Special Paper No.6

Gold - Precious Currency

"In reality there is no such thing as an inflation of prices, relative to gold. There is such a thing as a depreciated paper currency."

Lysander Spooner, 19th century American writer.

Misclassified

Investing in gold is not a straightforward concept. Gold is viewed by many as a commodity, even though the rules of supply and demand for industrial commodities do not apply. Jewellery and industrial applications account for around half of gold demand; the remainder comes from central banks and other investors. In the case of these latter purchases, the gold is most often stored in vaults, periodically audited but rarely practically applied. There are retail investors who will paint bullion bars black to serve as doorstops but, in all but the most eccentric cases, this is 'storage by disguise'. Demand drivers cannot be ascribed to normal patterns of economic growth or industrial activity. Instead, demand for gold is a function of perceived rather than practical value. For those assessing gold as a commodity, this will no doubt appear unsatisfactory. The inability to neatly quantify the drivers of demand, and their basis in perception rather than utility, renders the analysis of gold too elusive for many investors.

However, this is to misclassify the asset. Gold's place in our investment universe has been cemented over millennia and it continues to play a vital role as a currency, not as a commodity, in today's portfolios. It is fitting that the first gold coin is said to have been minted in Lydia, part of modern-day Turkey, around 550BC. Over the past five years, Turkey has seen the value of its currency fall by two thirds against the US dollar. This is illustrative of a fragility inherent in all fiat currencies; they reflect a promise by a government to repay with all the instability that this entails[1]. Any investor prepared to hold dollars, yen or Argentine pesos should also be prepared to hold gold. The credibility of fiat currency depends upon the fiscal and monetary prudence of the issuing government. It can be shattered overnight, as we have seen in the case of several emerging market currency devaluations, or it can be eroded gently, as looks likely to occur in much of the developed world.

Gold, by contrast, exists outside of the financial system; it is no one's liability. It has been used as a currency in numerous economies historically and latterly was the anchor for the majority of developed market currencies during the time when the gold standard prevailed in the 19th and 20th centuries. Whilst no longer explicitly a

[1] Fiat currencies are those which are backed by the government which issued it rather than being underpinned by any physical asset such as gold or silver.

medium of exchange, gold continues to represent a rare store of value which central bankers cannot print. In 2014 Alan Greenspan, former governor of the Federal Reserve, wrote,

"If the dollar or any other fiat currency were universally acceptable at all times, central banks would see no need to hold any gold. The fact that they do indicates that such currencies are not a universal substitute."

Continued widespread acceptance of gold's role is evident in central bank holdings which, according to the World Gold Council, stood at over 34,000 tonnes in Q1 of this year. These holdings have risen steadily since 2009. 651 tonnes were purchased in 2018 which represented the highest volume on record under the current monetary system. This increase in demand from central banks has coincided with two major shifts in the global monetary landscape.

1) Fiat fragility

The first of these has been the tacit acknowledgement by the US Federal Reserve of the impossibility of reversing quantitative easing. The so-called 'Powell Pivot' in January saw the Chairman of the Federal Reserve, Jerome Powell, abandon his previous stance of raising interest rates, and continuing to reduce the Fed's balance sheet 'on autopilot'. Normalisation of monetary policy has failed. Consequently, a potential resumption of central bank balance sheet expansion at some point in the future looks firmly back on the table, both in the US and elsewhere. This comes at a time when increasingly unorthodox fiscal policy is garnering cross-party political support, most notably in the US and the UK. Talk of more extreme fiscal intervention by way of 'Modern Monetary Theory' or 'People's QE' is gaining traction even though US unemployment at 3.6% is lower than it has been since the 1960s and UK unemployment at 3.8% is lower than it has been since the 1970s. During the next downturn, further and more aggressive expansion in the supply of paper money looks inevitable.

Driving this need for further expansion of the money supply is debt and the need to service it. It is also the reason why interest rates cannot rise any further. Developed market levels of government debt to GDP are at multi-decade highs and the only way this is likely to be reversed is via inflation. The inevitable devaluation of paper currencies which will follow creates an urgency for investors looking to preserve the real value of their wealth.

In this context, gold offers a precious alternative. Gold is virtually indestructible, and, unlike other resources, is not depleted through use or wear. There is also a finite amount of gold in the ground. These two characteristics render gold's supply remarkably stable. Contrast this with the expansion of central banks' balance sheets over the past decade (Figure 1) and gold's merits as a supply-constrained currency are compelling. Mined gold in any one year consistently amounts to c. 1.5% of the overall stock. With typically a five-year lag between a new gold mining project starting and the mine being operational, production is slow to react to price rises.

2) Dollar marginalised?

The second shift we are witnessing relates to the US dollar's status as the world's reserve currency. The dollar's pre-eminence was confirmed after the Bretton Woods system, which linked exchange rates to gold, broke down in 1971. A monetary system in which foreign entities can reliably hold reserves in dollars requires the US to maintain a trade deficit to ensure sufficient overseas supply of the currency. The logical conclusion of the current administration's 'America First' policy is incompatible with this. It is also incompatible with the preservation of trust required in a nation assuming currency leadership among its trading partners. As relationships turn more adversarial, it is unsurprising that countries such as Russia and China are increasingly prioritising gold, their holdings being up 102% and 84% respectively versus five years ago. Today central banks account for 12% of gold demand, up from 2% in 2010.

A sudden dethroning of the dollar looks improbable but it is also not required for a notable move in the gold price. A continuation of the gradual shift away from dollar hegemony would likely have a substantial impact, as it has done over the past 16 years since Troy first bought exposure to gold. According to the IMF's figures (the accuracy of which the IMF itself caveats as being subject to the validity of central bank disclosures), global central bank gold reserves are worth $1.8trn compared with their total FX reserves of $11.6trn (of which $6.7trn is in dollars). Central bank gold reserves account for c. 17% of total above-ground gold stocks which are worth a little over $10trn. If they wished to switch all their foreign currency holdings into gold in one fell swoop (at today's prices) they would have to buy up all the remaining gold in existence. This assumes that the 48% of stocks in jewellery and the 21% in private investment are 'for sale'. It is therefore reasonable to infer that increased prioritisation of gold, as a component of central bank reserves, should have a material impact on the price.

Recent performance of the gold price has not however come at the expense of the dollar even though the two have tended to exhibit a negative correlation historically. Their ordinarily inverse relationship is in part due to their interchangeability as reserve currencies, in part due to the gold price's denomination in dollars (depreciation in the dollar renders gold more attractive in other currencies) as well as the fact that mining costs tend to be denominated in USD. US economic outperformance has attracted investors to dollar assets at the same time that central banks and investors have recognised the merits of increasing reserve allocations towards gold. Thus, gold with its dollar denomination has provided a doubly valuable hedge against the depreciation of more febrile currencies. In sterling terms, gold has made a new all-time high over the past two months and has more than doubled over a decade.

Lessons from history

Historical data support the case for holding gold at this juncture. Whilst this report has referenced the necessity of inflation to reduce the real value of global debt, the timing of this is far from certain and there are numerous deflationary forces which may prevail before we get there. Gold's role as a hedge against monetary uncertainty, in both

directions, has been borne out over history. Figure 2 shows gold returns after inflation across 18 countries in the 111 years to 2011. In both deflation and inflation, gold has preserved its real value.

Recent financial commentary has made much of the staggering global stock of negative-yielding debt, currently amounting to $16trn. An environment in which investors desperately prioritise return of capital over return on capital paints a bleak picture for economic growth. It also risks itself becoming a determinant of a more stressed financial environment. A host of financial institutions, from banks to insurance companies, will struggle to operate in a world of sustained negative rates. The correlation between gold's recent rally and the increase in negative-yielding debt has often been cited as a function of the reduced opportunity cost from holding a non-yielding asset. This is indeed true but it is also the case that negative yields themselves are a likely cause of further pain. Negative rates not only eliminate a reason to not own gold but they also, regrettably, create a strongly affirmative reason to own it.

In the long run, gold has provided an effective hedge against risk assets during periods of stress. When investor faith in risk assets has weakened, gold has tended to perform well. Its place outside the financial system is likely to become increasingly valuable going forward. Figure 3 highlights the relationship between investor confidence and the gold price. This inverse correlation tends to strengthen when turbulence is most acute. The chart in Figure 4 highlights the negative correlation between the gold price and US equities. As occurred in Q4 of last year, this negative relationship reasserts itself most strongly when the volatility of markets to the downside intensifies. Gold's role as a diversifier within portfolios has enormous scarcity value in a world where prospective returns from government bonds have diminished and one can no longer depend on their positive returns to offset equities in a bear market. The same decreased potential is true of the dollar today, both for the reasons we have mentioned as well as, for UK investors, its particular strength against sterling.

How, and how much

Cognisant of the risks to fiat currencies and financial markets, Troy's multi-asset mandates began building up their gold exposures in 2003. Since the financial crisis, we have doubled the holdings to c. 10% of the NAV, acknowledging that the reasons for which gold was initially purchased have not gone away but have instead intensified. The gold is owned physically, in the case of Personal Assets Trust, via exchange-traded commodities (ETCs), as in the Trojan Fund, as well as in the form of a holding in Franco-Nevada, the Canadian gold royalty and stream company. Importantly, the ETCs are physically backed, mitigating the counterparty risk and tracking error inherent in synthetic ETCs. Franco-Nevada boasts a highly effective team of capital allocators who have a track record of successfully investing in mining projects. They share in the revenue upside but do not actually run the mines, operating a capital-light business model in a capital-intensive sector.

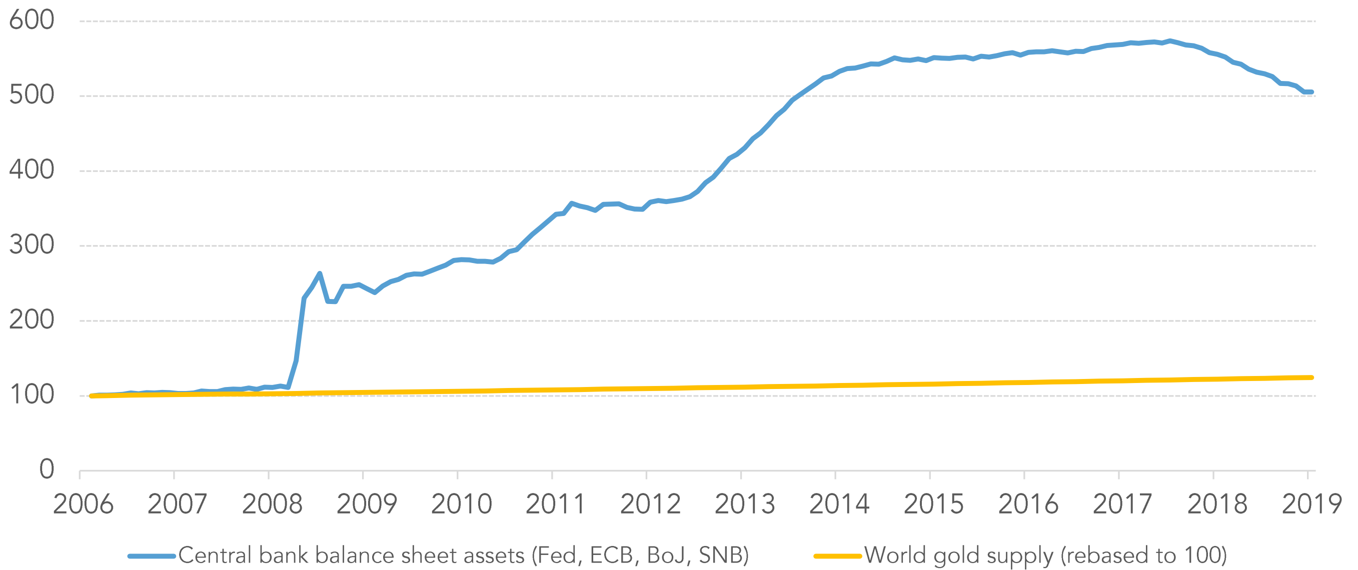
We are often asked how we size exposure to gold within Troy's multi-asset portfolios. As is often the case in investing, there is no

scientifically exact answer to this. Enough gold is required in order to provide sufficient downside protection. However, too much and one risks substantially skewing the performance of the entire portfolio during periods of gold weakness. Owing to gold's status as a currency, and consequently greater reliance upon perception, episodes of underperformance can be self-perpetuating, lasting longer than would be rational given the monetary environment. We have recently emerged from one such period of purgatory for gold, powered by a hopeful expectation of monetary policy 'normalisation'. This time last year sentiment towards the currency reached a multi-year nadir and speculative short positioning on gold, via futures, was more negative than it had been since the early noughties. It was then that we added to our gold holdings, with a view that the long-term rationale for an alternative to paper currency would reassert itself once more.

A return to a world of 'sound money', without severely damaging asset prices, is a hopeful vision of the future. With the supply of fiat currencies in flux, and more esoteric options for protection unproven, gold provides an alternative of substance, tested over centuries of investment history. We are wary of the increasing financialisation of markets and the fragility which this has engendered. Gold exists outside of the financial system and its worth is therefore not contingent upon any government or financial institution. Central banks and investors are taking note.

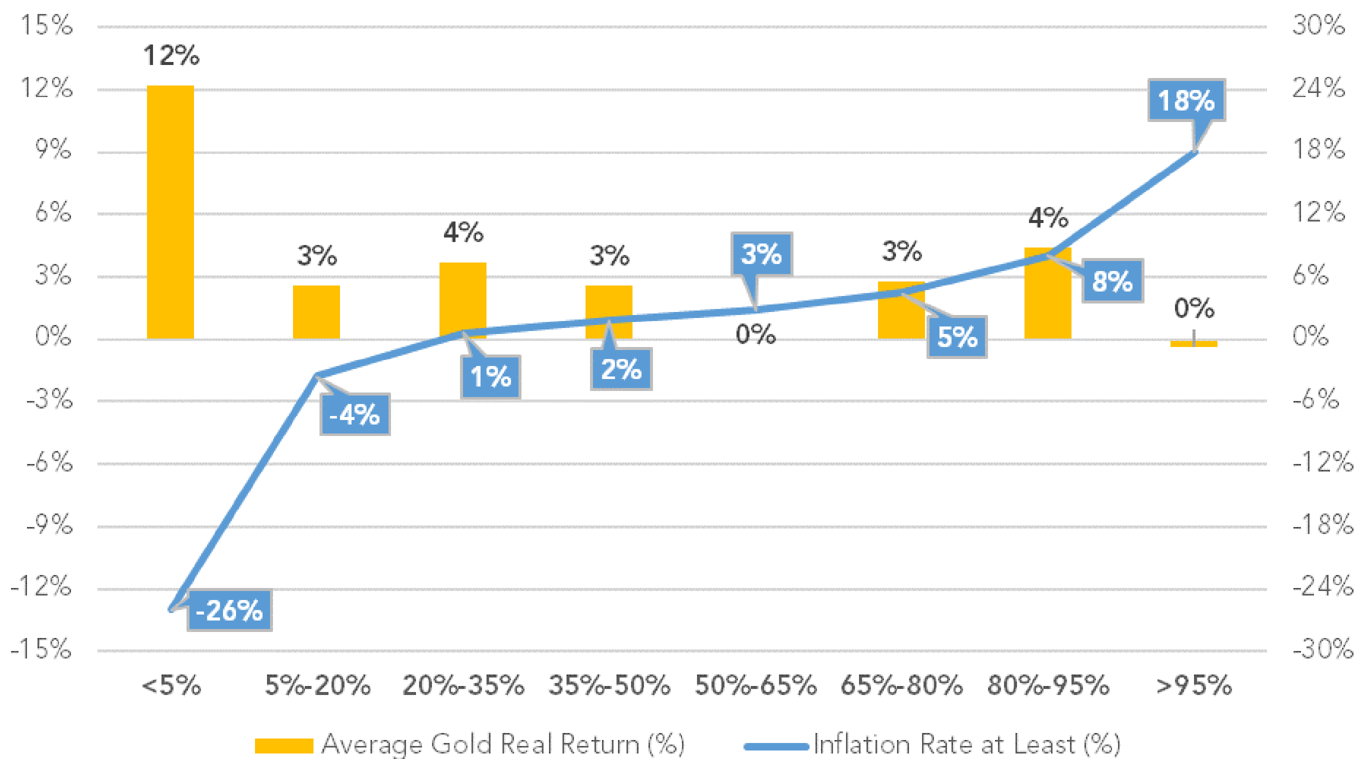
Charlotte Yonge
September 2019

Figure 1: World gold supply versus central bank balance sheet expansion



Source: Bloomberg, World Gold Council, 31 July 2019

Figure 2: Real gold returns by inflation percentile, 18 countries, 1900-2011



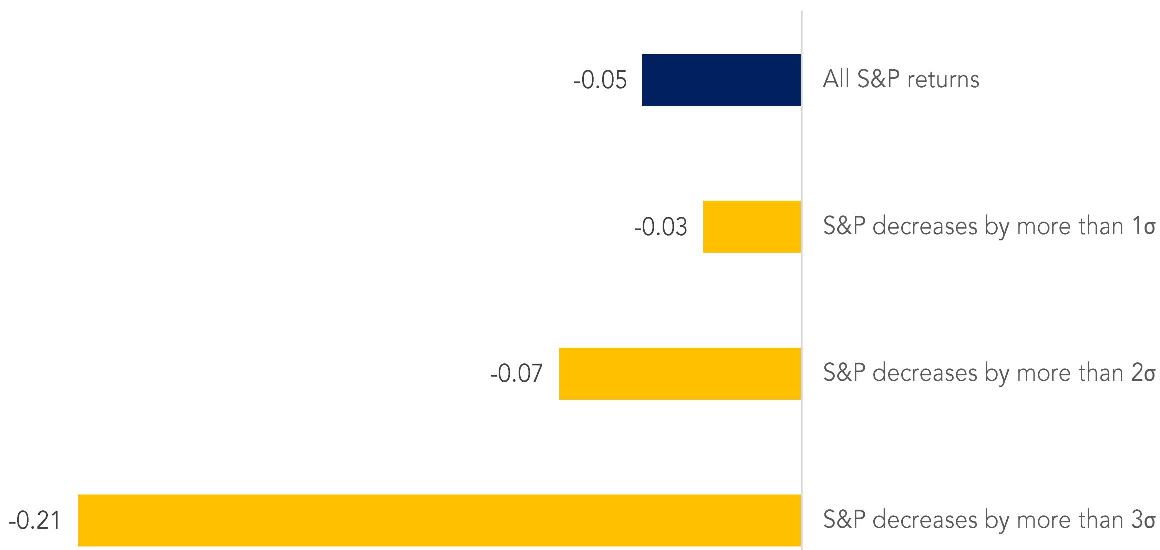
Source: CS Global Investment Returns Yearbook, World Gold Council, 30 June 2019

Figure 3: Gold price versus State Street investor confidence index (inverted)

Index shows a quantitative measure of global investors' risk appetites by considering exposure to risky assets

Source: Bloomberg, 30 June 2019

Figure 4: Correlations between gold and the S&P 500 Index



Source: Bloomberg, 31 July 2019. Based on weekly returns of the S&P 500 from 1988 to 2019
σ = standard deviation of weekly returns. Over the period, 1σ = 2.2%.

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