

Tools or jewels?

Louis-Vincent Gave | GaveKal | 03 February 2016

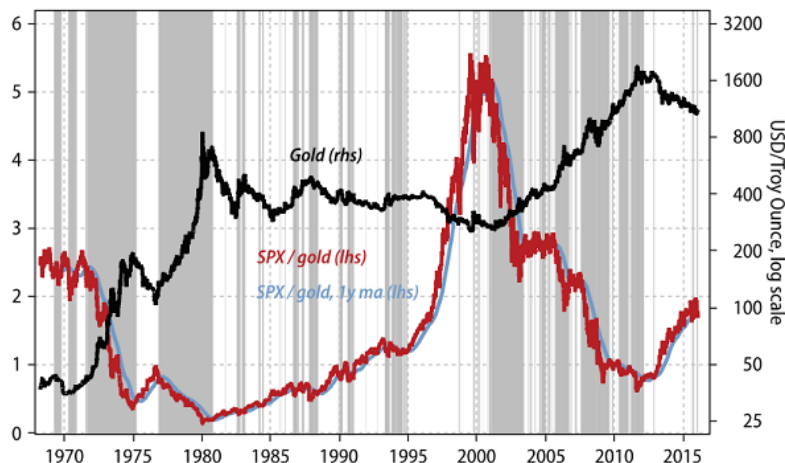
An asset can have value for reasons of scarcity (a jewel), or because it is useful and productive and so over time generates positive cash flows (a tool). In the long run, tools tend to go up more in value than jewels. Tools also have a terrific advantage in that projecting their future productivity and discounting their future cash-flows allows them to be valued objectively. By contrast, valuing jewels is a crapshoot – buying a painting, a car, a bar of gold or a diamond in the hope of future monetary gain is an inherent bet on the "greater fool theory" (i.e. that down the road, another sucker will buy the same (unchanged) asset for a higher price).

Of course, this does not mean that tools cannot underperform jewels for long periods. For example, if the S&P 500 is used as a proxy for "tools" and gold as a proxy for "jewels", it can be seen that scarcity outperformed usefulness for long periods including 1970–75, 1976–81, and 2000–12. For their part, tools recorded fairly steady outperformance in 1982–2000 and 2012–2015.

Which brings us to today and the fact that the S&P 500/gold ratio has again moved back below its one-year moving average – gold is back to outperforming stocks (Figure 1). Is this a head fake, as happened repeatedly in the last big stretch of equity outperformance (1982–99), or the start of a new trend?

Figure 1: Gold and US equities

Shaded areas: S&P 500 underperforms gold (ratio below 1-year moving average)



Sources: GaveKal Data / Macrobond

Perhaps a quick glance at history would be helpful as, conceptually, the stocks–gold relationship can be broken down into six types of environment:

1. **Stocks and gold rising, but stocks outperform (1975–76, 2003)** – this is quite rare and the outperformance of stocks is usually modest or occurs for only a brief period.
2. **Stocks rising and gold falling (1982–99, 2012–15)** – this indicates rising animal spirits, falling nominal yields and lower inflation. In these periods overweighting growth stocks is a winning strategy.
3. **Stocks falling and gold falling more** – this seems to seldom happen over any meaningful period of time.
4. **Gold and stocks rising, but gold rising more (2003–08)** – this usually indicates that monetary policy is too loose.
5. **Gold and stocks falling, but stocks falling more (2000, 2008–09)** – this is the full on deflationary bust and the only salvation is to be found in long–dated treasuries and Japanese government bonds.
6. **Gold rising and stocks falling (1973–75, 1976–79, 1981–82, 1986–88, 1994, 2001–02)** – Interestingly enough, it seems that this combination occurs with the most frequency. It seems that when investors worry about the visibility of future cash flows, they seek the apparent shelter of scarcity assets. And, more often than not, such behavior points to stress in the financial system, rather than in the broader economy.

Today, after a 54–month bear market in gold, we seem to be entering this last configuration, with gold rising and stocks falling.

So, historically, how did such periods of gold up/stocks down typically end?

- **Outcome #1:** The Federal Reserve raised rates and crushed the bull market in scarcity in 1975, 1981, 1988 and 1994. At these points, tools started to rise again resulting in a following period of gold down / S&P 500 up.
- **Outcome #2:** In a bid to boost flagging growth, the Fed adopted too easy a monetary policy and the bull market in scarcity morphed into a broader bull market (2003–07), even though scarcity continued to outperform. The end point has typically been a crisis (2008), when both tools and jewels fell simultaneously.

This is not to say that Fed policy is the only driver of gold, or the S&P. Coming from us that would be a ridiculous contention since for years we have argued that gold was mostly another derivative play on emerging markets. Indeed, when Indians, Chinese, Russians or Arabs make more money, invariably the demand (and price) for gold tends to go up. And,

when savers in these markets struggle (the Asian and Russian crisis in the late 1990s), the price of gold has tended to suffer.

This background is interesting when you consider the backdrop to the recent rise in gold. The Middle East is hurtling into an economic maelstrom, Russia is on the ropes, China is slowing and having to sell central bank reserves to maintain the value of the renminbi, Venezuela is being forced sell its gold reserves to pay for basic imports (remember how Hugo Chavez ditched the USD for gold at the top of previous gold bull market?). Hence, by our conventional reasoning, gold should have struggled in recent times – but it has held on fairly firmly.

Hence, the question is what could jumpstart a renewed period of gold under-performance?

- Further tightening from the Fed – possible, but increasingly unlikely.
- A renewed emerging market crisis – let's face it, this is already the case, with markets from Korea, to Singapore, to China, to Brazil, all trading on single digit P/E ratios.
- Tightening of monetary policy outside of the US (whether in Europe, Japan, China...) – for now, monetary policies are headed the other way.
- Gold becoming obsolete as a diversification tool for portfolios with the rise of Bitcoins and the like – possibly, although with Valentine's Day looming, we men cannot count on our wives being much impressed if we bring a Bitcoin to the candlelight dinner.

Putting it all together, it seems that the markets are indicating that we have entered a period in which jewels will outperform tools. And try as we may (we at Gavekal are no gold-bugs), we struggle to find reasons to discard the market's message.



Louis-Vincent Gave is Founding Partner and CEO of [GaveKal Research](#). GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US\$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Ironbark Asset Management.
