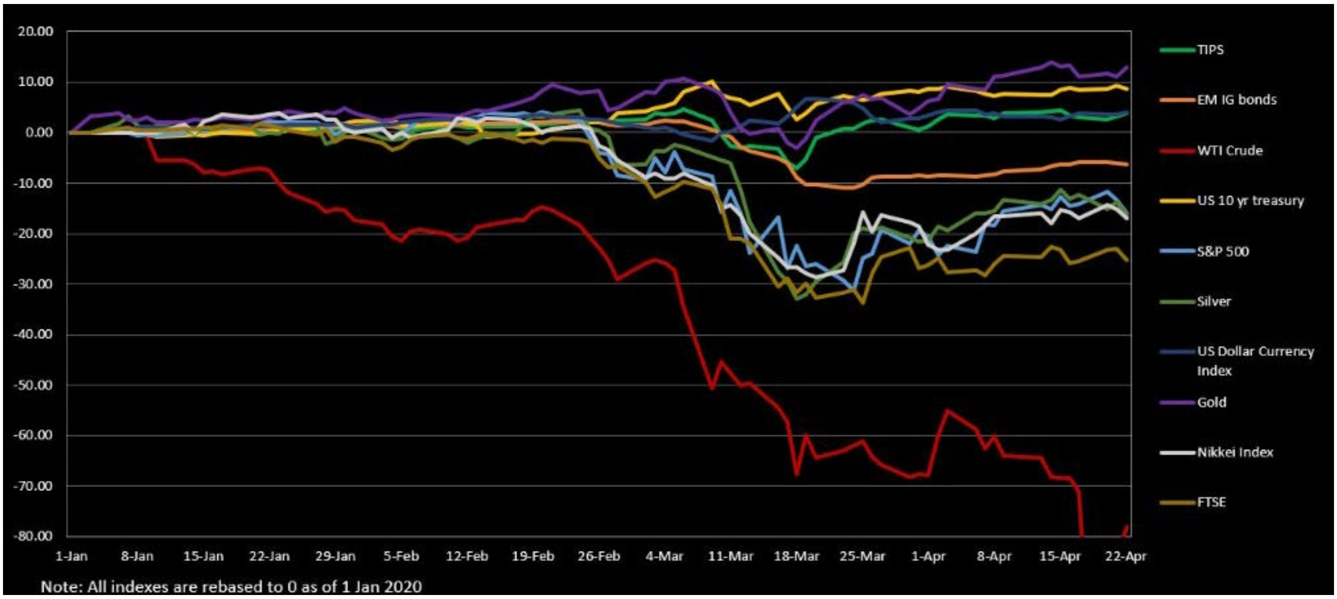
TIME TO HANDLE GOLD WITH KID GLOVES

A 'Labour Day / May Day' global celebration lies ahead on Friday. The world, however, is a very different place from the last time Labour Day took place. The world is in the grip of the worst pandemic since the Spanish Flu with no economy being spared. Oil prices have collapsed with analysts and economists trying to work out what our global economic future looks like. Can we expect a 'V-shaped', a 'U-shaped', an 'L-shaped' or a 'W- shaped' economic recovery?

A recent note from ETM Analytics mentions that it can be assumed that global economic growth will probably be negative for 2020 as the world adjusts to new ways of doing business. A massive debt burden has resulted from the pandemic which needs to be repaid, the travel industry has been and will be severely impaired, digitization will move ahead even faster, working remotely may become the norm and manufacturers might adjust their supply chains away from China (which will come at a cost) and we will more than likely see nationalist policies take center stage in the political arena.

In times of capital market distress and uncertainty, Gold is often part of most investment discussions. Gold has outperformed most asset classes in USD terms for the year-to-date.

Gold's performance against other asset classes



Source: Refinitiv data/Gaurav Dogra

At MitonOptimal most of our global and SA domestic growth portfolios or funds have held Gold ETFs or Gold Stocks since February 2016. In March 2016 we wrote:

'The justification for this addition to our funds range between the following:

- Gold has a long-term diversification benefit to portfolios in any currency when entering a Gold bull market (we do not profess to take that as a fact!)
- The objection against Gold for not paying a dividend or interest is fading fast when more than 20% of Developed Market Bonds trade at negative yields.
- The US Dollar rally relative to other developed and emerging market currencies is long in the tooth - Gold acts as an insurance policy to a potential countertrend action.
- From a technical perspective, Gold Bullion has made a constructive move. A comment from one of our technical experts summarised it as the potential first leg of an Elliot Wave Theory (5 waves, of which the current move could be the first leg)'

What has changed since February 2016?

- The global economic growth trajectory and shape of recovery is unknown as the COVID-19 pandemic is not over.
- Due to COVID-19 central banks have injected over US$ 5 trillion of monetary and fiscal stimulus to prevent a large-scale global depression. The immediate consequence is deflationary, but it is fair to be concerned that inflation can be a medium-to-long term implication as many countries may decide to move manufacturing back into home countries, which will increase production costs. A continued flood of fiscal stimulus/relief packages can also lead to higher global inflation.
- Developed market central bank balance sheets have quadrupled in debt over the last 12 years and one way in which a country can decrease its debt is via a weaker currency. Who can have confidence in any currency when country debt matrices are at historic highs across the world? Gold serves as a an 'alternative currency'.
- Developed market central banks will have to keep interest rates lower for even longer to prevent a large-scale bond sell-off and further economic decay.
- The technical indicators are also bullish for Gold bullion
- All of these factors are in favor of holding Gold Bullion and Gold Equities. Gold Bullion has returned 9.89% p.a. in US Dollar terms since 2 February 2016. The S&P 500 has returned an amazing 11.49% p.a. over the same period. For SA Investors these numbers change in ZAR to 14.14% p.a. for Gold Bullion and 15.80% for the S&P 500 over the same period. The Old Mutual Gold Fund has returned 24.3% in ZAR terms over this period.

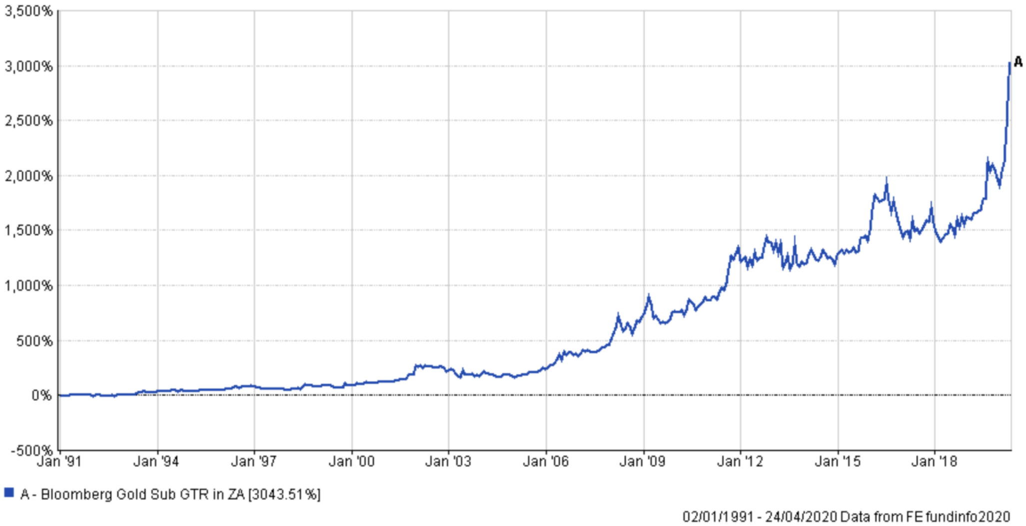
It's time to handle our Gold holdings with kid gloves

We are becoming more cautious in terms of our Gold ETF and Gold Mining exposure in our SA solutions. Why is that?

- SA Gold Miners are now trading at much higher levels and are expensive relative to other EM shares. According to Bloomberg consensus, the current 12 month forward PE ratio for SA Gold Stocks is trading at 12.2 and the historic PE is 35.3. The current historic price-to-book ratio is 3.83 and 12 month forward price-to-book ratio is 2.44. This appears to be expensive for these businesses which have a high dependence on the spot Gold price to remain profitable. When comparing this to the JSE ALSI excluding IT (i.e. Naspers and Prosus) it is expensive. The ALSI ex IT is trading at a historic PE of 12.7 and 12 month forward PE of 9.3. The current historic price -to-book ratio of the ALSI ex IT is 1.36 and 12 month forward price-to-book ratio is 0.77 (i.e. a 23% discount to book value if consensus views are accurate)

- If one expects further distressed trading, Gold could again - as per recent COVID-19 selloff - be a casualty as investors sell ‘good’ assets to create liquidity
- Gold is priced in US Dollars and the ZAR has devalued more than 2 standard deviations from a mean purchasing power parity matrix. I.e. the Rand is cheap, and Gold is much more expensive in Rand terms than ever before.

Gold price in ZAR since 1991



Source: Financial Express

- It is fair to say that some Emerging Market consumers in China and India may also need to sell Gold/Silver jewellery to fund their damaged lifestyle or just simply to be able to buy goods and services.

In conclusion, we are not long-term contrarian Gold Bulls. Gold has been one of the largest contributors of our fund performance (many of our funds are 1st quartile vs. peers over 1,3 and 5 year periods up to last week). If global deflation remains the short-term base case, Gold Bullion and Gold Equity exposure in our portfolios and funds will decrease. While we remain optimistic about the asset classes role as a long-term diversifier in our portfolios, we are cautious in the short term to purchase more of a more expensive asset class - that is, relative to 2016 when we started our journey with this asset class.

Roeloff Horne
Head of SA Portfolio Management

www.mitonoptimal.com