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Investing for a world of change

What the gold price is telling us

Gold has defied rising bond yields to trade in a range rarely seen before. Geopolitical risk has been the immediate cause. But is the gold price just reflecting safe-haven demand, or is it telling us something new? We explore why the precious metal may be able to sustain higher price levels.

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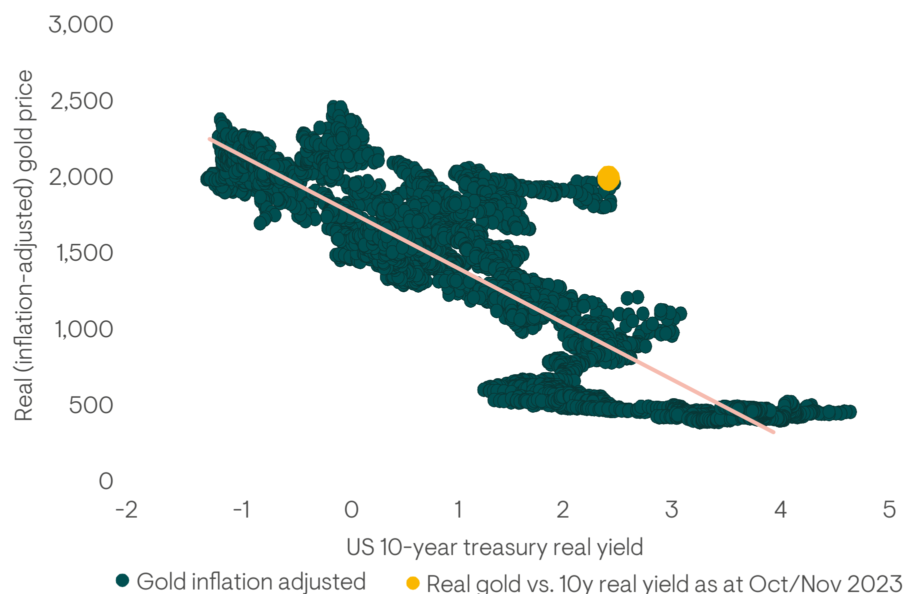
The gold price has rebounded 10% since early October to about US$2,000 per Troy ounce (oz)[1], back to levels last seen in May this year. The outbreak of the conflict in the Middle East has been the immediate driver of demand for gold as a perceived safe haven. Gold rising in response to increased geopolitical risk is to be expected. But the precious metal is now trading at an extreme versus the US 10-year Treasury real yield, as Figure 1 shows. That, by definition, is not normal.

Figure 1: Real gold price (US$ per Troy ounce) vs. 10yr US Treasury real yield (%)



Source: Bloomberg.

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1. As at 22 November 2023.

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Were there to be a resolution of the situation in the Middle East, or at least an easing of the perceived risks, we might expect the gold price to fall back to the low 'US$1,800s' per oz, where it was before the outbreak of the conflict. Perhaps a somewhat higher level would be anticipated for a time if market anxiety persists. Yet that would still leave gold trading at an elevated level relative to US real yields, particularly given the continued strength of the US dollar. Are other factors driving gold, besides the 'war premium'?

In recent speeches, US Federal Reserve officials have acknowledged that rising bond yields may mean further interest-rate rises are not necessary. One might argue that today's gold price is anticipating real yields falling back over the next year, justifying its current level. But there are reasons to think gold may sustain a different course in the coming years than it has historically:

1. Geopolitical risk is higher generally. In addition to Hamas' attack on Israel, the Russian invasion of Ukraine, tensions in the South China Sea around Taiwan and other factors have increased the sense of uncertainty globally.

2. The US sanctions on Russia have highlighted the risk of holding US dollars and US Treasuries. With many countries looking to diversify their holdings, gold is appealing as it is very liquid, US dollar-denominated, and easily transportable and stored. This is one of the reasons central-bank buying hit a record high in 2022 and continues to be strong in 2023.

3. The speed that yields have risen has unnerved many investors, and the deterioration of the US's fiscal deficit, at a time when growth is likely to be slowed by higher interest rates, continues to rattle markets. With Europe's economy in the doldrums and China's property market struggling to recover, investors are, correctly, very wary going into 2024.

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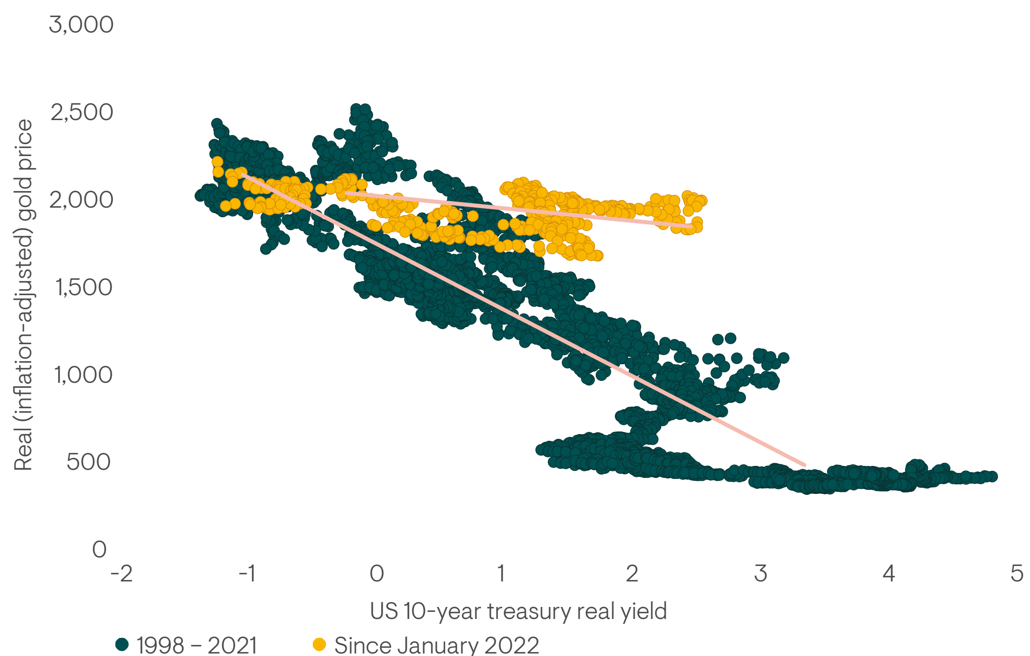
Evidence that we have entered a new cycle for gold can be found in Figure 2, which shows the real gold price relative to US 10-year real Treasury yields in different time periods. The best-fit line of the 1998-2021 period has become notably shallower since Russia's invasion of Ukraine, indicating that changes in real yields have less impact on the gold price than they used to.

With geopolitical risks likely to remain elevated and no end in sight to the desire to diversify away from US dollar reserves, gold may have entered a new normal. For the next few years at least, it seems likely that the price of the precious metal will continue to be less influenced by decisions at the US Federal Reserve and will remain supported at a higher level than previously. It is always risky to claim 'this time it is different'. But commodities have a habit of making step changes, and gold appears to have done that since COVID.

Figure 2: Real gold price (US$/oz) vs US 10yr real yields (%)



Source: Bloomberg.

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Gold equities should benefit if prices hold current levels

What of the companies that produce gold? If we are correct about gold's new normal, the outlook for them looks positive. A higher, and possibly less volatile, gold price would be beneficial for gold companies, especially as they begin to work through the impacts of the rapid cost increases of the past two years. Also, the strong US dollar has meant gold prices in many other currencies are at all-time highs. Effectively, this will help companies with large non-US dollar costs, of which labour is usually the largest component.

A higher and more stable gold price would also likely encourage more merger-and-acquisition activity. In any case, the completion of Newmont's purchase of Newcrest Mining is likely to lead to asset sales as the combined portfolio is optimised, which could act as a catalyst for further deals.

After negative returns for the equities of gold producers (as represented by the NYSE ARCA Gold Miners Index) in 2021 and 2022, following strong returns in 2019 and 2020, and the prospect of a fairly flat year in 2023, we believe that the conditions are aligning for a strong 2024. Gold equities (the shares of gold producers) have leverage to gold prices – they tend to move in the same direction, but with amplified moves – and thus have typically outperformed the physical metal in a rising or stable gold market.

In summary, we think Q3 2022 marked the start of a new cycle for gold and that this uptrend could last another 2-4 years, if previous cycles are a guide. Our preferred approach is to look for companies that can generate good cashflows and that have some organic growth options in their portfolios.

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