

# THE UNWAVERING VALUE OF PRECIOUS METALS

*The growth of precious metals is far from over, says Svetoslav Georgiev*

■ Gold and silver have undoubtedly been the focus of investors over the recent months. The price of gold increased by more than 27 percent in a year, and silver has gone from less than \$20 an ounce in September 2010 to more than \$49 in April 2011, an increase of over 140 percent. Investors, policy makers and business leaders are all intrigued by the factors that have contributed to this rally. In this review, I explore some factors that have historically impacted the prices of gold and silver and look at their current combination.

## THE NOBLE METAL

The increasing demand for precious metals is certainly a factor, but the demand for gold is largely driven by changes in investment. Use in jewelry, medicine and technology account for just a small portion of market demand. Like most other precious metals and unlike other commodities like oil, gold is not destroyed when used and can be recycled without losing its value.

However, producers determining the supply side of the market have limited ability to adjust output levels. Proven gold reserves are scarce, and the sector is capital intensive, requiring sizable investments in technologically complex extraction methods as well as time. It is common to prepare a goldfield for years before a mine can be exploited. When producers are unable to meet the increased demand, prices surge to offset the demand level. Although supply can be affected by sales of existing gold reserves by central banks and institutional investors, production determines the market growth in terms of volume.

The demand for precious metals as an inflation-protected store of value and a perceived safe asset has driven gold prices. India has traditionally been the largest importer of gold, with 624 metric tons in 2010 – interestingly not for industrial purposes, but for cultural and religious reasons. China has more recently become a major importer of gold, while being the world's largest producer – its imports increased fivefold in one year to reach 209 metric tons in 2010. The World Gold Council now expects China to overtake India as the largest importer of gold in 2011.

This increased appetite for the precious metal is driven not only by inflation fears, but also by the increasing wealth of the population. The demand for gold as an inflation-protected store of value and a perceived safe asset has an impact on gold prices.

The Chinese now have access to investment funds permitted to invest in gold on the international market. Private investors can also hold instruments based on the value of gold. Although gold investment is not openly encouraged by the government, it is available to proactive private investors. This trend will contribute to a shift in demand for gold on a global scale in the coming years.

## A CORE ASSET

The world demand for gold is also driven by the overall shift to precious metals as an asset class in investment portfolios of Western individual and institutional investors. According to the World Gold Council, investment demand for gold stands at 31 percent as of 2010. Cost effective investment instruments, such as ETFs issuing securities backed by physical stock, make ownership of gold and silver easier. ETFs are traded like normal stocks during trading sessions, allowing flexibility and making

exposure to precious metals possible for a large group of investors. The largest gold ETF, SPDR Gold, now holds 1,229 tons of gold compared to 1,143 last year, and 1,104 tons in 2009.

In developed markets, investors have traditionally used precious metals exposure as a safe asset in times of financial crisis or constricting economies. Increasingly though, institutional investors consider gold as a long term capital growth asset. The lack of dividends or any other cash flows have kept gold out of the core assets of institutional investors' portfolios. The consistent appreciation of the metal – most notably over the last decade – is turning the balance. Pension funds, such as the Teacher Retirement System of Texas, have started expanding their gold assets to a core holding in order to benefit from its long term appreciation and to reduce portfolio volatility. The traditional use of gold in a portfolio to hedge against inflation and as a low-risk asset has now changed to that of a core asset class.

Once again, gold became a safe haven for investors as revolutions swept through the Middle East, similar to the time of the Arab-Israeli war. Between 1970 and 1972, the price of gold reached a local maximum of about \$200 per ounce, up from \$34 an ounce. In 1979, the political unrest in Iran contributed to the dramatic increase in gold price to over \$800 an ounce, the highest ever price in real terms. The fact is that one cannot ignore the impact of political events on asset prices and our ability to assess the dynamics of the precious metals market.

## POLITICAL IMPACT

The relationship between gold prices and the US dollar has been consistently inverse. At times of a weak US dollar, gold and other precious metals have consistently shown an upward trend. Gold, as a commodity with strictly limited supply, is priced in terms of a currency, which is subject to monetary policy manipulations.

The monetary and fiscal stimulus programmes that governments all over the world introduced in response to the global recession have increased liquidity and monetary aggregates. Most notably, the quantitative easing programme of the Federal Reserve made capital available and cheap at a near zero interest rate level. In an environment of low interest rates, the opportunity cost of holding gold, which does not bear dividends or interest, is relatively low. The ensuing inflationary pressure is an inevitable by-product of this policy, as it targets a renewal of economic growth.

A traditional function of gold has been as a hedge against inflation within a diversified portfolio. Increasing fears of inflation pushed more investors to expand their holdings of gold, causing a powerful shift on

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demand for gold. The rally of gold price over the past two years was to a great extent due to the fear of and protection against inflation.

#### SILVER RUSH

Within the precious metals group, silver outshined gold. Over a time horizon of just nine months, the price of silver has risen from \$20 an ounce range to nearly \$50, a growth of over 140 percent compared to just 20 percent for gold. Silver has been considered a more affordable store of value, thus accessible to a larger group of people. This, combined with the abundance of investment vehicles that made holding silver as an asset relatively easy, drove the demand for the metal more aggressively.

Another factor contributing to this trend was the industrial application of the metal. While just 13 percent of demand for gold comes from medical and industrial application, silver is widely used in optics, for its reflecting properties, and electronics, for its exceptional conductivity. These two sectors accounted for more than 60 percent of silver demand in 2010, according to the Silver Institute in Washington DC. Silver benefits substantially from being a store of value as well as an industrial commodity – many investors have recognized this advantage and are betting on continued short and medium term appreciation of silver prices.

#### MARKET OUTLOOK

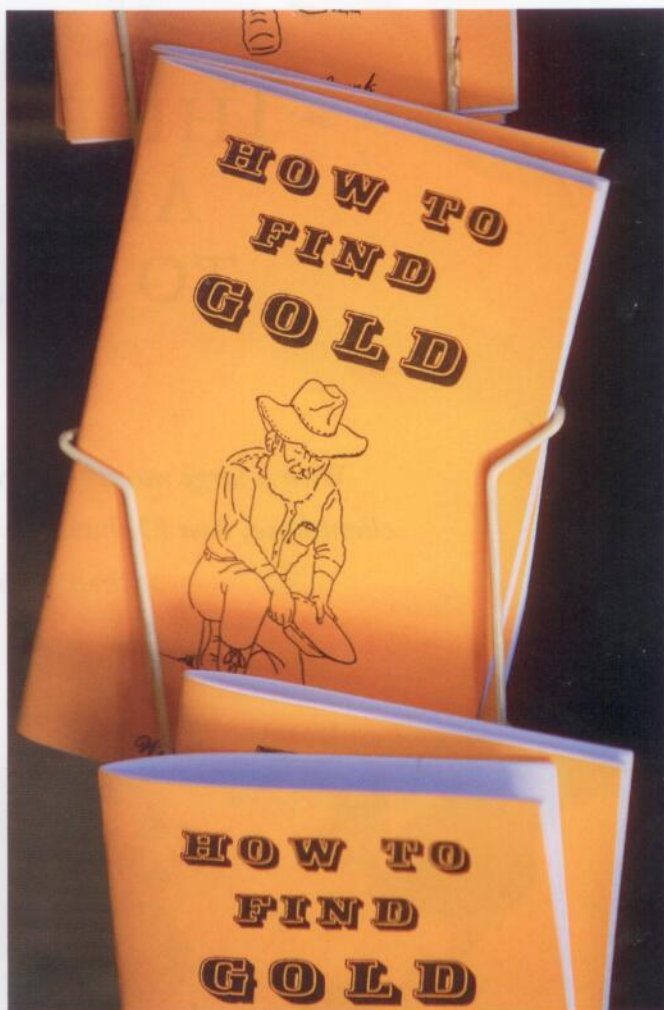
The fundamental factors that have been driving the rally in precious metals are still present and are likely to remain active in the short and medium term. Fears of market instability originating from the Middle East remain high, with the crisis in Libya in a deadlock. The potential impact of political instability in the region, which provides a sizable part of the world's supply of oil, is daunting. Escalation of the crisis can slow the pace of global recovery and reinforce the fears of investors as they consider adjusting their portfolios by moving away from gold to equity.

The near zero interest rate policy of the Federal Reserve is likely to continue in the foreseeable future as the US recovery is slow, not irreversible, and with a persistent high unemployment. The recent downgrade of economic outlook in the US by S&P further deepened the lack of confidence in the US dollar. This will also drive investors further to the safety of the 'ultimate currency' – precious metals.

Furthermore, we should not forget the fears caused by the sovereign debt crisis in Europe. The government bonds, which were previously perceived as near zero risk instruments, now carry high risk premiums causing capital flight to the safety of precious metals.

Re-establishing stability requires time. Meanwhile investors are likely to keep their preference with the precious metals. Growing imports by China and India, increased acquisition of precious metals by central banks, and pension funds will be a key factor determining the dynamics of the gold price in the medium and long term. Considering the economic forces in play and fears fuelled by political instability, the growth of precious metals is far from over. Unlike the past, this time we may even witness a long term shift in the perceived role of gold as an asset in private and institutional portfolios. After all, gold has retained its purchasing power for centuries. Few currencies can compete with this. ♦

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Above: 'How To Find Gold' booklets on display in Jamestown, California. Above left: Svetoslav Georgiev

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