





# A GOLDEN FUTURE ON THE HORIZON?

THE UNWAVERING VALUE OF PRECIOUS METALS: A MEDIUM-TERM VIEW, BY **SVETOSLAV GEORGIEV**, HANTEC MARKETS

**GOLD AND SILVER** have undoubtedly been the focus of investors in recent months. The price of gold has increased by over 27% in a year and silver has gone from under \$20 an ounce in September 2010 to over \$49 by April 2011, an increase of over 60%. Investors, policy makers, and business leaders are all intrigued by the factors - economic and otherwise - that have contributed to this rally.

The increasing demand for precious metals is certainly a primary factor, but the demand for gold is largely driven by changes in investment. Use in jewelry, medicine, and technology account for a smaller portion of market demand. Gold, like most other precious metals and unlike other commodities such as oil, cannot be 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 imported in 2010, interestingly not for industrial purposes but for cultural and religious reasons. China has more recently become a major importer of gold, whilst also being the world's largest producer. The World Gold Council expects that China will become the largest importer of gold in 2011, replacing India. China's imports have increased five times in comparison to 2009 to reach 209 metric tons. 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

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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.

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% 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 crises or a tight economy. 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 past 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 you simply cannot ignore the impact of political events on asset prices and the ability to assess the dynamics of the precious metals market.

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 programs that governments all over the world introduced in response to the economic recession, precipitated by the financial crisis of 2008, have increased liquidity and monetary aggregates. Most notably, the quantitative easing program 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 byproduct 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 demand for gold. The rally of gold prices over the past two years was to a great extent due to the fear of and protection against inflation.

Within the precious metals group, silver outshined gold at the beginning of the past month. Over a time horizon of just nine months the price of silver rose from \$20 an ounce range to nearly \$50 before falling back to \$35, a growth of nearly 60% compared to just 20% for gold. Silver has been considered a more affordable store of value, and as such



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% 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 over 60% of silver demand in 2010, according to The Silver Institute in Washington DC. Silver benefits substantially from both areas, i.e. being a recognized store of value and an industrial commodity. It seems, many investors have recognized this advantage and are betting on continued short and medium term appreciation of silver price.

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 still 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 US dollar. This will also drive investors further to the safety of the "ultimate currency", i.e. precious metals. Moreover, 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 in 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 fueled 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 that. ●

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