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## Golden Opportunity

Much has been made of the 12 year bull market for gold bullion that abruptly came to a halt on Friday, 12 April 2013. The price of gold has cut a clear path upwards over the past decade which is contrasted by the relatively flat returns offered by the stock market during that same time frame. Since reaching highs of $1,899 per ounce gold has sold off with a significant portion of that selling coming in two trading days, 12 and 15 April 2013. The questions remain – why the abrupt sell off, what does this mean for the metal going forward, and why should investors care?

Gold had been weak for much of 2013 since posting highs of $1740/oz in Oct of 2012, but that weakness turned precipitous on the afternoon of 12 April and that sell- off continued into trading on 15 April. When all was said and done, gold dropped from $1,480/oz to $1,340/oz at the time of this writing. This represents a 9.4% pullback in the course of two days. Originally the sell-off was attributed to the fact that Cyprus would need to sell its gold reserves in order to satisfy requirements for a European Union bailout package. This coupled with somewhat weaker than expected Chinese GDP growth figures of 7.7% annually, and the prospect for an earlier exit by the Fed seemed sufficient to explain the sell-off in gold. Looking further below the surface however tells a different story.

Let's begin with Cyprus. The island nation currently holds 13.9 metric tonnes of gold. Central banks have been buying gold at a rate of 535 tonnes annually. This means that the sale of Cypriot gold represents 2.5% of annual gold demand from central banks alone. This modest supply coming to market does not explain the drop in gold's price.

Chinese GDP of 7.7% is consistent with most expectations of between 7.5% and 8%. In short a 7.7% number is not out of the realm of market expectations. But, even if it were, gold is not an industrial metal like copper or iron ore and its demand in China tends to vary little with economic output and more with excess reserves invested by Chinese banks in gold. Again, this appears to be a thin explanation of gold's sell-off.

The Federal Reserve accidently released copies of its minutes earlier to some banks and not others. Within these minutes certain members seemed more inclined to exit monetary easing strategies by the end of the year. To be clear, anticipating the Fed with much accuracy is a difficult task at best, but current economic data points do not support a Fed exit from the bond markets and likewise do not justify the current drop in the yellow metal.

What is most interesting to note is that the sharp sell-off that began on the afternoon of 12 April started before any of the above hit the newswires. A single trade from what appears to be a hedge fund to sell 400 tonnes of gold was affected and precipitated the selling, triggering other stop orders already in place. One can only speculate as to the reasons for the sale but it would not be a stretch to think that short-sellers have benefited from the drop. This leads us to believe that the selling has been driven more by technical functions of the gold market and less by fundamental drivers affecting the price of gold.

So what is the outlook for gold? It is always difficult to say but one can find some sense of gold's value by understanding what it costs on average to get an ounce of it out of the ground. The "cost of production" for gold is essentially the number that, if the market price goes below, gold producers will have no incentive to produce; supply would contract and prices would then rebound above that cost of production. Our research indicates that the six largest gold miners in the world have a cost of production of roughly $1,300/oz.

Therefore, if the investment demand for the metal remains constant then this figure could serve as a logical floor in gold's price. Clearly markets can move on other data points but knowing the cost to produce the metal is critical in understanding where the price could go from here.

But gold isn't consumable; who cares what it costs to produce if we've got plenty of it above ground? Great question. But the fact is that most of what is above ground is not for sale. The world at large is a net buyer of gold. Whether it's for cultural reasons such as in India, Central bank buying or individuals purchasing coins, planet earth is largely still accumulating gold and the new supply brought forth from the earth is critical to meet that demand, and in doing so establish a market price for the commodity.

Why should investors care? Regardless of one's propensity to own gold, the manner in which it behaves is important. It's important because of the underlying reasons that have propelled gold over the past decade. Certainly, part of that move has been driven by a level of irrational fear as the proverbial "gold bug" awaits the apocalypse. But a great deal of that buying is by banks, banks who while buying gold are simultaneously producing massive quantities of currency backed by nothing but the full faith and credit of sovereign nations under increasingly heavy debt burdens. This is not a healthy combination and is not sustainable in the long term. The simple realization that money has lost a level of its meaning and can be produced at whim causes concern, and rightly so. That concern leads people, banks, and countries to the ancient store of value that is gold.

Does gold present us with a buying opportunity? Maybe. One can only speculate as to future price moves and other developments but many of the drivers that have brought it here are still intact and it isn't getting any cheaper to produce. That being said, markets can still behave irrationally for extended periods and gold, as with any asset, should only be used within the construct of a well-diversified portfolio that is consistent with client objectives and risk tolerance.

Yours Very Sincerely,

CAPSTONE Investment Group

*Sources Cited:*

*Federal Reserve Minutes*

*UBS Investment Management*

*Annual Reports of Barrick Gold, Newmont Mining, Goldcorp, Kinross Gold, Yamana Gold, Anglo Gold Ashanti.*