# The SA Bullion Gold Report

Q1 2011

SA Bullion

**Analyst: Hilton Davies**
Email: hilton.davies@sabullion.co.za
Date: 20th April 2011

Gold Performance to 31 March 2011 (% per annum)

| | Quarter* | 1 Yr | 2 Yr | 3 Yr | 5 Yr | 10 Yr |
|---|---|---|---|---|---|---|
| Gold in USD | 2.0 | 29.0 | 25.3 | 15.5 | 19.8 | 18.8 |
| Gold in ZAR | 4.4 | 19.0 | 5.8 | 8.7 | 22.1 | 16.8 |

** not annualized for periods of less than 1 year*

Gold Prices

| | Gold in USD/oz | Gold in ZAR/oz |
|---|---|---|
| 31 Mar 2001 | 257.70 | 2061.29 |
| 31 Mar 2006 | 582.00 | 3587.74 |
| 31 Mar 2008 | 933.50 | 7586.09 |
| 31 Mar 2009 | 916.50 | 8715.92 |
| 31 Mar 2010 | 1115.50 | 8192.18 |
| 31 Dec 2010 | 1410.25 | 9335.85 |
| 31 Mar 2011 | 1439.00 | 9748.51 |

*Note 1: The above prices are LBMA Afternoon Fix prices.*
*Note 2: At time of writing gold prices were $1,507.00 and R10,163.96*

## Performance Commentary

Gold continues to produce excellent returns in virtually every currency over medium to long term time periods. Short term returns have been very pleasing as well, but we are invested in gold not for short term gains, which can be highly variable, but for long term reward of good judgment.

Of course in our business we are often asked to pin our colours to the mast and declare what we expect from gold. For a number of years now we have been stating our expectation of gold price performance in the 'upper teens'. By this we mean returns in the range of 15 to 20% per annum. Naturally we expect a high degree of variability from year to year, but thus far we seem to have been proved correct with our estimations for the medium to longer term. Our 'hard analysis' continues to indicate more of the same and our view remains unchanged.

**The key comments to our story have been:**

*" In the good times gold is a commodity, in the bad times gold is a currency"*

*" Industrialized nations have to 'inflate or die' "*

*" Currencies are in a race for the bottom "*

*" Stagflation is the likely outcome "*

*" Gold is in a generational bull market "*

Some interrogation of the major financial and economic forces at play in the world today will help define our comments.

## Macro Picture

The wild private sector credit expansion from the mid-80s to 2007 has reversed and the world finds itself in a long and painful credit contraction. The problems have largely passed from the private sector (individuals and businesses) to the public sector (governments) and the country-level solutions lie in inflation. By manipulating monetary and fiscal levers, regulators are creating inflation and depreciating their currencies. Meanwhile, state credit prevents the problems of the past from being expunged and economic growth therefore is anemic at best. These factors lead to loss of faith in national currencies and the corollary to that loss of faith is renewed faith in gold.

Those readers who are really concentrating will have noticed that the preceding five sentences directly deal with each of our key comments respectively! In this quarterly report we will focus on real interest rates.

## Steal from the Savers

We cannot overstate the importance of real interest rates. If there is a single item we believe to be terribly, terribly important – it's real interest rates. That is to say, interest rates minus the inflation rate.

In order that a financial system should work, capital must be rewarded when loaned. The broad sweeps of time have taught us that capital must be rewarded by 3% per annum in real terms i.e. the lenders must be paid the inflation rate plus 3% per annum. In the short run considerable variation from this number can be tolerated but over the span of years anything much less will set up problems.

What we have today is moderate inflation and extremely low interest rates such that real rates of interest are close to zero or actually negative. In South Africa today Call Rates are around 4% and CPI is around 4% providing a real interest rate of about 0%. In the USA today Call Rates are around 0.25% and official CPI is around 2%! The situation is in fact much worse in the USA as the official rate of CPI is manipulated to the extent that it does not represent reality. In any event, those who save and place their hard-earned savings in bank accounts for the productive use of borrowers, are not being rewarded. Their savings are being eroded, or to put it another way, their savings are being confiscated by the state in a manner that is not readily apparent.

These actions of the regulators were anticipated by SA Bullion some years ago – hence our thesis that sovereign states would 'inflate or die'. At this point it should be mentioned that the inflation in the world today is not as a result of strong economic demand but rather the monetary actions of central banks, most notably the US Federal Reserve.

Today we see high rates of inflation in commodity prices such as oil, and in food stuffs. These inflationary forces put enormous pressure on the poor and the middle class which in turn can lead to political instability and even insurrection such as we witness today in many Arab and African nations. China has reversed from being an exporter of disinflation and today, with its CPI at 4.6% and rising, has become a global exporter of inflation. This means that governments walk a fine line when it comes to resolving credit problems by creating inflation which can easily lead to political instability and risk.

## So what of the future?

The likely outcome, as we've been saying for some years, is stagflation. In such a scenario one has low or even negative economic growth (stagnating) and high inflation. In these tough times one then expects that for reasons of political expedience regulators will keep interest rates low, meaning that savers should expect negative real interest rates. To put it bluntly, productive people who put their savings in the bank will be robbed of their wealth over time.

## So how does one store one's wealth?

Obviously equities and property present a good long term avenue for investment but there are periods of time when even these asset classes may offer very unsatisfactory returns and at considerable risk. By way of example, if one invested in the South African All Share Index at its peak in 1969, it took until 1984 to recover one's investment. Generally one would not want to be 100% invested in these risk assets, and we would argue that at time of writing one would want to be considerably less than 100% invested in risk assets. And money in the bank presents a grim alternative. Well, the answer lies in gold. Negative real interest rates cause currencies to decline in value which in turn causes gold to rise at the same rate. Additionally, as savers get punished in cash they start moving into gold and as this move gathers pace so the price of gold moves up.

## So where to for gold?

In the short term one cannot know where the gold price is going. That the gold price direction cannot be deduced is not due to laziness when it comes to analysis or lack of intellect. It is simply impossible to foretell what short term events might present themselves whether they be tsunamis, nuclear meltdowns or bank collapses. Rigorous analysis is generally well-rewarded in the long term however, and in this regard we can see every reason why we will look back many years from now and marvel that in 2011 one could buy gold at just $1,500 an ounce.

## Conclusion

Industrialized nations will default on their onerous debt obligations and they will do this by way of inflation, currency depreciation and negative real interest rates. Savers in cash will become worse off and savers in gold will be rewarded. As an investor it's all a matter of getting your bets right!

This research report is based on information from sources that SA Bullion believes to be reliable. Whilst every care has been taken in preparing this document, no research analyst or member of the SA Bullion gives any representation, warranty or undertaking and accepts no responsibility or liability as to the accuracy or completeness of the information set out in this document. All views, opinions and estimates contained in this document may be changed after publication at any time without notice. Past performance is not indicative of future results. The investments and strategies discussed here may not be suitable for all investors or any particular class of investors; if you have any doubts you should consult your investment advisor. The investments discussed may fluctuate in price or value. Changes in rates of exchange may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. This report is intended solely for clients and prospective clients of SA Bullion and is not intended for, and may not be relied on by, retail customers or persons to whom this report may not be provided by law. This report is for information purposes only and may not be reproduced or distributed to any other person without the prior consent of SA Bullion. Unauthorised use or disclosure of this document is strictly prohibited. By accepting this document, you agree to be bound by the foregoing limitations. All rights reserved.