Publication: The Economic Times-Wealth

Headline: Is there a Gold Bubble Now?

Edition: All Editions

Date: 22nd August, 2011

Coverage

Is there a gold bubble now?

Though gold prices continue to rise steeply, experts believe that the trend may not continue for long.

NARENDRA NATHAN

After reporting consistent gains for the past 10 years, gold continues to be the best performing asset this year as well. The year-to-date return is a whopping 35% as the price of gold touched an all-time high of ₹27,840 per 10 gm on 19 August. While new investors and speculators are rushing to benefit from this 'golden harvest', seasoned players have already started raising an alarm. "Gold is getting into a bubble territory. Though the short-term uptrend may continue due to the ongoing sovereign crisis in the US and Europe, it can burst any time," warns Prithviraj Kothari, president, Bombay Bullion Association. So investors need to be cautious. While it is the 'safe haven' demand that is propping up gold, investors need to keep in mind that this is not a risk-free market. Gold had crashed to $260 an ounce (nearly 69%) after hitting a peak of $850 in 1980.

How long will the current rally continue? "Gold may remain strong for the next 6-9 months, but once things stabilise and other markets start doing well, money will move out of gold. After three years, gold prices may be lower than the current level," says Kishore Narne, head, commodity, Anand Rathi Financial Services.

What is triggering the gold rally?

Here's a look at some crises that are driving the gold market now.

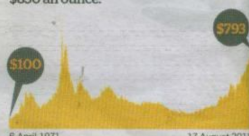
US crisis: One of the causes has been the downgrading of the US sovereign debt to AA+ from AAA, a rating it had held for the past 70 years. The efforts by the US government to support the faltering economy is another reason. For instance, rising interest rates usually lead investors away from gold. However, the decision by the US Federal Reserve to leave interest rates close to zero for two more years will boost the gold market.

Euro crisis: Several European countries, such as Portugal, Ireland, Greece, Spain and Italy, may be forced to default in the short to medium term. Their efforts to reduce spending and increase taxes are being hampered by a faltering Eurozone economy, which grew by just 0.2% in the second quarter, its worst performance after emerging from the recession in 2009. There are also concerns about the ability and willingness of relatively stronger countries, such as Germany and France, to support the troubled ones.

Currency crisis: As two major economic blocks (US & Europe) suffer problems, central bankers of several countries have started losing faith in their reserve currencies and have decided to buy gold as an alternative. For instance, in July, Thailand, South Korea and Kazakhstan added gold valued at $2.56 billion to their reserves.

Inflation-adjusted gold prices

The highest price of gold was in 1980 at $850 an ounce.



Gold price per ounce

Falling consumption demand

While the investment demand is shooting up (holdings in exchange-traded products backed by gold rose to a new record of 2,217 tonnes on 8 August), the consumption (jewellery) demand is on the wane. According to the recently released World Gold Council report, the global gold demand in the second quarter of 2011 came down by 17% y-o-y to 919.8 tonnes. "Gold demand is very poor now because of the high price. The consumption is down by 50% in the country compared with that last year," says Kothari. The majority of purchases from investors are for gold bars. This falling consumption demand is a warning sign of an emerging bubble. "There is a difference between investment and spending. Unlike gold jewellery, there is no emotion attached to gold bars, so when the price starts falling, these will be resold in the market," says Narne.

Why this may be a good time to buy a car **Page 35**

Traditionally, gold is a hedge against inflation and should be treated as such. Though there may be some trading potential left in gold (it is yet to reach its highest peak if one adjusts for inflation), the gap is small now. So, the investors who are in the gold market for quick gains should consider exiting their positions once their target is achieved.

Gold versus other precious metals

The speculation in silver is much higher compared to gold and this is the reason there has been a recent spurt in silver prices. However, high prices have already started affecting the jewellery demand, while industrial usage is being restricted due to the ongoing economic slowdown. "We are not bullish on silver now. It is predominantly a speculative commodity and holding on only because of the gold strength," says Narne. Silver is also extremely volatile. Its price crashed from a peak of $50 per ounce in January 1980 to a low of $4.90 by June 1982. The sideways moves continued for the next 10 years and touched a low of $3.50 in December 1993 (a whopping loss of 93% from its peak). Currently, silver is trading at $40, 20% below its all-time peak of 1980 (in absolute terms and not after adjusting for inflation).

Currently, the sudden spurt in gold price has taken it above that of platinum, which is not considered a pure precious metal, and hence, doesn't qualify as safe haven in a crisis. "In volume terms, the demand for platinum jewellery in India is less than 1% of gold jewellery," says Hasmukh Bafna, president, Gold Chains & Jewellery Wholesalers Welfare Association. Platinum's main demand comes from the automobile sector and this will fall further with the weakening global economy. "In the short term, gold will continue to outperform platinum, which will do well only when the global economy picks up," says Narne. However, platinum is extremely volatile and adding it won't bring stability to your portfolio. For instance, during the 2008 financial crisis, platinum prices crashed by more than 65% in just seven months.

The purpose of adding gold to your portfolio is not to increase returns, but to add stability by helping you generate better risk-adjusted returns. "Historically, gold has shown very little correlation with other asset classes, so it helps reduce the volatility of your portfolio," says Gaurav Mashruwala, a Mumbai-based financial planner. So, there is no need for you to indulge in panic buying or selling now. "Since gold is held in a portfolio as a hedge, gold component should be maintained irrespective of the price," advises Lakshmi Iyer, head of products, Kotak Mutual Fund. As a thumb rule, it should be restricted to 5-15% of your portfolio.

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