



TD Economics

Special Report

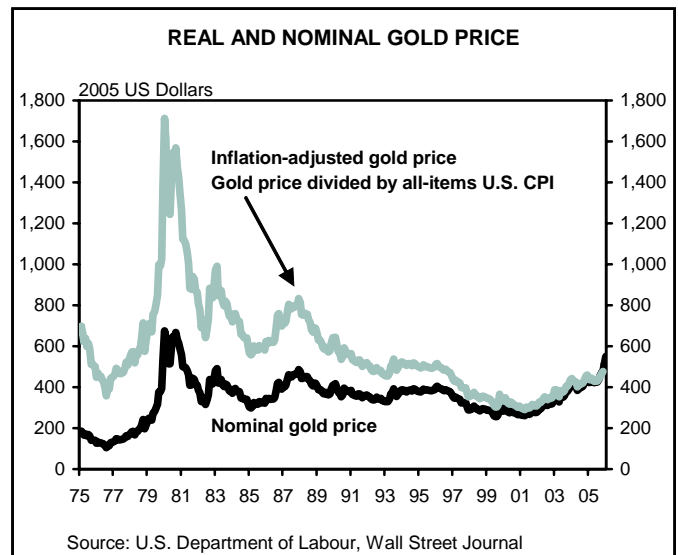
February 14, 2006

GOLD'S NEW ERA

Bullion enjoys renewed life as a hedge against global risks

- The price of gold has more than doubled since April 2001
- Naturally, the price boom is drawing interest from a broader spectrum of investors
- The positive fundamentals for gold should remain in place through 2007
- But investors need to be aware the commodity is risky, has delivered poor longer-term returns and unlike most other investments, provides no income yield
- Still, gold can play a valuable role for many investors – as part of a well-diversified portfolio

The price of gold has taken centre stage in financial markets recently, reaching 25-year highs of about US\$575 per ounce. The price has more than doubled since it plumbed the depths of about US\$260 an ounce in April 2001. Naturally, the price boom has been drawing interest from a broader spectrum of investors. If they have not already invested in the precious metal, they are wondering if they should now. The answer of course depends upon the view of future price prospects. To assess this, we look in this note at the factors that have driven the price of gold in the past and extrapolate these forces into the future. Most notably, the era of global disinflation has recently been replaced by one of rising inflation and rapidly-growing developing markets will continue to place demand pressures on the limited supply. Furthermore, there will continue to be concerns about global risks including the world savings-investment imbalances and geopolitical tensions since 9/11. In short, we find a good case for gold prices remaining elevated.



As some of the recent run-up in gold prices has been driven by momentum buying and speculation, there is the risk of a near-term pull back towards US\$500 per ounce in the first half of 2006. However, this weakness is expected to be short-lived with gold prices moving above US\$600 later this year and remaining in the US\$550-575 range throughout much of 2007.

We also look at the return to gold holdings over the longer-term. Its price volatility creates the potential for considerable short-term gains if investments are timed right. But the longer-term returns have been unfavourable relative to most other investment vehicles and unlike stocks or bonds, gold does not provide an income flow. Gold's best days as a hedge against inflation are behind – our bet is that the world will remain in this new era of low inflation – but it will continue to be attractive as a defense

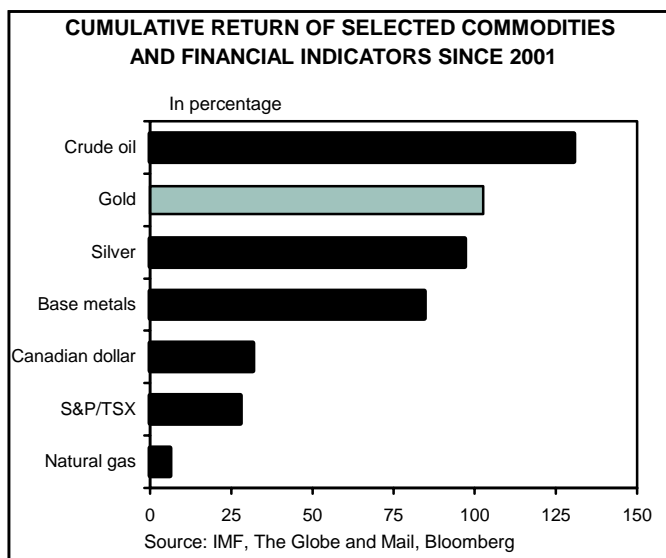
against global financial and economic risks. Therefore, gold has a place in many investors' portfolios, but those portfolios should be well diversified. Finally, we point out ways to participate in the gold market other than buying the physical metal.

Putting the recent rally in perspective

First, it is important to keep the current run-up in the price of gold in context. Gold is not alone in flexing its muscles. For example, gold's latest rally is in the same ballpark as the run of commodities like crude oil, silver and base metals. Further, as the accompanying chart on the first page reveals, gold prices in real (inflation-adjusted) terms remain at the low end of the 30-year range, one-quarter of the record level registered in 1980, and just a notch below the average real price that prevailed in the 1990s.

All factors turn positive for gold

Gold prices may be far from setting new historical records in real terms, but there is no denying the fact that the recent turnaround has packed considerable punch. Indeed, the current rally – 57 months in the making – represents the longest winning streak since the stunning ascent of the 1971-75 period, and slightly longer than the bull run of 1976-80. Most striking, however, is that the current rally snapped an unprecedented 20 year downtrend, where the only discernible respite was a three-year rally in the mid-1980s. This raises two questions: what has changed for gold recently? And then, will the rally have staying power?



FACTORS INFLUENCING GOLD PRICES OVER SELECTED PERIODS						
	1971-75	1976-80	1985-87	1988-00	2001-05	2006-07F
U.S. dollar	-	-	++	-	++	+
Global financial risks	-	-	-	-	++	++
Inflation hedge	++	++	+	--	+	-
Supply / Fabrication Demand	N/A	N/A	N/A	N/A	+	+
Geopolitical risks	-	-	-	-	+	+
Speculation	N/A	N/A	-	-	+	-

Legend: - is small negative, + is small positive, -- is a large negative, ++ is large positive for gold prices, N/A is not available

In order to address these questions, we first have pulled together a table summarizing the most important drivers of gold prices and their respective influence on prices during recent historical episodes. Two points become apparent from the table. First, the price of the yellow metal is driven by a complex set of factors – arguably more than any other commodity or major asset class. And, second, in contrast to other episodes, all major factors have provided support to gold prices since 2001, albeit to differing degrees. We now provide some colour on each of these important drivers.

Supply and demand fundamentals provide support

One fundamental to consider is the commercial market for gold (i.e., demand for gold as a raw commodity rather than for investment.) About 80 per cent of world gold demand is intended for the fabrication of jewelry and industrial products, with the balance comprising investor purchases, gold bar hoarding and the reduction of hedging positions by gold producers. Meanwhile, mine production and old gold scrap represent about 65 per cent and 20 per cent of annual world gold supply, respectively.

A closer look at the commercial market shows that demand has been outpacing supply over the last few years. More specifically, after declining in the late 1990s and early 2000s, fabrication demand increased by about 4 per cent annually in 2004 and 2005, thanks largely to robust buying by the middle class in the emerging markets of China and India.

At the same time, after declining by 4 per cent between 1999 and 2004, mine production edged up by only 1.2 per

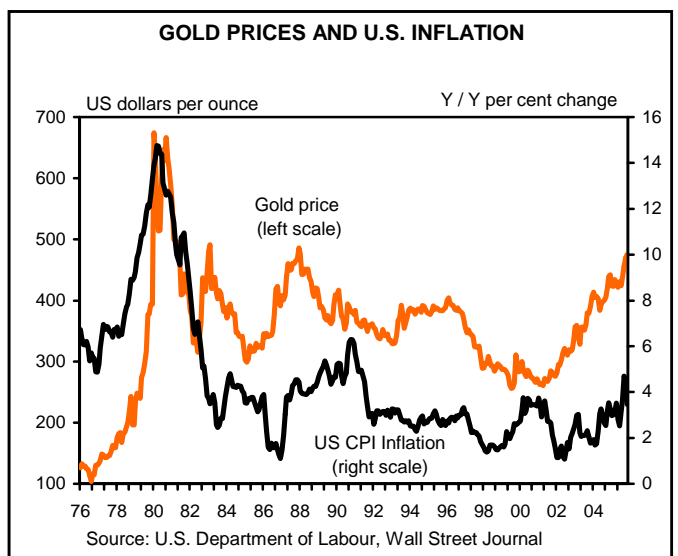
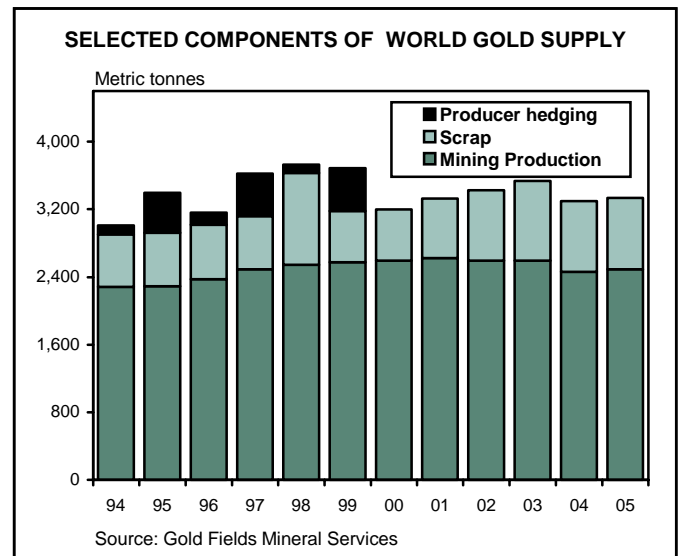
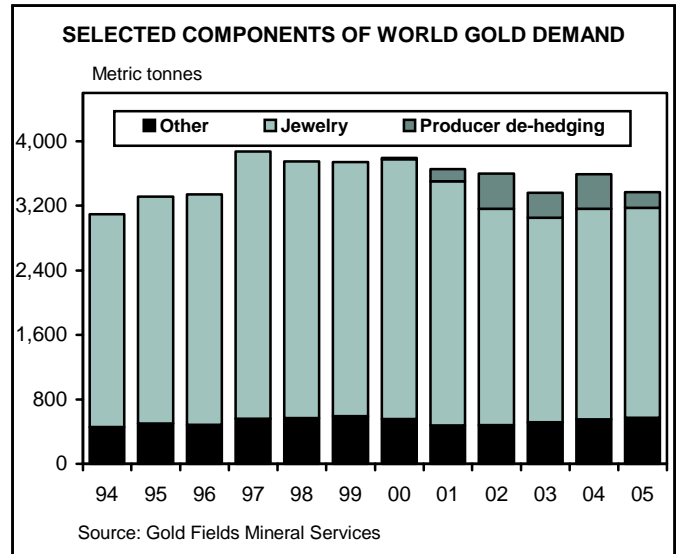
cent in 2005 and remained close to near-decade lows. Despite new production from operating mines in Latin America, output from South America – world top gold producing country – has come under severe downward pressure from mine closures and under-investment in the 1990s. Growth in old gold scrap has been even slower, growing by only 0.8 per cent in 2005.

Another factor in the commercial market that has been providing support to gold lately is reduced hedging by producers. Back in the 1990s, when prices were on a downtrend, hedging activity (e.g. forward contracts) was increasing steadily, as gold suppliers were looking to sell the metal at current prices, assuming that the price of the bullion would continue to decline down the road. To hedge this exposure, gold producers had to borrow gold – indirectly with the assistance of a chartered bank – to a central bank and sell it on the gold market, which acted to boost supply. In contrast, gold producers reduced their hedging position (de-hedging) starting in 2001, providing an added fillip to demand.

Firming inflation a plus

While the commercial market has been a positive force on gold prices of late, it has not tended to be the biggest driver over the long run. A much stronger relationship has held in the past between gold prices and inflation, as investors have frequently taken refuge in the yellow metal to maintain the purchasing power of their capital. For example, double-digit inflation triggered by oil-price shocks was the main engine of the gold rallies in the early and late 1970s. Conversely, the economic recession of the early 1980s – and a resulting drop in inflation expectations – were key players in bringing gold prices out of the stratosphere at that time. And, in the 1990s, gold suffered a particular setback when central bankers around the world successfully arrested inflation from mid- to low-single digits. And, with low inflation went one of gold’s key uses.

Not surprisingly then, the surge in crude oil and natural gas prices over the past few years has brought inflation back to the radar screen – an unambiguously positive development for gold prices. Still, there is good reason to believe that the inflation “premium” on gold prices is relatively modest, especially in comparison to previous rallies. First, headline inflation has remained well contained across the industrialized world, as the dramatic rise in energy prices has failed to spread to most other consumer

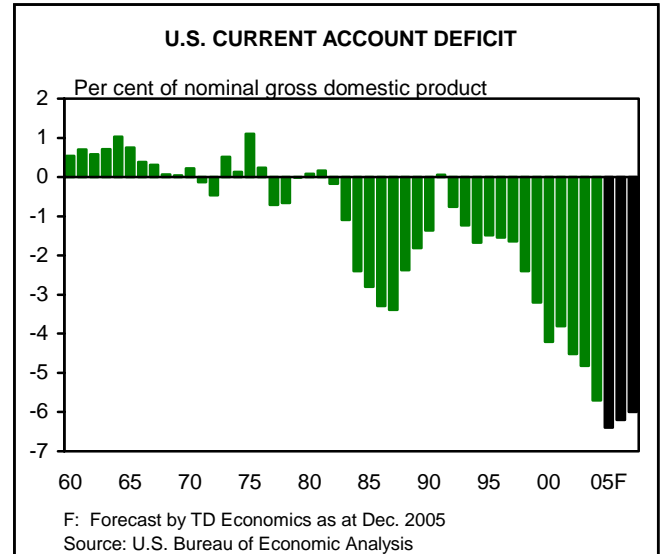
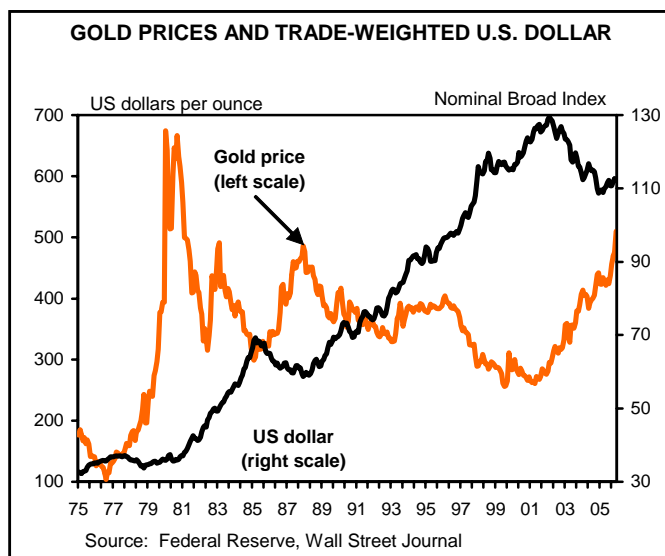


goods and services prices, even in the heavily oil-dependent U.S. economy. Moreover, inflation expectations embedded in the U.S. bond yields (i.e. the gap between the yields of a conventional 10-year U.S. bond and a treasury inflation protected security) has risen by less than one percentage point since 2003, and remains relatively well-anchored at less than 3 per cent.

The fall of the greenback from grace

The relationship between gold prices and the U.S. dollar was spotty at best during the 1970s and early 1980s. However, it has strengthened markedly beginning in 1985, following the signing of the Plaza Accord.¹ In fact, over the last two decades, the (negative) correlation between the greenback and gold prices has proved to be even more powerful than the (positive) one between the bullion and inflation. All things equal, a rising value of the U.S. dollar decreases the U.S.-dollar price of gold worldwide. Hence, in order to restore equilibrium between supply and demand in the world market, the price of gold quoted in U.S. dollars tends to fall. Not surprisingly then, it was only when the U.S. dollar began to depreciate from its unsustainable highs in 2001 that gold began to find its legs.

Interestingly, this gold-U.S. dollar relationship has broken down over the past year, with a positive bounce in the value of the greenback on international currency markets coinciding with – if anything – an acceleration in the rally in gold prices. This development is certainly not unprecedented, and suggests that other influences appear to have taken over in the driver's seat recently. And, as we argued



earlier, firm inflation expectations and the tight supply-demand picture on the commercial market tell only part of the story.

Safety from global financial risks moves to centre stage

In our view, a factor that appears to have moved to the forefront is concern about global economic and financial risks – and in particular mounting global savings-investment imbalances – which have pushed investors into the safety of gold. At the heart of this concern is the massive U.S. current account deficit, which is running at an unprecedented 6 per cent of GDP. This sizeable shortfall reflects the fact that Americans have been importing more goods, services and investment income than they have exported abroad. Fortunately, countries such as China and Japan that are running large current account surpluses have been willing to finance the U.S. deficit by purchasing U.S.-dollar denominated securities. However, if this willingness were to subside, the U.S. dollar would weaken sharply with negative repercussions for the entire global financial system. In fact, research by the International Monetary Fund (IMF) shows that the risk of current account problems rises considerably once a deficit moves above 5 per cent of GDP.

Geopolitical risks are adding to the tensions about global financial imbalances. These worries range from further terrorist attacks, to heightened conflict in the Middle East to the risk of a global flu pandemic. Most recently, it has been al-Qaida's renewed threat of terrorism within the United States borders and tensions about Iran's nuclear program that have added fuel to the gold rally.

In the 1990s, the U.S. dollar was viewed as the safe-haven asset during periods of uncertainty such as the Asian Crisis. But, with the U.S. greenback losing some of its lustre as an insurance policy, especially following its 4-year downward trend, gold has increasingly become an asset of choice during periods of financial-market volatility.

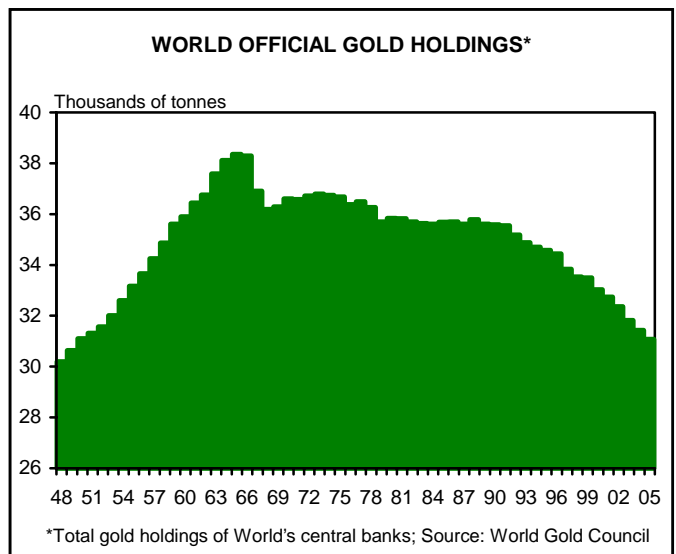
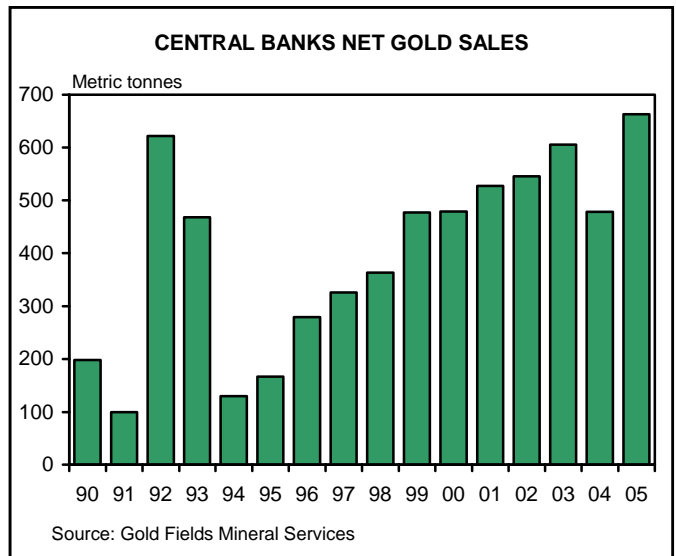
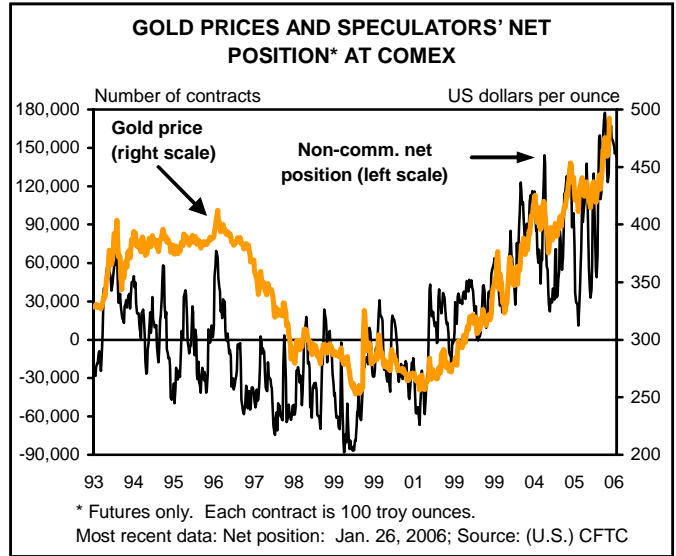
Speculative activity a key driver

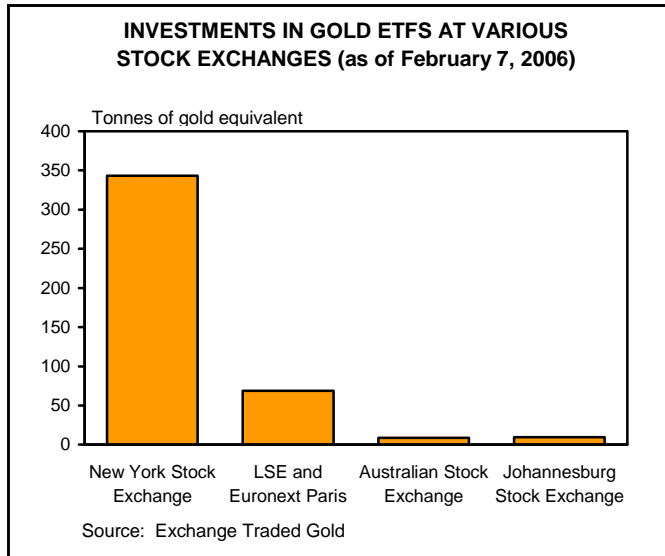
Another key factor that might have shifted gold's rally into overdrive in recent months has been the activities of speculators. The accompanying chart shows that the momentum in gold prices has recently accelerated in tandem with purchases of speculators, who have increased their net long positions to a 20-year high. History shows that the converse is also true. When speculators have reduced their long positions in order to realize profits or for other reasons, gold prices have dropped. In general, speculators are trend followers, moving with the mood of the market. Even more importantly, among all of the influences that we've touched on, this one tends to be the most volatile and hence is the most powerful driver of gold prices over the short term.

In addition to expectations that the fundamentals will continue to turn more positive for gold down the road, speculators appear to be taking increased bets of late that central banks will soon halt a protracted period of selling gold. Last year, net sales of bullion by central banks continued to rise, sending gold held in reserves to a 50-year low. However, in recent months, there has been increased chatter that countries such as China, Russia and Argentina will soon add to their reserve positions in part to diversify away from the U.S. dollar. At the same time, the prevailing view is that these central banks would accumulate gold in an orderly basis in order to prevent a sharp depreciation in the U.S. dollar, an accompanying drop in value of their U.S.-dollar holdings and a strengthening in their own currencies.

Investment activity spurred partly by ETFs

While speculators have been busy taking short-term bets, gold has generated even broader investor appeal with the launch of seven exchange-traded funds (ETF) since 2003. The gold ETF made its first appearance in Australia in 2003, then followed by its introduction in the United Kingdom, France, the United States and South Africa. This new investment vehicle has certainly facilitated investment in the yellow metal, without the hassles of actually hold-





ing the physical asset itself. At the end of 2005, holdings of all ETFs were up 115 per cent on a year-to-year basis, representing a new investment demand for the precious metal. It is still an open question, however, if the gold ETFs will continue to create incremental investment interest in gold or simply cannibalize the market.

Gold to remain well supported in 2006-07

Looking ahead, there is little indication that the positive economic and financial environment for gold will change meaningfully over the next two years.

- Despite our view that the U.S. economy is likely to slow sharply in the second half of 2006 and 2007, we project that the U.S. current account deficit as a share of GDP will narrow only slightly. Hence, this cloud will continue to hang over global financial markets.
- With large U.S. dollar imbalances remaining intact, the greenback is expected to remain under some downward pressure. At the same time, however, we don't believe the U.S. dollar will shed more than 3-5 per cent of its value on a trade-weighted basis in 2006-07, as investors continue to be attracted by the relatively high yields generated by U.S.-dollar fixed-income assets and continued weak economic conditions elsewhere. Put simply, the U.S. will continue to be viewed as a relatively attractive place to invest.
- There is no reason to believe that geopolitical risks will abate.
- The supply-demand balance on the commercial market will remain fairly tight over the foreseeable future.

Look for gold jewelry demand to strengthen further in the fast-growing economies of China and India and little major uptick in mine supply.

- Inflation will remain on the radar screen of investors. At the same time, however, we don't expect to witness an acceleration in inflation. Indeed, as the U.S. economy weakens in the second half of 2006, this will help to pull the price of oil back to \$US50 per barrel by year end. As such, inflation concerns will largely subside.
- Investor activity will remain favourable for gold. Gains in competing financial assets are likely to moderate amid a weakening in North American and global economic growth in the second half of 2006 and in 2007. At the same time, central banks will likely halt the upward trend in net gold sales going forward.

In sum, the key drivers are expected to remain supportive for gold over the next few years. While we see a strong likelihood of a pull back in gold prices over the next few months – back toward the US\$500 per ounce mark – this downward move is likely to be short-lived. Driven in part by seasonal buying, look for gold prices to rise above US\$600 per ounce in the third quarter of 2006 and to remain in the US\$550-575 range throughout much of 2007. *Keep in mind as well that this is TD Economics' base-case forecast. Any unanticipated turbulence in world financial markets, related to events such as terrorism or a crisis of confidence, could push the price of bullion to US\$700 or even higher.*

Gold is not a passing fad

Beyond the short-term horizon, the revival of gold has long-run portfolio implications for investors. First, despite the fact that gold's long secular downtrend appears to be behind, investors should be cautious about the prospects for bullion to deliver a return over the long haul. Put simply, as shown in the above table, gold is fighting

GOLD FORECAST								
End of period price in US\$ per ounce *								
	Forecast							
	2006				2007			
13/02/2006	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
549.30	525	510	605	575	555	540	580	560
* London gold bullion PM ; Source: Kitco ; Forecast by TD Economics as at February 2006								

GOLD AND STOCK PERFORMANCE (PER CENT*)			
Average annualized return (reward)	1975-2005	1985-2005	1995-2005
Gold	5.5	1.5	1.8
U.S. stocks	9.8	10.9	10.3
Canadian stocks	8.9	8.0	9.3
Standard deviation (risk)**			
Gold	24.1	10.5	10.4
U.S. stocks	13.0	13.5	16.3
Canadian stocks	16.2	13.5	16.3
Reward to risk ratio			
Gold	0.2	0.1	0.2
U.S. stocks	0.8	0.8	0.6
Canadian stocks	0.5	0.6	0.6
*Except reward to risk ratio			
** The standard deviation is a measure of the dispersion of a set of returns from its average. The more spread apart the returns are, the higher the deviation.			
Source: Global Insight, Wall Street Journal, TD Economics			

against a poor track record, regardless of the time frame chosen (i.e., 10, 20 or 30 years). And, given the fact that gold has been prone to a considerable volatility in the past, risk-adjusted returns have been even worse.

This fact has been corroborated by Jeremy J. Siegel, a Finance Professor from Wharton, who calculated total cumulative returns (including capital gains, dividends and interest) on stocks, long-term government bonds and gold over the last two centuries after the effects of inflation have been removed.² In other words, he looked at what a dollar would be worth today in real terms if invested in these competing asset groups since the early 1800s. According to his findings, stocks would have earned \$597,485, Treasuries \$301, and gold a paltry \$1.39. In percentage terms, gold has returned 0.1 per cent per year in real terms compared to nearly 7 per cent for stocks. Siegel then explained why these results materialized. From

1871 through 2003, he estimated that 97 per cent of the total after-inflation accumulation from stocks is generated from reinvesting dividends, while only 3 per cent came from capital gains.

We're not suggesting that the results back to 1803 are all that relevant for the future. But, they do provide a powerful message. In particular, a number of investment vehicles reasonably track prices higher, but the strong real gains from equities come from re-investing the dividends. And, that's where gold falls short. Its volatility can make large profits (or losses) of timing. But, unlike dividends from stocks, it yields no income flow. So, over long periods of time, it doesn't tend to go anywhere in real terms, corroborating the chart on page one.

But while gold may not be rivaling equities for returns over the long run, this does not mean that gold won't have an important role to play in an investor's portfolio. Above all, we see gold continuing to play a role as a useful hedge against risk. Here, we are not talking about its traditional role as a protection against inflation risk, since there is no reason to believe that an era of percolating price pressures is poised to return. Rather, gold is likely to be viewed increasingly as a safe haven during periods of global economic and financial uncertainty, with its price rising during periods when higher risk equities and other financial instruments fall victim to selling pressure. Thus, for many investors, holding a small share of gold could help to smooth out the magnitude of year-to-year swings in portfolio values.

Lastly, there are options for investors to benefit from gold rather than buying the physical metal. As we noted earlier, ETFs are one investment vehicle. Moreover, another investment option are gold mining stocks, which often provide investors with leverage to rising gold prices.

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ENDNOTES

- ¹ The Plaza Accord was signed in September 1985 by governments of 5 major industrialized economies (France, West Germany, Japan, the United States and the United Kingdom) to intervene jointly in currency markets. After the agreement, the U.S. dollar depreciated heavily, leading to a surge in gold prices until 1987.
- ² See Jeremy Siegel "The Future For Investors", Crown Publishing Group, 2005, pages 126 and 170.

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