

## An Overview of Gold: For Now, It's Golden

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*On November 3, 2009, India stunned the world when its central bank, the Reserve Bank of India, purchased 200 tons of gold, worth \$6.7 billion and equal to approximately 8 percent of the world's annual gold-mine production. The purchase, considered the largest by a central bank in 30 years, was viewed by many as "a signal governments around the world are becoming increasingly uncomfortable about the sliding value of the US dollar."<sup>1</sup>*

The short-term impact of India's purchase from the International Monetary Fund was to propel the spot price of gold in nominal terms to a new record high of \$1,085 per ounce on that day. Subsequently, gold reached a 2009 peak price of \$1,226 an ounce on December 3, falling to \$1,097 an ounce by year end.

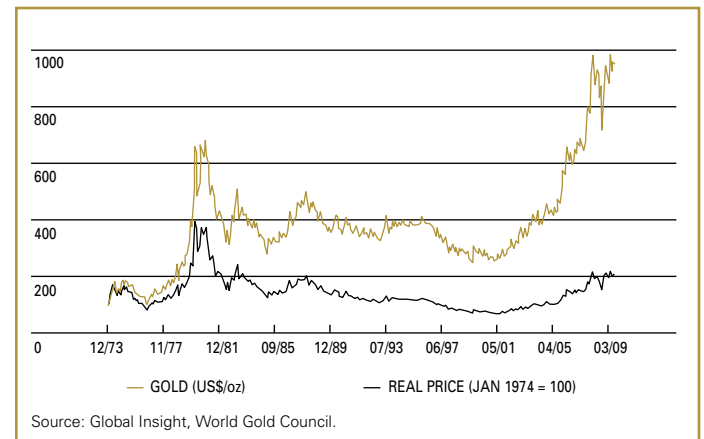
On an inflation-adjusted basis, the spot price of gold remains well below the interim month high of \$873 an ounce hit on January 21, 1980, a time when the rate of inflation in the US was heading towards 20% and investors were worrying about the Soviet presence in Afghanistan and the fallout from the Iranian Revolution.

India was not the only large buyer of gold in 2009. Numerous institutions have been attracted by the investment attributes of gold — as a diversifier, as a safe haven during volatile times and as a hedge against inflation and dollar weakness. Hedge funds, asset managers, broker/dealers, pension funds and endowments have all turned to gold as exemplified by their holdings in gold exchange traded products (ETPs). SPDR® Gold Shares, for example, held \$40.2 billion in gold bullion as of December 31, 2009 for a similar cross section of institutional investors ranging from hedge funds to endowments.

Acknowledging the appeal and challenges for an institutional investor of investing in gold, Shayne McGuire, Managing Director and Head of Global Research at the Teachers Retirement System of Texas, recently said, "Within a portfolio setting, gold can make tremendous sense." In their September 30, 2009 13F filing, the Teachers Retirement System of Texas said they had increased their position in SPDR Gold Shares by \$144 million. According to McGuire, "we added gold as a tactical position for a number of reasons. We see gold benefiting from increased central bank purchases, from rising affluence in Asian countries, from continuing weakness in the US dollar, and from limited supply from mining production."

However, despite gold's stunning performance in recent years as it's benefited from tight supply and strong demand, it should be remembered that gold has not always performed that well as an investment. From its January 1980 peak, the price of gold subsequently declined to trade mostly in the narrow \$300 to \$400 an ounce range for the next two decades. In fact, it took nearly twenty seven years for the price of gold to top its 1980 peak on January 9, 2008. As we'll see, the ups and downs of the price of gold are determined by many hard-to-predict variables that can impact the fragile balance between supply and demand.

**FIGURE 1: HISTORICAL PRICE OF GOLD (US\$/OZ, END OF PERIOD) AND REAL GOLD PRICE (JAN 1974 = 100)**



### THE VARYING SUPPLY AND DEMAND DYNAMICS OF GOLD

Like oil, gold supply is impacted by the ability of producers to identify and deliver newly mined gold to the market. Unlike oil, however, gold is not consumed or destroyed in its use, and there is the ability to recycle above-ground stocks to add to supply. Central banks, or the so-called official sector, are significant owners of gold reserves and also return a certain amount of supply to the market each year. Over the 5 year period (2004–2008), 59% of gold supply came from newly mined production, 28% from recycling of fabricated products such as jewelry, and 13% from net official sector sales.

Gold mining takes place on every continent except Antarctica. The supply sources are more geographically diverse than ever before, with China, the United States, South Africa and Australia all producing between 200 and 300 tons each of newly mined gold in 2008. However, mine production has declined since 2001, from a high of nearly 2,650 tons to just over 2,400 tons in 2008.

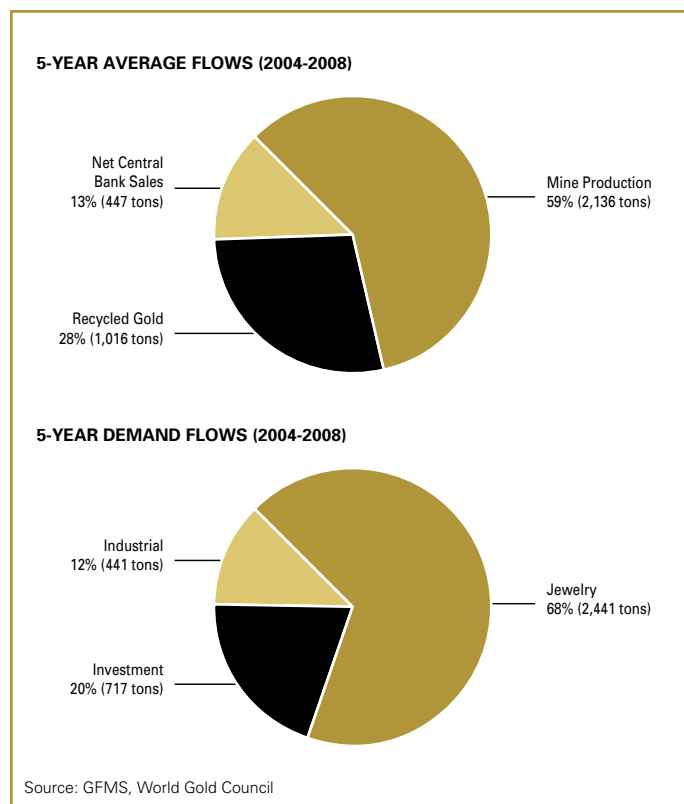
Because gold is virtually indestructible, practically all of the gold that has ever been mined still exists. Of the 163,000 tons of above ground stocks of gold currently estimated to be in existence, the GFMS Group calculates that 51% is held in the form of jewelry, 18% is in the hands of the official sector, 17% is with investors, 12% is in industrial products and 2% is unaccounted for.

Official sector supply stands at 28,700 tons, down from the 38,000 tons in the 1960s. From 1980 through the third quarter of 1999, many central banks systematically reduced their gold holdings which was a major factor in depressing the price of gold in those two decades.

However, in September 1999, a group of European Central Banks signed the first Central Bank Gold Agreement (CBGA1) to limit official sector gold sales to 400 tons a year for five years. CBGA2 was signed in 2004, and in August 2009, a third five-year CBGA agreement was announced, reducing the annual ceiling to 400 tons which includes the IMF's planned sale of 403 tons, half of which was already purchased by the Reserve Bank of India.

Gold demand comes from three sources: jewelry, industry and investment. In the five years from 2004 through 2008, annual demand for gold was 3,599 tons on average. The primary source of demand comes from jewelry, accounting for 68% of total demand over the five years. Investment demand, which includes both retail demand — largely gold coins and bars — and ETPs, accounted for 20% of aggregate demand during the same 2004-2008 period. Industrial demand, which comprises electronics' consumption as well as medical and dental uses, represented the remaining 12%.

FIGURE 2: SUPPLY AND DEMAND FLOWS FOR GOLD



The demand factors can vary considerably from year to year. In 2008, for example, jewelry demand fell dramatically to 62% from the average 68% of total demand, reflecting the poor economic environment.

However, even as jewelry demand fell in 2008, investment demand rose to 25% from the average 20% of total demand as gold was used as a safe haven investment. Overall investment demand has more than tripled since 2004, much of it driven by the availability of gold exchange traded funds.

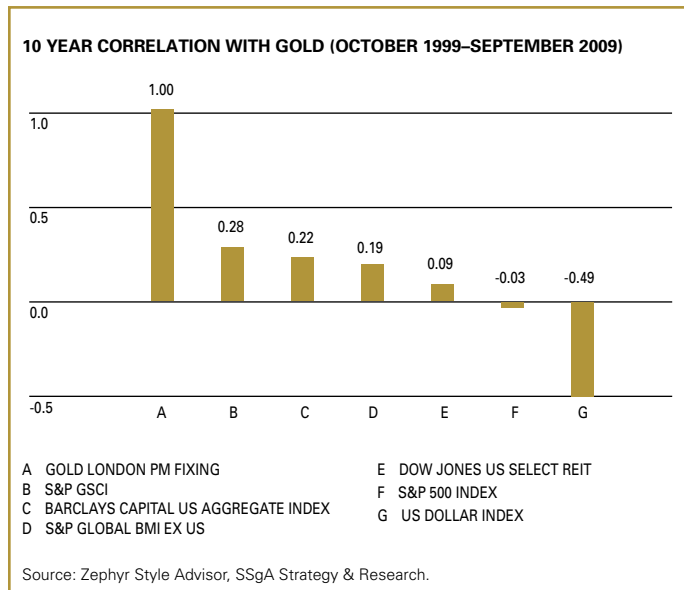
**THE INVESTMENT CASE FOR GOLD: A POSITIVE PRICE OUTLOOK AND DIVERSIFICATION BENEFITS**

As with any asset class, investors turn to gold for both tactical and strategic investment reasons. The tactical case has been driven by the positive price outlook associated with strong demand and tight supply for gold. The strategic case is driven by the investment diversification benefits of gold.

**GOLD AS A PORTFOLIO DIVERSIFIER**

One of the most compelling reasons to own gold is to help diversify a portfolio. Gold’s diversification benefits are manifold. As can be seen in Figure 3 below, gold’s correlations are exceptionally low to traditional equities and bonds as well as to broader commodity indexes.

**FIGURE 3: GOLD CORRELATION TO MAJOR ASSET CLASSES (INCLUDING THE US DOLLAR INDEX)**



**GOLD AS AN INFLATION HEDGE**

Gold has been used as a hedge against inflation for centuries. Since 1973, when the price of gold became free-floating, gold has provided an annualized real rate of return of 1.8% over the US consumer price index (CPI). Gold has tended to see its strongest price performance in years of high inflation such as 1980, providing an average real return of 14.9% in years in which CPI has been greater than 5%.

**GOLD AS A DOLLAR HEDGE**

Gold has historically demonstrated an inverse relationship to the dominant global currency — currently the US dollar. Over the past 10 years, the correlation of gold to the US Dollar Index, a trade-weighted basket of non-US currencies, was -0.49.

**GOLD AS A SAFE HAVEN ASSET**

Gold has long enjoyed a reputation as a safe haven asset and tends to trigger investor interest during periods of uncertainty. The market crisis of 2008 was no exception. The price of gold rose for the eighth consecutive year, climbing 4.3% in a year in which the S&P® 500 fell 37%, MSCI EAFE dropped 43%, and broader commodity indexes such as the S&P GSCI Index fell 43%.

**FOR NOW, IT'S GOLDEN**

So at least for now, the overview for gold is golden. But as gold’s history tells us, that can always change and change very quickly.

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<sup>1</sup> Alia McMullen, "India Propels Gold to New High," *Financial Post*, November 4, 2009.

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