

(WallStraits.com, www.wallstraits.com, May 2003)

ALL THAT GLITTERS COULD REALLY BE GOLD

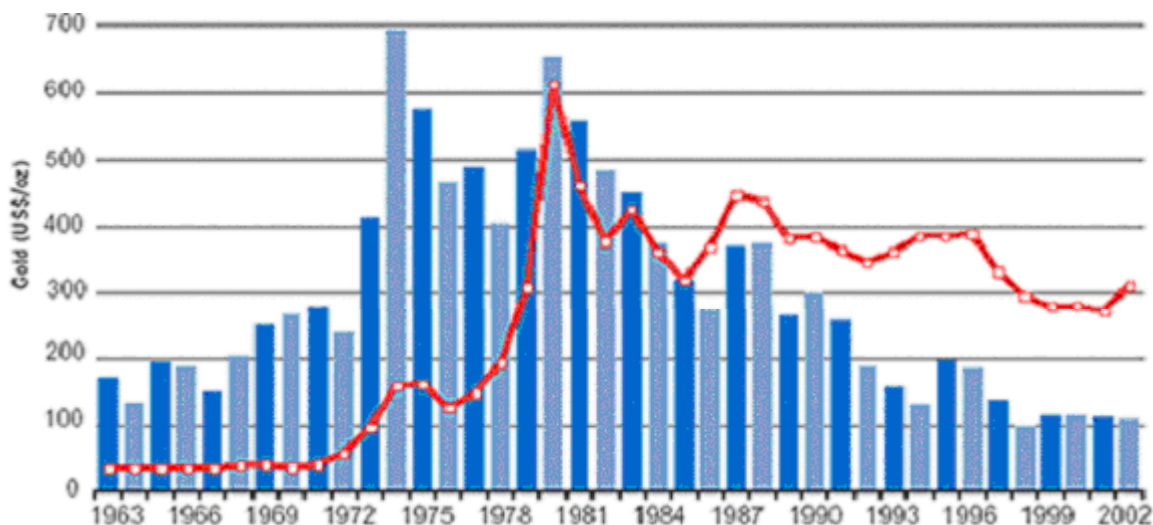
by: Don See

Gold, since antiquity, is synonymous with wealth. The yellow metal which is probably the most durable metal has always been valued for its beauty, rarity and its ability to be a store of wealth, a hedge against inflation and as a currency reserve.

For thousands of years, many gold architects have worked tirelessly to churn out millions of ornaments and jeweled luxuries for the royals and the commoners alike. Many folklores and stories have been written around gold and many heroes were heralded for discovering gold or recovering them from baddies. The San Francisco Gold Rush in the early 1900s probably epitomized the allure of gold in twentieth century.

A hundred years later, Gold is, now, making a comeback and has captured the attention of many people. Treasures aside, gold is an equally important asset class for many investors, institutions and nations. The strength of a nation's currency used to be wholly dependent on the amount of gold reserves they held. Although it is less so in present times, it continues to occupy an important status in an astute investor's portfolio.

Gold is and will continue to be an excellent hedge against inflation and as a store of wealth. To illustrate my point, look at the following chart:



The blue bars represent the rates of inflation in the OECD. The rise in gold prices coincided with the major inflation peaks. Gold cannot be replicated like paper money can. Thus, prices of gold must rise with general price levels in the country.

It was not too long ago when many investors associated gold with declining values. In fact, Gold was trading just marginally above US\$260/oz in 2001. Two years later, Gold has traded to a high of US\$382/oz at the height of the recent Iraq-US War. Even before this, when Gold broke out of its long term downtrend and cleared the major US\$300/oz resistance level, the world believed that a structural bull could be in place for the metal.

This view is positively reinforced by several reasons. First, economic situation, policies and ideals in US lend support to a weakening dollar. Since 1995, Gold has traded in the opposite direction to the US dollar. Central banks around the world, commonly, use US treasuries or gold as their reserve. When the US dollar climbed steadily in the late 1990s, many nations began to exchange their gold for US dollars in order to improve their exposure. This led to a lower demand for gold. As the Euro is not yet a formal reserve currency and the US keen to see the dollar go lower, the demand for gold has and will continue to increase.

Second, growth in gold supply has been limited and on a slight decline. The low gold price has not encouraged new exploration exercise and producers are not yet keen to do so. On the other hand, since Apr 2001, the demand for gold has begun to creep upwards. The divergence will play a major part in the resurrection of gold as an important asset class in investors' portfolio.

Third, the equity markets continued to be mauled by the bears for the third straight year. With more economic and geopolitical uncertainties on the horizon, investors who are seeking growth find no prospect in equities and bond prices high. They began to seek alternative investment class and gold has begun to feature prominently.

Finally, producer hedging activity has slowed considerably. Simply put, a gold miner will sell gold in forward contracts, before gold is actually mined, in order to lock in current prices are finding it, considerably, less profitable to do so with rising prices. Forward supply has dropped and prices will climb.

We will look at another chart. The following chart shows the negative correlation between equity returns and gold values.



It does seem like gold could continue to be well supported and a structural bull could be in place if you believe that the equity markets are not likely to look up anytime soon and the US dollar will decline.

The risks to any investment remain real, be it for equities, bond or gold. Although gold seems to be a good instrument to diversify your portfolio as the chart above shows its non-correlation, and remember, gold is also a passive investment that pays no annual cash dividends like a bond or stock. Investors must always be alert and aware to the risks of investments and to changing macro-economic conditions in the world.

Don See is a long-time guest columnist with WallStraits, has written the article without bias and prejudice and with the intention to educate.