Is the case for gold stronger than in 2008?

Baker Steel Capital Managers LLP

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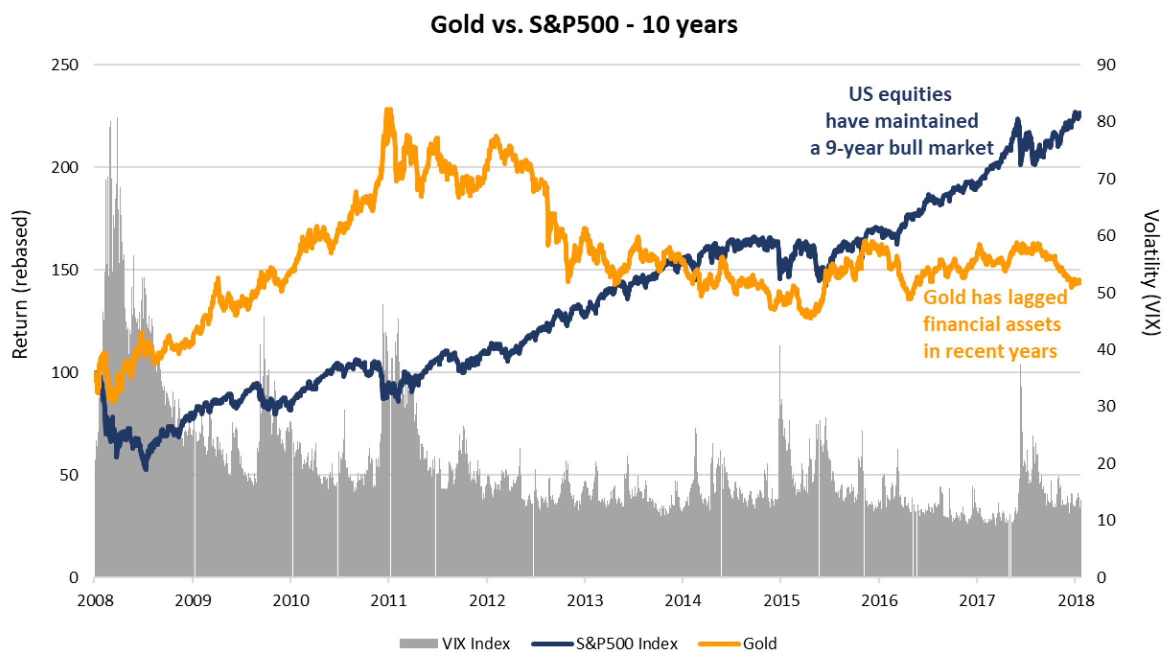
The tenth anniversary of the collapse of Lehman Brothers and the peak of the financial crisis has been extensively covered by financial media in recent weeks, with a wave of cautionary tales and reminiscence by market veterans of the market meltdown, as well as discussion of the causes and effects of the crisis. While virtually all major asset classes declined during the crisis, gold's rally from its 2008 lows outstripped broader financial assets, as governments fought to contain the fallout from the most severe financial crisis of our time. With the gold price currently at a its lowest since early 2017, but well-supported by macroeconomic fundamentals, and with signs of rising financial risk amid what may be the late stages of the longest bull market in history, the case for holding gold is strong.

The gold performed well in the years after the financial crisis, as policymakers implemented unprecedented financial stimulus and loosened monetary policy to historic levels. After falling to around USD 712/oz in 2008 the gold price soared to USD 1900/oz in the three years after the crisis, before tumbling to lows of around USD 1051/oz in 2015 as the start of the US interest rate tightening cycle sparked a collapse in sentiment towards gold. Since then gold has recovered modestly to around USD1200, substantially below its 2011 high. Despite recent headwinds from the strong US dollar the outlook for gold is positive, supported by a range of macroeconomic and market factors. Rising inflation, low real interest rates, and high debt levels are supportive of higher gold prices. Meanwhile current low gold prices present an attractive entry point for investors seeking diversification after the 9 year bull market in US equities.



Source: Bloomberg. Data at 20 September 2018.

The opportunity in the gold sector is twofold. Firstly, investors may gain exposure to a sector which appears oversold but is supported by a range of macroeconomic indicators, such as low real interest rates, ballooning debt and signs of inflation returning. Secondly, an allocation to gold offers effective diversification in response to rising financial sector risks, highlighted by factors such as the rapid flattening of the yield curve in recent months, the surge in US dollar strength over the summer, and sporadic bouts of equity market volatility, such as was seen in early 2018. Where the next crisis will come from, we cannot tell, yet the range of potential triggers continues to grow. Similarly, we identify a range of catalysts which may result in a re-rating of the gold sector.

Rising interest rates and the outlook for US growth

While the US Federal Reserve's ongoing cycle of interest rate rises appears largely priced-into financial markets, with another hike anticipated for next week, the risks for the US economic growth outlook appear to be building. US growth, which has surpassed expectations over the past year, is expected to cool in mid-2019, as the impact of the Trump Administration's tax cuts wear off. To continue to raise rates during a period of slowing growth would be an unnecessary risk for the US Fed to take and would likely be met with strong opposition from the White House, the current incumbent of which has made no secret of his desire for lower rates to boost growth. The impact of raising rates too far presents a core threat to US equity markets, which have enjoyed many years of steady gains. Should the optimism in US markets fade, as higher rates and the strong dollar take a toll on growth, markets may reprice risky assets.

The US interest rate "normalisation" cycle appears therefore to have almost run its course, but rising US interest rates have overall proven to be a positive factor for the gold sector. The first hike of this cycle in December 2015 marked the bottom of the market for the gold price and the beginning of the gold sector's recovery, as investors' concerns over impending rate increases were replaced by recognition that the pace of hikes would be steady and monetary policy would remain relatively loose. This beneficial effect on gold occurred because while nominal rates have increased, 'real' interest rates have remained low due to a rising inflation rate. Low real interest rates are a highly supportive economic environment for gold and any signal from the US Fed that the pace of hikes may slow will likely be a positive catalyst for a rebound in the gold price.

The impact of the mixed outlook for US rates and growth on the US dollar is a significant factor for gold. It is our view that the recent surge in US dollar strength appears unlikely to last, as investors anticipate slowing economic growth next year, rising inflation, uncertainty over the monetary policy outlook, and the ever-present burden of rapidly expansion public and private debt. Furthermore, as other central banks begin to raise rates, as is broadly expected, we expect the US dollar's recent shine to fade. Gold has exhibited a negative correlation to the US dollar in recent months, and undoubtedly dollar strength has been the key reason for the gold price's recent retracement to below USD 1200/oz. A weakening of the US dollar would remove a headwind for the gold price.

Trump's trade war risks slower growth and higher inflation

The escalation of Trump's trade wars with China, the EU, Canada and other trade partners is underway, with implications and effects for the US and global economy which are likely to be long-lasting, and negative. The

Trump Administration targeted a further USD 200 billion of Chinese goods with 10% tariffs this week, on top of the USD 50 billion of good already subjected to 25% duties. With Trump himself having promised tariffs on a further USD 267 billion of good if China retaliates, which it almost certainly will, the tension between the world's two largest economies appears unlikely to subside.

The impact of tariffs on the domestic US economy is likely inflationary, potentially resulting in significantly higher consumer prices over time as the increased costs of imported components are passed on to customers. Furthermore, an overall reduction in cross-border trade will put further pressure on growth, both in the US and globally. While the full extent is unknown, the risks are clear both for investors in US assets and equity investors more broadly. While the US dollar has proven to be a safe-haven during 2018 so far, the impact of the trade war, at a time of growing financial risk, will likely have a negative impact on the currency. As a proven portfolio diversifier, with a demonstrable recent negative correlation to US dollar denominated assets, an allocation to gold will likely be a prudent investment given the risks to global trade and the outlook for the US dollar.

What's different in 2018?

A lot has changed during the decade since the global financial crisis and, whilst similarities can be seen with previous late-stage bull markets, the risks today are different. Most worryingly, policymakers lack the tools to fight a major financial or economic crisis. Interest rates are already low around the world, even in the US following two-and-a-half years of monetary policy 'normalisation'. Slashing rates will not be an option for many economies when faced with the next crisis. Governments' response will be more reliant on fiscal policy to support flagging growth, implying a significant worsening of the debt situation in the aftermath of a future economic or financial crisis. High debt levels are already a significant problem for major economies, developed and emerging, and given the ongoing unpopularity of austerity policies around the world after many years of deficit reduction efforts, and the recent growth in the influence of populist parties, out-of-control spending may prove tricky for policymakers to avoid.

Against this economic and political backdrop, the case for gold is compelling. While we cannot know how gold will perform during the next crisis, it is our view that the gold sector offers upside potential at present and diversification benefits for investors during times of market turbulence. Importantly, gold has no counterparty risk, a significant factor in a potential financial crisis situation where the viability of financial institutions may come into question. Gold appears oversold, following its retracement to around USD 1200/oz in recent weeks, and is backed by an increasingly supportive macroeconomic environment. Meanwhile gold equities are at attractive valuations relative to the broader market. In particular a selection of producers offers enhanced potential upside, having successfully implemented cost controls and management reforms in recent years, and now offer strong margins, growth potential and returns to shareholders.

The next crisis may have unforeseen repercussions for the world economy, as the global financial crisis did a decade ago. We believe a contrarian opportunity exists to build a position in the gold sector, through physical or through gold mining equities, to benefit from the recovery of this undervalued sector and to achieve portfolio diversification in the face of rising risk in financial markets.

*Baker Steel Capital Managers LLP manages the **BAKERSTEEL Precious Metals Fund**, an actively managed gold equities fund with a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities.*

*Fund Managers Mark Burridge and David Baker have been awarded **two Sauren Gold Medals for 2018**, and the Fund is the 2018 winner for the third year running of the **Lipper Fund Award** for Best Fund over 3 years and 5 years, Equity Sector Gold and Precious Metals, for Austria, France, UK and Europe and winner over 5 years for Switzerland and Germany.*

Sources: Bloomberg, Capital Economics, Baker Steel Capital Managers LLP

Important

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