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Gold will keep its lustre with either inflation or deflation

By Jonathan Spall
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Over the past 10 years gold has increased five-fold and recently hit an all-time nominal high above $1,270 per ounce. There are many commentators confidently predicting further gains before the end of the year as well as a new inflation adjusted all-time high (estimated to be $2,250 in today's money) in the next few years.

Part of the reason for gold's price appreciation has been continued concern about rising inflation. More recently, however, talk of hyperinflation has given way to fears about the equally unpalatable threat of deflation. Despite these seemingly contradictory scenarios, the price of gold has continued to increase.

Gold does not protect against inflation or deflation *per se* but it is likely to do well in either scenario as it is a hedge against financial dislocation and uncertainty. Its historic tie with inflation is simply recognition of the fact that for much of the world's economic history we have been struggling to tame rising prices rather than been confronted with the far more intractable problem of falling ones.

So, if the dilemma now confronting the world's central bankers was as simple as a choice between inflation and deflation, then there is no doubt which option they would pick. They know they have the tools to beat inflation and even aggressive inflation as the experience of the 1980s illustrates.

The outcome they most fear is deflation. For this, they need look no further than Japan where the hike in interest rates at the start of the 1990s as they looked to deflate the asset price bubble led to the "lost decade" – the impact of which is still being felt today.

Indeed, the last time gold was in the middle of a prolonged rally was at the end of the 1970s with the global economy suffering under oil price shocks and the resultant inflation which culminated in gold hitting its then all-time nominal high of $850 in February 1980.

However, as the decade progressed, the Federal Reserve under the stewardship of Paul Volcker and the Bundesbank run by Karl Otto Pöhl were viewed as institutions determined to combat inflation while guiding global monetary policy and growth. By the end of the 1990s, the credibility of monetary authorities had perhaps never been higher and consequently the perceived attributes of gold were seen as irrelevant – leading the metal to slump to $250.

Gold's recent performance is partly due to low interest rates, which clearly enhance the attractiveness of all investments, but more pertinently to a feeling that central banks are no longer the masters of their own destiny as they were once perceived to be. The further uncertainties engendered by continuing questions over the validity of sovereign and municipal debt, and consequent concerns over currencies, are only adding to the unease.

In a sense, the notions of inflation or deflation are redundant and it is simply that gold is seen as being effective in times of stress to the financial system.

While it should be no great surprise that a hedge against financial uncertainty can rise in the current environment there remains the question of why it should be gold and not some other metal or commodity.

The fundamentals of gold are hardly compelling. There are few end uses for the metal and much of what has ever been mined remains in above-ground stocks, which are being added to each year and currently stand at some 165,000 tonnes, with a little less than 20 per cent sitting in the vaults of the world's central banks.

Indeed platinum, presently trading at a $300 premium per ounce to gold, where there are no known large stockpiles and which is "consumed" in the industrial process might seem a more natural candidate, particularly as platinum's annual production is only 7.5 per cent of that of gold.

Instead the price performance of this metal is rather more linked to changes in its supply and demand as well as the performance of other industrial metals such as copper and zinc.

However, there is one unique feature of gold that is possessed by no other investment and which ensures it is an investment of choice for many: its place in human psyche. It has been a global monetary unit for more than 2,500 years while also having significance in language, tradition and religion.

Consider "as good as gold" – a phrase not unique to the English language – as well as gold medals handed out at the Olympics and as traditional gifts particularly in India and China. Therefore, while other investments might have a rational claim to be effective in the current economic climate there are none that have the history and emotional attraction that gold enjoys and which can see it move further ahead whether prices are rising or falling.

Jonathan Spall is Director, Commodities Distribution at Barclays Capital, and is based in London