Erste Group: Gold Still Glitters, Even After its Correction

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Gold: 12-month target at USD 1,500

Gold attractively priced relative to other asset classes

"Chindia" represents 62% of global gold demand

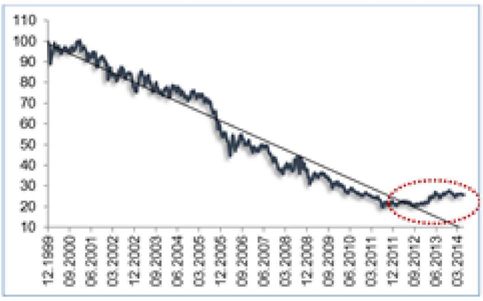
Over the past 12 months, after some ups and downs, the gold price has stabilized above last year's level. Many former gold bulls have since then joined the sellers, and as a result of the healthy price correction, speculative activity in the sector has declined significantly. Relative to other asset classes such as stocks and bonds but also relative to numerous hard assets, gold continues to appear attractively priced in the current environment. The 12-month price target for gold is USD 1,500.

Gold is extremely oversold

When the gold price reached its intra-day all time high of USD 1,920, its price was far above the 40-day moving average, hence extremely overbought. However, the tide has now turned. Technical analysis shows that the gold price is already extremely oversold from a long-term perspective. This indicates that major investors have in the meantime sold large holdings of gold. The current corrective period represents the third largest sell-off since 1971. One can also discern that the current bull market is characterized by far lower volatility compared to that of the 1970s. This could well indicate that the upside trend acceleration phase still lies ahead. *"Since the last Gold Report, the price has rallied by almost 8%, and has increased by 9% since the beginning of the year"*, states Hans Engel, global stock market expert at Erste Group.

Money supply vs. the stock of gold

Many central banks have increased the size of their balance sheets significantly in recent years. The ECB has increased its balance sheet, and with it the monetary base, by an average of 12.6% per year since 2002. That it was actually somewhat restrained compared to the Bank of England (20.5%) or the People's Bank of China (20.7%). By comparison, the global stock of gold has grown by only 1.48% annualized. This underscores the relative scarcity of gold compared to paper currencies. As a result of these monetary policy measures and the global devaluation of currencies, it is to be expected that the exchange rate between gold and paper currencies will continue to rise.



Basket of currencies measured in gold terms
Long-term downtrend intact, however currently bottoming out
Source: Datastream, Incrementum AG

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Where gold demand comes from

The bulk of physical gold demand nowadays comes from emerging markets. “Chindia” alone was responsible for approximately 62% of global demand last year. It is remarkable that per capita ownership of gold since the beginning of the 20th century is fluctuating between just 0.6 and 0.85 ounces (per person), while the total population exploded from 1.6 bn. to 7 bn. people.

In spite of their lower purchasing power, per capita demand is extremely high in emerging markets. They already represent half of the top 20 gold buyers. The growing importance of Asia's middle class and the passion for gold in Asia is still widely underestimated. If one assumes continued growth of prosperity in the region, as well as low, resp. even negative real interest rates, it becomes once again clear that gold is going to be a beneficiary of these developments.

Why gold is a sensible portfolio addition

Investors should not only invest in gold based on whether its price is currently high or low. Gold is “pure property” and contributes to better overall portfolio diversification, as its correlation with other asset classes amounts to only 0.1 on average. There is moreover no counterparty risk associated with it and it is highly liquid, so it can therefore be sold at any time. In times of unexpected political or economic developments, gold has also proved to be a factor of stability for investment portfolios. This is also buttressed by numerous international studies. An allocation between 5% up to a maximum of 10% of one's total wealth continues to be recommended.

The outlook is positive

The outlook for the gold price in the wake of a long drawn-out bottoming period is now positive. Nominally, the gold price may still appear high. However, relative to the base money supply, it is actually at an all time low. This can be regarded as an excellent entry point. Gold is attractively valued not only relative to stocks and bonds, but also relative to many hard assets. As a result, the often-used argument that there is a bubble in gold is put into perspective. From a technical point of view it is to be expected that the gold price has finally reached the end of its long consolidation period. Extremely negative sentiment, the recently observable relative strength in mining stocks, and especially the clearly positive data with respect to the market structure on precious metals futures exchanges all argue in favor of this interpretation.

About the Gold Report 2014

The Gold Report was written by Ronald Stöferle. He is an external advisor to Erste Group Research and has written reports about precious metals for the past seven years.

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