China and resources

Time to acknowledge the golden elephant

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Gold is behaving badly. It's supposed to be a safe-haven asset but, just when the global economy looks like going to hell in a hand basket, the gold market collapses. It should have rallied.

The gold bugs are bemused, but they are nowhere near raising the white flag.

UBS analysts in a recent note to clients said: "Our core view on gold remains bullish. We forecast an average 2012 price of $2050. Most of the factors that pushed gold higher in 2011 are not going away."

UBS says a compelling case for higher gold returns next year can be built on persistent sovereign stress, an expected recession in Europe, benign growth across developed markets, a relatively sedate outlook for competing asset classes, still low interest rates in the US and further rate declines in Europe.

Well, that may be great for gold, but if UBS is right it's the kiss of death for equities and industrial commodities.

Right now, though, this gloom is not even working for gold. Something is wrong.

As the euro zone debt crisis deepens and developed economies hurtle toward recession, the gold price has slumped to its lowest level since September while the US dollar has soared.

The gold price tumbled almost 9 per cent to $US1560 a troy ounce at one stage last week and gold is still trading below $US1600. It broke down below its 200-day moving average for the first time in almost three years.

Rather than gold being the primary safe-haven asset, US dollars and US treasuries have become the preferred safe-haven asset classes. The US dollar's position as the world's reserve currency gives it the advantage of liquidity and in very turbulent times investors seem to prefer liquidity to less liquid assets, even if those assets are seen as safe havens, like gold.

Some investors are concerned that this marks a paradigm shift in gold's safe-haven asset status. Gold's illiquidity in ever more turbulent times is tarnishing its status.

But this may well be jumping at shadows.

Even though gold's recent poor performance has rocked the confidence of some investors, it is important to put its recent price slide into perspective. Gold has fallen just 16 per cent from its all-time high in September.

The gold price remains at an extraordinarily high level and gold is still the best-performing major commodity so far

this year.

The gold bugs see its price fall as temporary and expect another bounce. They do not see any paradigm shift. They believe that gold remains an important safe-haven asset. They believe the selling is short term and driven by the need for cash.

And indeed the global economic outlook is not all that flash and should continue to support investment demand for gold.

There has been selling of gold by the big investment funds to take some profits and shift into more liquid assets. The selling has also been driven by the need for hedge/investment funds to raise cash to pay out investors who want to take money out of those funds.

But it is critical to understand that gold really is just yellow and heavy and in massive oversupply. The surge in the gold price is a massive asset price bubble.

It has been speculatively driven. One day the gold price will collapse.

It has been only investment demand that has driven the price of gold higher. Without investment demand the gold price would arguably still be wallowing around $US400 an ounce – where it was back in early 2005.

Gold's problem is that it flips from being a safe-haven currency to being a commodity. It's a touch schizophrenic.

As a currency safe haven it can soar, as it has, as fear and greed trigger an avalanche of speculative money into the gold market. And like any financial asset bubble, as more money pours in and as the price rises still more, so more money is attracted.

That is what has happened to gold over the past decade.

Yet as a vanilla commodity, gold is a complete dog.

Never believe anyone, especially the World Gold Council, which represents the interests of the world's gold producers, who says gold is highly priced because it is scarce.

The world's central banks alone hold 10 years worth of gold consumption in their vaults. Any commodity with a stocks-to-use ratio like this would be cheap, really cheap.

Then there is the hot gold in punters' funds. The amount of gold held by speculators in bullion-backed exchange-traded products (ETPs) now totals twice the amount of gold held by Switzerland.

Gold trusts rank as the fifth-largest holders of gold in the world, after the stocks held in the vaults of the central banks of the US, Germany and France and the holdings of the IMF.

And stocks aside, annual production (4155 tonnes in 2010) outweighs the annual total demand for gold, including investor demand, of just below 4000 tonnes.

The gold market is in supply surplus.

Other than investment demand, real end-user demand for gold is dismal. Gold jewellery demand, which traditionally accounts for 70 per cent of total demand for physical gold, has fallen by a third over the past 15 years, from more than 3000 tonnes a year in the mid 1990s to 2017 tonnes in 2010.

Gold, like diamonds, silver and pearls, is so plentiful that on any normal commodity-styled demand/supply analysis it would be worth $US160 an ounce rather than $US1600 an ounce. So keep a close watch on gold's mood swings from safe-haven currency to commodity.

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