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market impressions

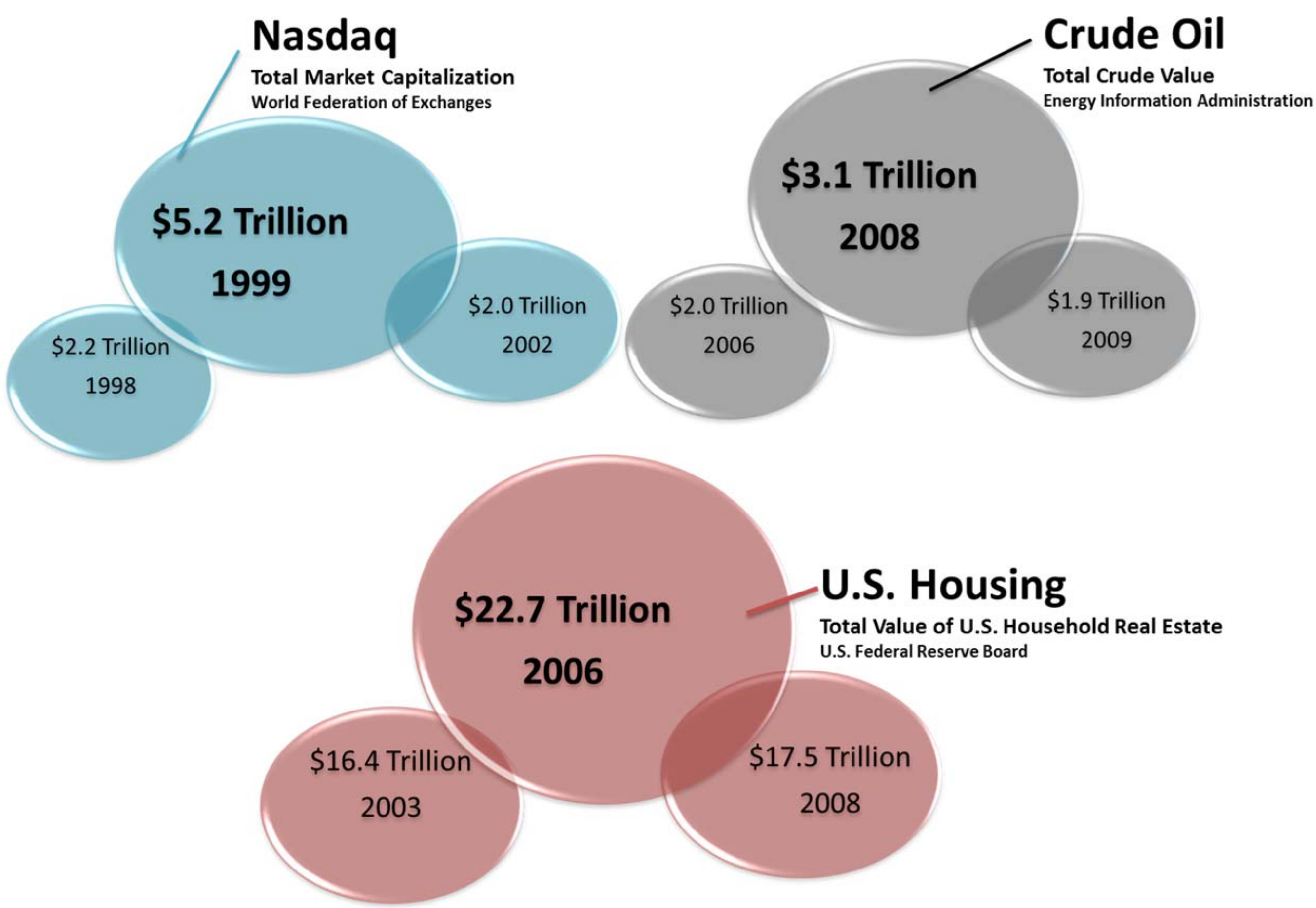
FOOTPRINTS ASSET MANAGEMENT AND RESEARCH, INC

# GOLD

## UNDERSTANDING THE FUNDAMENTAL AND PSYCHOLOGICAL ELEMENTS BEHIND THE PRICE OF GOLD IN CURRENT MARKETS

# BUBBLING TULIPS

One of the most glorified examples of a market bubble is *Tulipmania*, which is believed to be the first financial bubble. In 17th century Holland, the *Semper Augustus*, an inherently colorful tulip, emerged with strong demand. While the supply of purchasers grew rapidly, the supply of tulips did not. Despite that the tulip supply could be renewed through seeds, these seeds took seven years to produce a bulb. The strong demand had sent prices soaring, with some traders offering their yearly wages for one bulb. However, prices eventually came crashing down after investors realized they had traded everything they had – their pay, their homes, their belongings – for a simple tulip. It set the stage for an ideal bubble: investors lose track of rational expectations, psychological biases lead to an increase in prices of an asset or market, positive-feedback continues to inflate the market, and in the end, confidence is lost and the inflated market crashes. Bubbles appear to be more frequent than many realize and seem to naturally occur as part of an investor's irrationality and impatience in the market.




***In less than just ten years, we saw the dot-com bubble and a housing bubble. Could gold be next?***

Gold may be in a similar situation. The two that seem to appear more often are uncertainty of financial markets and the value of the dollar. The rational expectations ties in with the question "At which price is gold an attractive investment?" Psychological biases have occurred from investors believing that gold can only go up in price with increased money supply and a perception of high inflation. News of gold flirting with all-time highs has provided the positive feedback, which has further inflated the market. The last piece of the puzzle is where investor confidence stands. This is where we must ask ourselves "What is supporting (or backing) the price of gold at these kind of levels?"

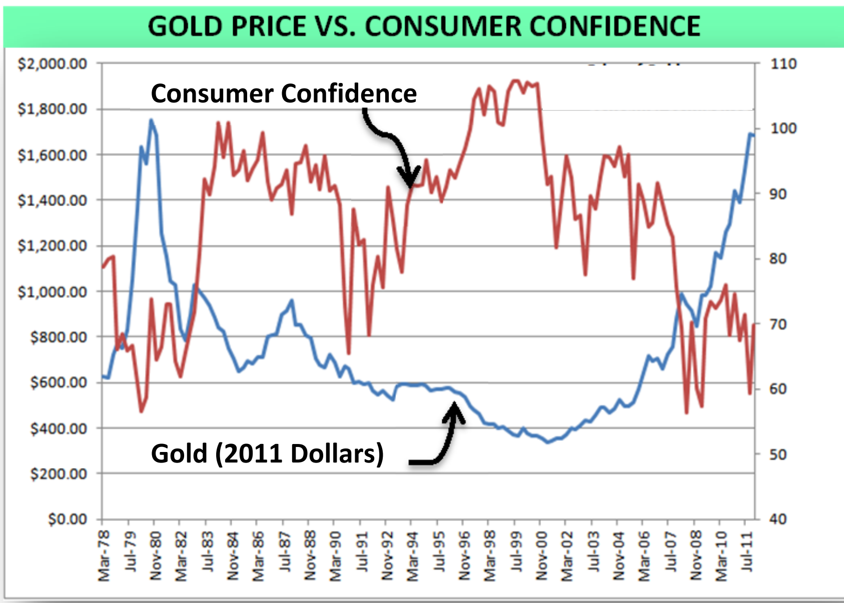
# RATIONAL EXPECTATIONS

There is no denying that a gold investor has had the opportunity to obtain significant returns over the years, particularly in the last decade. Just from the start of 2009 to the present, gold has come from below $900 an ounce to 30 year highs just short of $1,900 an ounce. Several factors can be attributed to this price gain. A declining level of output with an increase in demand would have the effect of driving gold prices higher. Also, low real interest rates have historically supported higher commodity prices. Lastly, it has been noted that the price of gold increases when central banks increase their positions in gold, which recent reports show that countries have been doing so. In August 2011, International Monetary Fund data showed the central banks of emerging market countries, such as Thailand and Korea, have added over $10 billion to their gold reserves in just the first quarter of 2011.


In answering the question "At which price is gold an attractive investment?" one must review why gold is at current prices and speculate on potential changes in those supporting reasons. Will there be upcoming changes in the real interest rate? Will there be a higher or lower inflation rate? Will central banks continue buying gold? These are all important questions when evaluating a good purchase price for gold. It is especially important to remember the old adage 'buy low, sell high', especially with gold prices near all-time highs.

# Psychological Biases

Gold investors are very defensive on their support for gold price levels. It seems any individual is either a gold-bull or a gold-bear, yet never in the middle. Many claims and perceptions are continuing to fuel the rise in the price of gold. There are claims that current inflation levels and future inflation levels support these price levels, and also that the doubling of the money supply in 2008 are a cause of current price levels. Furthermore, with the current European debacle (better known as the European debt crisis) and the United States' debt downgrade, many investors are worried over the future of fiat currencies, or currencies that are backed by faith rather than a physical reserve backing. These 'doomsday fears' continue to set a bias for higher gold prices, as confidence has shifted from markets and cash into commodities. Historically, it has been shown that the price of gold is inversely related to consumer confidence. The markets are seeing this currently.




# Positive Feedback

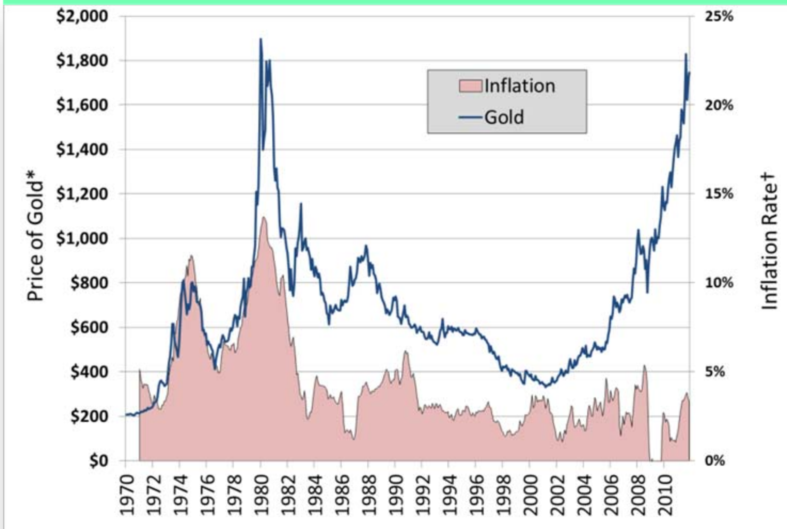
Naturally, positive feedback adds fuel to the fire. The best feedback from gold has been the price increase itself. With a return of over 400% in the last decade, many investors are buying in to get a piece of the action. Many believe gold will reach the inflation-adjusted all-time high of approximately $2,340. This would suggest approximately a 45% profit potential based on today's prices. Further positive feedback contributes regularly through pessimistic news, such as Greek default worries.

# MARKET INFLATION

The last and most crucial stage of a bubble is also the most important for evaluating support for current prices of a sector or market. Here, we will provide facts and figures that may suggest that gold is in a bubble rather than being fundamentally supported.

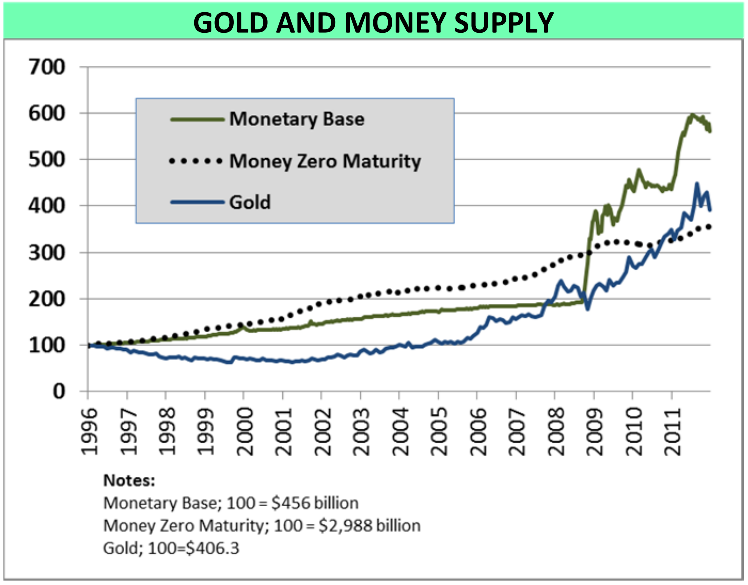
Inflation fears may be the biggest reason that investors buy gold. Gold's long stance as a store of value has made it the perfect substitute to the dollar. The Consumer Price Index, or CPI, is an index that measures price level changes in consumer goods and services. The annual percentage change in CPI is used to measure inflation rates. From 1871 to 2002, the CPI and gold prices had identical annual increases at an average of 2.1%, signifying a strong correlation between inflation and gold prices. However, the continued bull market in gold since 2002 has pushed the gold price's average annual increase to 2.9%, significantly separating the correlation between gold prices and the CPI[1]. The last decade has shown that the price of gold is not tied to inflation like it once was. Rather, despite with current low levels of inflation that at times have even flirted with deflation, gold has continued its incline. During the gold-highs of the late 1970's and 1980, the gold price could arguably be reasoned with high inflation levels. However, that is simply not the case of this gold rally.

PRICE OF GOLD VS. INFLATION




*Gold Prices in November 2011 Dollars
†Inflation figures are rolling 12 -month averages

Often cited by proponents of Gold is the "historic" rise in the U.S. Monetary base since 2008. When overlaid, the Monetary Base (M0) expansion and gold prices appear convincingly correlated. This correlation, argue those bullish on gold, that gold is simply adjusting for imminent inflation. This makes for good ratings and talking points, but poor economics. The Monetary Base "expansion" can be mostly attributed to the fact that on October 6, 2008 the Federal Reserve announced that it would pay interest on depository institutions' required and excess reserve balances. This policy change incented banks to hold reserves as the Fed now removed much of the opportunity cost once associated with holding excess reserves. Considering a measure that takes a more broad view of the money supply (Money Zero Maturity) the story looks a lot less compelling. Of the evidence available to those foreseeing higher gold prices, using the monetary base is a very poor predictor.




Despite the general haziness of the future, the US is projected to have slow, steady growth, particularly in the second half of this year. With improving conditions, the Fed will be expected to raise key rates in an effort to keep inflation low. This, in turn, will lower the prices of commodities and increase consumer discretionary spending and corporate profits. In August 2011, Fed Chairman Ben Bernanke said that the federal funds rate would likely be kept near lows until 2013. This does buy some time for gold, as investors cannot earn a significant return in cash or bank assets. However, it is important to be cautious for unexpected positive economic news that may bring a jolt to the economy.

Gold can be categorized as a bubble asset – it finds value from what others value it, not from what it produces. As a matter of fact, gold does not produce a new product or cash flows, so it cannot be accurately valued as an investment. Put simply, gold has value to an extent only because we believe it holds value. Despite not having an investment value, we can provide information on a commodity-basis that suggests gold's price is potentially trading at a 'fear-premium'. Historically, the median profit margin for gold miners has been 75%. As of June, 2011, this rate implied a fair value of approximately $1,085 per ounce of gold, suggesting that on a commodity demand basis, gold is significantly overpriced[2]. Also, the inflation-adjusted price of gold is trading dramatically above its median price since 1974. The premium to 'sleep well' a gold buyer is paying is currently nearly $800 per ounce, or about 100% of this median price since 1970.

# CONCLUSION

After evaluating the supporting aspects, one must decide if there is fundamental backing to support gold's price level. At these price levels, is the average investor investing too much – their wage, their home, their belongings – for a tulip or a piece of gold that does not produce anything, or is it likely to continue its decade surge? With current market uncertainties, gold's price may remain at current levels or increase further; however, the signs that gold is in a possible bubble cannot be disregarded, and investors should remain extremely cautious when making gold purchase decisions.

## Sources

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[1] Berezin, Peter. *The Outlook for Gold Prices*. Rep. no. 1. Vol. 62. Quebec: BCA Research, 2010. Print.

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## Other Valuable Sources

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