Opinion

FROM THE CAPITAL

Gold going nowhere fast

History suggests gold is more comfortable in a long-term trading range

John Robertson

Gold's roles as a physical good with utility, a decoration, a symbol of personal wealth and prestige, a financial asset and a monetary instrument traversing geographic and political boundaries mean its price is a function of a huge number of variables. A normal human brain is probably incapable of comprehending all the influences that, together, produce the daily gold price.

The gold market is also much smaller than many other mainstream financial markets, making it prone to large adjustments even as seemingly minor changes are occurring elsewhere. A 24-hour market adds to the complexity of trying to explain what is happening.

As the importance of different price influences varies from day-to-day, analysts with varying emphases are left to conjecture about what is happening. No-one comes out looking good.

Despite the apparent complexity, taking a few steps back from the daily noise helps to clarify some of the key long-term relationships that affect the trajectory.

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A broader historical perspective highlights persistent price patterns that belie the noisy short-term picture. The post 1970 gold price history can be divided into five phases, with just two periods of upward trending prices.

The first 10 years was a period of generally rising prices. In particular, between August 1976 and January 1980, the gold price rose as much as 720%. In phase two, from 1980 to June 1982, the price retreated to more stable levels.

The ensuing third phase then lasted 20 years. During this time, there was no net change in the price, which moved up and down between US$252/oz and $492/oz. Phase four, marked by a 445% rise starting in 2003, lasted another 10 years until September 2011.

The fifth phase, through which the market is currently moving, has involved a 38% decline very reminiscent of the 58% 1980-1982 adjustment, when the market was trying to find a fresh equilibrium.

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The missing ingredient in day-to-day reporting on the gold market is an accepted framework in which to analyse what is happening.

One way to look at the price formation process is to consider gold as one asset among any number of assets in which wealth can be held. The value of all gold holdings will be equal, by definition, to total global wealth less the value of all non-gold assets held.

If the quantity of gold and the value of the total wealth endowment is unchanged, movements in the gold price can be described mathematically as a function of relative price movements across other assets. If relative asset prices are not changing, on the other hand, the gold price will rise or fall with changes in total wealth.

This framework has limitations as a tool for predicting very short-term pricing fluctuations. Forecasting movements in the gold price presupposes a view about all other asset prices. Nonetheless, it helps to explain the broader sweep of prices over the past four or five decades.

Each of the two upswings described above as phase one and phase four came with dramatic changes in important asset prices and historical shifts in wealth ownership.

The 1970s gold-price rise coincided with the breakdown of the pre-existing global exchange rate regime and a dramatic flow of funds from the more advanced economies to oil exporting nations marking geopolitical shifts as well as creating the outstanding economic policy challenge of the day, namely: how to recycle petrodollars to avert recessions in advanced economies.

The second gold price rise in the 2000s also came with a dramatic alteration to the global economic power balance. In this case, the flow of funds favoured China and those other developing economies benefiting from economic reforms accompanying political liberalisation. The emergence of new centres of wealth and economic power was akin to the changes that typified the 1970s.

If this second rise is structurally similar to what had happened 30 years earlier, perhaps there will also be parallels in its aftermath.

Growth rates now appear to be converging among advanced and emerging economies. The seismic shifts in the distribution of wealth that defined the 1970s and 2000s seem less likely to recur in these circumstances.

After global equity prices have risen 124% and long-term bond yields have dropped below where they had been in the 1950s, at least in the case of US 10-year securities, one could easily conclude that a historic asset repricing has run its course.

Moreover, far fewer countries face the same political and economic restrictions as China and the Soviet Union once did. Liberalising the economies of Cuba, North Korea and Venezuela is hardly going to have the same wealth shifting impact. The economy of India, the next awakening giant, appears more evolutionary than revolutionary in how it changes.

Put into the framework of the gold price model described above, neither movements in wealth nor relative prices appear likely to be dramatic enough to force a directional shift in the gold price, at least not for some time.

As always, pressures will build before new restraining economic forces are eventually overcome. Perhaps it is an African economic revolution in the 2030s and the redistribution of wealth that brings that will frame the next 400% rise in the gold price.

Before then, if history is any guide, the gold price could replicate its 1980s and 1990s performance by slipping into a pattern that reflects relatively minor or countervailing wealth shifts. There is more historical precedence for this alternative than a resumption of upward trending prices or large price falls. ▼

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