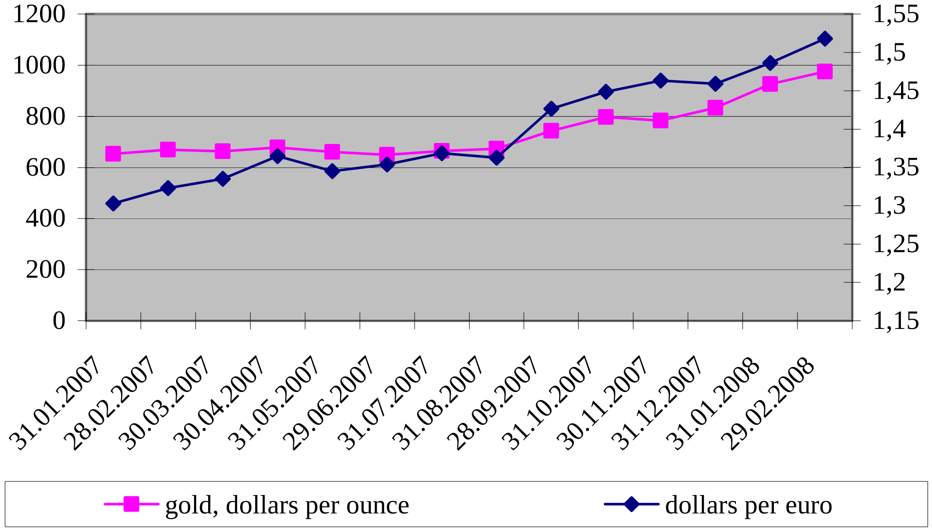
INSTITUTE FOR FINANCIAL STUDIES

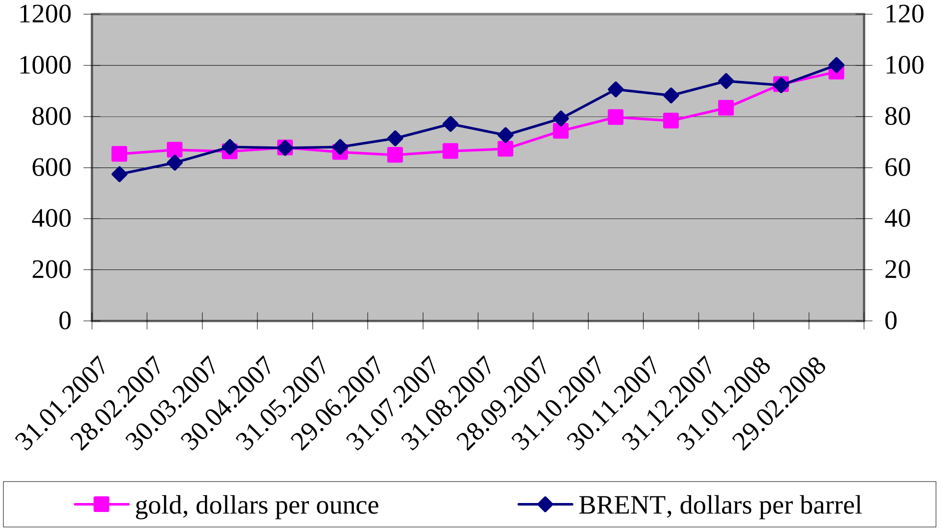
CRISIS GETS GOLD BOOMING

BY GALINA KOVALISHINA, HEAD OF THE CORPORATE FINANCE DEPARTMENT, MARCH 16, 2009

Until recently gold prices have been characterized by a high correlation with the dollar exchange rate and oil price (-0.83 and 0.94 respectively) (see Figure 1).

Figure 1. Gold and oil prices and dollar exchange rate in 2007-2008





Source: Bloomberg

Statistics show that when the dollar falls, gold prices rise and vice versa. This happens because for one thing, gold prices are set in dollars, thus they are subject to changes because of the exchange rate fluctuations. For another, gold assets have been traditionally used as an instrument to cushion whacks faced by the money market. Gold has a positive relation to oil prices – when they surge, the noble metal prices grow, too.

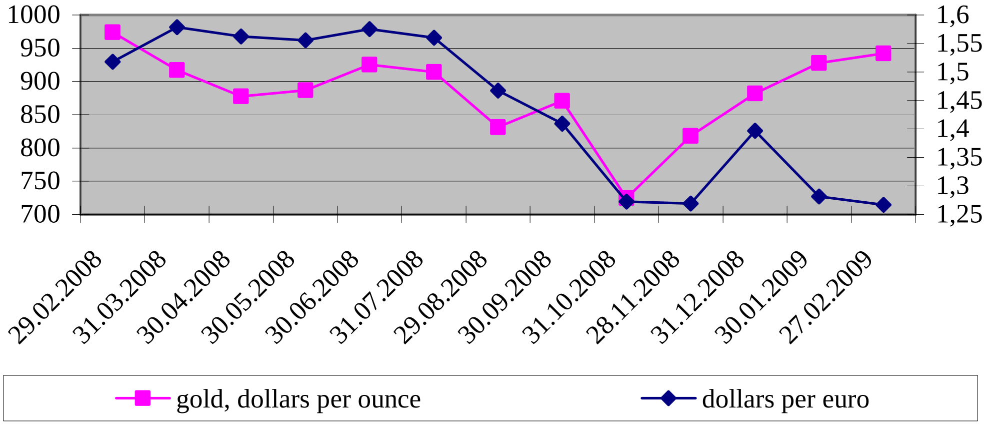
The humankind has been always interested in gold due to its magic attraction, and it's not only about unique properties and beauty of this metal. Gold has long been a symbol of prosperity. Partially due to this reason, gains from oil trading used to be invested in gold assets (this primarily concerns Middle East countries that hold the richest hydrocarbon reserves).

As the world financial crisis deepened and global stock markets collapsed, investors started to shift to alternative stores of value for their money. Practically all commodities markets came under pressure as the balance between demand and supply depended on the global economy. Investors thought gold was a good idea to invest. As a result, for some investors global financial turmoil appeared 'a crisis stronger than the Great Depression'[1], and for gold miners the crisis is reminiscent of the 'gold fever'. Depreciation of the dollar and cheaper prices for oil benefit the gold market.

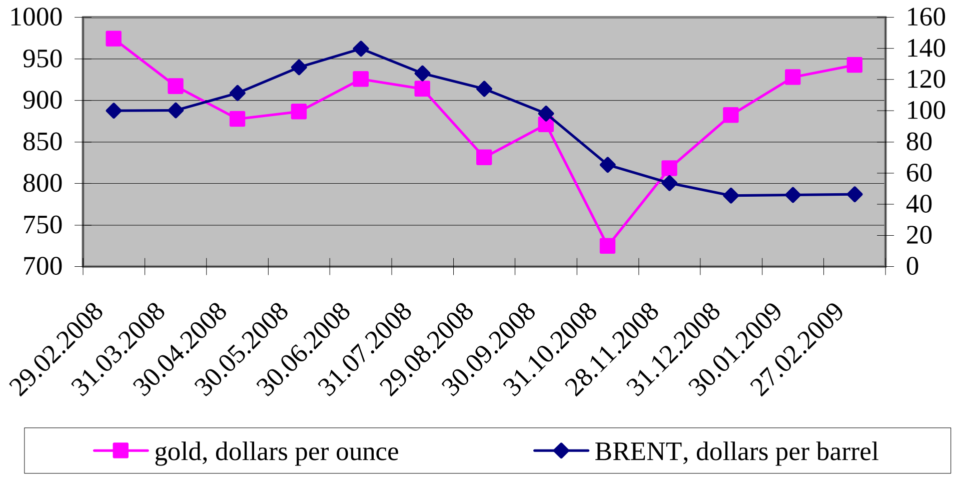
The statistical analysis of oil and gold price movements revealed that in the 1990s the value of one troy ounce of gold corresponded to the cost of 20 barrels of oil on average[2]. In 2000, this ratio dropped to 10. Currently, one ounce of gold trades as 22 barrels of oil.

Starting from late 2008, the value of the yellow metal stopped following the old trends and has been rising ever since regardless of oil prices and the US dollar rate (see Figure 2).

Figure 2. Gold and oil price and dollar exchange rate movements in 2008-03.2009



[1] J. Soros, the University of Columbia, New York, February 20, 2009
[2] C. Kindleberger, R. Aliber (2005), "Manias, Panics, and Crashes", WILEY, p. 4



Source: Bloomberg

Whether this is the beginning of a new trend or a short-term deviation from the old trend is not clear so far. Nonetheless, positive moves in the gold market are supported by flows of investment from other markets. Despite that the dollar has slightly strengthened over the past months, there is high probability that it will plummet again. Raw stock markets, including oil market, have come under pressure of the global industrial recession. Therefore, in view of absence of other stores of value, market players have no choices other than to invest in gold. They should remember however that a boom might go bust.