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Global Market Strategy – August 2016

Reasons to buy Gold…. one, two, three, four, five…..

Historic low interest rates may be good for mortgage holders, but they are a huge concern for savers and managers of pension funds.

Pension funds have the actuarial task of building their portfolio to service the needs of pensioners for decades. Hitherto, ten year bonds have been a guiding force to underpin higher risk assets such as property and shares, but with the UK ten year Gilt at 0.79%, the 10 year Treasury at 1.55% and the 10 year Bund at -0.05%…, perhaps it's no wonder that 84% of UK pension funds are in deficit to their funding obligations. (20 year gilts are currently yielding minus 1.4%.)

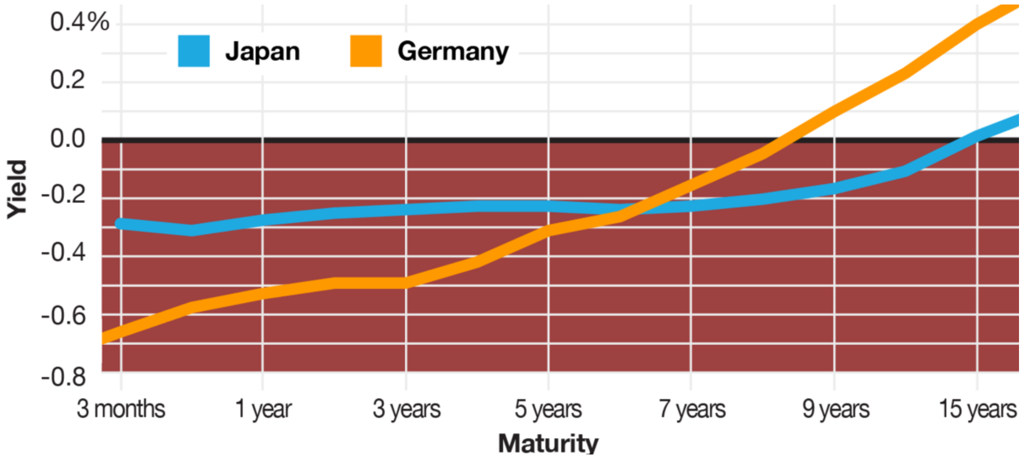
Bond yields have fallen hard in the wake of the Brexit referendum, as uncertainty over the future for both the UK and Europe has driven investors to safe havens such as bonds, despite their miserable yield, and gold and silver, which yield nothing. Brexit has heightened the prospect for a recession in the UK next year. Economists raised their forecast of a recession in the aftermath of the vote from 20% to 40%, as the UK is impacted heavily by the twin factors of weaker sterling (more expensive imports), and weaker investment from overseas while individuals and companies wait for clarity on the extent to which the UK will be accommodative toward external investment.

Headings and sub-headings from the FT last week drummed home concern that Brexit could be having ramifications far beyond those which might have been considered by Leave voters seeking to give smug, scare-mongering politicians and ex-politicians a sharp poke in the eye (it's hard not have a foul taste in the mouth at the sight of Melvyn King, Tony Blair, John Major, Gordon Brown, all of whom campaigned strongly for a Remain vote, collecting massive remuneration from 'advisory roles' with, respectively, Citigroup, JPM, Credit Suisse, Pimco), but the EU ship was heavily taking on water long before the Brexit vote, and it may be seen in the future that the UK's vote to leave was in some ways inevitable and the harbinger for a complete overhaul of the EU for the betterment of all. Perhaps among the saddest immediate consequences of the Brexit vote, is the sentiment expressed by 30% of 1014 international students polled by Hobsons career advisory service, that they are now disinclined to seek a university place in the UK. 6% said they would definitely not study in the UK as they sensed extreme racism and xenophobia.

Whether Brexit is the cause or simply an excuse, company results for the last quarter, coupled with deteriorating economic indicators, point to a general slowdown in UK economic growth. The same is true of the US. Both countries could be entering a period of stagflation (when inflation increases without any underlying economic growth). Inflation will likely increase in the near future, especially through the Winter months as appreciation in the price of oil and some other commodities over recent months, begin to bite the consumer. Such has been the slowdown in the US of late (annualised growth to the end of the second quarter came in at just 1.2% rather than than the 2.5% predicted by Wall Street economists), that the likelihood of a US interest rate hike this year is almost nil, and there may not be one either in 2017. The dollar has been on a tear since mid-2014, and the chart, below, suggests a topping pattern before a break to the downside. If the Fed is not going to hike rates for 18 months, the fundamentals and the charts tell the same story, and we could be in for a period of sustained dollar weakness.

US dollar index chart, October 31st 2011 to July31st 2016 (Source, BarChart.com)

Similarly, financial markets now expect no rise in UK interest rates until 2020, and having run out of monetary stimulus capacity, bar the remaining 0.5% left to the BOE, 'helicopter money' is now serious conversation. Rates could go negative but Japan, Denmark, Sweden and Switzerland have all been proving that negative rates do little other than heighten prospects for deflation (which as Japan has proved for 30 years is worse than inflation) and Mark Carney will surely not want to make imports more expensive by further currency devaluation.



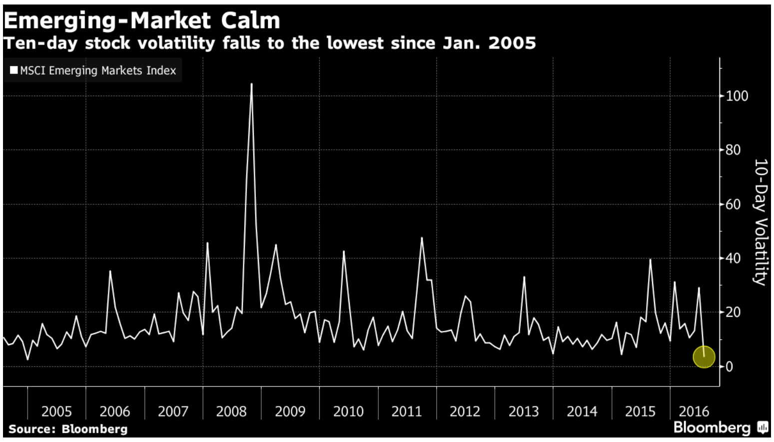
Bonds in Japan and Germany are in negative territory so investors will suffer a loss if they are held to maturity (Source: Bloomberg)

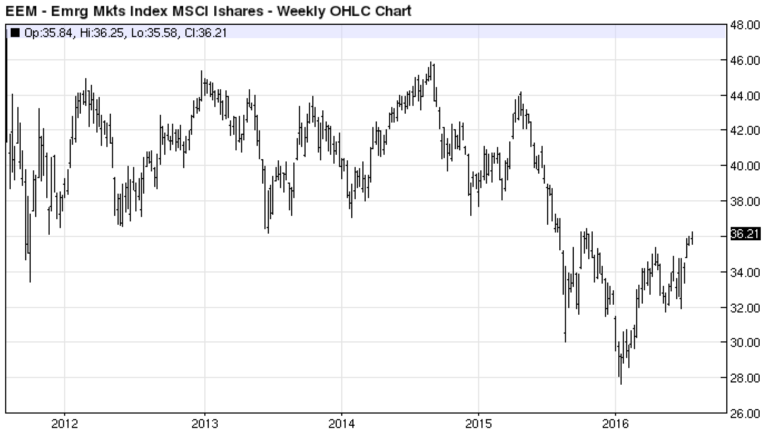
With the threat of stagflation, inflation, deflation, low bond yields and nil return on cash, where should investors put their hard-earned capital? Both gold and silver metals' prices have eased slightly in the last ten days, as have prices for gold and silver mining companies, but the pullback should be temporary. Aside from the economic arguments, BlackRock, who run the first quartile Gold and General fund, believe that precious metals' prices will be supported at current levels simply on the back of stronger production results and better than expected control over their costs. One note of caution: if there is a shock-event which sends equities sharply lower, investors may look to tap profits made in gold and silver over recent months to either boost at lower prices positions in traditional equities, or in order to show a profit from somewhere if they decide to move to cash. Failing that, gold and silver could be poised to move significantly higher over the next year or so.

Gold ETF holdings have held steady for the last two weeks at around 64.4 million ounces and could potentially tread water during the traditionally quieter summer months, but the one thing gold has now over government bonds is nil opportunity cost (for those in negative territory). Longer term, Asian retail demand, investor appetite for a hedge against systematic financial risk and inflation/deflation driven by global monetary easing should provide support for the gold price. On the supply side, plateauing mine production given limited gold discoveries and a collapse in investment in new mines, should also prove constructive.

Gold… Back on the upswing? (Source: kitco.com)

What else to look out for? If the investment cycle is indeed moving from growth to value investing, how do things look for emerging markets? With a weakening dollar not only is gold attractive but EM is too. Developed market indices could keep grinding higher for many months but they probably have limited upside now, and since it usually pays to be ahead of the curve than behind it, investors should consider moving back into the EM sector. Chinese stocks in Hong Kong have rallied recently after a private manufacturing index unexpectedly rose to the highest since February 2015, and as Gao Qi, foreign-exchange strategist at Scotiabank in Singapore said last week, "Emerging-market assets are responding positively to fading odds of Fed-rate hikes".





Favoured investment plays:

Nil risk: USD cash (in preference to Euro cash)
Cautious risk: AAA Corporate / Government bonds (short duration)
Balanced risk: Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk: UK**,** European equity
Adventurous risk: **Japan, Asia,** US equity, UK/European/US smaller company sector
Speculative risk: Timber, Water, Technology, **China, India, Other EM**, **Gold and gold miners, Silver, Cocoa, Orange Juice, Sugar, Coffee**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 10%, US smaller cos 2%, (Other) US equity 8%, UK smaller cos 10%, (Other) UK equity 4%, Iberia 1%, European Telecoms 1%, (Other) European equity 7%, India 1%, Japan 10%, China 5%, (Other) Asia 14%, Energy 3%, Pharmaceuticals 8%, Long-Short Hedge 5%, Gold miners 11%

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