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# Gold Consolidates Amid Late Summer Doldrums

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## Market Review

The late summer period of August into September is shaping up to be a period of consolidation for gold markets. This follows the strong 28.5% year-to-date gain in the gold price as of July 6, which represented a two-year high. Gold equities reached a new three-year high on August 12 having climbed 127.6%, as measured by the NYSE Gold Miners Index<sup>1</sup> (GDMNTR). In late August, however, the gold sector cooled off, and gold prices declined \$42.03 per ounce (3.1%) for the month, while the GDMNTR fell 16.2% and the MVIS™ Global Junior Gold Miners Index<sup>2</sup> (MVGDXJTR) declined 15.9%.

The summer doldrums came late this year for gold and gold stocks. Now that the U.K. Brexit decision is old news, the markets are again obsessed with the Federal Reserve's (the "Fed") shifting stance on rate decisions. Although the Fed's tone had been dovish on rate increases following the August 18 release of the Federal Open Market Committee (FOMC) minutes from its July 27 meeting, sentiment changed markedly just a week later following the Federal Reserve Bank of Kansas City's annual symposium in Jackson Hole on August 26. The selling pressure actually started on August 24 ahead of the Jackson Hole meeting, when unusually heavy selling occurred in the gold futures market. We continue to be amazed (in a negative way) at the inconsistent shifts in the Fed's guidance, its lack of leadership, and the damage this uncertainty must be causing to the economy. A speech by Federal Reserve

Chairwoman Janet Yellen, followed by comments in the press by Vice Chairman Stanley Fischer, convinced the markets that a rate increase is now possible at the next Fed meeting on September 21. As a result, the U.S. dollar strengthened while gold, and especially gold shares, took a tumble.

## Market Outlook

The Fed is now indicating that it might tighten monetary conditions with a rate increase either in September or in December after the upcoming presidential election. This is a questionable policy stance when GDP growth in the most recent quarter was just 1.1%, industry capacity utilization is low at just under 76%, worker productivity is in decline, and the last time the yield curve (2- to 10-year U.S. Treasuries) was this flat was in 2007. The jobless rate at 4.9% indicates near full employment, yet inflation remains subdued. The Fed has probably never tightened rates in past cycles with indicators so weak. In fact, at this point in the business cycle, a more normal stance would be to hold steady, looking ahead to a time when it might cut rates. Because of this, we believe any decision to raise rates in 2016 will ultimately be viewed as a misstep that increases financial and economic risks, and this will be to gold's benefit.

In the meantime, however, the anticipation of a rate increase and any attendant U.S. dollar strength could cause

gold to struggle. David Rosenberg of Gluskin Sheff<sup>3</sup> characterizes this anticipated rate increase as the fourth scare of the cycle. The first was the “taper tantrum” in 2013, next came the end of quantitative easing (QE) in 2014, and then lastly, the actual interest rate increase in December 2015. Each of these episodes lasted no more than a few months with volatility and downward pressure on stocks, bonds, commodities, and emerging markets.

Another aspect of Janet Yellen’s Jackson Hole speech furthered our conviction for strong gold prices in the long term. She describes all of the unconventional monetary policies implemented since the financial crisis (e.g., zero rates, QE, etc.) as components of the Fed’s “toolkit”. Perhaps she is a fan of the 1974 Doobie Brothers classic song “What Were Once Vices are Now Habits”. These once radical monetary tools are now considered conventional, and she plans to use them in the future if deemed necessary. She also suggested the Fed may follow the examples set forth by the European Central Bank, Swiss National Bank, Bank of England, and Bank of Japan by purchasing corporate debt and/or equities as part of stimulus measures. Ms. Yellen virtually guarantees that the policies that we believe are creating asset bubbles, wealth disparities, and other market dislocations will persist indefinitely. If these fail to generate the desired growth, “helicopter money” (printing money to give directly to the Treasury) might be the next experiment. The risks and currency debasement that generally accompany these policies stands to be supportive of the gold price for the foreseeable future.

In the near term, India could lend support to the gold market. Indian gold demand has been very weak this year due mainly to the higher gold price. This suggests there is pent-up demand. A good monsoon season in India leads to a bountiful fall harvest that typically spurs demand ahead of the Diwali Festival in October.

Our June update highlighted a new bull trend in the gold price. The base of that trend is currently around \$1,290 per ounce. If this price level holds through September, it would be a further sign of resilience in the gold market. A lower gold price, while disappointing, would indicate a new trendline with a lower trajectory. In the longer term, we regard the recent Fed machinations as just a bump in the road of a new bull market for gold.

The table below looks at the previous six bull markets since the

U.S. terminated the direct link between the U.S. dollar and gold in 1971. The table shows the bull market of the 1970s as two phases, separated by a mid-cycle correction in 1975. The bull market of the 2000s is also shown as two phases, separated by the 2008 financial crash. The bull markets are further classified as either secular (long-term) or cyclical (bull phases within an overall bear market).

#### Gold Bull Markets: 1971 to 2016

From	To	Gold Price Change	Duration (Months)	Type	BGMI Return
Oct. '71	Dec. '74	358.2%	38	Secular	297.8%
Aug. '76	Sep. '80	574.5%	49	Secular	535.2%
Feb. '85	Nov. '87	63.9%	33	Cyclical	20.3%
Feb. '93	Feb. '96	21.5%	36	Cyclical	52.8%
Mar. '01	Feb. '08	276.2%	83	Secular	464.4%
Oct. '08	Aug. '11	150.3%	34	Secular	145.7%
Dec. '15	Aug. '16	24.9%	8	?	95.1%

Source: Bloomberg, Barron's, VanEck.

Performance is clearly much higher in secular markets. Across these secular markets, the performance of gold and the Barron’s Gold Mining Index<sup>4</sup> (BGMI) are similar except for the 2001 to 2008 market when stocks substantially outperformed gold. We believe the reason stocks performed so well through 2008 is that this was a period of profit margin expansion when cost inflation was subdued for gold miners. In contrast, the '70s was a period of double-digit inflation across the entire economy, while 2008 to 2011 was a period of double-digit inflation that was confined to the mining industry. As a result of these periods of cost inflation, margins failed to keep pace with the gold price and stocks failed to outperform gold.

We believe the current market is similar to the 2001 to 2008 period. Mining costs have subsided and there are relatively no significant inflationary pressures. Other mining sectors — coal, tar sands, copper, iron ore — are depressed. We believe higher gold prices will encourage increased mining activity, but the gold sector alone cannot generate cost pressures without increasing activity in other mining sectors. In fact, we would use copper as a barometer of inflationary pressures in the mining business. With copper currently at \$2.09 per pound, we would not anticipate inflationary pressures until copper trades above \$3.00.

<sup>1</sup>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. <sup>2</sup>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. <sup>3</sup>Gluskin Sheff + Associates Inc., a Canadian independent wealth management firm, manages investment portfolios for high net worth investors, including entrepreneurs, professionals, family trusts, private charitable foundations, and estates. <sup>4</sup>Barron's Gold Mining Index (BGMI) 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.

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