The Four Key Factors Driving Gold

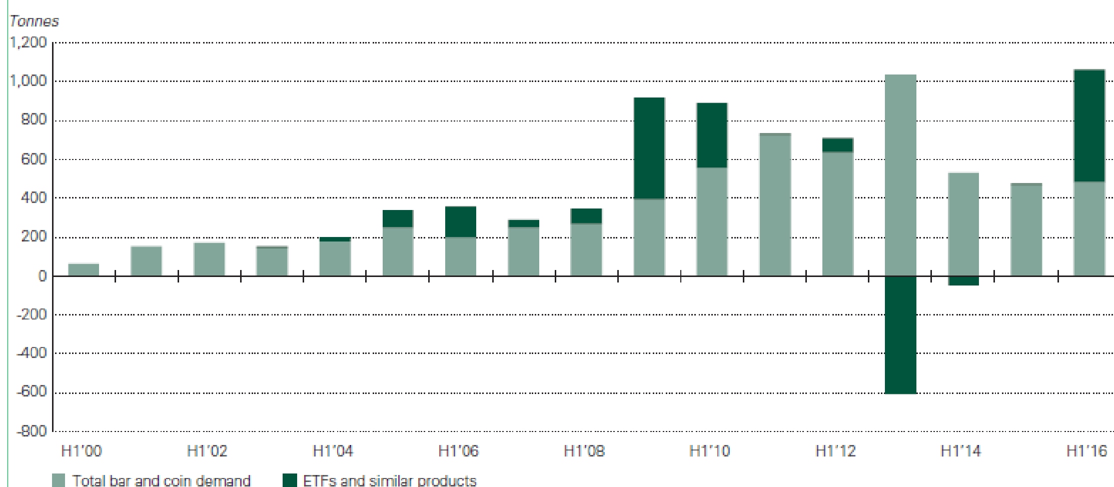
1 Skyrocketing Debt & Low Interest Rates

Gold's best friends remain the world's debt-addicted central bankers. Like a bunch of stimulant-addicted athletes looking for their next high, central bankers have become hugely dependent on stimulus.

What started out as a means post the GFC to avoid international economic catastrophe, has now morphed into a dangerous addiction – and the means of keeping the day-to-day economic wheels turning.

Keeping rates low for several quarters is very different from keeping them there for years, which in turn has punished savers and distorted market prices, encouraged enormous and destabilizing financial speculation.

Central bank policies of inducing negative real rates to 'incentivize' borrowing has expanded the money supply and devalued currencies – in turn forcing investors to chase riskier assets in order to generate returns.



Since the GFC in 2008, central banks around the world have employed monetary policies to stimulate economic conditions by encouraging borrowing and spending and inhibiting saving. Quantitative easing (QE) or central bank purchases of sovereign (and in some cases corporate) debt issues and low short-term interest rates, have dominated monetary policy around the world. These policies have resulted in more cash or liquidity in the global economy.

In Europe and Japan, rates have descended into negative territory. It costs money to put money on deposit in a bank on a short- and medium-term basis these days. In China, the government has pushed interest rates lower and devalued the yuan to stimulate economic conditions.

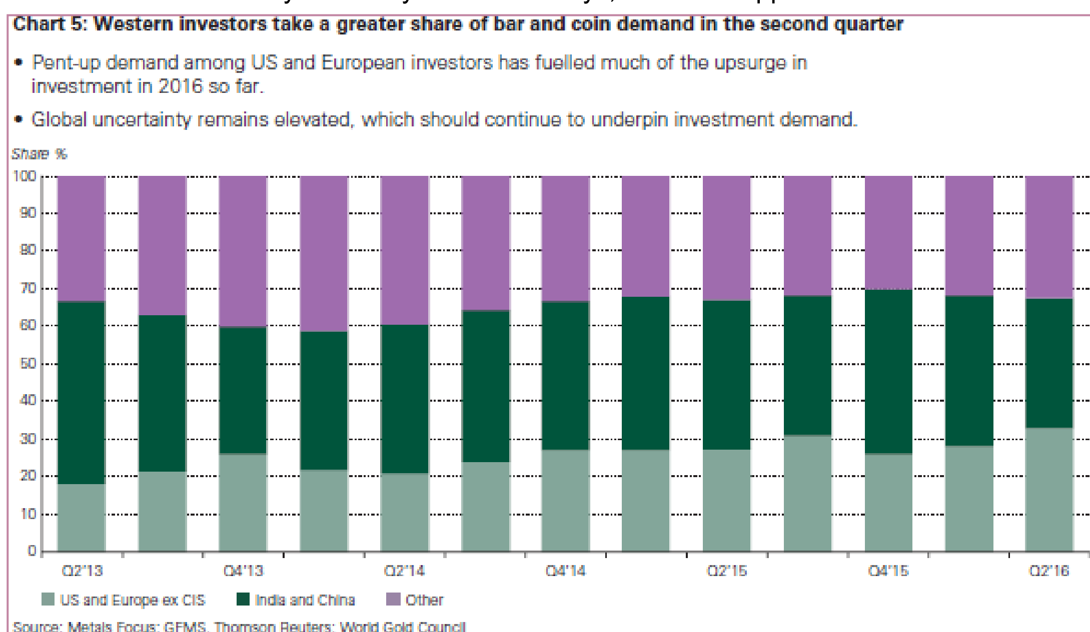
The U.S. economy has exhibited moderate growth since the period of QE ended in 2014. The Federal Reserve hiked the short-term Fed Funds rate for the first time in nine years last December, promising 3-4 more rate increases in 2016. However, a confluence of events - weaker than expected U.S. economic growth, the fear of contagion from other weak economies around the world, political issues stemming from the British referendum vote to exit the European Union and upcoming contentious Presidential election in the U.S. - have resulted in no change in monetary policy so far in 2016.

At the latest meeting of the Federal Open Market Committee in July, the Fed told markets that the short-term Fed Funds would remain at the 25-50 basis point level. With no meeting scheduled for August, this means that eight months will pass without the Fed keeping their promise to hike rates in 2016. The central bank would have to increase the Fed Funds rate in each of the remaining months of the year to keep their promise from December 2015.

However, this is not likely given weak GDP numbers, a continuation of a weak global economic landscape and the upcoming November election. If the central bank hikes rates at all in 2016, that move will come in December, but that also is not looking likely given the latest economic data.

As we've discussed ad nauseam over the past few years, the Fed has proved over and over again that they are doves and prefer to maintain the status quo than to hike the Fed Funds rate any time soon.

Historically low interest rates are inherently bullish for the prices of precious metals. When fixed income instruments provide little or no yield or negative yields (as is the case in Europe and Japan), precious metals become a lot more attractive assets. One of the arguments made by those who do not believe in holding gold, silver or other precious metals as stores of value is that they offer no yield. These days, the same applies to most fixed income vehicles.



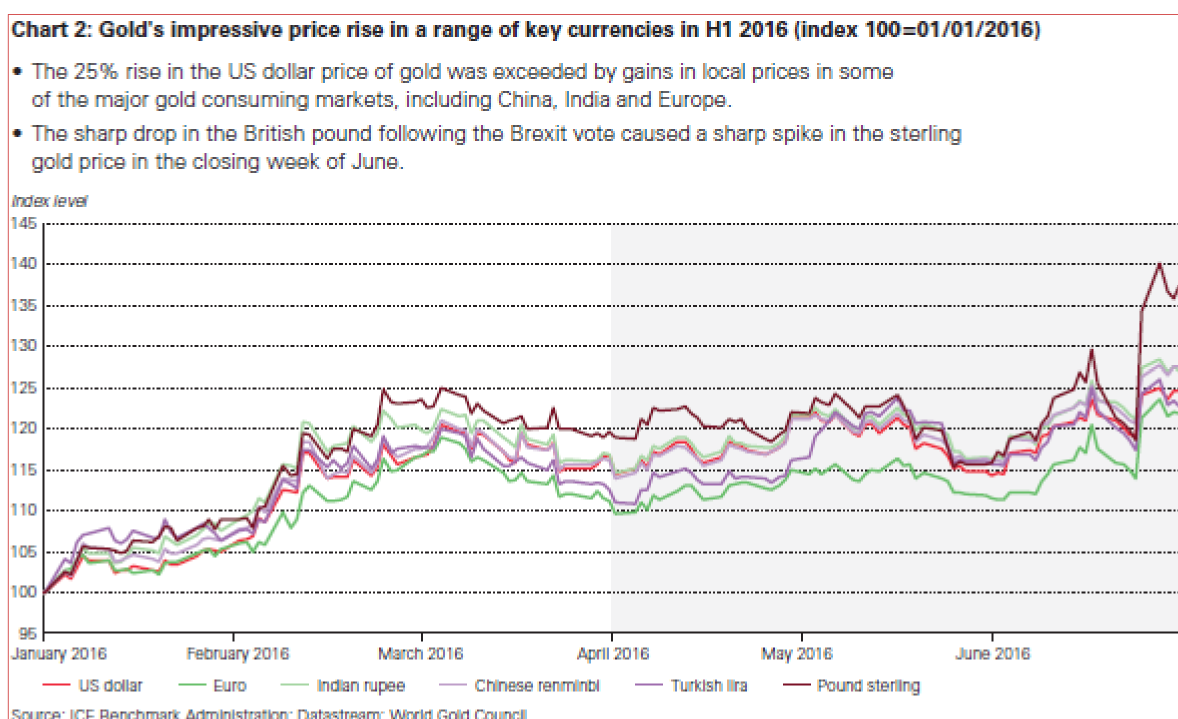
Additionally, the historically low level of interest rates has caused capital to move to equity markets, which have become very expensive when it comes to price-to-earnings multiples.

In the unlikely event the global economy miraculously recovers, and the Fed quadruples the Federal Funds rate from the current, minuscule 0.5% to, say, a tiny 2% in short order, dividend stocks would crater, US bond prices would crash with hoards of speculative liquidity and baby boomer savings looking for a safe haven — not exactly the recipe for a bear market in gold.

2 Gold Rising across Multiple Currencies

These days, no currency around the world is as stable as gold. A look at gold in all of the major currencies of the world since late 2015 but just prior to Brexit, reveals both the strength in gold and the corresponding weakness in fiat money. Prior to the Brexit vote, gold was up almost 24% in dollar terms, 19% in euro terms, 6.5% in yen terms, 29% in pounds sterling-terms, 20% in Australian dollar terms, 19% in Canadian dollar terms and 20% in Swiss Franc terms.

The fact that gold has outperformed all of the major currencies of the world points to a significant development, gold is the strongest currency in the world because other foreign exchange instruments are under siege.



After starting the year with a stellar 17% Q1 gain, the gold price climbed further during the second quarter to set the seal on the strongest H1 performance for more than 35 years. In US$ terms, gold was one of the best performing investments in a basket of commodities, behind only Brent crude and silver.

And given that the US dollar has strengthened against a number of currencies this year, gold's H1 performance when denominated in other currencies has been better still. Notable amongst these have been gains in the gold price expressed in pounds sterling (+37%), Indian rupees (+27%), Chinese renminbi (+27%) and Egyptian pounds(+41%). While most judge the strength or weakness of currencies as their exchange rates against one another, it is their trend against gold that exposes true weakness across all currency instruments.

Gold has a dual role as both a commodity and currency. Gold has been around a lot longer than any of the world's currencies. Gold is money and in today's environment, it offers a yield that is competitive with all of the major currencies of the world.

Moreover, while central banks can print paper currencies to their hearts' delight using monetary policy tools, they cannot print more gold!

As we highlighted above, one of the persistent arguments against owning gold by many financial advisers and brokers is that it "does nothing" and that it incurs storage costs. Unlike cash, which earns interest, gold is a non-yielding asset.

However, in today's world of zero-percent interest rate and negative interest rate policies in a growing number of countries, the old rationale that favours holding cash over gold is increasingly defunct.

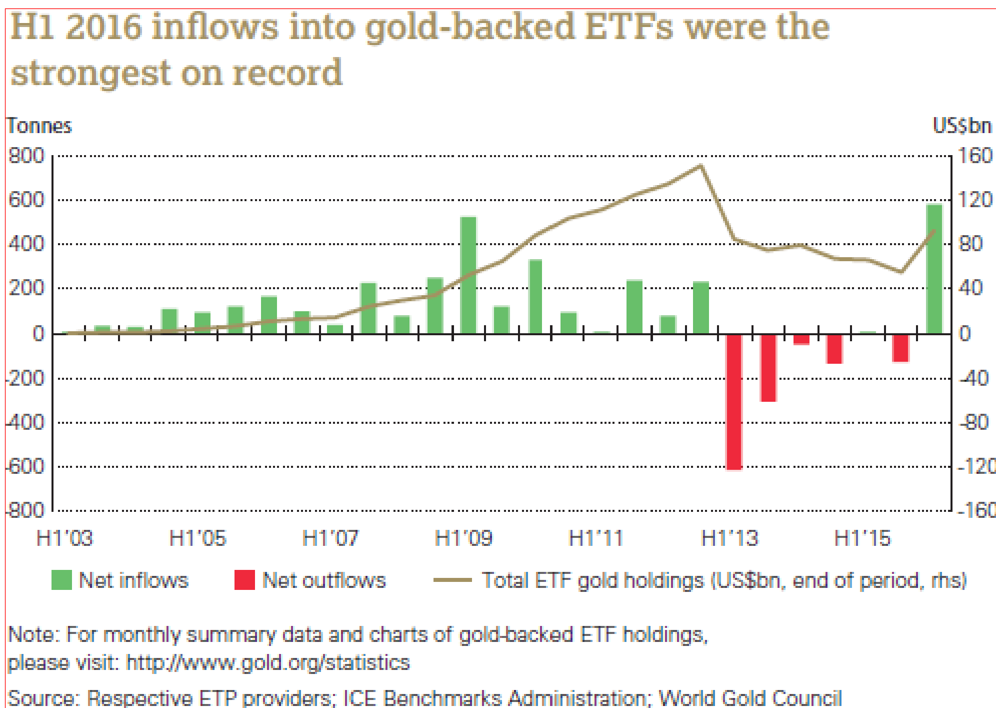
Base rates in the industrialised nations have been near zero since the financial crisis of 2008. Frequently throughout this period the rate of inflation has been higher than this, implying a loss in spending power over time for each unit or currency.
This factor, coupled with the many risks which were left unresolved (or have been exacerbated) in the wake of the last financial crisis, provides a strong incentive to hold gold – which is why gold is performing so strongly in terms of a broad range of currencies.

3 Robust Investment Demand

The latest WGC figures demonstrate that world gold demand has grown, with the H1 half-year data representing the second-highest amount yet of 2,335 tonnes – indicating a supply deficit of 27.1 tonnes. Jewellery has historically been the principal element in world gold demand, but not surprisingly due to strongly rising prices the actual figure fell in year-on-year terms by 227 tonnes.

This was more than offset by an enormous surge in investment demand, which came in at a new record of 1,064 tonnes for the half year, as compared to 469 tonnes for H1 2015.

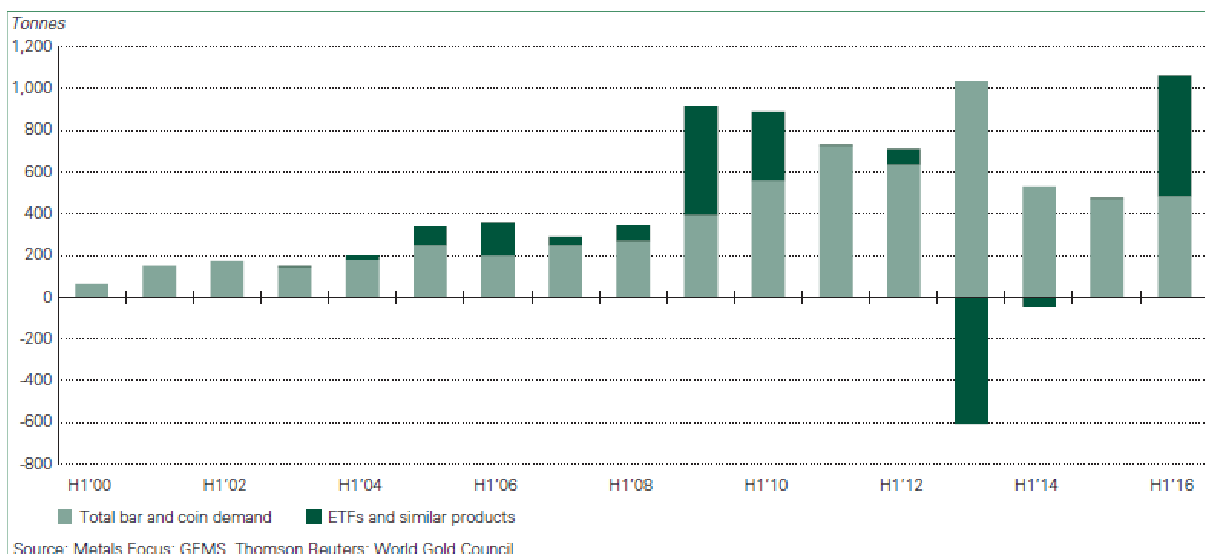
A 'perfect storm' of conditions in the gold market this year has pushed investment to historic levels. Demand of 448.4t was a near-record for second quarter investment, only lower than Q2 2010's stellar 606 tonnes. Consequently, demand for bars, coins and ETFs during the six months to end-June reached a first half record of 1,063.9 tonnes, worth a value of US$41.6bn.



Inflows into the ETF sector have been exceptional - 579.2 tonnes within the space of six months, compared with cumulative outflows of 616.1 tonnes over the preceding 10 quarters. The value of gold-backed ETF AUM increased by +69% (US$38.1b) in the first half of 2016 to reach US$93b, their highest level since Q3 2013.

In the USA, the world's biggest gold ETF, SPDR Gold Shares added a massive 307.7 tonnes during the half-year (up 48%) and has extended this by a further 22.6 tonnes since end-June. The smaller of the two major U.S. gold ETFs, BlackRock's iShares Gold Trust, has added a fraction under 55 tonnes so far this year, which is an increase in its gold holdings of nearly 36%.

Chinese investors too have continued to add to their investments in these products, taking holdings to 24.4 tonnes by the end of June – an almost four-fold increase since the end of last year. In value terms, Chinese gold-backed ETF holdings grew from US$215m to more than US$1b in the first six months of 2016.



These figures coincided with the gold price rise over the same period of around 25%. Whether the rising gold price was due to the huge increase in investment demand, or vice versa, remains an interesting question.

4 Lower Industry Spending

Another key supply-side factor involves the gold mining industry itself not spending enough in order to sustain itself into the future. Lower levels of primary gold supply growth is making a case for the view that the industry could be close to hitting a peak in production terms, amid slower exploration spend and a virtual halt to new projects.

Much of this is a result of the poor decision-making in terms of expensive and poorly-conceived expansion and acquisition deals over the past decade, which devastated shareholder returns and destroyed billions of dollars worth of value. Many gold CEOs rightly lost their jobs for these mistakes and their replacements are naturally reticent to potentially make the same mistakes again.

According to a recent presentation by Gold Fields CEO Nick Holland in Brisbane, the average reserve life of 11 gold mining companies that he has studied has fallen from 24 years to 17 years. At the same time high-grading is taking its toll, with the average head-grade of the same 11 companies being higher than the reserve grade over the past three years.

Interestingly, the high-grading has not stopped with the rise in the gold price, as evidenced by the widening gap between reserve grade and high-grade. In 2015 alone, 52% of production was mined at grades above the reserve grade, which clearly demonstrates a deliberate bypassing of lower-grade gold ore.

The bottom-line is this - if (or when) the lower grade is mined - operating costs will be pushed up as occurred during the early 2000s.

On a production-per-share basis, the gold companies in the study have actually gone backwards, indicative of shares being issued in order to either repair balance sheets or to retire underwater hedge positions, rather than to change fundamental trajectories.

Another important consideration is that the gold mining industry needs to embrace innovation and technology in order to cope with declining grades, as well as the increasing complexity of orebodies that are becoming more refractory in nature and no longer lending themselves to conventional cyanidation.

“All this tells us gold is becoming scarce because if primary supply is coming off, scrap is very price sensitive and central banks are buying, gold is going to be quite difficult to find particularly if you haven’t been exploring for the last 20 years,” Holland said.

All this is extremely positive for gold and we therefore retain our price target range for the yellow metals during 2016/17 of between $1200 and $1500/oz.

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