Gold Market Commentary

Gold Market Declines on Disappointing China Reserves Announcement

By: Joe Foster, Gold Strategist

Market Review

The gold market was met with selling pressure following the July 17 release by the People's Bank of China (PBOC) of its official gold holdings. The PBOC announced a 57% increase in gold reserves since its last announcement in 2009. China now holds 1,658 tonnes of gold in its foreign currency (forex) reserve, which is sixth highest globally behind the U.S., Germany, the International Monetary Fund (IMF), Italy, and France. This confirms suspicion surrounding China's official gold purchases and the PBOC remarked that gold is a unique asset and recognized that gold has always been a key part of reserve management and diversification. The market, however, was disappointed because many analysts had expected to see much higher gold holdings. There have been estimates based on gold flows through Hong Kong and domestic production that suggest that since 2009 there has been a significant amount of gold in China, perhaps over 2,000 tonnes, that is unaccounted for. We now know that not all of this purported surplus has gone into the PBOC vaults. There are pockets of the gold market that are opaque to market observers, and we can assume that more Chinese gold than previously thought has gone to individuals, institutions, or other government entities as jewelry, bars, and coins, or for use as collateral.

Gold represents 1.65% of China's forex reserves, which is a slight increase from 1.5% in 2009. We had thought China might be targeting gold reserves in the double-digit range like many of its Western counterparts. However, this announcement suggests the PBOC is content to maintain gold reserves at a percentage that is comparable to its Asian neighbors.

Gold experienced heavy redemptions in the bullion exchange-traded products beginning on July 17 that continued to month-end. Also weighing on gold was weakness in the overall commodities complex brought on by the collapse of the Chinese stock market, as West Texas Intermediate (WTI) crude fell 20.8% and copper declined 9.3% in July. On July 20, gold fell through the technically important $1,100 per ounce level and reached a new cycle low of $1,072 per ounce. In the midst of summer seasonal weakness, there hasn't been much anecdotal evidence of a demand response to the new lows from India or China. Gold finished the month at $1,095.82 per ounce for a loss of $76.60 (6.5%).

Market Outlook

Gold stocks took a hard fall as gold was making new lows. The NYSE Arca Gold Miners Index (GDMNTR)[1] suffered a 22.5% decline, while the Market Vectors Junior Gold Miners Index (MVGDMJTR)[2] fell 19.7% for the month. This might be the worst cyclical bear market for gold equities ever. It is certainly the worst since gold became freely trading in the post-Bretton-Woods era of fiat currency. We looked at the Barron's Gold Mining Index (BMGI)[3] and found that since 1971 there have been six cyclical bear markets with peak-to-trough declines ranging from 53.8% to 79.3%, with -79.3% being the current bear. In terms of duration this market —at 51 months—ranks third longest within a range from 20 months to 64 months. Over those same bear markets, gold bullion has seen peak-to-trough declines ranging from 33.7% to 56.2%, with the current market coming in second worst at -44.2%. The last time the BMGI traded at the current lows was the beginning of the last bull market in January 2002, when gold was $280 per ounce.

This analysis demonstrates that gold and gold shares have fallen to historically extreme levels. While there is always potential for further losses, it suggests that the bear market is capitulating and that a turning point could be on the horizon. What we believe many market observers are missing is that gold is broadcasting a warning. It is the antithesis of a euphoric market bubble. Gold's collapse is the market's expression of extreme complacency towards systemic financial risk. Gold is being shunned as a universal safe haven because there is unbridled confidence in the Federal Reserve Bank's (Fed) ability to steer the economy to lasting health, as evidenced by the strength of the U.S. dollar, the U.S. stock market, and demand for U.S. Treasuries.

It is difficult to identify a catalyst that marks an end to the gold bear market. Perhaps once the much anticipated Fed rate increase finally happens, the markets might adjust their risk outlook. Normally central banks raise rates to extinguish inflation or cool an overheated economy. However, the recovery from the Great Recession has been the weakest in the post-war era with virtually no signs of unwanted inflation. Never has the Fed raised rates for no reason other than a desire for them to return to historic norms. With current rates near zero, it lacks sufficient power to stimulate the economy if another downturn materializes.

Markets are obsessed with this Fed rate decision because it is virtually impossible to tell whether the glass is half full or half empty. The economy has been growing, albeit slowly, and full employment is within reach. Household balance sheets have returned to health and fuel prices are low. The economic mood we see across the country is generally positive and some areas are booming. Tax receipts are up and the fiscal deficit is declining. Perhaps the economic momentum is strong enough to continue through a series of rate increases. In our view, the glass must be half full.

WAIT A MINUTE ….

On July 7, the IMF warned of the risk of stalling the U.S. economy by raising rates too early and speculated that the Fed may be forced to reverse course. The IMF also downgraded its forecast for global growth to its weakest since the financial crisis. The Fed has consistently had to downgrade its U.S. growth forecasts, and this year is no exception, with first half GDP growth coming in at less than 2%.

The IMF's chief economist stated "The post-crisis world is one of high debt and it doesn't take much with these debt dynamics to go wrong." While the U.S. budget deficit is no longer in the trillion dollar neighborhood, at $431 billion, it remains a growing burden as federal spending keeps rising.

Improvements in the U.S. unemployment rate have come largely from working-age people dropping out of the labor force, dragging the labor participation rate to 62.6%, a 38-year low. Meanwhile, productivity growth has been much weaker than normal. In our view, these are not signs of a robust economy. They are signs that the glass is half empty.

In the longer term, we believe the glass is cracked, completely empty. Economies have been permanently disabled by a regulatory and tax regime that has become so overwhelming that we feel it stifles innovation, business creation, and growth. Government entitlements keep growing and we expect that the next generation in line will face retirement and medical programs that will likely have become bankrupt. The massive growth in the supply of money in the U.S., Japan, and Europe has not generated the intended economic growth. Instead, it has burdened our central banks with hordes of government debt and other securities. Artificially low, near-zero interest rates have distorted investment decisions and promoted asset inflation. The recent intervention the Chinese government imposed on its stock markets is just the latest example of the heavy-handed tactics that governments (communist, socialist, democratic, or autocratic) impose when things don't perform as they wish. The efficiency and discipline of free markets are being forever compromised.

Because none of this is new, we are astonished by the depth and length of the gold bear market. We can only conclude that the most prominent barometer of the utter complacency towards systemic risk in the markets is the depressed prices of gold and gold equities.

The sub-$1,100 per ounce gold price will likely throw the gold miners into a new realm of austerity. The efforts to lower costs on all fronts we have seen over the past several years continues. We expect further cuts to General and Administrative (G&A) expenses, exploration, and dividends. Capital projects will be stretched out further or postponed. While we had earlier felt that sub-$1,100 per ounce gold prices were a low probability, we nonetheless positioned the portfolio to weather much lower prices. The average all-in mining cost for the companies we track (excluding royalty/streaming companies) is $863 per ounce. The companies in our portfolio operate 103 mines, of which only five have all-in mining costs of over $1,100 per ounce. The companies in our coverage universe operate 191 mines, of which 30 have all-in costs over $1,100 per ounce. If gold prices remain at current levels for long, companies will be forced to curtail unprofitable production.

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Please note that Joe Foster is the Portfolio Manager of an actively managed gold strategy.

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[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] Market Vectors 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] Barron's Gold Mining Index (BMGI) is a weekly data series that spans seven decades from 1939 and is the sole survivor of the Barron's Stock Averages which was published for 50 years (1939 to 1988) for over 20 industrial sectors.