QUANTUM ASSET MANAGEMENT COMPANY PRIVATE LIMITED

As 2011 draws to a close, it is easy to say that the year has seen its share of ups and downs. This is mainly because of the high volatility in the markets, in reaction to the daily pressures on the world stage. We witnessed one of the most dramatic price increases in gold followed by a sharp correction, and 2011 can probably be defined as one of the most volatile years for the precious yellow metal. Gold surged from roughly $1400 to $1900 within a single year as Europe's debt crisis aggravated, only to be followed by a 61% revision from $1900 to just under $1600 in the last three months of 2011.

The overall global environment remains complicated, and the effects can still be felt on the markets. Historically, gold tends to thrive in such uncertain times. On the contrary, there is a sharp fall in gold prices, and hence investors are asking all types of questions surrounding this unexpected decline in gold prices. Many market watchers are so perplexed that they are surrendering to the "gold bubble" story.

Gold's recent decline is a much talked about subject these days. These discussions however, omit the very fact that gold prices are still positive with gains of almost 15% for the year. Such gains come at a time when most of the other asset classes are negative. We believe that the recent fall in gold's price is akin to the corrective phases seen in gold throughout this Bull Run. The fall can probably be attributed to a variety of reasons like the increase in dollar, liquidation to fund losses in other assets / meet redemptions, a dash for cash (dollar liquidity shortage) and severe slow down in physical demand, etc.

Yes, all these reasons do help surmise gold's recent decline albeit not completely. It is highly probable that the fall is more on account of lack of catalysts that have helped push gold to record highs. In simple words, it is a move towards more rational behavior despite the ongoing crisis. We are used to seeing interventions by central banks through monetary infusions to resolve the underlying issues and attempt to promote growth in such uncertain times. However, this time around, the market forces have pressured central banks to not bow down to such ill-conceived notions.

The reluctance of central banks although forced to avoid further easing measures have in the short term removed the catalysts for gold prices to increase further. Markets were expecting an announcement of QE3 soon which didn't materialise even after the recent FOMC meeting. In light of intensification of the euro zone crisis, there was a view that the ECB would start printing to paper over the debt problems, but it's not happened as yet.

This reluctance (although forced) along with other factors have triggered the fall in gold prices. It is perhaps a momentary phase, which will end at the first signs of monetary debasement. The current show of rationality is just an eyewash since there have been no real efforts to cut down spending, control deficits and solve the long-term funding and debt issues. The Euro zone crisis has not found a resolution yet. There have been some signs of easing lately because of ECB (European Central Bank) induced liquidity measure, which is again a bullish sign for gold.

Outlook:

Remember that gold prices have been soaring for 10 straight years, and from that long-term perspective, not much has changed for gold.

The main reason we believe that it's fundamentals are probably intact is because of the policy-making theories; mainly the concept that the economy can be made stronger via more monetary inflation, further credit expansion and additional government spending.

The main influencing factor in the gold market today is the massive and unrealistic pile of sovereign debt throughout the western financial system. This pile up is coupled with a paper currency that is positioned as the reserve currency of the world, which unfortunately can be issued and abused by a single government. These high levels of debt combined with slow economic growth, compel central banks around the world to 'print' more dollars and other currencies (in

order to pay the bills), stimulate the economy and inflate the debt burden with an intentional plan of currency devaluation.

The Euro zone is currently a ticking financial time bomb as sovereign debt slowly positions itself towards a massive explosion of epic proportions. The intended lending by ECB to European banks to facilitate liquidity and resolve the crisis is in vain as a debt crisis cannot be solved by issuing more debt or by creating money out of thin air. It is just an extension of the measures undertaken by the Fed towards more monetary debasement. Issues such as the lack of internal policing and commitment from its member nations render the possibility of a credible fiscal union meaningless.

The free market principles and a natural cycle of correcting the malfunctions and excesses in the economy have been severely hampered by the dominant policymaking. This is a cause for real concern. Various tools have been employed like accounting changes, bail-outs and support schemes, currency interventions, imposition of zero interest rates, collateral squeezes, etc. but they are only making things worse. Such aids leave the markets guessing about the potential levels that would propel the central bankers to pull the triggers for further monetary infusions. These actions could create short-term market rallies and add to the speculative fervor. Markets are functioning on a perverse logic that weak data is good for the markets as it only increases the certainty of further monetary interventions with money created out of thin air. However, these methods not only fail to address the underlying problems, but also complicate problems over the long term and lead to misallocation and misuse of scarce resources.

Negative real rates still prevail, and with the economic outlook still showing no signs of real improvement, these downbeat real rates will not fade away easily as any increase in interest rates would cause considerable strain to the already hampered public finances. They are likely to exist for a longer period, and would probably help gold move up as investors look at it from a 'wealth preservation' perspective. Diversification of reserves and investment into gold seems to be the course of action, and is likely to continue in the future as well, thereby supporting gold

prices. Such corrective phases tend to drive gold from weaker to much stronger and stable hands thus reinforcing the diversification theme.

To sum up, there does not seem to be any change in the fundamentals that have led to the Bull Run in gold. The factors that have caused a sharp decline in gold prices seem to be of a temporary nature. This is most likely a corrective, consolidative phase in gold prices, which has been an integral part of the move and should not come as a surprise.

The long-term trends:

The relatively high prices seen over the past few years are well supported by fundamental factors. We believe that gold is rightly increasing in nominal value being the only currency whose supply is highly constrained. In simple words, gold is simply adjusting to changes in global monetary conditions. When a central bank increases their money supply, the price of other currencies adjusts upwards. This is true for all currencies, including gold.

Long-term trends in gold prices are driven by changes in the overall level of confidence in the monetary system and economy. Therefore, we should view gold as a monetary asset rather than a commodity. Given the current economic backdrop where governments are struggling with problems like rising deficits and unsustainable debts, it is indeed logical for gold prices to increase in value. With policy makers continuously debasing currencies, gold can be viewed as an investment that will provide some solace in the current chaos.

Over the long term, we can clearly see that gold prices are trending upwards. The macro-economic and supply-demand drivers point to a continued increase in gold prices. Demand from consumption centers, such as India and China largely seem to be on a firm footing. Investment demand has been robust and is likely to continue to grow, lending support to gold prices. We do not believe that there is a 'bubble' developing in gold, as the relatively high prices seen recently are supported by fundamental factors. Broad themes that would drive gold prices are currency debasement, rising inflationary fears and diversification of investments to gold. However, gold as a percentage of total investments is still very miniscule and hence even a small shift to gold can lead to large price increases. If concerns surrounding Quantitative Easing, monetization and

European sovereign debt defaults trigger another broadly based loss of risk appetite, investors would no doubt want to increase their gold holdings.

The uncertain macroeconomic environment and looming inflationary threat over a long term reiterates the need for gold in one's portfolio. This seems to be a good time to make a strategic allocation to gold, as it is the counterweight to paper money, which is continuously losing credibility as a store of value.