



## GOLD SHINES AMID RISING RISKS – IS THE END OF THE BULL MARKET NEAR?

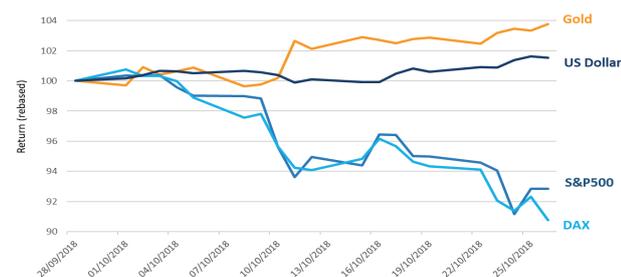
OCTOBER 2018

**The outlook for global financial markets has shifted markedly in recent weeks, as fears grow over the negative impact of rising US interest rates, the withdrawal of monetary stimulus in the US and Europe and the “trade war” between the US and China, on economic growth, trade and earnings. Gold has rebounded in recent weeks following a subdued summer, outperforming US treasuries and reinforcing its status as an effective hedge against the growing systemic risks in the financial sector.**

Having reached new highs during the summer, US equity markets have faced a resurgence of volatility and a substantial correction during October, amid rising fear and uncertainty over the outlook for the global economy. Investor optimism during the first three quarters of 2018 has been buoyed by strong US economic indicators, aided by the benefits of Trump’s tax reform and steady monetary policy, which has kept inflation in check so far. US relative economic strength was highlighted over the summer by a range of emerging market crises, most notably in Turkey and Argentina, which prompted a rush to US treasuries and other US assets as a “safe haven”, rather than gold.

Yet gold’s reaction to the recent downturn suggests that something has changed. Investors’ outlook for the US and global economy has shifted from optimism, bordering on complacency, to fear that the nine-year bull market, the longest in history, may be coming to an end. Growth in the US (and globally) is forecast to slow in 2019 (IMF) and the US Fed’s apparent insistence on raising rates into next year is proving a further drag on optimism. Meanwhile growing uncertainty over the impact of the “trade war” threatens to spook investors further.

### Gold gains as financial market risk rises



Source: Bloomberg. Data at 26 October 2018

The optimistic ‘buy the dip’ attitude of investors during recent minor corrections in equity markets may yet prove correct in the short-term. However, gold’s reaction to the recent downturn in US risk assets marks a significant shift in investor sentiment. Gold has been heavily oversold in recent months, having come under pressure from the strong US dollar and “risk-on” investor sentiment towards general equities, however the metal’s convincing rebound in the face of falling stock markets and rising systemic risks in the US, demonstrates that gold remains a safe haven for investors and an effective portfolio diversifier in volatile market conditions.

Importantly, gold outperformed US treasuries during this volatile period, an encouraging signal for the gold sector. Treasuries have proven a popular safe haven during the emerging market volatility and currency crises of recent months, yet ultimately do not provide the same level of portfolio protection and effective diversification as a holding in gold. Gold is a unique financial asset in that it is truly scarce and is nobody else’s liability. As a store of value, it has outperformed all fiat currencies over the long-term. During September 2018 it was reported that central bank gold buying had reached the highest level in six years (Bloomberg), a notable development highlighting the relevance of gold in an uncertain and volatile economic environment.

### WHAT NEXT FOR GOLD?

Alongside the case for gold as a hedge against rising financial sector risk and the increasingly uncertain economic landscape, the gold sector appears poised to benefit from number of increasingly supportive macroeconomic and policy factors. Having fallen to the lower-end of its recent trading range over the summer, gold appears positioned for a period of outperformance, while gold equities have reached extreme undervaluation relative to broader equity markets. A range of potential catalysts exists for a re-rating of the gold sector.

Firstly, the outlook for monetary policy is supportive of higher gold prices, with real interests expected to remain low in the medium-term. Gold has performed well despite the rising interest rate environment in the US, as the gradual pace of hikes coupled with rising inflation have ensured real rates remain low. Yet fears over the negative impact of tighter monetary policy on growth have been a driving force behind October’s market sell-off. Higher rates present one more threat to economic growth, which already appears likely to flag next year as the effects of Trump’s tax cuts wane and the US-China “trade war” impacts businesses. While the Fed remains committed to its rate hike programme, it is likely that pressure to maintain an “accommodative” stance will increase. A slower pace of rate hikes, or a



pause, would ensure real rates remain low, a highly supportive environment for gold.

A second significant factor for gold is that slower economic growth in the US is expected at a time when inflationary pressures are feeding through into consumer prices. The labour market is tight, energy prices are rising, and the impact of escalating trade tensions is likely highly inflationary. The potential fallout from the trade war is varied and uncertain, however higher consumer prices will likely be a result of tariffs on imported consumer goods and components used for domestic industry. Gold has historically performed well during periods of rising inflation expectations, something which has been lacking over the past decade but appears to now be building.

A further supportive macroeconomic factor for gold is rapid debt growth, public and private, and deficit expansion, which has become an increasingly worrying economic theme for investors and policymakers globally. In Europe, the Italian government's ongoing refusal to back down over its breach of EU deficit limits highlights these economic and political risks. Rising Italian bond yields threaten to worsen the country's economic situation, while failure to adhere to ECB restrictions undermines confidence in the central bank's ability to maintain stability among the Eurozone's member states. The rise of populist political parties in Europe suggests that quarrels over deficit control will remain a potentially destabilizing factor, as governments attempt to stoke growth. Meanwhile in the US, the budget deficit widened to a six-year high of USD 779 billion in September and appears likely to continue to expand under the Trump Administration's fiscal plans. The recent strength of the US dollar threatens to compound the impact of high debt levels, both for businesses and consumers in the US itself and for international borrowers with exposure to US dollar denominated debt. For policymakers, high levels of indebtedness heighten the risks of tightening monetary policy. In the US, the Fed's rate hike programme has limited the scope to increase the pace of hikes, while stoking inflation offers a chance to reduce the burden of debt somewhat.

Of course, should growth remain strong in the US and financial markets stable, we identify a different but still largely favourable outlook for the gold sector. Gold tends to thrive during periods of growth due to the wealth effect on demand for physical bars, coins and jewellery, while the inflationary pressures generated by growth are supportive of a rising gold price.

## IS THE NEXT DOWNTURN NEAR?

A decade after the global financial crisis began, investors have enjoyed a long spell of strong equity market returns and stable economic recovery in developed markets, propped up by pro-growth government policies and the promotion of easy money. Today, as investors consider the outlook for the end of the year and the start of 2019, the economic landscape appears to be shifting and the risks rising. We believe the frequency of market corrections such as has been seen in recent weeks will likely increase, as fears grow over slowing growth, tighter monetary conditions, rising equity market volatility and geopolitical tension.

Policymakers are likely to find themselves with less ammunition to deal with the next major downturn. Selected governments have room for lower interest rates, pushing real rates back to historic lows and potentially to negative levels, however any policy response to a new crisis will likely have a heavy focus on fiscal stimulus and increased government spending, at the expense of deficit and debt control.

The timing and scale of the next major downturn are unknown; however, the events of recent weeks have reinforced our view that gold is a proven hedge against systemic risk as well as an effective portfolio diversifier. An allocation to gold and gold equities offers an opportunity to protect against downside risks to equity markets, while participating in the recovery of an undervalued sector with an increasingly supportive economic backdrop.



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