

Is gold set for a two decade pause?

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Summary

- The fading price momentum of gold suggests that monetary stimulus drivers are looking all but exhausted
- A price reversal of gold could well imply several decades of below inflation or flat returns for gold, similar to but less severe than the 1980 - 2000 gold down cycle
- Current price levels of gold are high relative to fundamentals and historic prices of other commodities
- The de-coupling from equities and bonds is helping gold stand out until monetary stimulus is unwound and the elevated correlation between equities and bonds breaks
- Over-leveraged financial systems keep macro risk alive but gold's safe haven status is expected to fade once a broad based recovery in the labour market gains traction
- Once inflation expectations are fed by consumption and investment growth, the macro picture favours equities

Since the ECB announced its OMT (Outright Monetary Transactions) programme there have been months of calm in Europe's financial markets. A new banking crisis however is unfolding in Cyprus, potentially short circuiting the much needed recovery in Europe's peripheral bond markets and destroying investor confidence in risk assets. In market environments where contagion fears resurface and deposit runs become real event risks, sentiment invariably forces investors to take another look at the asset class of choice: gold.

Helped by the financialisation of commodity markets over the last decade, investors who seek shelter in times when even cash deposits no longer seem safe, now have simple and easy access to gold. But after posting more than a decade of double digit annual gains while leaving equities and bonds as correlated underperformers in its wake, the price performance of gold since 2012 has fallen short of lofty expectations. This is despite a range of stimulus measures such as 1) commitments of the ECB and the Fed to keep monetary stimulus programs alive for as long and for as much as needed, 2) potentially more unconventional inflation-friendly monetary policy from

the BoE, which is considering to target nominal GDP, and 3) from the BoJ which has officially doubled its inflation target to 2%.

In providing perspective as to whether gold is still a viable asset class to invest in given its current price and the macro backdrop, we briefly look at:

- the history of gold prices and assess its decade-plus-old rally against gold's last super cycle;
- the fundamentals for gold and how its price compares to its historic trend and those of other commodities; and
- what lies ahead for gold as a distinct asset class both in the near and in the long term.

A history of fixed gold prices

One of the main reasons for holding gold as an asset class is that it serves as a hedge against economic uncertainty, in particular bank deposit runs, currency devaluations and inflation. Back in the days when the financial system was still based on the gold standard, currency devaluations resulted only after there was an unsustainable run on bank deposits and gold.

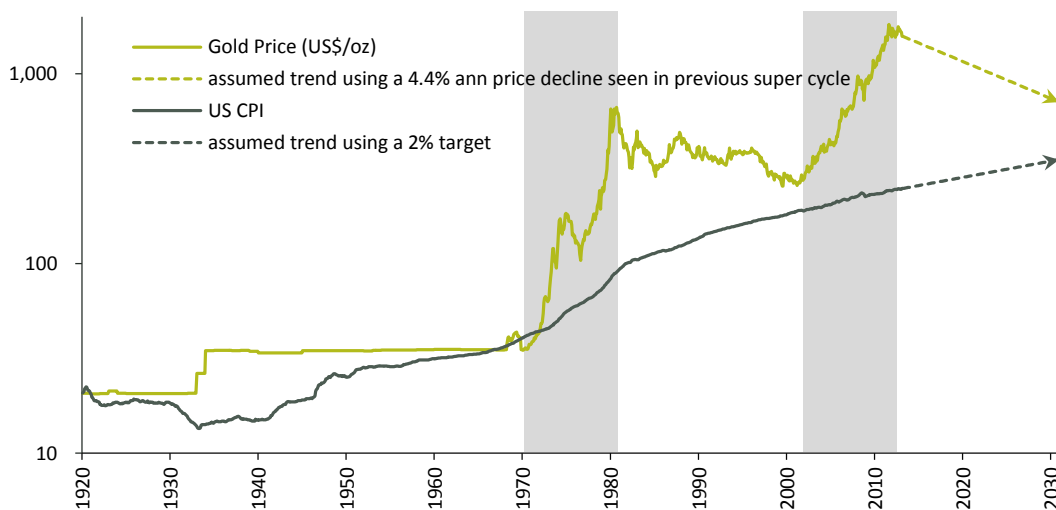
When the US stock market crashed in 1929 and a string of bank failures spreading across the country instigated a crisis of confidence, households, businesses and institutions halted spending, called in

loans and unwound their investments on a huge scale. With everyone simultaneously refusing to spend, invest and lend, prices started to drop.

Magnified by gold hoarding by foreign central banks, the normal expansion mode of money supply was suddenly put into reverse, setting in motion a huge shortfall in cash and creating history's worst credit crunch known as The Great Depression. In a prevailing fractional reserve system whereby money supply was managed in fixed proportion to its gold reserves (which fixed the price between the two), the stock levels of gold restricted the Fed's ability to inject liquidity into the economy of which it was desperately short. The attempt by the Fed to raise interest rates to reverse the gold and deposit outflows only worked to raise the cost of borrowing, exacerbate the spending and investment cutbacks, and thereby unintentionally deepened the crisis.

massive war spending programme was unleashed. However, as the US broke with the gold standard in 1934, it took well over three decades for the prohibition on gold trade to be fully lifted, by which time consumer prices had already caught up with the gold price. To show this episode we refer to figure 1, where we plot the history of gold and US consumer prices since 1920. Those who were exempt or were able to hide their gold during the decades of prohibition would have found it to be a perfect inflation hedge but also no more than that. If you had cash stacked under your mattress during the crisis but deposited it back at the bank once deposit insurance became law in the Banking Act of 1933, you would have outperformed gold by a wide margin.

Is gold entering a multidecade downturn similar to its previous super cycle?



Source: Boost Research, Bloomberg, March 2013

With the enactment of the Gold Reserve Standard by President Roosevelt in 1934, the US went off the gold standard. Holding and trading in gold was made illegal and by forcing individuals to sell their gold stock to the US Treasury at the prevailing fixed price of US\$ 20.63/oz, gold was taken out of circulation. With a stroke of a pen, gold was re-valued to US\$ 34.67/oz., instigating a devaluation of the dollar of nearly 30%. As money supply was again allowed to expand, inflation gradually returned and became self-sustaining following the outbreak of the 2nd World war when a

Two super cycles of gold since 1970

However, as soon as market forces started to dictate the price of gold from the late 1960s onwards, gold prices developed a life of their own: on the back of loose monetary policy and several oil crises (that by the end of 1980 allowed for inflation rates in the US and most of the West to accelerate into the double digits), gold prices during that period outran US consumer prices by a factor of 12 to 1. Investors who

bought gold at the end of 1960s when restrictions were relaxed and held it until the end of 1980 (assuming they missed out on selling at its January peak), would have enjoyed annual average returns in excess of 18%.

But as figure 1 also shows, from 1981 onwards, gold entered a prolonged downturn, as tight monetary policy and high real interest rates forced US inflation down to the low single digits we are used to seeing today. Investors who sat on gold for the next two decades since 1981 would have lost well over 4% per annum, even while at the same time US consumer prices grew by roughly the same rate: i.e. an average real loss in excess of 8% p.a. and equivalent to a cumulative real loss of well over one-third of your investment.

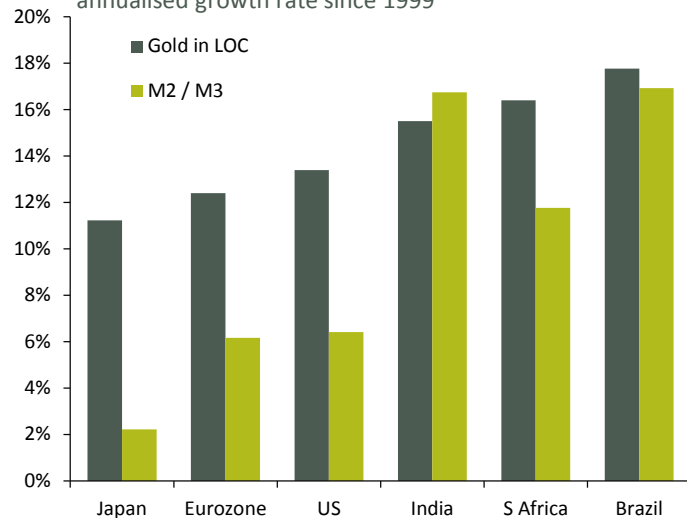
By the time the second super cycle in gold started in 2001 (see figure 1), the price performance of gold had long surpassed the long term trend in consumer prices. During that period, a rising new middle class in emerging market economies, coupled with the financialisation of commodity markets have been major driving factors behind the surge in both the physical and financial demand for gold. As credit became more accessible for EM economies, gold prices soared. As an asset class, gold had earned long term investment status.

In fact, since the start of the second super cycle in 2000 the price performance of gold, when translated in local currency, has largely been driven by the credit expansion in emerging economies. It grew roughly in line with the mid teen growth rates in money supply across key emerging market economies but at the same time overshot the money supply expansion in developed economies by a factor of 2 to 1.

Valuation and fundamentals of gold

If gold were not an asset its price inflation would be nothing more than a monetary phenomenon, which would imply that, when money supply grows by X times, prices will grow by the same amount and so would gold, over the long term. Since it is traded as an asset it is fundamentally justified that gold outruns consumer prices over the long term. However, it is the extent to which the price of gold divorced itself from the expansion of money supply in developed countries that has given reasons to believe that in this last decade gold prices look increasingly out of line with fundamentals.

Figure 2: gold vs money supply since 1999
annualised growth rate since 1999



Source: Boost Research, Bloomberg, March 2013

If the previous super cycle is anything to go by, then the flat trending gold price since 2012, having peaked at US\$ 1880/oz. in the summer of 2011, may well have set the stage for much more disappointment in the performance further out. As an indication (see figure 1), when the 4.4% average annual decline in the price of gold witnessed during the 1981 to 2000 period is applied onto the coming two decades, it would still leave gold prices at levels well ahead of the inflation trend. By recognising that as an asset class gold has produced real returns to investors over the long term, the assumed price correction is by no means exaggerated.

Ever since trade controls on gold were fully lifted in 1970 and the price of gold became market driven, gold performed almost identically to US equities. Taking into account reinvested dividends for equities but ignoring storage and insurance costs for gold, both asset classes produced average annual returns of close to 10%. Within the gold mining sector however, stock prices underperformed the gold price to a significant degree, having missed out on the relentless rally of gold since the 2008 credit crunch. As figure 3 also shows, gold mining stocks listed on the NYSE have lost close to 20% of their value since 2008, even while the gold price came close to doubling.

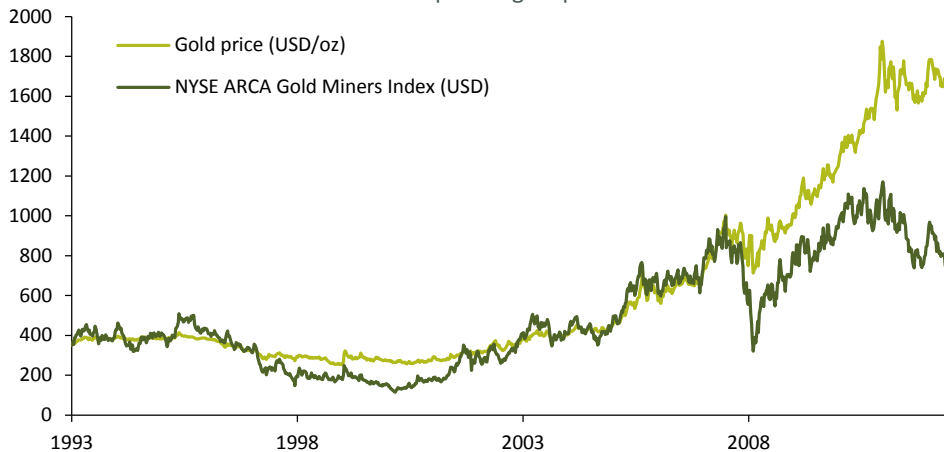
The argument often put forward is that because gold miners offer a leveraged play on the gold price (driven by debt finance and high capital outlays), the gold miners should be outperforming physical gold on any bullish sentiment. In the short term, the operating and financial leverage of gold miners certainly provided additional beta to the gold trade.

fundamentals, the gold price rally seems to point towards an overextended rally.

Figure 4 shows this by comparing the price of gold relative to the price of non-precious commodities (i.e. commodities other than gold and silver). Superimposed is the inflation adjusted short term interest rate which is used as a proxy for the monetary conditions in the US.

Figure 3: gold miners underperforming gold since 2008

Gold miners index is rebased to Sep 1993 gold prices



Source: Boost Research, Bloomberg, March 2013

But as the also chart below indicates, until 2008 they have been tracking rather than outperforming the rally in the gold price.

In assessing what the outlook for gold is, rather than argue why gold miners should rally to narrow the valuation gap between the physical commodity and the stocks that mine them, arguing the other way around may be more insightful. The stock performance of gold miners by itself may be saying something about the expectations of gold prices, and that if anything, could forebode more weakness for the gold price further out.

The problem with gold is that contrasting it to equities is not the same as contrasting equities to bonds. Unlike gold or any other commodity, equities and bonds derive their value from expected income streams. While the former is typically growing and the latter typically fixed, both income streams at best derive their cost and revenue line partially from the prices of commodities.

Therefore, since a yield or cash flow model on gold cannot be run, assigning a fair value on gold based on equities is impossible and probably as hopeless as trying to assign a fair value on Facebook's share price. However, when assessing the gold price relative to prices of other commodities and putting its historic developments into context with the economic

Assuming that a basket of alternative commodities are a fair benchmark to assess the extent to which gold prices have moved away from fundamentals, then at current levels, the price of gold relative to other commodities has reached highs last seen in the late 1980s.

However, back then interest rates were high due to erratic inflation, and with it briefly spiking in 1987 reignited fears of the 1980 oil crisis, driving gold higher. A similar reaction by the market came 20 years later, when in the summer of 2008 oil prices reached all-time highs which, in the months ahead fed through into core inflation numbers and also moved the gold price higher. Because oil can serve investors as a hedge against inflation and because it is disproportionately represented in the benchmark commodity indices, oil distorts the relative prices within non-precious commodities. By also using the non-energy commodity benchmark against gold to better capture macro uncertainty, the extreme relative prices of gold become even more apparent (see figure 5): here the relative gold price has almost doubled and in doing so has significantly overshot the peaks of the late 1980s.

Figure 4: gold reaching historic extremes relative to commodities
Gold price relative to non-precious and real interest rates in the US

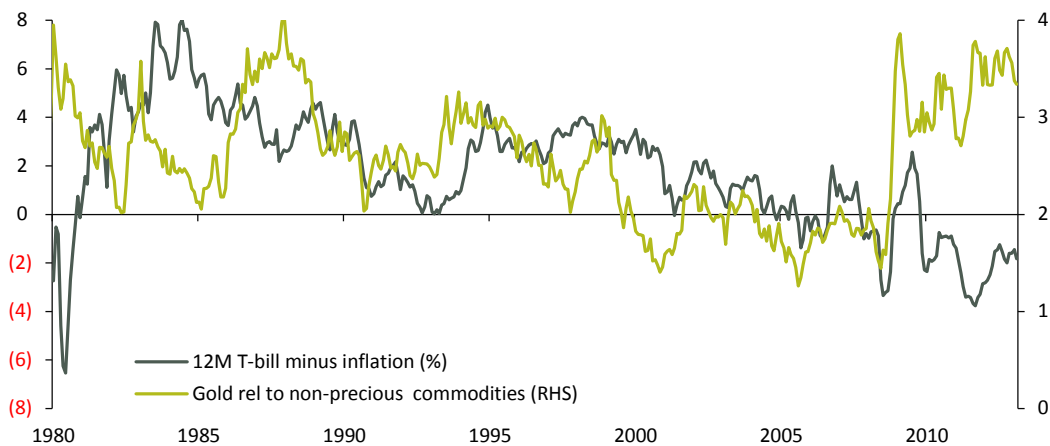
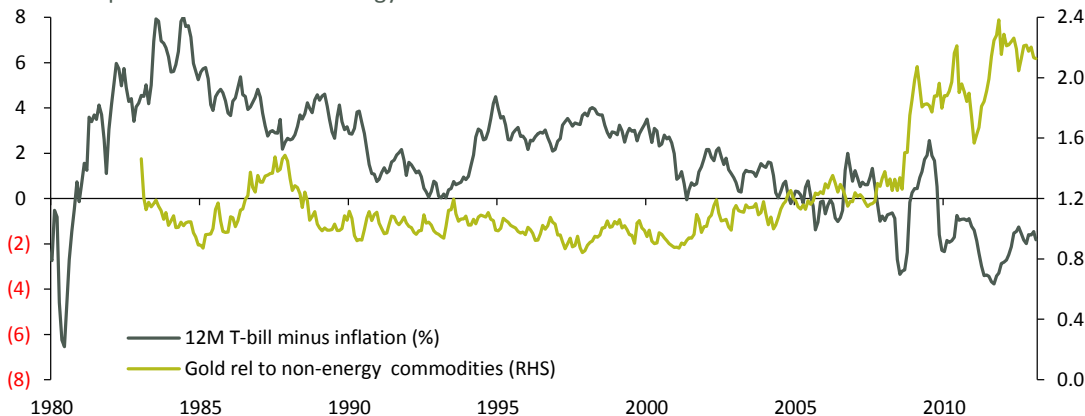


Figure 5: gold reaching historic extremes relative to commodities
Gold price relative to non-energy and US real interest rates



Source: Boost Research, Bloomberg, March 2013

As figures 4 and 5 also show, gold's relative high price occurs at a time of heightened uncertainty, with extraordinary monetary stimulus having pushed short and long term interest below inflation. The question therefore is what will happen to gold once monetary stimulus is gradually unwound and inflation expectations start building up. In order to make a case for gold based on inflation, it is important to distinguish between two kinds of situations that drive inflation risks. Firstly, in times of economic downturns and macro uncertainty where monetary policy predominantly drives inflation expectations, gold tends to perform well. Secondly, in times of growing confidence and improving economic activity, where inflation expectations are fed

more by consumption and investment growth the picture favours risk assets such as equities. For instance, in the large legs of economic growth in the 1990s during which time the US enjoyed one of the longest expansions in output, the stock market reaped broad-based gains even while gold prices fell. Yet over that time period US inflation was close to 3%. However, back then inflation was stable and hedging it with gold made little sense when strong equity returns had been supported by solid economic fundamentals. Hence, depending on where you are in the cycle, significant inflation can be both positive as well as negative for gold. In fact, more often than not, it has been the absence of inflation that drove uncertainty: referring back to The Great Depression in the 1930s for example, gold hoarding came at a time of severe

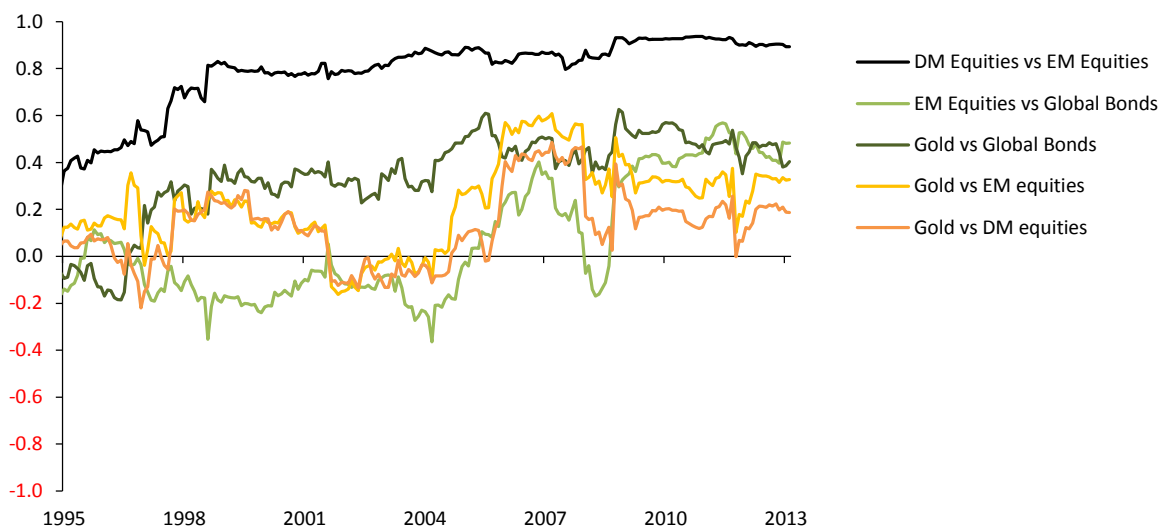
deflation, not inflation. A more recent example is the year 2002 when the Fed worried about the persistent low CPI readings. Following up on multiple interest rate cuts to stimulate the economy, it reduced interest rates by another 25 bps to just 1%. In that year with little inflation to speak of, gold rallied by almost 25%.

Gold's diversification benefits

Given that the extraordinary monetary easing measures by the central banks have given gold prices a final boost, the anticipation of a gradual unwinding of those policies may set the stage for gold prices to realign with other commodities further out in this super cycle.

Given that gold has continued to stay relatively uncorrelated from equities pre and post 2008, it will help gold to stand out as an efficient portfolio diversifier. As figure 6 also shows, while the diversification benefits within emerging and developed market equities is almost non-existent, thanks mainly to on-going capital market liberalisation in emerging markets, portfolios now see much greater improvements in their risk return profile when gold is added into the asset mix.

Figure 6: diversifying portfolios with gold has worked well
rolling 3yr correlations of monthly returns in USD



Source: Boost Research, Bloomberg, March 2013

Until it does however, investors will continue to be attracted to alternative asset classes, including gold. This mainly because the extraordinary liquidity currently feeding into the financial system through central bank intervention in bond markets have broken the traditional mirror image relationship between safe haven and risk assets. While normally negatively correlated, bond and equity markets have since the 2008 credit crisis moved very much in line with each other. Hence until the liquidity in the markets is gradually withdrawn, the near 1 to 1 correlation within equity markets on the one hand and the relative high correlations between equities and bonds on the other are expected persist.

Stimulus withdrawal poses downside risk to gold

As the outlook on growth currently remains subdued in the US, depressed in Europe and uncertain in emerging markets, gold will continue to appeal to investors. The ongoing political infighting in Washington over how to deal with the deficit and debt ceiling, resurfacing financial contagion risks, most recently taking hold over Europe as banks in Cyprus reel under high debts, the doubling of the inflation target by the BoJ with possible retaliatory devaluations to follow by other countries, are macro risks that will keep the gold trade alive.

But underneath the macro risks are signs of real economic improvements, most notably seen in the

gradual strengthening of the US housing and labour markets. Albeit still tepid, once economic activity leads into a sustained upturn, and the US\$15 trillion economy of the US switches to a higher gear, a lot of macro uncertainty surrounding Europe, Japan and emerging market economies will dissipate.

We are possibly entering a stage of prolonged weakness in the price of gold: after having rallied for more than a decade, the fizzling out of gold's price momentum since the start of 2012 comes at a time when gold's previous super cycle experienced a similar reversal lasting two decades. If reversion to the mean has been a widely observed phenomenon in asset classes such as equities and real estate, there is no reason to believe that gold can enjoy this rally with impunity.

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