

Gold may regain its shine

Dominic McCormick | Select Asset Management | 13 April 2015 |

Gold has largely been on the nose with investors since peaking in August 2011 at just over US\$1,900. Investor sentiment towards it remains terrible, with many commentators still calling for a price of US\$1,000 or lower while some higher cost gold miners are struggling to survive.

Recently, on 17 March – the night before the US Federal Reserve's Open Market Committee meeting for March – with gold trading at around US\$1,150, I came across the following articles:

1. "[Ricks Pick sees gold eventually falling to \\$817](#)";
2. "[Gold: The Stock Pickers Era Begins](#)" (the article argued for gold going below US\$1,100 in the short term); and,
3. "[Short-term gold bounce but danger looming](#)" (this article saw gold heading to US\$1,080 or lower).

Of course, there's nothing new in these sorts of headlines. Commentators have been writing bearish gold articles for years. However, the surprising element here is that these were the first three articles listed on prominent "gold bugs" website, 321Gold.com. When even the gold bugs are giving up on gold, there's a fair chance we are not too far from the bottom.

Since then, gold has rallied modestly to just over US\$1,200 in early April – certainly not enough to confirm a new bull run, but perhaps enough to give investors pause and reconsider their exposure (or lack thereof) to gold.

Indeed, despite the general pessimism, looking back over the last two years, there's a case that gold has done remarkably well considering the significant headwinds against it. After all, at around US\$1,200, gold is essentially at the same levels it reached in mid-2013 after its major, almost two year decline from US\$1,900. It has since traded in a broad range between US\$1,150 and US\$1,400. Importantly, though, it has held these levels since mid-2013 during a time when some key commodity prices such as oil, coal and iron ore have collapsed by 60% or more – perhaps hinting that gold's monetary role makes it more than just another commodity.

In addition, gold has held relatively steady despite the recent major strength of the US dollar, a factor which typically punishes gold. Indeed, non-US dollar investors have actually seen the local currency gold price rise – in some cases significantly – as their currencies have

weakened. For example, the Australian dollar price of gold at around A\$1,550 is actually almost 20% above the lows of around A\$1,300 in mid-2013.

But, the positive forward-looking story for gold is not its recent resilience (for local investors, particularly) but rather relates to the current and evolving financial and economic environment. History shows that gold tends to do well in periods where interest rates and, particularly, real interest rates are at low or negative levels. Today, we see very low and even negative nominal and real interest rates universally – that is, an environment where the opportunity cost of, and competition from, interest rates on fiat currencies is at very low or negative levels.

In a world where central banks seem committed to debasing the purchasing power of currencies locally (via persistent even if low levels of inflation) and overseas (via currency depreciation), at the same time offering savers close to zero or negative real return to compensate for this, gold – which cannot be debased by governments or central banks – is attractive.

To date, this attractiveness has been overwhelmed by fear that the US is poised to raise short-term interest rates and interrupt this environment. However, persistent dovishness from the US Federal Reserve and tepid US economic growth suggests that rate rises will either be further delayed or very modest when they do come. Given the corner the Fed has painted itself after years of near zero rates, the question is whether it can maintain credibility and the faith of investors through this phase.

Arguably, the initial strong bull run in gold post-GFC was driven by concern that central banks lacked policies to fully remedy economic problems, or that their policies would increase financial instability. However, perhaps this sentiment went too far in relation to fears of collapse of the Euro and was challenged by signs that the US was recovering without any significant inflationary implications. To many, it has seemed that the extreme monetary policies of the US central bank are working well without any major nasty side effects. Indeed, faith in central bank policies through this period was clearly in a major bull market.

But, now there are signs that this faith and confidence in central banks may be peaking. The US economy, while better than most, is struggling to maintain growth momentum and in the background still has some major debt problems, as does most of the developed world. While there is short-term confidence that European QE will support asset prices, views on its longer term impact on economic fundamentals are more cautious.

The much-quoted sentiment that there is a limited role for gold because these extreme monetary policies have not yet resulted in inflation is premature, in my view. Such an assessment can only be properly done after this cycle is fully completed and when economies and monetary policies have normalised, something that may be years away yet.

In the meantime, the fear of deflation has replaced any fear of inflation – which arguably needs to happen to set the base for an eventual inflation surprise. On this note, I was

amused recently by a media article that highlighted that Australia's inflation was "better" than that of the US because it was higher. It seems that the danger of inflation to an economy and to investors – which has been extremely damaging though parts of Australia's history – has been forgotten completely, and turned on its head. Debasing your currency is seen as good – and preserving or enhancing its value as bad.

It seems few investors today have any significant allocation to gold either via bullion (directly or via ETFs) or other ways of gaining gold exposure (such as owning mining stocks). Yet, in a world in which investors have chased risks in response to minimal interest rates and with increasingly fewer places for investors to hide, gold is one of the few unloved, undervalued and potentially diversifying investment areas available. While it has offered a very bumpy and challenging ride in recent years, I suspect those prepared to buy and hold some gold exposure today will be well rewarded looking back a few years from now.



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