

Will gold continue to glitter?



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As economic growth prospects improve, investors seem concerned about inflation and the health of government finances. Gold was pushed to record highs of around \$1 227/oz (or R285 000/kg) in December 2009. The question on many investors' minds is: Does the yellow metal still have further to go?

Total investor demand – comprising bar and coin investment and exchange traded funds (ETFs) – accounts for 41% of gold consumption. Considering it yields no income, there are two main reasons why an investor would want to hold gold. The first is to hedge against inflation and the second is as a safe haven in times of trouble.

Hedging against inflation

The factor that most consistently influences the gold price is inflation. We've seen over time that as inflation rises, investors have moved to gold as a store of value – and in so doing pushed up the price.

In our view of the global economy for 2010, inflation is unlikely to be a problem. Our reasoning is two-fold. Firstly, despite improving activity data the world economy is still dogged by excess production capacity. The US economy is plagued by 10% unemployment, while capacity utilisation is sitting at 67%. Given such a situation, cost-push inflation is unlikely to arise. At the same time, demand-pull inflation is not expected to occur while households are still in the process of repairing their balance sheets and the threat of job insecurity still looms. Secondly, we believe that central bank authorities have the necessary tools at hand to deal with any inflation threat. However, we do not completely discount the possibility of a delayed response.

A safe haven in troubled times

Historically, gold has tended to outperform other investments during times of extreme global uncertainty. We think these safe-haven purchases will continue to support gold at elevated levels.

What are the concerns of the investment world right now?

Economic data has shown that the worst may be over with regard to the recession, but consensus seems to be that full recovery to previous growth levels is not yet imminent. Part of the concern is how heavily indebted governments will repay the debt they owe. Doubts about a country's fiscal solvency can lead to higher interest rates (rising risk premiums) and/or exchange rate depreciation.

Governments have three options when it comes to dealing with debt:

- Increase taxes and austerity programmes;
- Inflate the debt away; and/or
- Default.

In the world we currently live in, not many governments, especially developed world governments, can afford to raise taxes or cut back expenditure, making option one unlikely for the immediate term. Option two assumes that central banks would not react to rising inflation, and option three would just result in frenzy across financial markets, à la the Russian debt default of 1998.

Be that as it may, our base case is that economic recovery will be entrenched in 2010, which will be supportive of equities and makes gold a less attractive investment. However, what I term the "fear trade" will keep the yellow metal's price at historically high levels.

South African gold companies will still face difficulties associated with declining grades, deepening shafts and rising costs. Company budgets for capital expenditure will keep rising just for the companies to maintain current production or slow down the rate of decline. This makes them fundamentally unattractive, and any expected return from an investment in gold companies' shares is wholly dependent on a rising rand-gold price.