

QUANTITATIVE EASING: CERTAINLY GOOD FOR GOLD

By Chris Gan, Nov, 2010

The U.S Federal Reserve (“The Fed”) recently embarked on another round of unprecedented loose monetary policy action which will let loose a tidal wave of liquidity, a powerful propellant for stocks and other risky assets around the world.

The Fed chairman, Ben Bernanke explained that this measure is needed to further stimulate a U.S economy that has been plagued with dismal growth, high unemployment and consumers who are continuing to reduce gearing (and, not spending). This measure is known as QE2 (or Quantitative Easing, Part 2, not Queen Elizabeth II, mind you) and it will involve the Fed pumping an additional \$600bn into the financial system to buy long term Treasury bonds over the next 8 months. The last time the Fed announced this, in March 2009, the equity markets rallied and pundits called it the start of the next bull cycle. Similarly, this time round with the announcement – the markets rallied. In fact prior to this, when Chairman Bernanke had reaffirmed the Fed’s commitment for QE in Aug 2010, the stock markets had also rallied.

Although this year, the equity markets have not rallied as much as last year in 2009, nonetheless, the Dow Jones Industrial Average (DJIA) is up 8.2% YTD, while the wider S&P500 is up 8.8% YTD. Emerging markets have also done well: the MSCI Emerging Markets Index is up 13% year to date while the MSCI World Index has appreciated less than 5%. Stock markets have certainly benefited from the large inflows of funds, seeking higher returns, and so if you are an investor in the equity markets you should surely be happy, right? Well, there is a flip side to the coin as far as QE is concerned. In this article, we will present the reasons why you should be wary of a good thing (and how gold and silver can help you to preserve and grow your wealth in these turbulent times)

What is QE2? And why is it good for Gold

In simple terms as explained by Mr. Mohamed El-Erian, CEO and CIO of PIMCO, one of the largest bond fund managers in the world: QE is basically the Fed, having the power to print money and is doing just that. With this large money bag, the Fed will come in, and buy long term Treasury bonds; what it hopes to achieve is to push investors out of safe haven Treasuries, into buying other risky assets like bonds, equities and real estate, thereby, reducing the cost of funds for companies. They also want banks who are sitting on a huge pile of reserves to lend again to the real economy as they are not getting any returns on it.

We can argue if this quantitative easing would work or not, as the jury is still out on its impact to an economy which is already flush with cash and interest rates close to zero, the more pressing questions is: what will happen to all this liquidity? Surely there must be a limit as to how low we can reduce interest rates; with this round of QE, the Fed are hoping to bring the real rates to below zero, by buying longer tenor Treasuries instead of targeting the shorter end of the yield curve. And, if this round of QE is not sufficiently effective, will there be a QE3? By the way, this new round of printing press action will push the Fed’s balance sheet to more than three times its pre-crisis level of \$2.9 trillion, and its holdings of Treasury will also increase. Incidentally the US is already running a budget deficit of close to 10% of its GDP and a current account deficit of close to 5% of GDP.

What happens to all the money?

When the US is engaging in super loose monetary policy, firstly the dollar weakens (as is shown by US trade weighted dollar index in chart below). That sends investors looking for better returns elsewhere as rates domestically is at all time low. As developed markets languished in the doldrums with sub-par growth rates post-08 crisis, emerging economies like China, India and others have taken up the slack. As such, emerging economies now will need to curb the capital inflows and increase interest rates to fight inflation and asset bubbles. The US dollar has weakened significantly and will continue to do so. By the account of one top fund manager, Bill Gross, also of PIMCO, the greenback's value may decline by as much as 20%. As such, the gains made in the equities market this year, may just about compensate investors for what they have lost in terms of their currency value. (So, it's not a surprise that stocks, commodities and other investments have rallied with the announcement of QE2).

Over the longer term, with the initial fiscal stimulus in the U.S of \$1 trillion (QE1) the S&P 500 have risen by some 65%, from its low of March 2009 (from 712points) to 17 Nov 2010 (of 1178.59 points), while the Dow Jones Industrial Average (DJIA) has gained a massive 63% over this same period, closing at 11,201.97 points on 17 Nov 2010.

Gold on the other hand in 2010, YTD has gained over 25% to a high of \$1400/oz and with much lower volatility compared to stocks, (15% in 3Q2010) vs. over 25% for equities and over 35% -40% for other commodities like Nickel, and crude oil. Much of this gain can be attributed to the weaker US dollar, and also the increased uncertainty from the QE2 program and also concern over rising inflation in emerging countries like China and other parts of Asia.

Dow Jones Industrial Average gained 63% since low of March 2009 but much of this to compensate for loss in value of dollar from QE programs

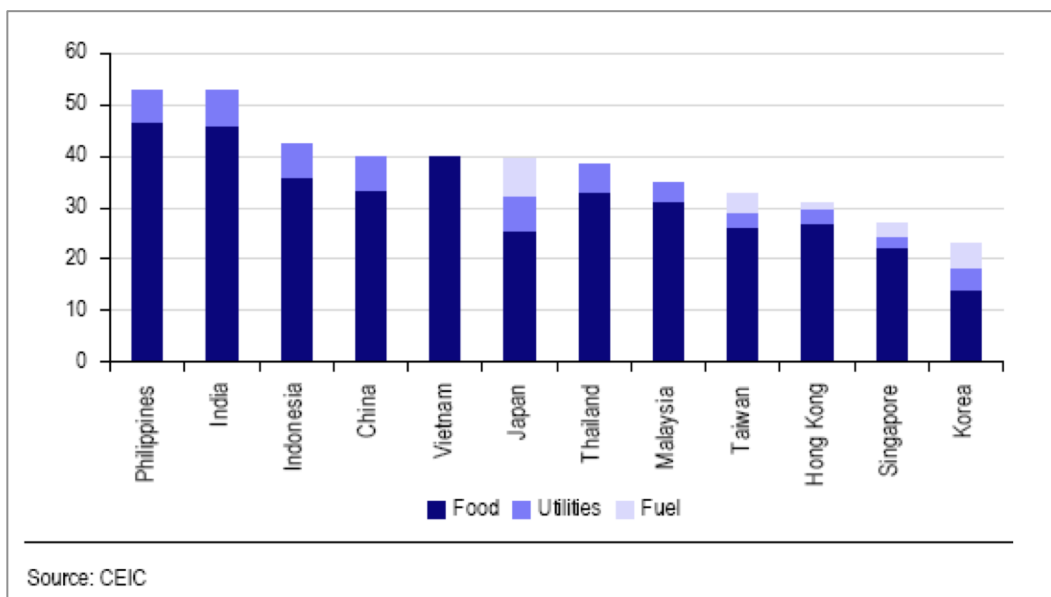


Source: www.bloomberg.com

Targeting rising inflation

Emerging countries are already complaining of what the US is doing: which is “beggar thy neighbor”; with strengthening currencies, inflation is starting to set in. While most countries like Thailand, Malaysia, China and Philippines can rejoice that their currencies have appreciated against the greenback, however, they are facing the headache that comes with it: lower export competitiveness and inflationary pressures. For example, countries that have a high component of food in their consumer price index or CPI basket are feeling the pinch as food prices have begun to move up. Although most Asian countries reported CPI numbers that are still benign such as in Malaysia, where CPI grew by only 2.1% y-o-y (in 2 Aug) and moderated to 1.8% y-o-y in Sept 2010, but interestingly other countries like China are already reporting higher food inflation numbers. Further, given it has always been fashionable to underreport the CPI numbers, we can only postulate that food inflation could be a bigger problem than what it appears now. Underreporting inflation may be a nice trick to prolong the economic boom but the consequence could be devastating in the long run for the general population.

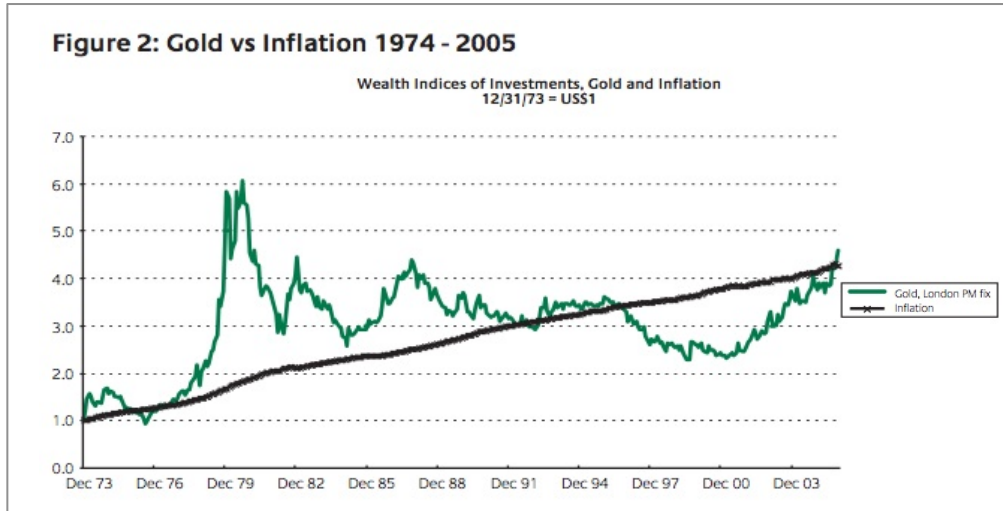
Food is a large component of Asia countries CPI



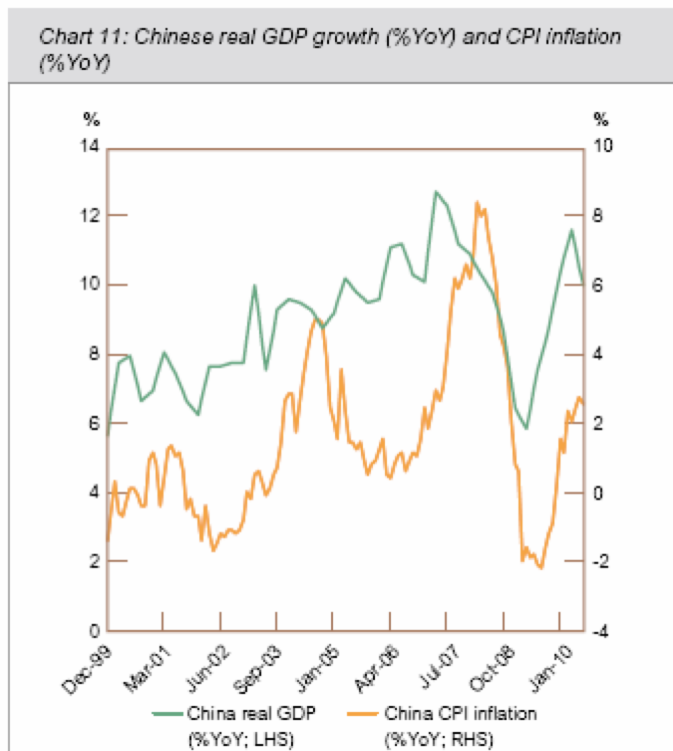
Gold as hedge against inflation

Gold is probably the only true hedge against inflation; in the long run it has kept up with inflation rate in the U.S and the scenario is the same for most other countries. With the likelihood of asset bubbles forming as more hot money chase after few assets, like in properties, and in equities, gold provides an alternative to preserve your wealth against the effects of a decline in purchasing power. Fast growing economies like China are also not spared from having to deal with higher inflation: China’s cabinet confirmed on 17 Nov 2010 that the government may impose price controls on basic needs and production materials. ‘Price caps will be used if necessary’, the State Council said in a statement after a meeting chaired by Premier Wen Jiabao. Incidentally the government has also approved its local banks to acquire more gold (which probably is a prelude to the central bank’s move to increase its already massive gold hoard of 1,054 tonnes currently).

Gold, the true hedge for inflation in the long run



Inflation in China rising again and so is their purchase of gold

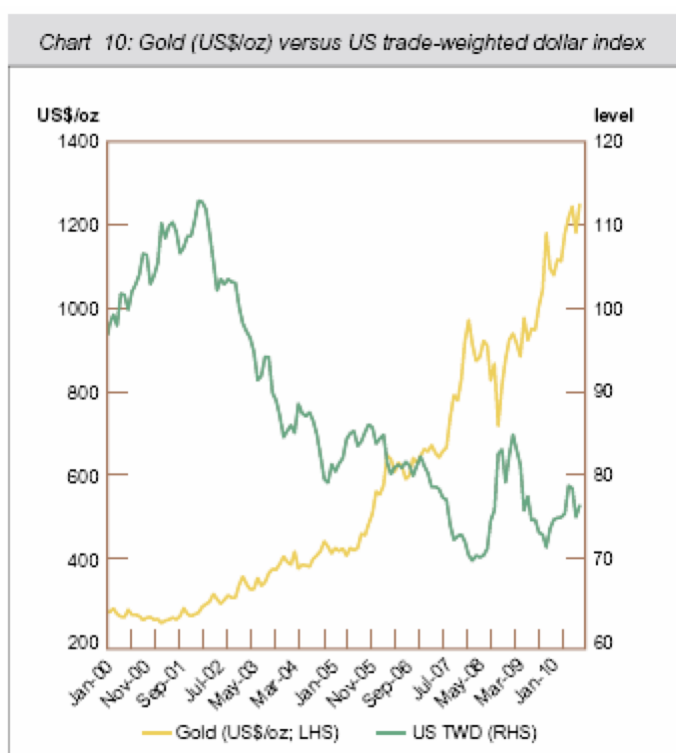


Source: National Bureau of Statistics, China Economic Information Net

Gold as hedge against US dollar weakness:

Gold prices tend to move up when US dollar is weak, and that is what is happening currently. In other words, its not that the price of gold that is appreciating, but rather the value of the dollar weakening. The World Gold Council 2008 report, identified that the annual correlation between US dollar and gold is between -0.4. to -0.6, meaning that a 1% decline in US dollar will lead to an increase of between 0.4 to 0.6% in the price of gold (and vice versa). As such, with QE2 we are likely to see the US dollar to continue to weaken which is a boon for those who hold physical gold.

As the US trade weighted dollar index declines, the price of gold will continue to rise.



Source: LBMA, Bloomberg

Gold as a safe haven

It is not surprising that the price of gold was the highest the day that Lehman Brothers went bust in 2008. Gold has always been seen as the ultimate safe haven due to its unique physical properties; it has no counterparty risk, unlike a gold certificate with Lehman. The gold stays in your vault and its weight is your security; 50g is equivalent to 50g, no matter what happens to the price today. Furthermore, the supply of gold is finite unlike financial instruments such as stocks or for that matter, paper or fiat money.

Today, as more hot money flows into emerging countries, talk of imposing capital controls are starting to surface more. Capital controls are being implemented selectively by countries like China, Thailand, Indonesia and Taiwan, to curb speculation. While at present, none have implemented capital controls like Malaysia in response to 1998 Asian crisis, we cannot discount this possibility.

What are the implications of capital controls? Well for one, its citizens may be restricted in being able to freely move their money in and out of the country, while the other being that the exchange rate could be fixed to a reference currency like the US dollar. In this situation, gold can play a vital role especially wafers which continue to store its value and can be easily moved from one place to another.

Finally, what are the current trends in the price of gold and silver:

Current trend, gold price well supported 3Q2010

In its 3Q 2010 Report, the World Gold Council says that the price of gold was well supported by (average prices in 3Q was \$1226.75/oz vs. \$1196.74 in 2Q10):

- Concern over U.S and other developed countries' economic health due to loose fiscal measures, like the QE2,
- Official sector i.e. reserve banks continue to be supportive, as we have seen negligible sale of gold by Euro central banks while Thailand, Russia and Bangladesh increased their reserves. China has allowed its bank to buy more gold.
- Demand from the jewelery sector in Asia and Middle East was still strong despite higher prices and investment activity (in ETFs) continue to grow,
- Gold use in electrical sector continues to be steady.

Silver prices to continue to outperform vs. gold

The price of silver has seen significant appreciation: in 2010, the returns YTD was around 47%; prices climbed as high as \$27/oz in November (the highest level in 30 years) before retreating a little back to around \$25/oz which presents excellent buying opportunities.

The gold silver ratio fell to below 53 (how many ounces of silver is needed to buy one ounce of gold) from a high of over 70 previously. Silver continues to outperform gold and certainly has good upside potential. The all-time high ratio was above 90 times while the long term average up to 2007 was around 54 times. Silver analysts and commentators are predicting that silver prices to hit \$30/oz before year end.

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