

What's up with gold?

Global economic update: September 2011

By Kobus Nell, Resources Analyst: STANLIB

With the gold price dominating headlines we take a closer look at what is driving the gold price and what the future holds for South Africa's favourite precious metal.

What is driving the gold price?

The price of gold reflects the level of global uncertainty and right now, the world is a very uncertain place.

- A sustainable solution for European sovereign debt issues seems unlikely in the short to medium term.
- The US economy will likely require further stimulus in some form, which means lower interest rates for a longer time, increasing the risk of inflation
- Investors are seeking "safe-haven buying" and "protection against paper asset dilution". The dollar is the world's reserve currency, so America can print more dollars as other countries will keep buying them.
- Developed-world debt levels have increased substantially since the turn of the century, especially in the US, and the risk of further US credit rating downgrades remains.

What is likely to support the gold price?

Although the gold price has been increasing over the last five years, this year has seen the most dramatic increase. Questions are being raised as to whether the current price is sustainable. The gold price could fall if demand for gold as an investment slows but this is unlikely given that:

- It is unlikely that the developed world will increase interest rates, given poor employment and housing trends in the US.
- The Chinese are unlikely to raise interest rates further as they are managing credit growth by increasing the amount banks need to hold as a reserve requirement when lending money
- The increasing availability of gold as an investment vehicle in China should continue to support demand for the yellow metal.
- Peripheral Europe's sovereign debt issues remain a problem.
- The strong demand for gold over the last three years is expected to continue well into 2012 as central banks buy gold as a diversification from the US dollar.

Are we experiencing a gold bubble?

An asset bubble is formed when the price of an asset is inflated due to excess demand, and can be aggravated by low interest rates. One could argue that this is the case for gold at the moment.

Yet gold remains the primary store of value despite losing a major part of its shine after the world did away with the gold standard in the 1970s. The main argument was that gold did not offer a yield (income) and therefore did not have any meaningful purpose away from the cosmetic value in jewellery.

The negative real yield (interest rates after inflation) that shorter-dated US instruments offer, coupled with the risk of dollar depreciation and US credit rating downgrades, changes the playing field somewhat and calls for alternatives to store countries' official foreign reserves.

An estimated 15% - 20% of the global official reserves are held in gold. This is a long way from the 60% that was held in gold 30 years ago. If countries increase their gold reserves significantly this will support the demand for gold and continue to benefit the gold price.

Will gold shares benefit from a higher gold price?

The share prices of gold mining companies have substantially lagged the price of physical gold over the years as the costs of mining gold have increased reducing profits.

Most of the gold companies are enjoying very good cash flow returns at current gold prices which should translate into much better earnings and dividends if these levels hold. Dividends and earnings are the main drivers of share prices.

The current rand gold price (at the time writing this report) of \$1 790/oz at R7.2/US\$ is around 26% higher than the last quarter. Some of the South African gold companies are trading between 50% - 60% of their theoretical net present values based on these spot prices which look attractive from a valuation perspective.

Some global gold companies also mentioned that their dividend will be directly linked to the gold price, effectively getting a cash flow yield on your investment which you don't get by investing in physical gold.

Liberty Group is an Authorised Financial Services Provider in terms of the FAIS Act (Licence no. 2409). The information contained in this communication, including attachments, is not to be construed as advice in terms of the Financial Advisory and Intermediary Services Act of 2002 ("FAIS") as the writer is neither an appointed representative of Liberty, nor a licensed financial services provider as contemplated in FAIS. Please consult your financial adviser should you require advice of a financial nature and/or intermediary services.