Gold and the Cycles of History

By Joe Foster, Portfolio Manager and Strategist

Gold spent July consolidating its gains above the $1,400 level, as we appear to be approaching the potential end of several different long-term cycles that may lead to elevated risks.

Gold Consolidates Gains Amid Easing Rates

Following the June breakout, the gold price spent July consolidating gains above the $1,400 per ounce level. Gold was supported by dovish comments from the U.S. Federal Reserve Bank (Fed) and European Central Bank (ECB) officials. Before the House Financial Services Committee on July 10, Fed Chairman Jerome Powell described increases in uncertainties; issues with trade, debt and Brexit; and the weakness of global manufacturing and investment all around the world. Gold reached a new six-year high of $1,453 on July 19 with further dovish comments from Federal Reserve Bank of New York chief John Williams and Fed Vice Chairman Richard Clarida, who talked of deflationary pressures and made aggressive comments on rate cuts. On July 25 after the ECB Governing Council meeting, Chairman Mario Draghi described an outlook that is getting worse and worse. The Fed kicked off the global easing cycle as expected on July 31 with its first rate cut since 2008.

Gold was not deterred by the U.S. dollar, as the U.S. Dollar Index (DXY)[1] ended July at the top of its recent range. Interest rates, rather than the U.S. dollar, have become the primary driver for gold. Real rates (adjusted for inflation) are near zero or negative for over half of the debt outstanding globally. When rates are so low, gold becomes competitive with interest-bearing investments in addition to its qualities as a store of wealth. We expect gold and gold shares to perform well for the duration of this rate cutting cycle. If, as in cycles past, this cycle ends in recession, risks could emerge that drive gold much higher.

Silver sprang to life in July, adding conviction to the recent gains in the gold price. According to Bloomberg data compiled on silver-backed exchange traded products (ETPs), July saw record inflows into the space and holdings also rose to a record high while volume spiked higher in Shanghai commodities trading. There was no fundamental news that could account for the move, as the price of gold is usually the main driver for silver. The staying power of gold prices during July focused attention on the extreme undervaluation of silver compared to gold. The gold/silver ratio had reached a 29-year high of 93 in June, compared to the 10-year average of 66. Silver usually outperforms gold in a strong market due to lesser liquidity and a more speculative nature. For the month, gold advanced $4.45 (0.3%) to $1,413.90, while silver gained $0.95 (6.2%) to $16.26 per ounce and the gold/silver ratio dropped to 87.

Gold stocks outperformed the metal again in July with the increased interest in the gold sector. The NYSE Arca Gold Miners Index[2] advanced 4.6%, while the MVIS Junior Gold Miners Index[3] gained 8.8%. When gold moves higher, the performance of smaller companies typically lags the larger companies initially. As the move continues, the smaller companies usually catch up and pass the larger ones. Investment management firm Paradigm Capital Management analyzed gold companies' performance in the strong gold market during the first half of 2016 when gold rallied $300 per ounce. Paradigm found the senior producers performed the best initially, but were surpassed by the junior producers after three months from the cycle low. Junior developers surpassed the seniors at four months, while intermediate companies outgained the seniors after five months.

Falling Backwards to Move Forwards

Many developments over the past decade have made it feel as if the world is falling backwards to a more dangerous and threatening time. Examples include Brexit and the potential failure of the European Union, polarizing politics in the U.S., extremist violence globally, the Russian invasion of Crimea, Chinese expansion into the South China Sea, and growing tensions between military powers. We thought global leadership was more mature and enlightened than to allow any of this to happen..

Perhaps what seems like slipping backwards is actually the advance of a cycle. A difficult period of time that needs to play out before the next phase of progress can begin. The universe is alive with cycles, from cosmic cycles, to nature's seasons, to our daily routines. Financial markets also move in cycles. However, the timing is inexact and depends largely on economic cycles, which are also inexact. What happened before happens again, although never in quite the same way.

In their book "The Fourth Turning" (1997), historians Neil Howe and William Strauss describe a cycle termed a "saeculum," which lasts about 90 years, or the approximate length of a full human life. The authors trace six Anglo-American saeculums dating back to late medieval times. Within a saeculum there are four generations (currently, from oldest to youngest: Silent, Baby Boomers, Gen X and Millennials). Each generation carries recurring beliefs, attitudes and psychology held by equivalent generations of past saeculums.

Within a saeculum there are also four periods, or "turnings," that begin when each generation comes of age (early adulthood) and lasts about 22 years. The interactions of the generations collectively drive the characteristics and events of each turning. The fourth turning of each saeculum is marked by an era of crisis that shakes a society to its roots and fundamentally alters the course of civilization. The climaxes of past fourth turnings in America were World War II, the Civil War and the American Revolution.

Bracing for the Fourth Turning

We find the evidence for life-long generational cycles as documented by Howe and Strauss to be compelling. They predicted a crisis catalyst would mark the beginning of the fourth turning around 2005, with a climax due around 2020. If history is playing out according to their theory, the catalyst actually occurred in 2008 with the global financial crisis and Millennials coming of age. This would move the climax to roughly 2023.

According to Howe and Strauss, fourth turnings are critical thresholds for national survival. Characteristics leading up to the climax include the reemergence of authoritarian government, elections that establish or reinforce one-party rule and political upheaval. The party out of power warns against, and shows signs of welcoming, a catastrophe on the horizon. Wide chasms separate rich from poor and immigrants from native borne, and America feels more tribal. A climax may include economic, social, cultural, technological, ecological, political or military distress. Some of these climax ingredients play little or no role at all, while others shoot along channels that swell and diverge.

Many of the fourth turning characteristics that were identified in 1997 seem to be in full swing today: Autocratic leaders in Russia, China and elsewhere. Divisive politics in the U.S., UK and elsewhere. Warnings of climate catastrophe. Disparities in wealth. Immigration crisis in the U.S. and Europe. It is not hard to imagine a spark that triggers a chain reaction of unyielding responses and further emergencies.

Big Wheel Keeps on Turning

Other thought leaders have also identified long-term cycles that they believe will culminate in economic or political difficulties in the coming decade. In a 2016 speech at the New York Fed, Bridgewater's Ray Dalio articulated a long-term debt cycle, which lasts 50 to 75 years. The cycle reaches a climax when debts can no longer be raised much and central banks approach the limits of their effectiveness. In a July 2019 essay, Mr. Dalio describes a "paradigm shift" in the markets that coincides with the end of the debt cycle, when storing money in cash and bonds will no longer be safe. It will be accompanied by significant internal conflict between capitalists and socialists, as well as external conflicts.

In a May 17 Wall Street Journal essay, Larry Diamond cites work explaining how democratic change surges forward and retreats in waves. We are now in the third cycle since the democratization of the U.S. The first cycle of democracy lasted 114 years, while the second just 32 years. The current cycle is ongoing at 45 years. The surge ended in 2006 after three decades of progress ground to a halt. According to Freedom House, over the past decade, one in six democracies have failed, while autocracies are becoming more repressive and aggressive. Mr. Diamond sees the current retreat in democracy as a slow decent that may culminate in the demise of democracy unless there is vigorous American leadership to support democrats, pressure autocrats, and counter the malign expansion of Russian and Chinese power.

Persevering Towards a New High

Long geopolitical and financial cycles are theoretical and difficult to verify. However, anyone observing global events since the financial crisis should be able to relate to the issues presented in this report. As the new decade unfolds, investors may face extraordinary risks. It is not too soon to think about gold and gold stocks, the more traditional role that they may serve as a portfolio diversifier and potential safe haven investment, and positioning for a possible time when markets are discounting a worst-case scenario.

At their current, historically low valuations, gold stocks are perhaps, too, well positioned to benefit beyond just that of any period of near-term elevated risk. As humanity has always persevered, once the climax of the fourth turning has passed, the first turning of a new saeculum brings a new mood, a reborn America, and opportunities for fresh growth that Howe and Strauss call "a new High".

While we are hopeful for a soft landing, a hard landing cannot be ruled out. The market is expecting a new cycle of rate cuts beginning in the second half of the year. Most people take out insurance on their houses, spouses, boats and cars, and the history of hard landings suggests it might be time to think about financial insurance. UBS found that over the last three decades, gold gained in four out of five periods when the Fed was cutting rates.

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*All company, sector, and sub-industry weightings as of 31 July 2019 unless otherwise noted.

[1]U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar by averaging the exchange rates between the U.S. dollar and six major world currencies.

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

[3]MVIS 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.

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