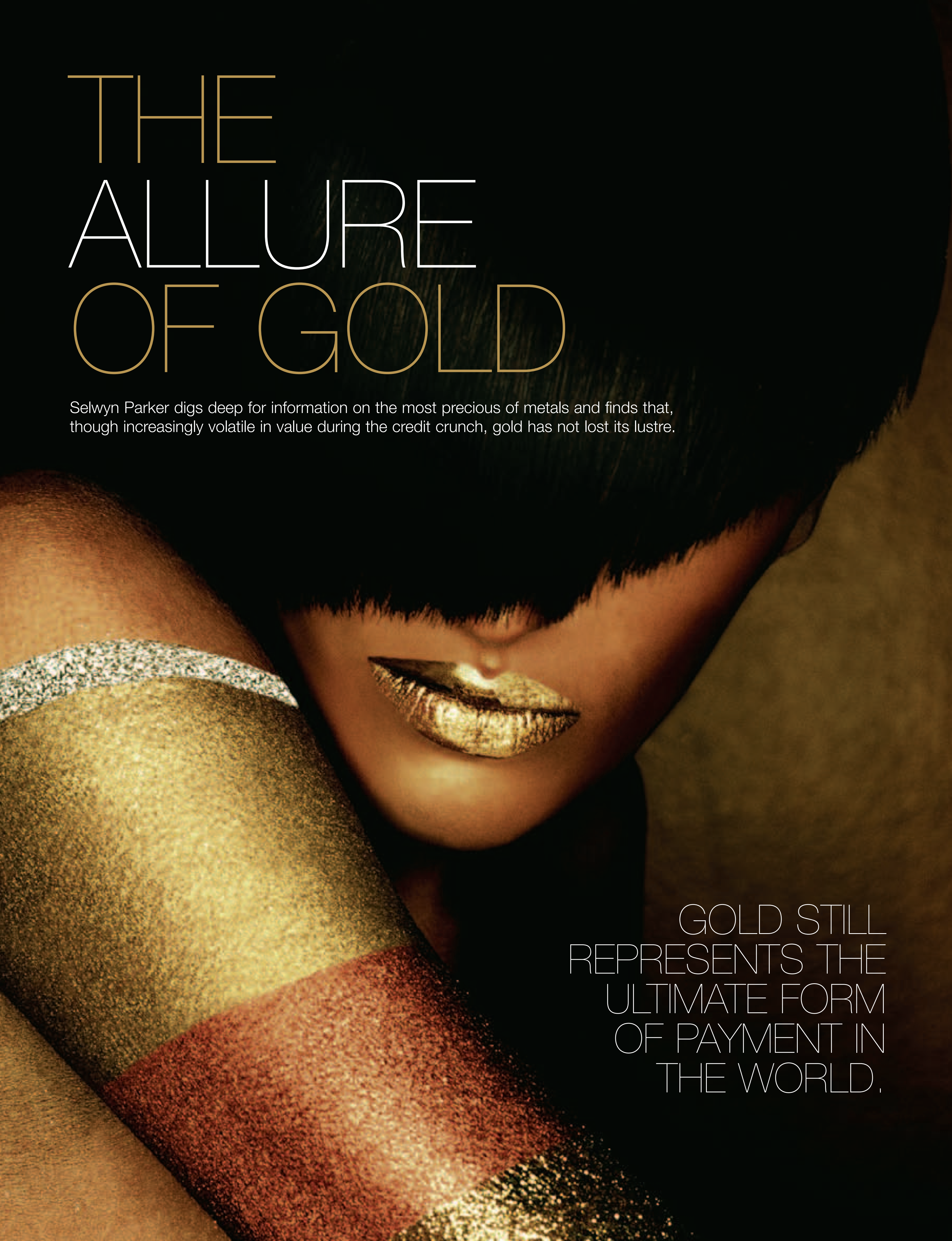
THE ALLURE OF GOLD

Selwyn Parker digs deep for information on the most precious of metals and finds that, though increasingly volatile in value during the credit crunch, gold has not lost its lustre.



GOLD STILL REPRESENTS THE ULTIMATE FORM OF PAYMENT IN THE WORLD.

Stacked on top of one another far below the teeming streets of central London are hundreds of tonnes of 400-ounce bars. Gleaming dully in the half-light they amount to one of Europe's largest hoards of the most precious of metals. Yet, this is not the Bank of England.

The vault belongs to SPDR Gold Shares, the biggest of the new breed of exchange-traded funds (ETFs), that allow investors to buy or sell gold without the inconvenience of having to physically transfer the precious (and heavy) metal. Investors buy gold shares representing fractional, undivided interests in the gold trust that stores the metal on their behalf. In this way the investor builds up a 'basket' of gold without having to find a home for it.

As SPDR points out: 'For many investors the transaction costs… are expected to be lower than the costs associated with the purchase, storage and insurance of physical gold.' Such is the demand for ETF-traded gold that SPDR's vault alone contains twice as much bullion as the Old Lady of Threadneedle Street.

In these financially troubled times, gold is gleaming. When, for instance, Russian troops invaded Georgia in August, the price of the metal jumped right around the world. When oil prices spiked again a few days later, gold spiked with it. Yet, prices have tumbled at times this year, so has gold retained its magnetism?

Value proposition

Apart from the inevitable falls as investors take profits, gold prices have held remarkably steady since the beginning of the credit crunch, reflecting demand from investors and industry alike. At $21.2 billion, global demand for gold hit record levels in the second quarter of 2008, up 9% on 2007.

According to the World Gold Council, the industry authority, investors accounted for most of that demand. Indeed total gold purchases during the quarter hit $3.5 billion, up a whopping 29% on the corresponding period last year. Rallying from a fall in total holdings at the start of the quarter, the ETFs picked up a disproportionate share of that $3.5 billion. By June, combined holdings in the gold ETFs cracked the 1,000 tonne barrier. This year's frenzied debut of the Shanghai gold futures market tells the story. On opening day – 9 January – China's gold-mad investors bid $100 over the prevailing international spot rate, already high.

But let's take a step back. It wasn't so long ago that the yellow metal was trading at $250 a troy ounce and gold bugs (in investment parlance) were considered cranks who should have been buying equities or gilts. But now that gold hovers comfortably above the $800 mark, down from the stratospheric $900 of May but still high, gold bugs are hailed as astute contrarians who stuck to their principles instead of following the herd.

Gold has always been a safe haven in stormy times. As Alan Greenspan, legendary former head of the US Federal Reserve has remarked: 'Gold still represents the ultimate form of payment in the world. Fiat money [currency], in extremis, is accepted by nobody. Gold is always accepted.'

It's been like that for millennia, which is probably why we have such faith in the metal. It was the quality of the coin, preferably a gold one, which became the basis for trade in the earliest European markets when nobody trusted other forms of payment.

Indeed, in the twentieth century, we have taken refuge in the comfort zone of gold during periods of upheaval. As US banks failed at the rate of a thousand or more every year in the Great Depression of the early thirties, so many Americans wanted gold that President Roosevelt felt obliged to outlaw private possession of it. Similarly, when interest rates turned negative in the stagflation of the seventies, so many investors wanted gold and other precious metals that they created a bubble, pushing up the price alarmingly.

Today, threats of war and other national crises highly motivate gold bugs who fear the local currency will be devalued or otherwise debauched as a result of the upheavals. Gold has certainly behaved true to form during the credit crunch. At the height of the ruptures in the money markets, the price jumped rapidly to $865 before hitting a peak of $1,011 on March 17. A decline was inevitable from these peaks but in late August gold was still nudging the $800 mark, which looked like a floor to many gold-watchers.

Home truths

American economist Tim Lee of Pi Economics, who measures the price of gold in relation to house prices, explains the significance of current values. When the price was low in the early seventies, it took 700 ounces to buy an average house. That compares with the roughly 350 ounces in more normal times. 'But now the ratio has fallen below 220 ounces,' Lee points out.

To put it another way, anybody buying 700 ounces cheaply in the seventies would now be able to buy three median-value homes instead of just one.

So, where now for gold prices? The bulls argue that gold is too cheap even at over $800. It's certainly true that in inflation-adjusted terms, gold is way off of its record peaks. In 1980, when Soviet tanks rumbled into Afghanistan, the price shot up to $850. Adjusted for inflation, that is equivalent to around $1,400 today. One bull argues that, if the value had only kept pace with inflation, 'the nominal price would be closer to $2,200 today'. Short of a complete meltdown in the financial and equity markets, nobody however is backing gold to hit those highs.

So, current gold prices look reasonably stable as long as uncertainty persists about the global economy. As Barclays Capital commodities researcher Suki Cooper and her colleagues surmised in their latest report: 'Bouts of dollar weakness and constrained mine supply, among other favourable external factors, are likely to support investor interest in gold.' As the research team points out, it is investors who are the key determining factor.

Some analysts of this most seductive of commodities say that the most accurate guide to gold's future performance is the state of the American economy, and more specifically, the state of the dollar and treasury bond rates. If the greenback continues to depreciate, goes this theory, gold will glitter and the bull-run will go on and on. Ultimately, this assumption is based on the rate of inflation – high inflation assumes a declining dollar.

For its part, the World Gold Council believes the bull run is based on

THE GOLD ROAD

- In medieval times, gold was often seen as beneficial for the health, in the belief that being rare and beautiful ascribed it medicinal powers. However, only salts and radioisotopes of gold are of pharmacological value, because elemental gold is inert to all chemicals it encounters inside the body.
- Gold has been associated with the extremities of utmost evil and great sanctity throughout history. In the Book of Exodus, the Golden Calf is a symbol of idolatry and rebellion against God.
- German chemist Fritz Haber attempted commercial extraction of gold from sea water in an effort to help pay Germany's reparations following the First World War. Unfortunately, his assessment of the concentration of gold in sea water was unduly high, probably due to sample contamination.
- The mineral pyrite, or iron pyrite, is an iron sulfide with the formula FeS_2. Its brass-yellow hue has earned it the nickname fool's gold.
- The largest goldmine in the world is BHP Billiton's Australian Olympic Dam situated 330 miles north of Adelaide, South Australia.
- 85% of gold is sold to the jewellery sector.
- The Federal Reserve Bank of New York is home to the world's gold repository. Roughly one-quarter of the world's official reserves, weighing in at 7,000 tons and worth $160 billion as of March, 2008, sits 26 million below sea level on the bedrock of Manhattan in a vault with no door, guarded by sharpshooters.

fundamentals rather than fear. 'I'm confident the general investment environment remains positive,' chief executive James Burton opines, pointing out that gold prices have a firmer foundation than they did in 1980. '[Current prices] followed a sustained six-year rise and were built on a combination of strong investment and jewellery demand.'

This does not however mean gold is entirely shock-proof. The price fell by double figures in the wake of the Bear Stearns banking crisis in March while oil jumped 17 per cent. And some go so far as to predict something of a collapse. Pi Economics' Tim Lee believes that, along with the commodities boom in general, 'gold is clearly well overpriced.'

However, gold prices have a habit of making fools of the bears. Not long after Henry Blodgett, author of the Wall Street Self-defense Manual, argued that gold's long-term role as a prop of the world's monetary system was over and would never again be a store of value, the price took off. What can definitively be argued is that, because of the sentiment attached to the metal, its future price has long been notoriously difficult to predict.

There's also the fact that, unlike oil, there is not a lot of gold around. The metal is increasingly expensive to mine, especially in the case of lower-grade seams, and it can take a decade from discovery to production. 'The major constraint is the cost of production', explains the World Gold Council's Matt Graydon. 'It has risen considerably in the last few years.' Output has been on the decline in South Africa, historically the world's biggest producer. Indeed China has just taken over its mantle.

BAR MADE

Usually found in pure form in veins, often mixed with quartz, gold is generally drilled, blasted or dug out of the rock in a growing number of nations but notably South Africa, China, Australia, United States (especially Nevada and Alaska), Russia, Uzbekistan and Papua New Guinea. It is washed and filtered at the site before being shipped off to a mill where it is separated from the ore by various chemical methods under the tightest security. Once isolated, the gold is skimmed off and melted into ingots of uniform size.

Who are the gold bugs?

Nobody knows the precise demographics but there is no doubt that the ownership of the metal is democratising rapidly. The ETFs' share of the world's physical bullion jumped by a remarkable 34 per cent over 2007, prompting Credit Suisse Standard Securities' analyst David Davis to observe that the funds have 'become the people's central bank'.

Industrial applications are increasing too, particularly in electronics. For example, a company called Nanostellar has developed a promising gold-based catalyst formulation for the automotive industry that will increase demand over time.

And forgetting for a moment the geopolitics of the gold market, there is the simple fact that more and more people want to wear gold, not just bury it in a vault. Rising affluence around the world, particularly in the petrodollar-rich Middle East, China, India and big-spending Russia, means more of the metal is actually being used in luxury, branded products from watches to necklaces. This is why gold bugs monitor the festival and wedding markets in India and the Middle East when celebrants buy gold by the tonne.

Whatever happens to the spot price, gold will always have a special allure partly because of its historic association with coin. In mid-2006 an anonymous buyer paid £460,000 at Spink's auction house for one of the great rarities of numismatics – an Edward III double leopard of about 1341. As Ian Goldbart, the managing director of Baldwin's auction house and a long-time collector, told me at the auction: '[English gold money] is part of our heritage, it's Agincourt and Crecy.'

You couldn't say that about pork bellies. ■