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Hard Stuff

What Moves Gold….And Why It's Looking Good for 2023

By Adrian Day

Last year demonstrated that rising inflation, war, and a weak stock market do not make gold go up, contrary to what many investors believe. What does make gold appreciate?

The primary driver is the value of the currency in which gold is being measured, which is not surprising if gold is money.

So while gold disappointed U.S. investors last year, it was largely because of the strength of the dollar. For investors around the world, from Britain and Europe to China and Japan, not to mention Turkey and Argentina, gold did in fact appreciate, and in some cases very much indeed.

This is not to assert that gold cannot go up, nor indeed go down, against all currencies at the same time, but it is a good starting point. Normally, we would expect gold to begin a bull market when the currency is weak. As a bull market develops, however, then we can see gold move up in terms of all currencies, even if the dollar is relatively strong.

Interest Rates Affect Gold Prices, But It's Not Straightforward
Interest rates have a major influence of the direction of gold, but it is not at all straightforward as "low rates mean a high gold price" and vice versa.

There have been long periods when interest rates have been exceedingly low and gold remained flat or fell (2011 to 2015, for example) or when gold rose even as rates were move up significantly (2004 to 2007). This is true even when we adjust rates for their real rather than just nominal level.

Interest rates, as with inflation, are not a good coincident indicator of the gold price. There are many periods, apart from last year, where gold was flat even as inflation was rising. What is important is whether the market

expects rates to continue moving up, sufficiently to quash inflation.

This is most clearly demonstrated in the great inflation of the 1970s. Contrary to his image as a very weak Fed Chairman Arthur Burns raised rates for most of his tenure, except during the deep oil embargo-induced recession of 1974-1976. In fact, he raised the Fed Funds Rate from 3% to 13% in the years ahead of that recession, and again, after it, from 5% to over 10%.

And what did gold do? He rose dramatically while rates were moving up until 1974, and it fell, almost by half, as rates were coming down, only to appreciate again as rates moved back up. That's the opposite of what the simple interest rates-gold measure would have us believe.

The years immediately after 1971 are special as the gold price was released from government control. But if we look at the period after the recession, interest rates, inflation, and gold all moving up. The market saw rising inflation and interest rates that never got ahead of the inflation level. The market did not believe that Arthur Burns could kill inflation, nor his hapless successor William Miller (who continued moving rates up).

It was only Paul Volcker was appointed Fed Chairman, and jacked up rates well above the rate of inflation that the market came to believe he would continue on the path until the inflation beast was under control. He was fortunate in having a president, Ronald Reagan, who supported him. Gold started its long descent from $850 to just above $250 an ounce.

Can the Fed Succeed?

Where are we today? Right now, even as the CPI rate has fallen and rates have seen their most rapid move up since Volcker–a move from zero lower bounce to 4.5% in less than a year is arguably an even more dramatic pace of rate increases than Volcker's move from 11% to 19%—interest rates remain below the rate of inflation. This is true of the U.K. and Europe and many other parts of the world as much as it is of the U.S.

It is clear is that the long period of extreme excesses in monetary policy, I would argue for the past 20 years and more, make the task more difficult than the one Volker faced, and that current rates are still not sufficient to kill inflation.

Like many a bar-room analyst on a Saturday night, we could devote a lot of time to debating whether Powell has the fortitude to ultimately succeed, and not come to a definitive truth. Powell has a President who is going into an election, while Volcker had a newly appointed one with time to get the bad

news out of the way early in his term. Will Biden support Powell as prices continue to rise and unemployment moves up?

The risk is that we see a continued decline in the CPI for a few months even as the economy moves clearly towards a recession, and that the Fed pauses. Doing so before the job is finished, as Powell himself has warned numerous times, would be devastating, but extremely positive for gold.

This indeed is why gold moved up in November, December and January, even as the CPI rates was coming down. The market is increasingly of the view that the Fed will not see the job through, and certainly not without a serious recession.

Gold Investors Should Not Fear a Recession
Some investors are concerned that a recession will be bad for gold and gold stocks. But that is another misconception, the result of looking at two events (inflation and gold, rising rates and gold, war and gold) coincidentally. Markets are forward looking, more so during a recession, the market may look ahead at another period of easy money.

Looking at the last seven recessions in the U.S. back to 1973, gold rose in all but one of those recessions (and in that one, 2001, it declined by less than half a percent).

The gold stocks had positive returns in four of the seven recessions, and very strong returns at that—up 37% in eight months in 2001 (per XAU index)—while in the three in which they declined, modestly, they outperformed the broad market in each case.

The economy is moving towards a recession. Remember, as Milton Friedman noted decades ago and Powell himself has reminded us, monetary policy works with long and variable lags.

We have yet to experience the full impact on the economy of the rates hike that have already happened. It is easy to be fooled when the economy does not immediately collapse in the face of such tightening. In fact, things often appear rosy immediately before the recession. Retail spending holds up as consumers draw down savings and build up credit card debt. The unemployment rate is at its lowest immediately before the onset of recession.

But this recession is coming before inflation has been killed. The most likely scenario going forward is for a sluggish (or worse) economy along with persistently high inflation, an environment known as stagflation, such as the

U.S. experienced in the second half of the 1970's, is a very favorable environment for gold and gold stocks (as well as, incidentally, other commodities).

The Gold Stocks are Undervalued

In this positive outlook for gold, the gold stocks remain very undervalued, despite a strong rally since mid September, that saw the index (XAU) up over 50% at one point.

- They have lagged bullion for a decade now after historically moving more-or-less in tandem for decades (the stocks multiplying the metal's moves, up or down, by three or four times)
- Gold stocks are undervalued on an historical basis, trading below average valuations and by many metrics, such as price to free cash flow, at close to the lows.
- Gold stocks are undervalued relative to the broad market, an unusual circumstance.

These under-valuations come at a time when the gold sector is in a strong shape, in aggregate net cash positive, with strong margins (not withstanding rising costs), and a powerful outlook for the metal. With a gold price of $1,850, a cash cost of around $800 or an "all-in sustaining cost" of $1,200 is actually a very positive margin, and higher than the gold miners had during most of the bull market from 2001 to 2011.

That the stocks should be so inexpensive in such a positive environment is a compelling buying opportunity, and one that I am convinced will not last.

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Asset Strategies International
1700 Rockville Pike, Suite 450
Rockville, MD, 20852
800-831-0007 | 301-881-8600
www.AssetStrategies.com