

Should we still be betting on gold?

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When the world's financial system appeared on the verge of meltdown following the collapse of Lehman Brothers last month, gold soared, gaining 22% to \$911 an ounce by mid-October. But more recently, the ultimate safe haven "has not proved quite so safe", says Javier Blas in the FT. Last week it slid to its lowest level in over a year before regaining the \$700 mark; it has lost around a fifth of its dollar value in four weeks.

Physical demand has been strong, with Fidelity, one of the largest gold coin dealers, last week quoting the popular South African krugerrand one-ounce gold coin at a \$75 premium to the spot price. But other, stronger forces are at work. Gold has benefited from the rising oil price over the past few years as it has stoked demand for a hedge against inflation, so the reversal in this market has put downward pressure on gold. The recovery in the dollar, up 5% last week alone against a basket of six trading partners' currencies, isn't helping either.

The greenback's rally is a reflection of global deleveraging and the flight to quality, which has caused a rush into Treasuries, says Christopher Laird of Prudentsquirrel.com. The trend is also prompting investors to ditch commodities as fears of a severe recession mount, which means they are selling out of benchmark raw materials indices that contain gold. Many investors desperate to meet margin calls are also selling gold as it is highly liquid. So while gold still benefits from a flight to safety, "it's being overwhelmed" by stock and commodity deleveraging, says Laird. Solid physical demand is not enough to stem the tide.

Nonetheless, as Chris Weber points out in Daily Wealth, this hardly looks like the end of the gold bull. In dollar terms it's down by less than 10% on a year ago, and even a slide to about \$615 would mirror the downswing within the longer-term bull run of the 1970s. What's more, thanks to the dollar's

recovery of late, measured in other currencies – notably sterling and the euro – gold is near all-time highs. And there is scope for further gains. The "long-term fundamentals remain tight, with little sign" of a significant jump in supply as mines are struggling to boost production and recent exploration has been unsuccessful, says Graham Birch of BlackRock.

Moreover, while the main near-term danger to the world economy is a period of deflation, inflation could well make a comeback over the next few years, as we noted in our cover story a fortnight ago. Governments will find that the only way to pay for all the stakebuilding in banks, the private debt they are accumulating, and the state spending sprees to prop up economies, is to print more money, says Jeff Nichols of American Precious Metals advisers. Gold may look weak now, notes Weber, but in time, as inflation returns, it will rise.