



# Platform

4 August 2011 Plexus Asset Management

Independent Insight in an Uncertain World

**P**lexus

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## THE GOLDEN QUESTION: TO WHAT LEVEL?

Over the past couple of weeks the news wires have hummed about the issue currently engulfing the global economy and market-places, namely the issue of debt.

We all know the US has an enormous amount of that. The fiscal situation in the US is appalling to say the least. For the US not to enter into default it needed to raise its US\$14,3 trillion debt ceiling by 2 August 2011 in order to again be able to borrow to support its fragile economy and service its current debt. Over the weekend US lawmakers concluded a debt deal whereby the debt ceiling was increased by an additional \$2,1 trillion on condition that budget cuts to the tune of \$2,5 trillion would be implemented over the next decade.

While a default has been avoided, there is still a very large probability of the US's credit rating being downgraded by rating agencies. And according to the newly appointed head of the International Monetary Fund, Christine Lagarde of France, this will have far-reaching global consequences. But what has this got to do with commodities and more so gold?

There has been a definitive feed-through of the debt crisis into commodity prices and especially the gold price as these items are all quoted in US dollars. Gold often also acts as a safe haven proxy in uncertain times. Looking at what happened post the financial meltdown, courtesy of the US, it is evident in the accompanying Graph A that currencies backed by commodities tend to be stronger than fiat paper currencies when converted into gold. In the commodity-producing countries like South Africa and Australia the gold price quoted in local currencies has been the same or slightly higher since the late 2008 financial meltdown.

In stark contrast, gold quoted in US dollars over the same period has risen sharply. Looking at the accompanying Graph B it appears obvious why this is occurring – US dollar devaluation driven by the money-printing presses of Uncle Sam. Over the past almost two decades, the US money-printing presses have been hard at work. The accompanying Graph B shows how gold in US dollars is correlated with increases in the US's debt limit, particularly in the past ten years. By increasing the debt limit it means more dollars are being printed and circulated, which will gradually weaken the dollar because of a bigger supply, and consequently lift the gold price that is quoted in US dollar.

US citizens, who denominate their wealth in US dollars, have had their purchasing power eroded. There are of course also fundamentals at play, such as China's economic boom that has resulted in higher demand for gold. Gold is about 14% higher in dollar terms so far in 2011 and has been

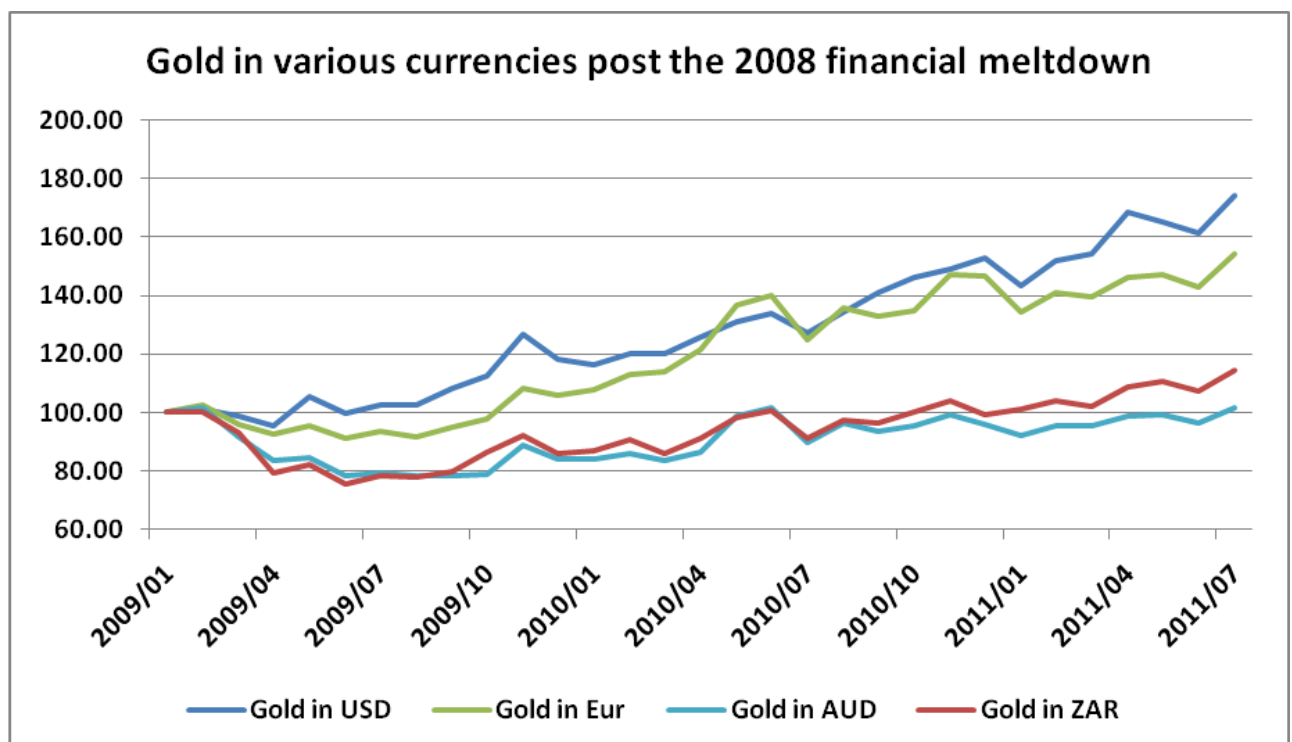
the best-performing currency in the world in the past 12 months according to Julia Yoo, a Seoul-based analyst at Korea Investment. According to her, gold has risen 34% against the US dollar over the past year, outpacing all of the more than 150 currencies tracked by Bloomberg. Gold has risen by nearly 6,5 times in the past 11 years.

Worth noting, though, is that in the bull market in the 1970s gold rose 24 times from \$35/oz to over \$850/oz in nine years. However, when adjusted for inflation, at its current level of \$1 664 gold remains well below its 1980 record high of \$2 400/oz.

According to Yoo the macroeconomic conditions today are even more conducive to gold than they were in the 1970s. Most industrial nations such as the US, Japan, Germany, etc. were creditor nations in the 1970s. Today they are debtor nations, with the US the largest debtor nation the world has ever seen. According to Yoo it looks like we are entering the late intermediate to final stage and the real risk of a currency crisis in any one of the major fiat currencies is rising by the day.

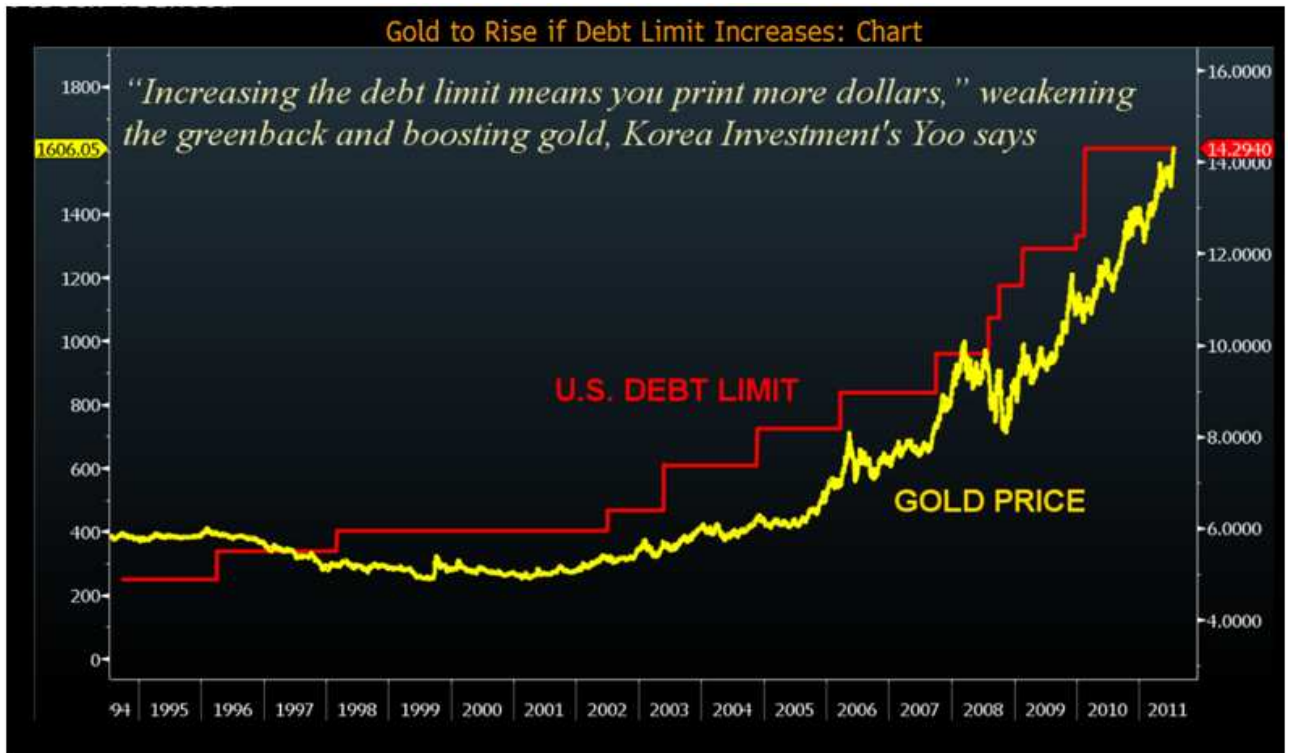
What does this mean for South African investors? We are of the opinion that although it is very difficult to predict how much higher the gold price can go, gold still has a place in an investment portfolio as a hedge against all the uncertainty. We prefer exposure to gold bullion through the NewGold exchange-traded fund. We prefer this over gold-mining shares, which have their own set of troubles including deep dangerous mines, declining grades and labour intensity.

#### Graph A



Source: Plexus Asset Management (data from I-Net Bridge)

Graph B



Source: Bloomberg Chart of the Day from Korea Investment