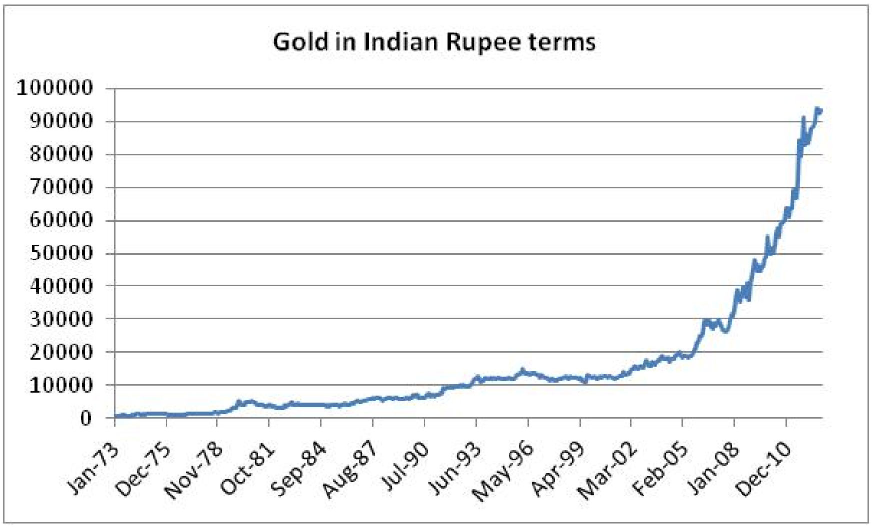
GOLD – A THOUGHT PIECE

In many recent meetings I have been asked my thoughts on gold. At the moment the Fund has neither a long nor short position on gold, so this note is unusual as I am not detailing an existing position in the Fund. Readers should consider the following as a thought piece, rather than an investment commentary.

Gold has been a fantastic investment over the last ten years. Its boosters can point to many and varied reasons as to why it has been and will remain a good investment. It reacts well to low or negative real interest rates. It acts as a safe haven for the wealthy in times of large government deficits. It is not a fiat currency, and hence will always rise in value. All of these arguments have merit, and it is no surprise that gold has performed so well since 2002, when the Greenspan led Federal Reserve pushed interest rates to the then-unheard-of 1%.

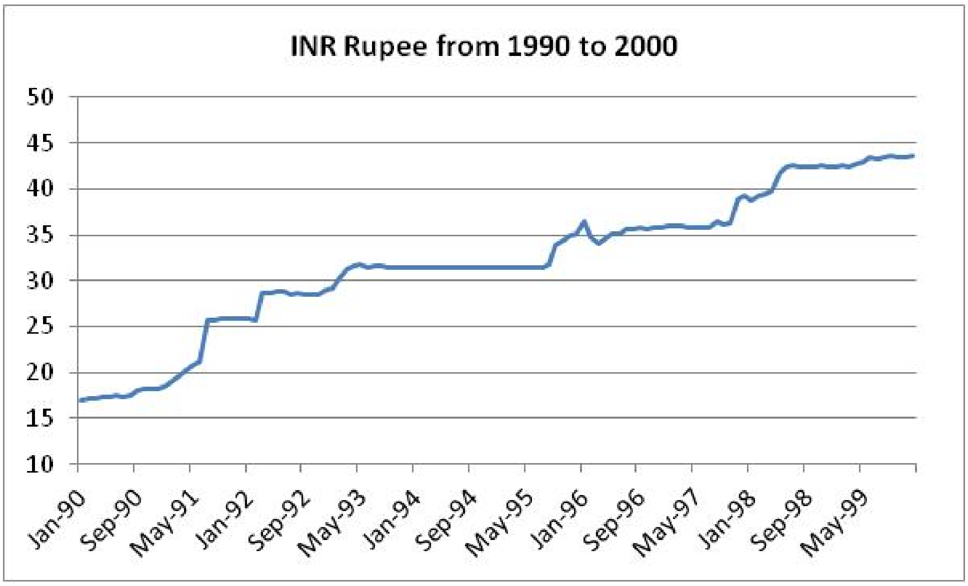
When I listen to gold bulls these days, the arguments would lead you to believe that the gold price should never fall, especially since the link between the US dollar and the gold price was cut by Nixon in 1971. However as a professional investor I cannot ignore the 21 year bear market gold suffered from 1980 to 2001.

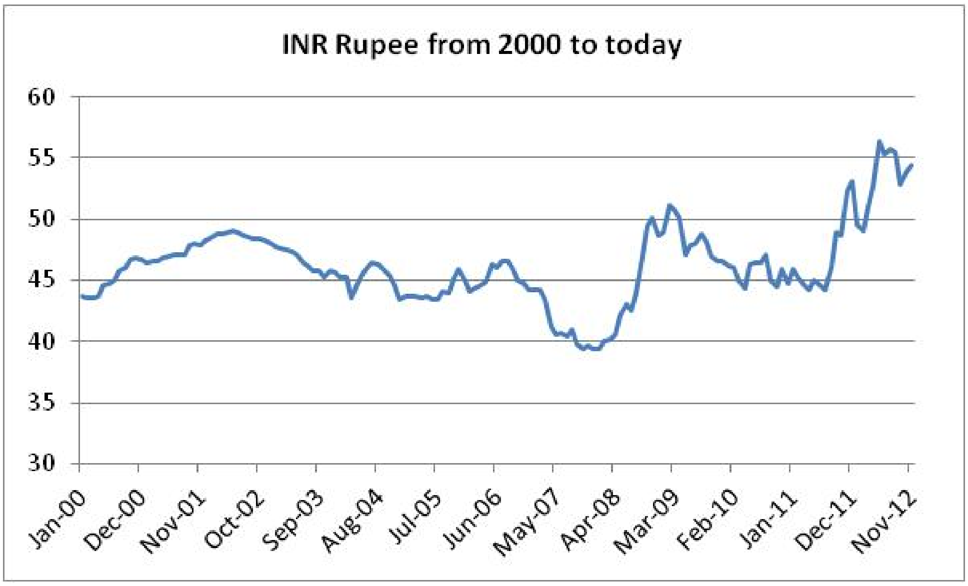
On the other hand, for investors in a country that has persistently high inflation and a seemingly structural current account deficit, gold would always seem attractive. India, which is the largest end consumer of gold, is such a country. For investors who think in Indian rupees, there has never been a bear market in gold.



According to the World Gold Council, total gold purchases (jewellery and bars/coins) in Q3 2012, out of total global buying of 742 tonnes, India consumed 223 tonnes, China 177 tonnes, USA 41 tonnes and Europe 64 tonnes. According to the chairman of the All India Gems & Jewellery Trade Federation, Indian households and temples have about 25,000 tonnes of gold. To put this in perspective, total gold ever mined is estimated at 165,000 tonnes, and total global official reserves of gold are around 35,000 tonnes. To me this implies that financial conditions in India and movements in the Indian rupee are very important drivers of gold.

One driver of a higher gold price has been the strength of the Indian rupee since 2000. In the decade from 1990 to 2000, the Indian rupee fell by 65% versus the US dollar. For Indian investors this meant that gold rallied by 100% over the decade, while for US dollar investors it fell 22%. Indian jewellery demand actually increased over the decade.

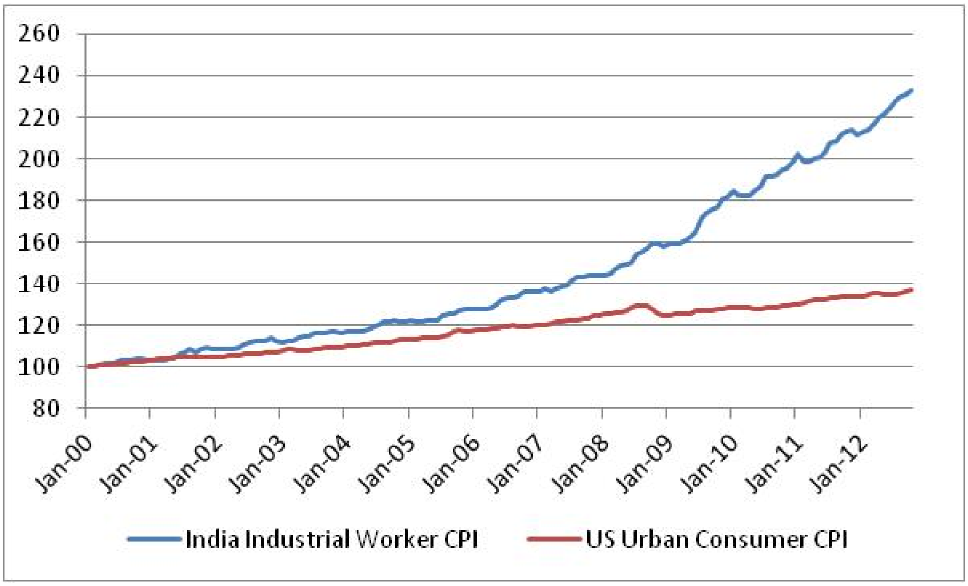




In the decade from 2000 to 2010 the Indian rupee moved from a weakening currency to a stable one that was broadly flat against the US dollar. However since 2010, the rupee has shown signs of returning to a weakening bias. One of the interesting things about the above chart is that the two 10% plus sell offs we have seen in gold over the last two years have occurred in 2008 and 2011, both periods when the Indian rupee sold off. However both were periods of tightening credit conditions in the West, first in the Global Financial Crisis, and the second during the Eurozone crisis. However in 2012 as we have seen credit conditions improve in Europe we have not seen Indian rupee strength or gold strength.

In my view gold investors need to think about whether we could see a substantial devaluation in the Indian rupee. As an emerging market investor I have two rules of thumb to determine the likely scale of a currency devaluation. The first is, the longer a country has been running a current account deficit, the higher the chance of a significant devaluation. India has been running a current account deficit since 2004, and most recently had a deficit of 4.6% of GDP.

The second rule of thumb is that once a currency begins to devalue, it will often fall by the level of excess inflation it has experienced over the last decade or so.



Prices have increased by over 100% in India relative to the USA since 2000. This means that the dollar should appreciate by over 100% over the Indian rupee from its 2000 exchange rate. In market terms this means that from a market rate of 54 rupees to the dollar today, we could end up with an exchange rate closer to 100 rupees to the dollar. This may seem fanciful to most investors, but I note that India's neighbour, Pakistan, has already managed to move from an exchange rate of 60 to the dollar in 2008 to 96 today. And this is during the period of most extraordinary monetary easing from the Bernanke led Federal Reserve. If the USA should ever seek to normalise interest rate policy, then I suspect my currency forecast is too conservative.

As stated at the beginning, this is a thought piece, but it does provide an observable hypothesis. If gold should weaken due to a falling rupee despite more QE from the Federal Reserve, then the hypothesis will be shown to have some merit. As always, I watch the market with interest.

INFORMATION

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