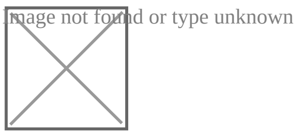
Is It Gold’s Turn to Shine?

“I believe in the Golden Rule - The man with the gold... rules.”
– Mr. T

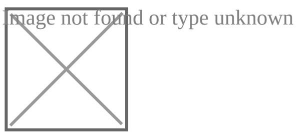
For several years, Evergreen’s weekly publication of Likes/Dislikes has maintained gold and gold-mining stocks in our “Likes” category. However, despite our long-term conviction, at times we have conceded that the asset class looked overextended and, thus, advised some profit taking and rebalancing. Last August is one example, when we updated our recommendation and presented a missive from Louis-Vincent Gave titled “What Will Stop the Gold Bull Market?”

In the introduction to that newsletter, we shared that Louis Gave has – for most of his career – been the furthest thing from a gold bug. Therefore, his shift in tone was noteworthy. Around the same time, Warren Buffett changed his long-dismissive view on the shimmering asset and took a small position in a well-known gold-mining stock. Despite the endorsements from two extremely respected investors, we warned that the asset class had become uncharacteristically crowded and looked expensive on a near-term basis. Between August 2020 and March 1st, 2021, the price of gold bullion sold off 18.4%. Gold miners were also hit hard, falling nearly 31%.

However, after a lackluster fall and winter, gold has made it to the front page once again. Of course, that’s not entirely unexpected after a 12.4% rebound in the price of gold bullion since March, which shot the asset back above its 200-day moving average.



This week, we are relaying a thoughtful letter on the subject from, once again, Louis Gave. In this article, Louis makes the case that gold *could* be the next trade to break out into bubble territory and join a series of rolling bubbles that has seen everything from electric vehicle companies to digital coins fly themselves to the moon…and beyond. However, unlike EVs and cryptocurrencies, the once-mocked “barbarous relic” has maintained its allure for thousands of years. Even looking at a *much* shorter time horizon (which is still before the genesis of EVs and cryptocurrencies), gold has – to the surprise of many – significantly outperformed the S&P 500 since the turn of the century. (As David Hay has noted in the past, you can win a lot of money at cocktail parties with that little trivia teaser.) The question for investors becomes: is there more good fortune ahead for gold bulls? Thanks to the concerted efforts of the Fed and the US treasury, we think the answer is…full stop! Let’s allow Louis to take it from here.



Source: Bloomberg, Evergreen Gavekal

My friend Kevin Muir, whose terrific MacroTourist newsletter is both very actionable and very affordable, has described the last year's investment environment as a series of rolling bubbles: as electric vehicle plays reached dizzying valuations, investors seemed to realize that EVs use about five times as much copper as combustion-engine cars, so copper miners duly soared to new heights. Then crypto was the next big thing, followed by video games, lumber, shipping... and so on. The bubbles have just rolled on from one exciting asset to the next, with investors wondering which will follow. In this note, I will explain why I think gold may be the next one.

To start with, after a fairly ugly August 2020-March 2021, gold is looking technically stronger. On Tuesday, May 18th, the gold price sliced through its 200-day moving average (see left-hand chart below), which may have the effect of attracting the attention of algos and momentum investors.

Also, this rebound is occurring against a macro backdrop that is generally favorable to gold: US treasury yields seem to have stalled in the 1.60-1.75% range (gold's August-March downdraft coincided with the rebound in US bond yields) yet US inflation data is surprising (some people) on the upside. At the same time, the US dollar—as measured by the DXY index—seems to be breaking down (the right-hand chart below shows that on Tuesday it fell below the psychologically important 90 level).

An environment of constrained yields, rising inflation and a weaker US dollar is manna from heaven for gold bulls. This environment may change but until it does, the gold price is likely to grind higher, posing the question: will it take out last summer's high? For the following reasons, I think it will:

1. Many investors who have grown concerned about currency debasement due to a USpolicy mix that has pushed twin deficits above 20% of GDP, have found refuge in cryptocurrencies. These gave extraordinary returns, yet the current reversal raises the concern that some investors may try to cash out of the asset class while they still can. Ifso, will they buy US dollars, which are likely still loathed, or instead allocate funds toprecious metals that are now enjoying positive momentum?
2. If, as I believe, the coming summer sees most Americans and Europeans hit the road, oil prices are quite likely to gap higher. This will only add to inflation fears, which—assuming the Federal Reserve does not act on these anxieties—should be good for gold. A rising oil price will also raise questions over the recycling of petrodollars earned by the likes of Russia, Algeria, Nigeria and Iran. As such countries are unlikely to just sit on a currency that is subject to US government control, might they exchange it for assets like renminbi bonds and gold?
3. A more technical reason is the looming adoption of Basel III rules that aim to make banks fund long-term assets with long-term money, and so avoid liquidity mismatches that helped spur the 2008 crisis. In theory, this sounds great but in practice the new rules oblige gold traders to keep a “required stable funding factor” of 85%. This will take effect in Europe by the end of June, and in the UK at the start of 2022, and will effectively kill Europe’s gold paper market. The rules may still change before these deadlines, yet with a Damocles sword hanging over the gold paper market, it would take a brave soul to keep a naked-short position on gold today. And given this regulatory threat, most banks will likely curtail their precious metal trading operations in the coming weeks, creating a situation where volumes are reduced, yet demand is rising due to higher inflation, positive momentum and falling cryptocurrencies.

Putting it all together, the odds thus seem skewed towards precious metals being the next “rolling bubble”.

Image not found or type unknown