AIG Investments

Gold Market Update

June 2010

Gold Market

Gold reached another all-time high on June 21st at $1265 before settling for a $26.05 monthly gain at $1242.25. There has been no clear resolution to the sovereign debt crisis in Europe. Many European governments have announced plans to implement austerity measures in order to strengthen their finances and reduce debt levels. We may not know for months or even years whether such measures will work. The higher taxes and/or reduced spending needed might dampen economic activity that is already weak. Meanwhile, economic measures in the US indicate that the recovery is in jeopardy of losing momentum. The index of leading indicators, consumer confidence, and retail sales were below expectations. The housing market is responding negatively to the end of government stimulus. New home sales fell to 300,000, an all-time low going back to the start of the series in 1963. Existing home sales, mortgage applications, and home builders confidence all declined in May. According to HSBC Securities, GDP has grown 3.6% since the end of the 2008 – 2009 recession. That is only about half the average 7.0% growth rate experienced in the three quarters following the end of the five “deep” recessions that occurred from 1957 to 1982. The global economy is not very well positioned to weather another economic downturn. We believe gold is responding to concerns over the financial risks associated with such a possibility.

While gold has already seen a significant rise, new investors with a long-term view continue to allocate to the sector. The global financial meltdown of 2008 has caused profound changes in investment objectives. In June the California State Teachers Retirement System voted to launch a commodities program as part of an inflation-linked asset class. The New York Times reported that the manager of Perella Weinberg’s $2 billion Xerion fund said that a few years ago he would not have taken a second look at gold as an investment, but now is very serious about gold. At UBS’ Reserve Management Seminar for Sovereign Institutions (representing $8 trillion in assets under management), respondents to a survey ranked gold as the second most important reserve currency in 25 years, behind the US dollar. So far this year central banks have had net purchases of 37 tonnes of gold. Central banks have not been net purchasers over a full calendar year since 1988. Physical demand for coins and bars are on the rise. Banks and bullion dealers in financial centers around the globe are responding to longer term demand by building or expanding vault space. New York Commodities Exchange (Comex) vaults are now holding a record 339 tonnes.

Outlook

The economy has not responded as hoped to the extreme monetary policies (near 0% rates and quantitative easing) and hundreds of billions of dollars in stimulus and bailouts spent by the government. Slow growth and high unemployment persist. Federal deficit spending continues. June ISM manufacturing fell more than expected and housing may be on the verge of a “double dip”. States across the country are undertaking austerity measures to counter gaping budget deficits. Stimulus that may have worked in past recessions now lacks efficacy. The difference this time is that the economy is in the grips of an historic credit contraction. The credit that greases the wheels of finance, growth, and innovation is lacking. Bank loans and leases have fallen 10.5% (around $740 billion) since the end of 2008 and 3.25% since the end of 2009. Eighty-six banks have failed so far this year after 140 failed in 2009. The ratio of household debt to disposable income has declined from its 2008 peak. It would have to fall another 35% to get back to pre-2000 norms.

The dominant macro-economic risk in a credit contraction is falling prices or deflation. After going 20 years without a recession, Japan went on to endure one every four years once its era of deflation began following the bursting of its credit bubble in 1990. Two key measures indicate the US economy may be moving closer to deflation: 1) ten-year treasury yields have been in decline, falling below 3% in June, indicating deflationary expectations are rising and 2) the consumer price index (CPI) fell 0.2% in May compared to the previous month. The CPI has been flat so far in 2010.

Incomes tend to fall in a deflation, causing the burden of debt, which is fixed, to become greater. The excessive debt levels across the US economy might make an insidious deflation that much worse. It is clear from past statements that Fed Chairman Bernanke will probably seek to aggressively avoid deflation. In a 2002 speech Mr. Bernanke said: “Like gold, US dollars have value only to the extent that they are strictly limited in supply. But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost. . . . We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.” This gets at the two core reasons that gold may outperform other asset classes in a deflationary environment: 1) government response to deflation is to increase the supply of money, thereby undermining the value if its currency and 2) actions characterized as printing money, quantitative easing, or monetizing debt all have the potential to create inflation in the long term. Looking back at the deflationary 1930’s, the price of gold was fixed, however, gold stocks performed extremely well as costs fell and margins expanded.

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