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Markets confused by gold-price narratives

Gold miners would benefit from clearer explanations for why gold prices move.

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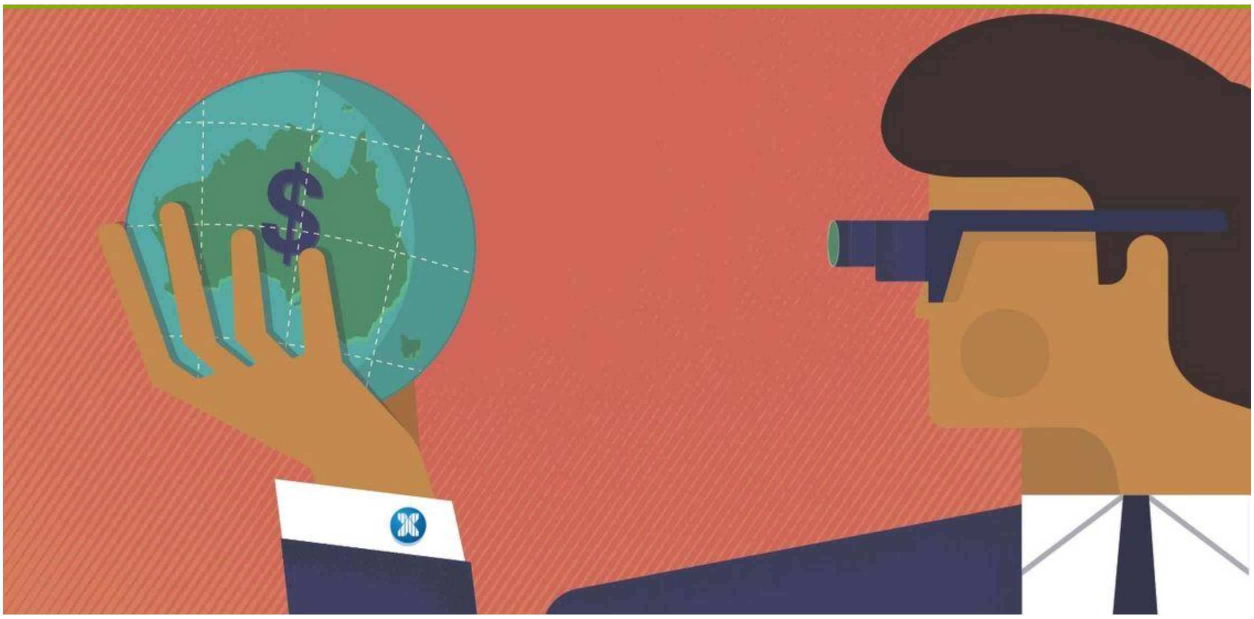

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Gold's backers have a seemingly never-ending list of reasons to buy the metal. It protects against inflation and the economic failure accompanying deflation. It supposedly benefits from good times as well as the fear of bad times.

Gold counters market uncertainty but thrives, too, on buoyant markets, according to its advocates. Geopolitical turmoil and peacetime prosperity are both times to invest. Rising bond prices are supposed to favour gold but so are falling financial asset prices and a weaker US dollar. Having less gold to buy is good. So, too, is increased physical metal use.

The plethora of sometimes contradictory reasons to invest is portrayed as one of gold's strengths. The varied and sometimes inconsistent and confusing influences on gold prices contribute to a zero correlation with the prices of other assets, another rationale for gold's universal addition to investment portfolios.

Simultaneously offering so many reasons to invest runs contrary to a world in which equity investors are used to herding around sharply worded slogans or catchphrases with intuitive appeal and from which market momentum can be created.

Occasional departures from widely assumed gold-price guideposts, such as the positive link with bond prices, also add to wariness about investing in the sector. While both US dollar bond and gold prices have trended higher since 2002, the anticipated nexus has failed to hold for prolonged periods. While gold prices rose 60% in 2005-2006, for example, bond prices were falling. Through 2014-2015, gold prices declined as bond prices moved higher.

Even more inconsistent with advertised reactions, the gold price fell as much as 30% through 2008 just as its protective qualities, including its low correlation with other asset prices, was most needed. Recovery occurred as optimism about the outlook spread.

Anxiety over the direction of financial markets or the potential for disruption is supposed to favour gold. Yet, in practice, the gold market seems largely oblivious to investor tensions when setting prices.

> **The more aggressive promoters of gold revel in their characterisation of the metal as a universal investment panacea**

When the Cboe volatility index based on S&P 500 options (the VIX) has been above 20, signalling above average investor anxiety about financial market conditions, the gold price has risen on 50% of the trading days since 1990. When the VIX has been below 13, evidencing belief in a relatively benign investment outlook, the gold price has risen on 53% of the trading days. Gold prices have not adjusted to financial market uncertainty in the expected manner.

Nor does viewing gold prices as the outcome of changes in physical market balances offer a more compelling model.

An emphasis on market balances has arisen from the way industrial metal markets are analysed. When demand outstrips new supply, industrial metal inventories are impacted. When inventories are especially low, prices rise.

In the gold market, where all the gold ever produced is always at work, the idea of fluctuating inventories dictating prices does not make sense. Purchases by one source (e.g. central banks or exchange traded funds) can be unusually high only if selling from another source is unusually strong.

Also contrary to the behaviour in industrial metal markets, physical use of gold varies inversely with price. Low gold prices attract consumers. High or rising prices detract from physical demand for gold.

The alternative to the physical balance model is to treat gold as a financial asset driven by wealth accumulation. In this model, total wealth can be viewed as the sum of the value of all gold holdings (i.e. the price of gold multiplied by the amount owned) and the value of holdings of all other assets (i.e. their prices multiplied by the quantity held).

The mathematics is compelling.

If the prices of non-gold assets rise, wealth builds. If asset owners want to retain a set proportion of their wealth in gold, the gold price would have to rise. If, on the other hand, a rise in the supply of financial assets, such as US government bonds, comes with a proportionate decline in bond prices, there is no change in total wealth and no change in the gold price would occur.

Since wealth is the accumulated value of historical savings, the financial market model implies that gold prices will benefit from stronger economic growth but only to the extent incomes are not immediately spent.

The savings-wealth model explains the two primary periods of gold price strength, namely, the rises which occurred between 1970 and 1980 and then between 2002 to 2011. These two, roughly 10-year bursts in performance account for the entirety of the gold price increase over the past 50 years.

In both cases, the rise in the gold price was accompanied by huge shifts in the distribution of global incomes. The first favoured oil exporting countries. Savings rates in Saudi Arabia, Iran, Iraq and Venezuela rose rapidly with the Saudi savings rate exceeding 80% in the mid 1970s around the time of the initial quadrupling in oil prices.

The second instance of globally significant income shifts came with China's rapid economic growth in the first decade of the 21st century. China's saving rate peaked in 2010 at 52% after commencement of its rise in 2002 coincided with the initial lift in gold prices.

The post-2011 fall in the gold price has coincided with China's declining savings rate and the consequently slower accumulation of wealth available for investment. The International Monetary Fund expects China's savings rate to decline further over the coming five years.

The more aggressive promoters of gold revel in their characterisation of the metal as a universal investment panacea. The risk for the mining industry is that they are so often wrong or their views so analytically suspect that they detract from any industry efforts to emphasise their capacity to build value.

The gold mining industry would be better off adopting a deliberately more parsimonious narrative about what drives prices based on a well thought through model validated by history and around which investors can congregate.

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