



By Daryl Liew

Financial markets today are paralysed with fear over the developing crisis in the US subprime housing sector and the ensuing problems in the Collateralized Debt Obligation (CDO) market. Amidst all this turmoil, the major central banks have had to step in to fulfil their role as lender of last resort and inject much needed liquidity in order to allow financial markets to continue operating. In the face of all this uncertainty, there have been calls from investors beseeching central bankers to hold off their planned interest rate hikes (Europe & Japan) and possibly even cut rates in order to preserve asset values.

This liquidity crunch is probably US Federal Reserve Chairman Ben Bernanke's sternest test so far and comes just a couple of days after a Fed meeting where they kept rates constant and reiterated their concerns with rising inflationary pressures. It remains to be seen in the next few weeks whether Bernanke has the mettle to stick to his guns and be hawkish on inflation. Indeed, we at Providend have stood firmly in the camp of the Fed Chairman, maintaining our belief that inflation will remain stubbornly high in the face of a tight labour market and rising commodity prices (particularly food & energy).

One interesting observation from the volatile financial markets in recent weeks is the rather unusual behaviour of the price of gold. Gold is traditionally regarded as an asset to hedge against inflation and a safe haven instrument that people flock to

in troubled times. Interestingly however, gold prices have actually eased back somewhat despite the favourable conditions of financial turmoil coupled with concerns of rising inflation.

Threat of stagflation

We have been paying particularly close attention to the price of gold as we decided to include an allocation to the precious metal in all our portfolios several months ago. The basis for our decision to invest in gold in March was to protect our portfolios against what we perceived as a potential threat – the increasing risk of stagflation. This term “Stagflation” was coined by Nobel Prize winner for economics, Paul Samuelson, to describe the situation of accelerating inflation amidst slowing growth, a scenario which manifested itself in the US during the 1970s. The problem with stagflation is that high inflation coupled with slowing economic growth makes for a lethal combination, which is bad for both equities and bonds, your traditional asset classes. In fact, Samuelson himself was quoted a few months ago as saying that he believed the current situation of higher oil prices and the bursting of the US housing bubble (translating to slower growth) could be the necessary ingredients to cause 1970s-like stagflation. Looking at the situation today, we may be slowly seeing the materialisation of this stagflation scenario, with the problems in the subprime sector threatening to spill over to the broader

economy and also infiltrating foreign markets through the banking sector, while food prices continue to sky-rocket.

Our rationale for allocating a portion of our portfolios into gold was because traditionally, real assets like property and gold are regarded as good assets to hold in the event of stagflation, mostly because real assets are hedges against rising inflation. With the strange behaviour of gold prices however, we thought it prudent to initiate a special research report¹ to find out the reasons for this divergence.

Special gold report

Our study uncovered several interesting points. One observation was that while inflation and political threats used to have a large impact on gold prices in the past, these factors no longer appeared to be the main driver of gold prices. The simple reason for this is that the factors influencing gold prices in today's market are no longer the same ones of yesteryear.

Like all assets, the price of precious metals fluctuates with the change in demand and supply. About 70 percent of the demand for gold comes from the demand for gold jewellery, with the balance coming from industrial purposes and a growing proportion attributed to investment demand. While jewellery sales make up the bulk of gold demand, this tends to act more as a price floor rather than drive prices higher. This is because people who buy jewellery typically adjust their purchases depending on the gold price, i.e. when prices are high, they may hold off making purchases, waiting instead for prices to come down. With industrial demand remaining relatively stable, our findings point to the growing investment demand for gold that is now the major cause for the fluctuation in prices. If this is the case, then gold can now no longer be regarded as a good hedge against inflation!

Fundamentals for gold still positive

With this new piece of information, we then had to ask ourselves whether gold still had a role to play in our portfolios. On

further analysis, we found that the fundamentals for gold appear very positive. On the supply-side, mining production of the precious metal peaked in 2001 and has been on the decline ever since. In fact, due to the lack of investment in exploration in recent years (between 1997 and 2002, exploration budgets were cut as much as 67 percent due to the low price of gold), this trend is expected to continue for the next few years at least until new mines come online. The other major source of gold supply is through central bank sales (central banks, particularly those in Europe, hold a large amount of gold reserves due to historical reasons). These sales however have now become fairly stable with the signing of the Central Bank Gold Agreement – the agreement restricts the 15 signatory European central banks to a maximum level of sales of 500 tons per year in aggregate.

On the demand-side, investment demand for gold also appears to be picking up with more portfolio managers (like us!) and Asian central banks looking to allocate a portion of their resources into the asset class. The emergence of several commodity-backed exchange traded funds and the sharp appreciation in commodity prices over the past few years have also helped fuel interest in this sector. If commodity-guru Jim Rogers is right, we are still in the early phase of a long multi-year commodity bull-run.

Negative correlation with the US dollar

Besides just looking for gold prices to appreciate, are there then any other benefits to holding gold from a portfolio context? Our study confirmed that other than the usual diversification advantage to holding gold (the asset class is less

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¹ “A Report on Gold as an Inflation Hedge” by Daryl Liew & Esther Perh, 18 July 2007

correlated to equities and bonds), gold does exhibit a very strong negative relationship with the US dollar, as illustrated in the graph below. Because of this, gold still possesses a useful quality – providing a good hedge against further depreciation in the US dollar.

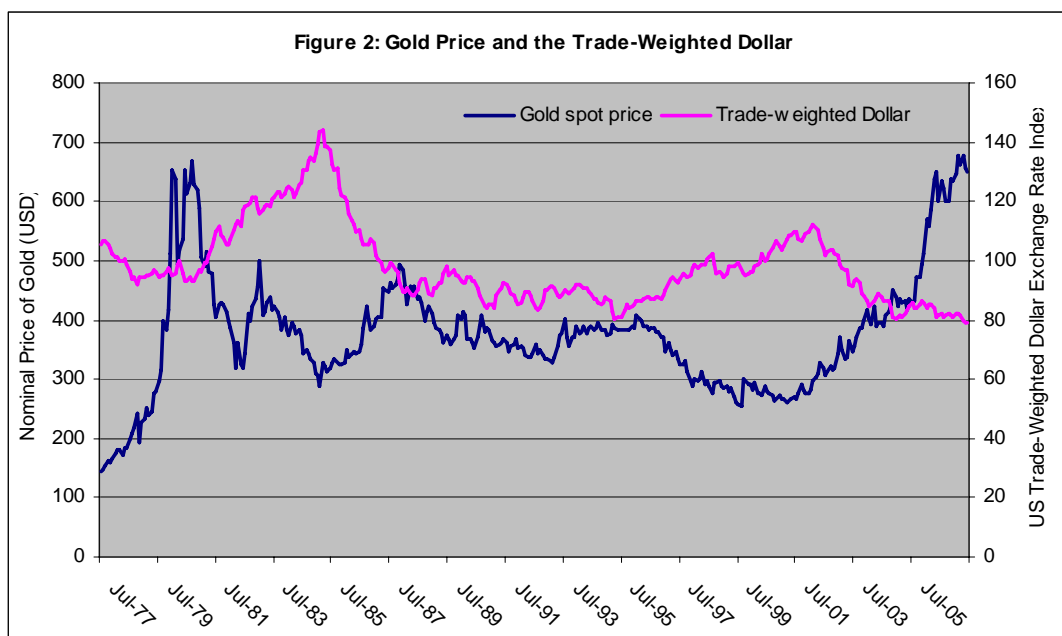
In fact, this negative correlation is probably one of the reasons why gold has struggled despite the current turmoil in the market. The credit crunch and concerns about the US housing market has caused a flight to safety and a flood of money into risk-free assets like US treasuries. This increase in funds flowing into US assets has caused the greenback to strengthen and hence led to weakness in gold.

In addition, reports indicate that European central banks have increased their sales of their gold reserves by 7.3 percent this year, with a large chunk being sold in the past month. The ECB said on July 31st that three member banks had sold 195 million euros worth of gold in the past week, and an additional 288 million euros of gold in the week before. Data from the World Gold Council also show that European banks have sold 358 metric tons of the 500 tons permitted annually, compared with the

333.5 tons sold through Aug 11th last year. This increase in gold supply on the global market would undoubtedly have contributed to softer prices in the past few weeks.

A third reason for the weaker gold price is the impact of higher interest rates around the world, which have made holding gold less attractive. This is because gold is a negative cashflow asset – not only do you not receive a regular dividend or coupon, but you also may have to incur added holding costs associated with storing and insuring your gold bullion! Some investors may thus find the opportunity cost of holding gold prohibitively high with the higher returns available on other financial instruments.

While gold has arguably lost its inflation-hedging properties over the short-term, there still are solid reasons for its inclusion in one's overall portfolio from a diversification point of view. We do expect prices to continue range trading in the next few weeks as the underlying concerns in financial markets work themselves out. We do believe however that the outlook for this asset class appears quite bright.



Source: Providend
Data: Bloomberg

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