Gold Silver Investment Fundamentals & the Lure of Commodity Markets

Prologue

Gold and its younger sibling silver have hedged wealth since time immemorial. However, investment in these assets is perceived as one that gains value slowly. While this is not far from the truth, the whole truth is that gold also has a limited downside.

Gold and Silver are Good Investment Choices for the Patient Minded
Image Courtesy of Carsten Reisinger at https://www.shutterstock.com/image-illustration/gold-silver-bars-placed-next-each-110566505?src=FWFf8TNe1HTEmZXhO0P8Ig-1-5

In this article, we explore the viability of ***physical*** gold and silver as asset classes within the broader context of commodity markets. We also consider the critical role of market sentiment in price movements.

History of Gold and Silver Prices

Prices in markets are more a function of the sentiment / expectation / perception of the market participants. The possibility of a certain event changes prices regardless of whether the event materialises.

People always look to hold assets that will appreciate in value over time. Or, at least, not depreciate. Inflation (price rise) steals purchasing power out of

your savings and investments – purchasing power measured in terms of paper currency.

When the confidence in paper money and paper investments erodes, people look to shift their wealth to assets that can maintain value or appreciate. Already, inflation has made gold expensive (in terms of paper money). This shift in sentiment boosts the demand and, therefore, the price of gold.

This has been the case since 406 B.C. in Athens, when mankind recorded its first inflation. And in his 1977 book, *The Golden Constant: The English and American Experience 1560-1976*, the late Roy Jastram has proved that the purchasing power of gold remains [fairly constant] around a broadly constant level.

What applies for gold, applies to silver as well. Why? Market sentiment again. And because silver has vast industrial applications as well (gold has only limited application in industry), the demand for silver will surpass the demand for gold.

Gold Prices 1915-2015
Image Courtesy of Macro Trends at http://www.macrotrends.net/1333/historical-gold-prices-100-year-chart

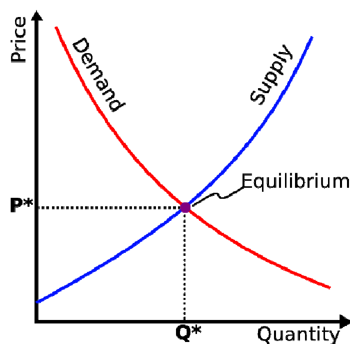
Of particular interest is the rise of gold prices during political or economical turmoil – real or perceived:

- Gold prices spiked from $215.5 to $287 an ounce after 9/11
- During the Great Depression, stocks of the Homestake Mining Company – the very epitome of a gold mining company – rose from $80 per share in October 1929 to $495 per share in December 1935
- Gold fell with the rest of the market after Lehman Brothers collapsed in September 2008 but gained rapidly throughout the Great Recession

- Gold rose to $120 per ounce in the free market (vis-a-vis $42 per ounce government rate) after the U.S. decoupled the dollar from gold in 1976 (the U.S. went off the gold standard in August 1971)
- Similarly, gold jumped to $481 per ounce from $453.7 on Black Monday viz. October 19, 1987. It fell back to $464.3 on the next day

Working of Investment Markets – Demand & Supply

All markets operate on the principle of demand and supply. Prices rise when demand exceeds supply and fall when the reverse occurs.

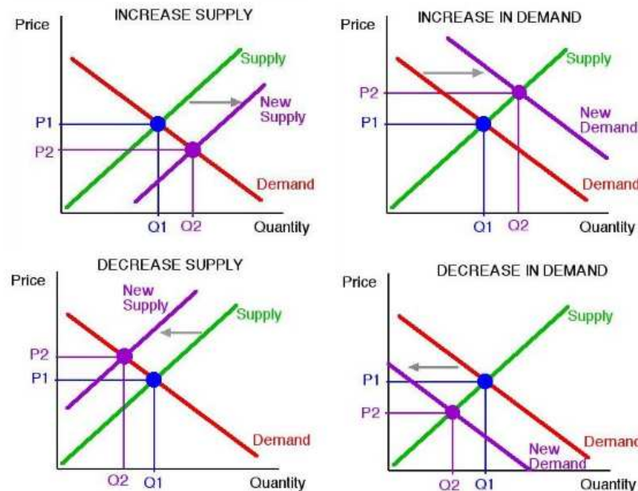


Demand & Supply Curves for Equilibrium between Price & Quantity
Image Courtesy of Resources for History Teachers at
http://resourcesforhistoryteachers.wikispaces.com/E.2.1

More precisely, markets operate on the perception of demand and supply regardless of whether the actual changes in demand and supply occur or not:

- The possibility of shortage in (say) sugar production (on account of drought / deficit rainfall / crop damage due to excessive rainfall / crop disease) will shoot sugar prices through the roof in the commodities market irrespective of whether the shortage materializes

  Stock prices of companies dealing in sugar will also rise in the capital market – again, regardless of whether the shortage actually materializes



Effect of Demand & Supply Changes on Price
Image Courtesy of YGRAPH at http://ygraph.com/chart/2225

- Gold and dollar usually move in the opposite direction because people look to park their wealth in either of these two

  Despite recent reversals, the dollar is still the reserve currency of the world. It has been so since Bretton Woods. And gold has been the reserve asset of the world ever since man discovered its noble nature, literally and figuratively

  If the Federal Reserve of the United States hints at lowering interest rates, gold will rise and vice versa. This is because lower interest rates mean more supply of dollars. According to the demand-supply rules, this will lower the price (i.e. the purchasing power) of the dollar

  Market sentiment will therefore favour gold, the competitor of dollar because people will look to shift their wealth into gold – the dollar is losing value

Why Commodity Markets Produce the Ultimate Boom-Bust Cycles?

Basic asset classes include stocks, bonds, real estate, commodities, cash / deposits, and other possessions. All commodities are assets.

All assets have two types of demand – investment demand and speculation demand. If market conditions favour a certain asset – gold and sugar as examples from our previous section – investment demand for these assets will rise.

This will also fuel the speculation demand for these assets. And speculation demand, by its very nature, is based on hysterical expectations. It can and usually does exceed the investment demand which creates it.

Commodities have a third type of demand – consumption demand. Because they are consumed. And there is a limit to how quickly you can increase their supply.

The speculation demand for commodities is therefore a function of their investment and consumption demand. This causes extreme price variations making commodities produce the ultimate boom-bust cycles.

Regarding gold and silver (both are commodities), their supplies are limited and it takes months if not years to expand supplies. Here, we are talking of real supplies, not perceived supplies based on rumours.

Commodity Markets: Bearish from late 1980s to 2000, followed by the Boom from 2000 to 2011

Commodities follow a 10 to 20 year boom-bust cycle because the response time to changes in demand for commodities is huge. Exploration, mining, and drilling for oil, gas, and metals is a protracted process. Producers also like to wait and watch the price movement of commodities because their prices are so very volatile.

During booms, producers anticipate a rise in demand and start boosting supplies. This entails considerable investment. And once production rises, it is not profitable to turn down the volumes because producers have to recover investments. This inevitably leads to over-supply and a bust.

Delinking of the dollar from gold and excessive printing of dollars in the 1970s meant that the currency lost value (purchasing power). Gold hit $850 an ounce in early 1980. The Oil Shocks of the decade spiked oil prices. All this changed in the early 1980s when the commodities bubble bust.

With commodities turning bearish, people turned to the stock market and there started the two decade steady rise of stocks – except for the 1987 Black Monday shock – when the 'buy and hold' approach was in vogue.

Naturally, investments in commodities fell. This led to falling prices and, therefore, falling supplies. And when the supply falls below demand, prices start to rise again. This time, the demand push came from the insatiable appetite of the Chinese economy for commodities starting from the year 2000.

We are still in this phase of commodities boom when a whole range of commodities – metals, Malaysian palm oil, uranium, wheat, rare earth

metals and what not – are steadily rising. The 2008 crisis depressed commodity prices by 48% but they soon recovered and posted an amazing recovery to surpass the earlier peak of 2008 by 10% in 2011.

Finally

Being commodities, gold and silver deliver margins slowly. But, by their very nature, they are safer in that they do not lose value quickly. Most importantly, they rise to the occasion – when the going gets tough, gold-silver get going!