With gold at a 2-year low, is this a buying opportunity or the start of a longer term decline?

“Gold gets dug out of the ground in Africa, or someplace, then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head." - **Warren Buffett**

It has been the darling investment of small investors and pension funds for over a decade. Seen as a “store of value”, a hedge against rising inflation and a staple long-term allocation, **gold had enjoyed one of the longest and most powerful rallies since the late 1970s**. Then suddenly in early April 2013, the price unexpectedly plunged by over 9% in just two weeks.

This month we explore the reasons for that fall, examine the various factors that influence the gold price and ask whether the recent sell-off is the first leg down or a long-term buying opportunity.

As reflected in Warren Buffett’s above quote, **gold is impossible to accurately value**. Gold is not a company or a bond, it has no balance sheet, profit/loss or cash flows. You can’t live in it or live off it (no dividend) and it’s very difficult to predict supply (would you believe that there is no verifiable audit of US stated gold reserves?), let alone demand.

Yet it is perceived to be an asset that is a “safe haven”, an asset that comforts those investors who fear the unknown. It is a “real” asset (unlike collateralised debt obligations), it is tangible, physical, an investment to put under the bed and forget about.

However, because it is impossible to sensibly value, gold is more susceptible to changes in sentiment than fundamentals and when sentiment towards an investment “turns” unexpectedly, it makes for much greater short-term movements in price.

On the 10th of April a Goldman Sachs report predicted that the gold price would tumble. Citing fallout from Cyprus and lower inflation expectations in the US, the investment bank recommended taking profits with immediate effect.

The very next day the Cypriot government announced a sale of €400m of gold reserves to help fund its enormous bailout and this led to jitters across the rest of peripheral Eurozone. At the same time the Federal Reserve hinted that they might stop the money printing presses sooner than expected. **All in all it was the perfect storm for gold** and in the biggest price plunge for more than 30 years, over $1 trillion was wiped off the value of global reserves in a matter of days.

Whilst each of these major economic factors on their own certainly would justify some selling pressure, the combination of three or four together led to a powerful wave of selling over just a few trading sessions.

To judge whether or not this sell-off was overdone, we must first assess **the factors that typically influence the price of gold**:

1. **The US dollar** - typically there is an inverse relationship between the value of the US dollar and the price of gold. When the dollar becomes stronger, the gold price falls and vice versa.

2. **Money supply** – when central banks print more money (Quantitative Easing), the value of that paper money should fall as it is less scarce. Gold is perceived to be a currency in its own right and as you can’t print more of it, the price will strengthen as other currencies weaken.

3. **Inflation** – “real assets” like gold perform well when inflation is high or rising because they have a finite supply.

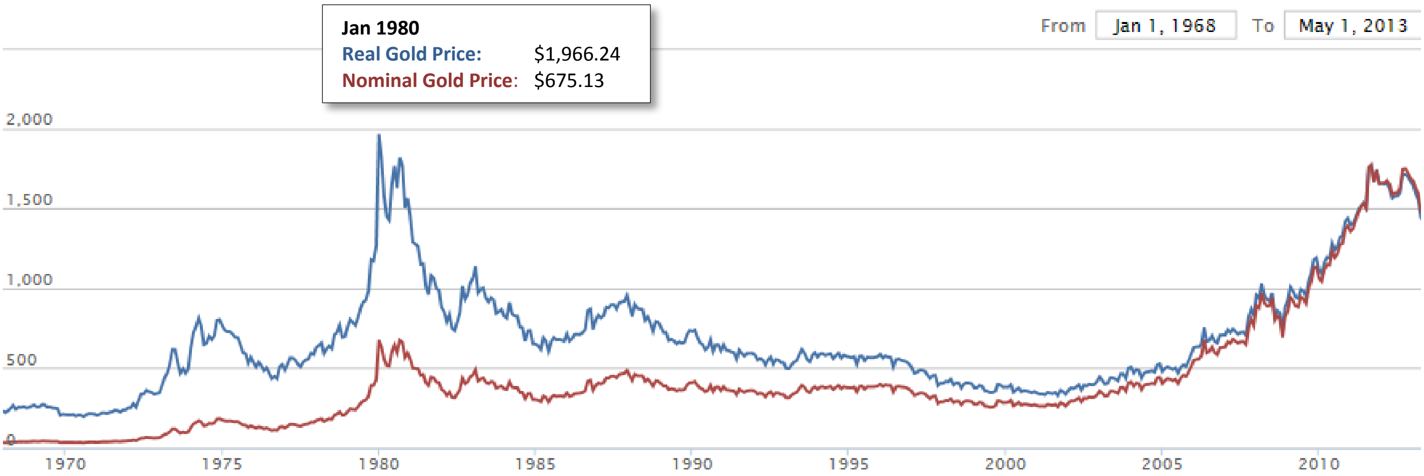
4. **Expected supply** – analysts will try to predict gold production for the year ahead as this will have a major influence on shorter term prices. Of more immediate concern, investors currently fear that other weak Eurozone economies, such as Italy and Spain, will follow Cyprus's lead and sell some of their gold stocks, adding further supply to weakening demand.

5. **Demand** for Gold in China and India - the largest consumers of gold in the world are Greater China and India. Economic growth prospects in the region are clearly an important variable.

1, 2 & 3 are all inextricably linked. If the US prints more money, the dollar weakens (1), money supply increases (2) and inflation will eventually rise (3) - good news for gold in the longer term.

Of course the opposite is also true and **the greatest current fear for gold investors is lower US inflation** than first expected. Combine this with the supply of gold increasing in the market due to Eurozone selling pressure (4) and it is clear to see where the recent selling pressure has come from and it is little wonder that investors have become concerned about the future prospects for gold.

But yet, since the sell-off, buyers have crept back into the market in increasing numbers. One bank’s gold analyst has suggested that if all three central banks of Portugal, Greece and Cyprus sold their entire gold reserves, it still wouldn’t have moved the price as much as we saw in early April and **many are seeing this as a buying opportunity** after a short, sharp, over-done sell-off.



So is there value in gold after the recent decline? We do know that whilst the gold price has hit all-time highs, if you take into account the effect of inflation, gold is still below levels reached in the 1970s (see chart above).

And **it is expectations about inflation in the future that are most important now.** If you think that inflation is dead, you should also expect the gold price to tumble because inflation binds together most of the factors affecting the price of gold.

If, however like us, you believe that structural inflation is likely to persist, led by upward-trending food and utility prices, sustained currency depreciation and aggressive money printing (see our Japanese comment last month), **owning gold should offer some protection in this environment.**

Also if emerging market central banks with large foreign exchange reserves continue to buy gold in order to diversify away from paper currencies that are losing value, this should further support gold in the longer term.

In addition this doesn't take into account that **some investors own gold to help balance against other investment assets elsewhere** in their portfolio that will perform well if inflation doesn't materialise.

We can't be sure that gold is now good value. However we do believe that gold still has a useful role to play for investors who are concerned about longer-term inflation and indeed when combined with other investments in a well considered portfolio. **To this end we recommend keeping some gold "under the bed" for the foreseeable future.**

Market "Stance" - the chart below illustrates our current general "market stance". Each of the dots on this chart represents a change in this market stance over time. The US markets are at all-time highs but show no signs of relenting whilst corporate earnings remain reasonable. Our current stance is still: **NEUTRAL.**