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Lumen – the Latin word for light

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Investor Demand Drives Gold Scarcity and Price

Last week, a good friend shared his insightful analysis of gold with me in an email. His email goes something like this:

> "It is interesting to see that global investment demand is now larger than jewelry demand. I have said for a long time that the investment sector will have a HUGE effect on the price of gold, since only about 2,700 tons are produce each year, which translates to 0.0126 oz/person/yr. If only 1% of the people buy gold globally, then the number is 1.26 oz/person/year, which is not much. Then consider that the 2,700 tons produced each year is already spoken for. So where will the gold come from when investors want to buy it? The answer is that there will not be much of it to go around. May be only another 500 tons per year will float out of hoards into investor's hands. So instead of 2,700 tons, only 500 tons are available, which is about 0.00233 oz/person/year. Again, if 1% of the population is to buy gold, they can get only 0.233 oz/person/year. That is very interesting. It seems like the price of gold has a HUGE sensitivity to investor demand."

After reading the email, I did a little digging to verify my friend's analysis and this is what I found:

Ton	**2006**	**2007**	**2008**	**Avg.**
Supply				
Total mine supply (incl. net producer hedging)	2,075	2,034	2,057	2,055
Central bank sales	365	484	246	365
Old gold scrap	1,129	958	1,215	1,101
Total supply	**3,569**	**3,476**	**3,518**	**3,521**
Demand				
Fabrication (Jewelry, industrial, dental)	2,748	2,866	2,621	2,745
Investment	676	685	1,184	848
Total demand	**3,424**	**3,551**	**3,805**	**3,593**

Data Source: World Gold Council

So my friend's production number is a little off, but his total supply tonnage is almost spot on. As the table shows, fabrication demand outstripped mine supply in each of the past three years. After using central banks supply and scrap for fabrication, there is really very little left for investors. And as you can imagine, and confirmed by data, gold investment has been on the rise. With so little gold left for a growing herd of eager investors, is there any wonder why gold spiked 60% between 2006 and 2009?

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Naturally, when investors cannot find enough gold to buy, they will look for substitutes. Historically, one of the substitutes had been silver, and this time should be no different. Borrowing my friend's analysis and using it on silver, I found another interesting result. Using data from GFMS, total supply exceeded fabrication demand of 833 million ounce by 50 million ounce in 2008. In other words, there was 50 million ounce available for investment. Again, if 1% of the world population buys silver for investment, each buyer would have been able to buy only 0.75 oz last year!

For decades, precious metals received no respect from investors. As there was little investor demand, producers were geared to satisfy fabricators only. But the world changed. Precious metal investment is gaining momentum; and producers are not prepared for it. There would not have been enough to go around absent 'leakage' from existing hoards.

How long can this leakage continue? Central banks are almost entirely out of silver. Their gold reserves stand at 35,000 tons. If they continue their sale rate of 400 tons a year, that gold will last under 90 years, a long time. But do we expect central banks to hold no gold and silver? And what if investor interest accelerates? Inflows into precious metal ETFs are rising. Or what if central banks reverse their position and start buying back gold to shore up currencies? What if there is a currency crisis and the global community demand the IMF to create a new reserve currency backed by gold?

These are far-fetched scenarios, but they are not improbable. Remember black swan? At a time like this, the upside for gold and silver far outweighs the downside.

Disclosure: Lumen Funds is long gold and silver