GOLD: 24 Carat or Same Old Shtick?

The precious metal has had a bear run since September 2011, falling at an annualized rate of -13.5%. At the July 2015 trough its value was only 57% of the peak. So what are the prospects for the yellow metal and how best to use it in the portfolio?

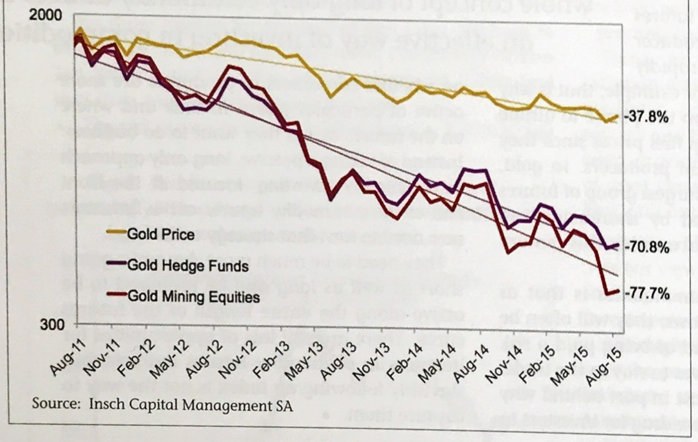
By Insch Capital Management

INVESTORS IN GOLD were badly hurt when, after range-trading for two years, gold took a plunge in the second half of July 2015. Gold fell precipitously on 17th July when the PBOC announcement of a mere 604 tonnes increase in gold reserves since 2009 disappointed markets.

The price nose-dived on 20th July, during Asian trading hours, when 57 tons were off-loaded at a time of least market liquidity.

Gold ended July with a monthly loss of -6.5%, at \$1,095.82/oz, a monthly low not seen since January 2010. The July results of gold mining companies and long-focus gold funds were nearly catastrophic: the NYSE Arca Gold Miners Index lost -22.5% and hedge funds that had long gold equity exposure lost on average -17%, following previous 2-year losses of -13%.

Figure 1: Gold Indices



Source: Insch Capital Management SA

Gold recovered to \$1,160.95/oz on 21 August, this time hurting short-sellers, after China's decision to devalue the currency led to falling prices of industrial commodities and Fed rates being put on hold.

The precious metal has had a bear run since September 2011, falling at an annualised rate of -13.5%. At the July trough its value was only 57% of the peak value of \$1,895/oz. The July drop was, however, not the deepest during the last 15 years.

Meanwhile, the global economy was passing a phase of particularly low volatility and investor complacency, with an occasional scare such as the US fiscal cliff or the sovereign credit risk in Greece.

A severe downturn in risk markets hasn't happened yet, since the financial crisis. Although it is true that the equity rally started to unfold in the last days of August – a long-expected correction with the equity bubble bursting in China.

Economic data – GDP, consumption and labour markets – have improved over the summer, both in Eurozone and US. However, stock markets – a leading indicator – have already priced in the economic recovery.

Gold Supply & Demand

According to The World Gold Council, demand for gold in Q2 2015 dropped to a six-year low of 914.9 tonnes. The fall was mainly due to consumer demand in India and China where negative consumer sentiment knocked demand for jewellery.

However, the Greek crisis boosted European investors' demand for gold during Q2. Investment demand by German investors has also increased.

Gold holdings through ETFs have fallen to 2009 values, driven by inflows into equities. There is no saying whether the tendency is towards a future rise or a future fall.

Central banks' net demand for gold has continued to be positive in the first half of 2015, especially by Russia, which purchased 67 tonnes.

Gold to S&P 500 Index Ratio

As Figure 2 shows, at the beginning of the 1980s, one ounce of gold was valued at more than three times the S&P 500 Index. Nowadays, one ounce of gold can buy less than 0.6 units of the S&P 500 Index.

This is a low compared to the 1980s, but also to the value of August 2011, when an ounce of gold could buy 1.5 units of the same index. Gold has fallen by more than 60% relative to the S&P 500 Index since August 2011.

At the current level, gold appears cheap compared to US equities. A long-term investor with a tactical view may well consider investing in gold rather than in equities.

Going Forward: Point & Counterpoint

There are reflationary signs in developed economies.

The Fed has been expected to raise interest rates for some time now. In our view, a rise in interest rates is not on the cards before the end of the year. The total US government public debt currently stands above $19.6 trillion. A 25bp uniform rise in interest rates would increase interest expense by approximately $50 billion per annum. The US debt ceiling is already a big problem to be tackled this fall when a spending bill needs to be passed by lawmakers in order to avoid the risk of a government shutdown.

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ECB total assets are not at a high but they are growing. There are also substantial off-balance sheet items, such as the sovereign debt fund, which accounts for €1 trillion. At the same time, Swiss National Bank balance sheet is about six times larger than a decade ago.

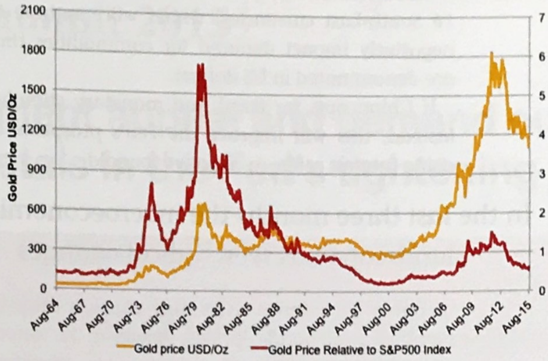
Monetary aggregates have risen rapidly – a bullish factor for those that see gold as a viable alternative to paper money.

- Eurozone M1 "narrow" money has grown at a rate of 14% over the last 12 months, while M2 and M3 money have grown at an annualized rate of 6.6%.
- US M1 growth has been 9.1% in the last 12 months. Job creation in 2014 was the highest since 1999 and the pace carried forward into 2015, accompanied by speedy growth rates in hourly earnings.
- According to the *Financial Times*, total debt in the developed world has risen by 30% since the Lehman crisis, to a record 275% of GDP, and in emerging markets by 35% to a record 180%.

According to some analysts, the price of gold looks severely undervalued relative to US debt and should currently be somewhere around $1,800 per ounce.

Alasdair Macleod, Head of Research at GoldMoney, sees reverting to the gold standard as

Figure 2: Gold Price & Gold/S&P Index Ratio

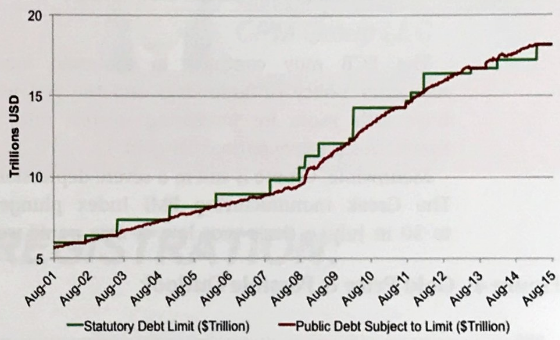


Data Source: Bloomberg

a possible solution to world's fiat money problem. He contends that we live in a potentially unstable economy, where each crisis is greater in magnitude than the previous one. The money problem extends beyond government currency, through the tremendous expansion of bank credit. All sectors, households, corporates and governments are exposed to debt default.

Ross Norman, CEO at physical gold broker Sharps Pixley, holds that gold is the sum of all fears but not related to inflationary expectations. Gold was hit by a bear raid in July and the price already incorporates all the bad news such as rising US

Figure 3: US Public Debt Subject to Debt Limit



Data Source: Bloomberg

interest rates. Gold has recently enjoyed a short covering rally, a buy signal. Besides, he points out, gold has only underperformed in USD terms; in other currencies it has performed quite well.

Emerging Markets Growth Slowing

China is in the deepest economic slowdown since the 1990s. The Shanghai Composite Index fell by 14.3% in July followed by 12.5% in August. A slump in China equities has a negative impact on consumer demand of gold, but supports gold demand for investment purposes.

What if China starts a currency war? The devaluation of the yuan has affected all other 16 South-East currencies, which will continue to negatively impact demand for commodities that are denominated in US dollars.

If China opts for fiscal and monetary stimulus instead, this will improve the Fed's prospects of rising interest rates – a negative for gold.

In the last three months the macroeconomic landscape has seen radical changes ...

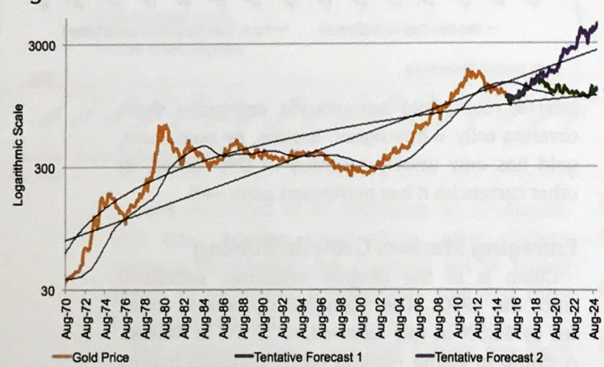
Higher US interest rates may cause a drop in equities' and bonds' prices; however, historical data do not indicate the presence of a negative correlation between the gold price and equity or bond indices. (We can't tell whether a bear market in bonds and equities is beneficial for gold prices or not.)

Various Market Events	Possible Effect on Gold Price	Reason
Bull Market	Up/Down	Up because commodities rally or down because other assets are more yielding
Bear Market	Up/Down	Up as safe heaven/alternative to high-yield assets or down as an industrial commodity
Interest Rates Rise	Down	Cost of carry increase
Interest Rates Fall	Up	Cost of carry decrease
Inflation	Up	Preserve purchasing power
Deflation	Down	Cheaper to buy in future

The ECB may continue to maintain loose monetary policy (inflationary) and the Fed will have little room for increasing interest rates – therefore a positive outlook for gold.

Meanwhile, Greece is still in a severe depression. The Greek manufacturing PMI Index plunged to 30 in July, a three-year low. A new panic was triggered in markets in August by the resignation of Alexis Tsipras, casting doubts on future bailouts for Greece.

Figure 4: Gold Price & Possible Outlook



Data Source: Bloomberg

In the last three months the macroeconomic landscape has seen radical changes, with substantial shifts in prices and a good deal of volatility.

Picture Two *Extreme But Possible* Scenarios

A. US runs into renewed fiscal cliff worries. Greece defaults and investors abandon trust in bonds, equities and the EUR. Asian growth suffers a hard landing. Precious metals become the most requested safe haven. The price of gold makes a spectacular recovery.

B. The FED raises interest rates while the developed world economy keeps recovering. USD appreciates considerably. Gold is driven lower and lower.

Gold's reaction to macroeconomic news has verged on schizophrenia in the last few years. On occasions, gold has behaved either as an industrial commodity or as a safe haven.

In the last four years, the fall in gold matched falls of similar magnitudes in commodities, except for two short-lived occasions, in January and August 2015, when it acted as a safe haven as panic gripped equity markets.

If China's economy implodes or if there is a severe reversal in developed market securities, will gold act as a safe haven, or as a commodity? Will it be dragged down by the fall in industrial commodities, or will it be supported by the lack of other viable investment opportunities?

We do not even attempt to answer.

What Exposure to Seek Going Forward?

The gold volatility index is now approaching a 5-year low. If the past repeats, volatility will soon start to rise. For investors, it is vitally important not to miss the investment opportunities brought about by the probable upcoming surge in volatility.

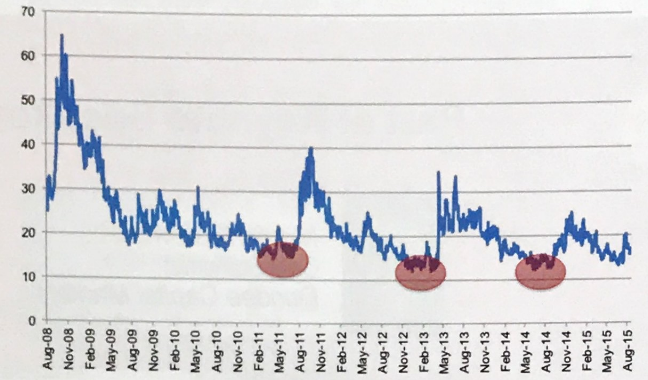
True, the macroeconomic outlook is uncertain at best. Analysts' forecasts are unreliable (see next section). Gold is difficult to price because it doesn't yield an income stream. It's attractive on the way up and ugly on the way down – this is why it is prone to trends.

Sideways price movement discourages gold buying. The dual reaction of gold prices to economic news makes it impossible to foresee the direction of future price moves. However, we do see tectonic shifts and higher volatility ahead.

What kind of exposure should one take, in order to participate in gold price movements in this rising volatility environment?

Depending on the type of trend – linear, exponential or moving average – and the period of choice, gold can be said to lie either below or above its long-term trend. In the chart above, we have drawn two tentative future price paths, both of which appear plausible: one mean reverting to the exponential trend and another one closer to the historical moving average line.

Figure 5: Gold Volatility Index



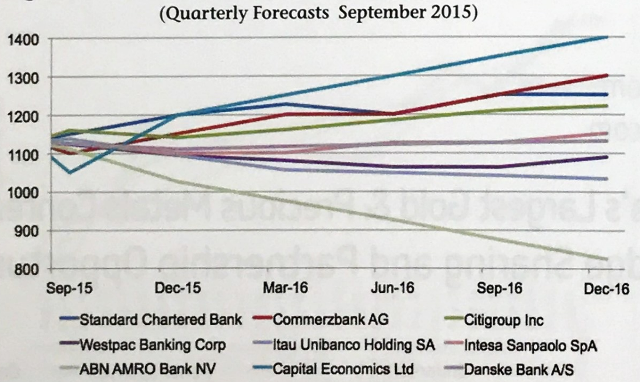
Data Source: Bloomberg

> If history is any indication, the analysts' predictions will be wrong again

Analysis would support either conclusion. Investors can pay their money and take their chances.

The difference between the prices over the two paths is 3% after 1 year, 8% after 2 years and 47% after 10 years. And we could simulate a myriad of such paths.

Figure 6: Will The Analysts be Wrong Again?
(Quarterly Forecasts September 2015)



Data Source: Bloomberg

Surprise! Analysts Forecasts Are Unreliable

"But I got the crystal ball", he said and held it to the light." Frank Zappa – Cosmik Debris

Now the good news: Gold price analysts *consistently* get their price forecasts wrong. They are, as we say, "often wrong but never uncertain."

In December 2010, they underestimated the upcoming rally of 2011. The forecasters strayed from the realized gold price by 6% on average but the error reached 14% in Q3 2011.

In September 2011 – at the gold price top – they expected the rally to continue. The forecasters were in a range of 38% away from the realized gold price in Q2 2012. On average, they strayed from gold price by 15% and by 21% in Q3 2012.

If history is any indication, the analysts' predictions will be wrong again. The price will do anything but remain flat or rise moderately. Instead, some trends might start either towards the upside or the downside.

Conclusion

Like other markets, gold can do one of three things; it can go up, it can go down or it can (annoyingly) stay around about where it is.

Having gathered various pieces of information, research (both fundamental and technical) and sampled a wide range of propaganda, we concede that we are none the wiser.

In truth, we don't know what gold will do, in which order, over what period of time or at what velocity. That may not be very helpful but it is helpful to know that we don't know.

On the other hand we are 100% certain that given the extraordinary dichotomy of facts and opinion, gold will do "something" at some time. The time may already be upon us as July and August showed.

Further, due to the almost unique emotive responses that gold elicits, we may have some confidence that this "something" will be dramatic. In part this is because investors often hold quite extreme views on gold. (Gold flips the emotion switch and the ego switch to 'full on' in many investors.)

Also consider this; under a number of possible scenarios, investable options may be regarded as diminishing. The investment opportunity set has shrunken and will continue to shrink.

Marc Faber, recently interviewed by Bloomberg, said that "there is no safe

Rates of Return	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	YTD
Kintore	9.51%	-2.60%	2.07%	-1.73%	-0.64%	-0.34%	11.49%	5.55%	24.67%
Long Gold	8.39%	-5.50%	-2.44%	0.07%	0.52%	-1.53%	-6.53%	3.56%	-4.19%
Arithmetic Difference	1.12%	2.90%	4.51%	-1.80%	-1.17%	1.20%	18.02%	1.99%	28.86%
Compounded Difference	1.03%	4.13%	8.94%	6.99%	5.74%	7.03%	27.67%	30.12%	30.12%
Short Gold	-8.39%	5.50%	2.44%	-0.07%	-0.52%	1.53%	6.53%	-3.56%	2.66%
Arithmetic Difference	17.90%	-8.10%	-0.37%	-1.66%	-0.12%	-1.87%	4.97%	9.10%	22.01%
Compounded Difference	19.55%	10.36%	9.97%	8.14%	8.01%	6.02%	10.96%	21.44%	21.44%

What is Insch Kintore & How Does it Work?

Insch Kintore is an investment strategy created to profit from both bullish and bearish trends in gold. It can take long and short positions in six different gold-currency crosses: XAU/USD, XAU/EUR, XAU/CHF, XAU/AUD, XAU/JPY and XAU/GBP.

The Figures above show Insch Kintore's historical performance gross of fees and trading spreads (back tested until January 2015 and actual from February 2015 onwards).

Insch Kintore performs especially well when a trend starts, either long or short. This is the kind of environment that we anticipate in the next few months.

We provide more details in separate performance and risk reports. The expected volatility increase in gold prices will provide trading opportunities for a strategy such as Insch Kintore as it assumes a truly unbiased long/short exposure.

The current performance track record, albeit short, empirically shows the potential for gain in the systematic trading algorithm.

asset any more", equities are in a bubble and there is not much hope for yield elsewhere in the short and medium run.

The question for investors, therefore, is how to participate in whatever this "something" may be.

It is for this reason we would highlight the vital importance of a systematic approach that – at the very least – removes emotion and ego. It would appear to us that taking a long or short view based on – well whatever, really... – may not be a sensible choice.

A nimble, cost-effective, bi-directional strategy such as that described would hold considerable appeal for "natural longs" (miners, for example) and also for holders of physical gold.

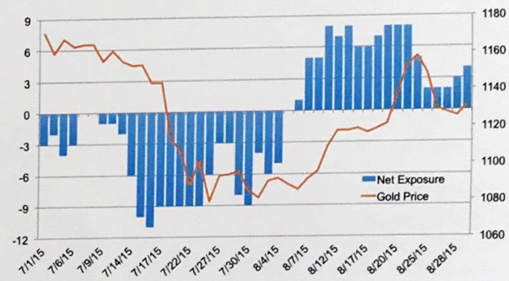
> ... we would highlight the vital importance of a systematic approach ... that removes emotion and ego

It would also appeal to those who merely seek a growth investment in an established, liquid and transparent market environment.

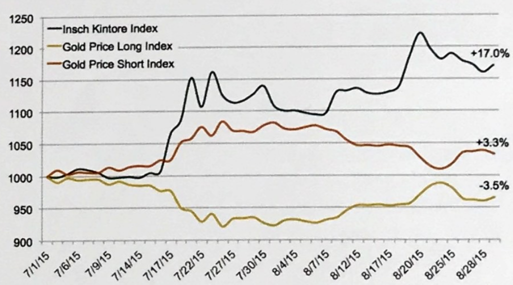
It would, of course, appeal to professional traders, professional investment advisors and investors who concede that they do not, in fact, know the future.

Do such people exist? •

Figure 7: Insch Kintore Net Exposure to Gold



Insch Kintore vs Long/Short Gold Exposure



Source: Insch Capital Management SA

Insch Capital Management SA ("Insch") is a privately owned alternative investment manager headquartered in Lugano, Switzerland.

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