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We Remain Neutral on Gold in 2015; Buying Opportunity if Gold Declines to $950-$1,100 an Ounce

By Henry To, CFA, CAIA, FRM

The Rise of the Asian Investor

Happy New Year. As you are reading this, I will be on a flight from Los Angeles to Hyderabad, India, visting our Indian clients. I will then swing by Hong Kong for a few days before I get back to California on January 21st. As such, my weekly commentaries for the next several weeks may be a bit abbreviated. This "on the ground exercise," however, will allow me to get a broader prospective of India's economic impact on the world going forward.

In previous commentries, we asserted that the rise of the Asian consumer will be a major, multi-decade trend that will impact businesses around the world—especially those with global brand names, inherent barriers to entry (e.g. Macau casino resorts, prime real estate in Tier-1 global cities), and an Asian-centric appeal. For example, leisure & travel spending only makes up 3% of total Chinese consumer spending today, versus 9% in the U.S. Asian leisure & travel spending will catch up as Chinese income and wealth levels continue to outpace those of their Western counter-parts. With Congress now granting 10-year visas to Chinese tourists and business travelers, you can expect more Asian consumers to literally be at your doorsteps over the next 5-10 years.

As Asian wealth levels continue to rise, Asian investors will have a bigger impact on U.S. and global asset prices. According to Capgemini, the number of Asian high net worth individuals (HWNIs)—those with $1 million or more in investable wealth—surged by 17% to 4.3 million in 2013, on par with that in North America. Meanwhile, the amount of investable wealth held by Asian HNWIs rose to $14.2 trillion in 2013, just shy of the $14.9 trillion held by North American HNWIs. By the end of 2015, both the number and the amount of investable wealth held by Asian HNWIs will surpass their North American counterparts. Such a surge in wealth acccumulation in Asia—and more importantly, its rise above that of North America—is unprecedented in modern history. It is not hard to see why we believe Asian investors will have an increasing impact on global asset prices as we move forward in the 21st century.

We are already seeing signs of increasing impact or dominance by Asian investors and policymakers, including:

- The rise of housing prices, due to the influx of Asian families especially in coastal cities. The Chinese especially has made a significant impact on housing prices since 2009, when the EB-5 foreign visa program was streamlined. Congress' new 10-year visa program for Chinese tourists and business travelers will continue to be a tailwind for prime real estate prices around the country;
- Asian policymakers are exerting more global influence than ever before. China, especially, now has the ability to bypass the IMF to provide direct currency swaps to beleaguered countries. It recently provided foreign currency relief to Russia through a $24.4 billion currency swap agreement; on December 26, China and Russia came to an agreement allowing the trading of the yuan/ruble exchange rate between the two countries—meaning that Russian purchases could now be settled in the Chinese yuan, instead of the U.S. Dollar. Moreover, through the $240 billion Chiang Mai Initiative, China and other major ASEAN countries now has the ability to directly backstop or bail out its smaller ASEAN members;

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- History suggests that as a nation's average income rises to US$20,000, the demand for savings products and financial services will rise dramatically. Japan went through this phase in the 1980s; China will follow over the next 5-10 years. While local folks are lamenting about rising housing prices in New York or Los Angeles, I believe this is just the tip of the iceberg. Over the next 5-10 years, we expect the Chinese and Indians to start driving global equity prices and interest rates as well. E.g. both Chinese and Indian citizens already have a disproportionate impact on gold demand and prices.

I cannot emphasize enough the importance of the rising Asian investor, along with his/her impact on global asset prices going forward. At the height of the U.S. Dollar and gold-standard crisis in mid-1971—when the U.S. financial system was seemingly on its knees—the U.S., by her sheer size and technological prowess, was still the master of the financial universe. Charles DeGaulle had a few years earlier loaded up on gold; then withdrew France's support for the London Gold Pool, hoping to dethrone the U.S. dollar and return the world to a gold standard. France failed. At the time, the European Union was still a six-country customs union. President Nixon's Treasury Secretary, John Connally, would later remark to a group of European finance ministers, "The dollar is our currency, but your problem." Even when President Nixon severed the dollar's link with gold, the greenback remained the world's undisputed reserve currency. Finally, the U.S. has been the world's largest economy since the 1890s; we project the size of the Chinese economy to surpass that of the U.S. by 2021-2023—ushering in a new era of global financial politics. Going forward, the U.S. global financial influence will weaken, and certainly, her days of remaking the world financial system overnight are long gone.

U.S. Crude Oil Supply/Demand Dynamics Are Already Balancing

In our December 22, 2014 newsletter, we remarked that the recent, 49% decline in WTI spot was long-dated driven. At the time, the five-year futures contract (December 2019) bottomed at $67 a barrel. This was interesting since at the last major bottom in December 2008 (when WTI spot traded at $30 a barrel), 5-year futures (December 2013) traded at $70 a barrel. This means the 5-year outlook for crude oil prices just two weeks ago was more bearish than the 5-year outlook during December 2008, the peak of the global financial crisis. Even with the advent of U.S. shale production, I do not believe this makes case.

Yesterday, the December 2019 WTI futures contract settled at $70 a barrel, rising nearly 5% over the last two weeks, despite the ongoing (slight) decline in the WTI spot price. <u>This suggests the long-term demand/supply situation in global crude oil prices is finally balancing.</u>

For the week ending December 26, 2014, U.S. commercial crude oil inventories declined by 1.8 million barrels, vs. expectations for a 900,000 barrel draw. Over the next several weeks, we believe drawdowns in U.S. commerical crude oil inventories will be higher than expected, as supply growth begins to slow and demand growth exceeds expectations. As discussed, the ATA Truck Tonnage Index (a measure of real-time U.S. freight activity) surged by 4.4% on a year-over-year basis in November, with freight traffic notching a record high. Meanwhile, according to the U.S. Federal Highway Administration, total U.S. vehicle traffic rose by 2.6% year-over-year in October—with October total miles traveled hiting a record high—when WTI spot averaged $84 a barrel.

Figure 1: Total Vehicle Miles Traveled - U.S.

Month	Miles Traveled (millions)	Year-over-year Change
Oct-07	261,505	4.0%
Oct-08	256,402	(2.0%)
Oct-09	252,683	(1.5%)
Oct-10	256,867	1.7%
Oct-11	252,058	(1.9%)
Oct-12	252,899	0.3%
Oct-13	257,558	1.8%
Oct-14	264,171	2.6%

Source: U.S. Federal Highway Administration, St. Louis Fed

We believe higher-than-expected U.S. gasoline demand will begin to show up in inventory numbers as soon as next week. We also believe that the higher-than-expected builds in U.S. commercial inventories over the last couple of months were due to: 1) The Saudis pushing millions of barrels more to their export markets in order to drive down prices, and 2) U.S. shale oil producers actually increasing production to prop up short-term cash flows, which is a common strategy in the natural resources industry (many gold miners have adopted this strategy as gold prices plunged from $1,900 an ounce over the last several years). With WTI spot at $54 a barrel, however (North Dakota Light Sweet closed at $39.21 on December 31st)—and with high-yield shale producers' debt now yielding over 10%--drilling activity will decline significantly over the next several months. Lower supply, along with higher U.S. gasoline consumption, will begin to show up as lower-than-expected oil inventory numbers very soon.

E&P Services a Good Buy Over the Next Several Months

Our watch list includes **ATW, RDC, HP, HAL, SLB**. We remain cautious on this group as we project the U.S. oil & gas rig count to continue its recent decline (note that the Henry Hub February 2015 natural gas contract closed at $2.91/MMBtu yesterday) as 2015 CAPEX budgets are revised over the next several weeks. We will buy this group once we see signs of a bottom in the U.S. oil & gas rig count, or once CAPEX budget revisions slow down.

We Are Neutral on Gold in 2015; Although We Believe 2015 Will Offer a Long-Term Buying Opportunity

We first became bearish on gold prices in August 2011, when gold traded at $1,848 an ounce. While we believe there was a real chance of a Euro Zone breakup at the time, we still believed gold prices were overbought as there was significant euphoria over gold at the time (e.g. the University of Texas Investment Company, UTIMCO, bought about $1 billion of gold bullion near the top). We subsequently became even more bearish on gold prices in late 2012, when it became apparent to us that 2013 was going to be an "anti-climactic" year as global and European systemic risks began to dissipate (especially when it became obvious that ECB President Mario Draghi would follow through on his pledge to "do whatever it takes" to save the European Monetary Union).

Our initial 12- to 18-month target of $1,100-$1,300 an ounce was issued in our January 25, 2013 global macroeconomic issue, when gold traded at $1,660 an ounce. Our call was made several weeks ahead of similar calls by Goldman Sachs and Credit Suisse.

While we are bullish on the US$ for the 1st half of 2015—and short-term neutral on gold prices—we are still wary of the global, fiat monetary experiment that has been in place since the "Nixon Shock," when President Nixon severed the U.S. dollar link with gold in mid-1971. We believe the ECB will be next to adopt a sovereign quantitative easing policy; more importantly, we do not believe any QE policy, once implemented, will ever end. That is, the size of the Fed's balance sheet—at $4.5 trillion today—will never be unwound. When the next global financial crisis or a major recession hits, QE will be a routine monetary policy tool for the world's major central banks. The size of the Fed's balance sheet could easily hit $7-$8 trillion when the next financial crisis hits.

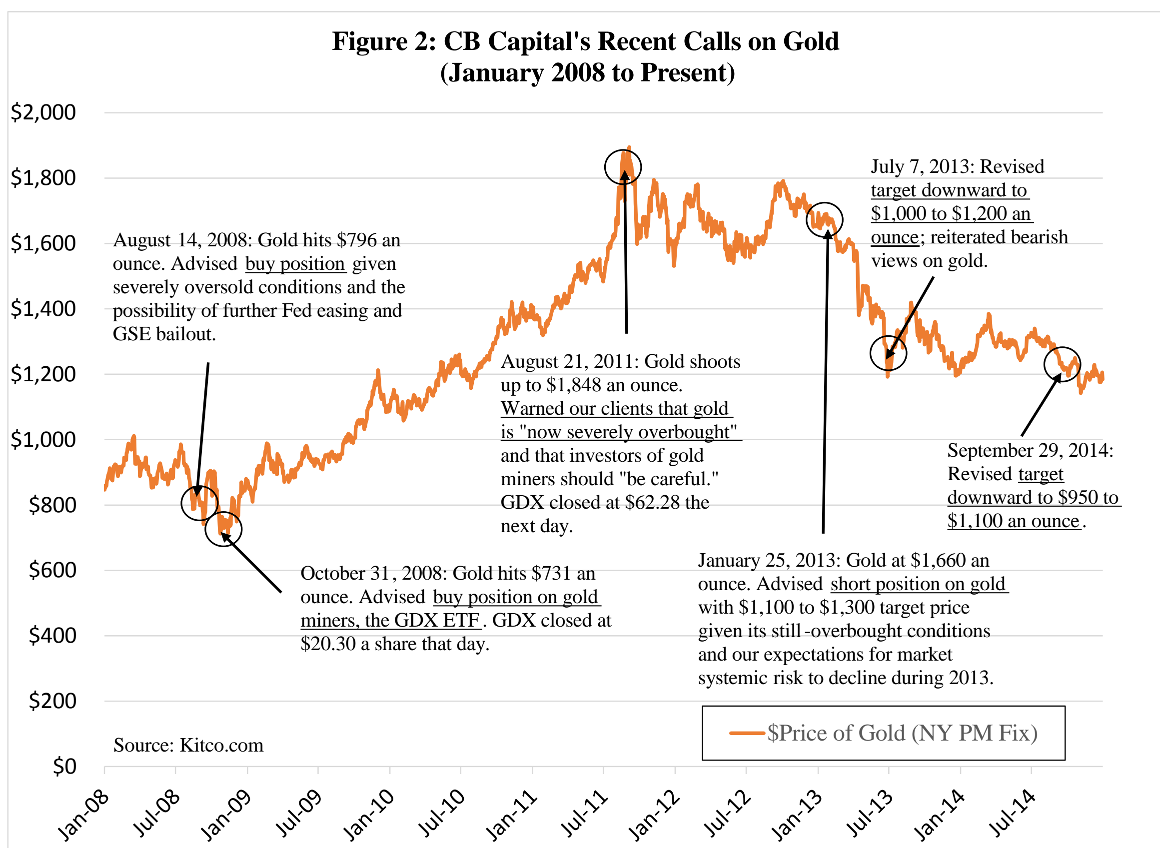
QE by itself does not cause higher inflation or erode the confidence of the US$ (or other fiat currencies). However, it does provide more "fuel" for credit expansion, social welfare programs, or to fight wars (note that the Bank of England was created to fund foreign wars) once the appetite comes back—which we believe are the best leading indicators for inflation (interestingly, in our study of leading inflationary indicators, the vast majority of factors which economists use (e.g. capacity utilization, M1 & M2 growth, growth in housing construction costs, weekly hours worked, etc.) were found to have no significant leading correlation/causation with U.S. CPI inflation.)

By far the biggest threat to the US$ (and other fiat currencies) in the longer-run is the pension & healthcare liabilities/obligations in the Western world. Before we proceed, I want to acknowledge that having longer life-spans—as well as better standards of living—is one of the most wonderful achievements in the 20th century. Unfortunately, the traditional retirement age of 65 was instituted in the 1930s, when about half of all 21-year olds were not expected to live beyond that age. Today, the average American can expect to live another 20 years once he or she reaches age 65; neither the design of our social security nor our Medicare/Medicaid systems could expect to handle the sheer size of these future, unfunded liabilities. According to the Congressional Budget Office's 2014 Long-Term Budget Outlook, the U.S. federal debt to GDP ratio is currently at 74% of GDP, its highest level since World War II.

While this is expected to decline slightly over the next several years, the sheer size of our entitlement programs—coupled with an aging U.S. population—is projected to lead to ever-rising budget deficits for at least the next two decades. By 2039, the federal debt to GDP ratio will rise to 100%, which the CBO asserts is "a trend that could not be sustained indefinitely."

Global policymakers have three options to tackle the incoming wave of retirement and healthcare obligations: 1) tax the younger/working population, and/or tax the wealthier baby boomers through higher capital gains or a wealth tax, 2) inflate their currencies, with higher global inflation as a result, 3) default on their obligations, or change the rules to cap their obligations.

My sense is that global policymakers will eventually have no choice but to use a combination of the above three options to tackle the incoming tidal wave of retirement and healthcare obligations. In my opinion, short of a regional war in the Middle East, this is the biggest overhang or potential "Black Swan" over asset prices over the next two decades. Because of the resultant threat of global inflationary policies, we would still advocate gold as a long-term hedge; while we are short-term neutral on gold prices, our long-term target for gold (2020-2022 timeframe) is US$2,000 an ounce.

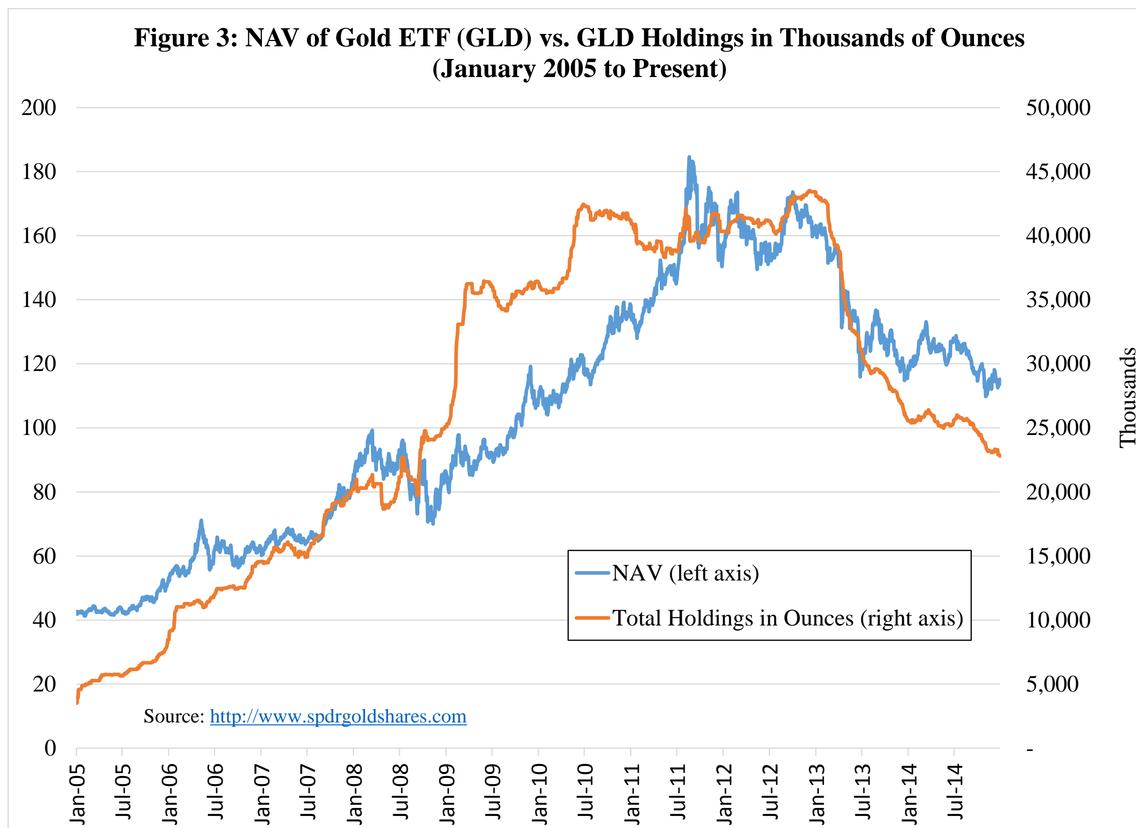


Three Indicators Suggesting a Potential Buying Opportunity in Gold in 2015

1) **Marginal Cost of Production**: A recent study by Goldman Sachs suggests that approximately 4% of the world's active gold mines is not profitable on an all-in-sustaining-cost (AISC) basis with gold prices below $1,200 an ounce. Similarly, as much as 11% of gold mines is not profitable with gold prices below $1,150 an ounce. We estimate conservatively that recent energy cost/labor deflation could take miners' cost down by $100 an ounce in 2015; meaning that our new threshold would be $1,100 and $1,050 an ounce, respectively. While these marginal mines could still operate profitably in the short-run if gold prices fall to $1,050-$1,100 an ounce, its long-run profitability will be hampered as they will not have the cash for maintenance or E&P spending to sustain their production. With the current gold price at $1,183 an ounce, we are getting to this threshold where global gold mining production may well peak. In fact, we expect gold mining production to peak in 2015 unless gold prices rise

substantially from current levels. Should the price of gold decline to the $1,050-$1,100 an ounce level, then we may be recommending a purchase of **GLD** or **GDX**.

2) One of our sentiment, overbought/oversold indicator is the change in the total holdings of the Gold ETF, GLD. Retail investors tend to be contrarian indicators, especially at major turning points. Gold holdings in GLD are highly indicative of marginal/short-term demand given its daily liquidity and the types of investors/speculators it attracts. As shown in Figure 3 below, total holdings peaked at 45 million ounces (orange line; right axis) in early January 2013, and have since declined to 23 million ounces, a drop of 49% over the last 24 months.



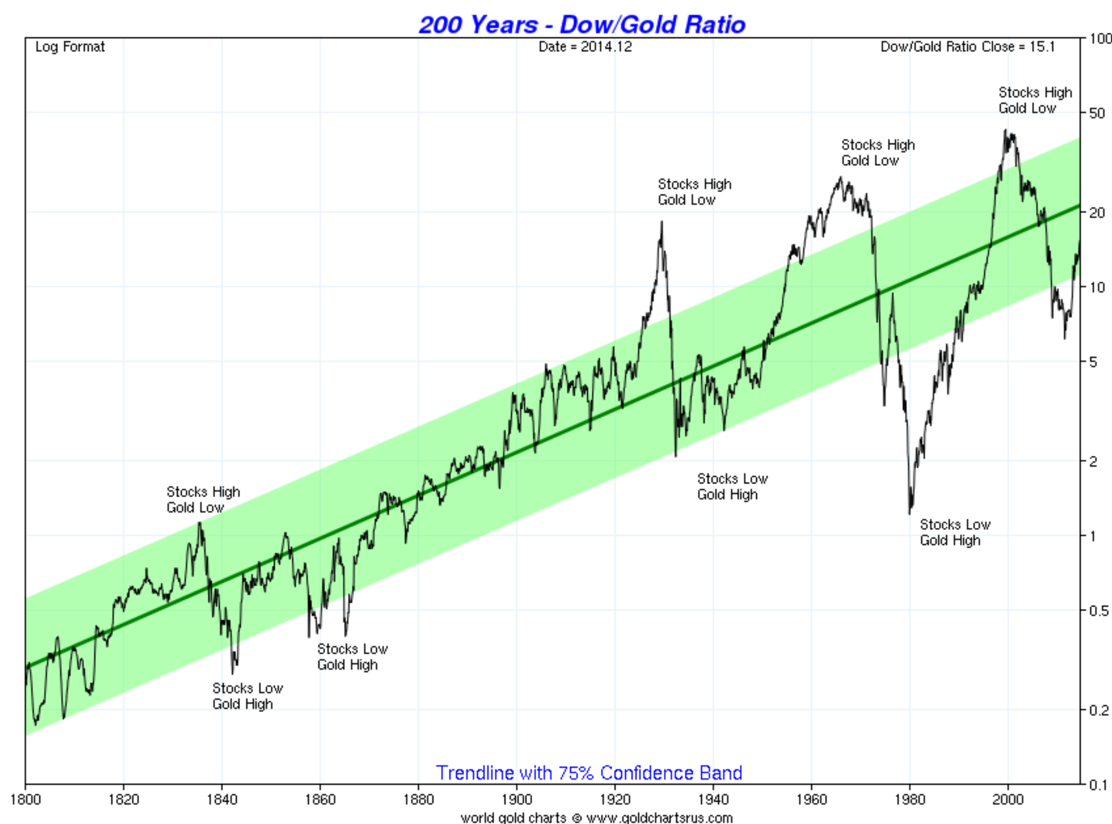
While a 49% drop in GLD gold holdings sounds dramatic, keep in mind that much of this drop occurred during 2013. For the first 8 months of 2014, GLD gold holdings actually increased slightly—suggesting that retail investors were not in panic mode for most of last year. Recently, however, GLD gold holdings have again been declining, with holdings down by 11% (from 25.6 million to 22.8 million ounces) during the final 4 months of 2014. Should panic selling drive GLD holdings down to the 18-20 million ounce range, we would likely be a buyer.

3) The Dow-to-Gold Ratio[1], a "ballpark" relative valuation indicator between U.S. stocks and gold, has nearly tripled from its trough of 5.88 in early September 2011 to 15.1 today. As discussed, a stand-alone reading of 15.1 isn't high by historical standards (the ratio has fluctuated from as low as 1 to as high as 50 over the last 35 years). But given the recent, 3-year spike in the ratio—and assuming the European Central Bank will implement sovereign QE by its March 5, 2015 meeting—we are

[1] We first covered the Dow-to-Gold ratio in our January 25, 2013 issue. The Dow-to-Gold ratio is calculated by taking the price of the Dow Jones Industrial Average (prior to 1896, a surrogate index of U.S. stocks) and dividing it by the spot price of gold. The trend of the Dow-to-Gold ratio is sometimes depicted as a "battle" between the forces of capitalism; and economic chaos/uncertainty, but as China and India matures, it has become more complicated. Consider that half of all gold demand in a given year comes from jewelry remand; or that capitalism—if allowed to function properly—is deflationary and "destructive" to obsolete businesses or industries. I.e. the "creative destructive" nature of capitalism could collapse profit margins in certain industries in both the short- and long-run.

overdue for a renewed uptrend in the gold price, especially if global equities continue to rise in 2015 (we are looking for a 10-15% rise in U.S. stocks in 2015).

Figure 4: The 3-year spike in the Dow-to-Gold Ratio suggests a highly oversold condition



Note that we are not calling for a bottom in the price of gold just yet. Chinese buying, for example, has remained subdued this year as Chinese economic growth slows down; while the increasing crackdown on graft has capped the purchase of gold jewelry by wealthy Chinese individuals. In addition, we still have not seen any indications of mine shut-downs—which we believe will need to occur before the price of gold hits a sustainable bottom.

We believe the price of gold will hit a sustainable bottom sometime this year in the US$950-US$1,100 an ounce range. We will advocate purchases of **GLD** and **GDX** at that time. Our longer-term (2020-2022) target for gold is $2,000 an ounce, driven by increasing Chinese and Indian consumption, with an upward bias should global policymakers resort to inflationary policies to ease retirement and healthcare debt obligations in the long-run.

Biography

Henry To, CFA, CAIA, FRM

Partner, Chief Investment Officer

Mr. To currently serves as Partner and Chief Investment Officer for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds and Raptor Group). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including international monetary policy, national security, education, and crime policy. Mr. To will again be teaching at the UCLA Luskin School of Public Affairs in summer 2015. In addition, Mr. To has been an instructor in the USC/CFALA Review Program, where he taught the CFA Exam Level II Economics section. Mr. To has been interviewed and quoted by the New York Times Business Section, the Wall Street Journal, MarketWatch, TraderPlanet, among other publications. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, an MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.

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