Has gold lost out to the US dollar?

August 2018

A dip in the gold price below USD 1200/oz has left investors wondering about the outlook for the metal in the coming months amid a surge in US dollar strength, emerging market currency chaos and escalating trade tensions. Has gold's status as a safe-haven real asset and portfolio diversifier been usurped or does current gold price weakness present a rare opportunity to gain exposure to an undervalued sector?

It has been a turbulent summer for global financial markets, rocked by the escalation of Trump's "trade war" against China and the unfolding of a dramatic currency and economic crisis in Turkey, which entered full melt-down last week.

Gold is often regarded to be a safe-haven asset and investors in the gold sector have been understandably disappointed that the gold price hasn't performed better during this period. As these recent crises dominated the financial news in July and August, the gold price declined in most currencies, most significantly in US dollar terms. Gold equities have also fallen despite having performed relatively well in recent months, outperforming the gold price in June and July as the increasingly supportive market and economic environment sent the sector higher.

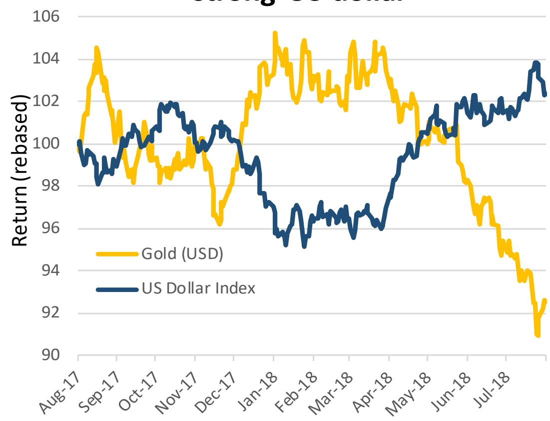
Why has the gold price fallen?

The primary driver for the gold price's retracement to below USD 1200/oz has been the sharp appreciation of the US dollar, which reached a 14 month high last week. The US dollar has been the primary beneficiary of rising financial sector risk and has been buoyed as investors rush to hold US treasuries and US stocks in response to economic uncertainty around the globe.

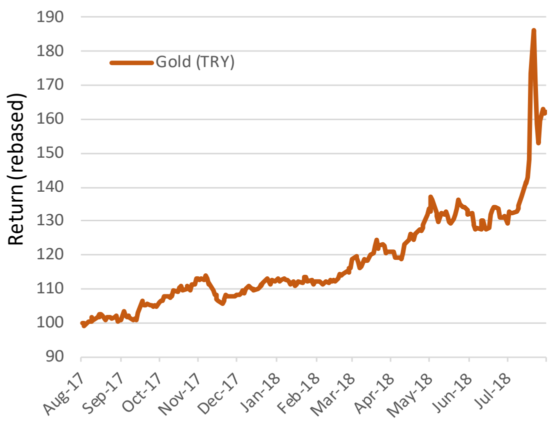
In the case of Turkey, which faces a range of severe economic troubles and a worrying political backdrop, the crisis has manifested itself in the rout of the Turkish Lira, amplified by Ankara's strong aversion to raising interest rates. There is a threat of contagion from the Turkey crisis for other emerging market economies, however at this time it does not appear overwhelmingly concerning for investors. Nonetheless with broader emerging markets under pressure from the potential negative impact of protectionism and European markets under pressure from the uncertainty of "Brexit" and encroaching populism, the US dollar has provided a relative safe haven.

While there has been some direct impact on the gold sector as result of the Turkey crisis, with a surge in Turkish gold trading volumes and a rapid gold price appreciation in local currency, for global investors the response to this crisis has undoubtedly been to favour the US dollar.

Gold is under pressure from a strong US dollar



Gold price in Turkish Lira

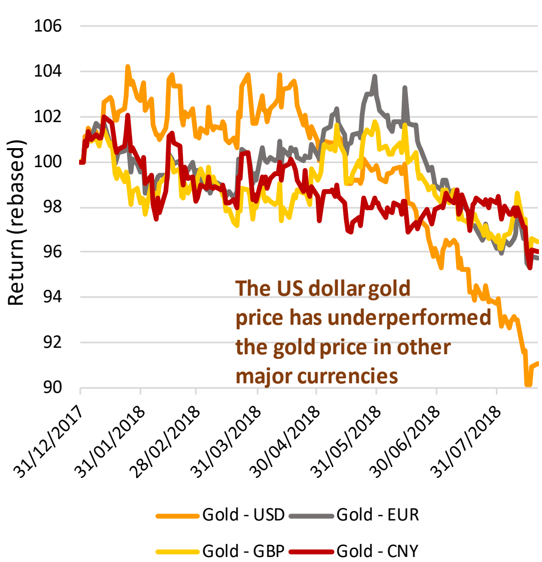


Source: Bloomberg. Data at 22 August 2018.

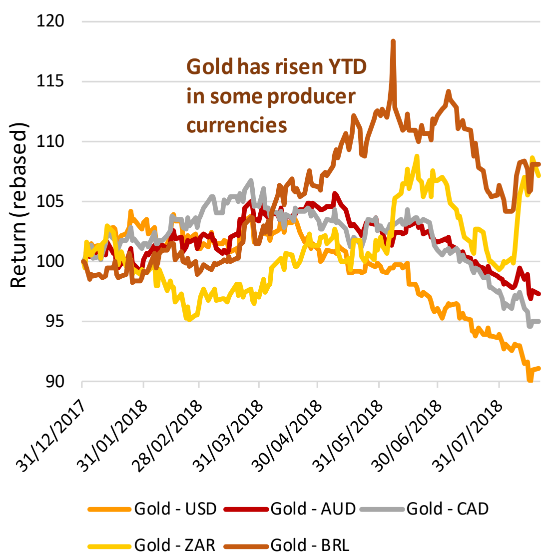
However, when assessing gold's performance in recent weeks, investors must consider indicators beyond simply the US dollar gold price. The dollar's strength is relative and represents investors' confidence in the US economy compared to the rest of the world. The decline in the gold price is the result of the recent surge of dollar strength rather than a fundamental change in the outlook and drivers for the gold sector. When measured in other major currencies, gold's performance has been substan-

tially better than in US dollar terms (see the chart below). Furthermore, gold prices in producer currencies have largely held up and in some cases, such as the South African Rand, have seen gold price appreciation. This is a significant factor for gold equities indicating a favourable environment for producers in these regions.

Gold in Major Currencies



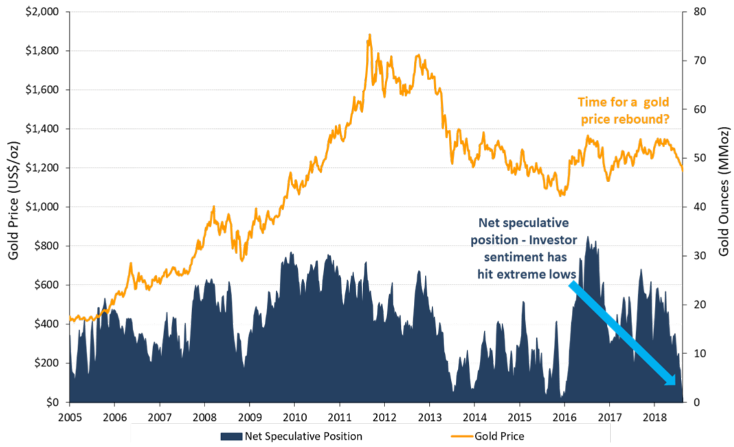
Gold in Producer Currencies



Source: Bloomberg. Data at 22 August 2018.

A lower gold price reflects both investors' recent bullish sentiment towards the US dollar and ambivalence towards gold. This is highlighted by the net speculative positioning on COMEX gold futures which has reached the lowest point since early 2016. Historically, a collapse in bullish sentiment has proved a useful contrarian indicator for investors in the gold sector, such as in late-2015 when an excess of short positions preceded a substantial rebound of the gold price, driven by short-covering and a recovery of investor sentiment.

Bearish investor sentiment - A contrarian opportunity?



Source: RBC Capital Markets, Bloomberg. Data at 17 August 2018.

Is the strong dollar here to stay and what are gold's prospects for recovery?

Given that much of gold's recent woes can be attributed to the surge in US dollar strength, the question of whether dollar strength is temporary is key. However, firstly it is important to highlight that, despite the strong dollar, the key drivers for the growth of the gold sector remain in place. Real interest rates are likely to remain at low levels, inflationary pressures are returning, public and private debt continues to expand, and demand for physical gold for jewellery, investment and technology remains robust.

It is our view that the factors which have pushed the dollar to recent highs are unlikely to persist in the coming months. A growing body of evidence suggests that the US dollar has become over-bought and that this level of dollar strength is not sustainable or desirable for the US and global economy. While US headline economic indicators remain positive, with encouraging GDP growth, stable (but rising) inflation and low unemployment, a range of factors suggest that the outlook for the US economy is more mixed than is implied by current US dollar strength.

Most notably the nascent trade war initiated by the Trump Administration against US trade partners will yield wide-ranging economic consequences for the domestic US economy as well as the global economy in the coming months. While the full impact of increased protectionism is unknown at this stage, it will contribute to already existing inflationary pressures. The impact on inflation may vary, from initial price rises for US firms due to import tariffs, to significantly higher costs for US firms forced to relocate production away from tariff-hit economies. Higher prices for US consumers and a drag on business activity pose a risk to US economic growth. After a long period of US economic expansion and rising stock markets since the Global Financial Crisis, markets are signalling risks ahead; the flattening yield curve, rising equity market volatility and lofty valuations of US stocks support the case for caution and diversification in the coming months.

Rising US interest rates and the outlook for monetary policy remains a key factor for investors when considering the relationship between gold and the US dollar. Over the past two and half years rising rates have boosted the gold price, as the cautious pace of rate hikes and rising inflation kept real interest rates low, a supportive environment for gold. Despite rising marginally in recent months, real interest rates appear unlikely to rise significantly in the near future and recent hawkish rhetoric from the US Federal Reserve belies the reality that there appears to be little political will among US policymakers to accelerate interest rate hikes and cause the US dollar to strengthen further. The strong dollar already poses a risk to US growth through making US exports less competitive and by raising borrowing costs, increasingly the burden of US dollar denominated debt. This point was emphasized by President Trump's comment this week that he is "not thrilled" by the Fed's rate hikes, an unorthodox and ominous intervention against the Fed's independence. The coming weeks will yield more information on monetary policy direction, as the Jackson Hole symposium gets underway this week and the September FOMC meeting approaches, however in the current political context it seems unlikely that policymakers will view a strong dollar as beneficial for the US economy. A continuation of cautious interest rate rises and a retreat of the US dollar would provide a highly conducive environment for a recovery of the gold sector.

Does the current weak gold price present an opportunity for investors?

A common incentive for holding gold is that it provides effective portfolio diversification, particularly during uncertain economic times. This is not because it is negatively corelated to US financial assets, but because it has historically proven largely uncorrelated with financial assets over the medium- to-long term. It is gold's lack of clear correlation to most asset classes which makes investments in physical gold and gold equities a useful diversifier. At a time when stock markets globally have reached new highs, the S&P500 Index has recorded its longest ever bull market, and factors such as rising volatility, a flattening yield curve and tightening monetary conditions indicate the rising risk of an equity market correction, or potentially a more severe downturn, we believe diversification is key.

The gold price appears to have found its floor and shows signs of recovery this week, while gold equities have likewise begun to rebound, as the current undervaluation of many producers and the improving outlook for the sector attracts growing interest from investors. Having reached heights of around USD 1350/oz in recent months we see substantial near-term upside potential for the gold price, should it remain within its recent trading range. Furthermore, given the range of potential catalysts for a gold price breakout; including inflationary pressures, rising interest rates, high debt levels and risks to the US dollar, gold's recent malaise may be quickly reversed. During the previous two gold bull markets, from 2001-2008 and from 2009-2011, the gold price rose +289% and +156% respectively (in US dollar terms). With today's gold price just +14% above its 2015 low, the upside potential appears substantial.

The fundamental investment case for gold and gold equities has not changed. We believe the pull-back in gold and gold equities seen in recent weeks presents an opportunity for investors to build their position in gold, to benefit from long-term security, portfolio diversification and for exposure to the next stage of the gold sector's recovery.

Sources: Bloomberg, Baker Steel Capital Managers LLP