The gold market and the vicissitudes of the financial markets since the Lehman Brothers collapse

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The decade since the collapse of Lehman Brothers as part of the financial meltdown of 2007-2008 has naturally seen a number of phases in the fortunes of the gold price. Given the fundamentals of the market, overall trends and specific turning points are usually driven by "hot money" especially in the past decade, although this knocked on in a dramatic way into the fundamental demand-side of the market, and the ramifications are still with us, as we shall see below. This is a brief overview of the patterns over the past ten years, but with a relatively detailed introduction in order to set the scene.

CHART 1: SPOT GOLD, JANUARY 2007 – SEPTEMBER 2018; US$/OUNCE

Lehman Brothers filed for bankruptcy on 15th September 2008. The early warning signs were in the market during 2007 with the problems with the sub-prime market. As the chart shows it is arguable that gold's performance in the second half of that year was already pricing in the risk of trouble, rising from the $640 region in midyear to challenge $1,000 in March 2008, then an all-time high in dollar terms as Bear Sterns collapsed.

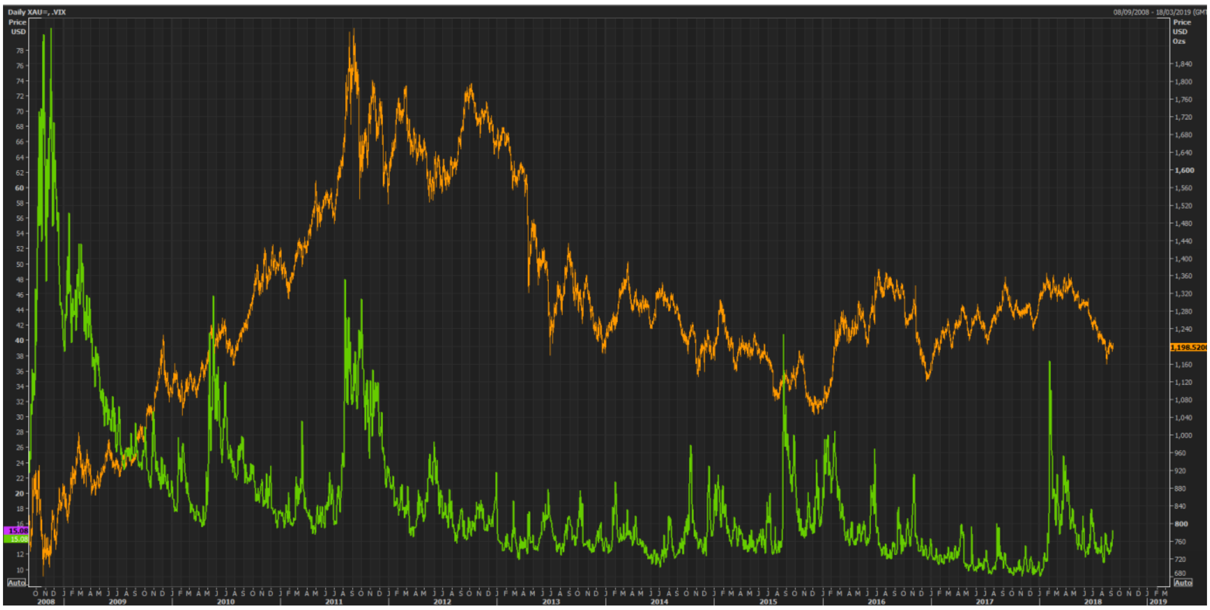
This price level proved overpowering for the market as a whole and prices slipped away under disappointment at the smaller-than-expected Fed funds cut (75 basis points in an effort to allay economic slowdown) and subsequent overall strengthening in the dollar. Consequently, gold fixed at $750.25 on the afternoon of Friday 12th September. In the chaos that ensued after the Lehman collapse (and with the U.S. Government having had to take over Freddie Mac, Fanny Mae earlier in September due to the sub-prime housing crisis) gold rallied hard and reached $899.00 on the afternoon of 23rd September.

While there was an inevitable correction, this set the foundations for gold's three-year bull run to peak on 5th September 2011 in the morning fix of $1,896.50 – although intraday prices topped $1,900 during that period.

By this stage the financial markets had settled down to a reasonable degree although the Fed remained a constant source of interest as the government continued its quantitative easing programme and, although the markets were constantly Fed-watching and most observers believed that gold had priced in further easing, there was always a reaction to any statement from the Chairman of the Board.

It is of interest to note that after many years on the sell-side, the official sector switched to become a net purchaser in 2010 and has remained so since (adding over 3,030 tonnes from 2010 to 2017 include, equivalent to 11 months' global mine production), which, although the buyers have been relatively few, so have the sellers, telling us something about different governments' attitude to risk and their desire for diversification.

CHART 2: GOLD AND THE VIX INDEX



Daily correlation between gold and VIX is highly erratic but in extremis the absolute performances tend to show similarity.

<u>The Official Sector became more risk-averse; what of investors?</u>

The "hot money" was relatively stagnant between the 2011 high and through to 2013, with gold prices drifting lower amid diminishing risk appetite, despite the launch of QE3 in mid-2012 and the subsequent announcement of QE4. This was reflected in the positioning on COMEX, with gradual long liquidation over the course of 2012.

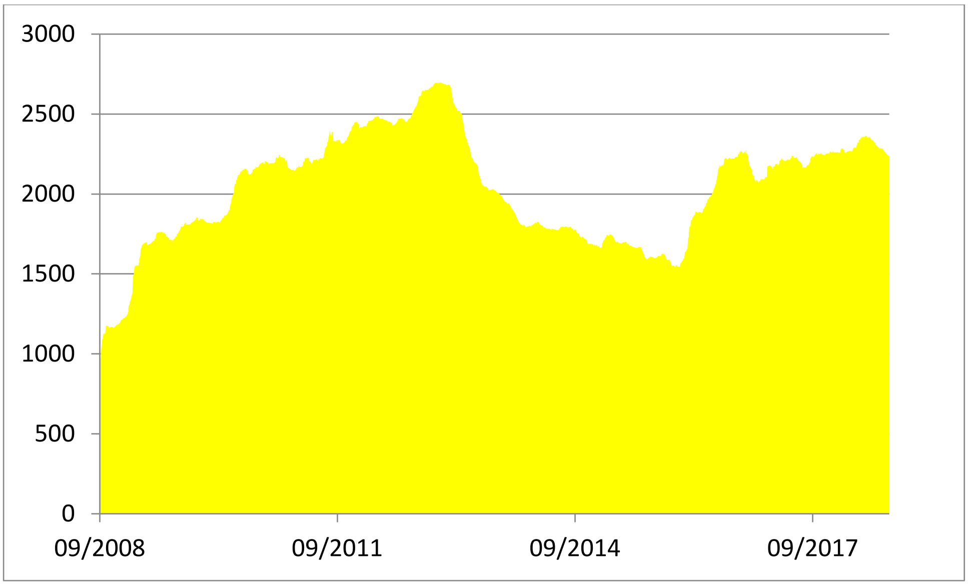
<u>The binary nature of 2013….</u>

The real excitement came in 2013 when professional investors appeared to have concluded that, despite vacillation over debt management in the United States, the worst was past for the financial sector and that gold, especially given its flaccid performance of the previous eighteen months or so, was out of favour. There was a massive outflow from the North American ETFs in April, generating a very sharp price fall, and again in June, when the fall was less severe but longer-lasting.

The widespread exodus of institutional funds from the gold market in 2013 saw a total of 880 tonnes leaving ETFs, while COMEX outright shorts increased massively in the first half of the year, although this was reversed in the second half of the year as profits were locked in. Over the year as a whole the net long managed money position on COMEX dropped from 587 tonnes to just 103 tonnes at end-2013.

A great amount of the ETF outflows went into Asia, with incredibly strong private buying of gold bars in mainland China in particular, at 412 tonnes against 249 tonnes in 2012. Global demand for investment bars, which had already been increasing from 2010 as private investors absorbed metal due to concerns about the economic outlook, shot up to 1,445 tonnes in 2013 (after 1,057 tonnes in 2012 and just 536 tonnes back in 2009). A substantial amount of gold was also bought by local banks in China, in order to take advantage of the high prevailing domestic premia as a result of the strong physical purchases.

CHART 3: GLOBAL ETF HOLDINGS; TONNES



... and the fall-out

This buying, both on the banking and private investor side, was way too enthusiastic for the actual level of longer-term underlying demand and the Chinese investment bar market has retreated since and remained broadly stagnant as investors licked their wounds against purchases at high prices. We also believe that it took the banking sector well more than a year to unwind the excess material that it had taken on board.

This weakening in physical demand, in China and elsewhere, has almost become self-fulfilling as there has been very little by way of positive price expectation (although the battle at $1,200 in recent weeks in 2018 has started to see some bargain hunting appearing at the grass roots level).

The latter years

Gold continued to drift lower through to the end of 2015 with professional and private investors continuing to migrate from the ETFs and COMEX positions shortening, with the Fed's tapering and ultimately the end of quantitative easing and a stronger U.S. dollar (itself helped by the onset of Europe's own QE programme). Improving economic activity in the United States contributed to the growing perception of stability.

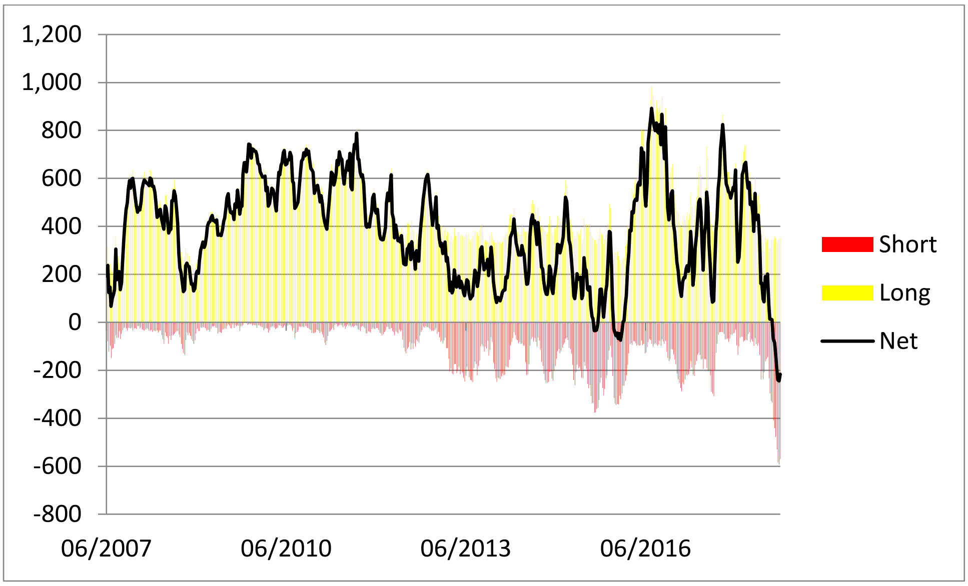
CHARTS 4,5 : THE S&P GOLD RATIO; BACK TO WHERE WE WERE TEN YEARS AGO…

…BUT NOTHING LIKE TWENTY YEARS AGO

So on balance, gold's role as a risk-averse asset was not really in demand over that period, as confidence improved overall, exemplified by the performance of domestic equities, for example.

The bull phase of 2016 and 2017 was essentially driven by resurgent geopolitical uncertainty, including the result of the Brexit vote and the U.S. election. Financial matters were by this stage, and for the time being at least, in the background. The subsequent bear market in 2018 has largely reflected the continued strength in the dollar, driven in part by trade wars and latterly by the crises in Turkey and Venezuela, with the contagion into other emerging markets' currencies. Whether any of the central banks of those struggling nations have been sellers of gold (broadly unlikely in our view, but not out of the question), has had less effect on the market's sentiment than the belief, well-founded or otherwise that they *might* be sellers.

CHART 6: COMEX GOLD MANAGED MONEY POSITIONS (TONNES)



So finance fears have re-surfaced, and we believe that ultimately they will prove to be supportive for gold. As we write this, though, the net short on COMEX was at record levels at end-August since the CFTC introduced its “managed money” classification, at 244 tonnes. With outright shorts standing at 593 tonnes. Some short covering has ensued; we expect more and a sharp short covering rally is not out of the question.