All That Glistens

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As I write this, a troy ounce of Gold will set you back one thousand, one hundred and seventy nine of your hard earned US dollars. For our English readers – and those who can't think in troy ounces – 31 grams of gold will cost you the best part of 708 pounds. If you look back to January 2008, you could have got yourself that ounce for just $800 (a bit over £400 with exchange rates as they were). Sticking to dollars for the moment, that's about a 50% increase. But why?

The argument being thrown about goes something like this; gold has traditionally been a “safe” asset in which to put money; in particular as a hedge against inflation. In the current crisis, amid fears of unstable banks and the possibility that governments may try to inflate away some of the potentially crippling debt they are taking on – it is understandable that peoples thoughts are drawn to gold. But is it really that safe?

In Golds favour it is a none renewable resource – there is a finite amount of it in the world and when it's gone it's gone. In addition, as pointed out in this paper – in the long term, (1895 – 1999) gold increased in value on an inflation adjusted basis by a modest 0.3% per year. The news is not all so good, the same paper goes on to point out that from 1982 to 1999 the inflation adjusted value of a gold holding actually fell by 59% - not such a good hedge. So are the people buying now in for 19 years or a hundred years?

In my view much of the rapid ascent of gold prices over the last six months can be attributed initially to people moving to gold as a “safe haven” and subsequently to speculators looking for short term profit from the resulting increase in demand. These two factors alone are enough to give us a classic bubble. There is however an additional factor which I believe will make the eventual collapse even sharper – I don't think a majority of the people in it for “safety” really understood the time scales over which gold can be considered a “safe” asset or what people mean when they call it a “safe” asset.

When the speculators start taking profits, the price of Gold will dip. This will then force a few margin calls from over leveraged speculators, forcing the price down a bit further. If a majority of the investors (as opposed to speculators) are really there for the (really) long term, this wouldn't be a problem – they would either be prepared to wait or use the dip in price as an opportunity to increase their holdings. I predict however that a majority of the current 'investors' will see the dip in price and 'realise' that actually gold isn't for them, dumping their holdings, pushing the price down further, hitting the “pain threshold” of the next level of not quite long term investors and so-on.

What does this mean? Short Gold. Next Article: Why you should buy Uranium.