



Time for GOLD

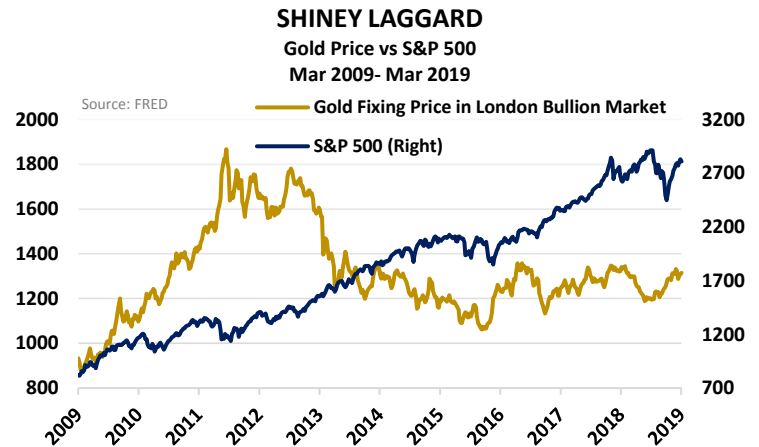
Market Viewpoint: March 29, 2019

Summary: Although gold has not had a rally anywhere close to its largest of all time in 2010 – 2011, it has still been quite resilient in the face of tightening monetary policy over the last several years. And now that the Fed is putting rates on hold, the underlying fundamental trends in gold markets, including a long-term slowdown in production and a spike in demand from central banks, is setting the precious metal up for stronger performance through 2019 and beyond.

Gold has arguably been one of the most disappointing asset classes of the past eight years. Following a short run up immediately following the financial crisis, the precious yellow metal has floundered, especially compared to stocks, which have more than doubled in the same timeframe, and even to bonds, real estate and many other commodities as well. The gold fundamentals, however, argue for taking a fresh look at this point in the business cycle.

TURNING POINT

Gold remains 40% below its 2011 all-time high of almost 1900. More recently, however, it is up from its current decade trough. But that improvement was not completely linear. Gold dropped over 11%, for example, from April 2018 through September. Then, in the face of the downturn in equities at the end of the year, Gold outperformed most other global assets in 2018. It has also begun to shine in 2019, gaining 3% through March, and breaking back above the 5-year moving average.



GLOBAL MONEY PRINTING

One big reason to consider gold has been the past decade’s widespread adoption of quantitative easing policies, as major central banks around the world resorted to an unprecedented balance sheet expansion to prevent their respective economies from plunging into a deflationary spiral.

However, the Fed finally began reducing its balance sheet in October 2017, lopping off \$500 billion worth of assets from its peak near \$4.5 trillion. The same cannot be said for other major economies like Japan and the European Union, where balance sheets continue to grow. Most recently, reflecting a more dovish stance, Fed officials have suggested a pause in the balance sheet shrinkage.

[As MRP has pointed out before](#), since the U.S. Treasury moved off the gold standard in 1971, the value of gold and other precious metals has not grown anywhere nearly as much as the quantity of debt and base money



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that it once legitimized. Precise quantification of the degree to which gold has lagged debt and money creation is complicated by the fact that the price of gold was fixed at \$35 per troy oz from 1933 until 1971 while the cost of living more than tripled.

It should be noted that the price of gold rose above \$35 in the period from '68 to '71. In the immediate aftermath of its floating, the price soared to \$180 in just four years, in effect catching up with the inflation of the preceding four decades and the early 70s' inflation surge. Later in that decade, gold's price exploded even higher to a peak near \$850 in early 1980, as the 1970s' runaway inflation reached a crescendo. Gold is now priced at about 30 times its average 1971 price, while the monetary base is up a whopping 44-fold over the same period, even after efforts have been made over the past couple of years to reduce it. The national debt has exploded 90-fold to over \$21 trillion. The relevant series that has increased the least is the CPI. The inflation that might have been expected to result from this massive money printing has not shown up ... at least, not yet. It is widely believed it never is going to show up. [But MRP disagrees](#), and we expect to see inflation on the upswing before year end.

Indeed, energy prices, which have already begun turning around as crude has reached back to \$60 per barrel, had been the key catalyst in the CPI's downturn in the final quarter of 2018. When observing the core CPI (ex food and energy), it is obvious that price levels in other sectors have not been nearly as effected. Additionally, many companies are preparing to boost prices later in 2019 for everything from aviation equipment to non-discretionary household goods. Plus, labor costs are rising strongly with wage growth at a 10-year high.

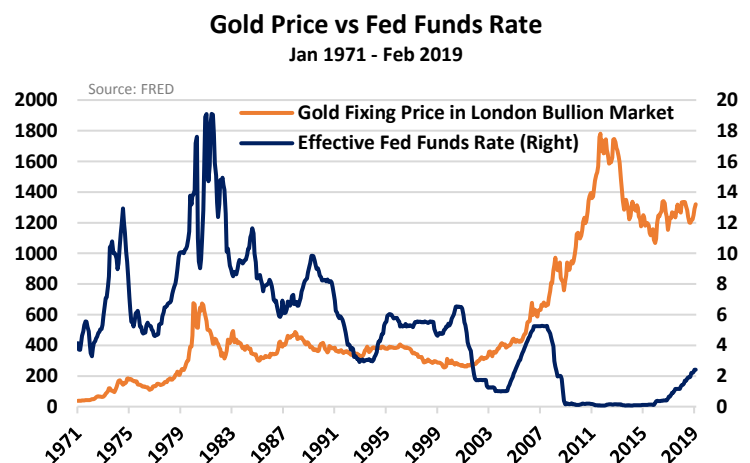
CONTRA-INTUITIVE HISTORY

Conventional wisdom has argued that higher rates would lead to lower gold prices. Yet, that reasoning defies the lessons of history: since gold was freed from its fixed value in 1971, there have been nine tightening cycles. Gold rose during eight of the nine. Also, it should be remembered that during the 4 years following its 2011 peak, gold lost almost half its value in the face of zero interest rates and the easiest monetary policy in modern history. Conventional wisdom must have been on an extended vacation during this period.

Moreover, in the last few years, the counterintuitive trend has held up. The Federal Reserve has now raised the Fed Funds rate by 225bp throughout their current tightening cycle, beginning in December 2015 – yet over that same span, the price of gold has still risen by a quarter.

So, right now we have gold that has actually become more valuable in the face of higher interest rates, and better yet, we now have reached a lull in the tightening as Chairman Powell and other voting members of the FOMC have expressed a more dovish, [patient attitude toward interest rates](#).

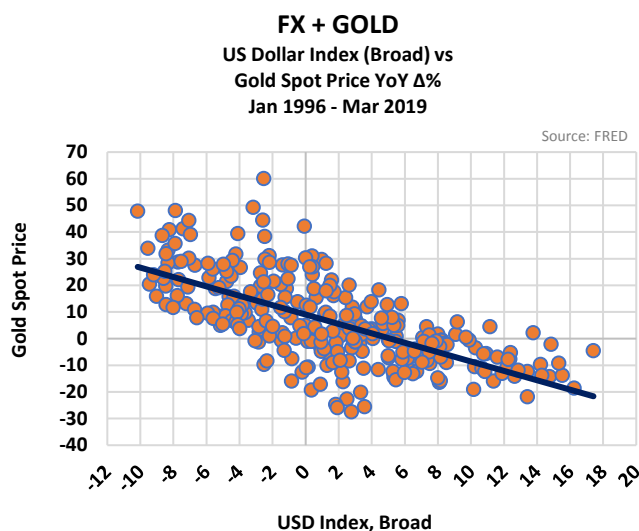
In many past cycles, rates have risen but not in a straight line. The tightening starts with a bunch of hikes, then a pause, then more hikes later. Very often, the uptrend in bullion prices has been strongest during those pauses. The next year or so may be one of those times. As we've mentioned, gold has remained in an uptrend versus rising rates. Now that the Fed has decided to pause the tightening, it could allow gold to finally break out.



According to the World Gold Council (WGC), the current cycle shares similarities with the last two: 1999-2000 and 2004-2007. In both of those cycles, rates had been rising without pause for at least 12 months, the yield curve was flat or inverted in, and retail sales were falling; our current cycle shares all of those characteristics. According to their analysis, gold does perform better in a post-tightening cycle, but the period over which this occurs varies. For example, gold rose 3.6% in 2001, 12 months after the Fed stopped raising rates. But it rose 7% only one month after the transition in 2007, a trend that continued as it was 19% higher 12 months after the Fed's last hike.

THE FX FACTOR

Similar to gold, the conventional wisdom seems to be that higher nominal U.S. rates will push the dollar higher, and vice versa. But historical data demonstrates that it is not merely nominal rates, but it is inflation-adjusted short term rates (aka real rates) that matter.

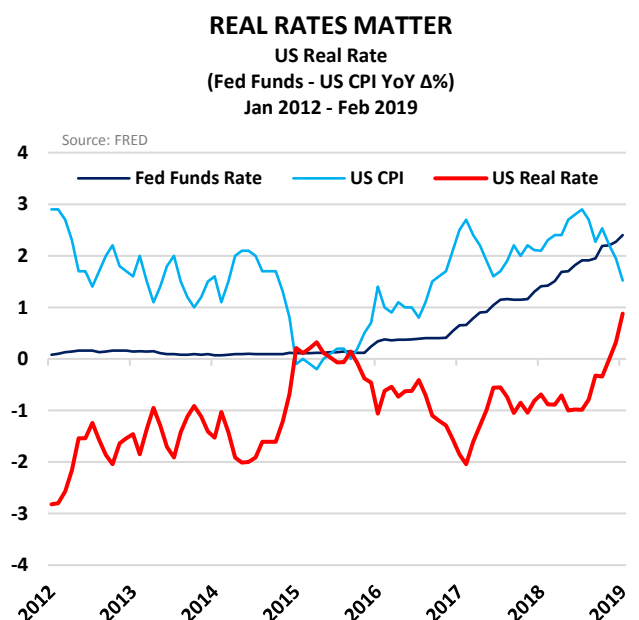


These real rates, the difference between the fed funds rate and inflation, had been held down in negative territory for some time, helping gold to appreciate alongside the dollar.

Three years ago, at the beginning of the current U.S. rate hike cycle, higher rates were cited most commonly as the reason the dollar would rise further. But as it turned out, rates got hiked, [and the dollar stopped going up](#); it then had some wild fluctuations including a short-lived surge following the surprise Trump election victory. But to this day, the Dollar/Euro and the MAJOR index have wound up below their Nov. 30, 2015 highs. The Fed raised short-term rates, but U.S. inflation rose faster so that “real” rates fell.

Recently though, US real rates have broken out into positive territory. The rising fed funds rate and disinflation we saw through the final half of 2018 concocted a perfect mixture for positive real rates, but as we've noted, the Fed has decided to take a pause on rates. Therefore, if inflation were to make a turnaround, negative rates could swiftly return, pushing the US dollar down. And as the accompanying scatter plot clearly shows, gold and the dollar are inversely correlated.

Finally, de-dollarization around the world is playing a role in weakening the dollar. According to Bank of America Merrill Lynch, Russia and China appear to be leading the de-dollarization trend, but analysts note that Europe is also jumping on to the diversification bandwagon. Just recently, the ECB swapped €500 million worth of U.S. dollar reserves into CNY-denominated securities.



CENTRAL BANK BUYERS

As nations shed those dollars, many of them are planning to replace them with gold. Central banks as a whole bought 651.5 tonnes of gold last year, the biggest buying spree for almost half a century, led by Russia, Turkey and Kazakhstan. Russia bought 274 tonnes of gold, its largest net purchase on record, according to the WGC. The US, by contrast, continued its 13-year tradition of not making any significant gold transactions.

Elsewhere in Eastern Europe, Hungary and Poland also notched huge purchases. Poland boosted their gold reserves by 25% YoY and Hungary increased its reserves 10-fold to their highest level in nearly 30 years.

On net, central banks have gobbled up 148.4 tons of the yellow metal in just the third quarter of 2018, representing a 22% YoY increase and the highest level of quarterly demand since Q4 2014.

China is leading the pack in gold buying to challenge Russia as the most aggressive buyer of the precious metal this year. The country's central bank, the People's Bank of China, has bought about 32 tonnes of gold in the past three months. China is the world's biggest gold producer but its gold reserves, at just under \$80bn, make up a fraction of its total foreign exchange reserves of more than \$3tn, meaning China is underweight the yellow metal compared with peers. That 3% share, for example, compares with 19% for Russia.

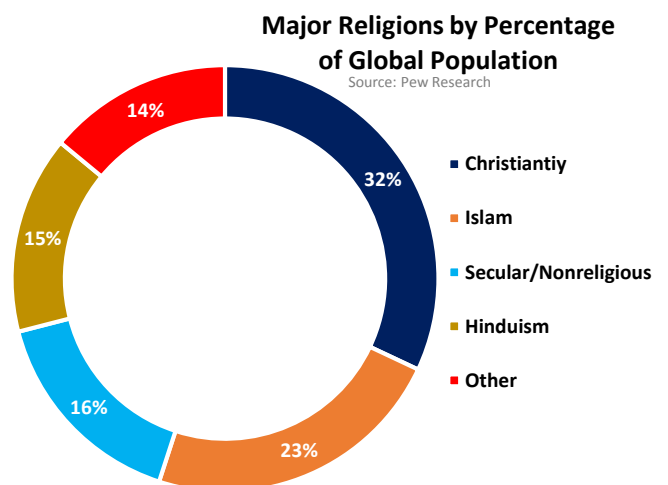
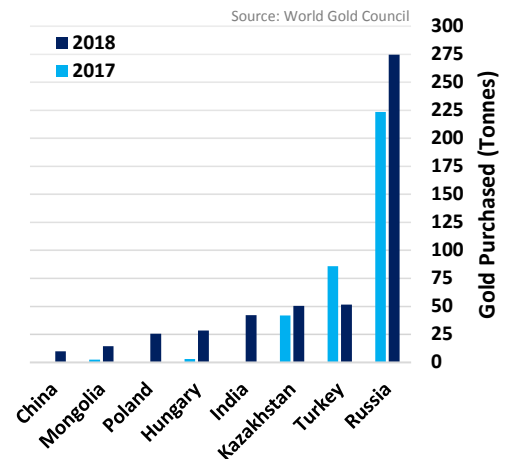
Schiff Gold reports sales of gold bars and coins rose 28% QoQ to 298.1 tons in the final quarter of 2018, with Chinese investors leading the way. The Middle East bar and coin market continued its recent uptrend, rising 144% year-on-year and 28% quarter-on-quarter. Meanwhile, economic sanctions pushed gold demand in Iran to a five-and-a-half year high, and some landlords have started collecting rent in gold instead of rials.

ISLAMIC FINANCE

In December 2016, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Muslim governing body that creates Islamic financial standards, concluded that Muslims across the globe (1.6 billion people who are said to hold close to \$2 trillion in assets) were now allowed to purchase and possess gold according to newly minted addendums to Shari'ah Law. At the time, the WGC said the new ruling could stimulate demand for "hundreds of tons" of gold as retail investors and Islamic banks shore up gold in their portfolios and balance sheets. If just one per cent of Islamic finance goes into gold, demand could increase up to a massive 1,000 tons per year, according to Goldcore.

While the WGC said 2017 saw much more interest in gold from Islamic countries, 2018 was not as strong due to weak jewelry demand across the Arab world – particularly in Saudi Arabia and the UAE, where value-added taxes (VAT) were introduced for the first time and likely dealt a blow to the sector. The market was also subdued in the Gulf as consumer confidence continued to hurt the broader retail sector.

GOLD HOARDERS 2017 & 2018 Gold Purchases - By Country

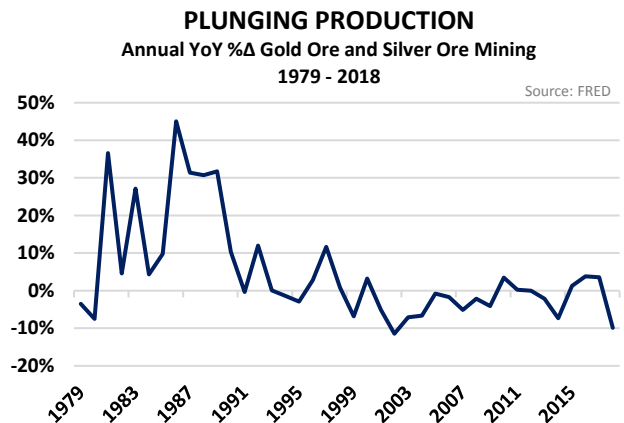


However, a better year for gold in Islamic countries could bolster Asian demand in 2019. Demand for higher karat gold, (specifically from 22 – 24 karats) has taken an upward turn across the Gulf Coast Countries during the past nine months, according to website search trend data from SEMrush. Online results show 24-karat search volumes equate to more than 1,200 online enquiries a month on average, their greatest volume of any time in the past three years.

PEAK PRODUCTION

MRP has previously pointed out the notion of “peak gold production” or the maximum rate of gold production. Year-on-year gold production has been declining despite technological advances in extraction techniques. The lack of new discoveries and decreasing volume of output by existing mines coupled with the failure to replace reserves in the face of rising demand supports higher future prices.

This trend continued in 2018 as the Fed's annual production index for gold and silver ore mining decrease by almost 10% YoY, the largest decrease since 2002. On a nominal basis, that index is down 44% since its peak in 1998.



BMO Capital Markets has projected falling production to continue through at least 2020 and are increasingly pessimistic about long-term prospects. The main rationale for their negative outlook is declines in new large-scale gold projects over the next 5 years, and even if that were to change, newly-discovered deposits are likely to be smaller than in the past and face development hurdles. The 10 largest mines that have been operating since 2009 will produce only 54% of the gold they used to 10 years ago.

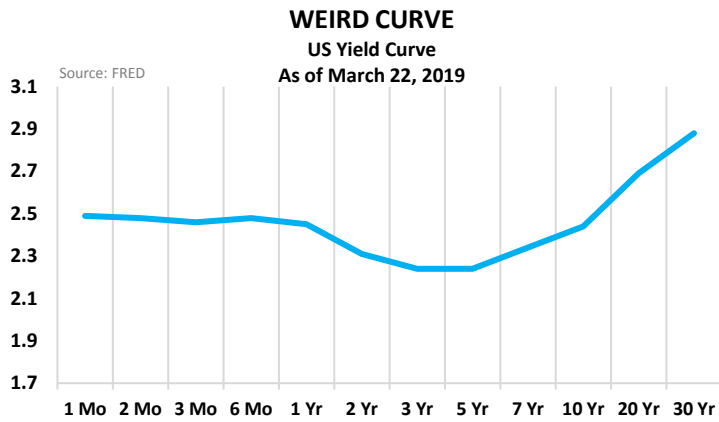
However, even with production declining, miners themselves aren't exactly suffering. According to Garrett Goggin of Gold Stock Analyst, gold miners are in much better financial health now and are focused on profitability, resulting in reduced cash costs, which have boosted their margins up to an average of 55%. Goggin's research has shown that, going back to 1995, there has been a 90% correlation between the HUI Gold Index and miners' margins, but in the last two years, the relationship has diverged with margins improving but the HUI index climbing very little.

Additionally, many are waiting on a miner merger wave. This month, the sector's largest companies, Barrick Gold Corp and Newmont Mining Corp said they would form a Nevada joint venture that, if a separate company, would be the third-biggest producer of gold in the world. Last fall, Barrick also bought Randgold Resources and in January Newmont bought Goldcorp Inc. The Wall Street Journal reports that last year's gold-mining deals totaled \$12.4 billion, around half the peak in 2010 – investors will be looking for a pickup in deals, led by this latest burst.

GLOBAL ECONOMIC AND POLITICAL UNCERTAINTY

Finally, many have begun to develop anxiety about a coming recession this year. While we believe [this is unlikely](#), a the slowing of growth alone could be enough to spur an increase in the prices of gold and gold-based assets.

However, it is worth noting that the 10-year note yields sank below three-month Treasury bill yield earlier this month, marking the first time this section of the yield curve has inverted since 2007. Many investors believe



inversion in the yield curve is a signal of oncoming recession, possibly causing investors to flee from riskier bets and into safe havens like gold and other precious metals.

Geopolitics may also be growing more volatile. American tensions with North Korea and Iran have cooled, as all eyes have shifted to South America where the US and a number of allies have attempted a soft coup of Venezuelan President Nicolas Maduro by recognizing Juan Guaidó as the new President of the country. The Maduro regime

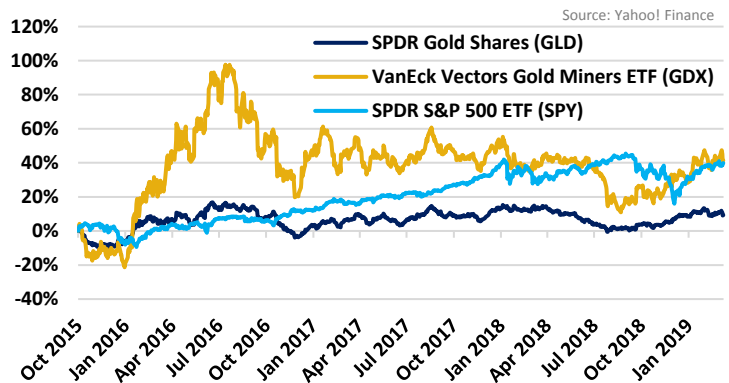
has made it clear they will not go quietly and have the backing of Russia and several other allies to keep them in power. If this situation escalates, the Venezuelan power struggle has potential to become a global crisis.

Additionally, although China and the US are still entrenched in an ongoing trade war, the two nations have been more amicable in recent months, signaling a resolution is near. Nothing is certain however, and one should take North Korea's (a very close Chinese ally) more recent defiance after a year of cooperation with US diplomats as a sign that China may be leveraging their ability to sway the behavior of North Korea's government as a bargaining tactic. According to NPR, North Korea is currently considering breaking off negotiations with the U.S. and resuming nuclear and missile tests.

BOTTOM LINE

Dovish monetary policy combined with explosive central bank buying – all tied together with slowing production from miners – presents a stronger case for gold demand than anything we have seen in the past several years. In addition to flat interest rates, a pickup in inflation through 2019 would also weaken the dollar, creating an advantage for gold, an inverse relationship that has been documented over the long term. And finally, other disruptions in Islamic finance as well as geopolitical tensions across Asia and South America could bolster the upward trend gold even further, given its safe-haven status.

MINERS READY TO SHINE
Gold (GLD) vs Gold Miners (GDX) vs S&P 500 (SPY)
Oct 2015 - Mar 2019



In light of these developments, MRP is re-affirming our LONG Gold theme. MRP added Long Gold and Gold Miners as a theme on October 21, 2015. Since that date, SPDR Gold Trust (GLD) has risen only 9%, underperforming the SPY's 39% gain. In comparison, though, the gold miners have soared with VanEck Vectors Gold Miners ETF (GDX) posting a gain of 41% over the same period.

For MRP's research disclaimer, please go to www.mcalindenresearchpartners.com/disclaimer.html