QUARTERLY MARKET COMMENTARY

There appears to be never a dull moment in politics and economics at the moment, although that could have been said for the last decade.

Currently, we have BREXIT, Trump trade wars, Brazil and the inexcusable destruction of the Amazon rain forest; we have Quantitative Easing and Tightening, we have tight and loose monetary policy in the US with rates being driven higher only for them to be cut again within a fairly short space of time. We have negative interest rates in Japan and Europe where investors have to pay the respective central banks to hold their capital at a time when many consider the European banking system still to be a major issue in world finance.

Therefore, with so much going on, it is important to cut through some of the noise and consider where economics and, by association, future investment returns (positive or negative) are likely to be seen.

There has been one asset class that has 'shone' in recent months but the recent gains have been largely overlooked in the press. Perhaps it is because BREXIT occupies every available column inch here in the UK but the rise in price has largely gone unnoticed. I am, of course, talking about the yellow precious metal, gold bullion.

In this edition of the Quarterly Market Commentary, we will look at the recent price history of gold bullion, the key factors affecting the price and ask what this direction of travel might perhaps indicate in the future.

This time last year gold was sitting below $1,200 per pounce. Forgotten, scorned and reviled by many. Today, gold sits at $1,525 per ounce. That is still some $400 per ounce off its all-time high of $1,920 per ounce set back in 2011. However, against the euro, the pound, the yen, the Canadian dollar, the Australian dollar and other currencies, gold is at all-time highs.

The move over the summer has been especially extraordinary. June to August is supposed to be the summer doldrums for the precious metal. The Indian wedding season has not got going yet; the brokers and CEOs are all off on their summer holidays – effectively the gold market goes to sleep.

Not this year! Gold was below $1,280 per ounce back in June. Less than three months later it is higher by $250 per ounce. These 25-30% year on year gains have been achieved while the US dollar itself has been rising, confounding the notion that gold only rises when the US dollar is weak. Clearly not true when the US dollar index is at two year highs.

So, what has driven this recent rise? Is it purely a lack of supply in terms of the usual demand and supply equation? It wouldn't appear so, given that the World Gold Council reported a 1% rise in gold supply for 2019 year to date from 4,447 tons to 4,490 tons. Therefore, could it be greater demand? Probably not for the reasons given above about the Indian wedding season and summer doldrums.

We must, therefore, look at fundamental analysis of the current economic environment. On this basis, it is fairly safe to say there have been several key indicators or events pointing to a slowdown in the current business and economic cycle. This is typically when gold starts to perform in periods of political and economic uncertainty.

The US-China Trade Wars continue and do not appear to be abating or reaching any final conclusion other than tariffs and counter tariffs being imposed. However, in recent weeks the Chinese Yuan reached a currency conversion milestone – seven Yuan to one US dollar. Many speculated that the Chinese authorities have specifically allowed the currency to depreciate against the US dollar to appear more competitive on the world trade stage. Why is this so important? Well if the Yuan is manipulated and allowed to fall, especially in relation to the US dollar, then general prices of goods will fall and investors are now concerned that deflation could be exported globally by lower priced Chinese imports. Perhaps this was the reason why the US Federal Reserve cut US interest rates by 0.25% at the end of July!

Another important indicator has been the US yield curve. A yield curve effectively compares the yield on bonds (IOUs issued by governments or corporations) that have the same credit qualities but different maturity dates. The yield curve measures the gap between short and long term borrowing rates generally on 2-year, 5-year and 10-year bonds. A healthy yield curve slopes up from left to right – in other words, bonds with longer maturities yield more than shorter-term ones.

An inverted yield curve suggests that longer term rates are lower than short term rates, implying investors are pessimistic. They are happy to lock in long-term yields today because they expect them to be lower in the future, which suggests they expect low inflation, or even deflation, which tends to go hand in hand with recessions. In the US, the yield curve between three months and the ten year US Treasury inverted some time ago. However, in the middle of August, the yield curve between the two year and ten year has also inverted. Why is this important? Because the same thing has happened prior to every single one of the last seven US recessions, with recession following inversion within 24 months of the event.

The other key statistics have come out of Europe. General European economic growth has been subdued with Germany and France already expected to be in recession. The latest Purchasing Manager Indices (PMI) data and manufacturing data was poor with rising unemployment in some countries and falling inflation. This is at a time when the calming influence of Mario Draghi, head of the ECB, will be removed when he steps down in October. Investors are also clearly concerned over the fallout of a no-deal BREXIT with the UK and, indeed, the European relationship with the US is far from perfect.

Therefore, investor attention has clearly shifted last year from one of central bank support assisting asset prices to the possible ending of this business cycle. It is important to note that there has been one 'false positive' on the US yield curve in that time – the curve inverted in the summer of 1998. At the time, the Federal Reserve under Alan Greenspan undertook a series of interest rate cuts and a recession did not materialise until March 2001. On this occasion, it may not be so easy.

The Fed cut rates in July but the market deemed it insufficient. That said, it is also important to note that stockmarkets have generally performed well in the 12 months or so after a yield curve inversion but unless we see more drastic action, it is hard to ignore this signal.

Clearly, the perma bulls for Gold are calling for a sustained period of price moves higher and it is difficult to argue that the changing economic landscape could not support this view. However, as always, it is impossible to predict the future - especially whether stocks and shares will fall or rise. Therefore, it is important that medium to long term investors maintain a diversified portfolio to benefit from stockmarket rises when they happen and to dilute volatility when there is a fall. Our strong belief is that a sensible investment strategy involves riding out stockmarket volatility.

September 2019