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Why gold is shining again

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- Though the performance of gold over the past two years has been dull in absolute terms, it has been remarkable in the context of a strong dollar and rising interest rates.
- Aside from the surge in inflation, a substantial increase in demand from central banks has likely helped fuel this solid performance.
- In the medium term, central bank demand, greater geopolitical uncertainty, a weakening economy, and the trajectory of US government debt should all continue to support the precious metal.
- We continue to believe in gold as an essential portfolio diversifier and tail risk hedge, offering low correlation to bond and equity markets while protecting wealth against inflation for the long haul.

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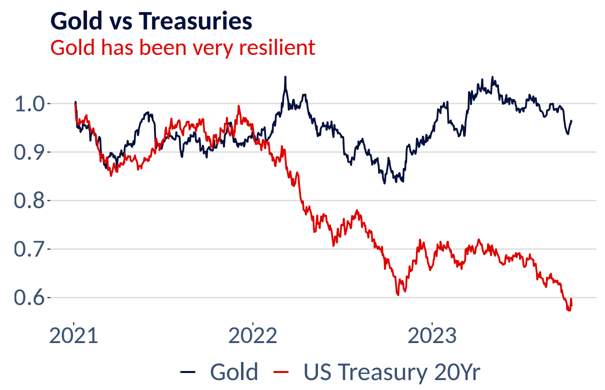
One of the world's oldest asset classes demonstrated its worth again in 2022 and 2023, protecting portfolios when pretty much all other investments tanked. Gold's solid performance thereby defied a strong USD and rising interest rates, usually considered headwinds. Our article explores some of the tailwinds recently enjoyed by the precious metal and explains why we expect its outlook to remain favourable.

1 A macro environment not (yet) fully supportive

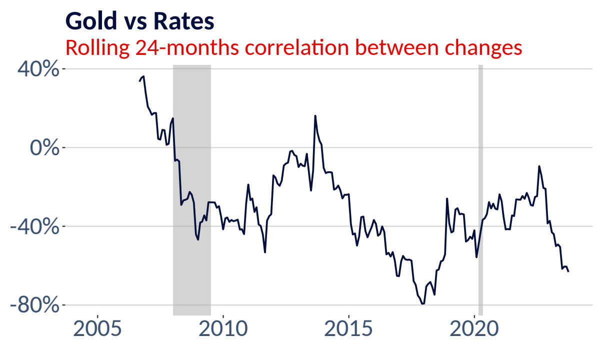
Gold is a complicated animal since, unlike financial instruments, it can't be valued by discounting a more or less likely future cash flow, and unlike oil or uranium, it is of little day to day use. So, apart from the minimal demand for industrial purposes, its high price is primarily based on its rarity, coupled with a lustrous appearance, which people have appreciated for millennia. Despite all the prophecies of doom and wild up-and downswings, gold's capacity to conserve and protect wealth has essentially remained unchanged over centuries. Moreover, it is cheap to store.

Financial markets' trajectory over the past months has reemphasized these attractive features, and we, therefore, think that it is an excellent time to revisit the case for gold as an effective portfolio diversifier and have a closer look its near-term prospects.

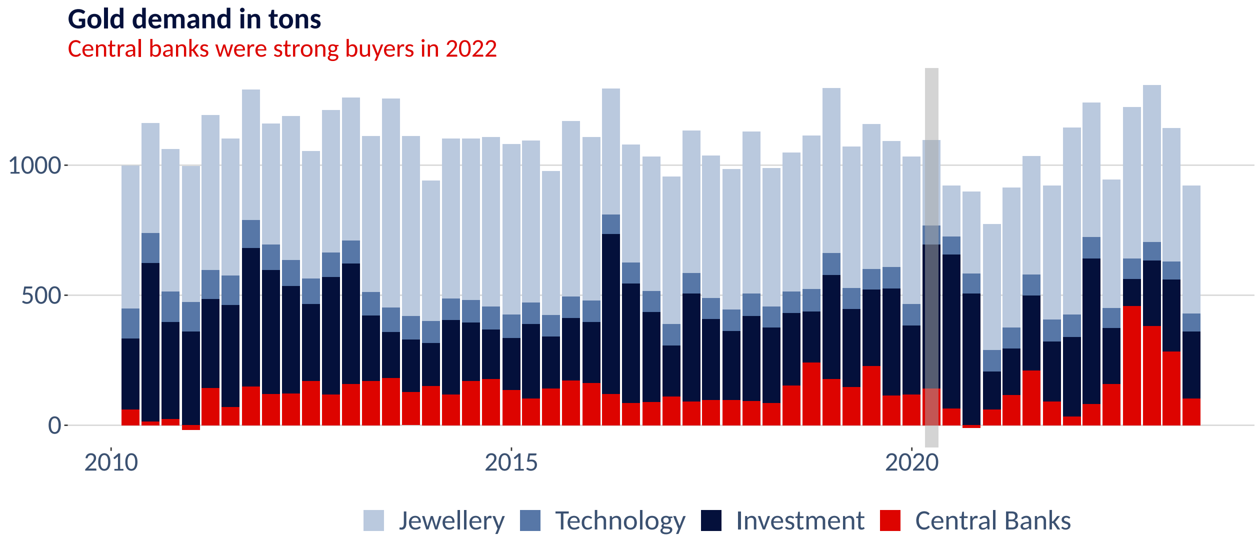
As indicated, the fundamental drivers of gold tend to be tough to quantify. Nevertheless, we find that between 2004 and 2023, a simple regression model using changes in US interest rates and the DXY Index as input variables explained roughly 28% of monthly price variations (see Table 1.2 on page 4). Interestingly, adding other variables commonly observed in



Source: *Source: Bloomberg, Amadeus Capital*
Figure 1: *Owning some gold has served investors well during a terrible time for bonds.*



Source: *Source: Bloomberg, Amadeus Capital*
Figure 2: *The negative correlation between gold and rates is intact and could eventually provide a tailwind.*



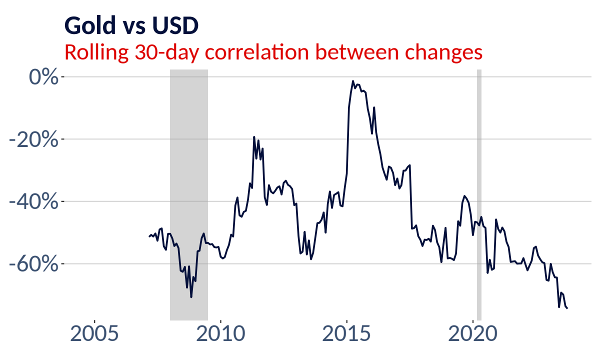
Source: *World Gold Council, Amadeus Capital SA*
Figure 3: *A rebound in jewellery demand and strong net buying by central banks likely stabilized prices in the rising rate environment.*

this context, such as inflation, inflation expectations or the level of financial market stress as indicated by the VIX, does not increase the explanatory power of the model.
Undoubtedly, there is an intuitive economic rationale behind the high correlation between gold, rates and the USD. The fact that the precious metal yields no carry becomes a disadvantage when the opportunity cost of forgoing interest income is high. Furthermore, gold is typically quoted in USD, while considerable (jewellery) demand stems from Chinese and Indian households.

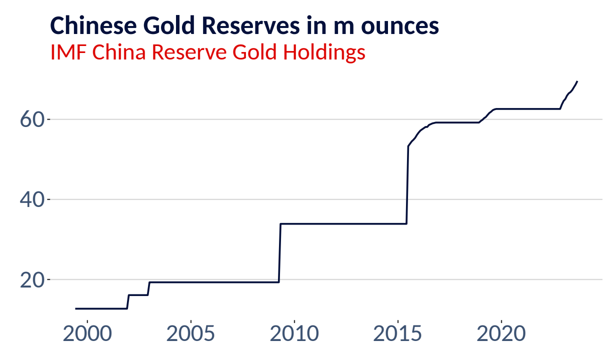
Consequently, the headline price watched most closely by market participants tends to come under pressure when the USD appreciates. This being said, gold has fared well over the last three years in an environment of surging real rates and USD appreciation. As illustrated in Figure 1, the gold price moved sideways while bond markets experienced a bloodbath not seen in decades (+61.0% vs -18.4% over the past five years). Gold was also almost flat in 2022 (-0.3%), whereas the trade-weighted Dollar index rose by 8.2% and it returned 8.4% against a 2.6% rise in the Dollar in 2023 (all figures as of October 20th, 2023).

Notwithstanding this, as can be seen from Figure 2 and Figure 4, the inherently negative relationship between the metal and interest rates has remained intact, and the same is true for the correlation with the USD, which remains very negative month-on-month.

So why did gold fare so well in this seemingly hostile environment, and will it continue to shine?
In our opinion, there are three arguments for a continued positive development.



Source: *Source: Bloomberg, Amadeus Capital*
Figure 4: *It is no surprise that the gold price in USD tends to be negatively correlated to the currency's relative strength. Recently, this correlation fell to a particularly low level though.*



Source: *Source: Bloomberg, Amadeus Capital*
Figure 5: *China has regularly increased its gold reserves. Currently, it looks like its stepping them up again and according to a recent survey, other central banks are casting an eye on the metal as well.*

1.1 Have central banks become buyers of last resort?

Of course, one factor that presumably benefited gold over the past two years is inflation. While the relationship between the development of consumer prices and the performance of the precious metal is all but stable, there is no doubt that in the long run, gold has served as a formidable inflation hedge, and as Figure 6 outlines, it also did pretty well during the inflationary periods of the 70s and 80s.

In addition, however, 2022 brought a notable increase in demand from central banks at precisely the time when jewellery sales recovered from the Covid-induced slump. Central banks became net buyers of gold in 2010 following the Great Financial Crisis, but, as Figure 3 shows, their buying activity really surged in 2022. An increase in holdings by EM countries primarily drove this step-up, and it remained robust in 2023, particularly if adjusted for the divestments triggered by Turkey's pivot to a more conventional monetary policy [9]. Consequently, as the World Gold Council notes, demand for gold from central banks has been the strongest since the previous record in 2000. More importantly, according to a recent survey, 24% of central banks plan to further increase their reserves [2].

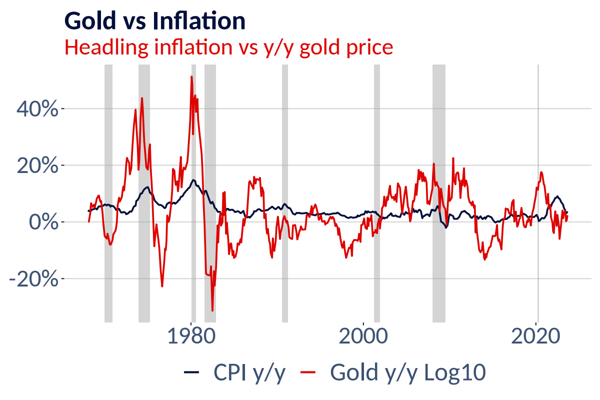
When comparing central banks' gold holdings, there are stark differences between countries. A souvenir from Bretton Woods, they represent 68.9% of total central bank reserves in the United States and 68.2% in Germany compared to meagre amounts in China (3.9%), Japan (4.3%), India (8.5%) or Singapore (4.3%). It is thus not surprising that recent demand primarily stemmed from Emerging Market central banks with relatively low existing gold holdings. Furthermore, these purchases are coinciding with a generally more negative view of the USD in the wake of repeated debt ceiling dramas in Washington, the weaponisation of the currency during the Russian invasion of Ukraine, and the financial sanctions against China (related to the Russian invasion of Ukraine and against the technology sector) and against Turkey (already in 2021 and again in September 2023 against companies that helped Russia circumvent the sanctions). In other words, as many Emerging Market central banks take a more critical and suspicious stance towards the US-dominated Western financial system, gold reserves have in part emerged as an increasingly appealing alternative to Treasuries. Demand from central banks is, therefore, likely to stay.

1.2 The FED may still break the economy.

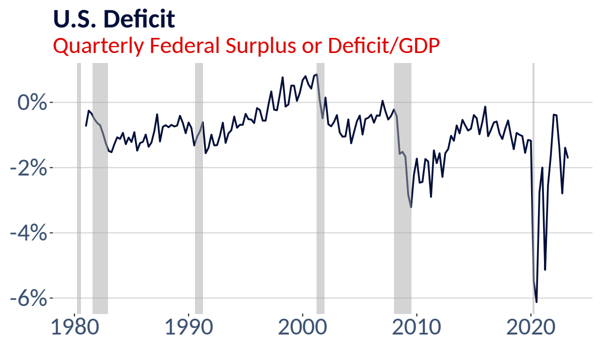
As outlined above, setting aside the return of meaningful inflation, gold faced a somewhat hostile environment in 2022 and 2023 since the resilience of the US economy in 2023 triggered a strong USD rally and delayed the widely anticipated Fed pivot.

> It's sort of standard thinking that monetary policy affects economic activity with long and variable lags. (Jerome Powell, 2022)

As a result, a "higher for longer" scenario became more likely and caused key interest rates to rise. On the other hand, it is precisely this factor that may benefit gold again in the medium term. Monetary policy usually affects the real economy but with substantial and time-varying lags [3], or to use the words of Janet Yellen and Ben Bernanke: "Expansions don't just die of old age ... they get murdered" [5]. Most market observers who regularly follow the FED's communication will probably agree that it is trying pretty hard to murder the current expansion. As S&P Global pointed out, U.S. corporations are facing a massive surge of debt maturities, in an environment characterised by a "combination of tighter financial conditions from elevated debt costs, decelerating economy and ... already tightened lending standards" [1]. In other words, higher interest rates have certainly amplified the economy's vulnerability. This does not mean that the long-awaited recession will finally happen or be severe, but it makes tail-risk events much more likely.



Source: *Source: Bloomberg, Amadeus Capital*
Figure 6: *In the very long run, inflation has explained 17% of gold's monthly variance and clearly supported it during the 70s and 80s.*



Source: *Source: FRED, Amadeus*
Figure 7: *US fiscal spending has normalised somewhat after the excessive Covid-related stimulus, but the deficit will remain high.*

	Dependent variable:
	$\Delta GoldPrice$
Intercept	0.009^{***} (0.004, 0.013)
$\Delta DXYCurncy$	-0.965^{***} (-1.167, -0.763)
$\Delta USGG10YRIndex$	-5.115^{***} (-6.932, -3.299)
Observations	229
R^2	0.289
Adjusted R^2	0.282
Note:	$^{*}p<0.1$; $^{**}p<0.05$; $^{***}p<0.01$

Table 1: *Interest rates (in our example defined as the yield on 10-year Treasuries) and the trade-weighted USD (DXY Index) have been shown to best explain the performance of this asset, which is otherwise difficult to pigeonhole. While inflation drives the gold price significantly in the long run, its short- to medium-term impact has often been limited.*

1.3 US debt trajectory calls for lasting financial repression.

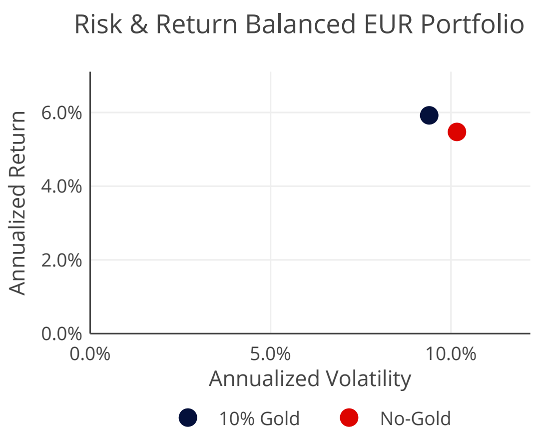
A slowing economy and falling inflation rates usually make a strong case for long-duration safe-haven bonds. However, the current economic cycle has been accompanied and probably fueled by massive fiscal expansions in most parts of the Western world, particularly the US. The Congressional Budget Office (CBO) now expects an annual budget deficit of 6.1% between 2023-2033, and Bloomberg economists are even more pessimistic, proposing a 7% deficit until 2033 [6]. Unlike the one-off spending during the COVID-19 pandemic, future deficits are expected to be rather structural. At 18% of GDP, health care costs in the US are already higher than in other countries, and with an ageing population and more people eligible for Medicare and Medicaid, the size of these programmes as a percentage of GDP has increased sharply over the years in spite of recent positive surprises [8].

The energy transition is likely to exacerbate the mounting financial burden on the state. As Goldman Sachs wrote, spending on the Inflation Reduction Act, an extensive investment initiative to fight the climate crisis, and the bipartisan Infrastructure Law centred around clean energy should amount to USD 1.2 trillion by 2032 [7].

Since the FED is free to print as much money as required, servicing the growing debt pile is, by definition, doable for the US. However, to maintain a sustainable debt trajectory and avoid an erosion of trust in the financial system, real interest rates must eventually stay low, probably through a mix of Quantitative Easing and tolerance of higher inflation (Japanification).

2 A rather favorably skewed outlook

We have always advocated gold as a robust portfolio diversifier within an efficient strategic asset allocation. Over the past years, it has lived up to its promises, exhibiting a low correlation to equity, bond and real estate markets. As demonstrated, the precious metal's relatively solid performance thereby occurred despite a strong USD and rising interest rates. While a swell in inflation may have helped it in 2022 and 2023, its correlation with consumer price pressure has historically been unstable. Simultaneously, driven by geopolitical tensions and economic uncertainty, several Emerging Market central banks have increased their gold reserves and, according to surveyed officers, intend to continue doing so [4]. This additional source of demand should support the precious metal's price in the near-term even if inflation rates normalise further. At the same time, lower interest rates, a weaker USD and continued financial repression in the US are all potential catalysts for a secular bull market.



Source: *Source: Bloomberg, Amadeus*
Figure 8: *Between 2000 and 2023, a 10% gold quote increased the Sharpe Ratio of a Balanced EUR portfolio by 0.1, enhancing returns while reducing volatility.*

Holding bullion may look foolishly outdated to the crypto crowd of 2021, but investors assumably find it harder to resist a millennia-old track record in uncertain times.

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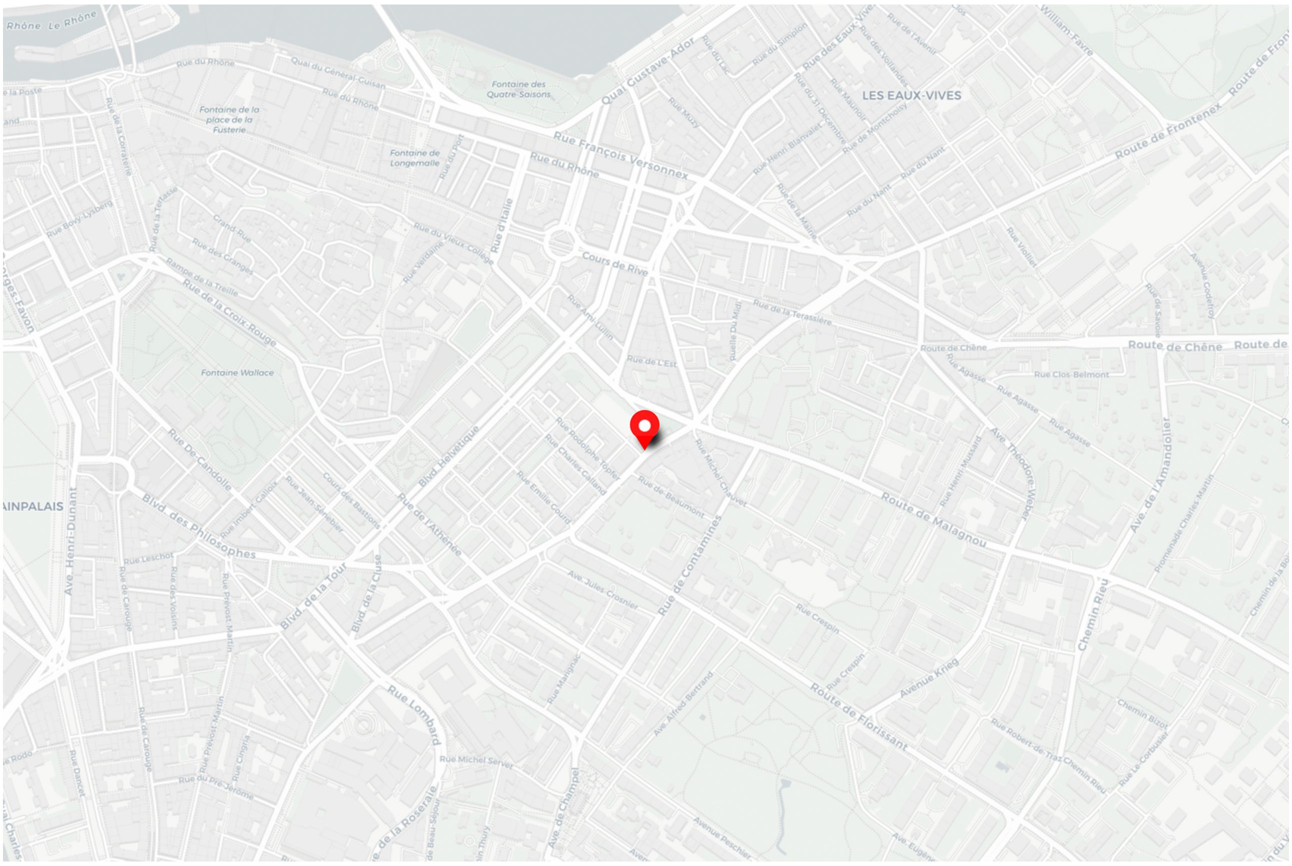

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