

**EARLY SIGNS OF HIGH INFLATION: BUY GOLD**

By Chris Gan, Jan 2011

At the start of this week, an interesting article caught my attention. It read: "*President Asks Indonesians to Plant Chillies*". At first I thought this was in reference to Chile, the country, but upon closer reading, this was a suggestion by the government as a way to help combat soaring food prices in the populous country of Indonesia. Such a suggestion may sound a tad odd, but it does send out an early warning: of impending periods of high inflation. A global alarm bell was sounded in December 2010, when U.N's Food and Agriculture Organisation (FAO) warned that millions of people worldwide were at risk after its world food prices index broke through the peak 2008 levels to hit a record high. The index tracks the prices of a basket of cereals, oilseeds, dairy, meat and sugar. In Asia, this is causing jitters not just in Indonesia but also in other countries like India and China, whose economies are still growing at a break neck pace. In 2008, when the FAO index was at a record high, the rising food prices sparked riots in Haiti and Cameroon and demonstrations in a number of countries.

In India, the Prime Minister called in his cabinet ministers to discuss the problem: food inflation had climbed above 18% and unseasonal rains in southern India are threatening food production. China also recorded food inflation of 11.7% in November 2010 prompting the Chinese government to take steps to ensure that there is adequate supply of food staples to the masses, and to crack down on commodity speculation. Both India and China had to make tough choices when it comes to monetary tightening as both are key engines of global growth – India's central bank has tightened interest rates six times in 2010 and China hiked rates twice in last three months of 2010, plus a slew of other preventive measures in an effort to cool the economic engines down.

So what's the impact of higher food prices? The problem is that food inflation has a trickle-down effect through the economy, affecting virtually every aspect of it. With higher spending on food, that would mean less disposable income to spend on other things (all things being equal, of course). Unless wages go up along with prices, it is unlikely that individuals can maintain their purchasing power in the long-run, thus causing productivity to slow to some extent.

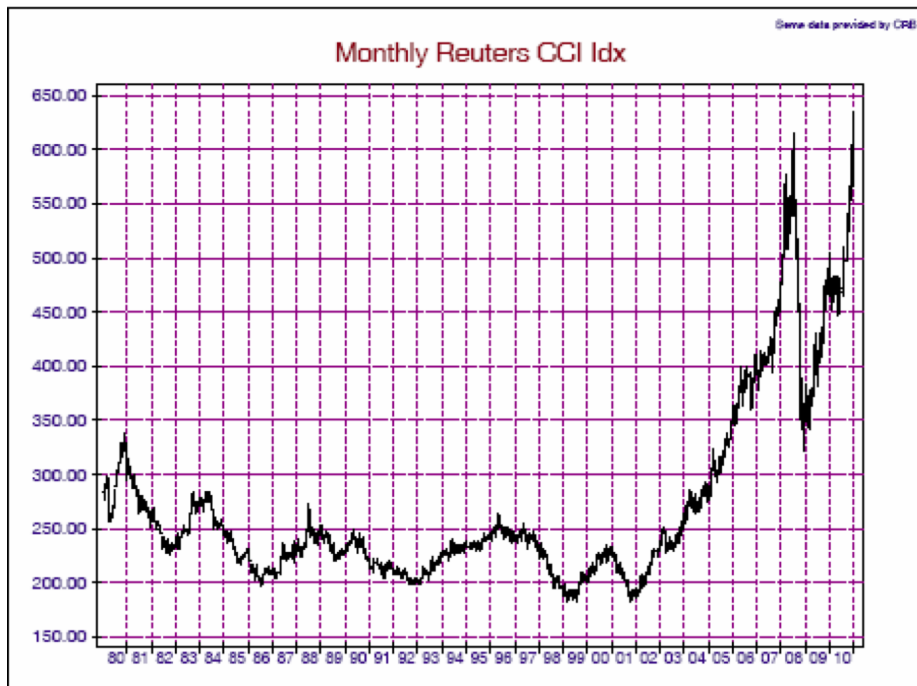
**What about other commodity prices?**

The Reuters CRB index of 19 commodity prices is up 29 percent since July 2010, the highest level since the global recession began in 2007/08. The price of soybeans rose as much as 5.2 percent to \$14.20 per bushel, the highest level since 2008 while corn prices also jumped: up 5 per cent to \$6.37 per bushel, the highest level since July 2008. The outlook for corn prices is for it to increase further, given the USDA report that the ratio of US corn stock-to-demand would fall to a surprisingly thin 5.5 percent, the smallest cushion in 15 years. The US is the largest corn supplier in the world, contributing to more than half the global needs. Corn is the main ingredient for animal feed, and the tightening market is reflective of the increase in demand for meat from emerging countries like China. Further record ethanol production in the U.S, in light of the prices of crude climbing past \$91.0 barrel is also taking up almost 40% of the U.S corn crop putting more pressure on prices. The strong demand for raw materials is a result of the continual high growth rates in China and India, as it spurred record demand for sugar and soybeans, and a rising import of copper – last year China alone consumed over 7.5million tonnes of copper, around 40% of the world's output.

Energy prices have also increased rapidly, up almost 20% in the last three months. The price of crude oil rose past \$91.0 per barrel with some analysts predicting that it could well be past \$100 per barrel soon. Global growth although hampered by the slower pace of developed nations still reeling from the deep recession in 2008, will still grow at around 3.3% per annum<sup>1</sup> which is significant, with ultra loose monetary policy from the US Federal Reserve and European Central Bank continuing. At the same time, strong demand for energy from China and India is expected to expand unhindered. Although China is tightening its reins, its GDP is still expected to grow at a clip below 10% p.a for this year (at around 8.7% according to World Bank forecast) and India is also expected to record 8.4% growth, down from 9.5% in 2010 due to capacity constraints. As a sign of increasing pressure on prices, India's state-run refiners will raise petrol prices by about 4.5 percent this month, which will put increased pressure on consumer's wallets as the country battles the highest inflation of any major Asian economy. Prices will increase by 2.50 to 2.54 rupees per litre.

<sup>1</sup> According to latest World Bank report

### Commodity Research Bureau (CRB) commodities index up 29 percent since July '10



#### What does this have to do with Gold?

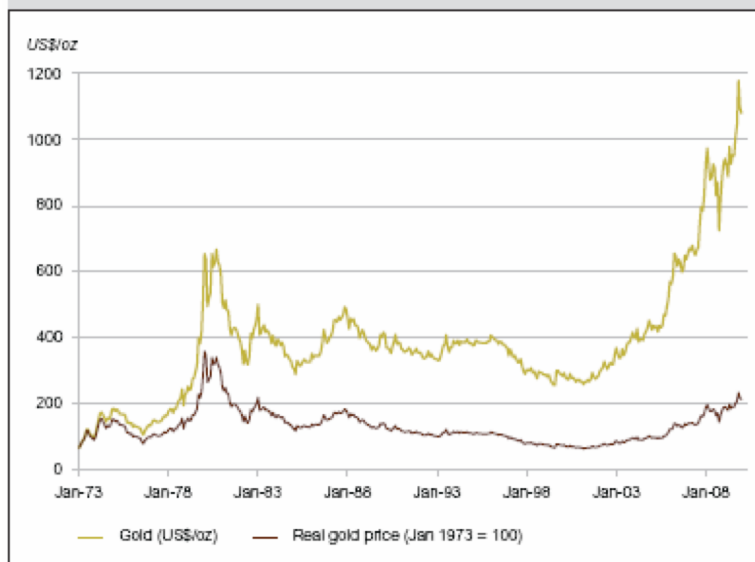
One can anticipate where all this is heading - we have been warned previously of the perils of the U.S continuing to print more money: under its QE2, an additional \$600bn is being pumped into the financial system through the purchase of long term bonds. The government is trying to print itself out of this financial mess: more stimulus, more printed money, higher debt, means weaker dollar. A lot of this "hot money" is seeking higher returns in places outside the U.S, attracted by higher growth rates, and appreciating currencies, especially in emerging countries; China, India and the likes.

All these conditions are favorable to the gold price. Inflation and gold have walked hand in hand through all time. Inflation is defined as when there is too much money chasing too few goods. Unlike paper money, which can be created by using the printing press, gold is scarce. And, in times when purchasing power is being eroded such as what we are seeing in Asian countries, individuals would swap their paper money for gold, thus pushing up demand and its price. This is because, it is often said, gold is probably the only true hedge against inflation; in the long-run it has kept up with inflation rates. Take example of the situation in the U.S

Take for example, the situation in the U.S. Between the end-of 1973, when the price of gold was freed from the gold standard, till Dec 2009, we can observe that the price of gold had increased from \$106.72/oz to \$1087.5/oz, a rise of 928%! But adjusting for cumulative rise in the U.S consumer price index inflation (CPI) over the same period, gold prices rose by 119% which equates to an annualized real return of 2.2%, supporting the claim that it has kept up with inflation.

**Gold has kept up with inflation in U.S.**

Chart 8: Gold (US\$/oz, end of period) and real gold price (Jan '73 = 100)



Source: Global Insight, Bureau of Labor Statistics, WGC

With gold demand rising, it's becoming evident that individuals, governments and central banks are responding to the forecast of higher inflation. We have already shown that food inflation is on the rise especially in Asian countries, and running neck-to-neck is the higher cost of energy. Crude oil price which is currently above \$91.0 a barrel, is predicted by some to reach \$100 per barrel soon and perhaps even higher. Some analysts are predicting price of gasoline in the U.S (which had just passed \$3 per gallon) could hit \$7 per gallon. The increasing cost of fuel impacts virtually every product that consumers would purchase. The consumer will have to factor in the cost of higher transportation and shipping. There is less to invest and to save when we have to pay more for basic necessities.

We need to ask ourselves: if the price of fuel doubles and food is also on the rise, what will happen to our savings and paper money eventually? Keeping money in fixed deposit or similar saving plans is not an option, given the low interest rates in most countries. Not everyone may need to drive a car but certainly everyone still need to eat! The daily need to hedge against the erosion of purchasing power becomes more critical, and the only asset class that has a clear and uncontested track record of this is of course, gold.

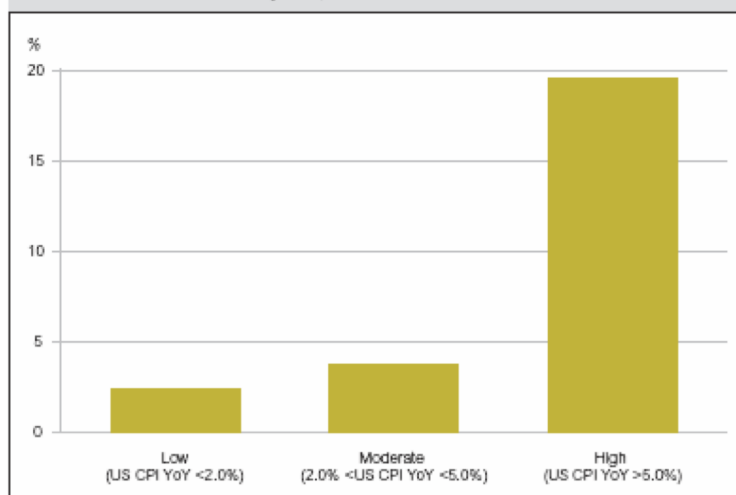
The awareness that high inflation will eventually hit us is only slowly emerging, and most people are still unaware of its devastating impact on their wealth and lifestyle. In this period, it is perhaps more important to preserve your wealth than it is to seek higher returns. Sure, the price of gold in US dollar terms has increased significantly; in 2010, it gained almost 26% and in the last decade, it is up 400%. And some would argue that the upside is limited. But note: all this happened when inflation was almost benign. In periods of high inflation, gold has been shown to perform well, see chart below.

According to research by the World Gold Council, in periods of low (U.S CPI of below 2%) and moderate inflation (CPI of between 2% and 5%), gold only posted small positive real returns. But in periods of high inflation characterized by CPI of above 5%, gold rose an average of 19.2% in real terms (and a median increase of 14.9%). Gold given its physical properties is an excellent hedge against inflation – with the ability to post strong price appreciation in times of high inflation to offset the negative impact of a rise in CPI.

Imagine what could happen to gold prices if inflation were to **really** take off? Preserve your wealth now, with an aim to grow it in times of high inflation – buy gold. The early warning signs are all there: as forewarned by increasing food prices in Asia and higher energy prices expected. The time to act is now.

### Gold does well in periods of high inflation

Chart 10: Average annual real gold price return (US\$/oz) during high, moderate and low inflation years; 1972-2009



Source: Bloomberg, Bureau of Labor Statistics, WGC

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