Gold Momentum Stalled by Fed Expectations

By Joe Foster, Portfolio Manager

Ending the month at $1,280.15 per ounce

The momentum gold experienced in August carried over into early September. Geopolitical tension continued as South Korea reacted to possible preparation by North Korea for an intercontinental ballistic missile launch. The U.S. Dollar Index (DXY) fell to new lows (levels not seen since early 2015) when the European Central Bank (ECB) increased its growth forecast and indicated it would begin discussing a tapering strategy for its quantitative easing policies in October. This drove the gold price to its high for the year at $1,357 per ounce on 8 September. However, for the remainder of the month, the Federal Reserve (the “Fed”) once again became the primary driver of gold prices, as interest rates and the dollar began to trend higher. After its 19 September Federal Open Market Committee (FOMC) meeting, the Fed announced plans to gradually allow its $4.5 trillion bond portfolio to runoff. It also forecast one more interest rate hike for 2017. Then, following a 26 September speech, the market became further convinced of a December rate increase when Fed Chair Janet Yellen endorsed continued monetary tightening in spite of a subdued inflation outlook. As a result gold trended lower, ending the month at $1,280.15 per ounce for a $41.25 (3.1%) loss.

Traded near their highs, then lower price

Gold stock indices also traded near their highs for the year, but then followed the gold price lower. During September the NYSE Arca Gold Miners Index (GDMNTR) retreated 6.6%, while the MVIS Global Junior Gold Miners (MVGDXJTR) fell 6.2%. There was little concern over September price weakness at the annual gathering of gold companies and institutional investors at the Precious Metals Summit and Denver Gold Forum. Managements from essentially every gold producer and most gold developers attend these events, and this year the focus was on the longerterm positive price trend. At the Denver Gold Forum, the majors reiterated their commitment to capital discipline and maintaining low costs. We were especially pleased with Newmont Mining’s (4.7% of net assets*) decision to consider raising its dividend yield to around 2% (gold stocks generally carry yields well under 1%). It looks like the industry may be gaining the financial strength to offer yields that outperform gold’s 0% yield which may attract more investors.

Many mid-tier companies highlighted growth

Many mid-tier companies highlighted growth projects that make this segment of the sector particularly attractive. We expect Iamgold’s (3.1% of net assets*) Saramacca discovery in Surinam to transform their Rosebel Mine from a marginal asset to a core driver of growth and performance. Also, B2Gold (6.1% of net assets*) announced it has commenced processing ore three months ahead of schedule and on budget at its new Fekola Mine in Mali, West Africa. This mine is a transformative asset for B2Gold and is expected to produce 400,000 ounces per year in the first three years at a cost of just $604 per ounce.

Companies with attractive development projects

A record number of junior companies attended the Precious Metals Summit. We are finding companies with attractive development projects in North America and West Africa as well as some exciting discoveries that merit watching. Recently there has been an unprecedented wave of producers that have taken strategic equity stakes in junior exploration and development companies. We observed a heavy presence of corporate geologists, as they continue to look for their next strategic investment that may eventually turn into a takeover opportunity.

Positive untold story of deregulation

While there is no shortage of negative headlines surrounding the Trump presidency, there is a very positive untold story of deregulation that should eventually lead to economic benefits. Developers we talked to with properties in Idaho, Utah, Nevada, and California are finding new cooperation...
amongst the bureaucrats they deal with. These companies have projects on federal lands administered by the Bureau of Land Management (BLM) and the U.S. Forest Service. Under the Obama administration, many companies saw their projects stalled by land use restrictions and permitting obstacles. With the new administration, environmental assessments are being processed on a timelier basis and permits for drilling and other development activities are being granted. We hope other sectors of the economy will see similar improvements that could ultimately add to economic growth.

Market Outlook
Since the financial crisis, the stock market has risen consistently as long as the Fed continued to buy treasuries and mortgagebacked securities through its quantitative easing policies (QE1-3). However, each time the Fed stopped buying bonds (in 2010, 2011, and 2015), the stock market suffered selloffs in the 10% to 15% range. Now the Fed has reversed course with plans to unwind its massive $4.5 trillion balance sheet (dubbed quantitative tightening or “QT”), yet there are no signs of a market selloff. In fact, the S&P 500\(^4\) has trended to new all-time highs, NYSE margin debt is at all-time highs, and the CBOE Volatility Index (VIX)\(^5\) hovers around lows last seen in 2007. Perhaps markets don’t care about QT because of the small initial runoff of $10 billion per month and the fact that it has been well telegraphed. However to us, it looks more like this market has a level of complacency rarely seen in history. A recent New York Times article by Yale Professor of Economics Robert Shiller shows current stock market valuations in a range experienced only in 1929 and between 1997 and 2002. To look for a reason as to why the current high valuations have so far failed to “precipitate those ugly declines in the past”, he searches newspaper archives and finds mass psychology to be in a “different, calmer place” today. Widespread fear of a speculative bubble is not evident in the current market. Dr. Shiller is at a loss as to why people are so calm about the markets and suggests maybe investors are distracted by the endless news flow around geopolitics, natural disasters, and violence.

Financial Risks

Investor complacency doesn’t hide the fact that there are financial risks to QT. Forty percent of the Fed’s balance sheet unwind is in mortgage-backed securities at the same time that the housing market is showing signs of slowing. The Fed plans to ramp its bond runoff to $50 billion per month or $600 billion per year. In her latest comments, Chair Yellen sounds set raising rates four times through 2018. As the Fed chokes off the juice that fed the feeble post-crisis expansion, it is not hard to imagine complacency turning to fear. We found this DXY/Gold chart compelling in our December 2016 report. Here we have an updated chart that we find even more compelling.

New development is fall of U.S. dollar this year

Notice the double bottoms gold experienced in 1985 and 2001 that coincided with major tops in the DXY and the beginning of a cyclical gold bull market in 1985 and a secular gold bull market in 2001. The most important new development is the fall in the U.S. dollar this year, shown on the far right hand of the DXY chart. This looks like the end of a U.S. dollar bull market that ran from 2011 to 2017. It also looks like gold has established a double bottom in December 2015 and December 2016.

While the gold price consolidates its August gains and faces the headwinds of the next Fed rate increase, the long-term technical chart suggests stronger prices for longer are possible. We believe the fundamentals support this technical outlook as the economic expansion ages and significant shifts in central bank policies and geopolitics create risks that drive investors to gold and gold stocks.

1 U.S Dollar Index (DXY) indicates the general international value of the U.S. dollar. The DXY does this by averaging the exchange rates between the U.S. dollar and six major world currencies: Euro, Japanese yen, Pound sterling, Canadian dollar, Swedish kroner, and Swiss franc.

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.

4 S&P 500 Index (S&P 500) consists of 500 widely held common stocks covering industrial, utility, financial, and transportation sectors.

5 VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market’s expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.
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