TRENDS AND OBSERVATIONS

When not to buy gold

BY RAUNO PERTTU

As a long-time economic geologist, I've been getting many questions on commodity prices lately, especially concerning gold. Over almost 40 years of work in the minerals industry, I've seen a few cycles in supply and demand. For several reasons, this current market is the strongest in that time. Energy, metals and minerals prices are at all-time highs and, if you listen to analysts, many say these prices will continue to climb. Gold prices could possibly reach $1,200 or $1,400 per ounce; some say $3,000 per ounce. However, I think it is likely that the price has peaked for now. I would strongly suggest that you don't buy gold (or silver) for investment purposes now. The old saying, which so many gold buyers ignore, is "Buy low—sell high," not the other way around.

Before the current boom, gold prices and many commodity prices were depressed for a decade. Gold prices from 1998 to the spring of 2002 languished below $300 per ounce. Some analysts stated that gold was finished as an investment and might never break $300 again. Since the autumn of 2005, when gold rose through the $450 level, the price of gold has had an accelerating price climb. After last September, when gold prices broke $700, the gold price formed a classic spike. Since its peak at above $1,000 per ounce in March, gold has corrected to the lower $900s at the time I write, which is still a stupendous price to those of us in the resources industry. It appears to me to be an even bet on whether gold again climbs through $1,000 as predicted by many analysts (and perhaps to as high as $1,400) or whether it seesaws downward at the beginning of an erratic slide. If it slides, the bottom of that slide is very difficult to predict, but could be $600 to $700.

A quick overview of overall commodities prices may be helpful. As I mentioned, along with gold, most minerals and metals prices were depressed, and even severely depressed, for several years before they began their climb of the past five years. During the decade of depressed prices, many mines shut down, new projects were canceled, and key people in the industry found other work.

When demand began to grow, supplies and the ability to increase production were limited, and the expertise to find and develop new reserves was in short supply. The accelerating shortages created rapid price increases in an international bidding war for resources to meet industry demand. Key to the soaring commodities demand and prices was strong world economic growth, particularly of China and India. With its exploding growth, China abruptly switched from a raw materials seller toa major consumer. To fuel this growth and the cars of a new middle class, Asian energy demand, plus the Middle East mess, triggered a huge increase in the cost of oil, which in turn increased the cost of other energy sources and the cost of producing minerals and, therefore, the sale price of minerals. For those of us in the United States, the sliding value of the dollar in international business further increased minerals prices, including gold, because minerals are internationally priced commodities.

There are now suggestions that at least some commodity prices are near their next down cycle. First is the apparent worldwide economic slowdown. The booming Asian economies will be hard-hit by a slowdown of our and Europe's economies. Although countries like China and India are developing their own middle class market demands, they still rely heavily on their ability to sell their goods to us.

There are now suggestions that at least some commodity prices are near their next down cycle. First is the apparent worldwide economic slowdown. The booming Asian economies will be hard-hit by a slowdown of our and Europe's economies. Although countries like China and India are developing their own middle-class market demands, they still rely heavily on their ability to sell their goods to us. A slowdown in demand will lead to slowdowns in production and decreased world consumption of raw resources. At the same time, mining companies have increased their production capacity of metals and minerals to take advantage of the current high prices. Soon, these companies with expanded production capacity may be competing for smaller sales markets. This is the classic price cycle I have seen several times myself.

Gold has some unique quirks. While the use of gold in industrial and technological applications is growing, the largest use of gold continues to be in jewelry. Gold jewelry in some Asian countries constitutes a form of currency, and gold jewelry is required to be essentially pure gold. The jewelry is bought and sold based largely on its weight in gold. In India, gold jewelry forms a woman's dowry at marriage and can determine her desirability to suitors. Gold jewelry purchased for dowries makes India the world's largest gold consumer.

Part of the dramatic price rise of gold has been tied to the exploding economic development of India and China. Many people in these countries see gold as a hedge against the uncertainties of currency and as a way of storing and hiding a portion of one's wealth. Rising wages have meant the ability to buy more gold. However, the gold price has recently risen much more quickly than the purchasing power of the new middle class. Purchases of gold jewelry and investment gold in Asia, which had been growing, softened during the last quarter of 2007 because, even with more money to spend, the number of ounces that money was able to purchase declined.

For many of us in the non-dowry world, the high gold price has resulted in the sale by their owners of huge volumes of gold jewelry, gold watches, and all things gold-bearing. At the same time, new gold jewelry purchases are being hampered by the limits of our pocketbooks. The net result is a glut of gold on the market. Further, remember that in jewelry and in most applications, gold is not actually physically consumed, and will eventually be recycled. For the reasons discussed and other factors, the current high gold price likely will be the trigger for the next down cycle.

Beyond normal supply and demand, part of the pricing of gold is emotional, and the emotions of those who control central bank gold supplies may be the most important. The buying and selling of gold by central banks, with their enormous reserves, can create a huge uncertainty in the price of gold. If, for example, central bank officials were to increase gold sales, we likely would see a rapid decline in gold price. The actions of central banks are not well connected to normal workings of world supply and demand, and because gold has this central bank ownership factor, gold is less connected to market fluctuations and less predictable than other commodities.

I personally believe that we are near, if not already past, the peak of the current gold cycle, and I would not be buying gold as an investment. However, if I had any spare gold lying around, I would pay attention to the market and be prepared to sell it soon or to hang on through the next down cycle.

Because of my view on the current gold price, I also would be cautious about buying the stock of major gold-producing companies. Their stocks are often a reflection of the current and anticipated gold price, and if the price of gold declines, so will their stock prices. Smaller, growing gold companies, however, should do well because the current gold price is so high that it could decline substantially and still provide good corporate earnings from high-quality new projects. The problem for those not in the industry is in how to select good companies from the more common lemons. Remember gold is lemon yellow.

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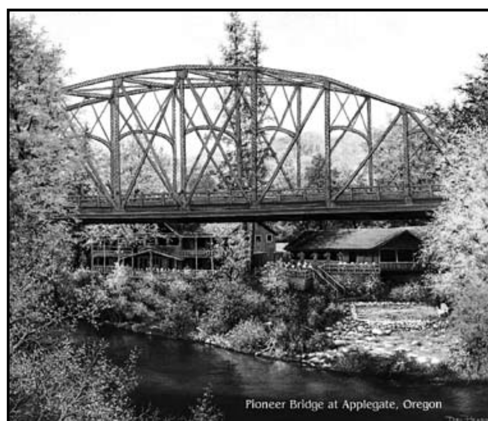

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