Gold: Always believe?

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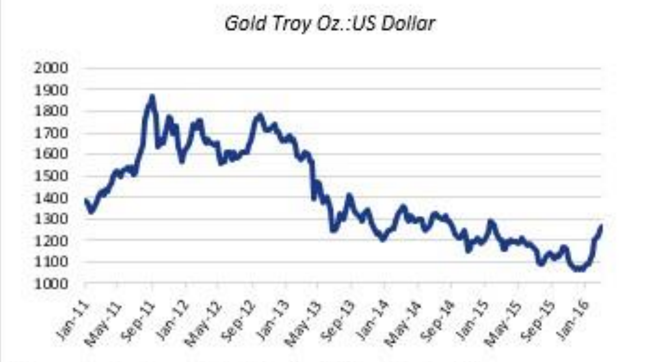
Having been off many people's wish list for the last few years, gold has once again become a sought-after asset. Even with prices higher than in the recent past, it may still be worth buying.

You have a choice of trusting the natural stability of gold, or the honesty and intelligence of members of Government

- George Bernard Shaw

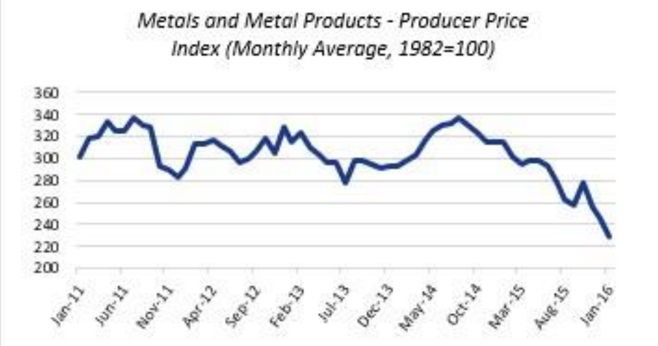
Back in August of last year, gold was at its lowest US Dollar-price in almost six years. At the time, I wrote that although I didn't expect a sustained recovery, gold could act as reasonably-priced risk insurance as part of a diversified portfolio.

Since then, there has been close to a three-month resurgence in gold prices, beginning in January this year. The average price in the week beginning 3rd March was 18% higher than in the first week of January 2016. In other words, anyone who'd bought an ounce of gold at the beginning of the year would be around USD196 better off in early March (see chart).



Source: Ice Benchmark Administration/St Louis Federal Reserve

Other metals, including lead, zinc and copper, are on a price slide which is over 2½ years old now (see chart). This is in line with the trend of other commodities[1] as well as oil.[2]



Source: U.S: Bureau of Labor Statistics/St Louis Federal Reserve

It has been suggested that this long-term decline may eventually lead to significant production cuts this year. This pressure also applies to precious-

[1] See Bloomberg Commodities chart (BCOM) 5 years, http://www.bloomberg.com/quote/BCOM:IND

[2] https://research.stlouisfed.org/fred2/series/DCOILWTICO

metal miners: platinum-group metals producers plan to reduce output as they struggle to stay in business, and high-cost-gold miners are beginning to close down operations. Ultimately reduced supply could help metals prices bottom out.[3]

So why has gold been any different? Why has it become so popular since the turn of the year?

To start with, it'd be wrong to jump to massive conclusions: it's a relatively small upturn at the moment, compared with the last five years. Nevertheless, gold still holds a mythical feel of stability – possibly down to its previous role as a standard for the world's currencies[4] before it was gradually abandoned between the 1920s and 1971. As 2008-2009 global financial crisis (GFC) brought a lack of confidence in the financial system, people looked for protection and headed for gold. By late 2011 concerns over lingering high levels of debt, still around post-GFC, lifted gold prices to record levels.[5]

Then, as central banks like the Federal Reserve embarked upon quantitative easing and zero-interest-rate policies, certain risk assets – including stocks and property – continued to rebound. The inflated return on equities helped to create the impression of a market boom. The consequence of this was a fall in the price of gold, which has a variable correlation to equities at different parts of the cycle but, other than late bull markets is more often than not negatively correlated on is uncorrelated to equity returns.

Since January gold has turned around.

Perhaps it's because fears over oil and commodities prices sinking over the last couple of years has started to become more of a concern than shares and houses are a comfort.

Maybe it's because some analysts dramatically announced in January that 2016 was going to be a dreadful year for finance.[6] I'm sceptical of such prophecies – I'm convinced that we're heading towards financial crisis; I just feel there are too many influential facts apparent at the moment to predict that such an event will happen this year. One thing history has taught us, though, is that when investors are worried, they tend to move towards gold.[7] Those who followed analysts' suggestions to sell everything[8] will have cash on hand, so may decide to buy gold

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[3] Bloomberg Intelligence

[4] *http://www.marketwatch.com/story/why-gold-is-falling-and-wont-get-up-again-2015-07-20?mod=MW_story_recommended_default&Link=obnetwork*

[5] http://money.cnn.com/2011/08/22/markets/gold_prices/

[6] http://www.mbmg-investment.com/in-the-media/inthemedia/75

[7] http://www.mbmg-investment.com/in-the-media/inthemedia/55

[8] *ibid*

with it, unless they decide to compound the recent common mistake of selling at the intermediate equity market bottom by buying at what may be close to a significant intermediate high.

There is also the possibility that investors are speculating on gold's recent volatility. Although, I'm not convinced that gold is a commodity on which people would be looking to make a three-month return. That's because it is different from a *normal* investment; such as equities, which have cash flows: or properties and bonds, which have yields. In fact, I've long tended to regard gold more as an alternate currency than a commodity sub-sector.

Some may even be readjusting their portfolios in fear of inflation, after the Federal Reserve slightly increased its base interest rate. That wouldn't come as a great surprise: it is a popular misconception is that gold protects investors against inflation. In fact, it's usually a poor hedge against most levels of rising consumer prices and only becomes relevant in extreme times, such as hyperinflation or deflation, or at least the credible threat of either of these.[9]

In essence, the value of gold is largely perception rather than real value. Its recent rise is thus more telling of people's concerns in these unpredictable times, than it is of gold's actual worth.

However, all that doesn't mean that I have swayed from my earlier belief that gold can be good risk insurance. Of course it's more expensive than it was three months ago but it may well hold its value given the current unpredictability of the global economy and capital markets.

In fact, policymakers target a bout of moderate inflation as though it would be a relief not a worry. There is still a huge amount of corporate and household debt right now[10] and typically businesses and individuals benefit from moderate inflation – above all an increase in nominal income - to help reduce the real value of outstanding debt. The Catch-22 here is that the higher interest rates that would inevitably accompany this nascent inflation would also make debt more expensive to service. This would undo the benefits of increased nominal purchasing power for all and would almost certainly lead to defaults by the most indebted individuals and corporates, which could implode the most valuable banks, which in turn could be the first dominoes to fall in what could quickly become a banking cataclysm in a deflationary bust. All of which would be beneficial for the price of gold.

It's long been clear that ultimately, one way or another many major economies are heading down a path that leads towards debt-deflation. I'm not sure whether this can be avoided any longer but I'm certain that this is where current policy in China, America, Britain, the Eurozone and Japan is headed and I don't see any signs of a *Road to Damascus*-style conversion by these policymakers.

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[9] Claude B.Erb, CFA AND Campbell R. Harvey, The Golden Dilemma, Financial Analysts' Journal, Volume 60 Issue 4, July/August 2013 *DOI: http://dx.doi.org/10.2469/faj.v69.n4.1*

[10] http://www.mbmg-investment.com/in-the-media/inthemedia/81

While Messrs. Yellen, Kuroda, Draghi, Zhou and Carney remain in situ, gold could be a really essential form of insurance against the risks that stem from their incompetence. Conversely as more and more rumours start to circulate that at least one of the 5 stages of grief above will be removed from office or given early retirement, the shockwaves that this would cause would also benefit gold exposure.

All of this explains why, just when gold prices were falling in the first half of last year, I maintained that holding up to 10% of a portfolio in gold justified the cost as insurance against some potentially harrowing times ahead.

The price may have gone up since then but even at today's prices, many of the fundamental arguments still hold.