Gold: the precious laggard that will hit $2,000

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Soaring oil costs have pushed the gold/oil ratio to the lowest levels in decades

By Ian Williams, Charteris Treasury Portfolio Managers

3:40PM BST 03 Jul 2008

In 1999 when oil was $10 a barrel, I suggested that the price would ride fivefold to $50 a barrel in real terms over the next few years. This forecast was dismissed with incredulity at the time. Almost 10 years later with the price over $130 a barrel, my original forecast turned out to be rather timid - with mainstream commentators now forecasting $200 a barrel.

My forecast was based on an analysis of long term future supply-demand trends, combined with a study of ultra-long term commodity cycles.

How to invest in gold

What is striking about ultra-long term commodity cycles is how seemingly unrelated commodities appear to rise and fall together.

Price data shows that around 1999-2000, virtually every single commodity hit a significant low before turning up sharply. Nickel hit a low before proceeding to rise ten-fold in the period up to April 2007. Similarly copper also bottomed around this time before an eight-fold rise up to May 2006. Copper is once again challenging its all-time high and looks set to move into new high ground.

The reasons for this stellar performance are now well-trodden - the emergence of China, India and Russia - as major consumers of scarce and in some cases increasingly finite resources.

This commodity super-cycle phenomenon shows no signs of abating. But to profit from it, investors need an understanding of the leads and lags within the commodity family to avoid being caught buying a particular commodity at a short-term peak in its price. I would be very wary about buying oil assets at present - simply because the price of oil in relationship to other raw materials is becoming very stretched.

Instead a study of the laggards in the raw material family is likely to prove more profitable and carry less risk.

Gold is one of the biggest laggards and the one that confuses investors most. Like other commodities it made its super-cycle low in 1999 at $250 an ounce - a level now etched on the record of Gordon Brown who made the calamitous decision to sell half the UK's gold reserves at the absolute bottom of the market. Unlike oil, copper, nickel and a host of other commodities which have seen rises of between eight and thirteen fold increases in the last ten years, gold has risen a mere three and a half times from its low. This puts gold and gold mining shares very firmly in the laggard category.

The sharp rise in oil and the relatively low rise in gold has pushed the gold/oil ratio to the lowest levels seen for decades. Either gold is incredibly cheap or oil is incredibly expensive on a relative basis.

Even if oil were to succumb to short term profit-taking, very few commentators think that it would fall back much below $80 a barrel - a level still eight times its low in 1999. (Gold hit a peak of $850 in 1980 and to equate that in real terms, ie adjusted for inflation, gold today would have to rise to around $2,500 an ounce at present. A rise of that magnitude would also restore the gold/oil ratio to its historic norm.)

A common reason offered for gold's relative underperformance is that it other commodities are driven solely by industrial demand whereas gold is subject to investor demand. This is only partially correct. Currently global jewellery demand of around 2,400 tonnes a year, roughly equates to global mine output so that this market is in balance. (Unlike oil, where a surplus of supply over consumption - as distinct from demand - has existed for several years.)

The swing factor that will affect the gold market is investor demand. Global investors can now buy exchange traded certificates (ETCs) and exchange traded funds (ETF) which alleviate the need to hold physical bullion in a bank vault.

The demand from this source has to be set against supply from the central banks who have been consistent sellers over the last few years. The balance between these two holds the key to if and when gold will catch up with the other commodities.

On a two to three year view the outlook looks increasingly bullish. Rising inflationary expectations around the world will lead to greater investor demand for inflation protected assets of which gold's 2000-year history in this space is unrivalled.

Previously it was the sale of gold by central banks that supplied the market and helped keep a lid on the gold price.

But this strategy is looking more and more like a busted flush. It is unlikely that the UK will be in a rush to sell any more of the Bank of England's gold, not that it has much left to sell. The same applies to many other central banks such as Holland, Belgium and Canada who have been long-term sellers of gold. They have run out of gold to sell. At the same time the central banks of the emergent economies, have become buyers.

Recent evidence shows that the central banks of Russia and Argentina are buyers. It is also rumoured but not confirmed that the central bank of China and other sovereign wealth funds are also buyers. As these possible central bank buyers have trillions more cash than the Western central banks have gold, it is very easy to envisage a scenario where the central banks in aggregate turn into net buyers - even if certain western central banks continue to sell.

And it is difficult to see where the extra supply would come from as mine output struggles to grow.

The gold market would then suffer a severe price squeeze similar to that already seen in other raw materials. Investors who subscribe to this view should look to either buying gold direct (via ETFs or ETCs) or to possibly make even more money in the gold mining sector. It is our belief at Charteris that in the current environment every portfolio should have an exposure to gold.

We favour certain selected mining stocks over ETCs or ETFs as they traditionally provide a geared play on the metal itself. If our view is correct that gold will more than double then we would expect several of our favourite mining shares to rise five or tenfold in the years ahead.

Ian Williams is chief executive of Charteris Treasury Portfolio Managers

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