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Gold: how strong is the investment case?

Summary:

1. In the medium term the demand for gold jewellery, and probably the store of wealth arguments in favour of gold are likely to be driven by rising incomes and by growing demand for luxury goods in the emerging markets.

2. Global mining output is still below the levels reached in the late 1990s, despite the rapid growth in production from China in particular. Long lags in developing new mines, increasingly difficult geological conditions and shortages of skilled labour (especially in South Africa) look likely to constrain output. However, the soaring price of gold has also transformed the underlying operating margins of the gold miners, and sustained high prices could elicit a significant response in production, despite concerns that output has been more constrained by geology than economics.

3. Retail investment demand for gold is encouraged by crises (as in late 2008) and by momentum marketing. Retail hoarding will follow prices which could (and probably will) exacerbate sharp market movements in either direction.

4. Central bank demand remains the 800lb gorilla of the gold market. Despite the existence of protocols designed to limit market impact, most recently renewed by Eurozone members in autumn 2009, the attractions of gold for central banks, which feel buffeted by the US government's "benign" neglect of the dollar, are considerable. But the decision of the central banks could go either way.

5. Despite the recent strong appreciation of the gold price, there are still good reasons to have a modest holding of gold in a long term investment strategy. We think that the most persuasive long term argument is that it represents a "play" on the emerging market luxury goods theme, rather than, for example, that as an inflation hedge or a "safe-haven" at times of crisis.

6. However, Delmore does not feel comfortable to recommend gold as a core holding for its client portfolios. This reflects our concerns about the extent of retail demand for jewellery and how supply through gold recycling will offset the recent sharp rise in price. We are also uncertain about how central banks will behave and furthermore we are not persuaded by the argument that gold is a sufficiently reliable hedge against poor financial markets.

Nevertheless, we expect that there will be times when we will have wished that we had been more positive.

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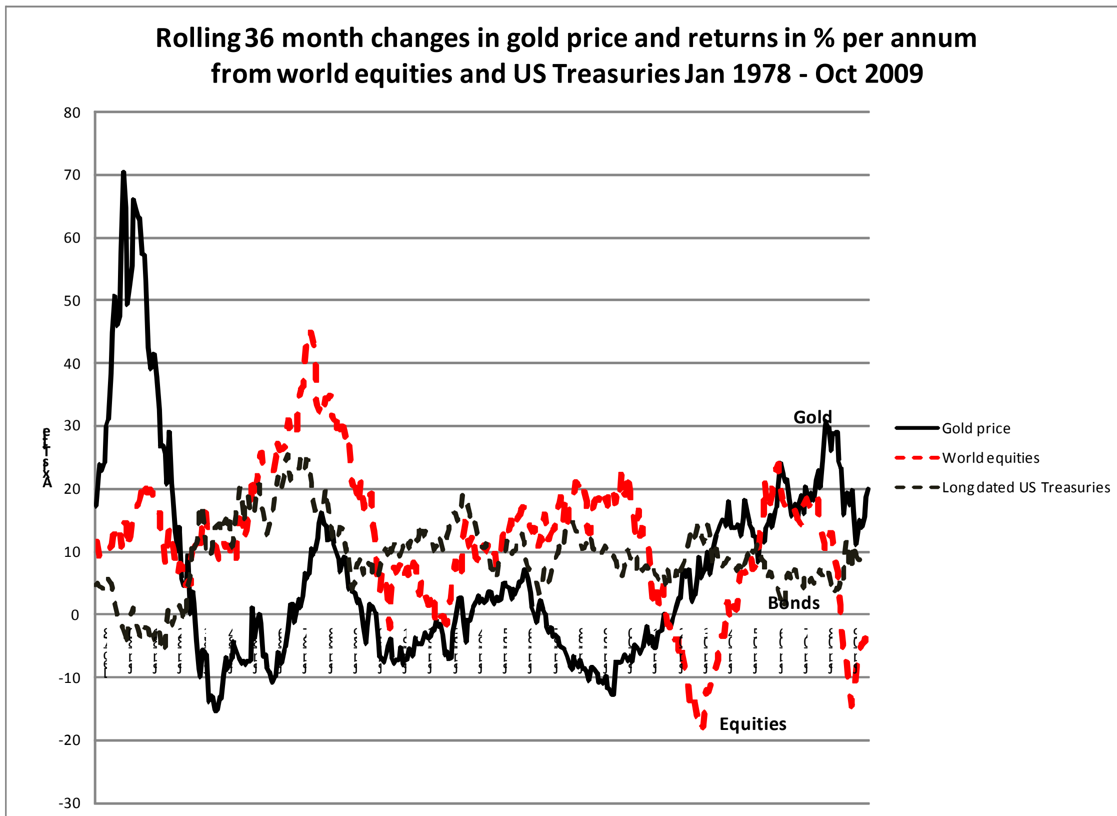
Market background

Any assessment of investing in gold needs to address two issues. Firstly, the prospects for the gold price and secondly whether gold provides an insurance policy against adverse financial markets.[1]

First, some history. The first chart plots the evolution of the nominal and inflation adjusted gold price since December 1975, by which time the market had been liberalised having been fixed until 1970 at $35 per ounce. The chart starts and ends with pronounced bull markets, with a prolonged bear market occupying much of the time in between. The striking feature of the chart is that after allowing for inflation, the current gold price of over $1,200 per ounce is still below the levels reached in the late 1970s, if allowance is made for inflation. The other highlight of the chart is the length of the persistent bear market from 1987 to the turn of the century.

[1] In this report, prices are quoted in US $ per troy ounce and volumes in tonnes. There are 32,151 ounces per tonne and so if the gold price is $1000 per ounce, 1000 tonnes of gold would be valued at $32.2 billion.

The next chart shows how the gold price has changed over rolling 36 month periods in comparison with the total return from the MSCI World index and the index for long dated US Treasury bonds. There are two main features: the first is the prolonged underperformance of gold during the 20 years that followed the gold bull market of the 1970s; the second is the outperformance of gold during the past decade.



The performance of the gold price during the credit crunch of 2007-9 and also during the equity bear market of 2000-2 supports the popular perception of a hedging role for gold. This experience is also illustrated in the table below which shows the performance of gold, and US Treasuries in the calendar years of weakest global equity performance since 1976. It is strongly suggestive of a diversifying role for gold, although it also warns against banking on strong gold market performance when equities are extremely weak.

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Gold and US Treasuries in worst years for world equities since 1976

	MSCI world equities	Gold price	Long dated US Treasuries
Dec-08	-40.3	4.3	25.9
Dec-02	-19.5	25.6	17.8
Dec-01	-16.5	0.7	3.7
Dec-90	-16.5	-3.1	6.2

Source: MSCI Barra, Morningstar Ibbotson, World Gold Council,

This issue is also explored in the appendix with a chart that shows the performance of gold and Treasury bonds in months of extreme equity market performance, a chart which suggests that the effectiveness of the short term hedging role of gold may be quite weak. The chart also looks at the performance of equities and bonds in months when the gold price has risen or fallen the most. If anything, the statistics suggest that gold tends to do well when financial markets are also doing well.

It is likely that gold's ability to perform well as a diversifying asset and even as a "safe-harbour" will primarily depend upon demand and supply conditions in the gold market. Around the time of the collapse of Lehman In late 2008, the gold industry statistics indicate a strong increase in safe-harbour retail demand for gold, demand which was unrelated to the longer term demand and supply trends. The attraction of gold as an opportunistic or as a medium term investment will of course depend on whether market conditions remain tight.

Supply and demand in the gold market

The table overleaf gives an overview of the main sources of supply and demand for gold. The picture can be summarised as follows: total gold production is around 2,500 tonnes per year and recent years have seen a major increase in production by China. In the past 20 years, gold production, which peaked in 2000, has been supplemented by sales by central banks (including the Bank of England). The other significant source of supply is recycling which is probably around 1,500 tonnes per year, but is strongly influenced by the gold price, and 2009's level of recycling may be unsustainably high due to the incentives offered by high prices in 2008-9. So, total world gold supply is around 4,000 tonnes per year. But central banks have in their vaults around 30,000 tonnes, equivalent to 8 years' global supply which is estimated to be almost 20% of the total gold ever mined.

The manufacture of jewellery is the principal outlet for the gold that is brought to market. In 2009, recession has reduced this to below 2000 tonnes or around 50% of world supply. Dentistry and industry (especially electronics) represents around 10% of global demand. The remainder represents private sector demand to acquire gold as an investment or a store of value.

Retail demand for gold

The demand for jewellery and the store of value motive for holding gold are both affected, in different ways, by the economy. In the short term, recession adversely affects the demand for jewellery, while increased uncertainty may increase precautionary demand for gold. In the medium term, the demand for gold is positively related to increasing wealth and incomes in the principal consumer markets, which are India and China.

Consumer demand for gold 2008
Tonnes

	Jewellery	Net retail investment	Total	%
India	502	211	713	23%
Greater China	356	76	432	14%
Middle East	318	28	346	11%
USA	188	79	267	9%
Turkey	153	57	210	7%
Other	669	412	1,081	35%
World total	2,186	863	3,048	100%

Source: World Gold Council

Since gold is a luxury good, it is reasonable to expect its demand to grow faster than incomes. The incomes that matter most for the gold market are those in China and India, which we expect to grow faster than the rest of the world for the foreseeable future. It is likely that the global demand for gold jewellery will grow at least as fast as the growth of consumer incomes in the BRIC nations.

However, retail demand is constrained by price. There are already anecdotal reports of dowries of gold in India being expressed in rupees rather than by weight, and also reports of growing demand for gold plated jewellery, apparently - but this is less clear – at the expense of solid gold jewellery. If there is a constraint on retail demand for gold in the years ahead, it is most likely to come from the impact of high prices. For investors, a fundamental difficulty is that estimates of how demand might respond to high prices will mostly be based on data from a period of less volatile prices or very different income levels, which may not be provide a reliable basis for forecasting the future. There is though significant scope for jewellery demand to weaken and for gold recycling to increase in response to recent price appreciation.

Central Banks

Central bank participation in the gold market is also difficult to assess. Gold has always been a mainstay of central bank reserves. This can be dismissed as an anachronism, a hang-over from the gold standard. But this begs the question of why banking was ever based around gold (and to a lesser extent silver). In fact, it was based around gold because gold was trusted as a medium of exchange and as a store of value. In short, it was trusted as money.

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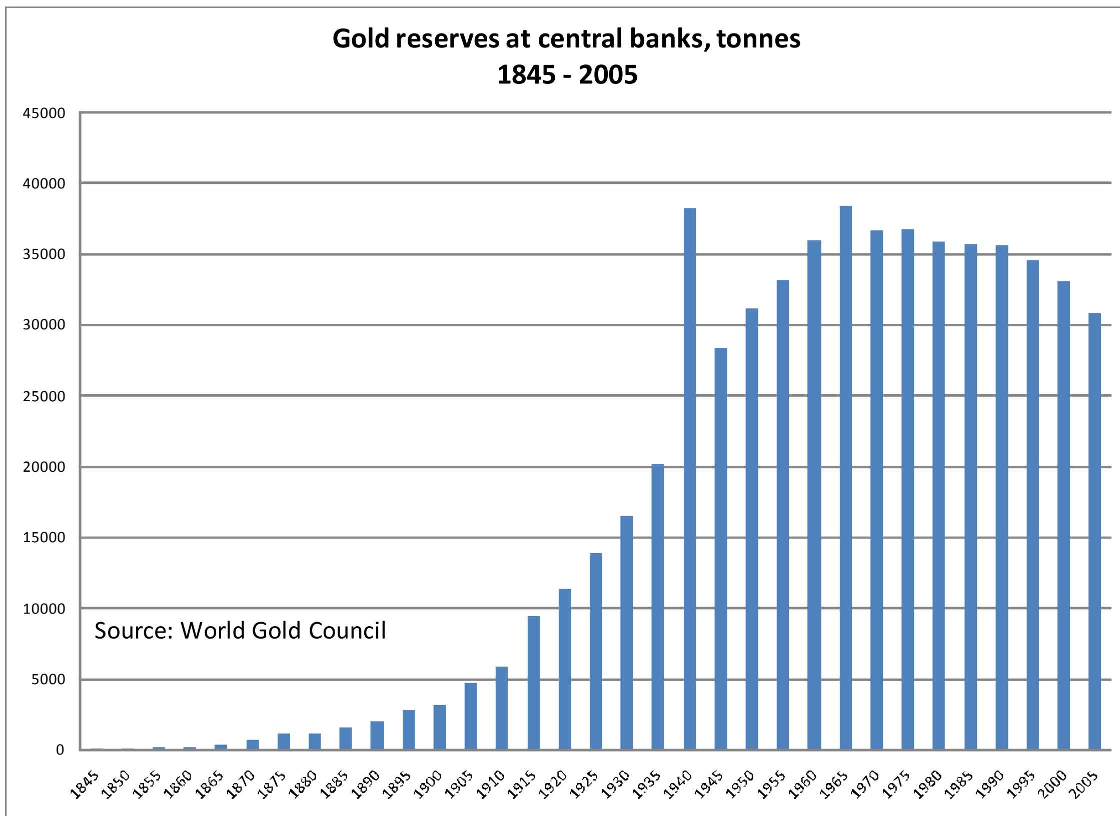
Future developments in the gold price may depend on whether over the decades ahead central banks trust gold sufficiently, or perhaps equivalently, distrust US Treasury debt sufficiently, to want a significant share of their foreign exchange reserves to be held as gold bullion. If gold stays in favour, existing holders will want to maintain their holdings and BRIC central banks and oil producers' sovereign wealth funds will seek ever more ingenious ways to acquire it. This could provide a substantial support to prices for a sustained period.



For the past 40 years, the amount of gold held by central banks has been falling. But the holdings are heavily concentrated in the US and Europe. At current market prices, gold represents more than 70% of the foreign exchange reserves of the US, Germany and France.

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Gold reserves (US$millions)

	Q1 2009
United States	239,664
Germany	100,557
IMF	94,803
France	72,274
Italy	72,247
China	31,058
Switzerland	30,648
Other	233,681
World	874,931

Source: IMF

The US alone has over 8,000 tonnes, or equivalent to 2 year's worth of global supply. But many emerging markets with large foreign currency reserves have scarcely any gold and while the US has seen the value of its gold reserves soar with the gold price, many emerging nations have seen their reserves eroded by a declining dollar. A major uncertainty for the gold market is whether reserve rich, emerging market central banks will try to acquire gold and if so, by which means and how quickly. Prior to 2008, there was much debate among the central banks of emerging nations which had rapidly accumulated substantial foreign exchange reserves of whether they should hive off part of their reserves to endow a sovereign wealth funds to invest in risk assets. Several started off down this route and may have been severely embarrassed by the collapse in equity markets in 2008.

Since 2008, diversification into gold – even though it is volatile – is likely to appear to be a more conventional form of investment for a central bank than investing in equities. These moves have already started. Earlier this year, India acquired 200 tonnes from the IMF and a recently reported increase in China's reserve holdings of gold is thought to reflect acquisition of domestic production. Several other large emerging countries are known to be debating the diversification of their foreign exchange reserves. But at the same time, little public attention has been given to the possibility that heavily indebted industrial nations (including the USA) might be approached to sell part of their gold holdings to countries which are keen to diversify out of the dollar. Such moves would be off- market and could offset (at least in part) the latent demand for gold as a reserve asset from the BRIC nations and other emerging markets.

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December 2009

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The balance of world gold supply and demand

Tonnes

	2005	2006	2007	2008	2009 *	Trend
Supply						
Mine production	2,550	2,481	2,478	2,415	2,560	Production peaked in 2000, very long lead times in response to higher prices and geology increasingly difficult
Net producer hedging	-86	-373	-444	-351	-200	
Official sector sales	662	367	484	236	40	The medium term 800lb gorilla. Has been a steady source of supply; could go either way in future but most likely to be a source of demand pressure (see text)
Recycled gold	886	1,107	958	1,209	1,632	Reflects both the level of prices and momentum in prices.
Total supply	**4,012**	**3,582**	**3,476**	**3,509**	**4,032**	
Identifiable demand						
Jewelery fabrication	2,707	2,283	2,404	2,186	1,705	Gold is not going out of fashion, and demand will continue to be dominated by growing incomes in India and China
Industrial and dental	431	458	462	435	348	Miniaturisation & substitution, little recycling, but new uses (catalysts & nanotechnology)
Bar & coin retail investment	412	421	446	649	668	Reflects both the level of prices and momentum in prices.
Other retail	-26	-22	-14	213	300	Reflects both the level of prices and momentum in prices.
ETFs and similar	208	260	253	321	690	Reflects both the level of prices and momentum in prices.
Total demand	**3,732**	**3,400**	**3,551**	**3,804**	**3,712**	
"Inferred investment" (residual)	280	182	-75	-295	320	

* Delmore estimate based on 1st 9 months data
** incl bar hoarding; official coins; medals and other

Data source: GFMS Ltd and World Gold Council

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Appendix

Does gold or US Treasuries hedge global equities?

Worst 10 months for world equities since 1976:

	World equity returns	Gold price	Long term US Treasury returns
Oct-08	-18.9	-17.4	-3.8
Oct-87	-17.0	2.0	6.2
Aug-98	-13.3	-5.4	4.7
Sep-08	-11.9	6.2	1.1
Sep-02	-11.0	3.5	4.2
Mar-80	-10.7	-22.4	-3.2
Sep-90	-10.5	5.3	1.2
Feb-09	-10.2	3.5	-0.6
Aug-90	-9.3	4.2	-4.2
Sep-01	-8.8	7.4	0.8

Best 10 months for world equities since 1976:

	World equity returns	Gold price	Long term US Treasury returns
Jan-87	11.8	3.0	1.6
Jul-89	11.3	-1.3	2.4
Apr-09	11.3	-3.6	-6.5
May-90	10.6	-1.3	4.2
Aug-84	10.1	1.7	2.7
Mar-86	9.8	1.7	7.7
Oct-90	9.4	-7.1	2.2
Feb-91	9.3	-0.9	0.3
May-09	9.2	10.4	-2.5
Oct-98	9.1	0.1	-2.2

Equity and Treasury markets in months of extreme gold price movements

Worst 10 months for gold price since 1976:

	Gold price	World equity returns	Long term US Treasury returns
Mar-80	-22.4	-10.7	-3.2
Nov-78	-20.3	-3.4	1.9
Oct-08	-17.4	-18.9	-3.8
Jan-81	-14.1	-2.8	-1.2
Mar-82	-11.8	-2.6	2.3
Jun-81	-11.1	-0.1	-1.8
Mar-83	-10.8	3.6	-0.9
May-82	-10.0	-2.4	0.3
Mar-90	-9.6	-6.0	-0.4
Aug-08	-9.3	-1.4	2.4

Best 10 months for gold price since 1976:

	Gold price	World equity returns	Long term US Treasury returns
Sep-79	26.1	2.4	-1.2
Dec-79	26.1	2.8	0.6
Jan-80	24.6	6.1	-7.4
Jun-80	22.0	4.9	3.6
Aug-82	20.0	7.4	7.8
Sep-99	17.4	-1.0	0.8
Dec-78	16.9	3.4	-1.3
Mar-85	14.4	3.5	3.1
Apr-82	12.9	5.0	3.7
May-79	11.9	-1.6	2.6

Source: MSCI Barra, Morningstar Ibbotson, World Gold Council

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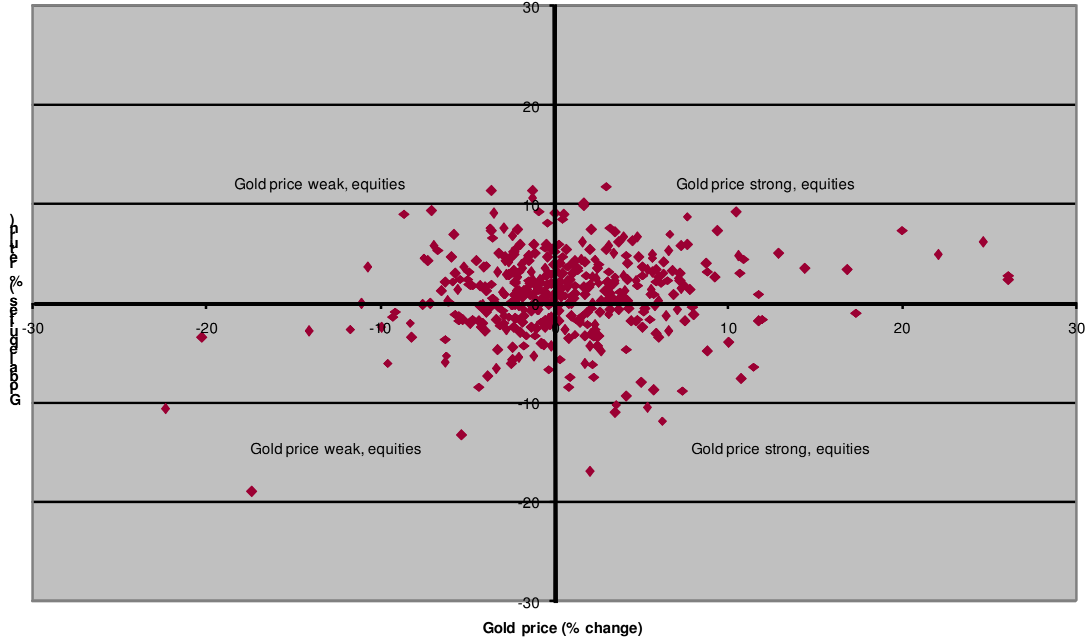

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