Investment Views

September 2020

As Good As Gold?

Precious metals have benefitted hugely from the collapse in real yields (interest rates minus inflation) and the surge in money supply engendered by the massive covid-crisis stimuli, both monetary and fiscal. Any hint of a policy U-turn will hinder gold's progress but, for now, this seems unlikely. Last month saw the Federal Reserve commit to a symmetric inflation target. If inflation undershoots the 2% pa target for a period, the Fed will now tolerate inflation in excess of 2% to arrive at the desired long run average. Given that US inflation has been c. 1.7% over the last decade and currently stands at 1%, the Fed has effectively committed to QE bond purchases and low rates for a protracted period. Elsewhere, other key Central Banks have also recommitted to emergency policy measures.

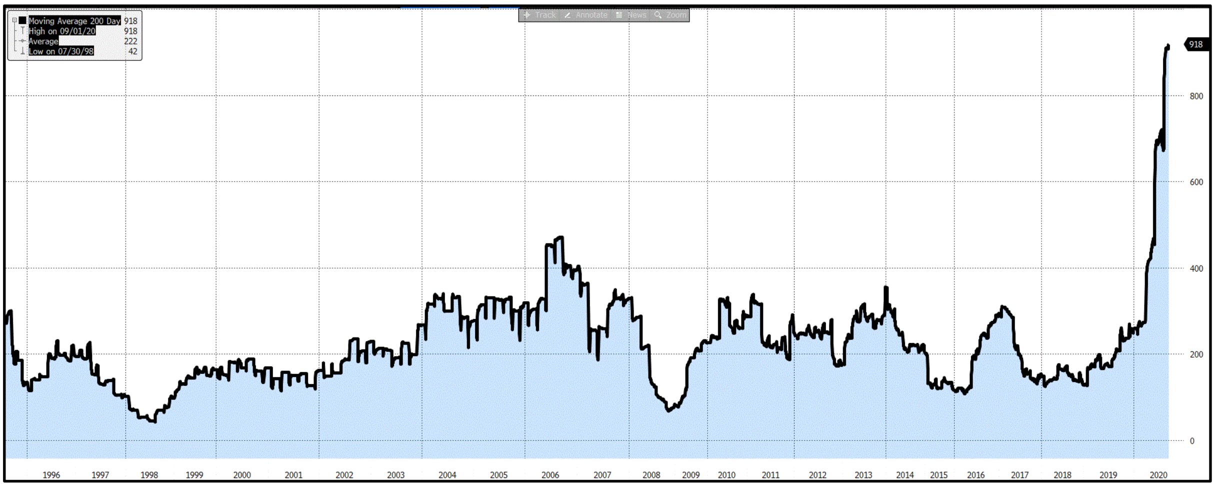
In the political sphere, we doubt that nascent US and UK efforts to moderate fiscal support will hold; in the EU and further afield, government spending is actually increasing at the margin. Riven by pre-election posturing, the US government has failed to replace the U$600 per week enhanced unemployment benefits that expired at the end of July; Democrats favour a simple extension, Republicans want to see a significant reduction. Similarly, in the UK, the furlough scheme starts to roll off this month, with various forms of 'soft loans' to business expiring. The British Chancellor has also been flying policy kites to test the appetite for tax rises; capital gains and corporation tax are in his sights (see later note).

With high-frequency economic data showing global activity stagnating in response to the ebb and flow of the virus, the prospects of a sustained, V-shaped recovery seem remote; this is doubly so if the western hemisphere winter heralds a 'wave 2'. We expect to see both the UK and US row back on efforts to moderate fiscal support as employment data fully reflects the delayed, lingering impact of the Q2 economic crater. As we have noted before, with the global economy now chronically indebted, temporary monetary support (QE) has become permanent with emergency fiscal policy set to follow suit.

Regardless of this backdrop, the gold price stumbled last month. After a sharp rally that saw nine consecutive weekly gains, it touched a record nominal price of U$2,075/oz on 7th August. It then lost

10% in less than a week but recovered to finish the month at U$1,968/oz. It remains one of this year's best performing assets with a 30% dollar gain.

The volatility seems to have been triggered, at least in part, by the gold derivatives market. In early August, the COMEX exchange raised the cost (or initial margin) required to gain exposure to a 100oz gold future contract (worth c. U$0.2m) from U$9,750 to U$10,320. These contracts are popular as they offer a cheaper and more tax-efficient way to trade bullion, compared to buying physical bars. Typically, few owners exercise their right to take delivery of the physical metal when the contract expires but, as the chart shows, this year has seen an unprecedented surge in delivery requests.



COMEX gold delivery, 200-day moving average from 1990 to 2020 (*source: Bloomberg*)

As delivery requests rose, this forced the banks that offer the contracts to buy physical gold at size; their stockpiles cover a small fraction of the aggregate contracts in issue. When COMEX raised the margin requirement to cool things down, a number of highly leveraged speculators were forced to close out their long positions ahead of expiration. This cut headline demand. It also reduced physical delivery at contract expiry, in turn, easing the supply/demand imbalance at the banks.

Regardless, gold was overbought and due a correction. We draw comfort from such a move as it washes out weaker, speculative holders forming the basis for the next leg of a more sustainable rally. Our core portfolio commitment to the gold and gold miners' positions remains unshaken.

Turning to the gold miners, as we have noted before, they are a geared play on bullion; to own them you must believe the gold price is heading higher. As noted above, the policy backdrop has rarely been this supportive and, although jewellery demand has almost halved year-on-year (it accounts for c. 50% of annual demand), this has been more than offset by investors looking to protect themselves against the twin threats of longer-term inflation or deflation. If the ultimate consequence of massive money printing and World War-era fiscal deficits is excess demand and higher "real world" prices, gold's track record as an effective inflation hedge should come to the fore. Conversely, if rising global indebtedness births a 1930s-type deflation, the increasingly desperate efforts to reflate economies would burnish gold as a reliable store of value amidst a period of fiat/paper currency debasement and intense financial uncertainty.

Mining company profits have already benefitted from the record gold price. Revenues are up sharply, with the fall in the oil price cutting overheads; energy typically represents c. 25% of the cost base. All told, total production costs are back down to around U$1,000/oz. Whilst this is a 5-fold increase since the turn of the century, it is only half the current gold price. This record expansion in profit margins was evident in robust Q2 earnings. Several of the large-cap miners announced annual profit growth of 200%+, raising guidance for the second half; a stark contrast to the S&P 500, where Q2 profits fell by more than 30% (source: Factset).

Miners have now re-rated. For the gold mining sector as a whole, the price/book ratio has risen towards 4x, comfortably ahead of its 40yr average of 3x and far above 2015's all-time low of 1x. Lest we panic, valuation multiples will ease back to less-alarming levels as the stronger earnings and higher book values filter through. This outperformance will pique the interest of generalist stockpickers and growth-oriented investors, attracting flow into this relatively small sector; quoted global gold miners are only worth $600bn.

As importantly, profits are rising after a multi-year period of balance sheet repair. Operational gearing has increased and most incremental revenue drops directly to the bottom line. In the first half of the last decade, an ill-disciplined capex and acquisition boom saw value and cashflows destroyed. The sector's average return-on-equity (RoE) troughed at an unsavoury -20%. This sparked a wave of management changes and a more conservative approach; costly mining projects were shunned and gearing reduced. Having peaked at 36% in 2014, net debt-to-equity for the sector has fallen to just 12% compared to a World equity average of 71%. This helped the gold miners' RoE recover to 9% in the second quarter, surpassing the global stockmarket 8% average for the first time in 20 years. Such balance sheet strength is increasingly rare (and appealing) amidst an over-indebted corporate world. It also lays the foundations for a value-accretive and share-price friendly round of M&A activity.

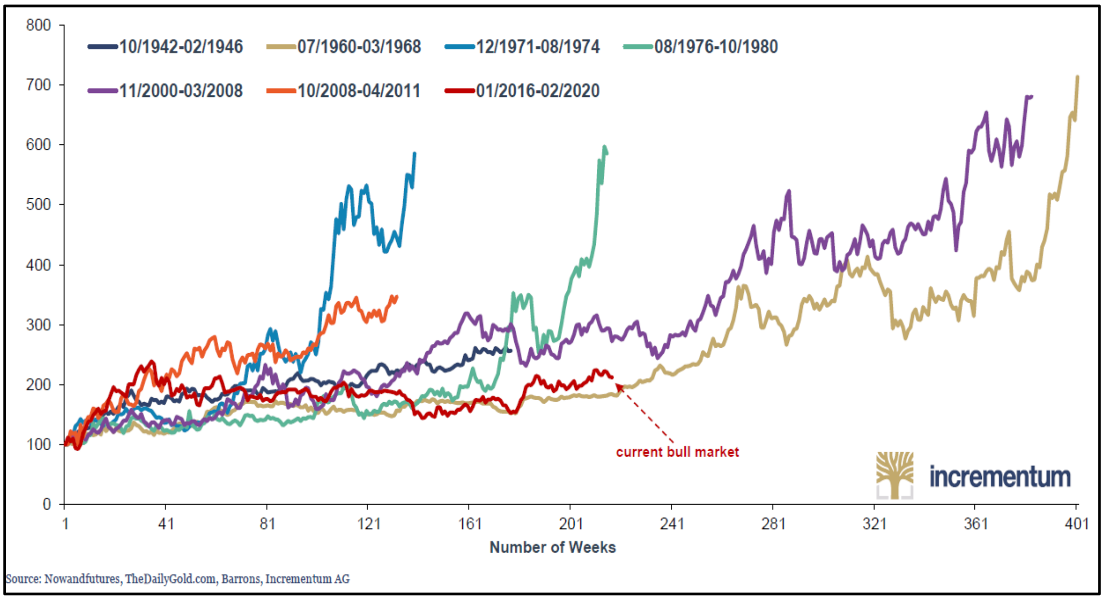
The most obvious threat to this bullish narrative stems from a softer gold price. As noted above, this is unlikely to come from a meaningful withdrawal of fiscal and monetary stimulus. However, if the developed economies reaccelerate to a "muddle through" state of 1-2%p.a. real GDP growth, with modest but controlled inflation, real rates are unlikely to fall further and concerns about inflation/deflation extremes will subside; gold will fall back. Equally, any meaningful rebound in the US dollar may also create a near-term drag.

More likely, if history is any guide, the mining shares will become victims of their own success. Past cycles have tended to peak during a speculative "mania" that sees the sector overwhelmed by flow from generalist stockpickers and retail punters. Whilst investment flows into instruments tracking the gold price have recently hit record highs, the gold miners remain unloved with related tracker funds experiencing net redemptions this year.

Institutional demand remains limited too, although there are signs of this changing. Last month Warren Buffett's Berkshire Hathaway revealed a $0.5bn investment in Barrick Gold, one of the sector's largest companies. This represents a significant change for the "Sage of Omaha," who has often described gold as a "barbarous relic". It is also telling that he simultaneously sold most of his US bank stocks despite their seemingly cheap valuations; this echoes our concerns about the sector. The position represents a relatively small 0.1% of Berkshire's NAV; if it allocated 5% to gold miners, it would own 3% of the entire gold mining universe. Perhaps more significantly, Buffett's disclosure provides covering fire for other professional money managers to invest in an asset class that continues to divide opinion.

Whilst valuation indicators will help guide our eventual exit from the gold miners' position, the timing will also be influenced by sentiment and flow metrics. We further note that the bullion price remains

40% below its inflation adjusted 1980 peak. As the chart below attests, this is the seventh gold miners' bull market since World War 2; the other six have ended after much higher returns.



Whilst the GDM gold miners index is up 239% from its January 2016 low, given the supportive backdrop, we are inclined to ride-out the occasional gut-wrenching correction in the belief there is still a lot more upside to come.

The UK Budget & Capital Gains Tax

With the Autumn Budget due in October/November, speculation is mounting regarding what tax rises the Chancellor may introduce to pay for the extraordinary cost of coronavirus spending. Having borrowed £128bn in the first 3 months of the 2020/21 financial year, the Office for Budget Responsibility expects the Government budget deficit to hit £322bn (or 16% of GDP) for the year as a whole; the highest since World War II. Pre-COVID, the government was expecting to borrow £55bn.

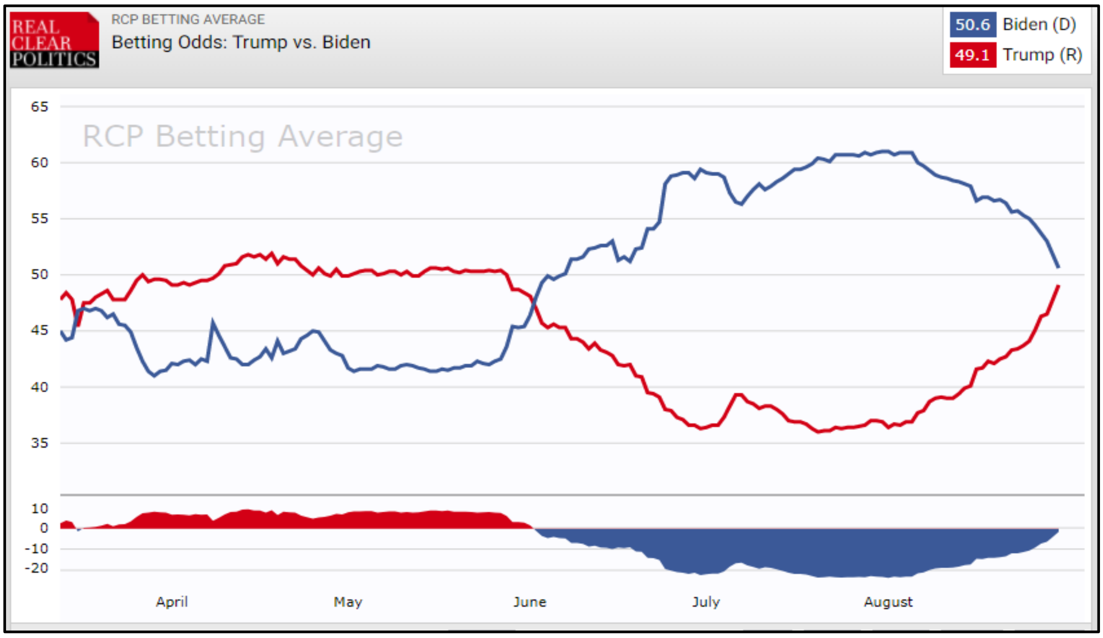
Given the Conservative manifesto pledge that they will not raise the rates of income tax, VAT or national insurance, there is a growing consensus that there will be an increase in capital gains tax (CGT) and a hike in corporation tax from 19% to 24%. At current rates, CGT can be the difference between paying 20% instead of 45% for additional rate (income) tax payers. Rumours are that CGT rates could simply be aligned with income tax rates, although this would be a bitter pill for a key Tory demographic who are more likely to own a second home and portfolio investments. Maybe the compromise will be to align future CGT with the higher rate of CGT on residential property (currently 28%).

Whilst any action should be considered on an individual basis, it could be worth triggering a disposal on investments standing at a significant gain, thereby locking in current capital gains tax rates. In doing so, an investor must beware of the various UK anti-avoidance rules, including "bed-and-breakfasting", whereby individuals are usually required to wait 30 days before reacquiring any shares that they sold. If any client or reader has any concerns or would like to discuss this further, please do contact our colleagues Karen Betts (UK@BentleyReid.co.uk) and Anna Warren (HK@BentleyReid.com).

It is too early to hazard an informed guess at the outcome of the 3rd November Presidential election. For sometime now, Trump has been lagging in the polls, dragged down by his mishandling of the COVID-crisis. Although his support has risen since its July nadir of 40%, he remains 7% behind his Democrat challenger, Joe Biden.

A historically wide margin at this stage of an election battle, we are not ready to call a Biden/Harris coronation. Firstly, the US COVID-infection rate has improved. The rolling 7-day average daily new case count has plateaued at about 42,000, down from a 67,000 peak; the daily death count has halved to 1,000. Whilst these level remains elevated and could easily reaccelerate, growth has bounced and will be "less bad" than the dark days of April/May. Furthermore, Biden's popularity has rested on a growing "anyone but Trump" cohort. As Biden is forced to become more visible and unscripted on the campaign trail (and during televised debates), the risk is that his shortcomings become apparent. At times, he lacks lucidity and mental clarity, harshly summed up by his "Sleepy Joe" nickname.

As such, we are unsurprised to see the betting swing towards Trump over the last couple of months. The chart below shows the betting odds on each candidate; Biden in blue and Trump in red. They are both now even money to win.



We expect a close race heavily influenced by the COVID infection rate and the TV debates. A divisive, narrow victory by one or other candidate is now a distinct possibility. Indeed, both parties have concerns about the ability of the postal service to handle a surge in postal voting, due to the COVID-crisis. If Biden squeaks home, expect 'Team Donald' to challenge the result birthing further unrest, division and uncertainty.

Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Gold Miners China A Shares Sustainable yield Japan Energy sector	Inflation-linked, Emerging Market	Gold
–	Equities Bonds	European US Technology	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 August 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3370	2.2%	8.3%	10.0%
CHF	1.1065	1.1%	6.4%	9.6%
AUD	0.7376	3.3%	10.6%	9.5%
JPY	105.9100	0.1%	-1.8%	-0.3%
EUR	1.1936	1.3%	7.5%	8.7%
BOND YIELDS (10 yr)				
UK	0.31	0.21	0.13	-0.17
US	0.71	0.18	0.05	-0.79
Germany	-0.40	0.13	0.05	0.30
Australia	0.98	0.17	0.10	0.10
Japan	0.05	0.03	0.05	0.32
EQUITIES				
US. S&P 500 (USD)	3,500.31	7.0%	15.0%	19.6%
UK. FTSE 100 (GBP)	5,963.57	1.1%	-1.9%	-17.3%
FTSE Europe Ex UK (local)	262.50	2.9%	5.5%	-1.1%
Japan. Topix (JPY)	1,618.18	8.2%	3.5%	7.0%
China. Shanghai Comp (RMB)	3,395.68	2.6%	19.0%	17.7%
HK. Hang Seng (HKD)	25,177.05	2.4%	9.6%	-2.1%
Australia. All Ords (AUD)	6,245.89	3.1%	6.4%	-6.8%
FTSE Asia Pac ex Japan	587.50	3.7%	19.9%	15.5%
FTSE World (USD)	684.83	6.2%	14.3%	14.2%
FTSE World (GBP)	758.29	4.1%	5.5%	3.9%
COMMODITIES				
Oil (WTI)	42.61	5.0%	17.0%	-17.4%
Gold	1967.80	-0.4%	13.7%	29.4%

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