Comerica WEALTH MANAGEMENT

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Weekly Market Update:
The Barbarous Relic

In 1924, the British economist John Maynard Keynes famously referred to gold as the "barbarous relic," generally questioning its usefulness as an investment vehicle while more specifically probing the practicality of the gold standard. To be sure, the nickname stuck, but it took almost 50 years before the U.S. officially abandoned the gold standard, in an effort to curb inflation and prevent foreign nations from burdening the U.S. financial system by redeeming its dollars for gold.

Yet, to this day, gold remains a constant source of interest for investors, despite its inability to generate income or deliver earnings. Indeed, the supply is limited, but demand can fluctuate for several reasons, including inflation, geopolitics, and market interest rates.

The price of gold has been surging for several months now and investors are trying to divine the catalyst – the war in Ukraine understandably has markets on edge, inflation is soaring around the world, and global bond yields remain elevated.

While the fundamental strategies driving the move higher in gold can be disputed between its use as an inflation hedge or a safe-haven asset, the technicals are indisputable – momentum is strong, and flows are mild – suggesting further gains ahead.

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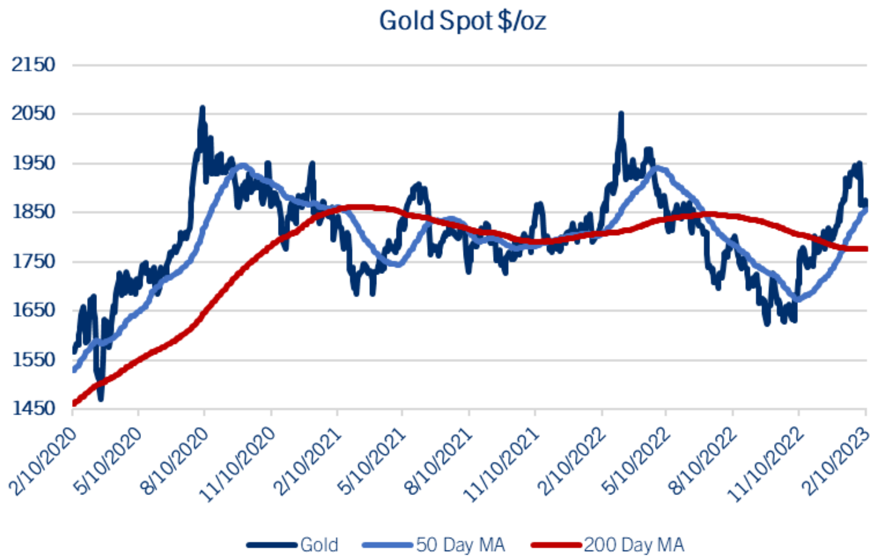
Gold Run

Since the start of the global pandemic, gold initially surged on safe-haven bids, before trending sideways and ultimately catching renewed bids, first on inflation fears and then on U.S. dollar weakness. See chart: Gold – ($/oz.)

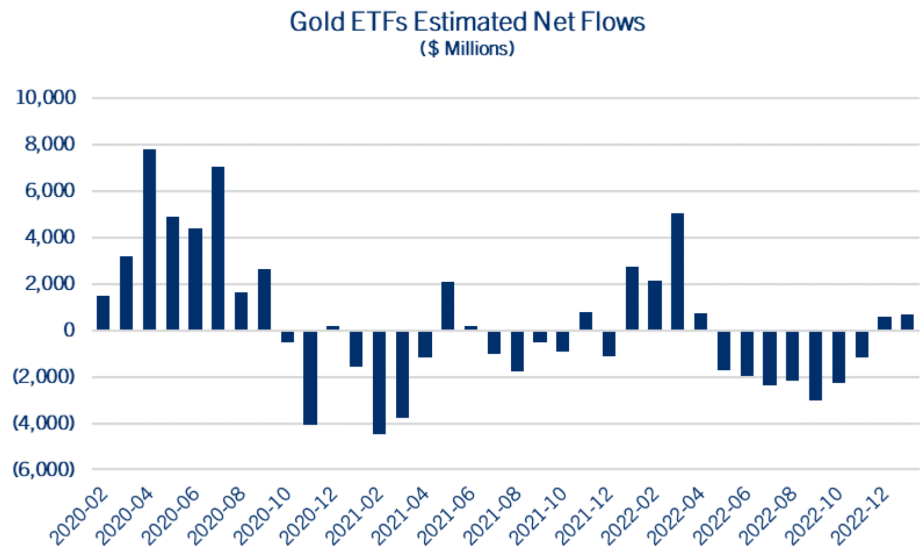


Source: Bloomberg L.P.

After the most recent price surge, gold entered an overbought condition, as defined by the 14-day Relative Strength Index (RSI). Yet, this consolidation phase within an uptrend is not unusual, and the successful testing of the 50-day moving average (DMA) may position gold for further upside.

Gold Run (continued)

Indeed, despite gold's recent strength, weak flows into gold-related ETFs have not indicated that this has been a crowded trade, further supporting the potential for more buying demand. **See chart: ETF Flows.**



Source: Morningstar

While the price gains for gold are notable, it is similarly important to mention that for the first time in 50 years gold has outperformed the S&P 500 in the initial 3 months off a market bottom – Oct 12, 2022. Gold was up 14.6% vs S&P 500 + 11.8%. If this were the start of a major new bull cycle in stocks, we would not expect to see an inflation hedge outperform. That is, unless there are other factors at play in driving up the price of gold.

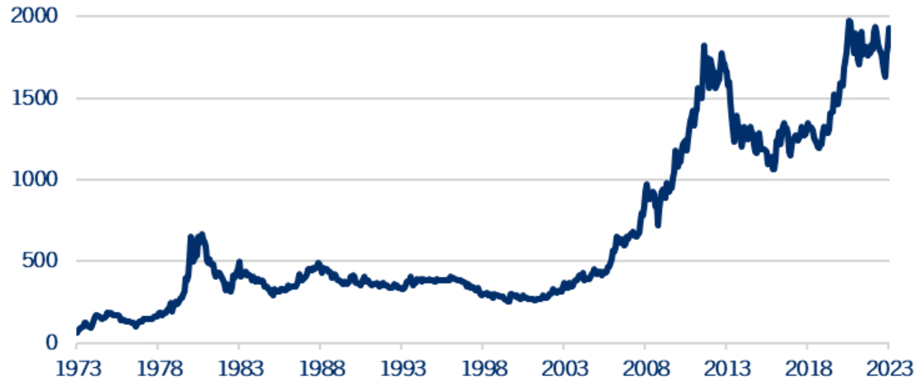
Inflation Hedge - Safe Haven - Store of Value

Gold has traditionally been considered a safe place to store wealth amid periods of high inflation and political turmoil.

It shines brightest when the inflation rate begins to outpace interest rates. During these negative real rate environments, the buying power of money is decreased with the overall increase in the price of goods and services. Gold as an inflation hedge is expected to maintain its buying power, outperforming other financial assets. In addition, it has zero credit or default risk, making it the ultimate safe-haven asset.

Modern history bears this out. **See chart: Gold – Long Term.**

Gold Spot - Long Term



Source: Bloomberg L.P.

Since the 1970s, after the U.S. abandoned the gold standard, the yellow metal still played an important role in the investment landscape. Between 1974 and 2008, there were only 8 years when U.S. inflation was high (exceeding 5%). In those years, gold prices increased by an average of 17% year-over-year adjusted for inflation, outdistancing assets such as bonds, equities, and other commodities. During the 21 years of moderate inflation (between 2% and 4.9%) and 6 years of low inflation (below 2%), gold posted only "mildly positive" real returns.

Central Bank Purchases

Since the 4Q of 2022, world economies have made some headway in raising interest rates to combat inflation, and indeed many measures of inflation appear to be rolling over. Against this backdrop of increasingly positive real interest rates, one would expect weakness in the gold price.

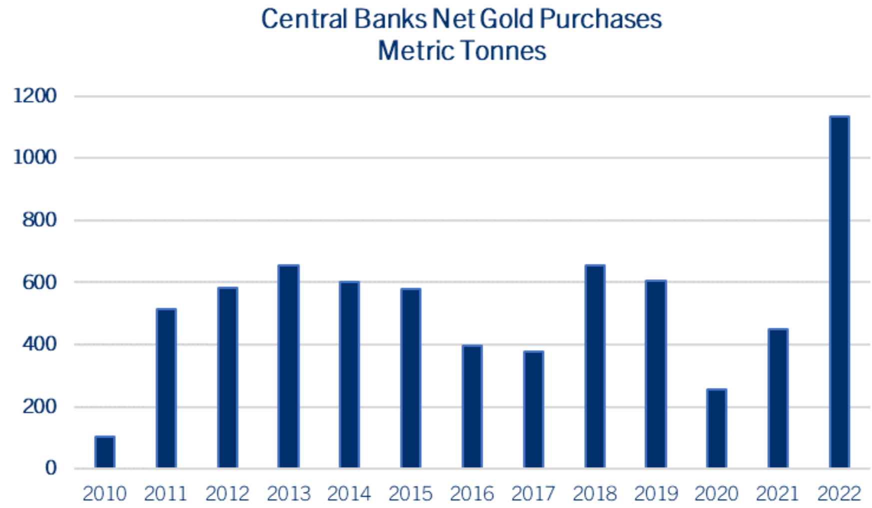
What we are seeing is the opposite.

Typically, demand for gold is broken up into four categories: jewelry (~50.0%), investment (~25.0%), central bank holdings (~15.0%) and technology (~10.0%).

Investment demand generally reflects the degree of inflation 'angst' in the market. The previous chart on gold ETF flows, as a proxy for investment demand, suggests that this has been tepid. This could well reflect investor confidence in the Fed's determination to bring inflation under control, keeping breakeven inflation expectations stable and pushing real rates to the highest level since the Great Financial Crisis.

So what then has been spiking the price of gold?

Data from the World Gold Council indicates that Emerging Market Central Banks (EMCBs) significantly ramped up their purchases of gold last year. In the third quarter alone, the World Gold Council estimates that EMCBs purchased 400 metric tons of gold. This is the largest quarterly figure on record, and approximately 300 metric tons above historical averages. See chart: Central Bank Net Gold Purchases.



Source: Bloomberg L.P.

Historically, central bank demand started to fall coincident with the lessening of geopolitical tensions following the end of the Cold War in the 1980s. Indeed, Developed Market central banks have not been significant gold buyers over the past 40-50 years.

Yet, the rationale for EMCBs buying gold is clear. Facing geopolitical tensions, those emerging nations aligned or reliant on Russia and China for trade are strategically opting to buy gold as a politically neutral asset as a foreign exchange reserve in lieu of the U.S. dollar. Russia does not report its gold purchases and given the freezing of its foreign exchange reserves they may well be buying domestically produced gold due to the lack of alternative investment opportunities. Purchases by other CBs, including China, may also be due to an abundance of caution.

Conclusion

Gold is a non-income producing asset. It costs money to store gold, which is a disadvantage in a stable price environment. Higher real interest rates are a negative for gold prices as investors gravitate towards financial assets generating positive real returns. Notwithstanding the negatives of holding gold in a growth environment, structurally higher EMCB demand due to geopolitical trends likely places a floor on the price of gold. In other words, CB purchases should offset reduced investor demand. Under our mild recession scenario in 2023, investor purchases and renewed ETF flows could drive prices up further in the months and quarters ahead.

Be well and stay safe!

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