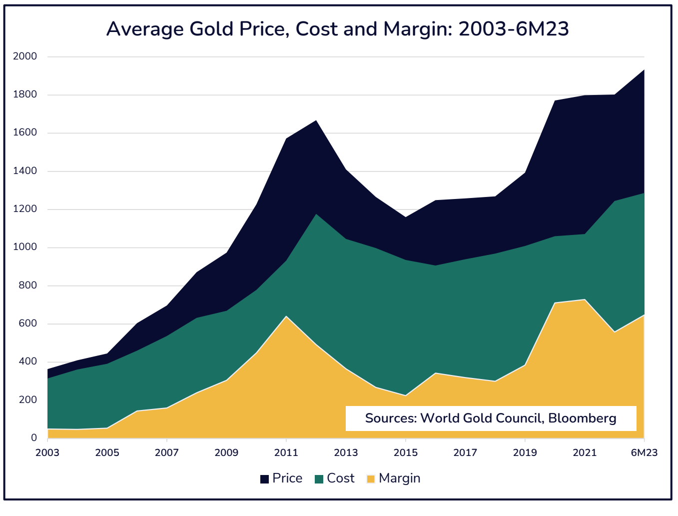
Beneath the Surface

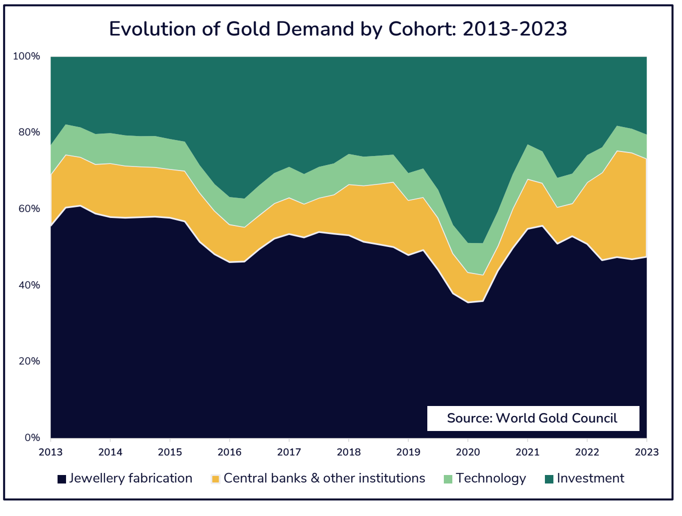
Gold – Shifting Dynamics

- Gold has enjoyed a robust performance in 2023, up c.12% to c.$2,040/oz at the time of writing. Constrained supply and central bank demand have helped. Demand elsewhere has been tepid, and the traditionally negative influences of a strengthening US Dollar and burgeoning real interest rates have hindered. This note will seek to explain gold's resilience in the context of these headwinds and consider its prospects and avenues to gain thematic exposure.

- Gold is employed as an insurance policy against economic, financial and geopolitical volatility (it was up 5.8% in 2008), and fiat currency debasement. Its appeal was enhanced by the 'Nixon Shock' of 1971, which abolished gold exchangeability for the Dollar and established gold as a 'sound money' alternative to fiat. Since then, US M2 money supply has multiplied 28x, almost 7% annually, and dwarfed the 1.4x, sub-2% annual growth in above-ground gold stocks. Were convertibility to be assured today, total M2 money stock of $20.7tr divided by the US Treasury's holdings of 260bn gold ounces would imply a gold price of almost $80,000/oz, or c.40x the current spot price. Since 1971, gold has generated total annualised nominal returns of 7.7%. Over the past decade, M2 money supply has grown in line with long term averages, almost doubling, while gold supply is up 13% in that time. Escalating costs, up almost 10% Y/Y, have constrained recent production and margins: chart, bottom left.

- The proportionate contributions of the four demand cohorts have varied over time: chart, bottom right. The most noticeable recent trend has been the central banks' outsized contribution, representing 26% of demand over the past four quarters, double the average over the past 10 years and up 61% Y/Y, or almost 10x the 10Y growth rate. China has accounted for 69% of net central bank purchases over the past 12 months (10Y average: 26%). Central bank purchases for 2023 are set to eclipse 1,000t for the second time ever (2022: 1,081t). This elevated buying coincides with international sanctions imposed on Russia in 1Q22 following its invasion of the Ukraine, which saw over $300tr of its FX reserves confiscated. Over thirty percent of countries are subject to "Big Four" - US, UK, EU and Japan - Financial Sanctions: this proportion has more than doubled since the Global Financial Crisis. To the extent that central bank purchases are strategic, they represent secular and price-inelastic demand, underpinning the gold price.





- While central banks have accelerated their gold purchases, they have limited their holdings of US Treasuries. US fiscal conditions have deteriorated, prompting global participants to question the Federal Reserve's traditional image as a sound monetary steward. For decades, the US Dollar has enjoyed currency hegemony, as the world's reserve, and primary trading, currency. Amidst escalating geopolitical tensions, contenders to challenge this status are emerging. US total debt stands at $33tr, having doubled over the past decade, and it currently represents 120% of US GDP (2013: 99%). Over the past 12 months, Federal Outlays of $6.3tr significantly exceed Federal Receipts of $4.5tr. Interest expense of $949bn, equivalent to 3.4% of GDP, exceeds total defense spending of $840bn. Over the past decade, foreign central bank holdings of gold have grown by over 5% annually, while the value of their US treasury holdings is broadly flat. Notably, China's gold holdings now comprise 4.3% of official reserves (2013: 1.3%).

Definitions

The World Gold Council is a trade association formed in 1987 whose members comprise executives from 32 mining companies with a combined footprint of mining operations spanning 45 countries.

Gold demand cohorts: Jewellery fabrication comprises consumption and inventory, and is the first transformation of gold bullion into semi-finished or finished jewellery. Central banks and other institutions comprise central banks and other official sector institutions, including supra national entities such as the IMF, excluding swaps and the effects of delta hedging. Technology captures all gold used in the fabrication of electronics, dental, medical, decorative and other technological applications, with electronics representing the largest component of this category. Investment comprises net purchases of physical gold (bars and coins) and gold-backed collective instruments: exchange-traded funds, close-end funds, mutual funds and other products which invest at least 90% in physical gold.

Gold price is quoted as US Dollars per Troy Ounce. Gold cost represents the all-in-sustaining-cost of production, comprising total cash costs, corporate general and administration costs, reclamation costs, exploration and study costs, and the costs of sustaining capital exploration, development and capital expenditure. Margin is calculated as the difference between the average gold price and the average all-in-sustaining-cost of production for each period presented.

- Prospectively, the US' effective interest rate on total interest-bearing debt, 3.1% at latest month end, is up 90bps Y/Y, and is more than 200bps below the Fed Funds rate of 5.2%. With c.$7.6tr of marketable securities due to mature in the next 12 months, the future rate path will be critical. Following a rate hike cycle twice the severity and thrice the rapidity of the prior one, a 2023 Gallup poll reflected that just 36% of respondents had a 'great deal' or a 'fair amount' of confidence in the Federal Reserve Chair, the lowest recording since the survey's 2001 inception. The 2023 Central Bank Gold Reserves Survey revealed that over 70% of the 57 respondents expected to increase their gold reserves over the ensuing 12 months. Five years hence, with gold comprising 15% of total reserves and USD comprising 51% of total reserves, 62% of respondents expected gold's proportion to increase, up by 16% Y/Y, and 55% the USD's proportion to decrease, up by 13% Y/Y. Separately, a 2023 Bank of America survey reflected that 71% of advisors had less than 1% gold exposure across their client books, with another 27% having limited gold exposure of 1%-5%.

- In this context of 'underallocation', the total values of physical gold ($14tr) and related investments in gold mining ($0.4tr) and precious metals ($0.5tr) companies and, to the extent that it is considered 'sound money', bitcoin ($0.8tr), are insignificant compared to the broader investable universe of equities ($101tr) and fixed income ($130tr).

- Going into 2024, the table below reflects the likely direction of gold price drivers - and their contribution to gold's performance – under various economic scenarios, as determined by the World Gold Council's valuation framework.

Gold's performance for various economic scenarios by direction and influence of key drivers

Key Driver	Subcomponent	Economic Scenario: Soft Landing	Economic Scenario: Hard Landing	Economic Scenario: No Landing
Opportunity cost	Ten year yield	↓	↓↓	↑
	US Dollar	↔↓	↑	↑↑
Economic expansion	GDP growth	↓	↓↓	↑
Risk and uncertainty	Inflation	↓	↓	↑
	Risk-off positioning and volatility	↓	↑↑	↑↑
	Geopolitical risks	↑	↑	↑
Momentum	Central bank purchases	↔↑	↔↓	↔↓
	Commodities	↓	↓↓	↑
	Gold net positioning	↑	↑↑	↑
Implied gold performance		↔↑ flat, upside potential	↑↑ Considerable upside	↓↔ flat, initial downside potential

Colour Key (effect on gold):	Positive		Neutral		Negative

Source: World Gold Council (adapted)

- Gold's recent performance has been aided by abating Dollar strength, decelerating real rates, cost-constrained supply and robust central bank buying. Going forward, interest rate futures are expecting a c.1.5% cut to the effective Fed Funds rate over the next 12 months, reducing both gold's opportunity cost and the Dollar's appeal. Meanwhile, gold futures anticipate limited upside of c.2.5% in 2024. Against this backdrop and considering the economic scenarios in the above table, an allocation to gold as a portfolio hedge currently presents potential upside opportunities. Further, the table suggests limited downside in a consensus, benign 'soft landing' scenario and considerable upside if expectations are disrupted.

- We would be delighted to guide you on accessing this investment theme. Please contact us if it is of interest to you.