Gold remains a safe asset against global chaos

Investment Officer, 20th September 2022 – Jurgen Vluijmans

Gold started the year outperforming both equity and bond markets with a positive 5% return (in USD and 18% in EUR), but since its $2,000 peak in March 2022, gold has lost its shine. "As long as US real interest rates are rising, I remain tactically underweight in gold."

So says Jan Longeval, independent consultant, senior advisor at Eurinvest Partners and author of "Heavy Metal", a book about precious metals and monetary policy, in an interview with Investment Officer Belgium. M. Longeval cites positive real interest rates in the US as one of the main reasons for the correction in the yellow metal. Over the past 150 years, the correlation between the gold price and real interest rates in the US has been -0.82. So there is a strong inverse relationship between gold price and real interest rates in the US.

Against the backdrop of a poor to awful year for financial assets such as equities, bonds and real estate, M. Longeval highlights a key point in favor of gold: the absence of any counterparty risk. Gold cannot go bankrupt and is therefore considered a safe haven, just like US government securities. Since the US is not only an economically and militarily powerful country, but also a monetarily sovereign country, whose debt is only denominated in US dollars, it cannot go bankrupt either, unless it decides so.

A monetarily sovereign country can create as much money as it wants through its central bank and does not need to raise taxes or go into debt first. This magical power is called "The Power of the Purse". Countries that have given up their monetary sovereignty, like all the countries in the Eurozone, have therefore also given up their sovereignty in terms of monetary policy. They no longer have their own currency and therefore cannot create money at will. They are completely dependent monetarily on the European Central Bank, which has more limited monetary leeway than the Fed.

Gold, which has been pinned down for five weeks in response to stubbornly high US inflation – which is driving up US dollar and government bond yields – fell below support which has now turned into a resistance at $1680. The market was overwhelmed by momentum and technical selling linked to the risk of a 1% rise in US interest rates next week. In addition, the market has continued to raise its expectations for a Fed funds rate hike in the coming months.

Ole Hansen, head of commodity strategy at Saxo Bank, said in a research paper that the case for holding gold in the event of policy failure has only strengthened with recent developments. The risk of the FOMC plunging the US economy into recession before bringing inflation under control is increasing and, once this happens, the dollar is likely to fall sharply, supporting renewed demand for precious metals. Before then, however, gold could continue to suffer from a weakening technical outlook. With a weekly close below $1,680, the market could aim for the 50% retracement of the 2018-2020 rally to $1,618.''

At its lowest in nearly 2 and 1/2 years, gold is struggling to shield itself from the FOMC's hawkish tone, and like other bullion metals, such as silver and to a lesser extent platinum, it could continue to suffer until some bullish drivers reassert themselves. The focus remains on interest rate hikes by the FOMC rather than the increasingly inevitable economic consequences - a risk highlighted this week by the plunge of FedEx stock price and the sharp decline in shipping costs worldwide. In our view, recent CPI (consumer price index) prints may indicate difficulties in bringing US inflation below 5-6%. If the market comes to the same conclusion, we are likely to see a sharp upward - and gold-friendly - correction, with forward inflation swaps still forecasting a decline to around 3%.

Dollars

The US Treasury can therefore print dollars at any time to pay off its outstanding debts. In other words, the US government can only go bankrupt if it decides to. The US long-term real interest rate bottomed out in August 2021 at -1.19%. It coincides perfectly with the peak of the gold price at the time, around $2,000 per troy ounce.

In the meantime, the financial landscape has changed dramatically: Russia has invaded Ukraine, US real interest rates have continued to rise and are now comfortably above the 1% mark. The dollar has risen

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13% against the euro since the beginning of the year, which is also a headwind for gold price, at least in dollar terms.

Not negative

Jan Longeval recommends his clients to moderately and tactically go underweight in gold.

After all, gold is and remains an insurance policy against chaos and, as we have said before, in its physical form it presents no counterparty risk.

"With the risk of recession increasing daily, Putin becoming a cornered cat capable of making sudden leaps, and the threat of an arm-wrestling match in Taiwan, the risk of chaos and military unrest increases. The past has shown that war and economic recession make gold perform well," says M. Longeval.

Philippe Gijsels, chief strategist at BNP Paribas Fortis, also said in a recent interview that he remains a "gold miner" and continues to believe in the benefits of gold in the long term, but that the yellow metal could lose its luster in the short term.

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