

**Title: The Colors of Swans & Dubai Burj**

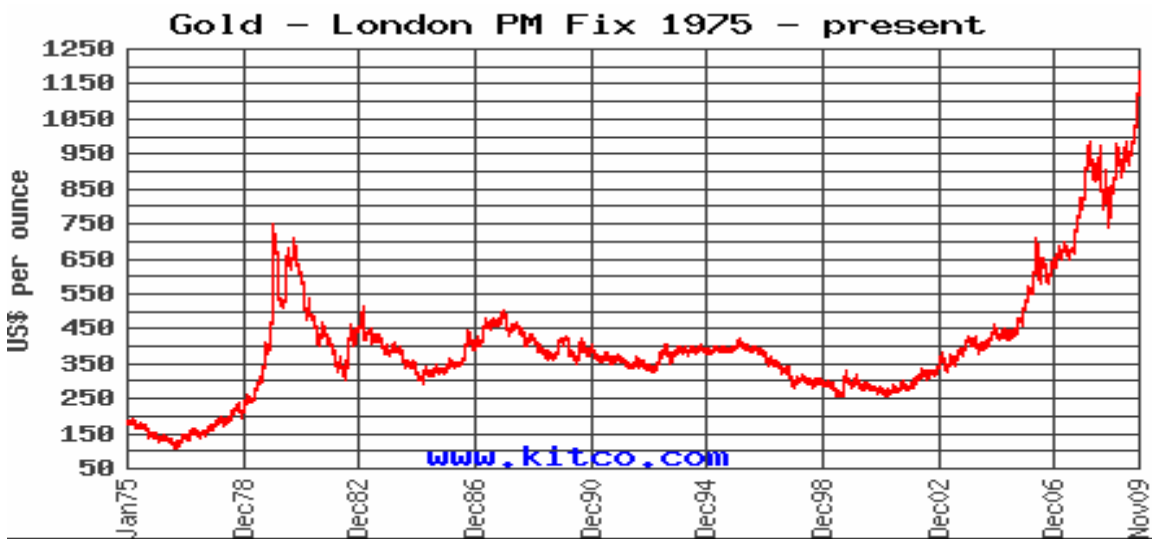
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The financial world was rocked by the USD 59 bn Desert Storm in last week. The Dubai debacle once again allowed the demon of credit crisis to raise its head. When the world was talking about the demise of recession and the credit crisis, Dubai came in form of the Black Swan in the flock of white ones, as aptly described by Nassim Taleb. It's an event which has very low probability of occurring. This set off the trigger for the synchronized fall in risky asset classes on the day of the unfateful announcement was made by Dubai World.

“The Fear of Unknown proved to be larger than the fear of known. “

Unknowingly, another event went unnoticed, which though was not surprising. Gold in international markets touched at an all time high of USD 1220/oz. This event though by any chance can't be termed as a Black Swan one, since all the factors for a gold price rise have been in place.

### Chart I: The Golden Swan



Source: www.kitco.com

Now the simplest question that can be put to any investment professional is “Will Gold Prices go above the level of top floor of Dubai Burj, the world's tallest building?” And the answer to that simple question is not very simple.

To begin with let's understand the 10 reasons as to why did the gold price go up and whether any of these reasons are likely to change in coming years.

1. The US dollar depreciated sharply and Gold has historically a very high negative correlation with it. If USD goes higher, Gold goes lower & vice versa.
2. As the sentiment on US Dollar turned negative, the global central banks such as from India, Sri Lanka, and Mauritius started buying physical Gold

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- directly from IMF to diversify there reserves from the USD onslaught. This also took the equivalent supply off the markets. Globally around 65% of the official world's reserves are held in US Dollar. If other central banks like China which holds only about 1,054 tonnes of gold (out of almost USD 2 trn of reserves), start diversifying even to the extent of say 1% more, I can't make a guess on gold prices. And I had read in many columns that Central Banks world over don't like gold and would work to keep its prices lower as it's a proxy currency which competes with the paper currency issued by them. Lower gold prices also signify global economic calm and certainty which every Central Bank is keen on. Well, another myth on Central Banks has been busted. They love Gold as we do.
3. Global Foreign Exchange policies (especially the US Dollar pegs or semi pegs) and buying insurance in event of another crisis have boosted the foreign exchange reserves of countries like China to dizzy levels. So the world's official reserves now stand at around USD 8 trn. Export dependent countries need to stem there currency appreciation to reflate there economies. As reserves rise, global liquidity as well as need for diversification of currency risks rises, creating more demand more gold.
  4. The massive monetary (money printing) and fiscal stimulus globally has lead to rise in the inflationary expectations (expected currency debasement). Traditionally Gold is an excellent inflation hedge as it's a good store of value, viz protects your purchasing power, as rising inflation reduces it. Higher inflation pushes the demand for real assets such as commodities higher as paper currencies/assets are shunned.
  5. As the US Dollar is negatively co related with Gold, the global risk appetite is also negatively co related with US Dollar, more so in recent times. As risk appetite in the world rises, the US Dollar depreciates and vice versa. This happens as US Dollar loses its safe haven status, resulting in capital outflows from US. And the world changed on March 09, 2009, when global risk appetite was back with vengeance.
  6. Any incoherency or political influence on the US fiscal or monetary policy, especially on the timing of exit of the same, leads to lack of confidence on US Federal Reserve/Government. Especially with reference to the ability to control an inflationary spiral. This has also helped the Gold Prices in recent times.
  7. The emergence of China as the new consumer of Gold has added significantly to the jewelry demand. China might overtake India in Gold consumption in the coming years. China's consumption is expected to be at 450 mt in 2009 vis a vis 395.6 mt in 2008. China had already overtaken South Africa as the largest producer of Gold in the world.
  8. The Non physical demand for gold in form of Exchange Traded Funds (ETFs) been growing in recent times as smaller investors run for cover against the falling US Dollar. World over, now ETFs hold more than 1,700 mt of Gold.
  9. The supply of gold remains restricted with no new discoveries happening around the world as very little amount of investment has gone in the new

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discoveries. Higher cost of mining remains a constraint too. Though the jewelry demand world over was weaker, its expected to improve as global recession ebbs completely, especially in countries like India, where demand arising out occasions such as weddings etc tends to be price inelastic. The China demand for jewelry was on a strong upswing in 2009. As prices rise, the gold producer's de hedging activity is likely to remain a reasonable source of demand. Though the recent termination of hedges by Barrick Gold (3 m oz) since September 2009, will ease some demand pressure.

10. The US Dollar carry trade will continue as long as Fed doesn't explicitly signal a hike in interest rates or clarifies its exit strategies and the unilateral directional bet on a weaker US Dollar persist. Gold like other commodities is one of the beneficiary of the global carry trade

Most of the above 10 reasons are likely to continue supporting the gold price in 2010. Though there are likely to be bouts of profit bookings and volatility, especially stemming from USD appreciation if risk aversion returns. But the characteristic of gold to act as portfolio insurance in event of a Black Swan event would necessitate exposure of 10-15% of your portfolio by making regular investments. You need this exposure even for a "Brown Swan" event like the recent report (The Washington Post) on revaluation of the North Korean currency (Won) sent by a very close friend of mine. This would wipe out the value of the currency notes in one shot overnight and thus savings of millions. Imagine the pain if your bill of USD 1,000 is replaced with a USD 10 one overnight, without an equivalent rise in purchasing power of it. Thankfully this can't happen with Gold.

On a closing note, this is for the students of statistics. Broad estimates of gold extracted world over till date range from 158,000 to 165,000 tonnes. At current prices the value of the same comes at around USD 6.5-7 trn. And again a broad estimate of the US Dollar under circulation worldwide is around USD 60-65 trn, viz almost 10 times the gold value.

With this statistic, which currency is undervalued: The US Dollar or the proxy one, Gold?

And for Indian gold investors, the expected Rupee appreciation, weakness in the jewelry demand at higher levels and rising gold scrap sales, remain the headwinds to the gold prices. It will be probably a "Black Swan" event if Gold does not deliver reasonable risk adjusted returns in next few years.

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