

Gold goes all Google!

Gold suddenly seems all-too popular. But does Wall Street's love of the metal mean gold's five-year bull market is finished...?

Don't whisper it too loudly, but gold in 2007 looks like a crowded trade. Both the *Times* and the *Telegraph* in London just ran bullish reports on the metal. The *Financial Times* notes that institutional money has a "growing love affair with gold..."

Deutsche Bank AG, the world's largest securities firm, expects gold to rise as the US dollar falls further, and individual traders and dealers are also backing gold to go higher this year. Bloomberg says that 22 out of 31 finance professionals surveyed last week all advise buying the metal.

Gold's right up there with Google, in fact! The top 100 amateur investors tracked by Marketocracy.com now recommend Goldcorp, a major gold mining stock, alongside shares in the internet search engine.

Yet Google now trades for 64 times its 2006 earnings. Both Goldman Sachs and Bank of America just reiterated their "buy" recommendations on the stock.

What on earth did gold do to deserve this red-hot dotcom for company? "Now that everyone expects [gold] funds to continue powering ahead, expect a downturn," warns one City fund manager. There's too much "hot money" in the metal, says another.

Could they be right? There's a lot of speculative money riding on the answer. So let's take a look at the year ahead.

India's Demand Set to Rise

India leads the world in its love of physical gold, and by March it's due to get its first of three exchange-traded gold funds (ETFs) too. These products have proven very popular in the West, despite charging 0.4% annual storage fees and merely backing each share with gold held in trust, rather than giving investors outright gold ownership. New gold ETFs in 2007 are planned for Germany, Italy, Belgium and Luxembourg. But India could put them all in the shade. Gold already has "the highest

penetration of any other financial product," says the head of Kotak Mahindra Bank, the company behind one of India's new gold ETFs. The numbers are staggering. Private individuals in India own more than 14,000 tonnes of plain necklaces, rings and

bracelets – nearly 10% of the world's entire above-ground gold stocks, and a larger hoard than the US, German and French governments' put together.

But until now, "India [has been] a one-way street when it comes to investment," says David Gornall, director of Natexis Commodity Markets Ltd. Exporting scrap gold is illegal, so the only way of taking profits in the metal is selling to a jeweller –

"...India leads the world in its love of gold. It's due to get its first gold ETF by March..."

who might charge 10-15% in fees. Kotak Gold, on the other hand, will charge 4% in and 1% out, on a minimum investment of around \$1,200.

The festival of Akshaya Thrithiya in late April should then give a more traditional boost to India's physical gold demand. The third most auspicious day in the Hindu calendar, it packed Bangalore's 2,000 gold shops "choc-a-bloc" last spring, says the Times of India. Across southern India, 70,000kg of gold jewellery was sold in one day. The number of shoppers rose 50% from 2005. This year's festival could see gold sales rise further if last autumn's Diwali festival proves a guide. In October, says Suresh Hundia of the Bombay Bullion Association, India's gold consumption more than doubled in October.

Don't call your broker to buy a fistful of gold call options just yet, however. "A feature of Indian demand is its extreme sensitivity to price volatility," notes Kotak Bank, because these seasoned gold investors hate buying necklaces and bracelets on a spike, only to watch the price fall back. This month's violent action in gold prices may dent Indian demand this spring. What's more, says Neil Meader at the GFMS consultancy in London, "the modernisation of an economy can be a double-edged sword" for gold investment.

In poor rural areas with no formal banking system, gold often acts as a savings account. But as India and China modernise, people may put their money into bank accounts rather than plain gold jewellery. "Certainly in the case of China," says Meader, "we've seen a huge shift in patterns of jewellery buying from the very high-carat to 18-carat and gem-set jewellery." More money is going on design, and that's sure to cut the fine weight of gold in each piece. But gold remains "an integral part of Indian culture," notes Gornall at Natexis, and with the number of households earning above \$80,000 per year set to treble in the next decade, it seems more likely that gold ownership will continue to grow. On a per

capita basis, India still lags more developed markets. Per head of the population, Turkey's jewellery sales in 2006 were six times greater than India's in volume terms, according to data from Virtual Metals and Fortis Bank.

Increased wealth certainly hasn't hurt Chinese or Indian gold demand so far in this bull market, and two billion people living through the greatest economic boom in history can buy an awful lot of gold jewellery! Over the last three months, strong physical buying has kicked in every time the gold price dipped towards \$600 per ounce – twice what it was only four years ago.

Why Mining Output Fell in 2006

If jewellery demand from Asia's emerging giants puts a floor under gold prices in 2007, what might set the ceiling? Despite the bull market, gold mining supplies fell 2% last year, says Helen Holten at Standard Chartered Bank, and GFMS's latest data agree. Virtual Metals in London reckon output slipped only 1.5% from 2005. Gold mining companies are trying to shift all the earth they can, of course. But mounting problems of cost, politics and finance are capping how fast they can dig gold ore out of the ground.

First, the "easy gold" in secure and safe regions has already been mined. North American output this year is forecast at just 78% of 2002 levels. South African output has halved since 1998. Ore grades in both countries are falling fast too, while less stable regions have yet to pick up the pace. Zimbabwe's gold output, for instance, has fallen to "pathetic levels" according to press reports from Harare.

Then there's cost. Newmont Mining Inc., the second largest gold miner in the world, was recently downgraded to "underweight" by mining-stock analysts due to its increased expenses. In the five years to November, average production costs at Newmont rose by two-thirds per ounce. Prudential Equity now forecasts that Newmont's combined output with Barrick

Gold, the largest gold miner in the world, will be 40 or 50 tonnes less than expected in 2007. As the gold miners extract their ore, the value of their balance-sheet assets shrinks. But replacing gold-in-the-ground with new discoveries is proving tougher than ever. Westhouse Securities estimates that between 1985 and 2003, new gold ounce discoveries slipped by 30% from the previous 15 years. Each new ounce discovered also cost 2.6 times as much to locate. And large deposits – judged at 2.5 million ounces or more – aren't enough to replace the major gold mining companies' current rate of production, says the Metals Economics Group in Halifax, Canada. Between 1992 and 2005, world output totalled 1.1 billion ounces. New large reserves were barely half that size.

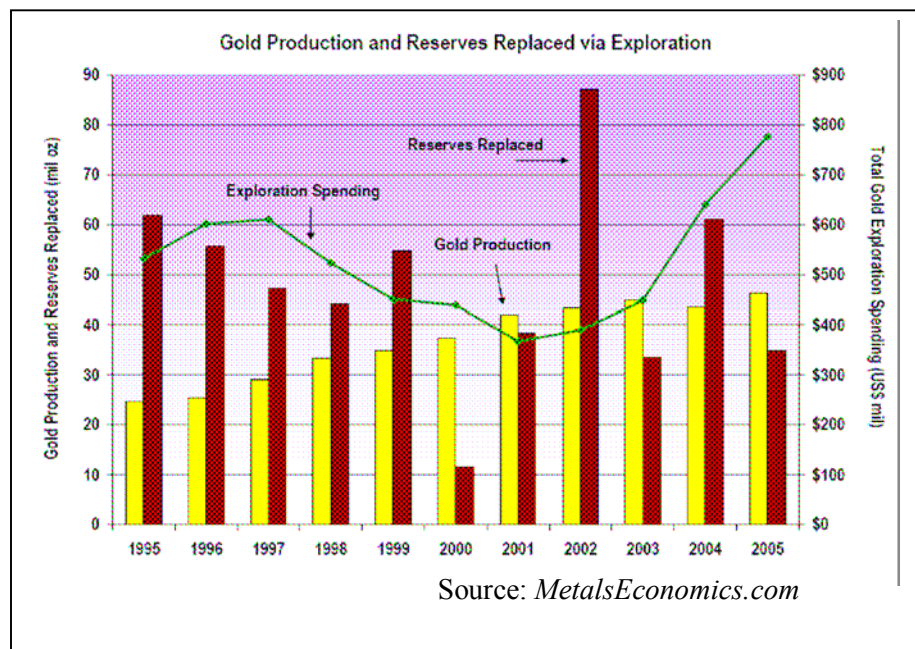
Gold mining stocks also face the classic problem thrown up by a commodities boom – populist governments stealing their assets. The military government in Fiji last week seized the Vatukoula mine belonging to DRDGold, an Australian firm. In December the Russian environmental agency Rospriradnador revoked two mining licenses owned by Peter Hambro, the London-listed gold producer. Western gold mining firms must also contend with a new political threat bred much closer to home – environmental activists backed by charities like Greenpeace, Friends of the Earth and American Oxfam.

Take Gabriel Resources' project at Rosia Montana in Romania, for instance. It may hold the largest undeveloped gold reserves in Europe, but upturning five mountains to get at 450 tonnes of

gold doesn't fit with today's green politics. And there are no "carbon offset" contracts for spilling mercury, cyanide and heavy metals into local rivers.

What can the major gold miners do to defend their share price? Like any sane corporate executives today, mining bosses have gone crazy for mergers and acquisitions. Merrill Lynch said last week that global gold mining M&A hit a record \$19.3 billion in 2006 amid frantic corporate action. But digging for gold on the stock market did nothing to increase total global supplies. Nor does M&A simply shift gold reserves from one balance sheet to another. The net effect is to cut exploration spending as the majors focus on boardroom deals and the number of risk-taking juniors is reduced. Falling reserves replacement over the last 10 years "may result in gold supply shortages in the long term," warn the analysts at MEG.com.

Will today's M&A frenzy prove short-sighted? Consider how the industry responded to the slump in gold prices during the 1980s and '90s. By June 2001, says the Mitsui Hedge Book, the global gold mining industry had sold forward a massive 3,421 tonnes of production – as yet unmined – onto the futures market. Well over 135% of



an entire year's output, that "hedging" made short-term sense during gold's 20-year bear market. It funded production and locked in fixed prices for future gold output. But it also helped drive prices lower.

What De-Hedging Means for the Gold Price

Now that investors have taken control and trebled the gold price versus the US dollar, the mining companies are desperate to buy back their forward sales. Between April and June last year, gold mining companies led by Barrick and AngloGold Ashanti de-hedged by 158 tonnes. That helped drive the gold price up to its huge spike above \$720 per ounce in mid-May '06. "The rate of dehedging was bound to slow afterwards," says Edel Tully, head of precious metals research at Mitsui. But the latest data – for June to September – show that "global mining companies remain committed to reducing their hedge commitments and have very little appetite for new hedging."

Falling sales by Western governments should also support further gains in the gold price. European central banks sold only 396 tonnes of gold last year, against an agreed limit of 500 tonnes. Emerging economy governments, meanwhile, are buying gold for their central bank reserves. The details are secret, but analysts guess that Russia bought 8.7 tonnes of gold between August and October, while Middle Eastern governments, flush with petro-dollars, may have bought 100 tonnes in 2006.

Trying to forecast 2007 demand and supply like this, however, misses the crucial point – why would anyone want to buy gold in the first place? The metal is famously useless, with few industrial applications. New compounds are replacing it in dentistry, and the yellow stuff will never pay you a dividend. Indeed, gold costs you to own it – in storage and insurance fees. Add a

minimum 2% surcharge from the gold dealers, or the stockbroking charges should you trade gold ETFs such as Kotak, StreetTracks or LyxOr, and gold soon looks like a losing trade – unless the price rises in terms of your local currency. And therein lies its potential today.

Gold cannot be made at will, no matter how pricey it gets. This is why people across the world have used it as a store of value for 5,000 years or more. Gold's utility is simply that it is rare – an attribute of money that no longer holds for dollars, pounds, euros or yen. Gold is also the most popular investment in India, remember, the world's second most populous country. Private demand from the sub-continent accounted for one ounce in every five sold anywhere in the world last year. But what do Indian investors think they are getting when they buy gold – and what might you get from the yellow metal if you buy it today? Well, gold acts as "a global currency," says Anthony

S.Fell, chairman of RBC Capital Markets in Toronto – "the only one that is freely tradable and unencumbered by vast quantities of sovereign debt and prior obligations."

Royal Bank of Canada now trades gold off its currency desks, rather than viewing it as commodity. If you look at the flood of paper assets now washing across the world's financial markets, you can why.

India's money supply, for example, has surged more than 200 times over since 1975, helping to knock the value of the rupee down from 8 per US dollar to 48 per dollar. Here in Britain, the broad money supply is rising at 14% per year, faster than at any time since 1991 and well ahead of every other major world currency. But the supply of stock market securities, bonds and complex derivative products is rising faster still. "Financial innovation in the last few years has been extremely strong and powerful," says Gilles Gilcenstein, head of asset management at BNP Paribas. "We've

*"...Gold is the ultimate
antidote to today's craze
for financial innovation..."*

seen that in credit derivatives and equity derivatives, trackers, certificates..." Financial innovation is now so rampant, in fact, that derivatives weigh in at \$340 trillion altogether, more than eight times the value of all goods and services traded in the real global economy last year.

Today's bubble in novelty and complexity is sure to blow up – if not in 2007, then all in good time. You might like to hold gold as insurance. For the "barbarous

relic" – so beloved of apparently naive investors in the booming economies of India, China and the Middle East – is the ultimate antidote to "financial innovation". Nobody's promise, gold is also no one's to create. And while you're waiting for the mountain of debt and derivatives to explode, you will own a secure physical asset likely to keep rising in value, thanks to the simple rules of supply and demand.

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