Philequity Corner (April 22, 2013)
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Gold Meltdown

During the joint Philequity and Wealth Securities investors briefing last February 19, we presented our recommendation on gold. We said that since September 2011, gold has been declining in peso terms. With the yellow metal losing its investments value, we said it is no longer worthwhile to invest in gold.

From April 11 to April 15, gold spot prices fell from $1,561/t. oz. to $1,348/t. oz., thereby proving our recommendation to be accurate. In 2 days, the price of gold fell more than $200, the largest drop in 30 years. In order to make sense of this plunge, we present the fundamental reasons behind the diminishing demand for gold and the triggers that led to the most violent sell-off since the 1980s.

Fundamental Reasons Behind the Drop

To better understand why gold prices fell as much as they did, we will enumerate below the fundamental reasons behind it.

1. **Sluggish global economic growth** – With the global economy slowing down, it means that inflation is no longer a primary concern. In fact, the concern now is deflation. Hence, investment in gold has lost its priority.
2. **Benign inflation** – The consumer price index (CPI) numbers coming out recently are pointing towards low inflation. Since gold is viewed as an inflation hedge, this is bearish for gold.
3. **Search for yield** – With low interest rates brought about by global monetary easing, as well as benign inflation, investors looked for assets that can provide yield. Unfortunately, gold has no yield, making it unattractive to them. Thus, they buy high dividend yielding stocks and high yield corporate bonds instead.
4. **Flight to equities** – The all-time highs reached by indices in the US and the Philippines shows that investors have been allocating their funds into equities. A consequence of this move into equities is less demand for gold.
5. **Shift to defensive stocks** - Investors are looking for companies that have stability of revenue and earnings growth. These companies do not require a strong economic recovery to grow their earnings. This is why consumer stocks like Pepsi and Kellogg, as well as pharmaceutical companies like Johnson & Johnson and Pfizer, have been performing well in the stock market. At the end of the day, everyone still has to eat and take medicine. On the other hand, gold is cyclical in nature and has no earnings.
6. **Hunt for countries with stable growth** - Investors have also been searching for countries whose growth is not dependent on exports or a healthy macroeconomic environment, like the Philippines. So while gold prices have been dropping, our stock index has been making new highs.
7. **Strong US dollar** – The strong US dollar has caused the prices of gold and other commodities to soften. While a weak US dollar has worked to the benefit of commodity prices, its strength in the past months has caused commodities to become cheaper in dollar terms. Gold is the clearest example of this inverse relationship.
8. **Fear trade waning** – Investors normally flock to gold when there are fears of another financial crisis. However, the measures of central banks have alleviated these fears. Thus, investors have no more need to buy gold.

9. **Insurance no longer necessary** – Portfolio managers normally allocate 5% of their portfolio to gold. It acts as an insurance against a possible financial crisis. With the concern of a financial collapse dwindling, they began trimming their positions in gold.
10. **Drop in demand from China and India** - Demand for gold in India and China is also slowing. According to the World Gold Council, more than half of the world's gold demand came from these two countries. Therefore, any drop in demand from them will have a significant impact on the price of gold.
11. **Shift from commodities to equities** - In a regime of low global growth, commodity funds tend to underperform. The switch from commodity funds to equity funds has also hurt the fundamental underpinnings of gold.
12. **ETF liquidation** - With goal losing its attractiveness as an investment or even a hedge, investors liquidated their holdings of gold exchange-traded funds (ETFs).The largest gold ETF, GLD, experienced $15 billion dollars in outflows so far this year. As an asset-backed ETF, it would have to sell physical gold whenever investors redeem their shares, sending the price of gold spiraling down.

The Triggers Behind the Meltdown

Although the reasons mentioned above explain the downtrend in gold prices, they cannot account for the timing and the swiftness of the drop. An examination of the recent news flow has proven to be informative. See below a discussion on the various triggers that eventually led to a meltdown for the yellow metal.

1. **China GDP below expectation** - China announced that its 1Q13 GDP growth was 7.7%, below the expectations of economists.
2. **Cyprus contemplates selling its gold reserves** - When Cypriot President Nicos Anastasiades announced that Cyprus was committed to selling its gold reserves to save its economy, gold bugs were sent skittering away. Now, there is speculation that if Cyprus can sell its gold reserves, other countries in Europe might do so as well.
3. **Goldman Sachs shorts gold** - Goldman Sachs came out with a report recommending a short position on gold, saying that they see the metal reaching $1,450/t. oz. by year-end.
4. **Increased margin requirements** - The CME (Chicago Mercantile Exchange) also increased the margin requirements for precious metals. Palladium, silver, platinum and even gold are covered by this. Thus, traders who are speculating on these metals will have to put up more collateral for the same amount of investment.
5. **Margin calls** - This measure by the CME led to margin calls. Investors who could not put up the collateral required then had to sell down their gold futures.
6. **Technical breakdown** - $1,520/t. oz. was a crucial technical support for gold. When this broke, traders who rely on technical analysis sold their positions since this breakdown pointed to a continuation of gold's drop. This then became a self-fulfilling prophecy as more people sold their gold positions as the price fell.
7. **Heavy institutional selling** - Many large investment houses also lowered their estimates for the price of gold. Institutional sellers, relying on the advice of firms like Merrill Lynch, Bank of Singapore, Morgan Stanley and Credit Suisse, dumped their large holdings of gold in quick and vicious fashion.
8. **Possible early exit from QE** - There has been talk that there is a possibility of the Federal Reserve ending QE early. A possible result of an early exit is higher interest rates. This triggered additional selling of gold.

Drop in Gold Good for Philippine Stocks

The slowdown in the world economy and very low interest rates have caused gold to lose its luster. This has dragged down the prices of other commodities, including crude oil. While the Philippines is an exporter of gold, copper and nickel, it is also an importer of crude oil and other agricultural commodities. While this looks like a negative at the outset, by and large, this is good for our country, which is primarily driven by domestic consumer demand. In fact, it is actually very good for the local stock market because many of the listed companies are reflective of the strong consumer demand. Our index closing at an all-time high of 6,957.10 last Friday is a testament to this fact.

Sell Your Gold Jewelry!

During Berkshire Hathaway's last shareholder meeting, Charlie Munger said that "civilized people don't buy gold, they invest in productive businesses." We at Philequity share the same investment rationale of Warren Buffett and Charlie Munger. Our message to our married male readers is this: tell your wives to stop buying gold jewelry. As for the women, you will find that while an investment in the Philequity mutual fund does not glitter like gold, many years from now, it will be much more valuable than the necklace or ring you are wearing. So, sell your jewelry and go long Philippine stocks! 7,000, here we come!

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