The SA Bullion Gold Report

SA Bullion

Second Quarter 2010

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Gold Performance to 30 June 2010 (% per annum)

	Quarter*	6 Mth*	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
Gold in USD	11.5	14.4	33.1	15.6	24.1	23.3	15.7
Gold in ZAR	16.1	18.7	31.8	14.3	27.5	26.7	17.1

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

Prices

	Gold in USD/oz	Gold in ZAR/oz
30 Jun 2000	288.15	1953.66
30 Jun 2005	437.10	2917.05
30 Jun 2007	650.50	4587.33
30 Jun 2008	930.25	7282.14
30 Jun 2009	934.50	7216.68
31 Dec 2009	1087.50	8008.08
31 Mar 2010	1115.50	8192.18
30 Jun 2010	1244.00	9508.89

Note 1: The above prices are LBMA Afternoon Fix prices.

Performance and Price Action

Gold ran hard in the second quarter. In US dollars bullion was up 11.5% and this was compounded by Rand weakness to deliver a return of 16.1% in Rand. This was too much. A pull-back was necessary and following quarter-end the spot price of gold has retreated to $1,194.70 and R9,060.39 or approximately 4%. At the heart of the matter - support had not followed the price, and a break below the 20-day EMA (Exponential Moving Average) indicated that gold was going down to longer term support levels in the upper-$1,100s. Support above $1,160 has held so far and the near term target of $1,300 remains on track.

Long term the price trajectory of gold appears very attractive.

Modelling, Drivers and the BIS

We have great sympathy with the views of Steven Levitt, eminent economist and co-author of *Freakonomics* (William Morrow, 2005). Levitt believes that it is not possible to model complex economic and financial pictures so as to derive predictive outcomes with any degree of usefulness. We concur. Now this position might seem in contradiction to our analytical approach towards gold, money and macro-economics but we would argue not. We hold three core views:

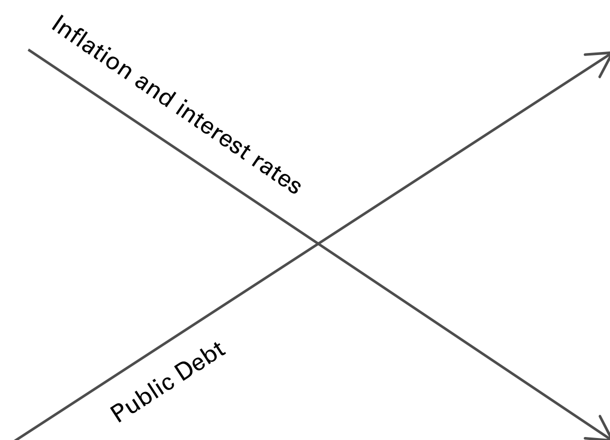
in the good times gold is a commodity, in the bad times gold is a currency;

we are in the bad times and will be for a long time to come;

in the bad times the price of gold is driven by secular (long term) factors which are fairly predictable and by cyclical (short term) factors which are highly unpredictable.

In previous reports we have touched on these items. The point to be made now is that detailed and complex modeling with the objective of predicting gold price direction is not helpful, but a big-picture understanding of key long term drivers of the gold price is of great value.

In thinking along these lines we offer the following:



This graphic spans the most recent 25 or 30 years. At the beginning, around, say, 1980, we had high rates of inflation and interest rates following the oil crisis of the 1970s. We also had low levels of sovereign (national) debt. Over the ensuing 25 years inflation rates fell. The late-80s saw the release of the 'peace dividend' as communist states tumbled into democracy and the 90s witnessed the rise of manufacturing-China and its exportation of disinflation. In the 90s and early 00s monetary inflation moved out of the banking system and became hidden from national accounts (and from Alan Greenspan who spoke in error of "the Great Moderation").

Sovereign balance sheets were on the whole, fairly sound over this period. Bill Clinton even had a balanced budget towards the end of his second term as president of the United States.

All this was about to end rudely however. The reckless super-sizing of financial leverage saw a private sector effectively bankrupted by its profligacy and these debts and liabilities assumed by national governments which had themselves become highly indebted as they sought to provide fiscal stimulus to weak economies. Unfortunately these governments (of most major industrialized nations) have assumed these debts at a time when their economies can least afford to service them – let alone pay them down. The upshot of all this is rapid deterioration in the finances of most of the world's leading nations. Today we find ourselves to the right of the graph above. Public (government) debt is escalating at breakneck speed. Interest rates are effectively zero and governments are faced with liquidity traps and debt-deflation.

Government solutions lie in reflation and monetary inflation. Other possibilities are too painful for governments to consider. All this would point to weakening currencies and strengthening gold price as 'the full faith and credit' of nations is eroded.

So what does the Bank for International Settlements (BIS) have to say on the matter. This 'central bank to the central banks' is after all one of the most thorough, forthright and trustworthy institutions in the world. In BIS Working Papers No 300 dated 26 March 2010 and titled 'The Future of Public Debt: Prospects and Implications', the bank predicts that public debt levels will rise for the foreseeable future. Compounding this problem for many leading countries are a rapidly ageing population and that employment and growth are unlikely to return to their pre-crisis levels for years.

To quote the BIS:

"Our projections of public debt ratios lead us to conclude that the path pursued by fiscal authorities in a number of industrial countries is unsustainable";

"According to the OECD, total industrialized country public sector debt is now expected to exceed 100% of GDP in 2011 – something that has never happened before in peacetime";

"We take a longer and less benign view of current developments, arguing that the aftermath of the financial crisis is poised to bring a simmering fiscal problem in industrial economies to boiling point"

And the cracker –
"When, in the absence of fiscal actions, will investors start demanding a much higher compensation for the risk of holding the increasingly large amounts of public debt that authorities are going to issue to finance their extravagant ways?".

The Fisher Theory of Debt-Deflation

In the 1930s Irving Fisher developed his theory of economic crisis called debt-deflation and attributed crises to the bursting of credit bubbles. According to this theory, following the bursting of a bubble a sequence of effects would manifest:

1. Debt liquidation and distress selling
2. Contraction of the money supply as bank loans get paid off
3. A fall in the level of asset prices
4. A still greater fall in the net worth of businesses, precipitating bankruptcies
5. A fall in profits
6. A reduction in output, in trade and in employment
7. Pessimism and loss of confidence
8. Hoarding of money
9. A fall in nominal interest rates and a rise in deflation-adjusted interest rates.

We could point out that most of these factors are presenting themselves in the industrial nations today. These are some of the most pertinent factors in what we regard as "the bad times". Most pertinent today is the rate of contraction of the US broad money supply, notwithstanding the greatest fiscal stimulus in history. Since December, plunging M3 figures point to a double-dip recession; and with Larry Summers asking Congress for another $200 billion in stimulus to add to the already $800 billion already spent, we can expect massive deterioration in the US Balance Sheet. The IMF has warned that US public debt will breach 97% of GDP next year and 110% by 2015.

SA Bullion exhibits at the Financial Planning Institute Convention 2010

Leading financial advisers in South Africa belong to the Financial Planning Institute (FPI) which organization educates, examines and accredits them. We support the activities and functions of this meritworthy organization.

The FPI holds a large annual convention which this year was held at a large convention centre in Johannesburg. SA Bullion was proud to be an exhibitor at this convention and to become acquainted and contracted with, many quality financial advisers.

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