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A "glittering" bubble: Where is gold, at a record high, heading next?

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The world's interest in gold seems to be intensifying. Since 2000, the price of gold has surged more than four times from some US$300 per ounce to more than US$1,400 now. This multi-year, unprecedented boom has created vigorous debate as members of the investment communities differ among themselves on the validity of this surge, its importance in asset allocation and ultimately, whether or not gold, as an investment, will continue to shine.

Tarun Kumar Tandon, CEO of FLS Corporation (http://www.flscorporation.com/), weighed in on this discussion recently at a seminar organised by the International Trading Institute@SMU (http://www.smu.edu.sg/centres/iti/index.asp). He gave not just a broad overview of the historical importance of gold, but also its various attributes as an asset class, as well as the different ways it can be traded.

Tarun has more than two decades of experience in the financial markets, in areas such as derivatives, prime brokerage services, fixed income, foreign exchange and managed futures. He was most recently heading MF Global Singapore's foreign exchange and precious metal operations.

In order to fully appreciate gold's pivotal role as a monetary and physical asset today, Tarun believes that it is important to understand its history. In the ancient days, across civilisations and continents, from Romans to Egyptians, Chinese to Incans, gold was a precious metal used as a medium of exchange.

When fiat currencies took centre stage, they were backed by gold reserves. Most notably, under the Bretton Woods accord of 1944, the US dollar (USD) was pegged at US$35 per ounce of gold. Another milestone in the use of gold came about in 1971, with the unilateral dropping of the direct convertibility of the dollar to gold by then-US President Richard Nixon. This act cut loose the dollar – and the price of gold. Nevertheless, gold still plays a key role within global financial and monetary systems.

Demand for gold: investors and consumers

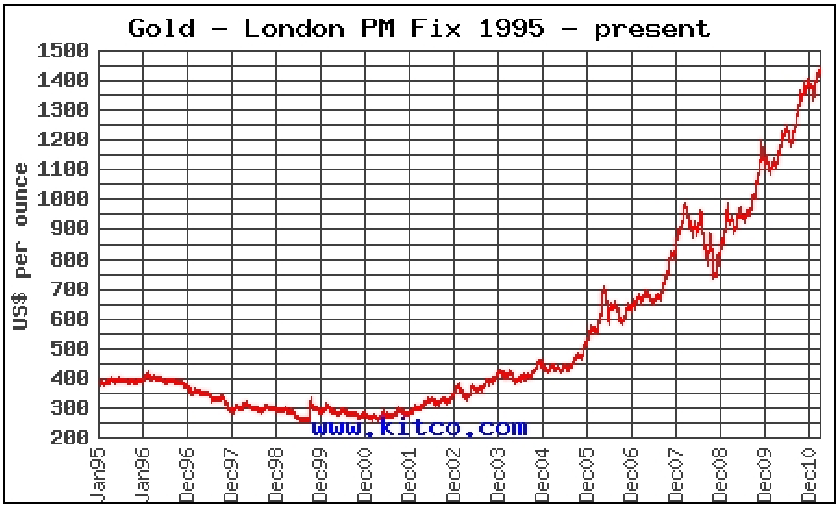
Gold has always been in demand. Since time immemorial, gold has been traded as a physical asset. Today, even as the markets have become more sophisticated, it is still available as a "paper" asset.

It might be interesting to note that demand for its use, such as in jewellery, actually exceeds demand for gold, as an investment, by as much as 54% last year. Also, more pertinent to engineers than speculators, gold has many technological applications, such as in the bonding of wires, in automotive electronics and dental work.

One of the sharpest surges in gold prices took place from 2007 onwards, when it was around US$700 per ounce. Tempting as it might have been to point the finger at speculators, Tarun believes it was genuine demand that drove up gold prices. "A high (price), when backed by increasing trading volume, is a genuine high," he said.

Last year, demand for gold reached a ten-year peak of 3,812 tonnes, despite a 40% rise in price over the last two years. Between 2009 and 2010, investment demand for gold – through gold exchange traded funds as well as physical coins and bars – was down by 2%. However, technology and jewellery demand – where gold is actually needed for use and not just for investment – was up 12% and 17% respectively.

While financial capitals of the world like London, New York and Tokyo are where gold, as an investment product, is actively traded, real physical demand comes largely from emerging Asia. "India is by far the largest physical market – it is an insatiable demand," he said. The demand is especially high during the Diwali holidays, where gold traders can exploit opportunities arising from the jacked-up prices. Meanwhile, Asia's other emerging economic giant, China, is not just the second largest consumer market but also the world's largest producer.



Supply of gold: role of central banks

Gold comes both from the mining companies that extract the metal from the ground, and significantly, from the world's central banks. Producers are primary sellers of gold but can indirectly become buyers when they unwind their hedge books in anticipation of higher prices. Another important source comes from the recycled gold market, which becomes especially active when there is supply shortage.

Within the vaults of the central banks – especially those of the developed countries, massive reserves of gold are held. For example, some three-quarters of the US external reserves are held in gold, largely as a legacy of the gold standard. Their counterparts in emerging countries, in contrast, hold less than 10% of their reserves in gold.

Before last year, central banks were net sellers. Selling is governed under the Central Bank Gold Agreement, which limits the amounts that can be sold annually – so as to prevent a collapse should banks choose to sell at the same time.

The sale of gold by central banks has the effect of putting a cap (and therefore, some form of control) on gold prices. Prior to the financial crisis, Western European central banks had been selling gold in order to rebalance their external reserves portfolios and to also increase their foreign currency holdings. On the other hand, their counterparts in emerging market economies had been substantial buyers of gold, in a bid to diversify their holdings away from the US dollar.

Gold as a hedge

Though gold has been a traditionally popular hedge against inflation, Tarun believes oil may be a better hedge – since it is 'black gold' and not real gold that fuels inflation. "Contrary to popular belief, there is no stable correlation between gold and oil," he said. However, gold can still be an effective hedge against the weak dollar, due to the strong inverse historical relationship between gold and the greenback, he added.

Just as there are real refugees boarding boats and crossing borders carrying suitcases with gold bars and jewellery hidden within, gold is also the sanctuary of choice for many investors seeking shelter from geopolitical and financial uncertainties. Tarun pointed out, however, that in the wake of the September 11th attacks and the 2008 financial crisis, gold remained flat or fell in tandem with the stock market. "When such an event takes place, most people want to be long cash," he said. That includes selling their investments across assets – including, gold.

Still, regardless of what individual investors do to gold, this metal is special for its universal appeal and long history as a monetary asset. Unlike fiat currencies, the value of gold cannot be debased by governments or central banks. With its low correlation with other mainstream financial assets, gold lends an element of diversification in many investment portfolios.

Mechanics of gold

How are the prices of this commodity decided? The London Bullion Market Association (LBMA), which represents the wholesale bullion market in the British capital, plays a key role, along with the central backs, producers and traders. Twice a day, "fixing members" in London do as their title says – fix the prices of gold trades settled in London. This will then serve as the benchmark price for contractual agreements around the world.

Buyers of physical gold – gold bars and the likes – should only buy from LBMA-accredited refiners. The association conducts checks on its accredited refiners to ensure that the quality of their physical gold is up to mark. Standard bars weighing between 350 ounces and 430 ounces have a minimum purity of 99.5%. They also come with individual serial numbers, its level of fineness and an assay stamp (certifying purity) of the accredited refiner marked on the bars.

Drawing imagery from the shady side of the business, Tarun quipped that physical gold is a traditional favourite for thieves, money launderers and smugglers – since it is virtually indestructible and can be melted and reformed, making it untraceable.

Gold price movements can also be seen through derivatives, which can give savvy investors a leveraged bet on investment views, be it on rising or falling prices. However, Tarun cautioned against the use of such instruments: derivatives, according to Warren Buffett, are "financial weapons of mass destruction". So "never sell an option naked, you would get hammered and it is something you would remember and tell your grandchildren about.

Try to play from the long side and not the short side," he said, as writing (or selling) a naked option might give rise to unlimited losses.

Watch that rate

Because of what it is, the price of gold can be affected by a myriad of factors, such as global economic outlook, trades made by central banks, physical and investment demand, hedging activities of the producers, margin trading, and of course, geopolitical situations driving levels of safe haven buying.

While his view is that gold at current levels has strong support, he feels that a further rally is unlikely. "The first sign of a top (for gold) is when the US interest rate rises," he said – a move which many market watchers are expecting later this year, with the US economy showing more convincing signs of recovery.

As another gauge, gold investors can take some reference from another precious metal: silver. Historically, silver is 50 times cheaper than gold. The current ratio is around 42 and silver is also at (or near) all-time-highs. This suggests gold will drop or silver has more catch-up to do. But, as demand for gold is well-supported, there is scant froth.

"Gold is not a bubble because the investment demand is strong," Tarun concluded.

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