

Ryan Sharp

# Where's the Price of Gold Going?



**W**hen I was growing up in Toronto in 1980, a very strange thing happened.

People were lining up at downtown banks to buy Gold. The price was driven up to over \$800 an ounce.

Personally, I hate lining up for anything. When you are first in line, it feels good, but when you are last in line, with nobody behind you, it doesn't feel so good. Having been close to \$120 an ounce a few years earlier, the run-up in the price of gold was frenzied. Two years later, it was down to around \$300 an ounce. The last people in those lineups to buy gold didn't fare so well.

In inflation-adjusted terms, gold peaked at almost \$2200. Is that where we are headed? There are many theories out there. Personally, I don't buy into most of them. We are simply headed where the market takes us. Having an understanding of the market, however, helps us make better decisions.

## What Happened in 1980

Looking back at the environment in 1980 helps to us understand what caused the price of gold to increase so dramatically. You often hear people say that you buy gold to hedge against

inflation because its value should move up with inflation. In 1980, inflation reached over 12% and interest rates were about 15.25%.

Interest rates eventually peaked at around 21% in August 1981. Since then, central banks have become much better at controlling inflation but that fear of inflation is one of the drivers in the price of gold.

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## Supply and Demand

As with all investments, I like to first look at the supply and demand characteristics to fully understand what is going on. In 2005, the largest physical demand came from jewellery manufacturing at 2736 tonnes, with dental and industrial uses adding 418 tonnes of demand, for a total of 3155 tonnes in demand. Gold production from mines was a net 2356 tonnes in 2005, with 841 tonnes of gold coming from scrap, for total physical production of 3197 tonnes. This would seem to be a balanced market where prices should be stable.

The remainder of demand comes from investment—individuals, institutions, and governments that purchase gold in the form of Bars, Coins, and Exchange-Traded Funds (Exchange-Traded Funds purchase physical gold on an investor's behalf). In 2005 this demand equaled 590 tonnes, offset by central bank selling of 656 tonnes.

From the supply side, gold is a scarce commodity. The cost of exploration and mine development is increasing, in part due to the increasing cost of labour, fuel, and steel. With the increase in the price of gold over the past 3 years, mining exploration and development have increased significantly. Production increases from the increased activity, however, won't significantly change the supply for a number of years.

## Why is the Price Increasing?

Like everything that goes up in price, the incremental demand must be outpacing supply. In the case of gold, the increase demand is mainly investment-driven. Overall, the physical demand for gold has decreased over 12 percent in the last 5 years.

Central banks, mainly in Europe and the United States, hold about 28,000 tonnes of gold in reserve and have been a constant supplier of gold

to the market for many years. While those banks will continue to supply gold into the market, 2006 will most likely see buying of gold into reserves from countries in the developing world. How much is purchased will be somewhat price dependent.

The primary reason for the purchases is the desire to hold reserves outside of US dollars and other foreign currencies. The largest demand should come from China and Russia. China, however, has not indicated it will be purchasing gold, only that it intends to diversify its reserves.

The remaining incremental demand comes from individual and institutional investors who not only buy physical gold but gold exchange-traded funds. In 2005, gold ETFs accounted for 203 tonnes of demand and should increase this year.

**Unlike most other commodities, the price of gold doesn't have the same underlying fundamentals to support the price.**

The reasons for purchases are varied. One would be the perception that gold is a good hedge against inflation. Others purchase gold as a hedge against the currency in their respective countries. The largest reason would be expectation or speculation that the price of gold is going to increase.

Unlike most other commodities, the price of gold doesn't have the same underlying fundamentals to support the price. The market is very reliant on central banks, institutions, and individual investors to provide the demand necessary to support the rising price.

The price will continue to go higher as long as the consensus believes in the reasons for buying gold. When those reasons change, the price can drop as quickly as it rises.

The key to investing in gold or gold-related securities is not to be the last in line. ▲

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