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Gold's eternal allure: the value of scarcity

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James Holt: Director, Investment Specialist

A landmark event in the annals of modern economics went almost without acknowledgement amidst the anxiety whipped up by recent capital market gyrations. August 15, 2011 was the 40th anniversary of the 'Nixon Shock,' denoting the day US President Nixon ended the last link between gold bullion and the US dollar. Until then, the greenback's status as being as 'good as gold' had been a pillar of post-WWII global economic architecture.

The end of the era, in which countries had been able to exchange their US dollars for gold from US bullion reserves, heralded the beginning of the paper currency age. From that point on, market forces rather than gold would determine the US dollar's value.

Jolting as President Nixon's move must have seemed at the time, there was also an inevitability about it. Rising US inflation on the back of funding the entrenched Vietnam War and Great Society programs eroded the US dollar's purchasing power. Consequently, countries increasingly substituted US paper currency with gold.

Though many societies have venerated gold for centuries, not all mourned the end of its privileged status. John Maynard Keynes, among others, once derisively referred to it as 'a barbaric metal.' It was not a universal view, but one shared by a number of thinkers who viewed gold as an economic relic, unbecoming of the modern world.

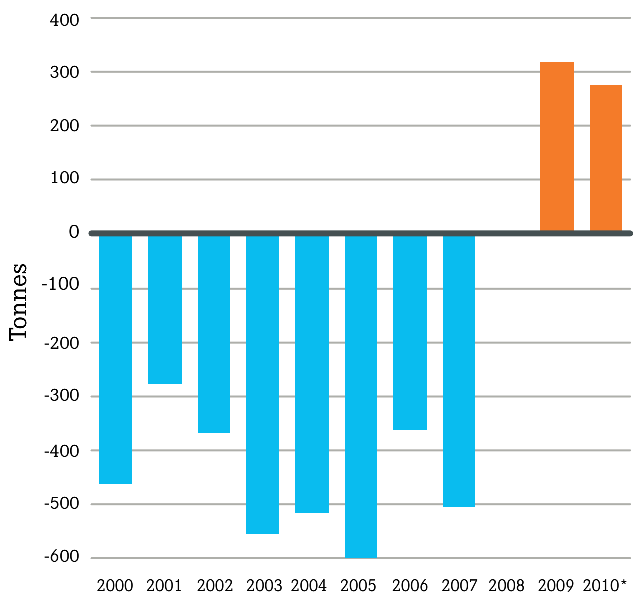
Others, however, feared that without the gold anchor, governments would be tempted into money-eroding policies.

The fall and rise of gold

Gold did fall out of favour for many years; the gold price bottomed in August 1999 at US$251 an ounce. Convinced by 28 years of gold-free policy successes, including the taming of the inflation dragon, central banks morphed into gold-dumpers dumpers (Figure 1).

Until recently, central banks were selling gold

Change in official gold holdings: 2000 – 2010



As of December 31, 2010. Source: World Gold Council; *estimate

US policymakers were especially confident. The late 1990s was a time of the 'goldilocks economy,' neither too hot nor too cold, but just right. Sky-high equity market valuations were justified, it was argued, by a transformational internet boom.

Gold's comeback began around the turn of the 21st century after the dotcom bubble turned to dust. Its value as a safety asset was reinforced by the terrorist attacks of September 11, 2001 when the metal's price jumped 6%. Subsequent geopolitical unease involving Iran, Iraq and the Korean Peninsula bolstered gold's safe haven status.

The gold price passed US$400 in late 2003, US$500 in late 2005, $US700 in 2006 and swept past US$800 in 2007 before the global financial crisis pushed it to new records. While the recent high of US$1,910 is over twice as high as the previous US$850 peak in January 1980, gold is still below its inflation-adjusted peak of around US$2,400 an ounce.[1]

Recognising a store of value

The upshot is that despite losing its official standing as the backbone of currencies, gold has clawed its way back to reclaim investor support. This stems from several dynamics.

Firstly, gold's limited correlation with financial securities is appealing (Figure 2).

Gold's limited correlation

Correlation of gold with select financial indices: 10 years to June 30, 2011

	MSCI World Index (AUD)	S&P 500 Total Return Index (USD)	S&P/ASX 300 Accumulation Index	Citigroup WGBI Hedged A$ Index
FT Gold Mines Index	-0.12	-0.17	0.06	0.14

As of June 30, 2011. Source: DataStream

The complementary relationship between gold, equities and bonds endows it with portfolio risk-mitigation attributes. In times of market turmoil and geopolitical tension, gold is often the asset that helps to cushion other assets' decline.

Secondly, gold's scarcity makes it an intrinsically impressive store of value. Gold's rarity contrasts with the abundance of money today. US Federal Reserve (Fed) actions such as quantitative easing (Fed purchases of assets with newly created money, which is sometimes equated with 'printing money') are stirring qualms that inflation is being incubated.

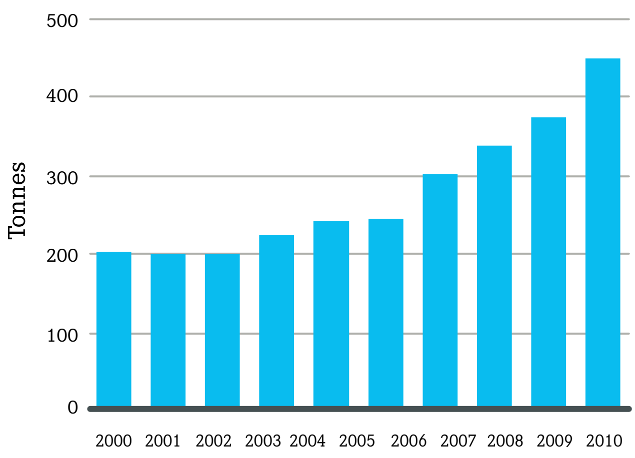
The total amount of gold ever discovered amounts to only around 160,000 tonnes. If formed into a single cube, its base would be two metres less than a tennis court![2]

Meanwhile the amount of new gold discovered each year is less than 3,000 tonnes, or less than 2% of the total stock already discovered[3]. Hence, for a growing number of investors, owning gold makes intuitive sense; gold's scarcity and slow growth of the metal's stockpile underpins its value versus paper currency.

Finally, the appetite for gold is growing. As is the case with many raw materials, China is the great new force driving gold demand. Chinese gold demand, which was around 200 tonnes in 2001, has advanced relentlessly to nearly 450 tonnes in 2010 (Figure 3).

China's growing appetite for gold

China gold demand trends: 2000 – 2010



Source: World Gold Council World Demand Trends Q1 2011

Rising Chinese demand has taken place at the same time as escalating investor demand. Since 2003, around 2,400 tonnes of gold has been absorbed into Exchange Traded Funds (ETF).

The magnitude of gold traded on ETFs is formidable. ETFs' combined gold hoard would make them equivalent to the world's sixth largest central bank. Moreover, after having reduced their gold holdings over several decades, central banks, anxious to diversify their asset bases, have featured among the world's armies of gold buyers in recent years.

Significantly, of all the major central banks, the People's Bank of China (POBC) holds the least amount of gold as a percentage of its reserves. The POBC's current gold reserves are estimated to equate to less than 2% of the Middle Kingdom's total foreign currency reserves of US$3 trillion. Chinese policymakers have flagged a desire to raise the country's gold holdings tenfold to 10,000 tonnes by the end of this decade.[4]

[1]Bloomberg [2]Business Insider, January 25, 2011
[3]Gold Fields Mineral Services [4]'Gold News', December 1, 2009

Accessing gold through investment funds

Because gold bullion is a physical asset, it does have a notable disadvantage. Unlike securities such as equities and bonds, which provide income streams, physical gold is not an income-generator.

Investors interested in gold, however, can access gold equity funds. Gold equity funds generally generate dividends and provide leverage to the gold price.

Recently, gold equities have lagged the price of bullion, effectively giving investors a discounted entry point. For example, when the gold price was US$1,900, gold equity funds were trading at values equivalent to around a US$1,500 gold price.

Trying to predict the future of the gold price is impossible, but it is worth reflecting on the reality that gold has been rediscovered, as the world has become a riskier and less predictable place. Gold is once again winning acclaim as a store of value and a portfolio diversifier.