



LPL Financial Research

# Lincoln Anderson Commentary

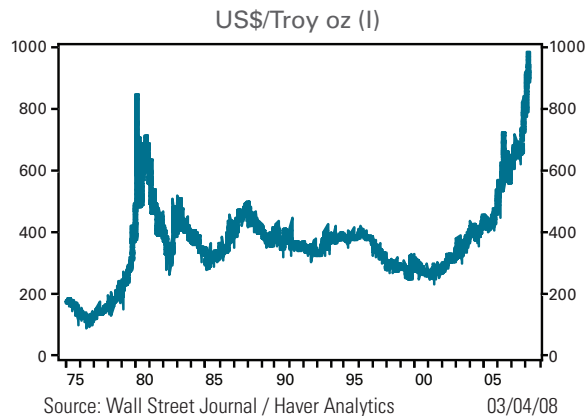
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Lincoln Anderson  
Managing Director,  
Chief Economist,  
Chief Investment Officer,  
LPL Financial

## Fool's Gold: \$1000 per oz.

Recently, the price of gold soared to nearly \$1,000 per troy ounce, barreling past the previous \$850 peak hit on January 21, 1980 when CPI inflation was 13.9%, headed for the peak of 14.8% in March, 1980. Does this make any sense from a fundamental perspective? Why on earth should gold be hitting these highs?

### Cash Price: London Gold Bullion, PM Fix



Some say that it is demand from China and India. Some say it is a harbinger of future inflation. I tend to think it is mostly speculative demand, largely driven by the recent creation of gold ETF's. (GLD was started in November 2004.) Today, GLD alone holds 647 tonnes (spelled that way because a metric measure is used; from now on I will use "t" for tonnes) of gold, making GLD the 8th largest holder of gold in the world. GLD has a "market cap" of \$20 billion dollars. It has no earnings, pays no dividends and has storage and other expenses totaling 40 basis points per annum. If you thought the P/E on tech stocks was high in 1999, think about gold's – it's infinite!

How about the rising demand argument? As we learned in Econ 101, supply and demand always balance. For gold, according to the World Gold Council, the average demand and supply over the last five years is 3,692 t per year. Gold demand is categorized into three areas: jewelry, industrial and investment demand. On a five year average basis, jewelry demand has averaged about 2,548 t and industry demand 441 t. Gold production (2,239 t) and recycling (926 t) have averaged 3,165 t. So, production/recycling has exceeded non-investment demand. Investment demand (703 t) has exceeded central bank net sales (527 t) with production/recycling and soaring prices clearing the market. Bear in mind that the 2,239 t produced per year is a permanent addition to the estimated 160,000 t stock of gold; only an estimated 2% of all the gold ever produced has been lost, according to the World Gold Council. However, total gold stock and loss estimates are fuzzy. The U.S. Geological Survey (USGS) estimates losses at 15%; either way, stocks are big.

On the investment demand side, GLD is now the 8th largest holder of gold; who are the others? In order, there is the U.S. at 8,133 t, Germany has 3,428 t, the International Monetary Fund has 3,217 t, France has 2,622 t, Italy has 2,452 t, Switzerland has 1,166 t, and Japan has 765 t. And if you think that these countries, central banks and international institutions just sit on these gold reserves, think again! GLD is in 8th place now, because the European Central Bank sold 115 t over the last two years. France has sold 270 t, Pakistan 218 t and Switzerland 124 t. Even the Bank for International Settlements (BIS) has been a seller, unloading 43 t. The only big official purchaser has been Russia, which bought 52 t over the last couple of years.

Some, but not all of these official holders of roughly 28,000 t have varying degrees of discretion in when and how much they can sell (the U.S. does not). Europe has a Central Bank Gold Agreement that limits their annual sales to a maximum of 500 t. Total central bank sales were 659 t in 2005 and 319 t in 2006, so it is clear that some have been hitting the bid. One, among many, of the risks in owning gold is that there are large discrete holders who could put a lot of gold on the market.

Then there are the private stocks, estimated at 132,000 t. In total, we have approximately 160,000 t of gold stocks (now rising about 2,400 t per year). Netting out annual supply against demand, net demand is rising 322 t per year relative to the stock. Even with high investment demand, it would take nearly 500 years to transfer ownership of currently available stocks! Talk about inventory overhang! For normal businesses, inventories average about 3.5 months worth of sales, not 500 years! Almost all the gold inventory would still be here; very little goes into outer space or is lost at sea. Further, global gold “resources” (gold in the ground) are estimated to be 90,000 t (USGS). Now it sounds a little crazy, but if production stays constant, we would have roughly 280,000 t in stocks in about 40 years. If a method to economically recover gold from sea water can be found, then gold resources would jump again, by a very controversial estimated 780,000 t. For all these reasons, I see big inventory risk.

Production costs average about \$428 per troy ounce according to the World Gold Council. Australia is now the leading producer (280 t), South Africa is second (270 t) and China (250 t) has supplanted the U.S. (240 t), which is now in fourth place. Given the very high price of gold compared with the production cost and substantial gold resources, I expect that economic forces will, over time, lift production substantially, adding another risk to owning gold. Remember the old adage – the cure for high commodity prices is high commodity prices; meaning high prices tend to push up supply and push down demand, leading to a price correction. Note that the World Gold Council says gold demand in India fell 64% from Q4 2006 to Q4 2007 and overall global demand fell 17%.

Given potential threats to high prices from the huge inventory, the potential for additional supply and lower demand due to current high prices, and the lack, in my opinion, of any chance over the foreseeable future of a sustained return to double digit inflation rates, I think gold is a very poor choice for portfolios. I do not like gold as an investment. I do not think an “investment” that has no earnings, no dividends and a negative cost of carry makes sense. In general, timing has to be very good to make money on gold. The return on gold bought at the end of 1979 and held to today is less than 100%. Over that same time period, the S&P 500 had a total return of 2,685%.

Finally an editorial comment – please do not take offense if you are a lover of gold. I also like gold – in jewelry. But I abhor the waste of resources, bad labor conditions and the significant hit on the environment associated with digging gold out of the ground, only to turn around and put it back in the ground as bars in vaults.

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