Gold Set to Take a Tumble as Miners Rev Up

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The argument in favour of rising gold prices – the U.S. is printing money like you wouldn't believe! – was heard throughout most of 2010, when gold reached its high of more than $1,400 (U.S.) an ounce. But the supply-and-demand picture continues to suggest that gold's lustre is fading.

Pawel Rajszel at ***Veritas Investment Research*** recently published a detailed report on the matter. It argues that global production of the precious metal is headed up, which will mean increased supply and likely put a lid on prices.

As ***Mr. Rajszel*** noted, gold production had been falling steadily since 2001, when gold traded below $300 an ounce – but it is picking up as producers take advantage of higher gold prices, low debt levels and big cash holdings. In 2009, production snapped back to its highest level since 2003, and this rise is not likely a one-off event.

"We see 2009 as an inflection point that precedes a new leg of rising global production," Mr. Rajszel said in his note. "A long streak of record-setting prices has made once-marginal deposits economic – such as previously abandoned properties – and has spawned the development of new mines, which we expect will ramp up in the coming years."

He looked at the growth plans of 20 gold producers, collectively representing half of the world's current mine supply. These companies include most of the household names – such as Barrick (ABX-T50.30-1.29-2.50%), Goldcorp (G-T43.61-0.89-2.00%), Newmont (NMC-T57.84-0.82-1.40%) and AngloGold (AU-N46.48-0.40-0.85%) – and therefore give a good indication where the global supply is headed.

The answer: Up. These 20 companies are set to increase production by 25 per cent by 2013, to an estimated 50 million troy ounces from 40 million troy ounces in 2010. Factor in output from the other half of the world's producers and global production should rise to 100 million ounces, which sails past the previous high of 83.7 million ounces.

You can see why. The cost of pulling gold out of the ground is estimated at about $800 an ounce, which is considerably below the price at which gold is currently trading hands, even after its dip on Tuesday to $1,379 an ounce, down about 3 per cent from its peak.

"This follows the old adage that the cure for high commodity prices is higher commodity prices. Eventually, producers respond with more supply, bringing prices down," Mr. Rajszel said.

This new supply of gold could be hard to sop up by the market. With gold at, say, $1,400 an ounce, Mr. Rajszel argues that investors will have to buy an additional $29-billion worth of gold each year just to keep the price of gold flat.

"Since buyers are harder to find amid rising supply, we suspect investors may not rise to the challenge, choosing to let prices fall instead," he said.

He estimates that gold could meander down to $900 an ounce by 2013. If central banks start to sell their gold holdings again, after taking a recent breather, then $800 an ounce could be possible.

Yes, a 35- to 40-per-cent drop sounds catastrophic. Maybe inconceivable. But let's put it another way: Even a dip of that magnitude would only send the price of gold back to where it was just two years ago.