MV CAPITAL MANAGEMENT

Weekly Market Flash

The Gold Bugs Go Institutional

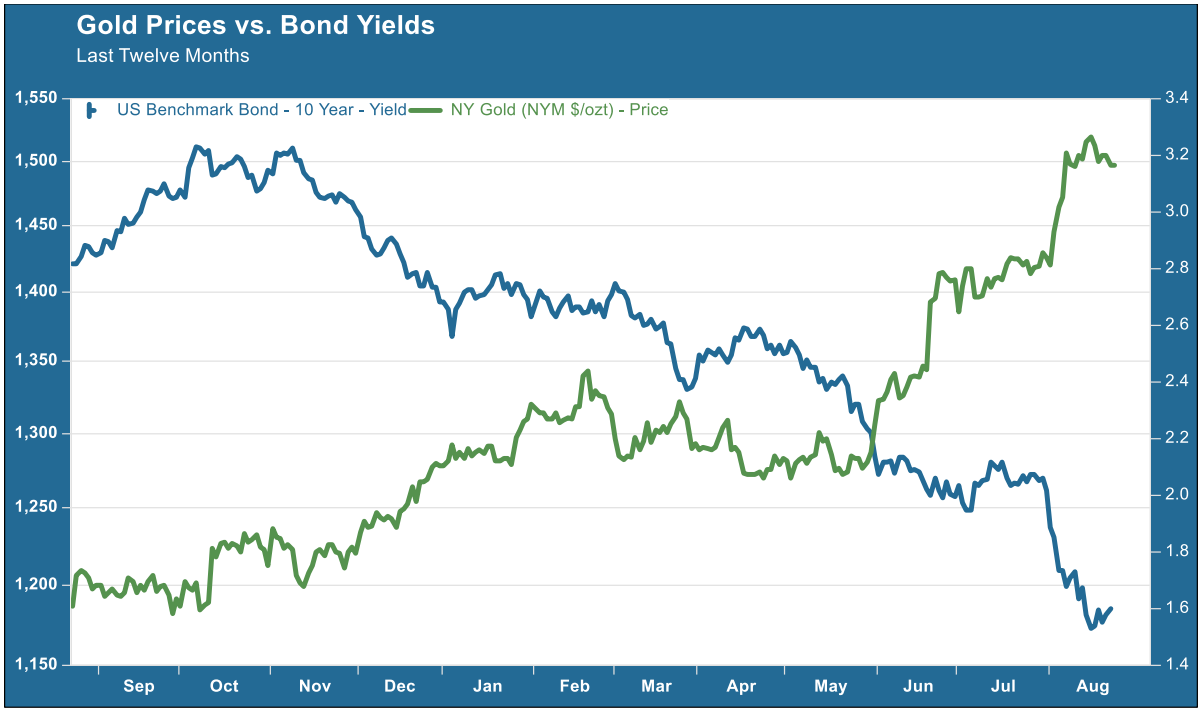
August 23, 2019

We are writing this column on Friday morning, right smack in the middle of a speech by Fed Chair Jay Powell about the future of everything, apparently, but since we have a publishing deadline there is no opportunity to sit back and carefully consider whatever insights our chief central banker has to communicate about the world economy and what remedies his institution might consider appropriate. We will note, however, that the stock market is bouncing up and down like a ping pong ball, so apparently there are differences of opinion among the trader-bots at play as well and no obvious directional trends.

Banks Buy the Bars

Chair Powell is out in Jackson Hole, Wyoming today with his monetary policymaker-friends from around the globe, this being the annual central bank confab hosted by the Kansas City Fed. One bright and shiny thing that has grabbed the interest of many of these bankers over the past twelve months is…an actual bright and shiny thing – gold. Central banks have purchased $15.7 billion in gold over the first six months of this year, a record amount which comes on the heels of a year – 2018 – in which these institutions bought more gold than at any time since 1971. If that year rings a bell then you know your monetary history – 1971 was the year then-president Richard Nixon took the US off the gold exchange standard, thus ending seemingly forever the two century-plus reign of the gold standard.

Unsurprisingly, gold prices have been inching up over this period, but they went into turbo mode back in June. The chart below shows that this sudden spike in gold roughly coincided with bond yields flipping on their own hyperdrive switches.



Source: MVF Research, FactSet

An Asset For Our Day and Age

Why all the interest in gold? Readers who have been with us for a while know that our traditional view on this asset class has been fairly skeptical, to say the least. Gold is a commodity like any other physical thing that gets extracted from a topological location, be that oil or tin or coffee beans. Like these other commodities it goes up and down in price according to supply and demand, and offers little in the way of predictability as to the timing and magnitude of cash flows. As a haven asset, in other words, it doesn't seem to offer much in the way of a safe harbor.

But those views may be better suited to the world we lived in a few years ago – namely one in which there was still a fairly mainstream expectation among economists and other market observers that interest rates would eventually wind up back somewhere close to historical norms. Those days are gone. We now live in a world where $16 trillion, or about 25 percent, of the total amount of government and corporate debt outstanding trades at negative interest rates. As things stand now that negative-rate volume is much more likely to increase than to decrease.

The Lesser Fool Theory

Negative interest rates only make sense in the context of the "greater fool theory" of investing: the idea that no matter how ridiculously priced an asset seems to be, there's always a sucker out there (i.e. the greater fool) willing to take it off your hands for a profit. The greater fool theory has been a staple of financial markets since the days of tulipmania in seventeenth century Holland. It is literally the only explanation for 10-year German Bunds fetching yields of minus 0.7 percent.

Now it makes more sense why gold, long the preserve of paranoid "gold bugs" holed up in remote bunkers in rural Idaho or wherever and touted by dubious snake oil salespersons on late night cable TV, is gaining favor as a reserve asset by the monetary mandarins of global central banks. Call it the "lesser fool theory." Nothing has changed about the fact of gold as a simple physical commodity with no inherent value outside the regular market forces of supply and demand. But hey – it sounds a lot more attractive than paying interest to the sovereign entity which is borrowing from you to fund all its (rational or otherwise) spending plans. Money has to go somewhere, after all.

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