AFTER THE GOLD RUSH

Stock exchanges across the world have been hit hard by American banking leaders in crisis. This has some experts asking whether this might see the return of the gold bulls, as investors lose confidence in stocks and shares and move their money onto the commodities markets. Eric Payne examines the current state of affairs and ponders the likely outcome.

The possible depth of the current economic crisis was revealed on the 15th September 2008 when Lehman Brothers, a company with a 150 year history, the fourth largest investment bank in the world, filed for bankruptcy, prompting falls in financial markets around the world.

The news in itself was unprecedented, but coming so soon after the US Government bailout of Fannie Mae and Freddie Mac, the sale of Merrill Lynch to the Bank of America and AIG – one of the biggest insurance companies in the US – teetering on the brink, analysts were prompted to declare it 'the biggest financial crisis the world has faced for decades.'

All of which, has some investors concerned about just how deep the banking crisis might go. What is the likely long term impact? Who might the next victims be? In a situation like this rumours can create a reality, hence the massive importance of market confidence. At a London news conference on the same day, Pricewaterhouse Coopers partner, Tony Lomas, said he was stunned at the bank's failure. He said: "It seems amazing that a business as huge as this [Lehman Brothers] can fail in this way, but what it underlines to me is the massive importance of market confidence out there, and once that is gone and nobody wants to trade with you, you are in serious trouble."

Disruptions and adjustments

While American President George W. Bush talked about "disruptions" and "adjustments", carefully steering clear of words like "crisis" and "collapse", it was interesting to note the response of the two Presidential incumbents, one of which will most likely have to manage the result of the current situation, with who knows what waiting to be revealed, they might yet find themselves responsible for guiding the world economy through some very troubled times. Neither men hesitated in condemning the 'greedy and complacent' practices of investors on Wall Street. Democratic Presidential Candidate Barack Obama in a statement called it "the most serious financial crisis since the Great Depression." Republican Presidential Candidate, John McCain, took a slightly different but nevertheless critical tract, stating his belief that while the fundamentals of the American economy remain strong, "Those fundamentals are being threatened because some on Wall Street treated Wall Street like a casino."

The message from all concerned was clear: the American Government will not bail out every bank and insurer on the brink of collapse, they will be allowed to rise or fall by the strength of their own decisions – market forces will be allowed to govern – and no one is too big to fall.

One would hope that the epochal events of 16th September 2008 will be the start of the clear out the banking system needs, the trigger that re-boots the system. However, investors reassured after the government buyout of Fannie Mae and Freddie Mac, were shaken by the onset of even deeper problems with the banking system. Now many of the chips are back up in the air, the question of whether uncertainty on the financial markets might prompt a surge of investment in precious metals rears its head again.

A store of value

Uncertainty on the financial markets and fear of a recession may yet lead to a crisis of confidence with the banks that triggers a spike in gold prices. Many of the early signs are there; the day that news of Lehman Brothers' insolvency was officially announced, the price of oil dived to a seven month low, trading at less than $90 a barrel. One of the characteristics of a recession is that the oil price falls – there is less demand because people will not need to travel as much and they consume less energy. Also, speculators and hedge fund managers who see money to be made from falling markets.

Historically, in times of crisis or economic recession, the Gold price goes up – it is considered a secure investment, with a guaranteed value – a tangible asset recognised the world over. So, in the midst of a global economic crisis, while banks flounder, gold's universal appeal might prove significant.

When the US government guaranteed the future of Fannie May and Freddie Mac, it was believed that this would act as a spur for investors to resume trading. But, with the failure of Lehman Brothers, Merrill Lynch being bought out by the Bank of America, and AIG being bailed out too, while some are being reassured, others are worried that problems with the banking system may run deeper than originally thought.

Charles Dumas, Director of Lombard Street Research, had this to say on the matter: "It may be that major new problems have yet to emerge from the US mortgage crisis, but my perception is that we are now seeing some things getting attractive: triple-A CDOs at 50 cents in the dollar, for example, must offer some opportunities. The economy is clearly set for a tough time, but that is a different matter." In Mr Dumas' opinion, measures taken by the US government to 'steady the ship' as it were are already going some way towards mitigating against unsustainable levels of instability.

A leg up for commodities?

With commodity prices currently so high across the spectrum, volatility extends across the markets. As recently as March gold was ↘

up over $1000 per ounce, now it is trading closer to $800 per ounce – and banking problems have led to the expectation of a new spike. Could falling financial stocks cause the start of a new gold bull run? Is it the leg up that starts it rolling again? Mr Dumas states, “Gold has generally been seen (rightly) as inverse to the dollar. With the latter strengthening in the short term, as the US finally gets real about solvency issues – getting a proper return for the extension of state aid, circling the wagons and beating off the hedge funds – I would not be especially bullish on gold.”

However, as one would expect, there are other investors and analysts who are taking a different view – in their opinion the current situation offers an outstanding opportunity for long term investors to buy gold, and given the financial crisis we are in, the gold price is amazingly cheap. Some analysts have suggested that gold could go as high as $1500 per ounce in just the next two to three years. When you consider that gold was over $1000 dollars an ounce just a few months ago when the Bear Stearns situation happened, ostensibly, this is a very bullish indication that gold can go up significantly from where it is, primarily because of inflation and the expected weakness in the US dollar.

Further indication that gold and other precious metal commodities are currently being oversold is surely evidenced in the fact that there are so many new mines currently under development and commission. Looking at the long term picture, there are new gold mines due to come online in 2011/2012 from companies such as Harmony, Oz Minerals and Kento Gold. The physical demand for gold remains high. So, the likely next move remains in the balance, though government intervention has gone some way towards settling investors' nerves in the short term, as ever, regardless of market trends the long term future of commodity stocks looks strong. □