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The case for gold resurrected

Dominic McCormick | Select Investment Partners | 04 February 2016

Gold peaked at just over US$1,900 in September 2011. And then it fell almost 45% to under US$1,050 in late 2015 before clawing its way back to around US$1,140 currently. Many still expect it to resume a downward trend and fall further, including breaking the important US$1,000 level.

However, there are solid reasons to be positive on gold – and even to make the case that gold is entering a new cyclical bull market, or resuming its secular bull market from US$250 in 2001 (depending on your perspective). Many of these reasons relate to a reversal of some of the factors that have driven gold's weakness and widespread bearishness over the past several years:

1. The expectation of a series of rises in global interest rates, led by the US Federal Reserve, which has weighed on gold sentiment for the last couple of years and which may now not occur, or at least may occur at a much slower pace than previously expected given the response to the Fed's initial rate rise in December 2015.
2. An increasing number of short-term official interest rates and sovereign bonds are now trading at negative yields so the opportunity cost of holding gold largely disappears. JP Morgan estimates that approximately US$5.5 trillion of developed market sovereign bonds are currently priced at negative yields.
3. Confidence in central banks is faltering as they resort to more extreme and haphazard policies. Just a couple of weeks ago, Bank of Japan (BOJ) head Kuroda said the BOJ was not considering negative interest rates – before announcing them on 29 January.
4. A natural investor reaction to minimal/negative interest rates in recent years has been to seek income from stocks and property. However, the recent sharp weakness in most global stockmarkets and easing property markets has dampened this appetite.
5. There are therefore few alternatives left as investors grapple for opportunities to preserve and enhance wealth. Gold is looking more attractive when the major competition is minimal or negative interest rates. Historically, low or negative real interest rates (let alone negative nominal rates) have been a key driver of a higher gold price.

6. Counterparty risk is coming back on the table after several years of complacency and low debt defaults. This is showing up in higher credit spreads and in the recent under-performance of bank stocks globally. Gold's lack of any counterparty risk becomes more attractive in such an environment.
7. Although gold's recent resilience versus other commodities (which have plummeted in the last year) has highlighted its unique monetary characteristics, an eventual recovery in commodity prices should also be supportive for gold.

What was interesting in regard to the BOJ's announcement to move to negative interest rates on 29 January was the initial reaction of the gold market. Gold immediately fell by around US$6 (a knee jerk reaction to a stronger US Dollar versus Yen) but then reversed that fall within minutes, rising by US$4 and then fluctuating around unchanged levels for the rest of the day at around US$1116. In US trading that Friday night, gold edged up slightly but has since rallied further as markets have reassessed the implications for more negative interest rates globally.

This response is telling me that while there is plenty of uncertainty about the gold price outlook, the move to lower and negative interest rates globally is becoming more of a force compared to the simple inverse relationship with the US Dollar (USD). In any case, USD strength seems to be waning and is certainly a very crowded trade. Indeed, its strength has been another key bearish argument for gold's weakness in recent years that may dissipate soon, particularly if we see more disappointments regarding economic growth.

But isn't gold a protector from inflation? Isn't deflation the big issue for global markets currently? Why should gold perform well in this environment?

Gold offers protection against debasement of currencies – something central banks are going all out to achieve at the moment, both by lowering their currency in terms of other currencies and/or desperately trying to achieve higher (at least 2%) domestic inflation.

The risk is that unconventional policies pushed too far will eventually succeed wildly in this debasement, manifesting either through disorderly currency declines or surging domestic inflation (or both) but with chaotic implications for a range of financial markets and economies. Even if these risks are still several years away, there is a strong rationale to hold some gold as a safe haven/diversifier. Those who assess the gold price outlook only in terms of the current consumer price inflation are assessing the situation far too simplistically.

Of course, the above discussion regarding gold has been in terms of its USD price. In various other currencies, gold has arguably been in a new bull market for some time. Australian Dollar (AUD) gold is currently around $1,600 from around $1,350 towards the end of 2014 (up almost 20%). It's worth noting that at the USD gold peak in September 2011 the AUD gold price peak was around $1,750, only 10% above current levels. Gold has obviously also performed particularly well in a number of other currencies that have fallen sharply against the USD in recent years.

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The recent strong AUD performance of gold partly explains strong returns from many local gold mining stocks in the last year or so. Gold and gold stocks have also been resilient in the latest stock market sell off, with both up solidly so far in 2016 compared to falls of 5% to 10% for global stockmarkets.

As noted above, even over longer periods, gold has actually been one of the best performing "commodities" in the mining industry and indeed has benefited generally from the woes in mining. A range of mining costs have come down significantly - labour, contractors, equipment hire, etc. The sharp decline in energy costs is also a significant input to the gold mining industry. Companies have therefore been able to cut costs and expand margins despite the gloomy mining environment. A similar dynamic in a different context was at work in the 1930s when a one-off devaluation of the USD against gold and significant falls in mining costs in a deflationary environment led to good returns from the few listed gold miners available at the time.

Obviously, any further sustained recovery in the USD gold price (assuming a continued subdued AUD) could lead to further significant improvement in these economics. Currently, most gold mining stocks are trading below book value.

Despite the recent good performance, particularly from an Australian perspective, it doesn't seem that many investors have yet become particularly enthusiastic about gold or gold stocks. Indeed, many of our clients have largely given up on gold in their portfolios. In addition, the investment industry (platforms/research houses/media) is making it increasingly difficult to access the few available gold investment options. In an *Australian Financial Review* 2016 outlook piece for Australian shares published on 29 December 2015 which discussed 73 stocks, not one gold mining stock was mentioned. Bearishness is still the dominant sentiment. This is not surprising given that gold mining stocks are coming out of arguably their worst bear market in history.

In another interesting anecdote, in the current popular US online series "Billions" featuring a fictional US hedge fund manager Bobby "Axe" Axelrod battling a US Attorney, gold got a mention at the beginning of the second episode. Taking a phone call from a strategist Axe says, "Pete, the gold standard is never coming back" followed by a few expletives, before hanging up. His personal assistant apologetically says, "If I had known it was a gold play, I would never have put it through" to which Axe responds "always put that lunatic through, one out of every 200 ideas is 'expletive' brilliant!"

Perhaps we are never going back to a gold standard. But when a popular TV show is dismissing gold in this fashion, you get a clear idea of where the consensus view - and contrarian opportunity - is.

Indeed, I think it's a dangerous time to dismiss anything left field in global financial markets, economics or geopolitics.

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When central banks are taking to extreme policies, and Donald Trump has a decent chance of becoming the next US President, we need to be prepared for anything. Gold may not be the perfect hedge to a range of these risks, but what is?

The future is always uncertain but it is important to attempt to look forward, not backward, and the inherent behaviour of markets can tell you something. It's worth taking notice of the refusal of the gold price to crash below US$1,000 in 2015, as many commentators and investment banks expected it to, at a time when commodities were generally extremely weak.

The current environment is particularly challenging for investors. There are few clear investment options in a world where interest rates are extremely low (or negative) and many equity markets seem to have rolled over into downtrends that likely have further to go, particularly with the key US market still expensive at a time of declining earnings.

Meanwhile, confidence in the ability of central banks to resurrect world growth without financial instability is fading, and increasingly desperate policies and haphazard decisions are being introduced.

The east (China and India) continues to buy gold aggressively. However, a major move up in the USD gold price is only likely once Western interest and demand improves. The slowing of Gold ETF redemptions and growth of holdings by 40 tonnes so far this year is a positive development in this regard.

Gold exposure certainly has a role in portfolios as a diversifier – and as an undervalued opportunity in the current challenging environment. However, given the pain experienced by investors who bought in towards the top, many of whom have since abandoned that exposure, it is no surprise it will take some time for them to view gold favourably again, if they ever do.

Perhaps the good performance of gold and gold stocks so far in 2016 in a very tough equity market environment will encourage more interest and 2016 could well be the year when many investors embrace gold again. However, having seen a number of false dawns, even the gold bulls remain somewhat cautious. Still, this is another positive sign, as experienced investors know that the most robust of bull markets always "climb a wall of worry".

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