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The case for a new gold rush

By MARTIN MITTELSTAEDT

Fears of government deficits and renewed money printing will drive the metal to record prices, Austrian bank argues

When it comes to gold, Warren Buffett doesn't know what he's talking about, according to one of the metal's most ardent European fans.

Gold is likely to hit a record high of $2,000 (U.S.) an ounce over the next year, driven by fears over government deficits and worries that central banks will be forced into more money printing, according to Erste Group, an Austrian bank.

The bank believes the precious metal will eventually rise even further, reaching at least $2,300 an ounce, which would match its high from the early 1980s if inflation is taken into account. In a recent report to clients the institution says that given the instability in the global financial system, its price forecast "could be on the conservative side."

Erste Group has been producing annual forecasts of gold prices since 2007, and has been bullish over the period – an accurate call, given gold's surging fortunes over the past five years.

This year's 120-page report includes such quirky measures as how many litres of beer can be purchased at Munich's Oktoberfest each year with an ounce of gold. It also features a lengthy discussion on Mr. Buffett's well-known antipathy toward gold, which the bank views as an irrational form of "aurophobia."

The bank says that Mr. Buffett doesn't understand that bullion is a form of money and therefore shouldn't be compared to stocks as an investment. It maintains that the proper comparison is between gold and competing types of money.

Mr. Buffett "criticizes the low industrial use, the lack of intrinsic value, and questions the general reasonableness of buying gold. We believe that Buffett has made a fundamental error, having missed the connection between gold and money and is thus comparing apples and oranges."

The bank says that Mr. Buffett's negative view on gold would apply equally well to the U.S. dollar, which "has no intrinsic value, no industrial use, and does not pay any interest at this point in time either."

To be sure, Erste Group's Oktoberfest beer comparison indicates that gold is a little pricey now, at least compared to the long-term average of the yellow beverage in terms of the yellow metal.

Since 1950, an ounce of gold bought an average of 87 litres of beer at Munich's outdoor gardens. Currently, it's 136 litres.

However, the record high for this beer-based measure of a liquid asset was 227 litres back in 1980, a level the bank says could again be attained.

"We think it is indeed possible that we will see these values again. Beer drinkers with gold in their portfolio should therefore look out for sparkling times," it noted.

The bank says one of the big questions facing investors is whether the global economy will be hit with higher inflation or a bout of deflation.

Either scenario will be bullish for gold, in its opinion. "In times of inflation tangible goods are the preferred asset class, whereas in deflation it is cash. Gold is liquid, divisible, indestructible, and easily transportable. It also has a worldwide market and there is no default risk. It is thus cash of the highest quality."

Turning to gold stocks, the bank says mining equities are at "extremely attractive" valuations.

Stocks in the Gold Bugs index, a basket of large producers that don't hedge their production against price fluctuations, have a projected price-to-earnings ratio this year of 13.9 times, less than half the average level of 28 times over the period from 2000 to 2012.

Investors are as pessimistic toward gold mining stocks as they were four years ago during the financial panic, but gold miners are far healthier than they were back then, the bank says. Their balance sheets are stronger, their free cash flows are higher, while their debts are low and their dividends are rising – all factors that will eventually drive share prices higher.

The bank says gold investors should restrict themselves to jurisdictions that are unlikely to experience "resource nationalism," the term for countries that try to extract more value from their wealth in the ground at the expense of mining companies.

Among its favoured jurisdictions is Canada.

"We believe that solid mining shares in politically stable regions currently represent a high-leverage bet on the gold price with an attractive risk/return profile," the bank says.