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ARE THE FUNDAMENTALS FOR GOLD POOR?

There have been some negative views expressed of late regarding the fundamentals for gold. The GFMS group executive chairman Philip Klapwijk recently presented at the New York Hard Assets convention. He highlighted falling fabrication demand and increasing levels of scrap sales as the key underlying factors for poor supply and demand fundamentals. He made the point that the current supply/demand balance shouldn't even support the present gold price. Today I would like to refer you to a very informative article written by Paul Van Eeden back in August 1998, aptly called: **Understanding the Gold Price**. This article makes some very pertinent points which I will share with you here in summary:

- In the ten years to 1997, fabrication demand for gold increased significantly leaving heavy supply deficits (anywhere from 200-800 tonnes). An overwhelming increase in these deficits in 96/97 was met with sharp falls (not increases) in the gold price. Conclusion: Commercial supply and demand fundamentals perhaps have a limited influence on gold prices.

- Reference was made to the sheer size of the gold market. The daily volume of gold traded in London alone as reported by the London Bullion Association back in 1997 was **1,000 tonnes a day**. This admittedly included derivatives trading but still highlighted the insignificance of annual deficit/surpluses of just 500-1,000 tonnes or more.

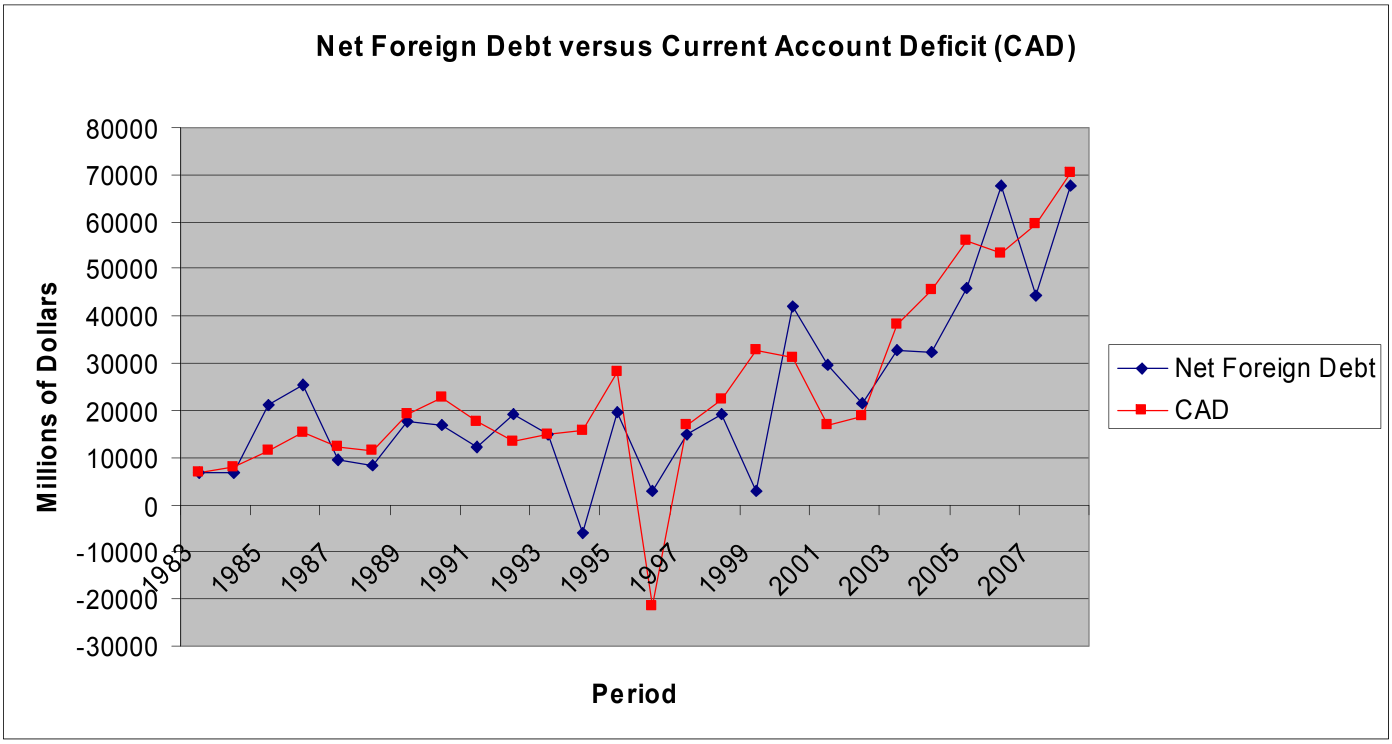
- Van Eeden also looked at the increased sale of gold by central banks and the impact this had on the gold price at the time. He concluded that the influence seemed very short term in nature. This however, coupled with increased forward selling by producing gold mining companies, may have had some role to play in negatively influencing gold prices.

- **Is gold money?** He makes the point that many analysts view gold as nothing more than a commodity. He goes on to say that if gold were a commodity like rice or aluminum it should be priced as such. Under these circumstances gold would be deemed the most overpriced commodity in the world. Its value would stem from its physical properties: electrical and thermal conductivity, resistance to corrosion, malleability and ductility. Thus its biggest market would be in the electronics industry, where it would primarily compete with copper. At presently US$13,560/lb versus US$2.00/lb, fat chance! There is clearly a demand for gold which transcends its commodity value.

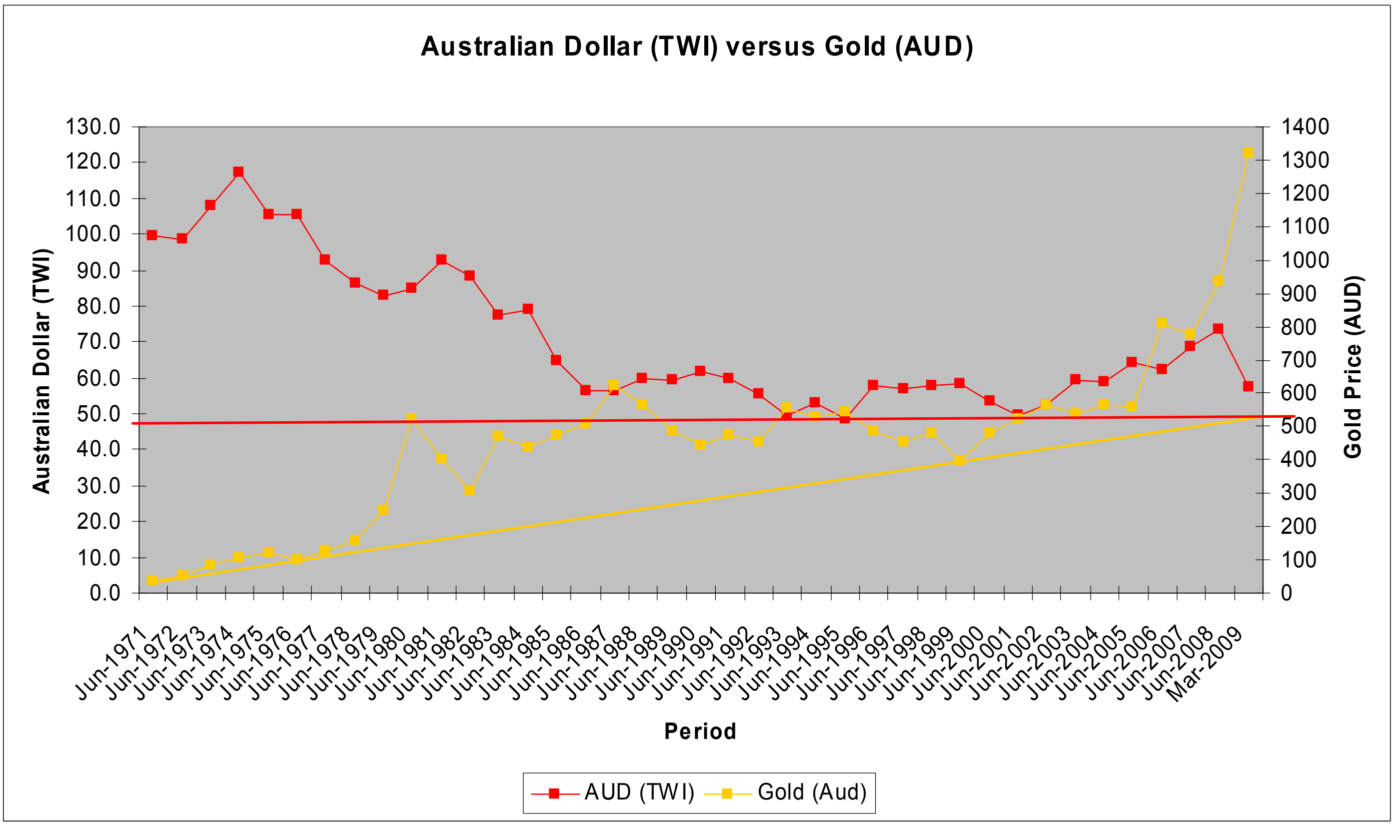
- In support for gold being money, the example of South Korea and Thailand publicly calling their citizens to turn in any private gold during the South East Asian currency crises was made. In times of financial crises countries still turn to gold. The valid point was made that **paper money is only as good as the credibility of the issuer and paper money issuers are losing credibility.**

Van Eeden next turned to analyzing exchange rate influence. He deemed the stronger US dollar in the late 90's was the major driving force behind weaker US dollar gold prices. The point was made that gold in other currencies, such as the Japanese yen and Swiss franc during the late 90's, declined by only half the levels of the US dollar gold price. He suggests that perhaps this half could be a function of the central bank gold sales, producer forward selling, private sales etc. The remainder was more a function of currency movements. If you agree that gold is money, then making this important connection between exchange rate movements and the price of gold is not that greater leap of faith. To determine the true fundamentals for gold you then really need to focus more on the fundamentals of the currency in question. Two key indicators for this are the **Current Account position** and **Net Foreign debt levels**. Generally speaking, the higher these two levels are relative to the size of the economy and other countries, the riskier the respective currency is deemed to be.

Being an Australian and having gold investments in companies with domestic operations, this becomes a very important factor. Looking at the trend of Australia's annual current account deficits and the consequential increase in net foreign debt levels, one can very quickly appreciate why the Australian dollar is considered risky. It also explains why Australia's interest rate levels are generally so much higher than other western countries.



A look at the next chart clearly demonstrates the ill effects of this trend on the Australian dollar over time. The gold price in Australian dollars is charted along side to demonstrate the protection it offers investors against this risk. As the global economy continues to slow and risk aversion increases, the probability of the Australian dollar breaking long term support at just under 50 on a Trade Weighted basis (TWI) looks increasingly likely. Unless interest rates rise to a level which fairly compensates international investors for risk, a potential currency crises looms large. With the bulk of what Australians consume coming from overseas, the risk of higher inflation levels is increasing. The recent spike we have seen in the domestic gold price highlights this risk.



So in conclusion, when you read about the poor fundamentals for gold from various sources ask yourself this. Is the analyst in question looking at gold as a currency or simply as a commodity? A failure to acknowledge gold's monetary role is short sighted and invariably leads to inaccurate not to mention non-committal forecasts. This generally leaves investors confused and frustrated. It must be said that similar supply and demand fundamentals were present throughout the 1970's as the gold price rose. The above chart would suggest that they were as irrelevant then as they are today. The trend in respective currencies appears to provide a much more accurate assessment.

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