Gold (13 Jul 07): Rs.14592 / 10gm (MCX)

Gold to soon break-out of the range and resume Long Term uptrend

Gold is where money was rushing when all other investment assets worldwide were losing value during Nov08-Feb09. Gold rose 40% from 11500 to 16000 during this period. The sharp rise was followed by a correction from 16000 in mid-Feb09 to 14000 in mid-Apr09. Gold has since been in a narrow range of 14000-14900. We are of the view that Gold is likely to break-out of this three and a half months long range soon and resume its long term uptrend.

Chart1: Gold Daily Line Chart from 01-Nov-08 to 13-Jul-09

Some of the leading technical indicators indicate an eventual upside break-out. A close above 14900 is likely to lead to an explosive up-move.

While a flight to safety led to the forty per cent up-move during Nov08-Feb09, what will lead the next leg of the rally? We are of the opinion that it is China that may cause this rally. China holds a significantly large portion of its forex reserves in USD. As USD is weakening and likely to weaken given the huge monetary expansion taking place in the US post stimulus-cum-bailouts (what with clamor for another stimulus), China is likely to gradually shift part of its reserves from USD to Gold. The process is already underway. China's official gold reserves have risen from less than 1% to over 1.5% of its forex reserves in the last few months. This is a significant amount of gold. This is more than what central banks of entire Europe sold in the last 5-6 years. China holds 1/5th of the global currency reserves. If even a fraction of that is converted to gold, that would be significant demand for gold given that new supply of gold from mines is limited.

While China lately reiterated that it fully supports USD, we think that's pure posturing. China, being the largest holder of USD, can't talk it down.

Besides China, Russia too wants to build gold reserves. While both China & Russia have overtaken South Africa in quantum of gold production, they are still buyers of gold. We are of the view that unless an alternative mechanism to hold forex reserves is found and accepted by major economies (SDRs & global sovereign currency / bonds are some of the alternatives that have been proposed); many countries are likely to raise proportion of gold reserve in total forex reserves. Hence, this is the single biggest factor that is going to keep Gold strong and USD weak. (Impetus Advisors' long term view on USD can be accessed at www.impetusadvisors.com/research.htm)

It's widely believed and accepted that a weakening USD causes money to flow to commodities including Gold. While investors' money may flow to Gold on USD weakening, it is worth keeping in mind as a caveat that the 40% up-move in Gold till Feb09 happened when USD was strengthening.

Stimuli released by governments world-over to tide over recession or slowdown are likely to lead to inflation with a lag. While some gold-buying has already taken place as a hedge against inflation, more is likely to take place when inflation actually becomes visible.

Current marginal cost of production (MCP) for gold is around Rs.12000. MCP is supposed to act as a long term support. However, MCP itself is dynamic and changes/fluctuates over time with energy prices being a significant cost element of MCP. Over a long term, producers have to recover not only MCP but huge capital costs & mark-up also. But this dynamic & hence flexible support works only over the long term but it gives an idea that at current price of energy & MCP, the support is not far below.

Chart2: Gold Weekly Line Chart from 01-May-04 to 13-Jul-09

The long term uptrend in Gold is intact. This report makes a case for resumption of the up-trend, as the intermediate correction is over and consolidation is likely to give way to an upside break-out soon. This is based on both fundamental and technical indicators mentioned & discussed in the report.

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