SA BULLION

Position Paper | The Case for Investing in Gold

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Our Vantage Point

We see gold as money – a form of currency. We view gold similarly to the way we view cash in the bank. In fact we see gold as a competitor to cash in the bank.

We haven't always seen gold this way. For the last 20 years of the previous century we observed the systematic de-monetization of gold. Gold was on its way out as a form of currency reserve. There were many reasons for this, including massive productivity gains, falling inflation, declining global risk premiums, money supply growth, asset price inflation and the export of dis-inflation from China.

Change, however, is a certainty. Late in the 20th century we anticipated the commodity boom, we witnessed ramp money-supply growth and we have come to expect economic weakness and rising inflation.

It must also be said that we recognise inflation for what it is – the depreciation of currencies due to excessive money supply growth.

The Case for Cash

We don't like cash – generally speaking. Cash is where investors park money when they're bereft of good investment ideas. It is the asset class that assures, at best, stodgy performance when taxes and inflation are factored in.

Most of the time however, we see the need for some cash - perhaps 5 or 10 percent of one's total holdings. This need, we see for two reasons: firstly due to the possibility, and occasional incidence, where the markets in general and one's investments in specific, are struck by unforeseeable and catastrophic events. In such an instance, at the time when one's holdings are hurt along with everything else, cash is on hand to take advantage of the massive opportunities that have suddenly presented themselves due to re-pricing of assets. This methodology creates a self-righting system.

The second reason we see the need for some cash is for risk diversification. This is the possibility that one is totally wrong in one's investment strategy and therefore needs to keep a little in cash to safeguard some of one's portfolio.

There are times when we love cash. At the time of a market crash we love to be loaded up with cash. Liquidity is a tremendous advantage when the great investment opportunities come along. At such times we love to invest heavily in value situations such as high quality companies with sustainable earnings and high prospective dividend yields.

We don't know if we'll have a tremendous investing opportunity anytime soon, but we're convinced that this is the right time in the cycle to be going high in cash exposure and low in share exposure.

Currency Selection

A cash decision requires a currency decision. There is no cash investment without a currency decision, whether deliberate or by default.

Upfront we must declare that we don't advocate cash exposure to one currency only - no matter what one's take on currencies. Cash is the safe haven asset and therefore should not involve excessive risk-taking in terms of exposure to a currency. Naturally the investor does need to factor in the currency exposure of the other assets in the portfolio.

Over the years we have learnt that currency direction cannot easily or accurately be discerned. Particularly not in the short term. It is perhaps redundant to say that an investor should be looking to hold cash in currencies on the ascendancy. But we would add that direction should be estimated for the big broad sweeps of time.

For the last twenty years of the previous century there were no compelling reasons to hold gold and every reason to hold Dollars. Within the US the essential conditions required in order to maintain Dollar strength remained intact – these included positive real interest rates, modest money supply growth, economic pre-eminence, a modicum of fiscal discipline and an element of saving. Globally interest rates rode a long descent, stocks rode a long ascent. The world enjoyed a huge peace dividend, economies of the world became 'globalised', and inflation was tamed. Confidence favoured the Dollar and it was permitted to maintain its status as the senior currency while gold slid into the doldrums and for twenty years was an extremely poorly performing currency.

The dawning of the new millennium corresponded with a turning of the tide. In fact, Y2K even aided and abetted the sea change, by virtue of the Federal Reserve's monetary response to the computer change-over problem that wasn't.

So far, this century we're in a period of Euro, Franc, Renminbi and Yen strengthening relative to the Dollar and a period of gold strengthening relative to all the major currencies. The Yen could strengthen considerably if the Yen carry trade were to unravel, and the Renminbi should appreciate due to Chinese economic strength. However, broadly-speaking, it is not in the interests of the US trade partners to have strengthening currencies which is the reason we have witnessed competitive currency depreciation by way of low interest rates and high money supply growth rates in the trade partners. Such a race to the bottom translates into gold ascendancy.

Decline of the US Dollar

The US government and the Federal Reserve will not protect the dollar. Safeguarding the currency would imply significantly raising interest rates and tax rates. Were such a course to be followed the US could anticipate a Japanese-style deflation. America's unspoken mantra must be "inflate or die".

US money supply is increasing approximately five times faster than GDP growth presently. Reflation, or continued rapid increasing of the money supply, is the best of all bad choices. Reflation will alleviate federal debt problems, provide the banking system with liquidity and profit growth, and will present consumers with a means to settling their debts in the long run. Interest rates will stay low or go lower, money supply growth will continue unabated, and the dollar will slide. Since the US Federal Reserve was established in 1913 the Dollar has lost more than 95% of its value. This rate of depreciation should be expected to accelerate.

The negative consequences of reflation are not fully to be discerned but certainly extremely significant. Not least one can expect rising precious metals prices, increasing inflation, and at some stage widespread realisation that the US dollar is on a steep downward trajectory. This will cause unwinding of the yen-dollar carry trade, reduction in the purchase of US treasuries by foreigners, a worsening of the US balance of payments, at least for some time, a lessening of US imports, and many unforeseen consequences, of which we hypothecate many.

This century favourable socio-economic forces have reversed for the United States. The country confronts an inability to raise interest rates to required levels to combat inflation, an inability to control rampant money supply growth, loss of economic dominance, a profligate government with an inability to raise taxes, a dearth of savings, extreme indebtedness and rapidly declining global confidence in the senior currency. These forces conspire to raise inflation, introduce weakness in the economy and accelerate Dollar decline.

Risks to the South African Rand

South Africa is an emerging market country and the Rand is a commodity currency. These factors have caused the country and the currency to benefit enormously over the last five years. The spreads, or risk premiums, as applied to emerging markets, have declined to extraordinary lows in recent years. All emerging markets have prospered from a lowering of the cost of capital as risk premiums have all but evaporated. Foreigners have required little compensation for the risk of investing in emerging markets in general and in South Africa in particular. Additionally, exceptionally low rates of interest in Japan have resulted in an enormous yen carry trade where arbitrageurs have chased stable, high-yielding currencies causing massive inflows through the capital account. Emerging, high-yielding currencies have been on the receiving end of considerable strengthening.

High commodity prices corresponding with strong commodity demand have resulted in a commodity boom for South Africa. This boom has fuelled rampant growth, investment and profitability in resource companies. The multiplier effects in the economy have been dramatic, causing exceptional GDP growth rates, generational-low inflation rates, and as a consequence low interest rates. High credit growth was to be expected, and the consumer boom along with that.

Unfortunately for South Africa, the benefits associated with imported dis-inflation, particularly from China, have corresponded with a considerable loss of ability to effectively compete in manufacturing. This has translated into a significant transference of manufacturing base to the Orient and therefore the introduction of some structural weakness into the South African economy.

South Africa is thriving with a strong economy, low inflation and a strong Rand. All this would seem to indicate to us low upside and potentially considerable downside. Real interest rates are fairly high and therefore seemingly providing some protection for the Rand, but also putting a question mark over the capacity for the central bank to raise rates to stem a run on the Rand. Much upward revision would likely kill the goose that lays the golden egg – and this in a country where economic growth and job creation are political imperatives.

Were emerging markets spreads to widen or emerging markets to fall out of favour, one could expect pressure on the Rand. Were Japanese Yen and other foreign capital to flee South Africa's equity and bond markets, one could expect pressure on the Rand. Were commodity prices to decline, or export volumes to fall, one could expect pressure on the Rand. We see a lot of significant risks to the Rand.

Fundamentals of the Gold Market

A declining Dollar, a declining Rand, high money-supply growth rates and increasing inflation are undoubtedly good for gold. However, gold does not generate positive performance only as a result of negative currency performances. Gold also goes through its own cycles, mostly brought on by fundamentals.

Gold is experiencing supply-side constraints.

For years central banks have been suppliers of cheap gold but this trend is rapidly changing as inventories become depleted and price action dictates a different course. Of approximately 150,000 tonnes of gold in circulation only 30,000 tonnes are held by central banks and official institutions (IMF, BIS, ECB). Of late, while the Western institutions have been nett sellers, the Asian central banks have been on the other side of the trade. The Asian banks are holders of colossal reserves of US treasuries, and have been watching value destruction in these reserves due to Dollar depreciation. Several of these banks have stated that they are looking for diversification and some, including the Chinese central bank, have identified gold as a currency choice.

Gold miners were contributors to their own problems with their forward sales programmes. But that is in the past. Miners are scrambling to de-hedge. Today costs of gold extraction are escalating as reserves become more difficult to access. Add to that the fact that resource discoveries of any consequence are becoming fewer and further between.

Demand for gold is rising strongly.

The human population is adding enormously to its number each year and the economic advancement of many poorer people, particularly in China, is rapidly expanding the gold-consuming base. Political sensibilities today are also US-unfriendly in many countries and their population groups - favouring gold.

Investors are looking for new return generators and becoming interested in gold.

Professional money managers and wealthy investors are, on the whole, weary, to say the least, of the global bubble in asset prices. Stock markets are at record highs following a 25 year bull trend. Equities are currently valued on high multiples whilst margins and profits are at record highs. The sum of normalised p/e multiples and normalised profit margins is a goodly 35% lower than today's levels – implying significant downside risk for shares.

Parts of the property market are already turning down. Risk spreads are widening and the US sub-prime meltdown is foretelling of troubles to come in the credit markets and by association, the property markets. House prices in the US are well above the normal four times annual family income level and are now leading the mean-reverting trend for property assets.

Risk today is completely mispriced. Last year volatility as measured by VIX, junk and emerging debt spreads, CD rates and high quality vs low quality stock values reflected the lowest risk premiums in history. Some spreads have widened recently but the unwinding is only beginning. The cycle will be observed to have completed when high quality blue chips are restored to normal premiums again. Increasingly professional money managers are conducting research into the inclusion of commodities in investment portfolios.
The world's largest bond manager, Newport Beach-based PIMCO, commissioned research firm Ibbotson Associates of Chicago to analyse commodity exposure for strategic asset allocation purposes. The 2006 research report concluded that the commodity asset class has historically produced the highest returns of any asset class and in addition had the lowest correlation to other asset classes.

Ibbotson concluded that investment portfolios containing commodities produced higher returns and resulted in a superior efficient frontier. Many of the world's largest investors are following the Ibbotson findings – including the world's largest investor, Calpers.

In Conclusion

Some cash exposure is generally a good idea but a higher than usual cash exposure would be appropriate today given that competing asset classes are at record high levels and presenting considerable downside risk. The US Dollar is a currency in decline but there are also risks in the other major currencies due to excessive money supply growth and competitive depreciation. Equally there are risks to emerging market currencies, including the Rand, due to potential hot-money outflows through capital accounts and unfavourable trade deficits. The Rand has the additional overriding risk of being a commodity currency.

Gold is firmly established in a strong uptrend and the fundamentals are excellent. The gold market is coming off a low base and investors are starting to notice the price action and entering the gold market in growing numbers and volumes. This gold up-cycle is in an early stage and will peak in many years time only when the global population is fully involved and at prices that at this time would be regarded as unseemly.