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# Gold - the lead in too many portfolios

Louis-Vincent Gave | GaveKal | 23 October 2013

The recent news flow could hardly have been better for gold-bugs - a possible US debt default, QE tapering delayed, Janet Yellen nominated to the helm of the Federal Reserve, the Bank of Japan continuing to print aggressively. And, yet, precious metals continue to bring up the rear in this year's league tables. What should we make of gold's continuing disappointing performance? This has been a topic of discussion within our walls - and most of us come down on the side of one of four possible explanations.

**1. Who cares?**

Gold is not that big of a market and marginal prices are driven mostly by the emotions of speculators. Gold does not create value, or increase productivity (unlike say, energy) and is thus as meaningful to the overall economic system as diamonds, pearls, or vintage cars - none of which we spend too much time commenting on. In short, gold is a barbarous relic and the fact that some people seem completely obsessed with it is not enough of a reason for us to care about it. After all, we do not comment on the price of Bordeaux wine - even if that has a much higher marginal utility than an ounce of gold to the well-being of society!

**2. Is weak gold a sign of deflation?**

For the past decade or so, the main marginal inflationary force around the world has been the arrival of the Chinese money (whether cashing Hong Kong real estate, modern art, Bordeaux wines, copper, oil, or gold). Indeed, as we have never tired of pointing out, the past decade was the golden age of front running the Chinese. However, that age is now over. As the marginal Chinese buyer eases up on his purchases of scarcity goods, the value of such goods starts to fall. In itself, this is highly deflationary as a lot of money over the past decade has been invested, often on leverage, on the production and accumulation of scarcity goods. So the fall in gold prices could be a harbinger of tougher times ahead.

**3. Is the weakness in gold a direct consequence of events in India?**

As anyone who has ever been to an Indian wedding could guess, the country accounts for up to a quarter of physical gold demand, with imports of roughly 1,000 tons a year. But this demand created a serious drag on India's trade balance (gold imports make up 15% of India's total imports!) and, in turn, this deficit has triggered capital outflows by foreign investors. The cost of capital has risen and the government has been forced to impose new taxes and restrictions on gold imports. As a result, gold imports which were running at a pace of roughly 100 to 150 tons a month coming into the northern summer dropped off to almost zero in August and September; a surprisingly weak number given that the Indian wedding season is approaching. So watch the magnificent movie Monsoon Wedding and feel sorry for the poor entrepreneur father who today has to pay for a wedding while a) the value of his gold savings threatens to keep on falling and b) he finds it tougher and tougher to get financing.

**4. A sign of loosening capital controls in China?**

For years, our view has been that gold had a Damocles sword hanging over its head in the form of China's possible loosening of capital controls. Indeed, as long as the only assets that rich Chinese people could buy were stocks in the Shanghai stock-casino, domestic real estate and gold, then gold would be well bid. However, with more choices, the average rich Chinese investor would no longer be a marginal buyer of gold, but instead become a marginal buyer of more productive assets (US equities? Canadian real estate? European fixed income?). And lo and behold, this is what seems to be unfolding with China now actively positioning the renminbi as an alternative currency for pan-Asian and pan-EM trade financing. Indeed, everywhere one looks, one finds signs of the growing role of the renminbi - for example, China's announcement during the recent APEC conference that Asia should move away from the US dollar; the recent creation of a Shanghai free-trade zone; recent news that London would be expanded as an renminbi-trading hub; and, the recent currency swap agreement with the European Central Bank. If the role of the renminbi is to grow, then something else has to make room for it - right now, that "something else" may be gold.

Putting it all together, it is hard to see what, in the near term, will turn the tide for gold. A turnaround in Chinese or Indian policies? That seems unlikely. A surge in global inflation? Right now, most inflation data is surprising on the downside, not the upside. An even-easier monetary policy from the Fed? That seems unlikely unless US politicians really make a hash of things in the coming weeks. Or, perhaps, an absolute collapse in the price of Bordeaux wine, triggering money to flow from that specific scarcity asset and back into gold? We dare to dream...

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*Louis was a keynote speaker at PortfolioConstruction Forum Conference 2013 (20-22 August 2013).*