

# GLOBAL MARKETS UPDATE

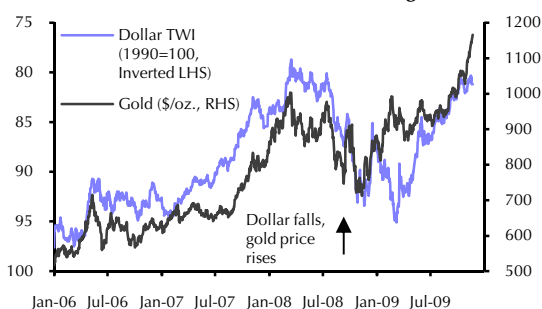
23<sup>rd</sup> Nov. 2009



## Gold is expensive insurance against bubbles

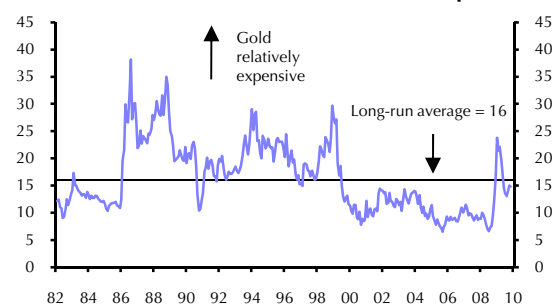
- The latest surge in the price of gold could be justified by the desire for insurance against the risks of inflationary bubbles developing in other assets, as well as a collapse in the US dollar. But as these risks are probably much lower than generally supposed, we are sticking to our relatively bearish view.
- Our forecast that gold prices will fall back below \$1000/oz by the end of this year and as low as \$800/oz in 2010 depends crucially on the assumption that the dollar stages at least a partial recovery. (See our *Global Markets Focus*, 15<sup>th</sup> October.) The continued rally in gold is therefore a challenge to this view not just because prices are going up (obviously), but also because this has happened despite the recent stabilisation of the dollar. (See Chart 1.) Against the euro, for example, the US currency has been hovering at or just below \$1.50 for a month, and yet the price of gold has risen by another \$100/oz or so over this period. Other key asset prices have also been relatively stable in the last few weeks, including oil and equity indices, confirming that gold has developed some independent momentum.
- This is not too difficult to explain. Gold prices have clearly been supported by the widespread speculation that central banks will step up their purchases, and from talk of asset price bubbles. **Indeed, gold prices could plausibly benefit both on the way up, as an inflation hedge while bubbles develop in other assets, and on the way down, as a safe haven against the renewed financial turmoil that would be caused by the bursting of these bubbles.** In the meantime, gold prices have actually risen by much less than most other commodities since markets turned higher at the end of the first quarter. The ratio of gold prices to oil prices, for example, is still close to its long-run average. (See Chart 2.)
- However, **the major central banks in the developing world have already increased their holdings of gold.** Gold bugs take it for granted that these banks will inevitably buy a lot more, and soon. But it seems just as likely that purchases will now continue at a slower pace, or even pause, given the high level of prices. (See our *Global Markets Update*, "What should we make of India's gold purchases?", 4<sup>th</sup> November). What's more, **while central banks are now net buyers, overall demand for gold has actually been falling.** The World Gold Council estimates that total identifiable demand was 34% lower in the third quarter than the same period a year earlier (albeit from a high base). As well as weakness in jewellery, industrial and dental demand, net inflows into ETFs and similar products have collapsed.
- We will look again at the broader debate about asset price bubbles in a *Global Markets Focus*, to be published tomorrow. But the short points are, first, that valuations in most markets have simply returned to more normal levels and second, that **central banks still have the tools and the opportunity to withdraw the monetary stimulus if required to prevent bubbles from developing.**
- In summary, while we do not think that gold is yet in a bubble, the weakness of underlying demand at these record price levels is at least a warning sign. It may take a while longer than we had anticipated for the usual relationship with the dollar to reassert itself, but we continue to expect gold prices to fall back in the coming months as the US currency recovers some ground.

Chart 1: Gold Price & Dollar Trade-Weighted Index



Source – Bloomberg

Chart 2: Gold Price (\$/oz) / Oil Price (\$/pb)



Source – Thomson Datastream

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