Title: Relatively ReValuing GOLD

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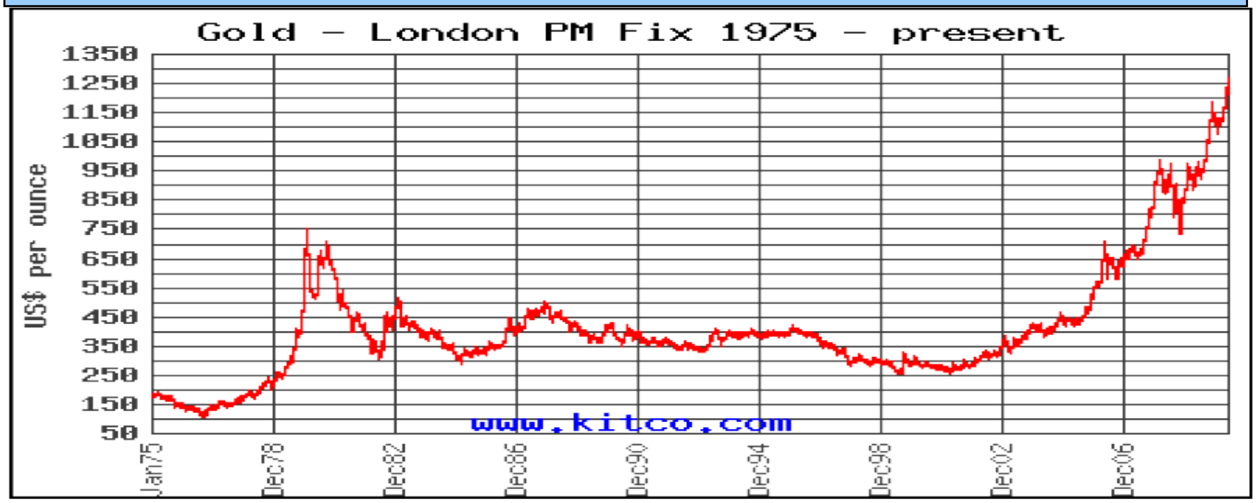
I was recently invited to speak at an Investors Forum in Mumbai. The first question that came up as soon as the Q & A session opened up was “What do we do on Gold?” Or “It’s already at USD 1,250/oz, up by around 12% in 2010? “. My response was “Do you urgently need the money“? NO, most of the investors replied in chorus. My next question was “Can you spare some more money for next 5 years or more“? YES, was the consensus and louder this time. “Invest at least 10% of that money in GOLD”. The immediate chatter amongst the skeptics was “At this price?”- No way. I asked “How does one value Gold? “. Expectedly, there was pin drop silence. I decided to try and break the ice on some of the interesting aspects on valuation of gold.

Chart I: Is GOLD the new “United Future World Currency”?



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Gold like any other commodity is very difficult to value. The standard asset valuation principles such as “Dividend Discounting Method” for stocks, often don’t work with gold since gold offers no dividends nor any future estimated earnings and a PE ratio. Like Bonds, Gold does not offer any fixed and regular coupons, which can be discounted at the appropriate interest rates, to arrive at the bond price. In fact Gold does not offer any regular or predictable cash inflows either in form of dividends or interest or in any other form. The only cash flow that can be generated from Gold is by “Leasing or Lending” it, but it’s a different ball game and not every gold investor has access to it or is keen to do it. The burden of returns from Gold falls more or less on capital gains.

So how does one decide whether Gold is correctly valued, undervalued or overvalued?

Here the unique characteristics of Gold such as “A Proxy Currency or Store of Value” come to our rescue. These attributes of Gold helps us to value Gold on “Relative Basis” vis a vis comparable macro economic variables or asset classes. For instance, take real estate as an asset class. If one wants to buy an apartment in a particular locality, one does check up the recent prices of similar or closely comparable apartments in the same locality, or more, in the same block. Some fine tuning is done to the final price depending on the condition of the apartment or community which one intends to buy.

If Gold has to be valued on relative basis, what can it be compared to? There are many options for relative valuation of Gold. We will primarily deal with the ones which have strong historical & economic relationships with the Gold Price.

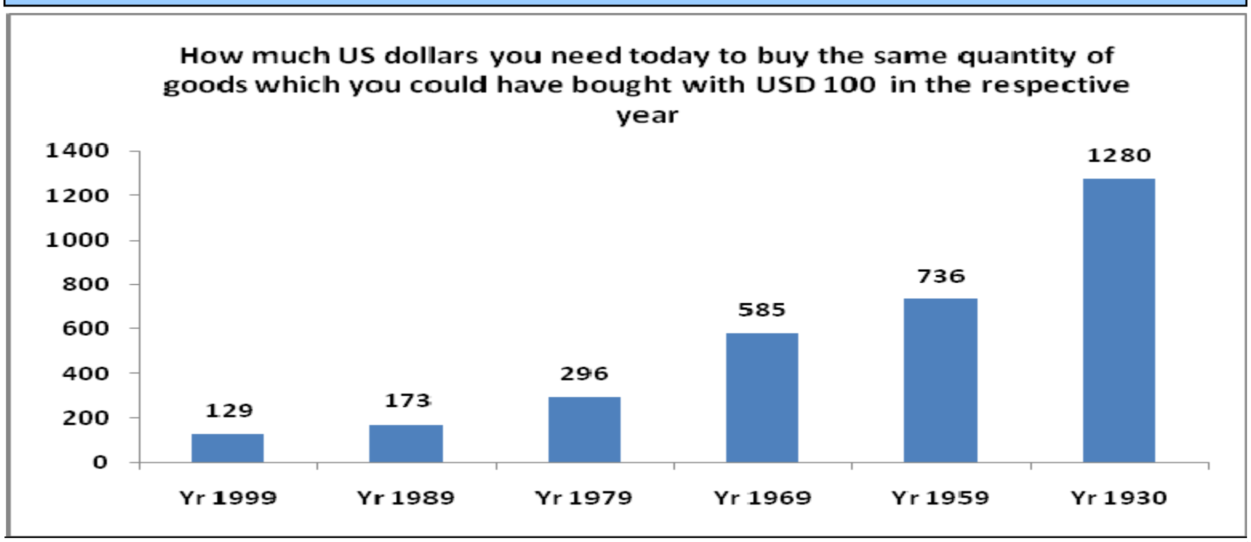
The first one is Inflation. Since Gold also is a Store of Value (it retains purchasing power) it can also be compared to Inflation which is nothing but a general rise in price levels in an economy. A rising inflation reduces the purchasing power of paper currencies. And Gold is an excellent Inflation hedge.

The second one that comes to my mind is the paper currencies or the paper money that are in circulation in the world. Since Gold is an alternative or Proxy Currency. These paper currencies are issued by respective Central Banks. We all remember the Gold Standard of 1970s in USA, where the value of the US Dollar was fixed in terms of weight of Gold, effectively making Gold as the Proxy currency or a monetary system.

And similarly Gold can be compared to many such other macro economic variables or asset classes. In other words we can express (or adjust) the price of Gold it in terms of changes in these economic variables and asset classes over a period of time, in order to compare the relative growth rates.

Let's see what the Gold price would be now if it's adjusted to the Inflation (CPI) levels in USA. In other words say from its 1980 peak if the Gold price rise would have matched the rise in inflation levels, the price of Gold would have been around USD 2,300 per oz. That's a rise of 84% from current levels. This is also known as the Inflation Adjusted price of Gold. The Chart II will show you how inflation has eroded US Dollar's purchasing power over past few decades. In last 30 years, consumers who pay in US Dollars had to shell out almost 3 times more.

Chart II: Inflation (CPI) – Loss of US Dollar's Purchasing Power



Data Source: www.measuringworth.com. Data up to year end 2009. For e.g: You will need USD 129 now to buy the same quantity of goods that USD 100 could have bought in the year -1999. Working based on US CPI.

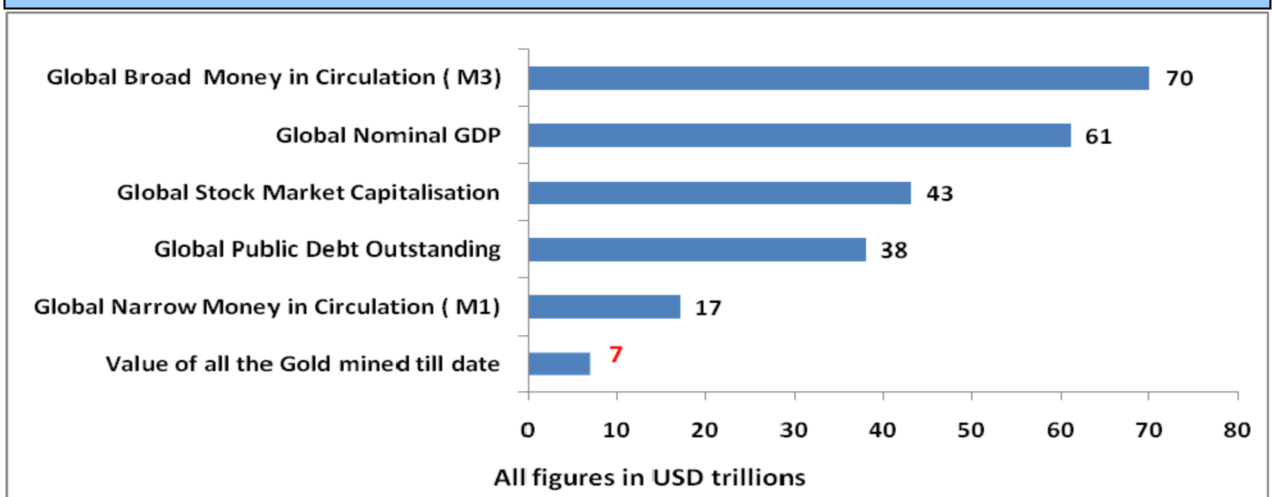
Now let's turn to Gold prices being compared to the growth Global Broad Money Supply (M3). Since 1980, the M3 growth world over has exploded due to various policy (monetary) and non policy reasons. Various estimates of the Global M3 growth since 1980 are at around 8-9 times at least. Whereas the Gold prices since 1980 peak are up just by 1.4 times. If all the money supply growth since 1980 has to be hypothetically backed by Gold by global central banks, the price of Gold would be anywhere between USD 6,000-7,000 per ounce. If the same calculations are done for Global Narrow Money (M1: Currency in Circulation + Demand Deposits) the price of Gold should have been around USD 3,100 per ounce.

The Global GDP (output) growth has been around 6 times since 1980. If the Gold price had to match with the gains in Global GDP, it should be around USD 5,500 per ounce now. The total value of gold mined till date is only around 11% of the Global GDP now.

Let's compare Gold's relative relationship with DJIA (Dow), the benchmark stock index of USA. The Dow to Gold ratio now stands at around 8. And the long term average is around 10. The ratio was at its low of around 1.5 when Gold peaked in 1980. For the ratio to revisit the lows of 1.5 either Gold has to go to USD 6,500 per ounce or Dow has to collapse to 2,000 levels, which certainly looks like a Black Swan event as of now. The total value of gold mined (above the ground stocks) till date is only 17%% of the current Global Stock Market Capitalization.

Similarly the Gold- Crude Oil ratio now stands at 16. The long term average of the same is around 14.5-15. The ratio signifies that "How much Gold do you need to buy a barrel of crude oil "over different periods of time. There is a strong relationship between Crude oil and Gold as the former influences inflation and the latter is a proxy currency, which retains ones purchasing power. If the ratio has to revert to its long term mean and crude oil remains at current level, Gold would be lower at 1,170 per ounce.

Chart III: Is Gold a "Relative" Bubble?



Source: Various Estimates. Note: In absence of authenticated figures from reliable sources, some of the above figures are only estimates and extrapolations.

These "Relative Valuations" though may not be precise "being relative" and have to be supplemented by a forecast of demand supply balance. Such valuations may not be exact science or forecasts and are more hypothetical in nature. But in absence of traditional methods of valuations for Gold, they do provide an insight into where the gold prices are now vis a vis other related economic variables.

Table I: The Why's and Why Not's for GOLD

Why Gold?	Why not Gold ?
Lower interest rates for some time & Liquidity	Rise in Real Interest Rates
Sovereign Crisis & Safe Haven demand	Stronger Economic recovery, with low inflation
Debt Monetization and Currency Debasement	Rise in Global Risk Appetite
Rising newer Investment Demand (China)	Weaker Jewelery Demand at higher prices
Central Bank diversification Demand buoyant	Sovereign risks abate : Lower Safe haven bid
Higher Inflation and USD depreciation	Indian Rupee appreciation (For India only)
New Gold supply restricted	New reserves discovery & Higher scrap supply

Source; Delta Global Partners Research

Recently Bloomberg reported that the Russian President Dmitry Medvedev illustrated his call for a supranational currency to replace the US Dollar by pulling from his pocket a sample coin of a "united future world currency". Though it was not mentioned that what the coin was made of. I did suspect Gold, which perfectly fits the bill, since Russian Central Bank has been buying Gold to diversify its foreign exchange reserves position.

I did put my final question to the audience at the forum "Do you wait for the lowest level of insurance premiums for taking your medical or car insurance policies? NO was the answer, "We renew it on expiry". So why wait for lower prices to buy your portfolio insurance? There is never a wrong time to buy Gold, in fact Gold does comes to your rescue as portfolio insurance during wrong times. And the cost of insurance will be the highest after a crisis takes place.

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