EUREKA report

Gold is all a-glitter

By Troy Schwensen
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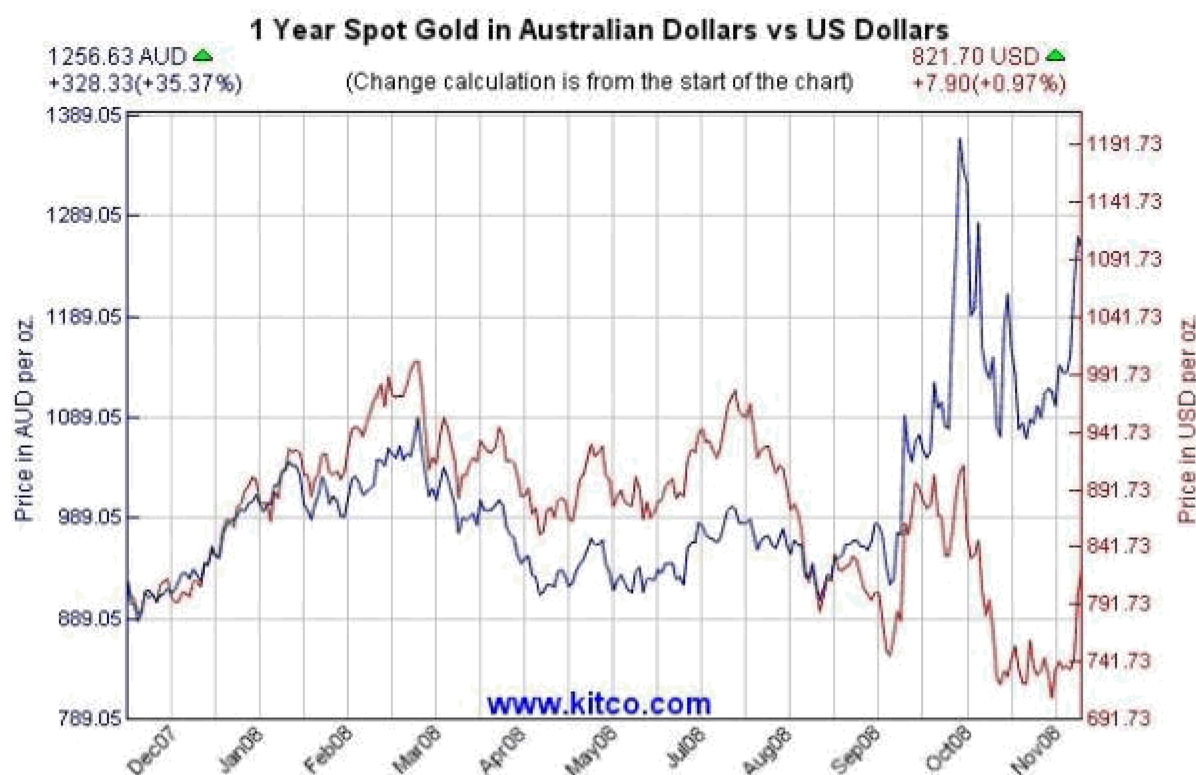
PORTFOLIO POINT: A falling Australian dollar is amplifying the rise in the gold price.

Despite the turmoil in commodity markets, gold is enjoying an extended price rally. The spot gold price is now comfortably above $A1000 an ounce, up from $A800 at the start of the year.

The price acceleration in local currency terms follows the sharp decline of the Australian dollar against the US dollar. Moreover, these trading factors are now being underpinned by more fundamental developments such as the flourishing exchange traded funds industry and the commitment of central banks to restrict gold sales.

Unlike other commodities, gold is a monetary metal and hence does not suffer from the same economic fallout experienced by industrial commodities. Most of the gold ever mined still exists today, with additional annual production adding about 2% to above-ground gold stocks each year.



It is amazing the number of analysts and financial journalists that concentrate their efforts on this 2%. They look at issues such as jewellery fabrication demand and the shrinking supply coming out of Australia and South Africa in determining their outlook for the yellow metal. Meanwhile, the remaining 98% of above-ground gold is virtually forgotten.

I repeat: gold is not an industrial commodity. The more pertinent question to ask is, how willing are existing gold investors to part with their holdings given present economic conditions and inflation expectations?

If there is economic stability and inflation remains under control, gold investors (generally speaking) are prepared to sell some of their gold and invest the proceeds in alternative opportunities. Likewise, the investment demand for gold during these times is low and the gold price as a result remains subdued. In times of economic

uncertainty, as we are seeing today, the holders of gold demonstrate a reluctance to part with the metal while, at the same time, investment demand increases putting upward pressure on the price.

Retail investment demand for gold is currently at record highs all around the world, with the Perth Mint only recently declining to take any more orders for gold and silver coins given the existing backlog of orders. This is consistent with what is being seen elsewhere. Central Banks and exchange traded funds are some of the biggest holders of gold and obviously their actions need to be followed closely to get an indication of sentiment.

Gold sales under the Central Bank Gold Agreement have been declining. The agreement, which was signed in 1999, restricts central banks to the sale of 500 tonnes of gold a year. In 2007-08, just 345.5 tonnes were sold. Indications are that even less will be sold in 2008-09, with both Germany's Bundesbank and the Swiss National Bank announcing they do not intend to make any more material sales.

The advent of exchange traded funds over the past four years has also made gold ownership more accessible to investors. Gold ETFs have collectively accumulated close to 1000 tonnes of gold. Reduced central bank selling and expanding gold ETF holdings tell us a lot about investor sentiment at the present time and are much more meaningful when considering the outlook for the gold price going forward.

Troy Schwensen is editor of GlobalSpeculator and a research analyst with GoldNerds.