Timely Topics

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Updating Our Thoughts on Gold

This *Timely Topics* piece discusses LPL Financial Research's updated thoughts on the gold commodity asset class.

In light of the dramatic move in gold prices, we would like to take this opportunity to clarify our views on the precious metal. Many factors have played a role in the sharp recent decline in gold prices, but the central bank of Cyprus being forced to sell gold reserves to raise cash in conjunction with its recent bailout was the news that drove the accelerated, seemingly indiscriminate selling that began on Friday, April 12, and has continued into this week. Cyprus may sell 400 million euros worth of gold, which has raised fears that other troubled European countries may have to do the same.

A number of underlying currents have conspired against gold and driven its price to breach key technical support levels, which has added fuel to selling.

- **Fears of a gradual pullback by the Federal Reserve (Fed).** Last week's Federal Open Market Committee (FOMC) minutes revealed that more than half of the participants suggested tapering bond purchases during the third quarter of 2013. The perception, whether justified or not, of the Fed pulling back stimulus this summer reduced the attractiveness of holding gold as the threat of US dollar weakness due to Fed action is diminished.
- **Monetary stimulus by the Bank of Japan (BoJ).** Unprecedented stimulus by the BoJ has prompted investors to increasingly consider yield-bearing investments within equities in the form of dividend-paying stocks and, of course, bonds. The yen's safe-haven currency status has been called into question given the sheer size of the stimulus, causing investors to turn to such vehicles as real estate investment trusts (REITs) and to the bond market and away from gold. In addition, yen weakness (and euro weakness) has prevented the US dollar from falling, removing a potential tailwind for gold.
- **Reduced risk from Europe.** Aside from Cyprus, which is very small in dollar terms, Europe appears to have contained the risks of a systemic shock to financial markets. Ongoing bank lending programs and the mere existence of the European Central Bank's (ECB) bond buying program to support troubled debt issuers has limited downside risk from Europe and lessened investors' interest in gold's safe-haven appeal. With the market's perception that the likelihood of a disorderly breakup of the Eurozone is extremely low, market participants see less need to insure against "tail risk," or significant, highly disruptive, and unpredictable but very infrequent market events.
- **Stronger-than-expected U.S. growth.** Better-than-expected U.S. economic data has fueled investors' confidence in stocks and other riskier assets. While we believe the equity markets may have advanced too far

Precious metal investing is subject to substantial fluctuation and potential for loss.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Bonds are subject to market and interest rat risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Dividend paying stock payments are not guaranteed. The amount of a dividend payment, if any, can vary over time and issuers may reduce dividends paid on securities in the event of a recession or adverse event affecting a specific industry or issuer.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

too fast, the positive tone has undermined investments in gold as investors seek investments with greater return and income producing potential.

- **Near-term risks in Washington have fallen.** Gold prices rallied sharply to all-time record highs in the summer of 2011 on the heels of the debt ceiling debacle in Washington that led to the United States losing its triple-A credit rating from Standard & Poor's. While gold surged during that period, stocks were correcting nearly 20% peak-to-trough, based on the S&P 500 (July 25–August 10, 2011). The market's perception that Washington will not repeat its mistakes from 2011 has reduced demand for gold as a perceived safe haven against policy mistakes by Congress.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

- **Fears of deflation overtaking fears of inflation.** Gold tends to be an effective hedge against inflation. While aggressive central bank stimulus may be inflationary in the long term, current inflation pressures are moderate given little upward pressure on wages and contained commodity price inflation. As a result, the market's demand for gold as an inflation hedge has waned and contributed to downward pressure on gold prices.

Technical Analysis Overview

The aforementioned factors have contributed to gold's latest slide. From a technical perspective, gold's daily price broke critical support at 1540 on Friday, April 12, which also executed a triangle pattern to the downside [Figure 1]. These two factors together set up a bearish price objective at 1350. Support zone 1 is between 1350 and 1400. Support zone 2 is in between 1175 and 1250.

Also worth noting is that gold's 14-day daily relative strength index, or the RSI(14), is currently at 16.2. This indicator has not been this oversold since July, 1997, back when gold's price was at $318/ounce. In 1997, gold was in

1 Gold Commodity Daily Candle Chart

Source: LPL Financial Research, Bloomberg 04/15/13

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Relative Strength Index (RSI) is a technical momentum indicator that compares the magnitude of recent gains to recent losses in an attempt to determine overbought and oversold conditions of an asset.

a multi-year bearish trend (1/26/96–3/30/01); and from July 1997–August 1999, gold lost another 21.4% before it finally bottomed.

Although we understand the gold asset class faces a number of challenges as discussed above, we see many longer-term drivers as still supportive of gold as an investment.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

- **Low inflation-adjusted, or "real," bond yields.** In general, low real yields have boosted the allure of gold in the past. Low real yields, or inflation-adjusted yields, imply a reduced opportunity cost of holding gold. However, gold prices have disconnected from what are still historically very low real yields on bonds. In prior rounds of quantitative easing (QE) from the Fed, resulting lower real yields were met with gains in gold prices. Over the long term, we would expect this relationship to be re-established and for low real yields to support gold prices.
- **Central banks remain very stimulative.** Both the Fed and BoJ remain stimulative and the Fed's potential exit remains very data dependent. Fed leadership remains dovish (the so-called center of gravity at the Fed including Chairman Bernanke, Vice Chairperson Yellen, and New York Fed Chief Dudley), indicating the Fed may continue to err on the side of providing more stimulus and not less, and put renewed pressure on the US dollar. As a result, we believe gold may return to its role as an alternative, safe-haven currency.
- **Attractive long-term emerging market demand outlook.** China is the world's largest consumer of gold, and India is also a very large source of global gold demand, a lot of which is jewelry-based. These economies are experiencing rapid economic growth that we expect may provide a source of strong demand for gold and other precious metals.

What Actions Have We Taken With Our Gold Positions as a Result of the Selling Pressure?

We believe gold is technically oversold in the short-term and that the selling may be overdone; however, we have chosen to eliminate some of our exposure to the commodity at current low price levels. We have reduced exposure in some of the more conservative portfolios to limit volatility, and to reflect some of the increasing near-term risks cited above, as some of the drivers of gold price performance have reversed, or been pushed out in time, and key technical support levels have been broken.

In our more aggressive portfolios, we have added short hedges to insulate against further price declines. Gold may still benefit from the longer-term trends described above. However, when selling is intense and seemingly indiscriminate, and given that gold has little intrinsic value, we believe it is prudent to limit this near-term exposure through these actions.

In addition to these decisions, we are maintaining some exposure to the gold commodity. We may continue to see drivers that might help gold reverse some of its recent losses, and we will evaluate those opportunities as they arise. We will continue to monitor our positions very closely and will communicate changes in our view or our portfolios as they occur. ■

IMPORTANT DISCLOSURES

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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