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Gold Ready to Cushion Hard Landing

By Joe Foster, Portfolio Manager and Strategist

Testing New Technical Levels

The gold price experienced a significant, and possibly historic breakout in June. We have commented extensively about the long six-year base that had formed around the price of gold in the $1,200 to $1,300 per ounce range. The technical price ceiling over this base period was $1,365 per ounce. During June, gold blew through two formidable technical barriers. The first was $1,365 on June 20, followed by $1,400 on June 21. It reached a six-year high of $1,439 on June 25 and finished the month at $1,409.55 for a gain of $103.97 (8.0%).

The breakout in gold prices was a global effort. The move through the technical barriers at $1,365 and $1,400, as well as the $1,439 high, all occurred in Asian trading. Support and momentum continued as trading moved to London and New York. Holdings in global bullion ETFs climbed to six-year highs and June saw the largest monthly inflows in three years.

Gold stocks came to life, and the earnings leverage to the gold price that they are known for, historically, was on full display. The NYSE Arca Gold Miners Index1 saw a 19.1% advance to its highest level in nearly three years. The MVIS Global Junior Gold Miners Index2 gained 19.3% to reach a 21-month high.

"Race to the Bottom" Fuels Fundamentals

There were several fundamental drivers that enabled gold to break out. Gold saw gains early in the month from continuing trade tensions between the U.S. and China as well as comments from U.S Federal Reserve Bank ("Fed") officials voicing concerns over the economy. Throughout the month, there was a steady stream of weakening manufacturing data, beginning with the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI)3 in the U.S. on June 3 and German industrial production on June 8. On June 16, Chinese authorities were reported to be trying to contain the fallout from the failure of Baoshang Bank, as brokerages and asset managers were looking to restrict trading due to possible counterparty risks. On June 18, the European Central Bank (ECB) indicated rate cuts are likely in the absence of any improvement in the economy. Then markets became convinced the Fed would also cut rates in the second half following the June 19 Federal Open Market Committee (FOMC) statement and press conference, which expressed a more dovish outlook. VanEck Chief Economist Natalia Gurushina characterized the situation as "a race to the bottom among major central banks." All of this created a consensus shift in the market's mood and outlook for weaker growth and increasing risks.

Supporting gold were interest rates that continued lower as five-year U.S. Treasuries now carry a real (inflation adjusted) rate of 0%. Ten-year German bunds fell to a record low -0.3%. The U.S. dollar weakened as the U.S. Dollar Index (DXY)4 fell through near-term support levels.

Hard Landing Cannot Be Ruled Out

Gold has begun July consolidating its strong June gains, as Presidents Xi Jinping and Donald Trump agree to resume trade talks and the S&P 5005 touches on new all-time highs. The gold market is now transitioning from a six-year sideways price trend. We expect most of August to be a month of consolidation around the $1,400 level before a new trend begins to develop. Heading into 2020, we see one of two scenarios playing out across the markets:

Soft landing – Manufacturing has been weak and on the verge of recession in China, Europe and now the U.S. A "soft" landing would occur if the global stimulus widely expected from central banks is able to keep a manufacturing recession from morphing into a broader recession across the entire economy. Averting a recession would be bullish for the stock market, interest rates would find a bottom, and the dollar would likely stabilize or move higher. This might limit the upside for gold, and in this scenario we might see gold establish a new price range supported by geopolitical risks and central bank demand.

Hard landing – A "hard" landing occurs if the current manufacturing recession transitions into a broader economic recession, causing central banks to suffer a loss of confidence. U.S. rates would likely trend to zero or less, and the stock market might enter a correction, while financial risks escalate. Central banks may restart quantitative easing (QE) or initiate other more radical policies. In this scenario, gold would probably form a positive price trend as a safe haven investment.

Last December, the Fed likely completed a rate hiking cycle that lasted three years. The current expansion is now the longest on record, as is the bull market in stocks. Since 1950, a recession has followed 10 of 13 hiking cycles, while three ended in a soft landing. The chart below shows the last recession started three months after the Fed's first rate cut in September 2007, while the S&P 500 peaked in October 2007. The prior recession started two months after the first rate cut in January 2001.

Historical U.S. Rate Hiking Cycles and Recessions

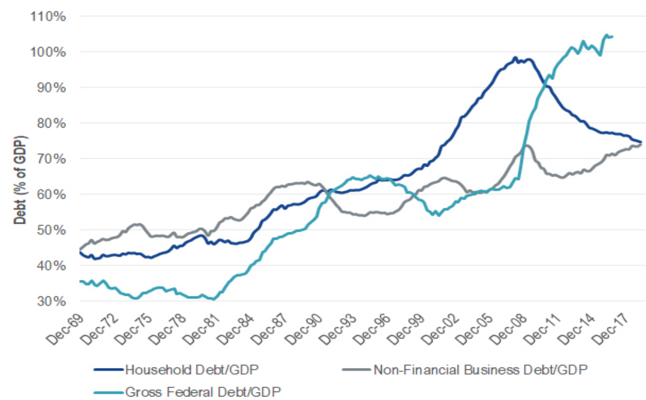
Source: VanEck, Bloomberg.

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.

Gold Could Gain from Dangerous Debt Levels

Recessions aren't necessarily gold drivers; however, the financial stress that often accompanies recessions can bring a bull market for gold and gold stocks. Debt or overleverage is usually the culprit, as was seen with subprime mortgages in 2008. The chart shows the household debt bubble of the last cycle has been replaced by a sovereign debt bubble and also a possible corporate debt bubble.

U.S. Debt to GDP



Source: VanEck, Bloomberg.

Sovereign debt exploded higher following the financial crisis. Republicans used to be deficit hawks; however, since Trump was elected, deficits have been used to fund tax cuts and more spending. Few in Washington seem concerned, and perhaps it is a reflection of the mood evolving across the country. A Pew Research Center survey6 found 48% of Americans said deficit reduction should be a priority, compared with 72% in 2013. Trillion-dollar shortfalls are expected next year and beyond. In a recession, receipts decline and expenses increase, so the shortfall grows further. With no end in sight, we believe eventually there comes a breaking point when foreign and/or domestic investors are no longer willing to buy U.S. treasuries in such quantity. At that point, treasury rates rise, U.S. credit may get downgraded, and the U.S. dollar may collapse. No one knows when the breaking point comes, but a recession increases its likelihood.

The second potential debt problem is corporate. As a percentage of GDP, the chart shows corporate debt has now surpassed the peak of the last cycle in 2009. The key risk in this cycle is lower credit standards. The amount of triple-B rated U.S. corporate debt – the lowest category of investment grade – has more than doubled since the crisis. It now accounts for 55% of the investment-grade market. Morgan Stanley figures7 that in a downturn, over $1 trillion of this debt is at risk of being downgraded to junk status. Many funds unable to hold junk debt would be forced to sell.

Another source of risk is the $1.3 trillion leveraged lending market, which are often packaged into collateralized loan obligations (CLOs). 80% of corporate leveraged loans have weak debt covenants ("cov-lite"), up from 6% in 2006. While banks are in better shape financially since the crisis, 85% percent of leveraged debt is held by non-banks. This suggests that significant systemic risk now rests outside of the banking sector.

As gold advocates, we focus on the risks to the financial system that may impact investment portfolios. In our view, It seems the potential for a hard landing is growing. Meanwhile, we believe debt and poor credit quality have reached levels that may bring another financial crisis.

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*All company, sector, and sub-industry weightings as of 30 June 2019 unless otherwise noted.

[1]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.

[2]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.

[3]ISM Purchasing Manager's Index (PMI) is a widely-watched indicator of recent U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. The index monitors changes in production levels from month to month.

[4]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.

[5]S&P 500®Index (SPXT) is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

[6]Pew Research Center, "Fewer Americans view deficit reduction as a top priority as the nation's red ink increases" (2019, February 20). Retrieved July 2, 2019.

[7]Bloomberg, "A $1 Trillion Powder Keg Threatens the Corporate Bond Market" (2018, October 11). Retrieved July 2, 2019.

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