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The many facets of gold: Hedging, inflation and interest rates

Research & Insights

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Gold can be a challenging asset class for investors. Ausbil's Global Resources Team talks through the different facets of gold, and why it is an interesting proposition in the commodities complex.

Typically, physical gold is seen as a safe-haven asset class, one that provides a level of insurance against adverse geopolitical events or rising inflation. However, gold equities often tend to be more closely correlated with underlying equity markets than the gold price. We are seeing a short-term opportunity in gold equities right now, however, with the economic building blocks in place to support the gold price, we believe equity valuations are not stretched.

The power of gold as a hedge for inflation and volatility

Gold does not follow the typical supply and demand characteristics that most other commodities adhere too, with the vast majority of gold produced never really being consumed, but instead sitting in vaults around the globe. Moreover, with the rising and falling costs of extraction, many assayed gold deposits are often left in the ground until technological advances and improving economics support the capital expenditure for extraction.

According to the World Gold Council, all above-ground gold in existence (205,238 tonnes) could fit inside a 22 square metre cube, with just around 53,000 additional tonnes below ground in known and proven deposits, as illustrated in Table 1.

Table 1: Where is all the world's gold?

All above ground gold	~205,238 tonnes
Jewellery	~94,464t or 46%
Bars and coins (including gold backed ETFs)	~45,456t or 22%
Central banks	~34,592t or 17%
Other	~30,726t or 15%
All below-ground gold	**~53,000 tonnes**

Source: Metals Focus, Refinitiv GFMS, US Geological Survey, World Gold Council

In its commodity form, gold is an asset that does not pay a dividend, nor is it interest-bearing. The physical nature of gold means that holding it in its physical form is usually costly, in storage costs, trading costs, and security costs, unless held through a physically-backed exchange traded fund (ETF).

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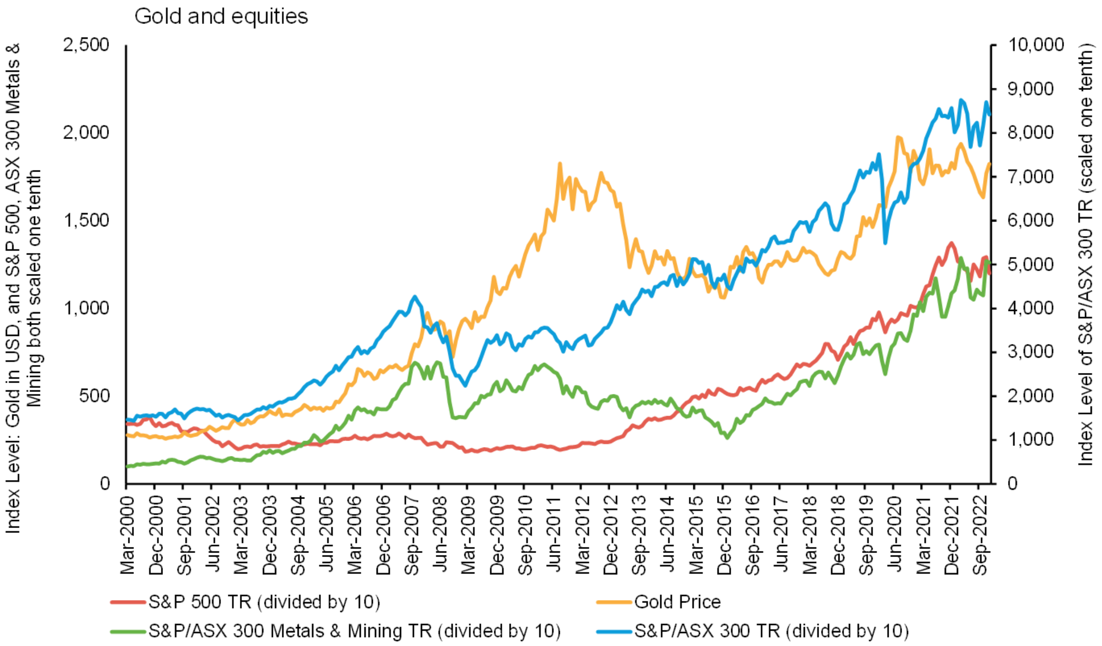
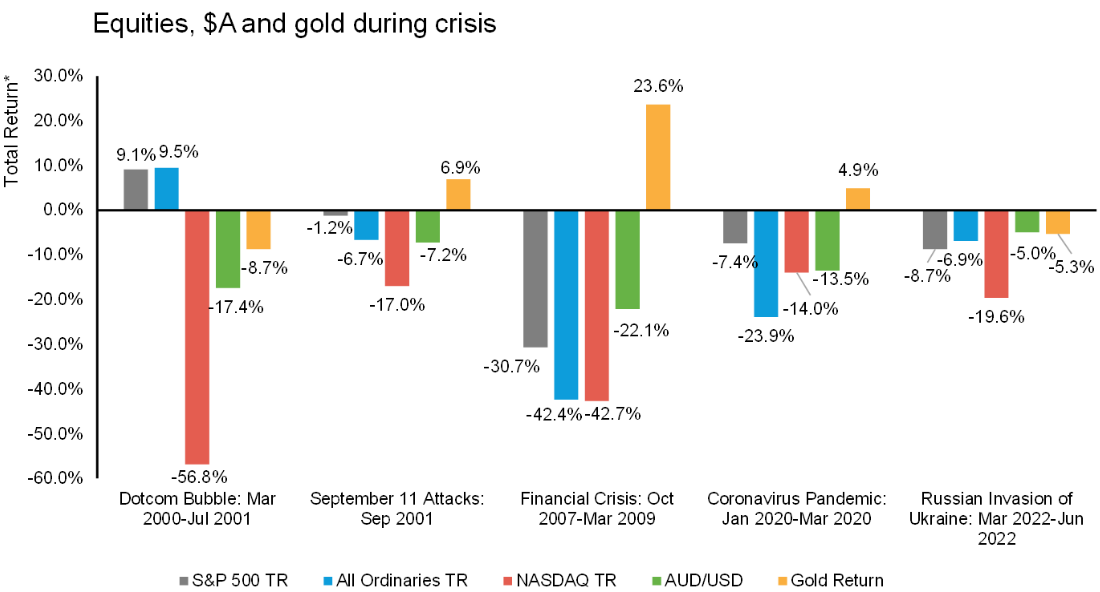
Chart 1: The gold price compared to equities over time



Source: Ausbil, Bloomberg, index data scaled to one tenth for illustrative purposes with respect to pattern, not levels.

Gold is a relatively expensive asset to hold in a portfolio when real interest rates are high (the higher the interest rate, the higher the carry cost associated with holding physical gold) but is often viewed as insurance against uncertainty in portfolios. In times when real interest rates go below nominal rates, investors tend to flock to physical assets that maintain their historical value such as gold. From the perspective of economic value, as a store of value, gold is considered a safe-haven asset in times of uncertainty. This does not necessarily mean it delivers positive performance, but that it demonstrates lower correlation or is less impacted by falls in other markets, as illustrated in Chart 2.

Chart 2: Gold typically offers hedging benefits when markets are volatile

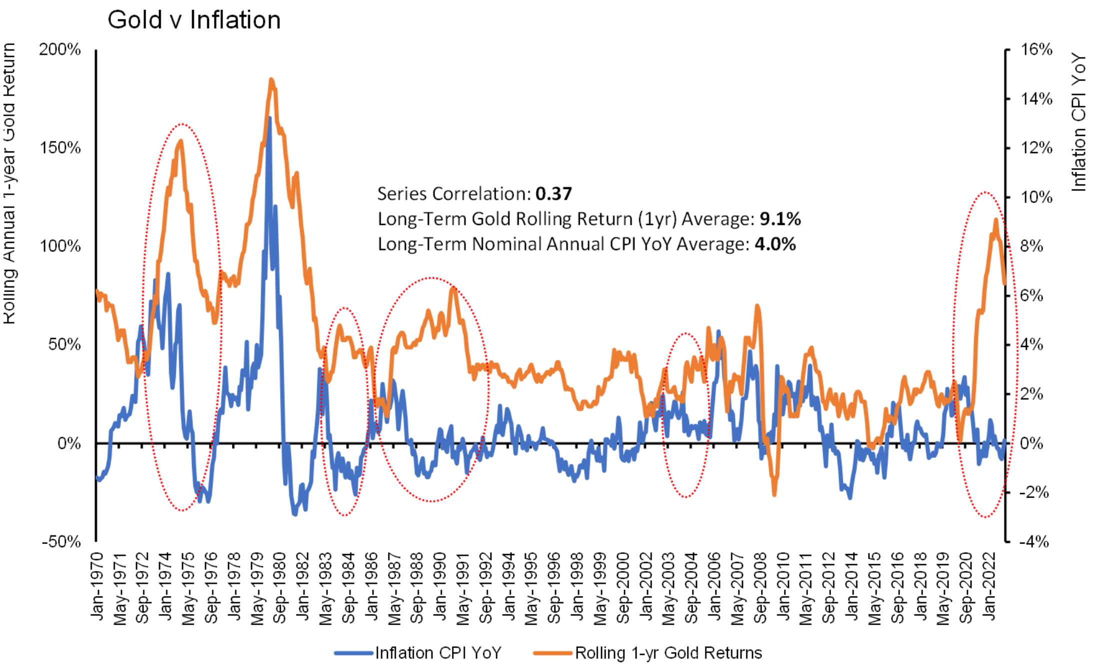


Source: Bloomberg, Ausbil, based on NBER US Business Cycle dates in whole months.

Chart 2 helps to illustrate that across a number of different crises, gold has acted as low correlation asset, offering far-superior downside capture as in the case of the Dotcom Bubble and the more recent energy crisis sparked by Russia's invasion of Ukraine. By comparison, during the September 11 attacks in the US, the Financial Crisis and during the onset of the COVID-19 Pandemic, gold offered a positive return hedge compared to the major falls in equity markets and the AUD.

When looking at the data, as illustrated in Chart 3, the gold price tends to hold an inverse relationship with rising real interest rates and is correlated with rising inflation. Interestingly, while gold holds an overall positive correlation to inflation over the long term, at points of relative 'inflation crisis' where monetary authorities tighten and the economic begins to slow, gold shows an inverse relationship with inflation, with the gold price rising strongly as inflation starts its fall back from highs. At the start of 2023, we believe we are at such a point in time with respect to the gold price, and as a function of that, the price of listed gold equities.

Chart 3: Gold tracks inflation at times of uncertainty, falling when it rises and then rising when it falls



Source: Ausbil, Bloomberg

Looking at the same issue from the perspective of interest rates, an article published by The National Bureau of Economic Research, titled 'The Golden Dilemma', reasserts the existence of a strong negative correlation between real interest rates and the gold price. Between 1997 and 2012, gold and interest rates demonstrated a negative correlation of -0.82. In this case, where -1 is the bound for perfect negative correlation, , if interest rates were to fall by 1 unit, gold would rise inversely by 0.82, and vice versa in the other direction.

Gold is generally viewed as an inflation hedge (a physical asset that maintains its value in a rising price environment). In Nov 2008 there was significant quantitative easing post the Global financial crisis – an outlier in the correlation as investors moved to the perceived safety of holding gold away from the volatility of equities. Inflation dropped as consumers spending habits were modified and investors looked for alternative assets to park their cash.

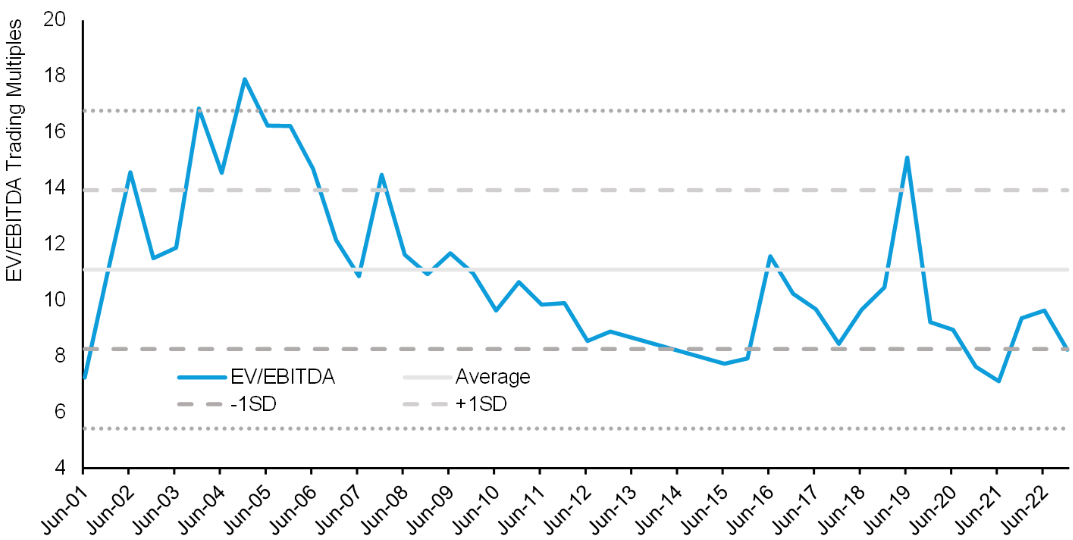
Both nominal interest rates and inflation rates were elevated in the latter half of the 1970's. The important element to note is that inflation was exceeding the nominal return on bonds, therefore investors shifted their capital into gold. This reaffirms the fact that whilst real interest rates are negative the price of gold tends to rise. In the second half of the 1970's Paul Volcker (ex-chair of the US Federal Reserve) hiked short-term nominal rates and we saw real interest rates return to positive territory (gold price dropped as a result, funds previously invested in the commodity shifted back into interest bearing investments). A downtrend continued in the gold price until 2001. Up until then, the Fed had cut nominal interest rates to the extent that real interest rates returned to zero. Chart 3 also underscores that a rising gold price goes hand in hand with falling rates in inflationary environments, evident in the interest rate pull-back post 2007 (the Fed lowered nominal rates, real rates fell and simultaneously gold flew).

What are we seeing at the start of 2023?

As outlined, theory suggests that gold should be correlated to the inflation rate, and that as inflation is being battled by central banks with higher rates, the gold price eases. However, as illustrated in Chart 3, when inflation begins to fall after a major peak, as the monetary tightening cycle draws to a close and growth has been muted, the stage is set for a resurgence in the gold price. Over the past two years, the gold price has detached from the fact that the economic growth had been surging, though we note that several other factors have also been at play, including a strong US$ and rising nominal rates (increasing the cost of holding gold). However, as we appear to have reached a stage where inflation may be peaking, we believe the gold price is likely to rise as inflation falls

Recently, the insurance aspect of gold was reflected in the rally following Russia's invasion of Ukraine on 24 February 2022, which sent a negative shock to equity markets From February to mid-April 2022. This saw an uplift to the price of gold as investors rushed to the safety of the physical asset away from equities with gold touching $1,978/oz.

Chart 4: Earnings multiples for the world's three largest gold miners are near 20-year lows



Source: Bloomberg, with data for Barrick Gold, Newmont and Newcrest Mining.

We believe there is a near-term opportunity in gold equities given the expectation that gold will rise with falling inflation and slowing economic growth. Chart 4 illustrates the downward trend in earnings (EBITDA) multiples against enterprise value (EV) for the world's three largest gold companies: Barrick Gold (NYSE), Newmont Corporation (NYSE), and Newcrest Mining (ASX).

Theory suggests gold should act as an inflation hedge and insurance against geopolitical shocks. From our perspective, we believe gold represents a near-term opportunity, as we see the peak of US tightening, and a weakening of the US$. At the same time, gold valuations are not stretched versus history. Gold equities are directly leveraged to the underlying gold price, with a firming gold price significantly benefitting the earnings outlooks for gold producers. Gold equities trading multiples have derated over the past 20-years and are currently trading around 1 standard deviation below the 20-year average. For this reason, we are expecting quality listed gold equites to benefit from re-ratings in earnings and value in the near term, assuming that the gold price follows past trends, and inflation continues to fall in the current monetary tightening environment.

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