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GOLDEN BROWN AND GOLDEN BUBBLES – JULY 2010

If all else fails, immortality can always be assured by a spectacular error
John Kenneth Galbraith
1947

Having sold 60% of Britains gold reserves on a 20 year low, it is perhaps entirely appropriate that in the last few weeks, as Gordon Brown finally retired from government, the price managed to make new all time highs. There can be few trades in the history of financial markets that lost so much money so publicly – see Chart.1 below;

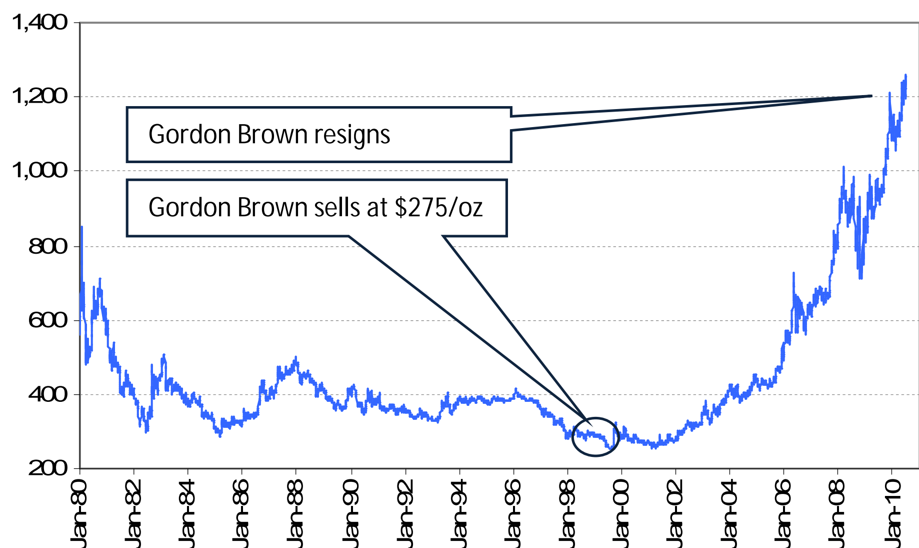


Chart.1 – Gold PM Fix (US$) *Source: Jaguar Investments*

The average price achieved for the sale was £185/oz vs. a current price of £787/oz (PM fix on 6th July 2010). Admittedly he did "invest" the proceeds in USD(40%), EUR(40%) and JPY(20%) but nevertheless most observers estimate that the exercise cost the British taxpayer some £5b-£8b. Nice.

When even shoeshine boys are giving you tips, it's time to sell
Joe Kennedy
Attributed, 1929

But what has driven gold to such heady heights – and can such price action be sustained. There have been many recent articles expounding the wisdom of owning gold, but it is increasingly difficult to find a gold bear and that makes us nervous. We believe that the gold market is demonstrating bubble-like characteristics.

The most recent reason to buy gold is as asset protection in case the Eurozone economy deteriorates further. The parlous situation in Greece has prompted market participants to look across borders and they have found that many European governments have acquired substantial deficits and that these may not be so easily funded in the coming months and years. The situation is severe and made more so by the existence of the ECB – individual governments are restricted in measures they may take to remedy their individual situations. In a world of banking meltdowns, economic collapse and worthless paper, gold is seen as the ultimate safe-haven, hence the recent demand.

O Gold! I still prefer thee unto paper, which makes bank credit like a bark of vapour

Lord Byron

But what is the likelihood of a complete economic collapse, with gold returning as the only store of value, and legal tender? This insurance buying appeals to the heart, but in my view is not one that bears deeper scrutiny.

The second widely-tipped reason to buy gold is as a hedge against inflation. This reason has been around since the last bull market in 1979 and is wheeled out from time to time to shore up the bull argument. In the current low interest rate environment, market chatter about coming hyper-inflation is once again giving succour to the longs. Chart.2 below shows US PPI and CPI;

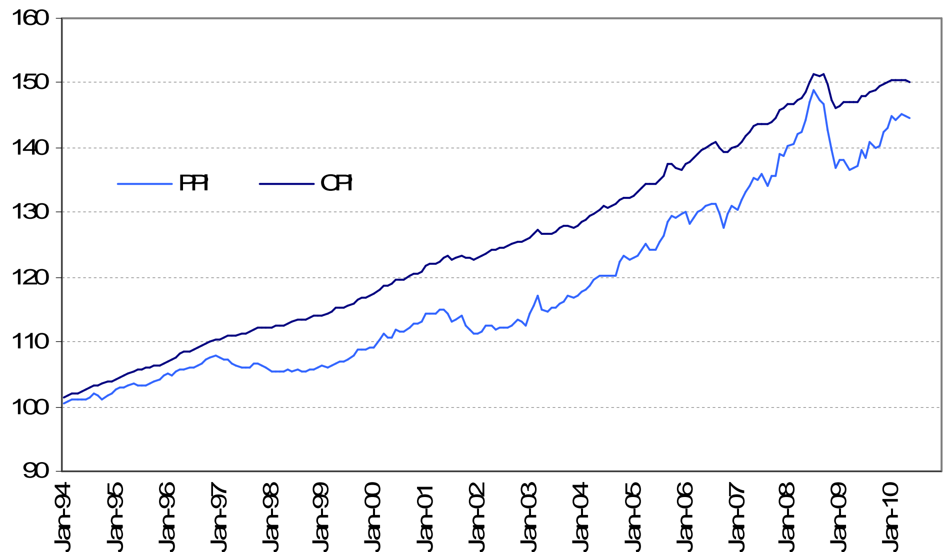


Chart.2 – US PPI and CPI *Source: Jaguar Investments, US Labor Dept*

When we have gold we are in fear, when we have none we are in danger

J Ray
English Proverbs, 1670

From the charts, there does not appear to be any impending risk of rampant inflation – indeed both measures imply steadily rising prices over time.

"Ah yes" I hear you cry, "but commodity prices are rising and energy and food costs are still in the relatively early stages of a twenty year cyclical bull market". Well maybe. But Chart.3 shows the Commodity Research Bureau (CRB) index, together with the S&P GSCI plotted against the gold price;

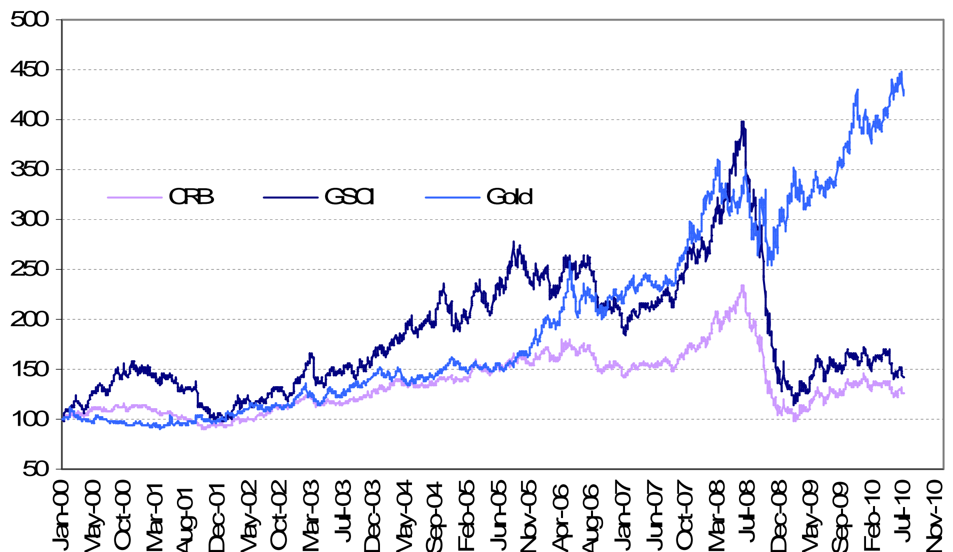


Chart.3 – CRB vs. GSCI vs. Gold *Source: Jaguar Investments, CRB, S&P*

Only when the last tree has died, and the last river has been poisoned and the last fish been caught will we realise we cannot eat money

Anon
Indian Proverb

Commodity prices have gone nowhere for a year – indeed the GSCI is back to where it was in the year 2000. So where is the commodity price inflation? And yet gold prices are up 50% in the last year.

The third reason often quoted for holding gold is that it is a hedge against dollar weakness. If gold is the ultimate safe-haven asset, then the dollar has been the more practical one for many decades. It has historically been more accessible, more liquid, there are smaller transaction costs and the dollar has historically paid interest! In times of dollar weakness, money flows into gold and there has been a tremendously close correlation between them (the correlation between USD gold and the spot EUR/USD rate has been +0.81 over the last decade)

Chart.4 below shows that as the dollar weakened dramatically last year, gold (as expected) rallied sharply. This year however, as the Euro was sold aggressively and assets switched back into dollars, one would have expected the gold price to slip back. It has continued to rise.

I want the whole of Europe to have one currency; it will make trading much easier

Napoleon I
Letter to his brother Louis,
6th May 1807

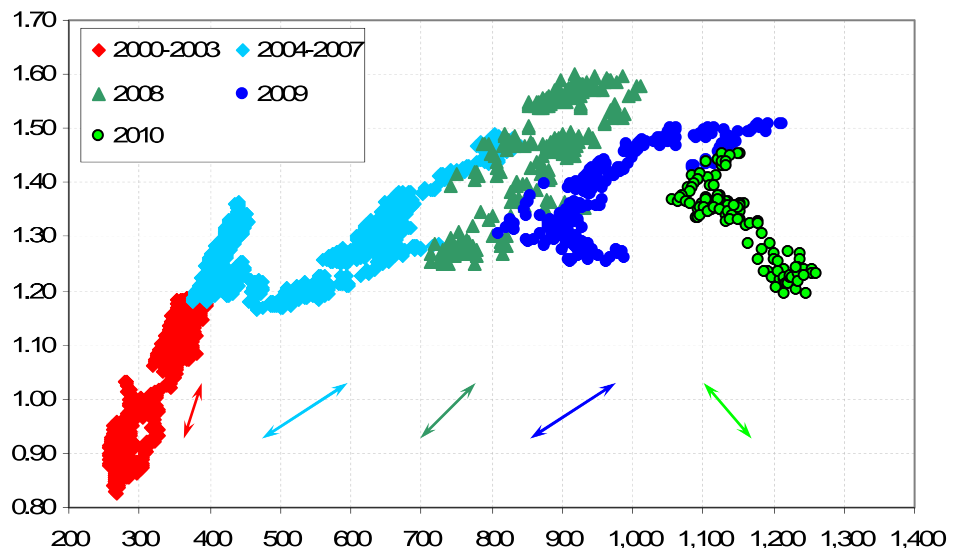


Chart.4 – EUR/USD vs. Gold *Source: Jaguar Investments*

If we assume that the EUR/USD is fairly valued at around 1.25, and we apply a more "normal" historical correlation, then the gold price appears to be overvalued at current levels (c$1200/oz) by some $200-300/oz.

Aside from these three key reasons for owning gold, there are three other factors that have contributed to the bullish sentiment in recent months;

It is easier to know it, than to explain why I know it

Sherlock Holmes
A Study in Scarlet, 1887

Firstly, there is an expectation (hope?) that certain central banks will diversify some of their massive FX reserves into gold. The usual suspects include China, India and Russia. In our view this is unlikely. As the Chinese State Administration of Foreign Exchange (SAFE) announced recently, the gold market is just too small to make any meaningful difference to their reserves. Just as important were their other comments regarding holding gold;

"It [gold] cannot become a main channel for investing our foreign exchange reserves"
"Return on gold over 30 years not very good"
"Gold can protect against inflation, but so can other assets"

O what a tangled web we weave, when first we practice to deceive!
Sir Walter Scott
Marmion, 1808

In any case, even if some central banks did seek to increase their holdings, we believe the trades would take place as off-market transactions between central banks (there are still a number of banks, mostly European, that are looking to realise the value of their gold holdings and raise cash).

Indeed in the current economic environment, and with so many pledges to cut deficits, the risk remains that in fact central banks turn net sellers again – a situation that would have a tremendously damaging effect on the market.

Secondly, today gold is much more available to the retail investor than it has ever been. Historically gold was very much an institutional plaything, and retail investors had to trade through specialist houses who took care of storage and insurance. For this they charged a hefty fee, and in the UK private investors buying gold bullion also had to pay VAT. The financial markets are full of acronyms, from PIIGS and BRICS to TARP, and the gold market has its' own. ETFs and ETPs have grown enormously in recent years and opened the gold market to the retail investor. At the latest count there were 32 open ETFs (25 long, 7 short) giving exposure to gold bullion (net long some 66mozs in ETFs alone). Most are cash-settled, few are physically settled. While these do give exposure to the gold price, they are simply paper financial instruments, and on this basis they do not provide the cover or insurance that perhaps many investors expect.

It was beautiful and simple as all truly great swindles are
O. Henry
The Gentle Grafter, 1908

Thirdly, and possibly controversially, there are many players that have a vested interest in a higher gold price. These range from gold producers (who have substantially removed downside hedges), to ETF/ETP providers, to any of the many larger fund managers that have recently opened long-only gold funds. There are very few people who have a vested interest in a lower gold price, and this selfish bias works over time to convince people that the only way is up. As with all bubbles however, ultimately there always has to be someone willing to pay a higher price.

CONCLUSION

This has been a very simple paper. I have not delved too deeply into many of the issues, but rather I wanted to highlight our concern that the gold market may be in the process of overheating.

In our opinion;

The three main reasons for buying gold are not valid;

- Hedge against financial meltdown – unlikely, in our view
- Hedge against inflation – unlikely, in our view
- Hedge against a falling dollar – relationship not working?

Gold is a vain and foolish fancy
Augustus Eugene Scribe
Robert Le Diable, 1831

Additionally, the three other factors driving the price up seem somewhat flawed to us;

- The expectation of central bank purchases is overly optimistic. Indeed there may possibly be net sales in coming years
- Buying retail products give cheap long-only exposure but most do not give title to gold bullion and therefore no security
- Gold producers are more exposed to a downward swing in prices than at any other time in the last 20 years. And the cost of production continues to rise (currently estimated at around c$700/oz)

There are two final points that I would like to make – both of which indicate to us that we may be approaching the end game for this rally;

If you see a bandwagon, it's too late

James Goldsmith
Attrib.

Firstly, Chart.5 below shows COMEX open interest which has just reached (and breached) all time highs. There is no question that the market is heavily long. The latest CFTC report shows Non-Commercial players (widely viewed as speculative) long some 245,000 lots. This is not at an all-time high (262,000 lots Nov'09) but is nevertheless up some 70,000 lots since the end of March. The price has rallied $150 in that time.

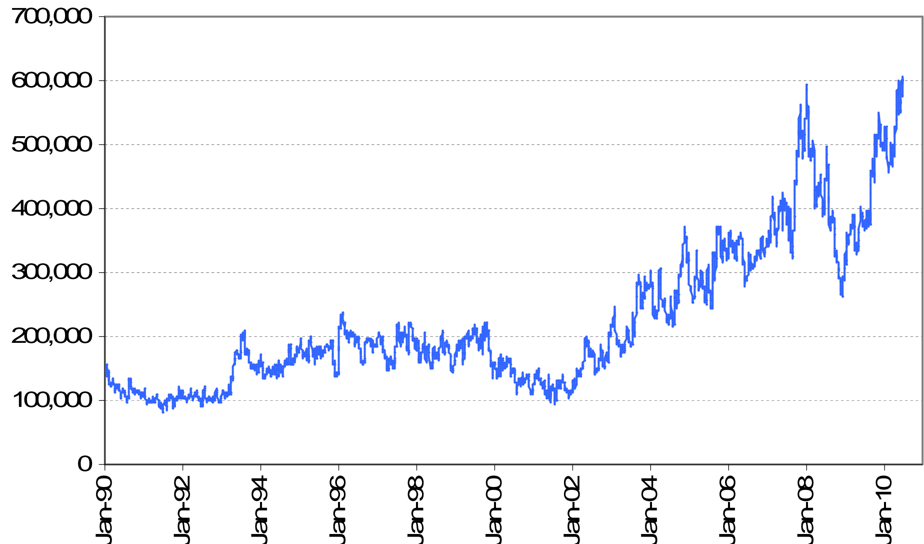


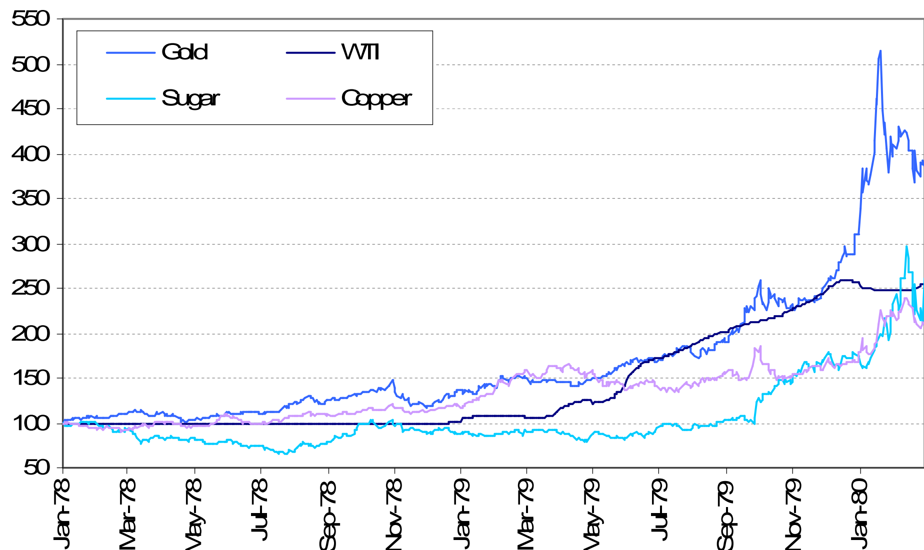
Chart.5 – Gold Open Interest *Source: Jaguar Investments, COMEX*

What experience and history teach is this: that nations and governments have never learned anything from history, or acted upon any lessons they might have drawn from it

G.W.F Hegel
Lectures on World History
1830

Secondly, and further to the comments by SAFE (see page 4), I'd like to highlight what happened 30 years ago in the last big gold bull market. Clearly there are several differences between then and now, and of course times were different, but some of the similarities are remarkable;

- General commodity price volatility (see Chart.6 below)
- Concerns over energy supplies / Oil price rising
- New Conservative government in the UK
- Concerns over government budgets
- War in Afghanistan



Those that bought gold in late 1979/early 1980 in the belief that it would protect them against both global conflicts and rampant inflation had to wait 27 years for the price to get back to the level they paid. In inflation-adjusted terms, they are still not there yet

History tells us that buying just because everybody else is buying can be a dangerous game. Just as dangerous perhaps as selling when everyone is telling you not to – if you can find him, just ask Gordon...