GLOBAL FIXED INCOME & CURRENCY STRATEGY

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Gold: Does The Bull Market Still Have Legs?

- Following the freezing of Russia's FX reserves, strong demand from central banks has pushed gold to record highs.
- With all of Russia's G10 FX reserves frozen, diversifying from the U.S. dollar to other major currencies is futile.
- Strained relations between the West and the Global South, particularly China, should continue to support central banks' demand for gold.
- Four factors could spark greater interest in gold by private investors: lower interest rates and dollar, a flare-up in geopolitical risks, concerns over rising government debts, and a hedge against a sell-off in global risk assets.
- The gold market is relatively small and stronger demand can push prices much higher. Long-term investors should maintain a core allocation to gold.

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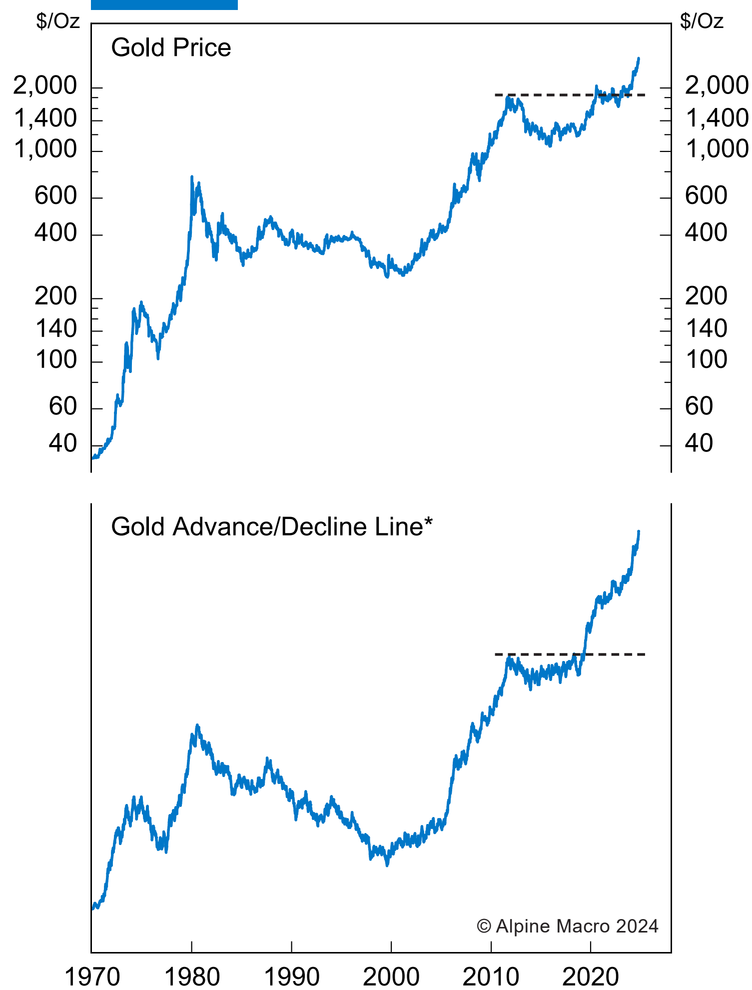
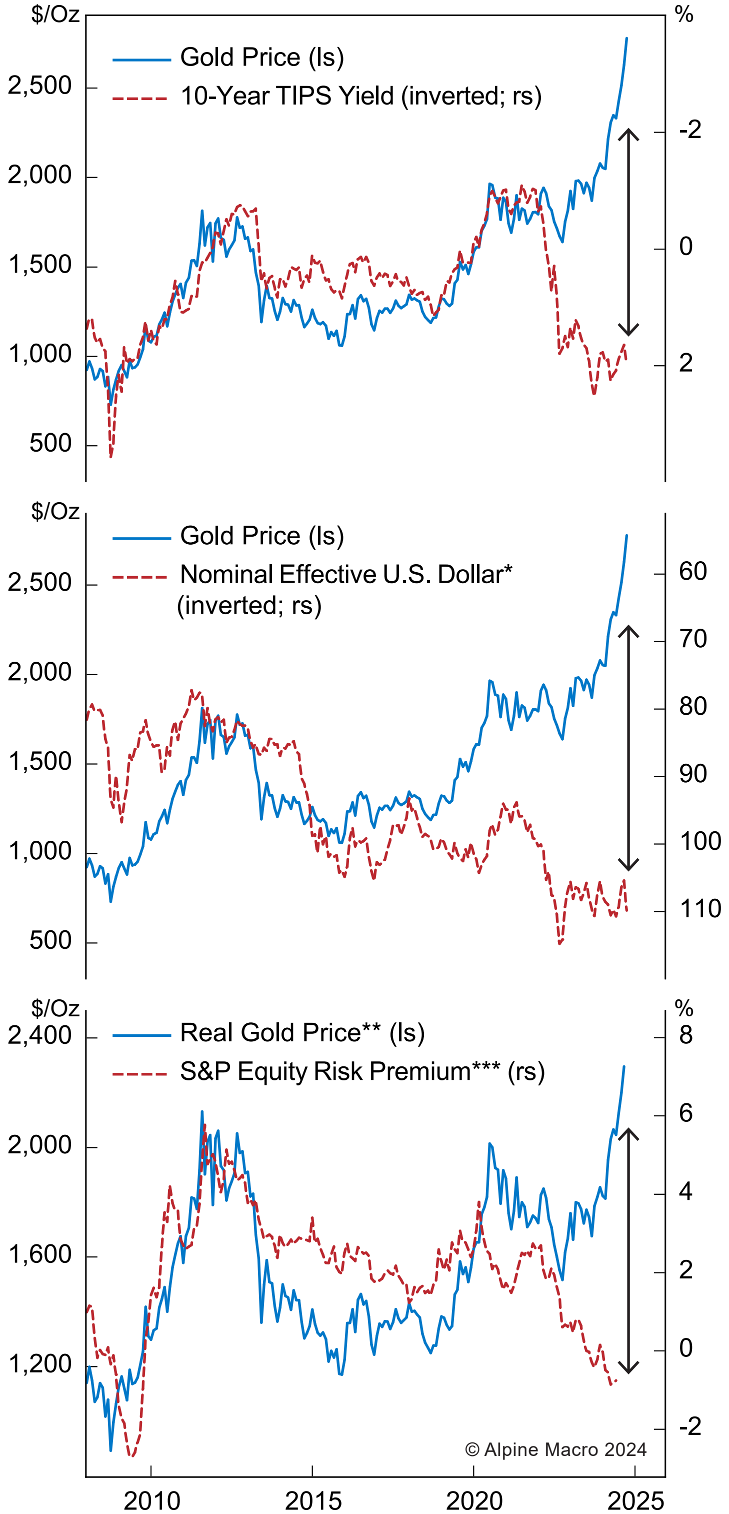
Gold has been on a tear, rising to new all-time highs this year. It has not only risen in U.S. dollar terms, but against all fiat currencies. In fact, gold's advance/decline line broke higher long before it did in dollar terms (Chart 1). In other words, a broad rally in gold has been underway for quite some time.

Chart 1 A Broad Bull Market In Gold



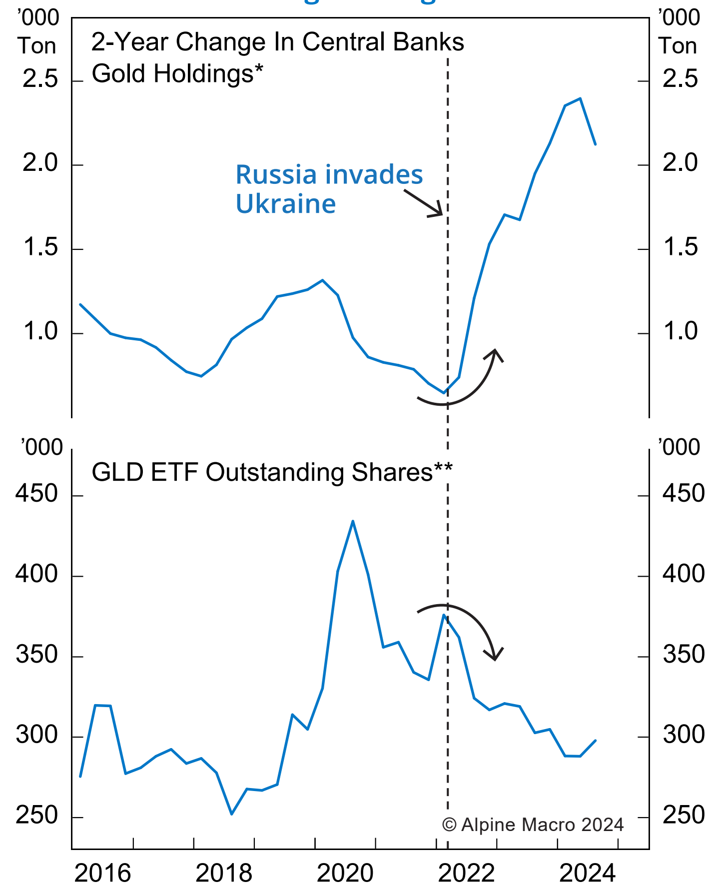
*Calculated against G10 currencies

Chart 2 Gold Has Decoupled From Its Traditional Drivers



*Narrow index; source: BIS
**Deflated by U.S. core PCE deflator
***S&P current earnings yield minus 10-year Treasury yield

Chart 3 Central Banks Have Been Driving Gold Higher



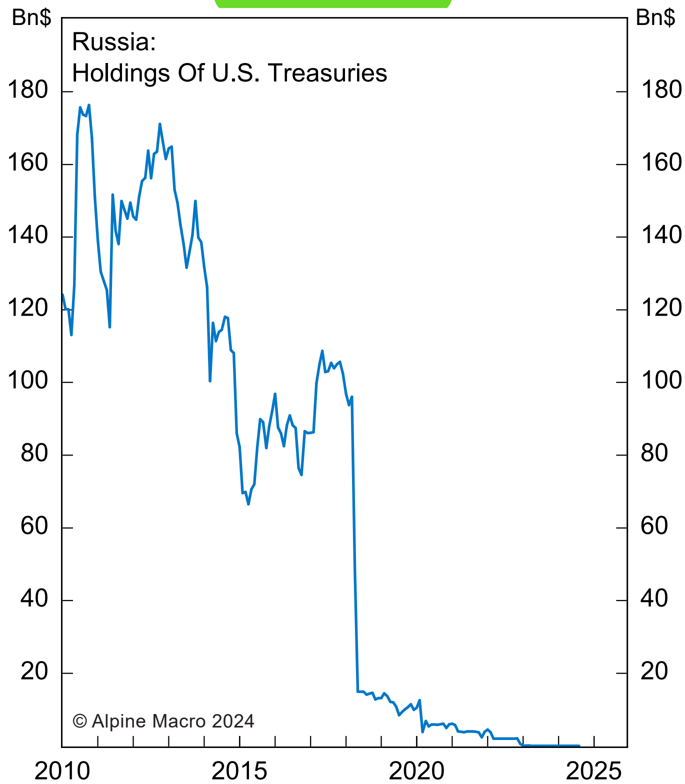
*Source: World Gold Council
**Source: Bloomberg Finance L.P.

What is most remarkable is that the strong uptrend has occurred when the traditional economic drivers of gold have been bearish. Historically, gold has performed well when real interest rates are low, the U.S. dollar is weak, and the equity risk premium is high. As seen in **Chart 2**, gold has completely decoupled from these fundamental factors.

So what explains the strength in gold? Quite simply, strong demand from central banks has been the principal factor pushing gold higher.

Chart 3 shows that central banks' purchases of gold soared after Russia's invasion of Ukraine. In contrast,

Chart 4 Russia Liquidated Its Holdings Of U.S. Treasuries

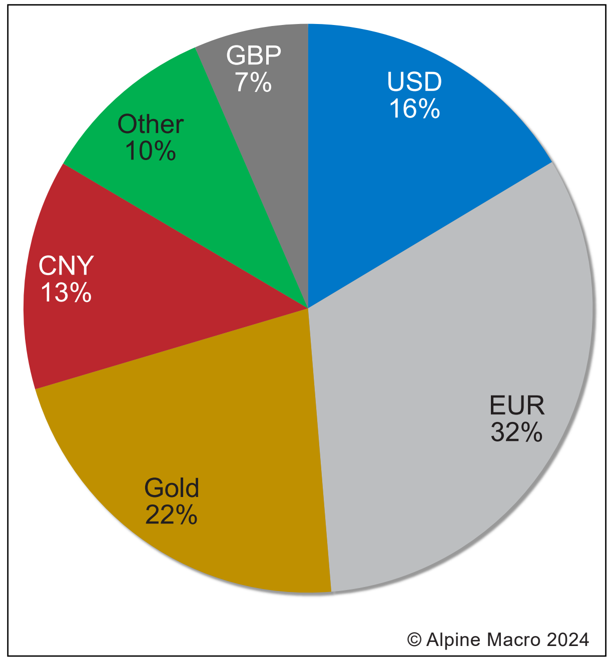


demand from private investors has been lackluster. This is reflected in the downtrend in the outstanding shares of GLD, one of the most popular gold ETFs.

The catalyst for the surge in central banks' demand for gold was the freezing of Russia's FX reserves by Western governments. Very importantly, the actions did not target only Russia's U.S. dollar reserves. Rather, ***all*** of Russia's G10 currency holdings were frozen.

For several years prior to the invasion of Ukraine, Russia had been reducing its exposure to the dollar. It divested out of Treasuries and shifted its reserves into other currencies and gold (**Chart 4**). This was clearly done to mitigate the risk of appropriation by the U.S. government. However, it has turned out to be a futile endeavor.

Chart 5 Russia's Reserves Prior To The Invasion Of Ukraine

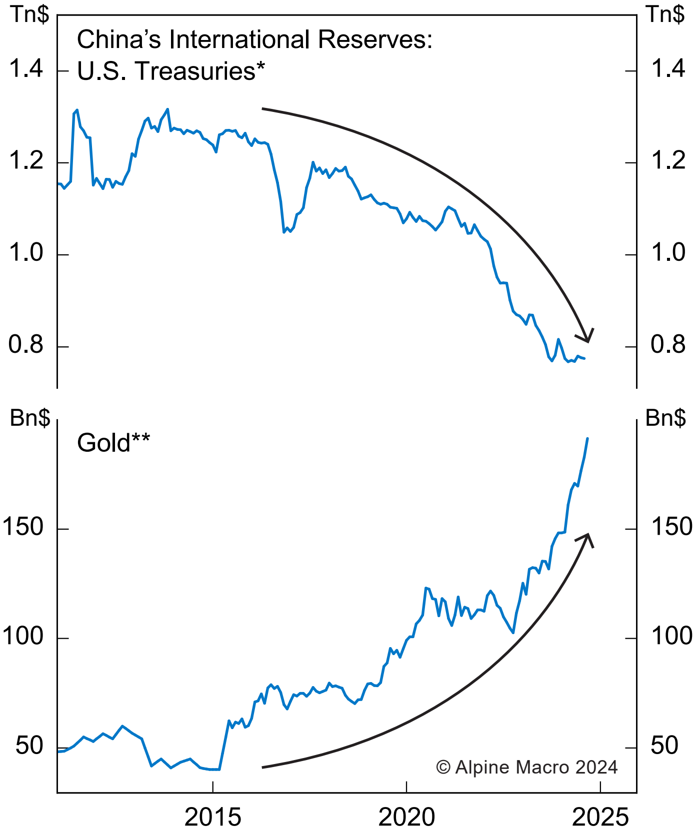


Because of the unified Western sanctions, the largest reserve currency that Russia can no longer access is the euro, not the dollar. **Chart 5** shows the breakdown of Russia's reserves prior to the war with Ukraine. The euro accounted for the greatest share at 32%, twice that of the dollar. Sterling and other currencies made up another 17% of Russia's reserves.

Out of all of Russia's FX reserves that have been frozen, the dollar accounts for only 25%. Nearly 50% of Russia's frozen reserves are in euros, with the remaining 25% in other G10 currencies.

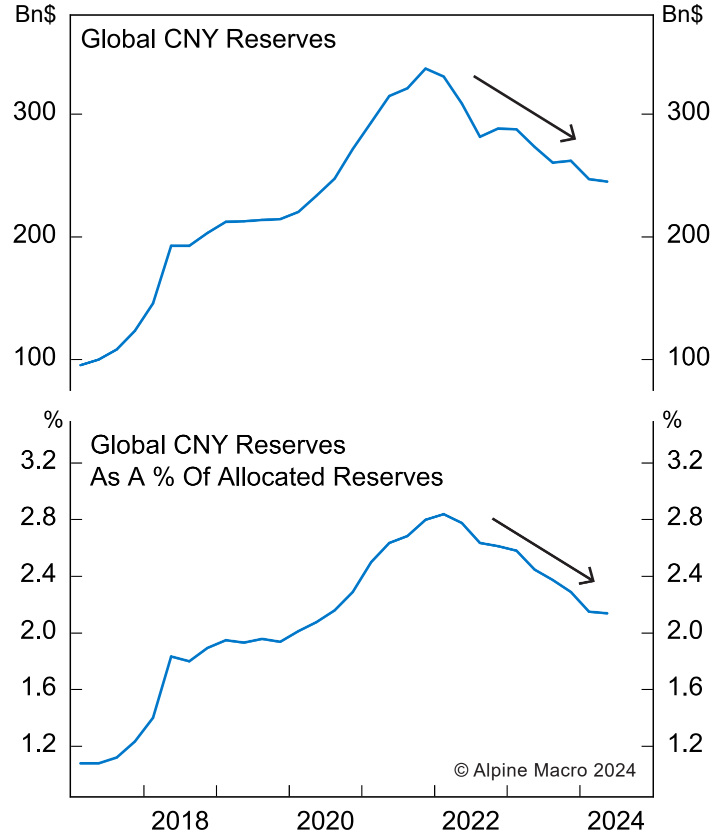
The key lesson from freezing Russia's reserves is that diversifying away from the dollar to other major currencies does not offer much protection. Russia has lost access to all G10 currencies. In the end, it did not matter if Russia held 100% of its G10 FX reserves in dollars or in euros.

Chart 6 China Is Moving Out Of Treasuries & Into Gold



*Source: U.S. Department of Treasury
**Source: PBoC

Chart 7 No Interest In CNY For FX Reserves



Source: IMF COFER

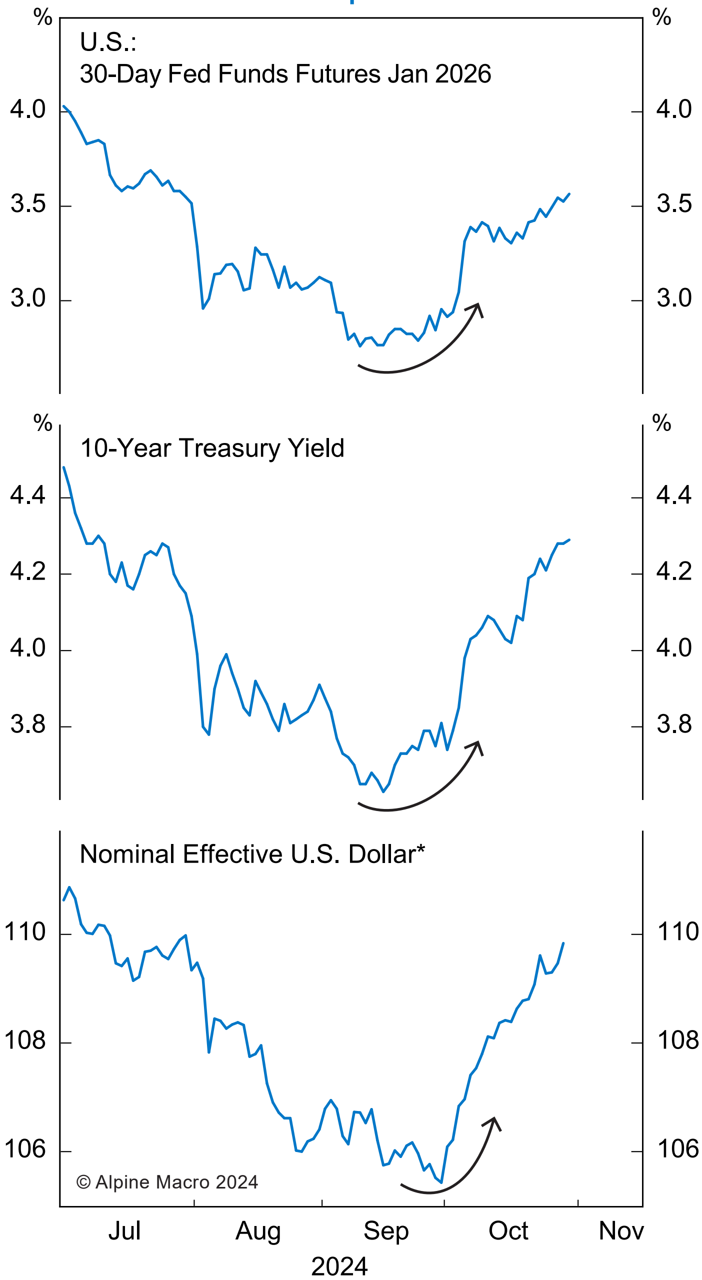
The unified Western sanctions have left Russia with access to only its gold and CNY reserves. Other central banks have taken Russia's experience to heart. In particular, China has been trimming its exposure to U.S. Treasuries and boosting its gold holdings (**Chart 6**).

It is likely that central banks will continue to accumulate gold:

- The rivalry between the U.S. and China is unlikely to improve regardless of who wins the upcoming U.S. elections. China is viewed as the greatest challenge to the U.S. by both political parties. Other Western governments are also turning more hawkish on China. Consequently, China's gold purchases should persist.
- Central banks in the "Global South" will also look to gold as a way to diversify away from Western currencies. Unlike Russia, other central banks are not interested in building CNY reserves. Since Russia's invasion of Ukraine, reserve holdings of CNY have been declining (**Chart 7**).

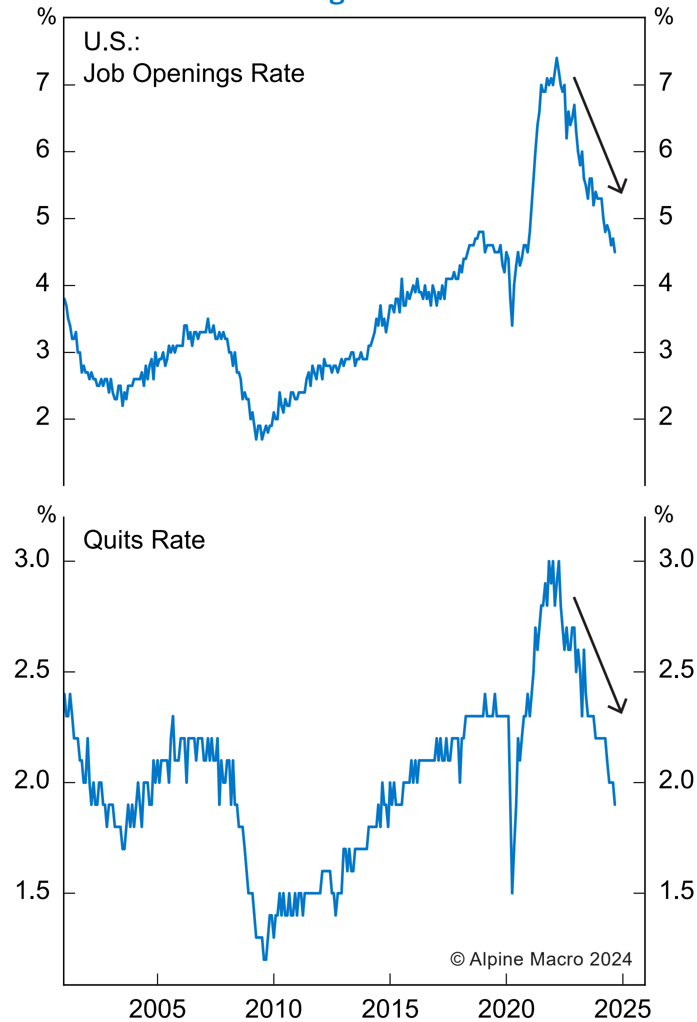
While steady purchases by central banks can continue to underpin gold, a revival in demand from private investors could send prices even higher. Several factors could lead investors to increase their allocation to gold.

Chart 8 A Reversal Of These Trends Would Help Gold



*Source: BIS

Chart 9 Is The U.S. Labor Market Softening?



First, real interest rates and the dollar, the traditional drivers of gold, could head lower. This would require the Fed to turn more dovish.

Since the start of October, the market has been pricing fewer rate cuts by the Fed, which have pushed up bond yields and the dollar (**Chart 8**). The U.S. economy has proven resilient with GDP growing 2.8% in Q3 and averaging 2.5% thus far in 2024. This has reduced the need for the Fed to cut rates quickly and aggressively.

However, market expectations for the Fed have been volatile and could swing in a dovish direction if the U.S. labor market shows signs of softening. This week's JOLTS came in weaker than expected with job openings and the quits rate falling further (**Chart 9**).

Weakness in nonfarm payrolls and a higher unemployment rate would put the Fed's dual mandate at risk. As the labor market falls short of "maximum employment", slower wage gains could pull inflation below the Fed's 2% target.

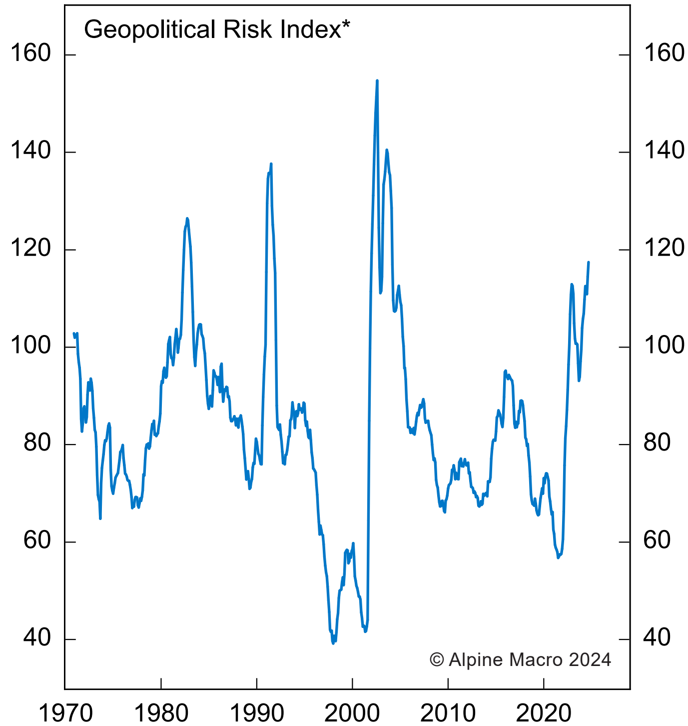
Second, a flare-up in geopolitical risks could force investors to increase their exposure to gold as a safe-haven asset. Gold's secular bull market that began at the turn of the millennium coincided with the 9/11 attacks and the war on terror, the European debt crisis, Brexit, a growing Sino-American rivalry, the war in Ukraine, and most recently the escalating conflict in the Middle East.

Chart 10 shows that geopolitical risks have risen to the highest level since the 9/11 attacks. Wars, shifts in political/economic regimes, and inflation outbreaks (all of which are usually interrelated) can destroy financial wealth and physical capital. For centuries, gold has proven to be the best hedge against such risks.

Third, investors could grow wary of rising government debt levels. Most developed economies, including the U.S., have debt-to-GDP ratios that are near or above 100%. Projections are for continued large deficits and a further rise in debt levels. In the case of the U.S., a "clean sweep" by either political party in the upcoming election could worsen what is already an unsustainable fiscal outlook.

Because it borrows in its own currency, the U.S. will not default on its debt. It can always print new money to meet its obligations. Of course, this would lead to rising inflation and a weakening dollar, which would be bullish for gold.

Chart 10 Geopolitical Risk Is Rising



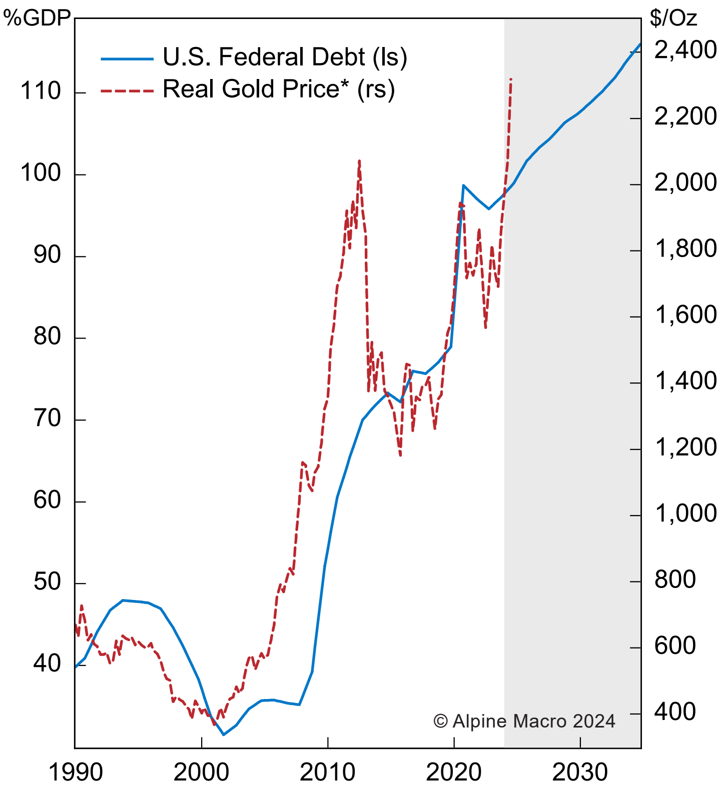
*Source: Caldara, Dario and Matteo Iacoviello, 'Measuring Geopolitical Risk,' working paper, Board of Governors of the Federal Reserve Board, January 2018; shown as a 12-month moving average

There are no signs that the U.S. is on the cusp of fiscal crisis, but investors' fears could grow with the rising debt burden. A core holding of gold would look increasingly prudent for those worried about soaring debt levels (Chart 11).

Finally, investors could turn to gold for diversification benefits and protection against a sell-off in global risk assets. Traditionally, investors used U.S. Treasuries to hedge all sorts of risks. Whatever it was — Tequila crisis, Asian crisis, Russian default, LTCM, tech bust, housing crash, European debt crisis, renminbi's devaluation, Covid — Treasuries served as a ballast to portfolios.

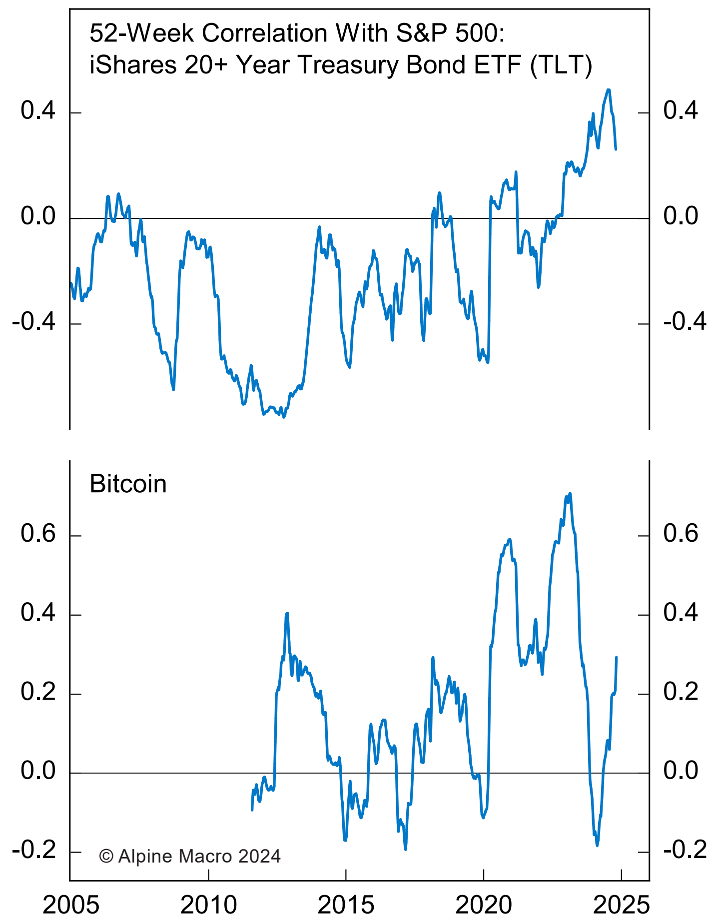
After being persistently negative for two decades, U.S. bond and equity returns have become positively

Chart 11 Soaring Government Debt Could Drive Investors To Gold



*Deflated by U.S. core PCE deflator
Note: Shading denotes federal debt forecast by the Congressional Budget Office

Chart 12 Treasuries & Bitcoin Are Positively Correlated With Stocks



Note: All series are shown as 4-week moving averages

correlated (Chart 12, top panel). Therefore, Treasuries may not provide the same diversification benefits as in the past.

And rather than being safe-havens as touted by its promoters, Bitcoin and other cryptos have proven to be speculative risk assets. Bitcoin has been positively correlated with stocks (Chart 12, bottom panel). It is unlikely that cryptos will offer much downside protection in a risk-off environment.

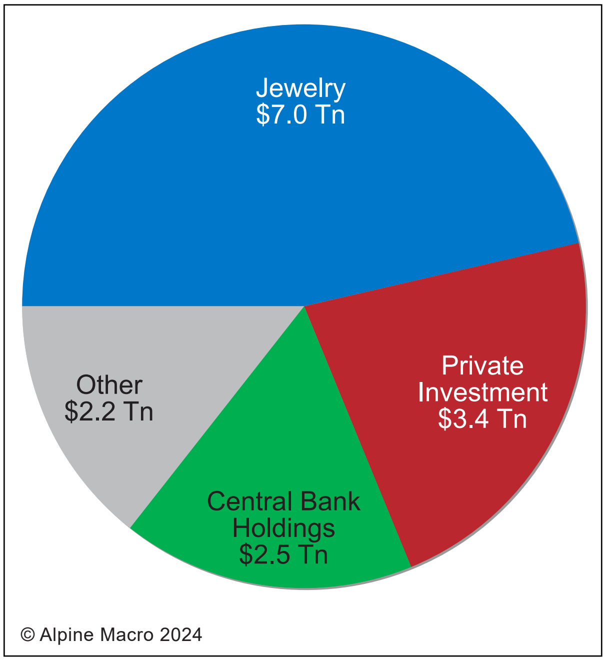
Investment Conclusions

Gold is technically overbought and a correction cannot be ruled out. However, we remain bullish on a longer term investment horizon. In addition to steady demand from central banks, private investors could also begin to increase their allocation to precious metals.

The gold market is relatively small and stronger demand can push prices much higher. The total global value of above-ground gold is about $15 trillion, of which nearly half is in the form of jewelry (Chart 13). $2.2 trillion is tied up in industrial use and $2.5 trillion is locked away in central banks' vaults. That leaves the readily tradeable gold stock at only $3.4 trillion.[1] This pales against a market

1 Annual mine production of gold is about $250 bn.

Chart 13 The World's Above-Ground Gold Stock



cap of $260 trillion for global stocks and bonds. An attempt to shift just 0.5% from stocks and bonds to gold would amount to almost 40% of the tradeable pool of gold.

The bottom line is that long-term investors should maintain a core allocation to gold. In addition to bullion, this could include exposure to gold miners, which have significantly lagged the surge in gold prices (**Chart 14**).

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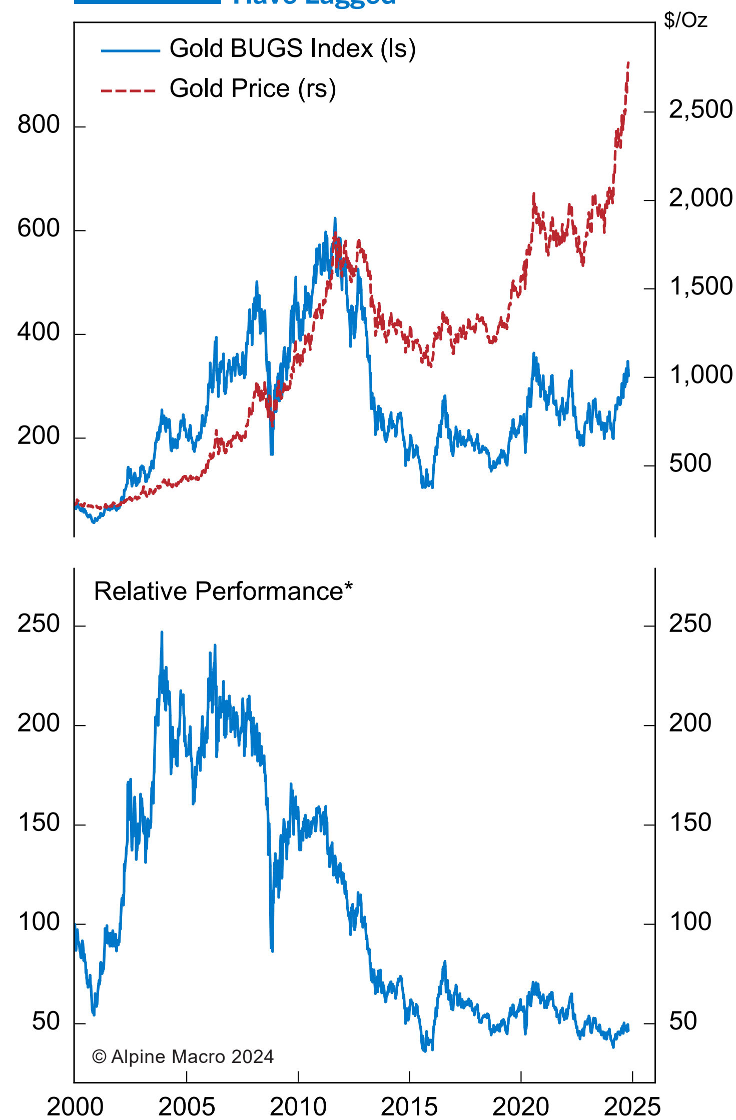
Chart 14 Gold Miners Have Lagged



*Gold BUGS Index divided by gold price; rebased to Jan 2000 = 100

Currency Outlook

Vs THE DOLLAR	1-3 Months	9-12 Months
EUR	FLAT	UP
JPY	FLAT	UP
GBP	FLAT	UP
CHF	FLAT	UP
CAD	DOWN	UP
AUD	FLAT	UP
NZD	FLAT	UP

Vs THE EURO	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	3
Japan	1
Eurozone	4
Core	5
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	4.13%	-4.08%	0.05%
Long Gold	2022-03-04	1,928	-	-	42.49%	-	42.49%
Short USD/JPY	2024-08-23	146.23	-	-	-3.90%	-0.97%	-4.88%
Long GBP/USD	2024-08-23	1.3094	-	-	-1.50%	-0.04%	-1.54%
Long AUD/USD	2024-09-27	0.6896	-	-	-4.55%	-0.03%	-4.58%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	84.79 bps

A Unique Mind On The Markets

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