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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Golden Trump Years Come With Inflated Expectations

Chris Kerlow, CFA

For the first time in five years we are taking a meaningful position in gold to provide portfolio protection and capture near term appreciation in the commodity price. The macro-economic environment has undergone a paradigm shift and now looks constructive for rising prices. Over the past half-decade of managing the Connected Wealth mandates we have only held gold for brief trading periods, but those were shorter term trades taking advantage of valuations or momentum in the market. This recent call has been implemented across almost all the investment vehicles we manage.

The overarching view holding us back from buying the commodity in the past was that from 2008 - 2012 the price was being artificially inflated by quantitative easing, a phenonomon that bubbled the price from below $800 an ounce in November 2008, the same month QE1 was announced, to $1,900 three years later. As the market noticed the economy recovering and expected quantitative easing was coming to an end, the price corrected dramatically. Year 2016 gave us evidence that this trend had reversed. With the prevailing macro-economic environment, we felt that it was an opportunistic time to add this asset class to our portfolios.

Bond yields are a major influence on the price of gold. Generally speaking higher bond yields are a negative for gold. When yields rise, it makes bonds more appealing than gold, which has no yield. However, there is a risk reward trade-off because even governments have credit risk, just ask the people of Cyprus. When yields are near zero, investors, receiving next to nothing, would rather park their assets in gold, which has no credit risk.

There are also two components of nominal bond yields, real yields and inflation. Real rates are the difference between nominal rates and inflation. When inflation expectations rise,

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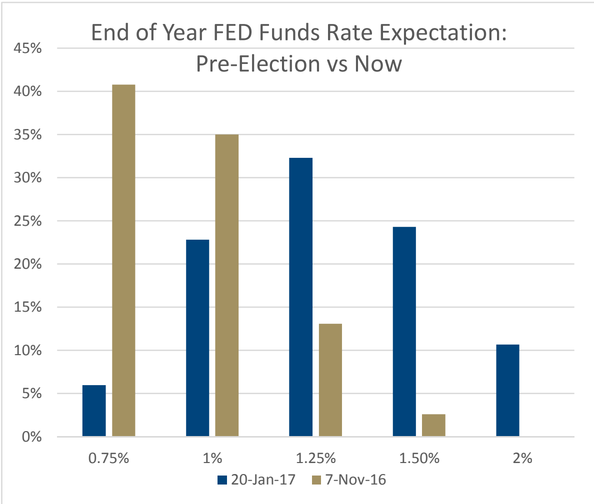
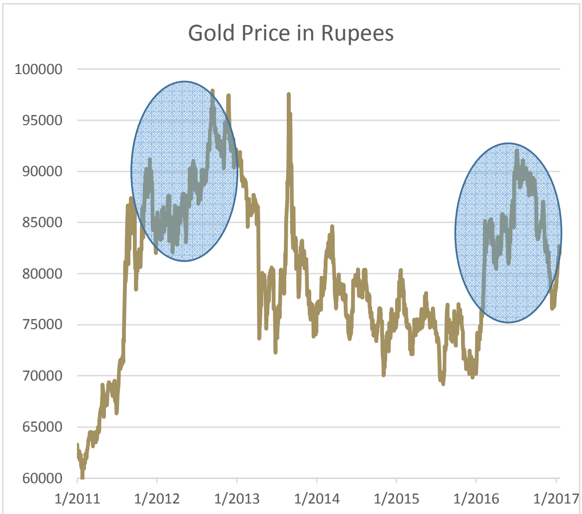
nominal bond yields will also rise. Rate hikes from the FED should have an upward impact on short yields, but it is more the shifting expectations of hike than the actual rate hikes that impact yields. The market is now pricing in a better than 67% chance that we see more than one hike in 2017. Before the election results on November 8th, there was less than a 15% chance of seeing that many hikes, with one to two hikes next year being priced into the market. There is some room for marginal expansion in real rates if the economy keeps chugging along, and we see expectations rise to two or three hikes, this could be a negative for gold. But the real boost in nominal yields could come from inflation, which historically will be a positive, because investor allocate capital to gold to hedge the risk of eroding purchasing power. So although our thesis of higher bond yields remains, it predicates much of our portfolio positioning. We see the pendulum swinging from being a negative to a positive for gold prices, as the rise is on the back of inflation expectations and to a lesser extent real yields.



There are several key factors that could provoke inflation in 2017, such as lower taxes, higher wages, and consumer spending. We wrote recently how tax reform can impact your investment portfolio, click on the link. Corporate tax cuts will expand the government deficit, which will need to be financed by the issuance of more government bonds. The issuance of government bonds was a major tailwind that supported the 180+% rise in gold from 2008 to 2011. Other pillars of the Trump campaign such as reduced immigration, which would apply upward pressure on wages and trade protectionism which would lead to higher import costs, are both highly inflationary forces. It will be a wait and see period to understand what type of policies will be enacted, but it appears that expectations are low, that the radical extremes of abolishing NAFTA, TPP and building a wall are likely to happen. But if the anti-establishment President does push through rash policies, we could see a flight to safety in gold, pushing prices higher. Protectionism and policy that crimps immigration would likely be a negative for growth, which would put a cap on real rates, which again is supportive for gold prices.

Uncertainty surrounding Trump policy reform, combined with other geo-political risks are another reason we are adding this implicit portfolio insurance to our funds. There are a slew of elections across Europe this year, tensions remain high in the Middle East, and OPEC compliance is under a microscope, just to name a few, all of which could shake the market if there is an unexpected negative event, in which case we would expect a flight to safety, giving a bid to gold. The biggest fear we have is the one nobody is paying close enough attention to, the black swan if you will. Then again, maybe the swan is in plain sight with a very good disguise. If every time the market corrected, we saw it coming, our assets under management would be measured in trillions not millions. Bull markets do not die of old age. But now this eighth-year run is getting mature from historical standards. Everyday higher is just one day closer to the end of this rally. And if there is a black swan swimming out there, we want to somewhat shelter the capital we have been graciously trusted to protect and grow, when it rears its ugly head!

The underlying fundamentals for the commodity provide support to our thesis, but are not the premise as to why we are adding the asset class. In China, the government is actively attempting to curb capital outflows as they are concerned about domestic inflation. Demand for gold buying from China accelerated into the end of the year on weaker prices. Indian gold buyers saw the highest local currency gold price since 2012 throughout the duration of last year, hurting demand initially but should reinforce gold as a good investment for those who have a strong affinity for the yellow metal. Additionally, since 2012 when gold was trading near $1,800 an ounce, gold miners have been slowing production. This austerity has continued for the past five years with miners only producing at the highest grade sites, cutting back capital expenditures and exploration budgets, causing mine production to decline at an estimated rate of over $5mm ounces a year until the end of 2018. The declining available new supply is supportive for higher prices.



There are risks to this trade, one of the biggest is the repeal of quantitative easing from the ECB and BoJ in 2017. As alluded to earlier, the massive rally following the recession was supported by huge QE programs around the world. The U.S. has since curtailed their program, which was the catalyst to reverse the trend. If the ECB and BoJ take their foot off the pedal, it could have a similar result. The combined programs currently sit at $140b/month, much higher than the $85bb/month the U.S. was adding at peak in 2012. However, this is likely a second half risk based on rhetoric out of their respective political powers.

Though risks remain, and we might be early in taking position, we believe that there is a strong enough case to warrant a serious look at gold in most investors' portfolios. Stock markets are near their highs, and equity volatility remains subdued. The market might very well be mispricing future uncertainty, which makes adding some exposure to the world's oldest fear barometer worth some consideration.

Charts are sourced to Bloomberg unless otherwise noted.