Gold and inflation – A turning point?

An update on the long-term upcycle for the precious metals sector

Baker Steel Capital Managers LLP

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It is often said that the gold market is cyclical, and it is certainly true that gold's long history is marked by clearly identifiable turning points, such as the inflationary crisis of the late-1970s and the financial crises of the 2000s, the economic impact of which drove gold to new highs. The gold price is now substantially above its lows of the last decade and, with seismic economic and political shifts underway during this unprecedented time in history, our team of natural resources specialists ask if gold is in the early stages of a <u>once-in-a-generation upwards move</u>. With inflation expectations rising and evidence that price rises are already underway, could the return of inflation be the catalyst for higher gold and silver prices in the months ahead?

The return of inflation?

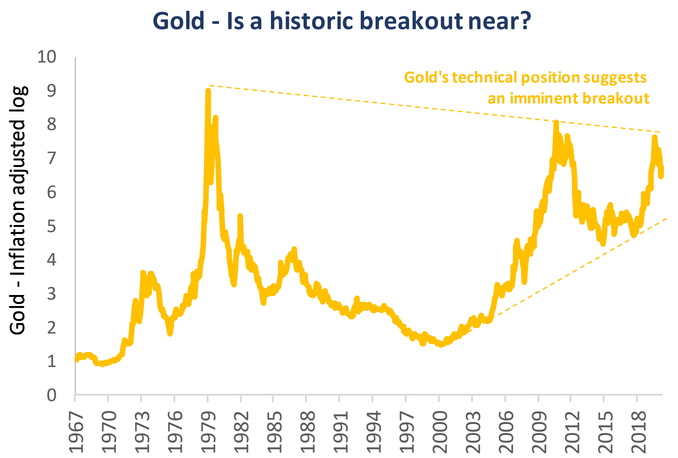
- Money printing/money supply growth.
- Public debt growth has accelerated.
- Bank lending has increased.
- Pent-up consumer demand unleashed.
- "Reshoring" and supply side issues.
- Central banks' new approach to inflation.

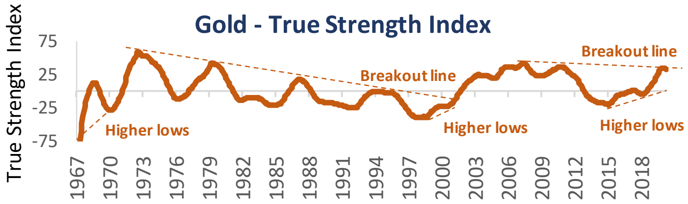
How can investors hedge against inflation?

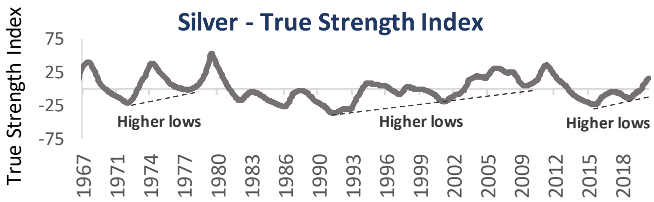
- Equities can rise with inflation but face risks from high valuations and nominal rate hikes.
- Bonds are negatively impacted by inflation.
- Real assets and commodities offer a hedge against inflation.
- **Gold historically thrives during inflationary periods.**

Are we at the start of a long-term upcycle in precious metals prices?

With the gold price having retraced from its highs at the height of the COVID-19 crisis last year, the metal now appears uniquely well positioned, both from a technical and fundamental perspective.







Source: Trading View Data – Patrick Karim Analysis. Note, based on inflation adjusted data. Data at 31 March 2021.

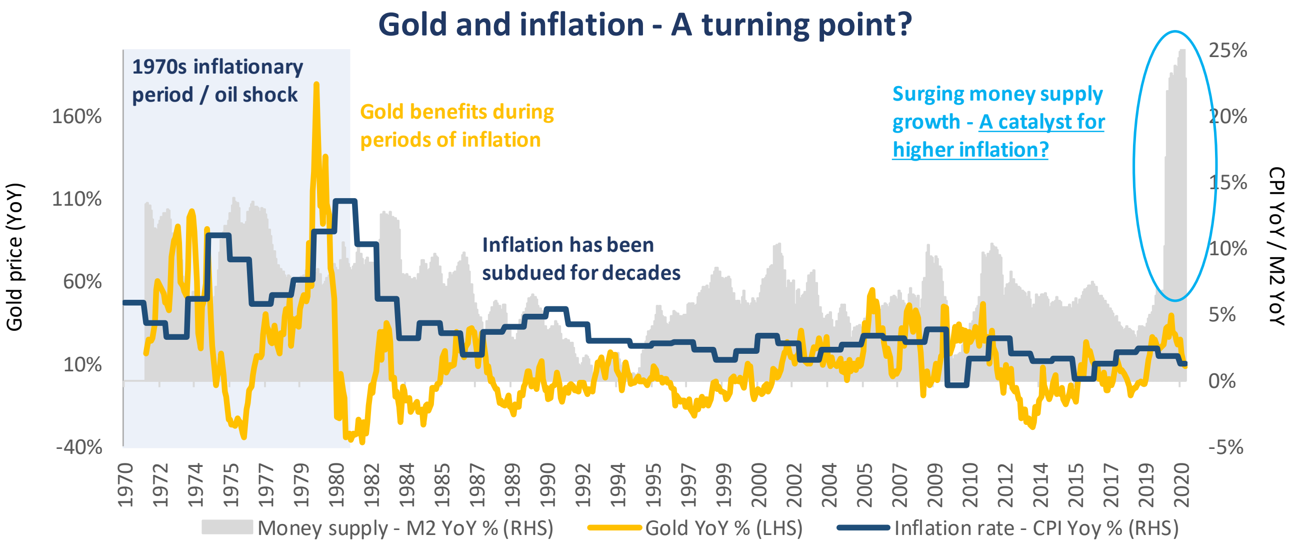
Many factors impact the long-term direction of precious metals, including inflation. Gold is a store of value, a scarce and unique asset, which is no-one else's liability and has outperformed all fiat currencies over time. Real interest rates have been a primary driver in recent years, as low and negative rates increased the appeal of holding gold over bonds. Gold does not pay a yield, but is an effective portfolio diversifier, which provides wealth protection and insurance against financial market risk.

Regarding silver, as in previous cycles, the metal started to outperform gold in 2020 as momentum gained pace in the precious metals sector. Having lagged gold for much of the past few years, silver's price recovery is perhaps overdue, while rising industrial demand projections, most notably from the solar photovoltaic industry, indicate a strong outlook for the silver sector.

Further current drivers for precious metals include the vast stimulus spending by policymakers, rising debt levels, as well as ongoing geopolitical tension. The aftermath of the COVID-19 crisis has seen these trends amplified, driving gold's encouraging performance in 2020. While there is already a strong case for higher gold prices based on current economic conditions, the return of inflation could substantially alter gold's trajectory in the months and years ahead, accelerating the metal's elevation to new price levels.

Is gold an inflation hedge?

With inflation rates having remained low and steady for many years in developed economies, we must look back to the 1970s to examine how the last major inflationary period impacted precious metals prices:



Source: Bloomberg. Data at 31 March 2021.

Gold has historically thrived as an inflation hedge during periods of rising prices, and this was certainly the case during the 1970s as the metal underwent a substantial cyclical uptrend. While inflation has remained low for most major economies over the past three decades, the global economic response to the COVID-19 crisis presents a potential turning point for consumer prices. The potential for inflationary pressures to be unleashed in the months ahead is stronger than it has been for many years. Money printing, heightened government spending on infrastructure and the "green deal" fuelled by debt, increased bank lending and pent-up consumer demand, alongside supply-side factors including "reshoring" and the impact of lengthy economic shutdowns, all indicate that a sustained rise in consumer prices is likely imminent.

Can money printing continue without causing inflation?

Among the most notable drivers of inflation is the truly unprecedented scale of money supply expansion over the past year, highlighted by the fact that around 25% of all US dollars were created during the last twelve months. COVID-19 recovery stimulus funding has topped USD 15 trillion globally so far, and this total seems likely to grow in the months ahead. Overall, historically sharp rises in M2 have coincided with an increase in the inflation rate.

As the world emerges from the COVID-19 crisis, the direction of travel seems clear; debt growth is accelerating, and monetary growth will continue as governments focus on economic recovery. Importantly, in contrast to the policy response to the Global Financial Crisis a little over a decade ago, the focus of stimulus packages appears more likely to stoke consumer price inflation, not just asset price inflation.

Whether these trends will result in sustained higher inflation rates remains to be seen, yet price rises appear to be starting to feed through. Food and lumber costs have risen sharply in recent months, with other commodities, including precious metals, poised for a period of "catch-up" should this trend continue:

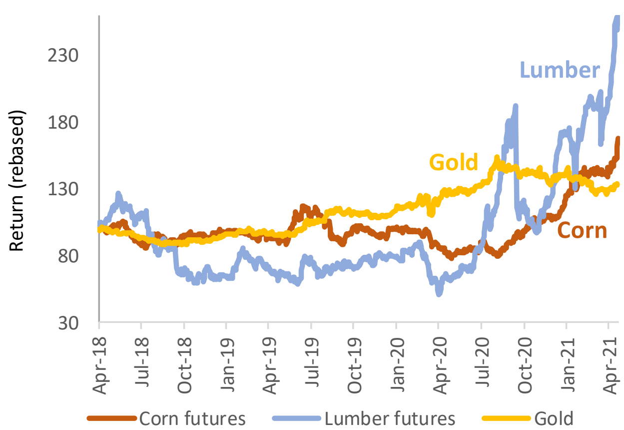
Commodity	12-month return	Commodity	12-month return
Lumber	+265%	Cotton	+54%
Oil (WTI)	+210%	Platinum	+32%
Corn	+84%	Wheat	+19%
Copper	+83%	Coffee	+13%
Soybeans	+72%	Gold	+3%
Silver	+65%		

Source: Bloomberg. Data at 21 April 2021.

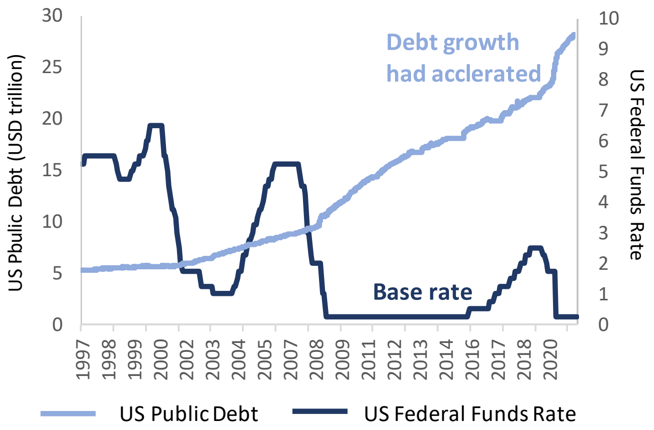
Alongside signs that consumer price rises may be imminent, there has been a fundamental shift in policymakers' approach to inflation management. Central bankers have been keen to signal that they will not undertake aggressive interest rate hikes in response to signs of inflation, in recognition of the risk of severe damage to their heavily indebted administrations, businesses and citizens. Led by the Federal Reserve, central banks are moving towards average inflation targeting, indicating that they will allow inflation to overshoot target levels. Furthermore, should inflation remain subdued, or rise only slightly, then we would expect to see more aggressive policy measures implemented by policymakers. Yield curve control remains a potential policy measure by the Fed, while debate over Modern Monetary Theory (MMT) continues to inform policymakers' views.

No matter how governments measure inflation over the coming years, and even if inflation remains muted, it is clear we are entering a period of fiat currency debasement during which gold, given its status as the ultimate real financial asset, will likely thrive. Furthermore, we believe the current high level of speculative investment in cryptocurrencies is an indication that a broad audience appreciates this risk to fiat currencies. It is sometimes asked whether cryptocurrencies are a competitor to gold, given the similar motivations for holding both assets, however we consider the two to be distinctly different. Cryptocurrencies are primarily used for speculation, while gold fulfils a broader long-term role for investors seeking diversification and a hedge against fiat currency debasement.

Higher consumer prices ahead?



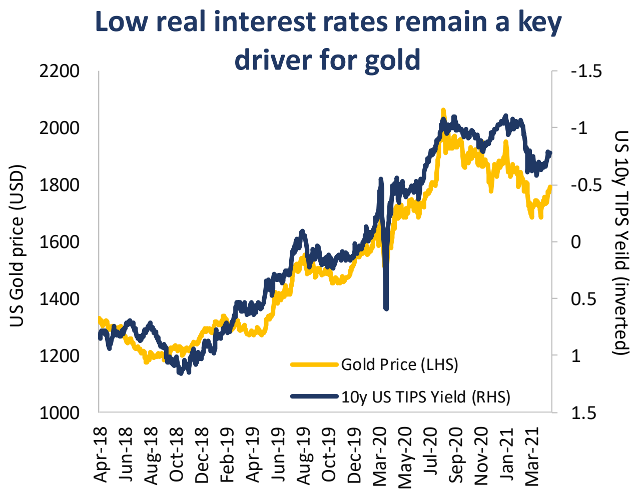
How far can base rates rise?

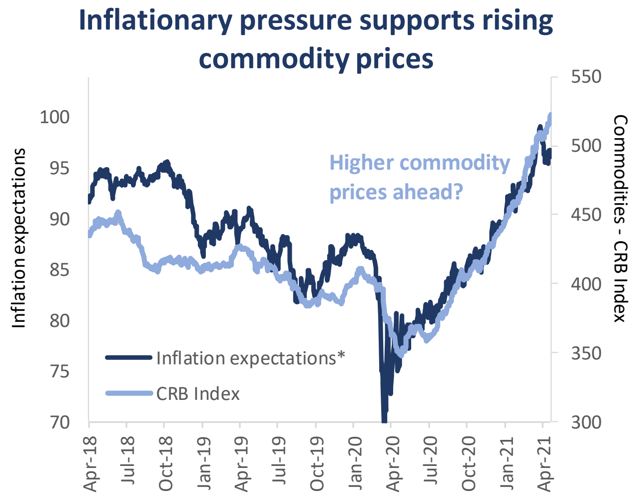


Source: Bloomberg. Data at 22 April 2021.

Will a return of inflation herald the "next leg" for the new bull market in gold and broader commodities?

A return of inflation would hold positive implications for commodity prices, particularly precious metals. Given the outlook for nominal interest rates, which we expect to remain low or rise slightly, higher inflation will see real rates fall further, in many cases into negative territory or at least around zero. Gold has a close negative correlation to US real rates and we would expect to see a strong recovery of gold prices under inflationary conditions. Similarly for broader commodities, as shown on the chart below rising inflation expectations have tended to drive prices higher.





Source: Bloomberg. Data at 22 April 2021.
*Inflation expectations are based on the ProShares Inflation Expectations ETF

Gold equities remain historically undervalued

Against an increasingly supportive economic backdrop for precious metals, as well as for broader natural resources, we see some compelling opportunities for investors at present. While the potential upside for the gold price may be sizeable under an inflationary environment, gold equities offer significantly enhanced upside potential, relative to an investment in the physical metal. We see historic levels of fundamental undervaluation in precious metals equities, with many companies experiencing margin expansion and poised for re-rating by the market. Furthermore, on a relative basis, gold equities are trading on multiples metrics far below that of broader equity markets, while relative to the gold price itself, miners have a long way to go. You can read more about our views on the gold mining sector **here**.

With the precious metals sector showing signs of recovery following the pull-back from its 2020 highs, we believe now is a compelling entry point for investors into this undervalued sector. We see a turning point for gold, as inflationary pressures return, providing a catalyst for the next leg of gold's bull market cycle.

About Baker Steel Capital Managers LLP

*Baker Steel Capital Managers LLP manages the **ES Baker Steel Gold & Precious Metals Fund, Baker Steel Gold Fund**, **BAKERSTEEL Precious Metals Fund,** **BAKERSTEEL Electrum Fund**, and **Baker Steel Resources Trust** and.*

*Baker Steel has a strong track record of outperformance relative to its peers and relative to a passive holding in gold or gold equities. Fund Managers Mark Burridge and David Baker have been awarded **two Sauren Gold Medals for 2020** and were awarded **Fund Manager of the Year** at the **2020 & 2019 Mines & Money Awards**.*

*BAKERSTEEL Precious Metals Fund is a **2021 winner** for the fourth year running of the **Lipper Fund Awards** while Baker Steel Resources Trust has been named **Investment Company of the Year 2020 & 2019**, Natural Resources, by Investment Week.*

Sources: Bloomberg, Company Reports, Baker Steel Capital Managers LLP.