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Market Insights

A STRONG BULL MARKET FOR GOLD LIES AHEAD, AS CONDITIONS TURN

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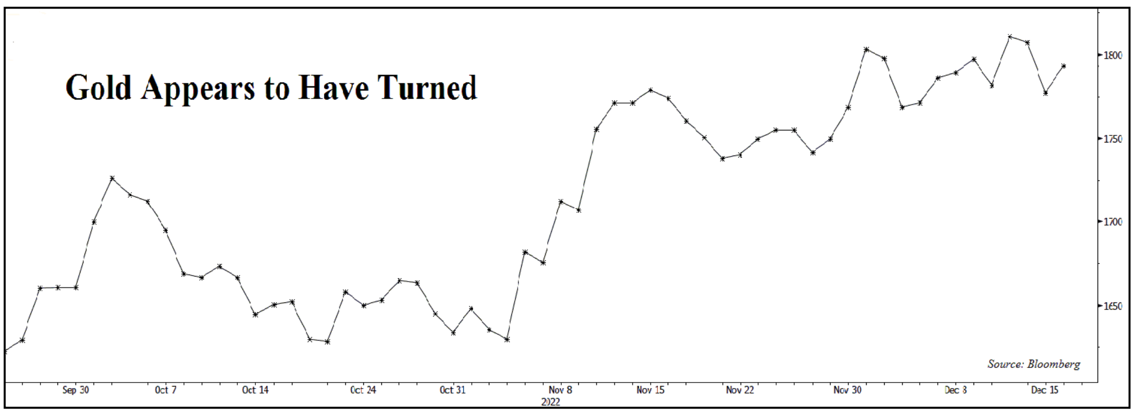
Federal Reserve chairman Jerome Powell put a damper on gold's incipient rally last week when he said that the Fed would remain tighter for long and was not yet "sufficiently restrictive". Gold had closed the night before over $1,800, and had arguably been ahead of itself, anticipating a dovish Powell. Gold had come to life after a weaker-than-expected inflation report earlier in the week. But it is only a matter of time before it breaks out above it again.



Many gold investors believed that this year, with a war in Europe, rising inflation, and a shaky stock market, conditions were aligned for gold to shine; the reality has left many disappointed, frustrated, and worse. Gold's performance should be put in context, however. Now, as I write, gold is close to breaking even (in U.S. dollar terms) for the year, down less than 2%, while the dollar (per the DXY index) remains up almost 10%. In addition, in a period of deflating asset prices, gold has held up far better than U.S. and foreign stocks and bonds, as well as other assets such as crypto. This is quite powerful relative performance for bullion.

Should investors be disappointed in gold's performance this year?

There are some misunderstandings in the simple narrative that gold "should" be higher.

- Wars or other geopolitical events tend to have only a short-lived effect on the price, unless there is concern about it spreading; the Russia-Ukraine conflict has been contained.
- High inflation in itself is not in fact the main driver of gold, as we shall discuss below.
- And although weak stocks can be positive for gold, much depends on the reasons for the weakness.

Offsetting those ostensibly bullish factors for gold have been two critical negatives: rising interest rates, and a strong dollar. For much of the year, a relentlessly strong dollar was a significant headwind for gold, but all along, gold's decline was meaningfully less than the dollar's strength.

Inflation alone is not good for gold

Inflation itself is not necessarily the optimum environment for gold. Markets, being forward looking, fear central bank tightening in an inflationary environment. If the market believes that central banks will be able to contain inflation, even as it rages, that is negative for gold. Gold shines when the market senses that the central banks will be unable to contain inflation.

One only has to look to the inflationary decade of the 1970s to see this. The market did not have confidence that Arthur Burns as Fed Chairman would succeed in bringing down inflation. But far higher inflation under Volker resulted in gold falling, because the market believed he would control inflation. The market was correct in both cases.

Indeed, this week's gold action reinforces this. The November CPI report, showing a lower-than-expected number, sparked a gold rally on the logic that this would allow the Fed to ease a little, and thus be positive for gold.

When will gold move up?

Since gold's drop in March, my response to repeated questions about when gold will "finally" respond to inflation has been the same: gold will turn when more investors realize that the Federal Reserve will be unlikely to achieve its 2% inflation goal. Its current policies—the most rapid interest rate appreciation ever—will likely provoke a serious recession, and at that point it will not follow through and quash inflation.

Investors for the most part have swallowed the Fed's narrative; all indicators of inflation expectations, from surveys to markets such as the TIPs, have been for inflation to drop significantly next year towards the Fed's target, and for it to happen without a recession. If you believe that, then you do not need gold.

Although the market broadly still believes the Fed's outlook on rates and inflation, concerns about a recession have increased, despite Powell still thinking a soft landing is possible and a recession will be avoided. Indeed, Powell at his press conference following the Fed meeting this past week, seemed somewhat touchy when asked about a recession, saying, at one point, "well, if it's positive growth (even weak growth), then it's not a recession." He might be thought to be having it both ways given his earlier assertion that just because the U.S. experiences negative growth, "does not mean it is in a recession." In short, fears are growing that the Fed will not be able to bring inflation down towards its target without provoking a recession that could be quite serious.

Why a recession can be good for gold

Again, since markets are forward looking, a recession would be positive for gold if the market sees a shift in Fed policy towards easing. Powell's press conference gave hints, despite the overall tough tone, of a pending shift. "We are getting close to a sufficient restrictive rate level," he said in his parting words. And he indicated that the Fed would not cut rates "until we are confident that inflation is coming down towards 2%" which, of course, is a quite different matter than actually being at 2%.

The Fed does not have to "pivot"—a misunderstood phenomenon in any event–for gold to move. The market simply has to believe that the Fed will have to because it will be unable to achieve its inflation goals without a recession. Tough talk from Powell following last week's final Fed meeting for the year saw gold drop sharply before a partial recovery at the end of the week. The gold market, it would seem, is finally seeing through the Fed rhetoric, and we have likely seen the lows.

The economic pain is only beginning

The signs of an imminent recession are becoming more and more clear, if indeed the U.S. is not already in one. The Fed recently noted Milton Friedman's dictum that monetary policy acts with long and variable lags. Indeed, the effects of what the Fed has already done has barely registered so far in the headline numbers. Even if the Fed were to pause right now, more economic harm is already baked in. Interest rate-sensitive sectors such as housing and automobiles are the first to feel the impact of rising (or indeed declining) rates. Housing sales are slowing dramatically, while car repossessions are increasing. For other sectors, the impact can be delayed and it can be nine or 18 months before it is clear; meanwhile, everything looks rosy on the surface.

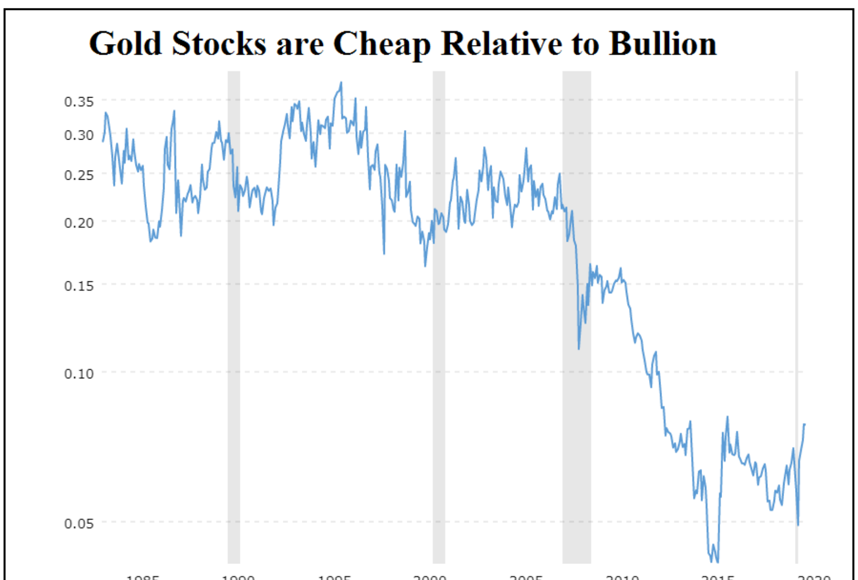
Retail sales are a good example. Since March, retail sales have been mostly flat, or moderately higher. On the surface, there appears to be no problem. Dig deeper and some things become apparent. First, if consumer prices are increasing at a nearly 10% rate, then if sales remain flat, that means that people are in effect buying nearly 10% fewer goods. Second, look at other indicators: the savings rate has collapsed to a 17-year low, while credit card debt has shot up at its fastest rate in over 20 years. (Vanguard reported last week that it had experienced record "emergency" withdrawals from 401k plans, another sign of consumer stress.) Consumers are not buying from income; depleting savings and running up debt can last only so long. It is only a matter of time before the stress shows up in declining retail sales.

As it becomes obvious that the U.S. is in a recession without the inflation goal being achieved–a stagflationary environment–then the focus becomes when the Fed will ease.

Against this macro-economic background is a new gold rush from the world's central banks. In the first nine-months of this year, central banks bought more gold than in any full year since 1987, sparked by U.S. and western sanctions against Russia which included the seizing of Moscow's reserves. This accelerated a trend for both investment and geopolitical reasons for many countries to rethink their reliance on U.S. dollars in their reserves. Significantly, the largest buyers this year have been countries such as Turkey, India, Qatar and Uzbekistan. This trend, away from the dollar and adding to gold, is, we believe, a long-term move.

Gold and gold stocks are inexpensive

We are, then, entering the sweet spot for gold and gold assets. A recession will result in a lower dollar—the result of a weak economy—while the gold market looks to the eventual Fed reaction. The outlook is positive, and while gold has moved convincingly off its lows, it has remained low relative to its price for most of the past two years. With gold nearly $200 off the October lows, there has been very little response yet by investors in the gold ETFs, another indication of the lack of interest among investors in general for gold.



Source: MacroTrends

If gold itself is underinvested and inexpensive, the gold stocks are even more so. Right now, in my view, they represent a once-in-a-decade investment opportunity, where the current situation is favorable, the outlook positive, and yet the prices and values extraordinarily low.

The XAU index of major gold and silver stocks, though up almost 30% from the end-September lows, are trading well below their average historical valuations. The stocks have lagged bullion for the last few years; prices for most stocks are well below the levels of 2009 to 2013. Another way of looking at this is the ratio between bullion and the gold stock index, which historically was which was rarely higher than 5 times prior to 2008, and then only barely, but is now at 15x, close to its lowest level ever. As gold moves up, we expect the gold stocks to outperform, and for that ratio to revert to its mean.

Let's not forget that with the gold price at almost $1800, and all-in sustaining costs (AISC) below $1,200 an ounce (while cash costs are far lower), margins are very healthy. The sector in aggregate is net cash positive, while valuations are low: price-to-cash flow of less than nine times against 13.7 times for the S&P; price-to-NAV of 0.65 times against a seven-year average 50% higher; and with a yield 25% above that of the broad market. It is an anomaly for gold miners to be less expensive, have better balance sheets, and pay higher dividends than the broad market, and investors should take advantage of the opportunities in bullion and in the stocks before the crowd starts buying.

There are many reasons to think that the time for gold assets is here. When gold moves, gold stocks typically exhibit leverage to bullion, multiplying your gains. With a strong outlook, an underinvested sector, and low valuations, this is the time to be buying the gold stocks.

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If you are interested in discussing the possibility of a managed account, please contact our office at AssetManagement@AdrianDay.com or 410-224-2037. It would be our pleasure to serve your investment needs.