Don't give up on gold miners

Martin Spring
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Gold bugs have been shocked by the sudden fall in the value of their favourite investment, which plunged about $250 an oz from early July to late October, although the metal has since bounced back to above $800 at time of writing.

They ought not to have been.

In the massive deleveraging that has taken place in the global financial system, gold got clobbered just like every other asset. Funds in trouble and needing lots of cash immediately, and unable to find buyers at realistic prices – or even any prices – for their illiquid assets, sold any investments they could turn into instant cash without difficulty.

Ironically, gold gained an additional and previously unpublicised advantage to its list of well-known attractions as an investment asset – liquidity at times of international financial crisis.

It has also strengthened its traditional claim to being the "anti-dollar" – a better alternative than rival currencies such as the euro and the yen as a risk-reducing element in a portfolio, whose value moves contrary to the direction of the dollar.

Over the same July-October period when the dollar rebounded, gold fell more than the euro or the Swiss franc, while the yen actually tracked upwards in line with the dollar.

According to a Fullermoney report quoting a study by National Bank Financial, in the third quarter "the greenback had a negative 90% correlation with bullion," following a negative 72% correlation in the second quarter.

Or to put it simply: when the dollar strengthens, the dollar price of gold falls. History suggests that the inverse is likely to be true: when the dollar weakens, we can expect gold to strengthen. It reduces the risk in a balanced portfolio.

Far from undermining the case for investment in gold, its performance since the credit bubble burst has been astonishingly good.

If you take the October 2007 peak in world share prices as a starting-point, from then till now we have seen global equities, using the MSCI index as a measure, fall 48% in dollar terms, with American stocks, using the S&P 500 index as the benchmark, drop 43%.

Over that same period the gold price in dollars rose by 9%.

In other currencies, the yellow metal did even better. It rose 10% measured in Swiss francs, 19% in euros, 44% in sterling, 50% in Australian dollars, 58% in South African rands.

Even more remarkable has been the way gold mining shares have underperformed relative to the physical metal (or exchange traded certificates giving ownership of bullion).

Over the same 13-month period the FT gold mine index (measured in dollars) fell 48% – compared to that 8% rise for the physical metal.

I identified this worrying anomaly – almost completely ignored by other analysts -- in the April 27 issue of my newsletter, warning that this underperformance was no temporary phenomenon, as it also happened in 2006 and 2007.

This makes nonsense of the generally-accepted wisdom that in a bull market for gold, investment in mining shares would do better than buying the physical metal because of the gearing effect of higher prices on mine profit margins.

Why has it come about? I can suggest two reasons:

• Mining costs have been rising even faster than the gold price, with energy, skilled labour and equipment all very much more expensive.

• Unwinding of speculative interest. Gold mining companies have been perceived as being no different from other commodity producers, which have gone very out of fashion, despite the resilience of the metal.

An interesting conclusion is that as these very negative influences wane and, in time, disappear, gold mine shares could start to outperform the physical metal when the next gold bull market resumes.

I'm certain that will happen, once "the world moves from the strong dollar deleveraging trade to the dollar debasement trade," as CLSA strategist Christopher Wood puts it.

One of my better calls, back in April when gold was trading at prices close to $900, was to recommend holding back from investing, as a continuing fallback into the $750-850 range could be expected.

I now expect several forces to keep gold under pressure:

• A strong dollar as American administrations are seen as providing robust leadership in tackling the developing global crisis, US investors continue to exit overseas assets and bring home their capital, and foreign investors continue to favour "safe haven" assets – especially Treasury bonds – in the US.

• The major source of demand for gold – the jewellery industry – is being hit hard by its very high price in the currencies of consuming countries such as India, and of course by the fall in demand for life's little luxuries by the world's wealthy (who are becoming notably less so).

• The flight from risk includes continuing disinvestment from commodity funds, with their significant gold components.

Until these forces lose momentum, the probability is that we're going to see gold's downtrend continue, although I expect the market to stabilize in a trading range of between $550 and $700.

If gold does go that low, it will become a great buy for the long term.

• *This article was written by Martin Spring in* On Target, *a private newsletter on global strategy. Email Afrodyn@aol.com if you would like to be included on the recipient list.*