

Manic gold?

Gold tests record high, stocks slump

June 25, 2010 – Since May of 2009, an investment in physical gold would have returned about twice as much as an investment in a gold mine. Even though most producing mines are digging the yellow metal out of the ground at a cost per ounce of something less than half the value of the refined stuff, generating earnings and dividends, and sitting on enormous stacks of cash. It's the product investors are interested in, not the producer.

SPDR Gold Trust vs. S&P/TSX Global Gold Index – 2-Year



Chart courtesy Yahoo! Inc.

And the interest in gold has started to reach levels that might be called manic. Last week, for instance, a 100 kilogram (3,215 ounce) gold Maple Leaf coin, the largest in the world, sold for a cool US\$4.02 million at auction in Vienna. The coin is actually legal tender in Canada, and has a face value of \$1 million. At a recent cash price of US\$1,243.45 per ounce for gold, the metal value of the coin was about US\$4 million, with a numismatic premium of about US\$20,000.

According to *The Wall Street Journal*, the Comex precious metals exchange is holding 10.9 million troy ounces of gold in its vaults. And it says physical delivery of the metal is up 39% from a year ago.

The World Gold Council's SPDR Gold Shares holds 42.3 million ounces of gold bullion, mainly at HSBC Bank's London vaults, with a recent value in excess of US\$53 billion. Even Toronto's Sprott Asset Management Physical Gold Trust has 582,417 ounces sitting in gleaming piles at the Royal Canadian Mint. The burgeoning business of gold vaulting

(that is, offering secure places to store gold – not a new Olympic event) is also a testament to the incredible demand for the metal.

There are plenty of good reasons for gold’s year-long rally – or, more accurately, five-year-long rally – and its significant outperformance compared with the broad US equity market. Looking at the chart of the US dollar index over the same period, it’s plain to see a fairly consistent inverse relationship in the external value of the US dollar and the price of gold.



Chart courtesy Kitco



Chart courtesy Bloomberg LP

That hasn’t held up through the first half of this year, as the eurozone debt crisis increased investors’ appetite for US Treasuries as a “safe harbor” investment, boosting the US dollar index in the process. The price of gold, however, continued to climb to record highs, as its characteristics as the ultimate crisis hedge began to drive demand.

In addition, some element of hedging against the almost inevitable return to US dollar weakness might also be at play in recent weeks, given the massive US budget deficits in store for the next decade and growing signals of slowing economic activity in the second half of the year.

Last week’s move by Chinese authorities to let the yuan appreciate against the dollar may ease the accumulation of China’s foreign reserves, primarily in US Treasuries, leading to reduced demand and rising yields. In addition, an appreciating yuan may also give commodity prices a boost.

Gold is also traditionally an inflation hedge. But inflation doesn't appear to be anywhere in sight, despite massive stimulus and quantitative easing over the past couple of years. In fact, disinflation seems to be the order of the day, at least in the industrialized West.

In both the US and the eurozone, core inflation remains below 1%. In Canada, the core rate fell to an annualized 1.8% in May, from 1.9% in April. Despite raising its key target overnight rate by 25 basis points in June, the Bank of Canada may hold off on another rate hike in its scheduled July announcement. And if more proof were needed, Japanese consumer prices fell at an annualized 1.2% in May, only slightly less than April's 1.5% drop.

In its semi-annual review of the financial system, the Bank of Canada focused on the risks and vulnerabilities to the global financial system, including "dislocations in international funding markets, a worldwide retrenchment from risk-taking, and a deterioration in the global economic outlook." This does not set the stage for a rush to "normalization" of interest rates. In fact, at the G20 meeting in Toronto, much of the discussion and debate was likely to revolve around the desirability of removing stimulus before economic and financial system fragility is discernibly shored up.

Faced with plunging new home sales, which is widely seen as the proverbial canary in the coal mine for the economy, the US is vociferously against removing stimulus, and is in fact making plans to add more. Last week, the Fed left its fed funds rate unchanged, at between 0% and 0.25%. At the other extreme, Germany and other industrialized countries are in favor of tightening the fiscal screws now. But then Germany may be using tough love to jawbone the so-called eurozone PIIGs into enacting some tough fiscal austerity. That's harder to do with the right hand, if you are pumping stimulus money with the left hand.

Is it any wonder, then, that against this anxious and uncertain backdrop, the price of gold remains near its record high? And is it any wonder that equity markets slipped last week, after a couple of weeks of advances?

The S&P/TSX Composite Index retreated 1.8% on the week, supported somewhat by a jump in crude oil prices to US\$79.19 per barrel from a mid-week low just under US\$76. The news was not as good for the big US indexes, despite the makings of a less onerous deal on financial regulation, as the Dow Jones Industrial Average dropped 2.94% on the week, while the S&P 500 Composite Index lost 3.65%.

Gold, incidentally, closed the week at US\$1,257 per ounce, just shy of its record high of \$1,258 in June. A manic market might still drive it well beyond that record in coming weeks, but any purchase of gold at this point is more likely to constitute a pure speculation than a considered investment. But gold stocks on the other hand... ■

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