Markets (EMs) since many EM central banks peg their monetary policies to the US. The resulting boom period years caused incomes and wealth to rise in EMs, with gold benefiting as a perceived hedge against US dollar weakness and the risk of higher inflation. Gold also benefited from its strong cultural role in leading EMs such as India and China, as seen through rising jewellery demand.

### Sovereign risk the new driver of gold

The second stage of the gold rally started with the global financial crisis, which was triggered by the bankruptcy filing of Lehman Brothers in September 2008. Although the gold price declined initially during this period, it regained footing when it became evident that policymakers were willing to take extraordinary measures in order to end the credit crisis.

These measures included the purchase of government debt by central banks – more commonly known as quantitative easing. Although quantitative easing was effective in ending the immediate crisis, it gave rise to fears of uncontrolled "money printing".

The risk when central banks "print money" is high inflation or even hyperinflation. Infamous episodes of hyperinflation include Germany in the 1920s and Zimbabwe in the past decade. Because inflation erodes the value of money, people then look for an alternative store of value. The classic asset that fulfils this function is gold.

### Investment demand overtakes jewellery demand

The impact of the global financial crisis on the gold market became evident in the shifting demand patterns in the gold market. Investment demand surged in the final months of 2009, as the Bank of England and then the US Federal Reserve announced their quantitative easing programmes. By the first quarter of 2009, investment demand for gold was so strong that net investment purchases overtook the jewellery sector as the biggest demand for gold.

Jewellery vs Investment


Source: GFMS, UBS, June 2010

Investment demand for gold has come from both retail and institutional investors, and is evident in multiple ways. Investors who want to see and hold the metal have purchased large quantities of gold bars and coins, to the point at which various national mints have run short of physical supply. There have also been significant inflows into Exchange Traded Funds (ETFs) which purchase and store gold on behalf of investors. By June 2010, total ETF gold holdings had increased to 2,058 tonnes[2] – equivalent to almost one year's global output from gold producers.

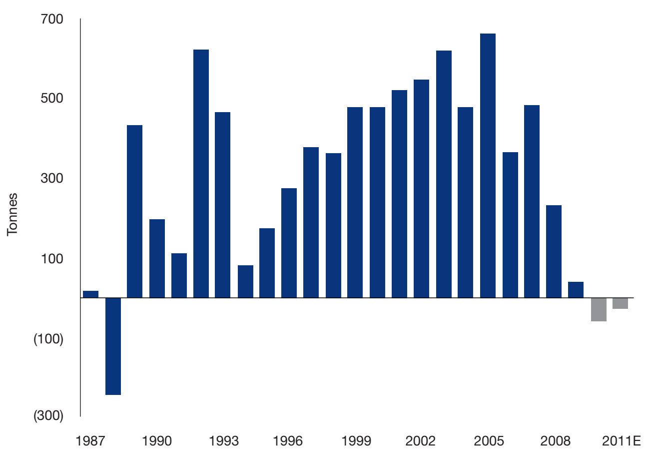
A further surge in investment-related gold demand has taken place in the first half of 2010. The developing debt crisis in Greece and other European countries has raised questions over the stability of the euro. Concerns over excessive money printing have also been raised by the announcement by the European Central Bank that it would begin buying government bonds. A notable development of the 2010 gold price rally is that it has occurred against the backdrop of a strong US dollar.

[1] *Source: Bloomberg, 23 June 2010*
[2] *Source: Deutsche Bank, Commodities Weekly, 4 June 2010*

## Central banks turn from sellers to buyers of gold

The second stage in the gold price rally has also produced a shift in the behaviour of central banks in the gold market. Central banks have typically been sellers of gold since the US effectively terminated the Bretton Woods agreement in 1971. While central banks continued to be net sellers of gold in the first quarter of 2009, however, they had become net buyers in the last three quarters of 2009.

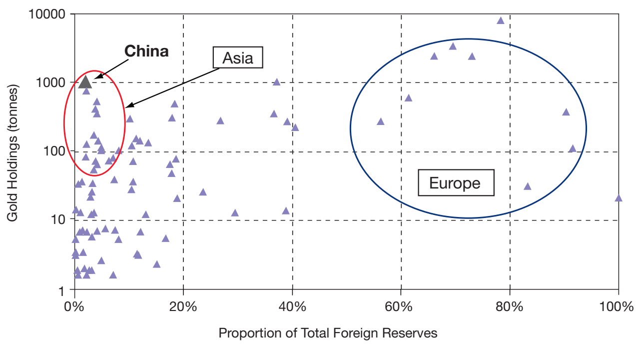
Central Bank Gold Sales




Source: GFMS, World Gold Council, UBS, June 2010

It is notable that EM central banks such as China, India and Russia have been the most active in buying gold. Compared to the central banks in the Developed Economies, many EM central banks hold relatively little gold as a percentage of their official reserves. For example, gold holdings in EM countries are typically below 2% of official reserves, compared to the 11% global average[3]. This is because, on a global basis, US dollar assets make up 62% of international reserves and euro assets 27%[1]. EM central banks are being prompted to diversify their foreign reserves because they have similar concerns about the value of the reserve currencies.

Makeup of Official Sector Reserves




Source: World Gold Council, UBS, June 2010

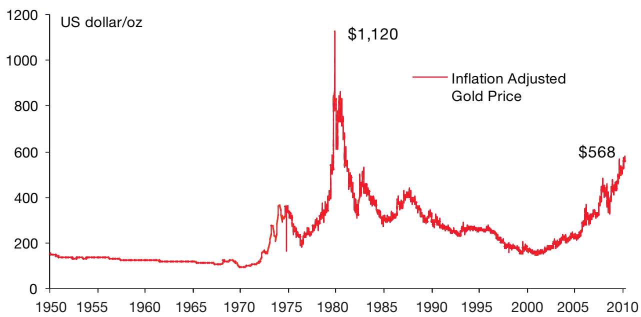
[3] *Source: World Gold Council, 15 June 2010*

## How high could the price of gold reach?

Although the US dollar-based price of gold stands close to record level, gold price is not that high as it might seem after adjusting for inflation or when viewed against other asset prices. Such comparative valuations suggest that the gold price could go higher, particularly if concerns over sovereign risk escalate from the current levels.

If the price of gold is adjusted for inflation using the US Consumer Price Index, then its current price is far below the previous price peak reached in 1980. In January 1980, the inflation-adjusted price of gold was US$1,120/oz, significantly higher than the inflation-adjusted price of US$568/oz as of 23 June 2010[1].

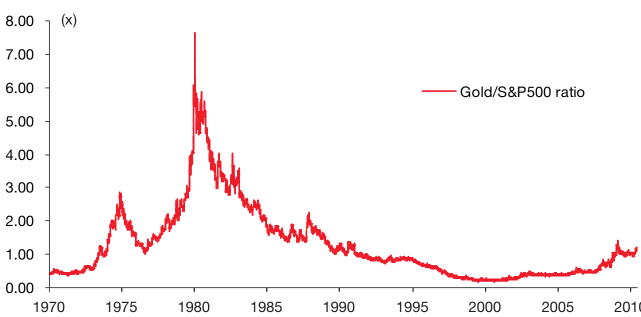
Price of Gold adjusted by US Consumer Price Inflation




Source: Bloomberg, 23 June 2010

Another way of looking at the gold price is to look at its value in comparison to alternative investment assets, such as the equity market. For example, the ratio of the gold price to the US-based S&P 500 Index shows that the rise in gold price comparatively to the rise in the US equity market since 2001 has been relatively modest.

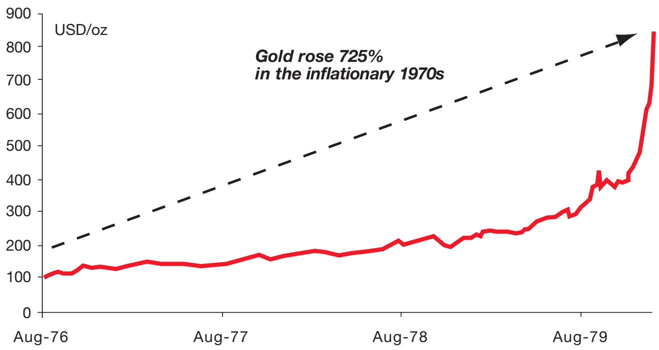
Ratio of Gold price/S&P 500




Source: Bloomberg, 23 June 2010

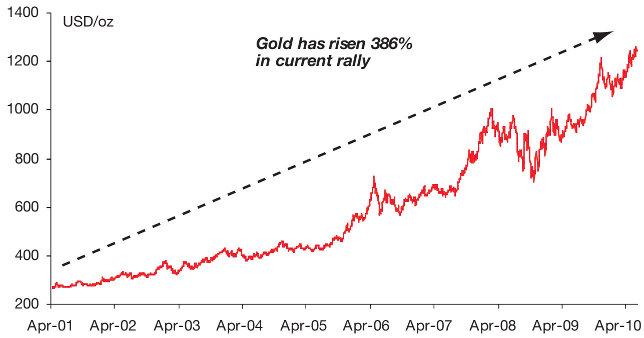
Some investors also note that there is still relatively little sign of speculative excess in the current gold price rally, when compared to the recent US housing bubble, the Internet bubble or the 1970s' gold price rally. Both the US Homebuilding Index and Nasdaq Composite index rose by over 800%[4] in their respective rallies. Between August 1976 and January 1980, the price of gold rose from US$103/oz to US$850/oz, a rise of 725%[1]. In the current gold rally, the gold price has risen from US$255/oz to US$1,241/oz, representing an increase of only 386%[1].

Gold's rally in the 1970s




Source: Bloomberg, 23 June 2010

Gold's rally in the 2000s




Source: Bloomberg, 23 June 2010

## Supply trends are positive

As with any asset, the gold price is influenced by the balance between supply and demand. New mine supply has been on a falling trend because of declining ore grades and the escalation of mining costs. Mining costs have risen partly because energy prices have been rising and also because governments have been imposing environmental taxes on mining companies. "Super profit taxes" on mining companies (such as the one recently proposed by the Australian government) would also hinder new supply. While higher gold prices make a larger number of mines profitable, on the whole, it is likely that new supply will continue to be on a declining trend.

However, unlike many other commodities, gold can return to the market as scrap gold. When the price of gold rises, some people simply sell what they have and this increase in scrap supply can stall the rise in gold prices. Scrap gold typically comes from the East, mostly Japan, but in 2009, there was also a measure of selling from western markets.

## Solid sustainable US recovery could end the rally

The biggest risk to gold is probably a strong, self-sustaining recovery of the US economy. If we see an end to deleveraging, a steady rise in employment, a return to full capacity, the restoration of corporate profits back to their trend and the US Federal Reserve beginning to normalise interest rates, then the 'fear' scenario would disappear and gold prices would likely tumble.

As long as sovereign risk remains a concern which we believe might be the case for a while, it is likely that gold prices will stay high.

[4] *Source: Wall Street Journal, 25 May 2010*