Will central banks and regulators drive gold prices higher?

Baker Steel Capital Managers LLP

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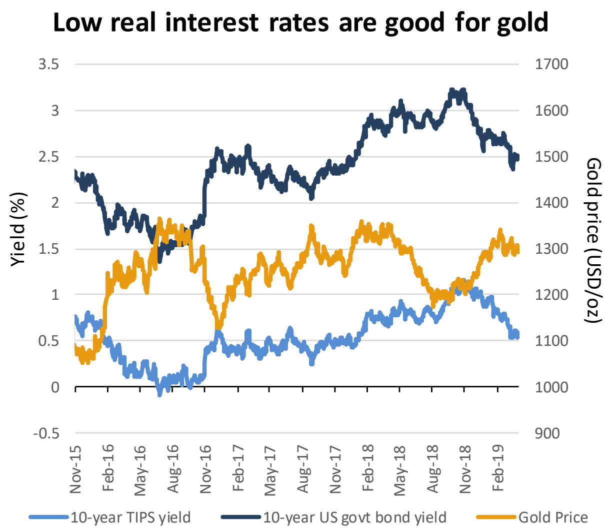
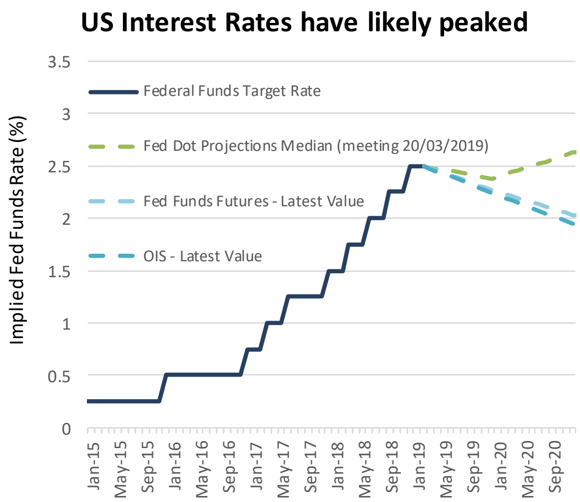
Gold has become under-owned following years of financial conditions which have favoured general equity markets and bonds. Gold demand has been steady yet subdued, as the sector has been side-lined for most of this decade. However, we believe that policy changes and a shifting economic environment are the first signs that we are close to a recovery for gold and gold equities. Rising concerns over slowing economic growth globally, high public and private debt levels, geopolitical uncertainty and with US stock markets once again near all-time highs, could it be time for a break-out in the gold sector, as part of a broader re-rating of real assets versus financial assets? The recent outperformance of gold equites might just be signalling that times are changing.

A recovery has been building steadily in the gold sector since its lows in 2015, yet the gold price has remained largely range-bound and weak investor sentiment has persisted. Importantly, selected gold stocks have performed very well during this period, rewarding active investors who have focused on value, quality and margins, however it is clear that the gold sector is yet to break out following the end of its bear market a little over 3 years ago. The gold price has not risen beyond USD 1360/oz convincingly for five years, despite testing this level frequently. However, with the sector backed by supportive economic conditions, including low real interest rates, high debt levels, policy uncertainty and robust physical demand, it seems only a matter of time before the precious metal breaks above this level and the gold sector enters the next phase of its recovery cycle.

With the gold price positioned for recovery, investors must consider the possible catalysts which may provide the trigger for the next rally. As an alternative currency which is often purchased as a 'hedge' against government failures and political uncertainty, the direction of the gold price can be impacted by policy announcements, particularly those relating to monetary policy and money supply. In particular we see some recent policy developments which we believe will have a significant impact on gold prices and gold demand in the coming months. Widely reported and much discussed in recent weeks has been end of the US Federal Reserve interest rate hike cycle. The March FOMC statement highlighted a significant shift in policy, signalling no further rate hikes and bringing an end to the tightening programme which began in December 2015. Following a period of uncertainty over the direction of US monetary policy, it is now clear that interest rates will likely remain low and may fall further in response to a potential economic slowdown in the US and globally. Low interest rates have historically proven to be a positive driver for the gold price and the Fed's apparent willingness to implement looser monetary, potentially allowing inflationary pressures to return, strengthens the bullish case for higher gold prices.

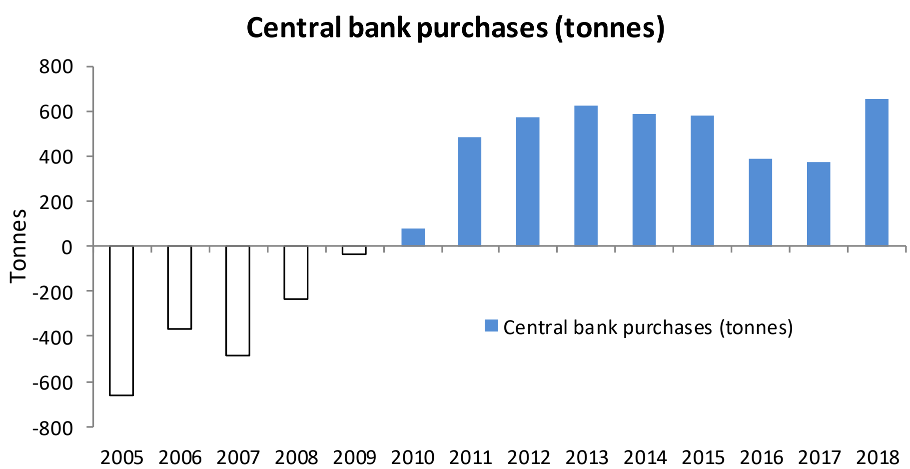




Source: Bloomberg. Data at 12 April 2019.

Less widely reported was the recent changes to international banking requirements, known as Basel III, developed by the Bank for International Settlements, which came into force at the end of March 2019. Basel III aims to promote financial stability through governing capital requirements for banks, to prevent excessive risk taking, in partnership with regulators from 28 countries and largely in response to the 2008 financial crisis. Under Basel III, from 29 March 2019 gold has been upgraded to a ‘Tier 1’ capital asset, from ‘Tier 3’, while a bank’s Tier 1 assets are now required to rise to 6% from the 4% previously. This subtle change represents a potentially significant shift towards gold as a backstop for financial institutions, with potentially a substantial important for long-term gold demand.

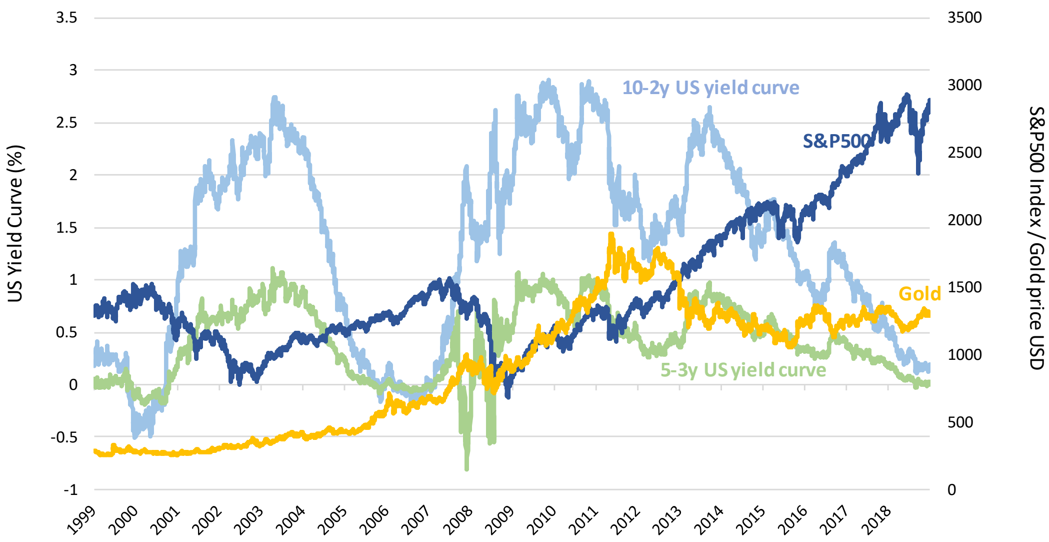
A further policy factor with significant implications for the gold price has been central bankers accelerated purchasing of gold. Central bank demand globally reached a multi-decade high in 2018, with the largest annual purchasing by these institutions since 1971 (source: World Gold Council). This has been led by countries which wish to diversify away from the US dollar, most notably China, Russia, India, Turkey, as well as a range of developing economies globally, and is a trend we expect to continue given the confrontational US trade policies employed by the Trump Administration. During the first two months of 2019 central bank net buying of gold has reached almost 90 tonnes already, compared with 56 tonnes during the same period in 2018.



Source: World Gold Council – Gold Demand Trends: Full year 2018

Aside from policy factors, we see range of macroeconomic and market drivers which indicate a stronger outlook for the gold sector. Notably the flattening of the yield curve, a reliable predictor of economic slowdown, and rising equity market volatility, indicate increased risks ahead for investors, particularly given equity markets' current lofty valuations relative to economic fundamentals. Recent downgrades to economic growth forecasts in the US, China and other major economies, alongside signs of a manufacturing slowdown, particularly in Europe, all point towards a diminished outlook for the global economy and risks for investors. Meanwhile political tension, most notably surrounding ongoing trade tensions between the US and its trading partners, appears unlikely to subside.

US Yield Curve - Flattening curve implies rising financial market risk



Source: Bloomberg. Data at 12 April 2019.

An allocation to gold and gold equities can bring a range of benefits to a portfolio. Firstly, the gold sector's current undervaluation compared to broader equity markets as well a relative to historical levels, the sector offers long-term returns for investors as the recovery of this cyclical sector gets underway. Secondly, gold and gold stocks are an effective portfolio diversifier that can mitigate losses in times of market stress. This point is of particular significance at a time of rising financial market risk and economic and political uncertainty.

Finally, it is worth noting that an allocation to gold and gold equities can enhance overall portfolio performance. Gold itself is a liquid asset with no credit risk that has outperformed fiat currencies over the long-term, while gold equities offer superior upside potential relative to gold, albeit with higher risk. Gold producers remain undervalued and with a selection of companies having undergone reforms, the potential for investors in the second half of 2019 and beyond appears substantial.

Baker Steel Capital Managers LLP ("BSCM") is a specialist investment manager focused on the natural resources sector. BSCM managers the BAKERSTEEL Precious Metals Fund Baker Steel (UCITS long-only gold equities) and the BAKERSTEEL Electrum Fund (UCITS speciality and precious metals equities), as well as the Baker Steel Resources Trust (LSE: BSRT), an LSE-listed investment company which invests in pre-IPO opportunities within the mining sector.

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