Gold's silver lining

There is divided opinion on whether government monetary interventions around the world will trigger higher inflation. We offer our analysis and what it potentially means for investors in our funds.

Ian Williams, Fund Manager
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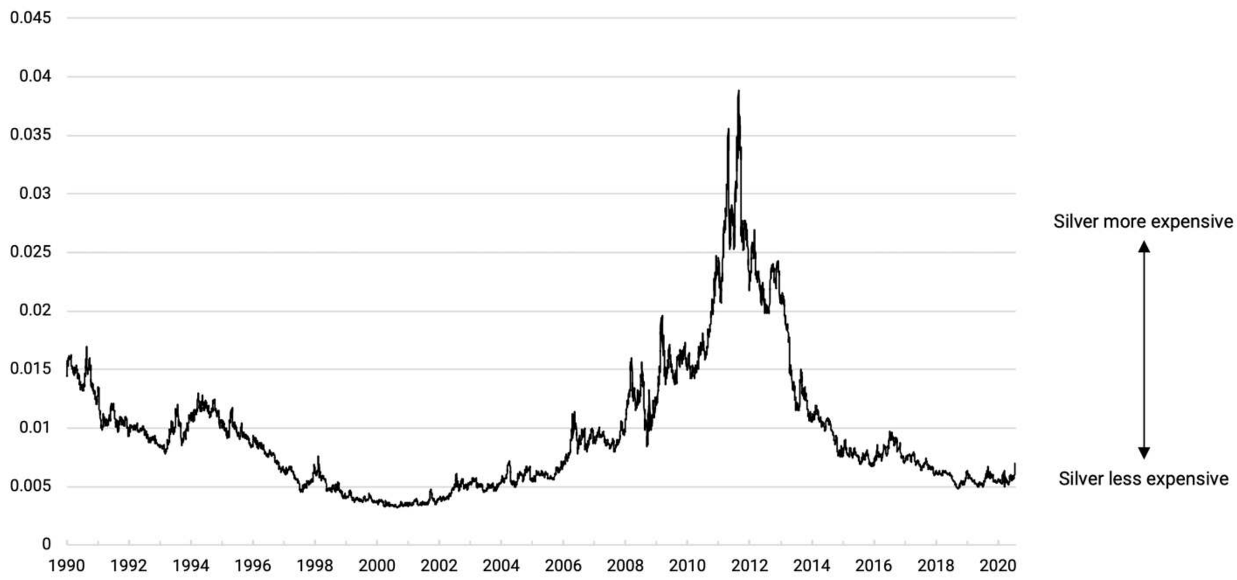
The rising gold price has taken all the headlines but it has been outpaced by silver in recent weeks – and this has buoyed the performance of the DMS Charteris Gold and Precious Metals Fund because of its much higher exposure to silver, at 50%, than its peer group.

Historical precedent shows that silver outperforms gold in bull markets. Although some investors might baulk at buying gold at an all-time high, this does not apply to silver, which at the current price of $24 is only half its all-time high. Indeed, looking at a long-term chart of the ratio of silver to the S&P 500 index, silver has just come off a 20-year low and, far from looking expensive, looks to represent value. Also, as the rise in silver has happened so quickly, the recent rise in the price of silver has probably yet to be reflected in the underlying mining companies we own. If silver maintains or rises above its current price then analysts should begin to upgrade earnings forecasts, which in turn could feed into positive price movements for the underlying companies held within the fund's portfolio.

Silver vs S&P 500 Ratio from 1989 – Present
Source: Charteris, Bloomberg



The fund continues to perform. Over the past 12 months, the fund is up 63.9% despite the coronavirus crisis, with the fund recovering sharply over the past six months (+53.8%) despite the market declines in February and March*. If we continue to see gold and silver do well, the fund should continue to perform as investors seek safe havens amid the continued market uncertainty and protection from higher inflation caused by rapidly expanding central bank balance sheets – the Federal Reserve's (Fed) balance sheet is at a record high.

The longer-term perspective
A most important consideration that seems to be a driver of investor sentiment towards gold and silver is the cumulative expansion of money supply we have seen globally since the financial crisis (GFC), that could ultimately lead to higher inflation.

Many investors believe Quantitative Easing (QE) is inflationary but analysis shows that its impact on prices was masked in the aftermath of the GFC by a very significant reduction in the velocity of circulation of money. This was constrained by a combination of demographic factors (ageing populations in the developed world and retiring baby boomers) and weak credit growth – a product of regulatory pressure on banks to build capital combined with huge reparation costs throughout the ten years of the post-crisis period. Absent these factors, QE probably would have led to higher inflation despite other disinflationary factors driving prices down such as globalisation.

Other factors that could drive precious and non-precious metals prices higher are more demand focused typically driven by the accelerating shift to electric vehicles – an electric car uses four times more copper than an equivalent fossil fuel one – and growing central bank holdings of gold. The Central Bank of Russia was ahead of the pack in switching its US Treasury bonds into gold in 2018, taking over a year to complete the task due to the scale of the holdings. It still might have a bit more to do but we would not be surprised to see a lot of other central banks following suit.

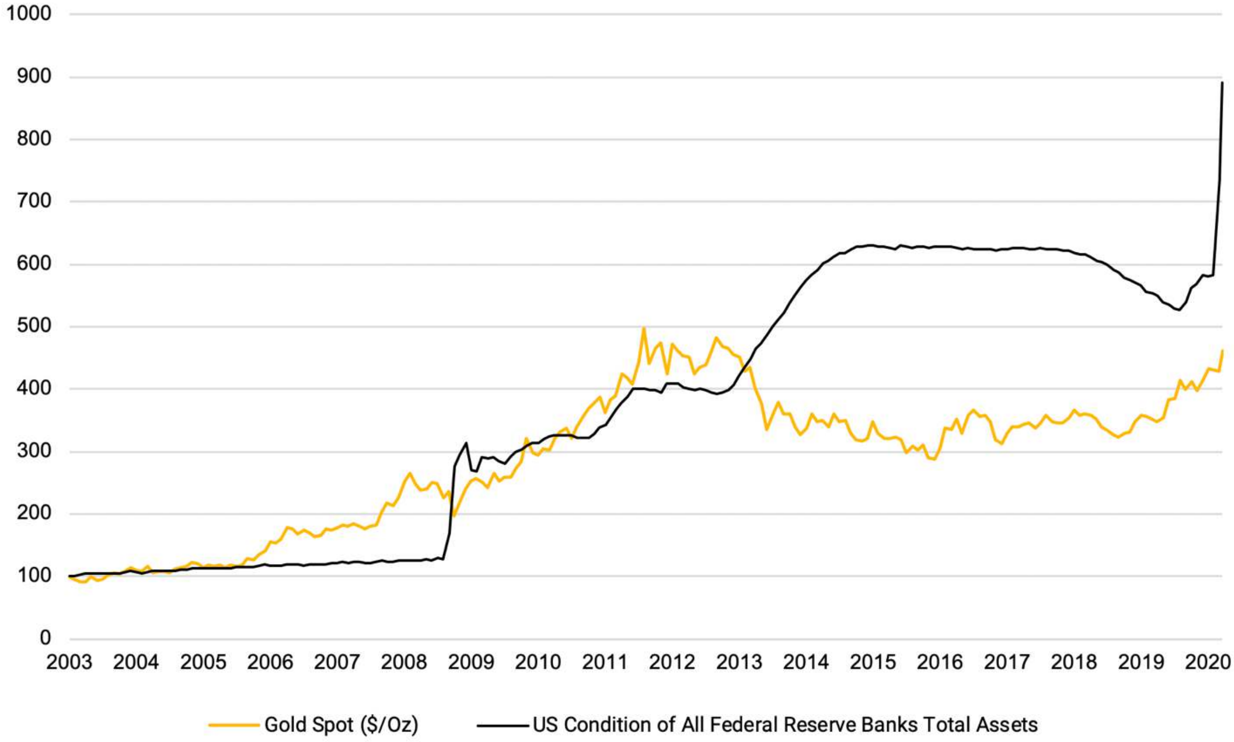
Demand for jewellery has fallen sharply in the wake of the coronavirus crisis. However, it is worth highlighting that gold and silver prices traditionally underperform in the first half of the year as demand is fuelled by the wedding season in India that runs from June to September. Prices have held up despite the jewellery demand slump and given the bumper harvest in India this year it would not be unreasonable to expect this demand to pick up once the pandemic starts to abate

Precious metals prices in the wake of the pandemic
The Covid-19 pandemic has resulted in the biggest global fiscal and monetary policy stimulus seen since the Second World War. It is becoming clearer by the day that central bank balance sheets are increasing at a rate that is unprecedented in order to offset the worst economic consequences of the crisis.

To put this stimulus into context, it may help to compare what is happening now with the period that followed the financial crisis. During the six years of QE1, 2 and 3 the Fed's balance sheet grew by $4 trillion. So far during this crisis, the Fed's balance sheet has expanded by $2trn over the last month and is forecast to grow by another $2trn throughout the rest of the summer.

When the Fed's balance sheet expands, central banks and investors buy gold

Gold price in tandem with the Fed's balance sheet
Source: Charteris, Bloomberg as at 17 April 2020



Negative real interest rates
Another factor that is supportive for gold and precious metals are the continued low nominal interest rates (and negative real rates) on bonds and cash savings. Gold tends to flourish when "real" inflation adjusted interest rates/Government bond yields are low or negative. At present other so-called inflation proof assets such as UK Index Linked Gilts are on record negative real yields of up to minus 2.3%. In contrast, the DMS Charteris Gold and Precious Metals Fund has a positive dividend yield of around 0.65%.

Midcap opportunity
The fund has an underweight position in the larger names because of better-perceived value towards mid-caps rather than the big gold miners. Blue-chip miners tend to have declining production profiles, while midcaps often do not and are, therefore, takeover targets. Midcap gold mining shares are not expensive relative to gold itself, so investors today are not paying historically excessive valuations to increase their exposure to the fund Furthermore, the miners are, perhaps, one of the very few sectors where investors can expect dividends to increase this year as revenue is going up and costs down.

Conclusion
Despite recent gains, gold and other precious metals do seem to offer further upside potential as gold and silver seem to be in a primary bull market that has yet to display the standard signs of an imminent market top. It is worth remembering that gold prices surged by 40% in the final nine months of the last major bull market of 1960-80.

Ian Williams, Chairman and CEO, Charteris Treasury Portfolio Managers

Important information
*Source: Bloomberg, as at 29 July 2020. Past performance is not a guide to future returns.

The views expressed in this document represent the views of the author at the time of preparation and should not be interpreted as investment advice.

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