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A Golden Future

With demand up and supply down, high gold prices could be here to stay.

By Frank E. Holmes

Thirty years ago in December, one of the most memorable events in modern investing occurred—the price of gold spiked to $850 per ounce, then the highest-ever price seen for the precious metal. Back then, the United States was not in a good way: Our economy was struggling, unemployment was high, rising energy prices were shredding family budgets and dire events in the Middle East were dominating headlines—two months earlier, Islamic fundamentalists took hostages at the U.S. Embassy in Tehran.

As 2010 begins, the U.S. economy is again struggling, unemployment is high, family budgets are under duress and the headlines are filled with distressing news from Iraq and Afghanistan. So what can we expect from gold today, which soared past $1,200 an ounce in December?

Will it reside at historic highs only briefly, as it did in 1980? After hitting the high, the price fell more than 25% within a week and 18 months later, it was in the $400 range as gold descended into a two-decade bear market. Or will challenges in the global economy reinforce gold's stature as the ultimate store of wealth?

I believe that gold will remain an attractive asset class for several reasons:

- Massive federal deficits and low interest rates in the United States and elsewhere will raise inflation risks and keep downward pressure on currencies;
- Rising incomes in Asia, where affinity for gold runs deep, will have a sizable positive impact on demand; and
- Gold production from mines is not adequate to meet demand.

That said, investors should consider a maximum 10% portfolio allocation to gold, split between physical gold or bullion-based exchange-traded funds and gold stocks or funds, and rebalance each year. Given the high volatility of the asset class, it is risky to allocate too much to gold. Investors should instead look at it as portfolio insurance, since it provides exposure to an asset class that has low correlation to other asset classes.

GOLD AND THE DOLLAR

Gold has a consistent inverse relationship with the U.S. dollar; when gold is up, the dollar is down, and vice versa. Looking at data going back 20 years, this relationship occurs nearly 70% of the time.

The Federal Reserve's massive stimulus spending and continued low interest rates are additional headwinds for the dollar, and thus tend to be positive for gold. The federal deficit for 2009 was estimated at $1.6 trillion, and over the next decade, the White House says another $9 trillion will be added to the national debt. This is deficit spending on a scale beyond anything we have seen, and it will undermine confidence in the dollar. As a result, many investors will turn to gold as an alternative reserve asset.

This scenario is not unique to our country. Others have also spent hundreds of billions of dollars in stimulus spending and slashed interest rates.

In fact, a major brokerage predicts that the price of gold will top $1,500 an ounce by early 2011 as a result of "competitive devaluation" of major currencies as countries boost their export sectors. Domestic markets in the G-7 stand to see low growth rates for the next few years, making corporate profits from overseas more important. Despite official reassurances from Washington that a strong dollar is in the national interest, the weak global economy argues otherwise.

In recent decades there has also been a significant relationship between federal deficit spending and the performance of gold-mining stocks, going back to 1971, when President Nixon deregulated the price of gold. When the federal government is spending more than it takes in, gold stocks tend to outperform the broader market. The gold stock index outperformed the S&P 500 through a quarter-century of deficits. The S&P 500 finally surpassed the gold stocks in 1997, in the midst of budget surpluses under President Bill Clinton and the stock market's technology boom.

When those surpluses turned into deficits after the September 11 attacks, the spread between the broad market and gold equities narrowed. At the same time, another important event occurred—China began to deregulate its precious metals markets. During that period, the S&P 500 dropped before largely leveling off, while gold stocks charged forward.

ASIAN LOVE AFFAIR

In late 2009, India agreed to pay $6.7 billion to the International Monetary Fund (IMF) for 200 metric tons of gold (6.4 million troy ounces).

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India, the world's largest gold jewelry market, made a rationally bullish call on gold in the face of declining supply—the largest sources of gold these days are governments with socialist policies that sell their reserves to pay for social welfare and bailout programs. The IMF is a classic case of this.

In this instance the buyer was a developing economy, another sign of the wealth shift away from developed markets and toward the emerging world. A decade ago, many emerging markets were in shambles, with contracting economies and huge current account deficits. Now many have surpluses to deploy, and they're thinking beyond Treasuries.

The IMF has another 203 metric tons of gold for sale, and China is a potential buyer. Beijing has made it clear that, while it may resist dumping its estimated $2 trillion in dollars, it wants to diversify its foreign reserve holdings. Its gold reserves have nearly doubled since 2003, when the price was around $350 an ounce.

Governments in India and China face little criticism for buying gold because these nations have a strong cultural affinity toward the metal. Many families store their wealth as gold jewelry, and as a bonus, it's also a way to display that wealth. If the U.S. government spent nearly $7 billion for the IMF's gold, it would be harshly condemned.

That's quite a disconnect. Our country holds most of its foreign reserves in gold. We are the largest gold holder at roughly 8,100 metric tons, more than double the amount of second-ranked Germany, but as a nation Americans are gold skeptics. In Asia, the citizens get it.

PEAK GOLD?

Many economists believe that we have reached or are close to reaching "peak oil"—the point of maximum production, after which there is an irreversible long-term decline in output. The same principle applies to gold in terms of mine production, and we are already on that permanent downward slope.

Gold miners hit their all-time production high of nearly 2,650 metric tons in 2001. In 2008, production was down 10% to about 2,400 metric tons. Declines have been most dramatic in South Africa, long the world leader; production there has tumbled from 395 metric tons in 2001 to 232 metric tons in 2008, a drop of more than 40%.

And as with oil, the production numbers don't provide a complete picture of mine supply. It has gotten more difficult and more expensive to find and develop significant new reserves, so going forward, mining companies will be challenged just to maintain current production levels.

The current price certainly presents a big incentive to bring new gold mines into production, but it's not that easy. A promising deposit found today would need five to six years to get over the geological, political, regulatory and logistical hurdles that stand between discovery and production. Many projects need even longer as they deal with delays and disappointments in their timelines, while others never produce a single ounce of gold.

While annual gold production is falling, the growth in money supply in both the United States and the euro zone is bent almost straight up. More money competing for a declining resource will drive up the price of that resource.

It's difficult to envision a scenario in which demand for gold falls off in the foreseeable future, given the weakness of the dollar and other paper currencies, the virtual inevitability of rising global inflation and the expanding wealth of the big gold-cherishing countries of the world. Combining those drivers with an inadequate supply makes a credible case for strength in gold prices. FP

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