Gold: The Beginning of the End of an Era

What Goes Up Must…

The past five years have been among the most tumultuous ever seen in global financial markets, with the collapse of Lehman Brothers in September 2008 unleashing a series of events without precedent since at least the 1930s.

The financial underpinnings of the crisis, the potential consequences of the reflationary “fix”, along with the rolling financial issues in Europe, all contributed to an extraordinary flight to quality. US Treasuries and gold were among the clearest beneficiaries, with the precious metal enjoying a Renaissance period as its role as a financial asset was reappraised by central banks and investors.

- In July last year the yield on 10-year US debt fell to an all-time low of 1.375% – the previous low (we have data since 1790) was 1.55% in 1945…
- Similarly, the price of gold surged to post a record nominal high in mid-2011 ($1,921), less than 10% below the all-time real high seen back in early 1980.

Given its historical role as a store of value, it was not surprising that investor demand for gold increased substantially. Now, however, with the acute phase of the crisis likely to be behind us, we think the peak of the fear trade has now also passed.

The inflection point appears to have been the day in late July last year that ECB President Draghi firmly committed the ECB to do “whatever it takes” to save the euro. Since then US 10-year yields have risen to 2.0%, and funds have begun to flow back to Europe. Interestingly, however, at least so far gold has not fallen but has rather drifted sideways.

Although is difficult to be precise, we feel that this sideways drift will turn into a modest downward trend over the course of this year – against any sensible benchmark gold still appears significantly overvalued relative to the long run historical experience.

- Despite the recent pullback, the price of gold has never before been this high for this long in real terms.
- Gold is also still close to the highest level ever seen relative to the average of industrial metal prices.
- And both US equities and US housing are currently almost the cheapest they have ever been relative to gold.

The forthcoming US fiscal debate may give the metal a short-term lift but, in our view, that will be transient. With global growth now improving and inflation expectations contained, we feel that downside risks are building for gold. It looks increasingly likely that the 2011 high will prove to have been the peak for the USD gold price in this cycle, and that the “beginning of the end” of the current golden era comes sooner than the Q3 we forecast in January.
Introduction

**Extreme Fear Fades**

The past five years have been among the most tumultuous ever seen in global financial markets, with a problem in the US housing market quickly morphing (courtesy of the collapse of Lehman Brothers in September 2008) into the first contraction in global economic activity seen in 80 years.

The largest stimulus in history saw global activity climb back from the brink of outright depression in early 2009, but the financial underpinnings of the crisis, the potential consequences of the reflationary “fix”, along with the rolling financial issues in Europe, all contributed to an extraordinary flight to quality, with “safe haven” assets seeing record demand.

- For example, in July last year the yield on 10-year US government debt fell to an all-time low of 1.375% – the previous low since 1790 was 1.55% in late 1945 (Exhibit 1)…

Exhibit 1: US 10-year yields fell to the lowest level on record last year…

In that environment, many investors developed quite legitimate existential concerns about the very essence of western capitalism, with many purchasing “insurance” against the meltdown of the financial sector and/or the collapse of fiat currency as we know it.

Against this backdrop, given its historical role as a store of value, it was not surprising that investor demand for gold increased substantially between 2009 and mid-2011, with the price of the yellow metal reaching $1,640 in 2007 dollars, only 6.3% less than the all-time real high seen in January 1980 (Exhibit 3).

- Despite the recent modest pullback, the price of gold has never before been this high for this long in real terms.
- The long run real average price of gold in 2007 US dollars (pre-global financial crisis) since 1841 is just $462.
- The long run real average price of gold in 2007 US dollars since the end of the dollar’s convertibility is $653.
But the times they are a changing…

As we highlighted in Commodity Forecasts: Back to the Future, while many risks remain, to us the “peak of the fear trade” has now passed, with the inflection point occurring the day in late July last year that ECB President Draghi (“super Mario”) finally firmly committed the ECB to do “whatever it takes” to save the euro – or to put it another way, the day that the ECB graduated from being a loose coalition of national central banks to being a genuine European central bank, with the essential buyer-of-last-resort backstop.

- Almost from the day of that speech, yields on US Treasuries began to move higher, while investors began to move back toward riskier assets – including in Europe.

Exhibit 3: “Super Mario” has effectively taken the heat out of the fear trade

The most recent high frequency data suggest that a modest global recovery is currently underway. In particular, with further signs that the epicenter of the crisis – the US housing sector – is healing, we feel that demand for “safe havens” will continue to moderate over coming months and years as the risk of a truly monumental economic collapse continues to diminish. If this central scenario proves correct, this will have significant implications for investor demand for gold and, as we outline in the remainder of this
note, probably suggests that Draghi’s now famous speech marked the beginning of the end of the gold bull market.

- We have been forecasting a 2013 peak in the gold price for more than 16 months now: Commodity Forecasts: A Dangerous New Phase, 4 October 2011).

- Indeed, we think it highly likely that the market has already seen the absolute high ($1,921 in September 2011) and we caution that our forecast of a peak in quarterly average terms in Q3 this year may also prove to be too bullish.

To understand where we are going we need to know where we have come from: a brief history of gold

The history of gold has encompassed countless civilizations, empires, conflicts, and societal and technological advances. Known use of the metal as an ornament dates back more than 6,000 years to Nubian settlements in what is now Egypt. It was being used as a medium of barter before 3,500 BC; Mesopotamian merchants were using the metal to underwrite trading contracts prior to 2,000 BC; while gold coins struck with the head of Croesus were in circulation around 550 BC. (For those interested in a fascinating and exhaustive account, we recommend The Ages of Gold by Timothy Green1).

Throughout that long history, the utility of gold has passed through many cycles during which its appeal and relative value have waxed and waned, often influenced directly by policy directed from above (kings, emperors, governments…). In more recent times, central banks, presidents, and multilateral institutions can be added to that list.

The three most recent gold periods can be very loosely defined as follows:

From the end of Bretton Woods to the Plaza Accord: 1971 to 1985. That period was characterized by (amongst other events) the termination of the US dollar’s convertibility to gold and move to a floating exchange rate regime; conflict in the Middle East and the oil-related inflation shocks of 1973-74 and 1978-80; the slide in the value of the dollar that accompanied the second of those; the subsequent determination of the Volcker-led Federal Reserve to bring inflation under control and a sharp appreciation of the USD; and finally the negotiations that culminated in the Plaza Accord of 1985.

The gold price reacted to those profound changes in the global financial system by climbing from $35/oz under Bretton Woods to $183 in December 1974 as US CPI accelerated to 12.3%. Gold then subsided alongside inflation to $104 in August 1976, before surging again during the second and more severe rise in inflation to peak at $850 in January 1980 (Exhibits 4 and 5). The following sharp collapse in US inflation, as the Volcker Fed pushed interest rates up to 20%, and rapid appreciation of the dollar saw an equally sharp collapse in gold, the price retreating to $300 by June 1982. Then, after bouncing back above $500, there was another fall back below $300 by March 1985.

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1 The Ages of Gold, Timothy Green, 2007, GFMS Ltd
From the Plaza Accord to the first Central Bank Gold Agreement: 1985 to 1999. That period was not particularly kind to gold investors. Initially, sanctions against South Africa and US action against Libya proved supportive. A pick-up in US CPI in 1987 also aided gold, spurring a move back up towards $500. But that marked the high point for the period (Exhibits 6 and 7). For much of 1988 to early 1993 the price was in decline, dropping to $330 in March 1993, due largely to forward selling by producers and sizeable central bank sales at a time of muted investor demand. The remainder of 1993 saw a pick-up in price and volatility as producer hedging and central bank sales eased and inflation concerns re-emerged. But rallies were capped below $400 by continued producer and central bank sales and, following a brief run up to $415 in early 1996, the price began to slide again, trading down to $283 in December 1997 then to $252 in mid-1999.

From the first CBGA to present: 1999 to 2013. The first Central Bank Gold Agreement to limit official sales, announced in September 1999, arguably marked the shift to a new era in gold, characterized by a re-appraisal of the metal’s role as a mainstream financial asset. The immediate reaction to the CBGA saw the price spike to $325 the following month before subsiding. Over the next two years a reduction in central bank sales coupled
with announcements from major gold mining companies that they would not hedge any further production stabilized the market. By 2002, major producers had started to buy back forward sales – a key component of the bull market that developed over the decade that followed.

**Exhibit 8: Gold and USD, 1999 to 2013**

Gold, USD/oz versus trade weighted dollar index

**Exhibit 9: US CPI and Fed Funds rate, 1999 to 2013**

Fed Funds Target Rate

Unsurprisingly, our clear conclusion is that against any sensible benchmark gold is almost as expensive as it has ever been – see Exhibits 11 to 14 on the following page.

Other key structural changes that we have highlighted previously included the launch of the first physically backed gold ETFs, the emergence of a growing number of central banks on the buy-side, and increased real-money institutional investment in commodities. A 55% fall in the value of the dollar (basis the trade weighted dollar index) between 2002 and 2004 contributed to the move higher in gold (Exhibits 8 and 9). The US sub-prime crisis and following global financial crisis reinforced the appeal of gold as a “safe” asset and hedge against currency instability, counterparty risk, geopolitical events, and the unintended consequences of extraordinary monetary policy. That culminated in the 2011 gold spike to $1,921 following the federal debt ceiling fiasco and Standard & Poor’s downgrade of the US credit rating.

**Putting the current price in a long-run context**

While the reasons for the bull market in gold are relatively clear, when assessing valuation it is useful to assess how the current level of prices compares to a range of benchmarks. Unsurprisingly, our clear conclusion is that against any sensible benchmark gold is almost as expensive as it has ever been – see Exhibits 11 to 14 on the following page.

The most common historical comparison is of course to assess the current price in real US dollars. On this metric gold has shown no clear trend over the 170 odd years for which we have reliable data, with the current price fully 317% above the long run average.

- In trend terms gold has never been this high for this long – refer to Exhibit 10 on the following page.
Gold is also close to the highest level ever seen relative to the average of industrial metal prices. As shown in Exhibit 11, the current price of gold is 180% above the stationary long run average of base metals.

Exhibit 11: Gold is still near the long run highs in terms of base metals
Real gold price divided by an equally weighted average of base metals prices

Source: Credit Suisse / IDC, Thomson Reuters DataStream
Another way of assessing the price of gold is to compare it with the price of other assets. As our global strategists have noted, both US equities and US housing are currently the cheapest they have ever been relative to gold (Exhibits 12 and 13).

The end of the decade-long uptrend

Moving away from long run indicators and zooming in, it is notable that gold was the only major asset to continue the trend of the 2000s after the collapse of Lehman Brothers. While other assets collapsed and then rebounded, until recently gold had mainly remained within the uptrend seen since 2002.

While there are many moving parts, it is no coincidence to us that the recent break below the 3-standard deviation below trend tram line has occurred following Draghi’s speech – Exhibit 14.
More bearish signals

Improving macro environment reducing defensive positioning

As noted in the introduction, the generalized improvement in risk over recent months is now being accompanied by a rebound in global growth, with IP beginning to recover in October last year. The flash PMI data for January suggest that this rebound has continued into 2013, with the surveys in Europe finally joining the modest improvement seen to date elsewhere (Exhibits 15 and 16).

Exhibit 15: Global IP started to recover in October…

Exhibit 16: With the recovery gathering pace in January…
The improvement has already been reflected in the US Treasuries market. At the start of this year our rates strategists had expected Treasury yields to fall back somewhat as the US fiscal debate intensified. The deferral of the immediate deadline pressure on Congress, however, has seen Treasuries continue to sell off as more capital flows into risk assets, and yields have broken higher. The resultant move up in US real rates has weighed on gold (Exhibits 17 and 18).

Exhibit 17: US 10-year notes have sold off
Gold US$/oz, Treasury yield %

Exhibit 18: And so real rates have turned up again
US one-year real rate, %

The fiscal and budget negotiations that will now occur between late February and mid-May should still result in a more favorable environment for gold, but the respite is likely to be temporary if the macro environment develops as expected. In particular, as we outline in the following section, US jobs growth may well accelerate as we move through the year.

Importantly, US housing is on the mend
Perhaps the most constructive development of the past year has been the emergence of clear signs that the worst is over for the crucial US housing sector – the epicenter of the US crisis. House prices are now clearly on the mend, with construction activity recovering rapidly, albeit from a still depressed level.

Exhibit 19: US house prices moving on up
US house prices, existing homes median price, yoy %

US budget debate should provide only temporary respite
Significantly the recovery in US housing activity appears on the cusp of flowing through to construction employment – in our view the next leg of the slow moving structural recovery in the US (Exhibit 20).

Exhibit 20: US housing starts and housing jobs with troughs in activity aligned
Housing starts series from January 1988. Housing jobs series tends to lag housing starts by 16-18 months

That opens up the possibility of a virtuous cycle developing, whereby a strengthening labor market recovery could lead to stronger household formation growth that in turns drives stronger GDP growth directly, via construction, and indirectly, via its impact on the services sector (see our strategists’ note The Housing Tailwind, 4 December 2012).

Exhibit 21: US household formation could grow much faster than consensus

Indeed, as our strategists write: “In our baseline scenario, residential investment … increases to almost $600 billion [over the next five years], contributing a cumulative 1.7% to real GDP growth. In our positive scenario, where household formation recovers cyclically, we see residential investment temporarily reaching $800 billion, contributing
3.2% to GDP growth. Furthermore, this increased building activity should drive employment in residential construction. Currently, there are nearly 2 million workers in residential building and contracting. Unsurprisingly, the number of workers in these sectors has closely followed residential investment GDP. Historically, when residential investment has been between 600 billion and 800 billion, construction employment has been between 2.5 million and 3.5 million. This allows us to forecast an additional 0.5 million-1.5 million jobs over the next five years in residential construction alone. (Our emphasis in bold.)

“The US economy faces numerous potential headwinds in the years ahead, including underfunded pensions, cuts in government spending, increases in taxes, and a large amount of skilled labor retirements. But it is critical to balance these negatives with visible tailwinds, such as household formation, strong corporate sector balance sheets, potential pent up demand for durable goods and investment spending, and a sharply improving energy balance.”

The bullish counter arguments

QE = Inflation? Possibly, but not this year

Hedging against a future break-out in inflation remains a key reason why many investors (ranging from large institutions to individuals) have built core long positions in gold over the past five years. In essence, the argument is that the accumulation of reserves on central bank balance sheets creates a sizeable risk that the assets created will, sooner or later, lead via an increase in the velocity of money to a marked acceleration in inflation. It is important to make the distinction between that situation and a more gradual return to moderate (c2.0-2.5% p.a.) inflation that policy makers in the developed world are targeting.

While the exit from the current policies will be highly experimental (we simply have not tried this before), our economists remain of the view that any substantial risk to inflation remains some way off, particularly in the developed world.

- In the near term the major central banks are still spinning their wheels in a desperate bid to actually create enough inflation (witness the BoJ over recent weeks), with large output gaps continuing to depress wages.
  - With the transmission from QE to inflation hesitant at best to us, it remains highly improbable that inflation will become a major concern in the next year or two.
Beyond the near term, for inflation expectations to move sharply higher in the US, it would be necessary for the Federal Reserve to fall behind the curve and not act soon enough to tighten policy. While this is definitely a possibility given the experimental nature of the current policy settings, we do not feel that the risk is as great as many currently fear.

True, the bullish outcome for the US economy suggested by the trends in housing and household formation does carry with it an increased inflation risk. And, in the longer run, the persistence of extraordinary monetary policy expansion, coupled with changes in the policy framework, may start to be embedded in expectations for future (higher) inflationary pressures. But given the depth of the financial crisis and resulting recession, the output gap in the US remains extremely large with no sign that labor costs (the most important component of US CPI) are likely to trigger an imminent rise in inflationary pressures.

In our view, the greater risk is that gold will weaken substantially as economic data improve long before inflation expectations move significantly higher and/or the credibility of the Fed is called into question. In fact, in the short term our economics team expect a quite marked fall in inflation rates across the developed world, (see *Global Inflation Watch*, 29 January 2013) because of base effects from last year’s sharp increase in oil prices. *These will likely push US inflation as low as 1.2% in April* (from 1.7% yoy in December). Assuming constant nominal yields that would see US real rates climb from -1.54% to around -1.04%, a sizeable change, that would tend to be bearish gold.

**Is gold really an inflation hedge?**

There is also the issue of whether gold will actually perform as well in a strongly inflationary episode in the US as many expect. We do not think the quantitative evidence for that is quite as strong as some gold bulls believe, certainly not over the past 25 years (see for example Exhibit 26). Going back to the 1970s, gold did perform as a US inflation/dollar depreciation hedge – but extrapolating that performance to today may be misguided, in our view, and we note that investors would have had to time their entry and exit points rather well to benefit.
There is better (though not conclusive) evidence that gold can act as an effective hedge against inflation over the very long run. But even then a critical issue is whether the price of gold is significantly above or below its long term trend in the period preceding an increase in inflation – in other words, returns are sensitive to the starting point. The high current valuation of gold relative to both historical means and other assets discussed earlier suggests investors seeking inflation protection who have not yet bought gold may have missed the boat.

And, of course, investors must consider the rate of return on gold expressed in terms of their domestic currency units. Interestingly, a 2007 study by a researcher at the Bank of Canada concluded that, based on the 1994 to 2005 period, gold “is a significant predictor of inflation for many developed inflation targeting countries”, but it is “a relatively weak predictor of US inflation”.

In summary, we recognize that at some point down the line concerns about US inflation may prove well-founded, but, in the interim, as the global economy mends, we think there will be insufficient new money moving into gold to keep the USD price supported, both in absolute terms and relative to risk assets such as equities.

**Increased role as a reserve asset / sound collateral**

Those who believe that the global economy is transitioning from a single reserve currency model (based on the USD) to a multi-reserve currency system often state that gold is likely to play a greater role as a currency during that transition period.

That may well be the case, and indeed central bank purchasing of gold over the past several years can be viewed in that context. But, we caution that:

- Central bank purchasing at current rates is unlikely, inter alia, to be sufficient to drive the price higher.

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1. For example *Short-run and Long-run Determinants of the Price of Gold*, Levin & Wright, 2006
2. *Gold Prices and Inflation*, Tkacz, Bank of Canada
• The higher the price relative to other currencies, the less gold will be required to meet reserve diversification objectives.

• Gold still faces some barriers to its increased use by financial institutions – it has not, as yet, been included in the Basel Committee on Banking Supervision’s definition of high quality liquid assets despite a strong lobbying effort by the World Gold Council.

• As a recent report from the Official Monetary and Financial Institutions Forum notes⁴, “For gold to play a greater role in the future, it has to become more actively traded, including by central banks … Outright buying and selling will go hand in hand with a more widespread use of central bank gold in official borrowing and lending operations…”. (Our emphasis in bold.)

Competitive devaluations will mean greater use of gold as an FX hedge

The fear of currency instability and competitive devaluations remains fairly prevalent, perhaps slightly more so in light of the BoJ’s recent open-ended (in time, if not volume) commitment to asset purchases. Linked to that is the issue of central bank independence from political interference. Those concerns were highlighted recently by Bundesbank President Jens Weidmann, who said: “Until now, the international monetary system has come through the crisis without rounds of competitive devaluations … I very much hope it stays that way.”

Concern about competitive devaluations is frequently cited as a reason to remain bullish gold (though confusingly, gold bulls who follow that mantra seem often to be bullish gold in both USD and other currencies at the same time).

However, the desire to protect purchasing power against currency depreciation using precious metals is hardly a new phenomenon – across much of Asia individuals from Japan to Vietnam are very well versed in using gold, silver (and, in the case of Japan, platinum) to hedge their local currency exposure; as now are a new generation of investors in Europe.

In addition, political statements alluding to “currency wars” have also been in more or less frequent circulation since the end of Bretton Woods in 1971 and typically play well with domestic audiences. The international reality is generally much less alarming and, in our view, gold bulls would do well to remember that exchange rates are multi-sided, and that global balance of payments positions have to sum to zero.

So we mistrust arguments that suggest somehow “this time is different” and that the demand for gold will be greater/have more of an impact on price than during previous periods of tension in FX markets. And we are not believers in an imminent USD crisis. Consequently, while we recognize the utility of gold as a currency hedge, we do not think that is sufficient justification to stay indefinitely bullish the metal in USD terms.

China will buy

We have no doubt that development of the Chinese domestic gold market will continue over the next five years, and that gold will remain a very important part of the investment landscape. Indeed, an over-the-counter interbank trading platform went live late last year, and the first gold-backed ETF is likely to launch during the first half of this year (see Gold: Chinese ETFs nearing reality).

However, the gold market is not evolving in isolation. The Chinese equity and bond markets are both developing rapidly. A few recent examples: QDII and QFII ceilings have been raised and permitted investments broadened, the market for offshore RMB denominated bonds has started the year strongly (RMB2.9 billion raised in the first two weeks of January), the first domestic bond ETF has been approved, insurance groups are

⁴ Gold, the renminbi and the multi-currency reserve system.
likely to be able to sell subordinated debt later this year, while the number of stocks that can be traded on margin on the Shanghai and Shenzhen stock exchanges has been increased.

Against the backdrop of much tamer CPI and real rates that moved into positive territory during 2H last year (albeit marginally so and reversing direction recently – Exhibit 27) that all diminishes the investment appeal of gold in our assessment. That is not to say we think the Chinese gold investment market will shrink in size this year – we think it will be static to moderately higher – but the competition for investors’ RMB is growing.

Exhibit 27: Chinese one-year real interest rate

%, China household savings deposit rate less yoy CPI

Supply

Some gold bulls argue that a renewed focus on capex discipline and cost control by major gold miners should result in slower growth in mine supply.

Perhaps, but (and this is a subject that probably justifies a note of its own, so we will be brief) we would counter that:

1) We do not believe mine supply has much impact on price over the short to medium term; and

2) There is a risk that project hedging from junior to mid-cap names will increase in a declining price environment

Please see the production costs section of our 3 January report for more details on this topic.

Slow slide rather than collapse – but gaps could open up

We do not forecast a collapse in the gold price akin to the 1980/81 crash (when gold lost 50% of its value in 18 months). We believe there is sufficient concern remaining about long-term US debt servicing, central bank policy, and currency depreciation to keep a segment of the investor community actively involved on the buy side.

The same applies to central banks, many of whom will continue with reserve diversification plans. And nominal rates are likely to remain very low by historical standards. But once any potential lift from the forthcoming US fiscal debate has passed those buyers are unlikely to be sufficient to keep gold in USD terms at what are historically high relative values. And, as has been demonstrated on numerous occasions over the last 12 months, gold is not sufficiently liquid to avoid gapping lower when buyers step back.
Risks to our view

There are, of course, potential hurdles and pitfalls that could derail our central constructive macro/bearish gold hypothesis. The one visible risk to our outlook that can be timed with some certainty is the second and potentially more bitter round of US fiscal cliff/debt ceiling/federal budget bargaining. The debates that will occur in Washington in the approach to amending the budget sequester (set to begin 1 March) and the expiration of the current continuing resolution (temporary funding measures) on 27 March, through to the official debt ceiling date of 19 May, could still be disruptive. Critically, if markets become concerned that a technical default by the US government is becoming more likely, then we would expect to see very strong flows into gold.

However, as we noted in Commodity Forecasts: Back to the Future and in Commodities Advantage: Good news outweighing bad, the resilience of global markets has impressed in recent weeks. And our quarterly gold forecast already accounts for some increased investor nervousness in the run up to and aftermath of the debt ceiling negotiations. Ultimately, we believe that the US Congress will “do the right thing”, which would set the foundations for a virtuous cycle whereby the private credit cycle starts to reinforce growth, and growth starts to reinforce the credit cycle. That, in turn, would empower central banks to begin thinking about a return to more conventional policy making. That cannot be bullish for gold, in our view.
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Sell: Indicates a recommended sell on our expectation that the issue will deliver a return lower than the risk-free rate.

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Market Perform: Indicates a bond that is expected to return average performance in its sector.
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