

Cooling late-cycle economy could rekindle interest in gold

By Joe Foster, Portfolio Manager and Strategist

Gold extended its two-year trend of higher lows

Gold's price action in March was very constructive, even though it only advanced \$6.62 (0.5%). Since the Fed began raising rates in December 2015, the gold market has shown weakness in the weeks ahead of each rate decision. This pattern was repeated once again, as the low for the month was \$1,306 per ounce on March 21, the day the Fed announced its sixth 0.25% rate increase since it began raising rates. The Fed-induced lows in 2017 were in the \$1,200 to \$1,240 per ounce range, whereas the March 2018 low (\$1,306) was much higher, extending the positive trend of higher lows to over two years. Gold was propelled to its high for the month of \$1,356 per ounce on March 27 following the Trump Administration's announcement of tariffs targeting Chinese goods. China's immediate response was modest in comparison and gold finished the month at \$1,325 per ounce.

Demand from India is weak, but bullion ETF demand solid

Physical demand in India has been weak for a couple of years now due to import restrictions, taxation, and currency changes. We have been expecting demand to return to normal. However, in February, Bloomberg reported weak Indian imports which suggests the gold market in India continues to struggle. While we wait for favorable developments from India, the positive trend in prices has been driven by investment demand for gold bullion exchange traded products (ETPs). Global bullion ETPs have seen steady inflows since early 2017 and holdings have now reached levels last seen in 2013.

Lack of interest, misguided cost concerns fueling gold equity underperformance

Gold equities outperformed gold bullion in March, as the NYSE Arca Gold Miners Index (GDMNTR)¹ gained 2.9%, while the MVIS Global Junior Gold Miners Index (MVGDXJTR)² advanced 2.2%. Perhaps gold stocks have begun to claw

back the performance they have lost relative to gold this year. In the first quarter, gold equities underperformed gold by 7.2%, while junior miners underperformed by 7.8%. We normally expect gold equities to advance with gold, which has gained 1.7% so far this year. There are several reasons for the underperformance:

1. A lack of interest in safe-haven³ investments:

While volatility has returned to markets this year, it has yet to reach worrying levels that might motivate investors to hedge their exposure. General investor apathy towards the miners was also evident at the BMO Global Metals and Mining Conference 2018 in late February. BMO commented anecdotally that institutional investor interest in precious metals was at levels last seen in the early 2000s, before gold's bull market.

2. Market worries that a new cycle of mining cost inflation has begun:

Several companies have guided to higher all-in mining costs in 2018 and we have seen some press and research that suggests costs are beginning to rise. Since 2012, industry average all-in mining costs have fallen roughly 25% to around the \$900 per ounce level in 2017. Based on company guidance so far, we reckon these costs will likely rise to roughly \$925 in 2018. After talking with many producers about their cost drivers, we believe cost concerns are overblown and that costs will fluctuate around the \$900 level for the foreseeable future. Many companies have long-term contracts for materials and consumables. Some have hedged fuel and currencies at low levels. It seems the labor market has tightened somewhat in Australia, but companies are not reporting any wage pressures globally. In fact, BMO Capital Markets sees the all-in costs of the gold companies in their coverage universe declining 8% in 2019.

3. Gold stocks have yet to recover from the early February sell-off:

Investors viewed the general market sell-off as an overdue correction, rather than the reemergence of systemic risks.

This interpretation precluded a flight to safe havens, causing gold and especially gold stocks to sell-off with the market in early February. As a result, RBC Capital Markets notes that the gold producers are trading at a roughly 20% discount to their historic valuations. So far, the general sell-off has been too short to benefit safe havens. In a February report, Goldman Sachs finds that it usually takes a month or so of equity drawdown for gold to start to act like a hedge.

Cracks appear in market and investor psychology

It appears that the confidence and complacency that has dominated the U.S. stock market for several years is now beginning to dissipate. Investor psychology is changing, the market is no longer bulletproof, and many of the high flying stocks are coming down to earth. Social media is facing a reckoning, as Facebook has become embroiled in a widening scandal over user data. Unfortunate mishaps for Tesla and Uber suggest autonomous driving may be much more difficult to achieve than expected. Regulators and tax authorities are targeting cryptocurrencies, while hackers target their exchanges.

Indications of late-cycle economy and rising inflation more evident

The U.S. Commerce Department reported retail sales fell in February for the third month in a row, while the University of Michigan Consumer Sentiment Index⁴ jumped to a 14-year high and the Conference Board Consumer Confidence Index⁵ hovers near 17-year highs. This suggests that while times are good for most people, they have little desire to spend more in an economic expansion that is one of the longest on record. Households may save their gains from the Trump tax cuts, rather than spend in the economy, as the Commerce Department reports the savings rate ticked higher in February. We believe these are signs that the post-crisis economic and stock market cycle is approaching its end. There are also many signs indicating core inflation could move beyond the Fed's 2% target. The S&P CoreLogic Case-Shiller Index⁶ is 6.3% higher than its 2006 peak. A shortage has led lumber to record highs. Freight costs are near 20-year highs. General Mills CEO Jeff Harmening was quoted in The Wall Street Journal, "we are seeing an unprecedented rise in logistics costs". In the 12 state Midwestern region, job openings outnumber out-of-work job seekers. Idaho workers led the nation with a 5.3% increase in earnings in 2017 thanks to labor shortages. The Fed's February Beige Book saw employers raise wages and expand benefit packages in response to tight labor market conditions in most districts. Layered on all this are new tariffs that could raise the costs of a wide range of goods.

Historically, tightening does not end well

With core inflation at 1.8%, it is likely that inflation achieves a "two-handle" (2%) soon, and rather than risk falling behind the curve, the Fed might tighten more aggressively. This would also be classic late-cycle behavior. The track record of the 13 hiking cycles since 1950 compiled by Gluskin Sheff⁷ leaves little room for optimism.

Fed Hiking Cycles, 10 Landed in Recession

First Hike	Last Hike	Result
October 1950	May 1953	Recession
October 1955	August 1957	Recession
September 1958	September 1959	Recession
December 1965	September 1966	Soft Landing
November 1967	June 1969	Recession
April 1972	September 1973	Recession
May 1977	March 1980	Recession
August 1980	December 1980	Recession
March 1983	August 1984	Soft Landing
January 1987	May 1989	Recession
February 1994	February 1995	Soft Landing
June 1999	May 2000	Recession
June 2004	June 2006	Recession
December 2015	???	???

Source: Haver Analytics; Gluskin Sheff

In addition, many other countries are enjoying growing economies. A February report by HSBC economist Stephen King identified all periods since 1990 in which the world economy has delivered synchronized growth. Mr. King finds that each was followed by some kind of economic or financial shock, attributed to excessive optimism and unanticipated shifts in monetary policy.

Increased risk and volatility should lead investors back to gold stocks

If we are right in our late-cycle assessment, gold and gold stocks stand to benefit if the current market, characterized by confidence and complacency, transitions to one filled with risks and volatility. We believe that once generalist investors take the time to assess gold stocks, they will like what they see — companies with strong balance sheets, cost containment, and good cash flow run by managements incentivized by profitability and shareholder returns. Under the right conditions, it probably won't take long for the global gold mining sector with a market capitalization of just \$250 billion to fill the valuation gap and regain its historic beta to gold.

IMPORTANT DISCLOSURE

¹NYSE Arca Gold Miners Index (GDMNTR) is a modified market capitalization-weighted index comprised of publicly traded companies involved primarily in the mining for gold.

²MVIS® Global Junior Gold Miners Index (MVGDXJTR) is a rules-based, modified market capitalization-weighted, float-adjusted index comprised of a global universe of publicly traded small- and medium-capitalization companies that generate at least 50% of their revenues from gold and/or silver mining, hold real property that has the potential to produce at least 50% of the company's revenue from gold or silver mining when developed, or primarily invest in gold or silver.

³Safe haven is an investment that is expected to retain its value or even increase its value in times of market turbulence.

⁴A survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

⁵The Conference Board Consumer Confidence Index® is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

⁶The S&P CoreLogic Case-Shiller Home Price Indices are the leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate both nationally as well as in 20 metropolitan regions.

⁷Gluskin Sheff + Associates Inc., a Canadian independent wealth management firm, manages investment portfolios for high net worth investors, including entrepreneurs, professionals, family trusts, private charitable foundations, and estates.

Important Disclosures

This commentary originates from VanEck Associates Corporation ("VanEck") and does not constitute an offer to sell or solicitation to buy any security. VanEck's opinions stated in this commentary may deviate from opinions presented by other VanEck departments or companies. Information and opinions in this commentary are based on VanEck's analysis. Any forecasts and projections contained in the commentary appear from the named sources. All opinions in this commentary are, regardless of source, given in good faith, and may only be valid as of the stated date of this commentary and are subject to change without notice in subsequent versions of the commentary. Any projections, market outlooks or estimates in this material are forward-looking statements and are based upon certain assumptions that are solely the opinion of VanEck. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur.

No investment advice

The commentary is intended only to provide general and preliminary information to investors and shall not be construed as the basis for any investment decision. This commentary has been prepared by VanEck as general information for private use of investors to whom the commentary has been distributed, but it is not intended as a personal recommendation of particular financial instruments or strategies and thus it does not provide individually tailored investment advice, and does not take into account the individual investor's financial situation, existing holdings or liabilities, investment knowledge and experience, investment objective and horizon or risk profile and preferences. The investor must particularly ensure the suitability of an investment as regards his/her financial and fiscal situation and investment objectives. The investor bears the risk of losses in connection with an investment.

Before acting on any information in this publication or report, it is recommendable to consult one's financial advisor.

Forecasts, estimates, and certain information contained herein are based upon proprietary research and the information contained in this material is not intended to be, nor should it be construed or used as investment, tax or legal advice, any recommendation, or an offer to sell, or a solicitation of any offer to buy, an interest in any security. References to specific securities and their issuers or sectors are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such securities or gain exposure to such sectors.

Each investor shall make his/her own appraisal of the tax and other financial merits of his/her investment.

Sources

This commentary may be based on or contain information, such as opinions, recommendations, estimates, price targets and valuations which emanate from: VanEck portfolio managers, analysts or representatives, publicly available information, information from other units or Companies of VanEck, or other named sources. To the extent this commentary is based on or contain information emerging from other sources ("Other Sources") than VanEck ("External Information"), VanEck has deemed the Other Sources to be reliable but neither the VanEck companies, others associated or affiliated with said companies nor any other person, do guarantee the accuracy, adequacy or completeness of the External Information.

Limitation of liability

VanEck and its associated and affiliated companies assume no liability as regards to any investment, divestment or retention decision taken by the investor on the basis of this commentary. In no event will VanEck or other associated and affiliated companies be liable for direct, indirect or incidental, special or consequential damages resulting from the information in this publication or report.

Risk information

The risk of investing in certain financial instruments, is generally high, as their market value is exposed to a lot of different factors such as the operational and financial conditions of the relevant company, growth prospects, change in interest rates, the economic and political environment, foreign exchange rates, shifts in market sentiments etc. Where an investment or security is denominated in a different currency to the investor's currency of reference, changes in rates of exchange may have an adverse effect on the value, price or income of or from that investment to the investor. Past performance is not a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. When investing in individual shares, the investor may lose all or part of the investments.

Conflicts of interest

VanEck, its affiliates or staff of VanEck companies, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives) of any company mentioned in this commentary.

To limit possible conflicts of interest and counter the abuse of inside knowledge, the representatives, portfolio managers and analysts of VanEck are subject to internal rules on sound ethical conduct, the management of inside information, handling of unpublished research material, contact with other units of VanEck and personal account dealing. The internal rules have been prepared in accordance with applicable legislation and relevant industry standards. The object of the internal rules is for example to ensure that no analyst will abuse or cause others to abuse confidential information. This commentary has been prepared following the VanEck Conflict of Interest Policy.

Index Descriptions:

All indices named in the commentary are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made.