Publication: The Times of India

Headline: Is there a gold bubble now?

Edition: All Editions

Date: 29th August, 2011

Coverage

Is there a gold bubble now?

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

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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. However, seasoned players have already started raising an alarm. "Though the short-term uptrend may continue due to the ongoing sovereign crisis in the US and Europe, the bubble can burst any time," warns Prithviraj Kothari, president, Bombay Bullion Association. Investors must remember 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? "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. The efforts by the US government to support the faltering economy is another reason. Rising interest rates usually lead investors away from gold. However, the decision by the US Fed to leave interest rates close to zero for two more years will boost the gold market.

Euro crisis: Several European countries may be forced to default in the short to medium term. Efforts to reduce spending and raise taxes are being hampered by a faltering Eurozone economy. There are also concerns about the ability of relatively stronger countries like Germany and France to support the troubled ones.

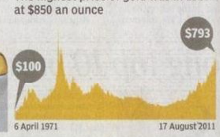
Currency crisis: As two major economic blocks suffer problems, central bankers of many countries have decided to buy gold as an alternative. In July, Thailand, South Korea and Kazakhstan added gold worth $2.56 billion to their reserves.

Falling consumption demand

According to the recently released World Gold Council report, the global gold demand in the second quarter of 2011 came down by 17% on a year on year basis. The majority of purchases from investors are for gold bars. This falling consumption demand is a warning sign of an emerging bubble. "Unlike gold jewellery, there is no emotion attached to gold bars. When the price starts falling, these will be resold," says Narne. Investors who are in the gold market for quick gains should consider exiting once their target is achieved.

Inflation-adjusted gold prices

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



Gold versus other precious metals

The speculation in silver is much higher compared to gold. 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. Silver is also extremely volatile. Its price crashed from $50 per ounce in January 1980 to a low of $4.90 by June 1982 and touched a low of $3.50 in December 1993. Currently, silver trades at $40, 20% below its all-time peak of 1980 in absolute terms. 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. "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. 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.

Gold helps to add stability to your portfolio by helping you generate better risk-adjusted returns. There is no need for you to indulge in panic buying or selling now. "Agold component should be maintained irrespective of the price," advises Lakshmi Iyer, head of products, Kotak Mutual Fund.