Why Gold Continues to Shine

Precious metals, especially gold is expected to act as a safe haven for investors in the medium term. This is supported by a confluence of factors. First, ongoing subprime issues in the US and geopolitical tensions in the Middle East will raise the demand for gold and thus, the upward trending gold price. The price of gold rose by 31% in 2007 (+23% in 2006), while the US dollar depreciated by 11% in 2007 (-10% in 2006). In the recent credit crunch, the weakness in the US dollar has been a vital factor leading to surges in gold prices. Reflecting the loss of confidence in the US dollar, investors used gold to hedge risk independently of the dollar's movement.

However, US dollar's depreciation does not necessarily imply rising gold prices. For example, both gold and the US dollar weakened marginally during the bursting of the high-tech bubble in March 2000. Following the 1998 rouble devaluation and the Long Term Credit Management crisis, the US dollar depreciated, but gold strengthened. Once the Long Term Credit Management was recapitalized, both gold and the US dollar strengthened. There were also large gains in gold prices after the September 11, 2001 incidence. In contrast, the price of gold remained depressed during the 1997-98 Asian financial crises since gold was used to rescue governments confronted with rapidly depreciating currencies.

The US dollar is envisaged to depreciate further in the medium term due to economic woes in the US as well as its burgeoning current account deficit. In turn, this will support the demand for gold. In addition, rising crude oil prices that spillover to higher general price levels in goods and services also increased the attractiveness of gold as a hedge against inflation.

Gold is also used to hedge against the volatile securities markets, which eroded the functioning of global financial markets. The gold market recorded its largest gain especially after the recent crisis in the credit markets. Moreover, inflation expectations may also influence the price performance of gold. When the US Federal Reserve cut its interest rates by 50 basis points, the gold market rallied since inflation is expected to rise in the long term.

Second, official gold reserves of respective countries also have a large influence on global demand for gold. As at end of March 2008, the US has the largest quantity of official gold holdings amounted to 8,133.5 tones or equivalent to 79.8% of its total reserves. Apart from the US, members of the Euro-zone, such as Portugal (382.5 tones or 90.7% of reserves), Italy (2,451.8 tones or 70.4% of reserves), Germany (3,417.4 tones or 68.9% of reserves), the Netherlands (621.4 tones or 63.6% of reserves) among others owned the largest proportion of official gold reserves.

In contrast, Japan (765.2 tones or 2.3%), Singapore (127.4 tones or 2.2%), China (600.0 tones or 1.1%), Malaysia (36.4 tones or 1.0%), and Korea, Rep. (14.3 tones or 0.2%) hold proportionately smaller amounts of official gold reserves. In general, these countries maintained relatively close international trading links with the US. Consequently, it is common for these countries to hold considerably more foreign exchanges, normally the US dollars, rather than gold reserves.

However, this trend is expected to change in the medium term due to the depreciating US dollar. These nations will diversify away from US dollar reserves into gold holdings, and hence, increasing demand for gold. Furthermore, growing affluence on part of both Chinese and Indian consumers will raise demand for gold as investment. In 2007, jewelry consumption by Chinese and Indian consumers rose by 6.0% year-on-year to 2,426 tones, representing 68.4% of total identifiable gold demands. Investment demand in gold will remain strong in the medium term due the falling US dollar and soaring crude oil prices. The availability of new channels in trading gold, such as gold exchange-traded-funds (ETFs) will also ensure the attractiveness of gold investment. An ETF is an open-ended investment fund listed and traded on a security exchange. The ETF aims to track the performance of gold prices.

Third, the fall in global supply also contributed to the rise in the price of gold. In 2007, global supply of gold dropped 3.0% year-on-year to 3,469 tones. Mine production sagged 2.9% year-on-year to a 10-year low of 2,047 tones (2,108 tones in 2006). Over 2004 to 2007, the top suppliers have cut their production levels as a result of rising exploration and mining costs. For example, South Africa, the US, and Australia cut their production by 36.3%, 15.5%, and 28.9%, respectively to 272 tones, 250 tones, and 251 tones by 2007. Only China has consistently raised its production levels from 172 tones in 2004 to 270 tones in 2007.

Meanwhile, the Metals Economics Group has estimated that gold miners' exploration outlays have risen for the fourth consecutive years since 2002. For instance, Barrick Gold, the world's largest producer, reported a total cost of US$361/oz for the first nine months in 2007 from US$308/oz over the comparable period in 2006. Moreover, the Gold Fields Mineral Services, a London-based precious metals consultancy, notes that production costs increased by 24.0% in 2007.

In summary, the global demand for gold as a safe haven asset is supported by various exogenous factors as well as demand and supply conditions. In terms of the exogenous factors, the subprime concerns in the US, the depreciating US dollar, the political instability in the Middle East, and volatile crude oil prices are expected to increase gold demands. Initially, the price of gold may fall in wake of financial market stresses, as trouble investors liquidate their gold holdings to gain liquidity. Once illiquid investors are purged out, gold demand may increase again as better-equipped investors resort to gold as hedge against further market risk and rising uncertainty.

Importantly, gold continues to attract investor's focus because it is universally accepted currency with zero counterparty risk. Moreover, potential official reserves diversification and jewelry consumption by Chinese and Indian consumers may account for rising demand influences for gold. Finally, rising costs of gold production may restrict supply and thereby, generating upward pressure on the price of gold.

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