



Bullish on bullion

As Soviet tanks rumbled into Afghanistan in January 1980, panicked investors sought refuge in the ultimate safe haven, gold - boosting bullion prices to a record \$850 a troy ounce. At the same time, oil prices were shooting up, driven by instability in the Middle East, and the dollar, amid fears of a US recession, was falling dramatically.

Fast-forward 28 years and all appears roughly the same. Again, trouble in south Asia - this time, the assassination of Benazir Bhutto in Pakistan - has pushed gold to a new high above \$860 an ounce this week. Once again, oil prices and fears about the US economy and the direction of the dollar are supporting the move.

The similarities end there, however. In 1980, after a surge from \$400 to \$850 in just five weeks, bullion prices collapsed to trade as low as \$300 a year later. But since then, fundamental changes in the gold market have taken hold that suggests higher prices might last a lot longer.

David Davis, analyst at Credit Suisse Standard Securities in Johannesburg, says the dynamics have begun to change "inexorably towards a diminishing supply of gold and increasing investment demand, which will ultimately impact on the gold price".

This time, the price surge has been slow and fairly constant since a low in 1999 of about \$250 an ounce and support has come not only from gold's status as safe haven. Fundamental factors identified by analysts include strong jewellery buying by the rising middle class in emerging countries such as India; investors' long-term interest in gold as a hedge against persistent dollar weakness; and falling output in South Africa, the world's largest gold producer.

Gold prices yesterday reached a fresh all-time high of \$869.05 an ounce, extending a seven-year bull market that in 2007 brought a 30 per cent surge - the largest annual increase since 1979. While in real terms the price is less than half the 1980 high (see panel), many experts believe the strength will be sustained and the value of the metal could go higher.

James Burton, chief executive of the industry-backed World Gold Council, describes the record achieved yesterday as "substantially more firmly based than that in 1980", adding: "It follows a sustained six-year rise in the price and was built on a combination of strong investment and jewellery demand. In contrast, the record of January 21, 1980 was the peak of a very volatile market in which the price had risen nearly \$300 in just three weeks from the beginning of the year and subsequently plunged sharply, giving up all this gain by mid-March."

JPMorgan, the investment bank, has picked gold as one its main 2008 commodities bets, expecting a trading range between \$750 and \$900 an ounce. Others are even more optimistic. Greg Wilkins, chief executive of Barrick Gold, the world's largest gold mining company, describes the gold market as being in the middle of a "perfect storm" that favours higher prices.

Among the factors that Mr. Wilkins and other experts cite are rising global inflation, concerns about the health of the financial system - and the weakness of the dollar, which could be aggravated by further Federal Reserve interest rate cuts to cushion the American economy against the impact of the credit squeeze.

Much of the price direction in 2008 will depend on the dollar's weakness or strength against other currencies, in particular the euro and the yen. But no short-term movements will change the fact that gold prices have seen a sustained rise since 1999 and are trading much higher than they have historically.

Analysts diverge on whether prices will test \$1,000 an ounce or remain flat, although at elevated levels, in the medium term. But either way, behind this secular change that is keeping prices high is sustained interest by investors in owning gold.

This change in investor attitude is reflected, for example, in the ownership of hundreds of 400 ounce gold bars, glowing under a dim light in a vault deep beneath the streets of London. Only a few years ago, it would have been safe to assume that a central bank was the owner of that gold. No longer. The bars belong to private investors in the New York Stock Exchange-listed StreetTracks Gold Shares, an investment vehicle that holds about 627 tonnes of bullion - about double the Bank of England's bullion reserves and more than those of the European Central Bank.

Philip Klapwijk, executive chairman of GFMS, the London-based precious metals consultancy, says: "We are getting closer to the point where private sector bullion holdings exceed those of the central banks."

Institutional investors, such as pension funds and insurance companies, have been piling money into entities known as exchange traded funds, which make it easier to buy and sell bullion. John Normand, of JPMorgan in London, says: "The underlying catalyst for this investor inflow into precious metals is not just broader macro thematic issues, such as a hedge on US dollar weakness, inflation or the efficacy of the fiat [non-gold backed] money system, but also a function of the bullish intrinsic fundamentals."

Investors in gold exchange traded funds now hold more than 865 tonnes of the metal, after an increase of 34 per cent last year. Collectively, this group now ranks as the world's seventh largest holder of physical bullion, surpassed only by the official reserves of the US, Germany, the International Monetary Fund, France, Italy and Switzerland (see table). "Gold ETFs have become the people's central bank," says Mr. Davis.

The exchange traded funds - which together hold more gold than the central bank of either Japan or China - have seen remarkable growth. At the end of 2004, they ranked 31st as a holder of gold, with just below 50 tonnes. But how loyal will their investors be? In general, the cash poured into ETFs has been seen as "sticky money" that should prove relatively resilient in a bear market for gold. But recent large outflows and inflows suggest investors are trading in the funds in a more aggressive way than before and it is unclear whether private holders will sell during any large price correction.

The last time the outlook for gold seemed truly bleak was in 1999, when in London the Treasury announced it was selling half of the UK's official reserves. That prompted some pundits to proclaim the end of gold as a private and official investment asset class. The British decision, combined with the threat of more central banks selling, a booming stock market, falling inflation and a strong US dollar, shocked the gold market, with the bullion price sinking to a 21-year low of \$250 an ounce. Jill Leyland, the World Gold Council's chief economist says: "Gold was considered old-fashioned."

Within months of the Treasury's decision, however, other central banks - worried about the impact of indiscriminate selling - arranged a pact, known as the Central Bank Gold Agreement, to cap sales and in effect put a floor under the price. The UK sale proved to be the starting gun for the current bull market.

Alan Greenspan, then Fed chairman, supported gold investments telling the US Congress in 1999 that gold still represented the ultimate form of payment in the world. "Fiat money, in extremis, is accepted by nobody. Gold is always accepted," Mr. Greenspan said.

Investors' regained confidence was underpinned by robust fundamentals as demand rose from emerging countries, in particular India, while mined production stagnated. James Steel, precious metals analyst at HSBC in New York, says mine output fell 7 per cent from 2001 to a 10-year low of 2,473 tonnes in 2006.

"The producer response to higher gold prices has been generally disappointing," he adds. "The more recent evidence reinforces our view that producers will find it difficult to increase mine supply measurably and that a lack of new mine output remains for now a consistently bullish factor in the supply-and-demand equation."

In South Africa, the world's top producer, output has collapsed to the lowest level since at least 1931, as previously rich seams become depleted. On top of that, a row of miners' strikes has taken place demanding higher safety standards. The country's production has halved in just 12 years, weighing down on the combined output of the four traditional - and now mature - producing regions: South Africa, the US, Canada and Australia. Output of the four, which together account for one-third of the world's gold supply, fell to 426 tonnes in the first half of last year, a 2 per cent drop from the same period a year earlier.

South African miners last month launched their first one-day national strike on safety grounds. Rock falls and explosions each year kill around 200 of their number. "If the big companies do not do anything to improve safety, we will be back on the streets again - we will stop the mines with a two- or three-month strike," Lesiba Seshoka, the National Union of Mineworker's spokesman, warns.

The miners' actions could have a long-term impact as they are likely to increase production costs as companies improve procedures. They could even force the closure of the more dangerous, deeper mines.

South Africa has been the world's top producer for more than a century - but its production decline leaves China poised to take that spot by next year at the latest. In the nine months to last September, China's output of gold reached 191.5 tonnes, just below South Africa's 192.8 tonnes. "South Africa will lose its crown as the world's top gold producer in favor of China," says Mr. Klapwijk.

Overall, rising costs are thought likely to limit the development of new projects and constrain production - a change from the 1980s, when gold output was expanding. James Mavor, vice-president of Barrick Gold, told the London Bullion Market Association's recent precious metals annual conference: "What would normally take three to five years to commercialize now takes about seven to 10." GFMS estimates that gold mining costs jumped to \$371 an ounce in the first half of 2007, a 21 per cent increase from the same period a year earlier.

According to Mr. Davis, if costs rise at an annual rate of 10 per cent, the mining industry would by 2015 need a gold price of \$1,420 an ounce to support global production at similar profit margins to those achieved in 2006. (He predicts bullion to average \$838 an ounce in 2008 and rise to \$1,050 in 2010.)

The cost rises have increased the number of marginal mines - those operating above the spot gold price - and these now represent about 2 per cent of the world's supply. "We expect these marginal producers to close and, as a result, cause a significant reduction in global production should the gold mining industry

continue to incur significant year-on-year inflation rates which are not offset by similar or significantly higher gold price increases," says Mr. Davis.

Further tightening supply, gold companies are reducing the amount they sell forward or even buying back their forward sales - a process known as "de-hedging". This and the lower mining output have been partially offset by official sales from European central banks and gold scrap, which these days together account for almost one-third of total supply.

During this time of constrained supply, gold demand has accelerated thanks to rising middle-class incomes in emerging economies that traditionally have been larger buyers of gold - including China, Turkey and the Middle East as well as India. Demand for gold jewellery in India jumped by almost 40 per cent in the first nine months of 2007 to 504.2 tonnes. For the same period, Chinese demand rose 24 per cent and that of the Middle East was up 14 per cent.

India is the world's largest gold consumer, accounting for slightly more than 20 per cent of global demand. "When poor India's people experience an increase of income, one of the first things they do is to buy gold," says Om Prakash Bhatt, chairman of State Bank of India in Mumbai. Ashok Minawala, chairman of the India Gems and Jewellery Trade Federation, adds that the price of rural land has risen tenfold in the last few years, lifting incomes among rural families and "creating a boost for gold consumption".

Yet the picture is not uniformly bright. The recent price increases have begun to hit sales in India, other Asian countries and the Middle East, according to gold traders in Mumbai and Abu Dhabi. Emerging markets are much more sensitive to daily price changes, as jewellery is sold at only a small mark-up above spot bullion, while in Europe and North America retailers usually charge a higher premium.

Gold sales growth in India slowed to an increase of 5 per cent in the third quarter. "Sales are down as the price goes up," says V. Govindraj of Tanishq, India's largest jewellery chain, in Bangalore. "Customers are deferring their purchases until they see lower or at least more stable prices."

But for many Indians, as for at least some of the international investors in exchange traded funds, the yellow metal is likely to have a continuing allure. As Chitra Pandeya, of HDFC Bank in Mumbai, says: "Gold is gold. You cannot replace it."

Ways to weigh up a solid performance

When gold reached its previous peak of \$850 a troy ounce in January 1980, it did not stay there long. Just 10 days after hitting that record, spot bullion fell below \$700 - and less than two months later it traded at less than \$500 an ounce.

The latest surge looks more robust: the price of the metal has hovered around the \$800 level since late October. By November it touched \$845.40 an ounce and the price fixed in the London afternoon market in recent months has frequently been above \$800 an ounce.

In January 1980 the London afternoon fix was above \$800 an ounce on only two occasions. The average for that month was about \$675 - a level surpassed in May 2006 and April 2007 as well as September to December last year. Indeed, the December average, at just over \$808, was about 20 per cent higher than that of January 1980.

Still, the latest surge looks much less impressive if adjusted for inflation. In real terms, gold bullion would need to be well above \$2,000 to match the price achieved in 1980

