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All that glitters is gold … and silver

Precious metals have performed strongly recently due to increasing safe haven demand amid the unprecedented and worsening global financial and economic conditions. The various monetary and fiscal stimuli from governments and central banks that are doing rescue packages are spurring inflation concerns among investors and attracting substantial demand for "hard currencies" such as gold and silver.

Gold has risen again above the important $1,000/oz level to close at 1,002.2 last week, up 13.3 percent year-to-date. Meanwhile, silver has climbed back to $14.49/oz, up 28.2 percent year-to-date.

Source: www.stockcharts.com

Reasons to buy gold

As shares on stock markets around the globe lost an estimated $30.1 trillion in value in 2008, investment demand for gold (which includes ETFs, bars and coins) was 64 percent higher last year compared to that in 2007, according to the World Gold Council. Most notable is the demand for physical gold which rose 87 percent year-on-year with shortages reported across many parts of the globe. This trend is likely to be sustained in 2009 given the rising risk of inflation from governments and central banks trying to revive growth in their respective economies.

Below, we cite a number of reasons why gold will continue to be a key beneficiary of the current financial crisis:

1. Gold is a store of value. Its first use as money dated as far back as 700 BC in Lydia (now part of modern Turkey) where merchants used it for trade. This "barbaric relic" is back in vogue as investors realize its safe haven status in periods of crisis. During the last 8 years, gold has gained value against the world's fiat currencies as it benefitted from the reflationary efforts of the 2001 Tech bubble and the more recent global financial and economic downturn.

Gold Performance vs. Major Currencies (2001 to present)

	USD	EUR	JPY	CHF	GBP	AUD	CAD
2001	2.5%	8.1%	17.4%	5.0%	5.4%	11.3%	8.8%
2002	24.7%	5.9%	13.0%	3.9%	12.7%	13.5%	23.7%
2003	19.6%	-0.5%	7.9%	7.0%	7.9%	-10.5%	-2.2%
2004	5.2%	-2.1%	0.9%	-3.0%	-2.0%	1.4%	-2.0%
2005	18.2%	35.1%	35.7%	36.2%	31.8%	25.6%	14.5%
2006	22.8%	10.2%	24.0%	13.9%	7.8%	14.4%	22.8%
2007	31.4%	17.9%	24.7%	21.5%	29.2%	18.6%	10.4%
2008	5.8%	11.9%	-14.9%	0.2%	44.3%	32.5%	32.5%
Average	**16.3%**	**10.8%**	**13.6%**	**10.6%**	**17.1%**	**13.4%**	**13.6%**
2009 ytd	13.3%	23.6%	16.7%	22.8%	15.0%	23.7%	15.0%

Source: Bloomberg, Philequity Research

2. Gold is a hedge against inflation. The ultra-loose monetary policies by the Federal Reserve, the Bank of Japan, the Bank of England, the European Central Bank and other major central banks are creating inflation and debasing their respective currencies. These policies, however, do not devalue gold. In fact, as the supply of these fiat currencies increases, the relative scarcity of gold enhances its value.

3. Gold, likewise, is a safe haven during times of deflation. As household spending shrinks (in anticipation of lower consumer prices) and savings rise, households hoard cash and cash-equivalents like short-term US Treasuries, bank deposits and money market instruments. Gold is considered a “hard” currency and is also a cash equivalent. Therefore, it also benefits during times of economic stress and uncertainty.

4. Gold thrives when interest rates are low. Since demand for credit is low, the Fed and other central banks have pushed down rates to encourage economic recovery. So the opportunity cost of holding non-interest bearing assets such as gold is extremely low, further encouraging investors to favour gold over other assets.

5. Gold supply has fallen short of demand. Despite the boom in prices, gold production has been declining for the last three years and is unchanged from 2000 levels. In contrast, demand for gold increased 4 percent to 3,659 tonnes in 2008 alone, according to the World Gold Council. The most striking is the demand in 4Q08 which surged 26 percent on the same period the previous year at 1,036 tonnes.

6. Central banks are becoming buyers instead of sellers. After years of selling, Western central banks are curtailing gold sales while other central banks are buying gold. China and other large creditor nations such as Russia and OPEC nations with huge dollar denominated reserves and assets have reportedly been increasing the percentage of gold they hold in their currency reserves. China, which holds the world’s largest foreign reserves worth 1.81 trillion US dollars, has only 1 percent of its reserves in gold.

7. Mining companies have been unwinding their hedges. As prices continue to trend higher, most major companies have ceased their forward sales of gold. Moreover, as the gold bull market gains traction, mining companies are able to attract equity financing without the need to hedge.

8. Gold is now more accessible to investors. The advent of exchange traded funds (ETFs) has made it easier for the investors to own gold. In fact, the gold ETFs alone held 1,028 tonnes as of last week, more than all but six central banks.

Add gold to your portfolio

For the reasons mentioned above, we believe that gold should be an important part of one's portfolio.

The most obvious way to do this is to own it in "bullion" form. Actual coins or cast ingots (also called bars) can be bought from dealers and put in safe-deposit boxes. However, for security reasons and corresponding storage costs, it may be easier to own ETFs, which is a security that trades like a stock but represents a mutual fund that holds certificates for physical bullion that is on deposit and insured.

Two are currently trading on the New York Stock Exchange are Streettracks Gold Shares (symbol: GLD) and iShares COMEX Gold Trust (symbol: IAU). Gold Bullion Securities (symbol: GOLD) trades on the Australian Stock Exchange; and the Central Fund of Canada (symbol: CEF) which holds gold and silver, is traded on the Toronto Stock Exchange.

Another way is to trade in commodity futures and options, but this would be way too inaccessible for ordinary investors and would be far too risky because of the leverage involved.

Lastly, one can invest in gold by owning mining stocks. Stocks offer leverage because a 10 percent increase in the price of gold, for example, could have a 50 percent increase in the bottom line of a mining company. In addition, as price of gold and their corresponding earnings increase, the likelihood of receiving higher dividend payments also increases.

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