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asset management

Thesis Market Commentary

December 2017

The allure of gold

With a tip of my hat to my mentor and predecessor Michael Lally who retired this summer after 40 years with Thesis, this month's commentary follows his tradition of combining Christmas with the financial markets...

When the wise men Balthasar, Melchior and Gaspar approached Christ they were very generous. Since Junior ISAs hadn't been launched (2011) they offered some gold. Gold has for millennia been viewed as a form of currency. Whilst the price of the shiny yellow metal is very transparent the true value of the metal is still being widely debated.

Similar to brussel sprouts, investors either love or loath gold. Those who adore the metal highlight the fact that there is very little in circulation, it is very hard to produce as there is a finite resource in the world and that since the time of Christ it has been a form of currency. Whilst government printing presses around the world have been flooding their economies with cheap money, gold cannot be mass produced at the touch of a button as it is a scarce resource. For many it is the ultimate currency whose value cannot be manipulated and it is often viewed as a way of hedging against inflation. Those that distrust the metal point to the fact that it is simply an inert metal which, apart from looking appealing when buffed up, serves little real purpose. Unlike silver, where 50% of the produced metal is actually used in manufacturing, gold is never used up.

Valuing the metal

There are two methods in valuing assets. The multiple method uses the cash flow or profits generated by an instrument to determine the overall value of the asset. For example property assets are often valued using either capitalisation rates, eg 6.5% yield, or valuing the property in terms of its square foot exposure. The replacement cost method values assets by calculating how much the asset costs to produce. Since gold does not produce an income stream or any cash flows, its value is determined by the cost of extraction. This varies according to each different mine as the ease of extraction then sale differs significantly.

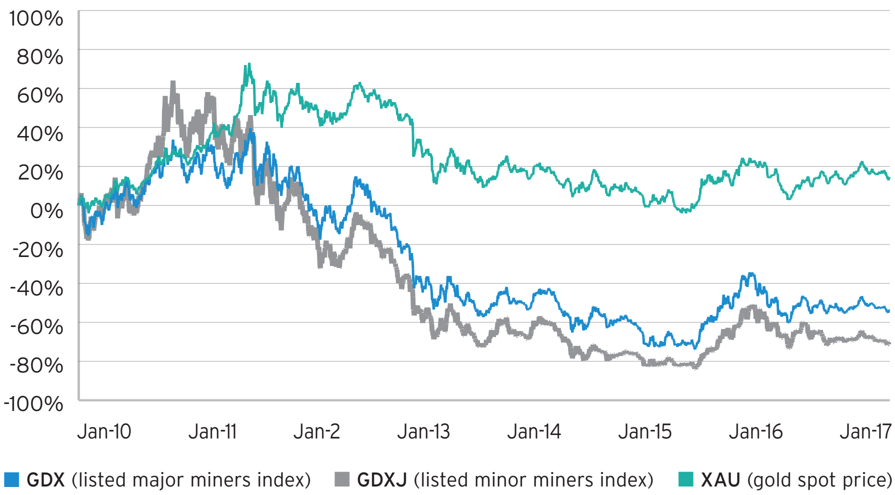
Getting direct physical exposure

There are three ways of getting gold exposure. The simplest way is to go out and purchase the physical bullion by going to a jeweller and buying gold sovereigns such as Krugerrands. These then need to be stored securely. A more liquid and scalable alternative is to buy an Exchange Traded Fund (ETF) which tracks the gold price. There are two types: the *physical* ETF where the ETF has full exposure to the physical bullion, or the *synthetic* ETF which uses derivative contracts (like futures, options, or swap notes and so on) to track the gold spot price.

Getting indirect exposure

If one wants investment exposure to gold then there is the option of investing in companies which produce the gold. The rationale here is that these companies are operationally leveraged to the gold price so when the gold price is high, the mining companies make super-normal profits, assuming the cost of gold extraction has not risen more than the rise in the gold price.

Gold is typically found in some of the most inhospitable places. In Northern Canada mining is restricted as the



Source: Bloomberg

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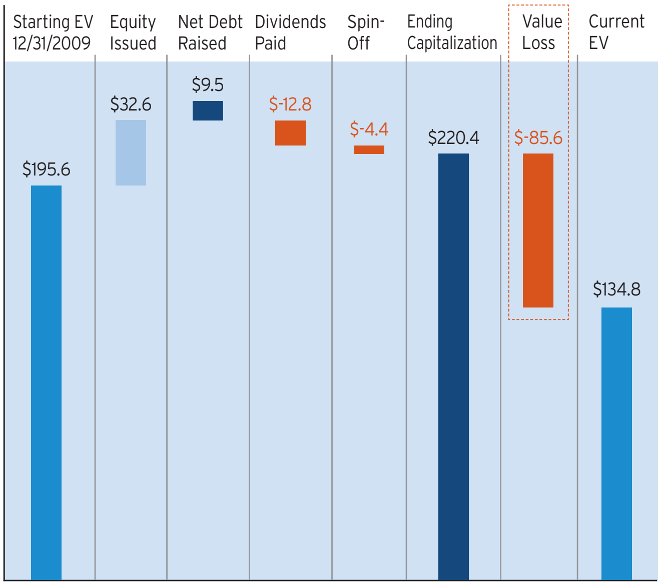

Source: Paulson & Co

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temperature can fall as low as -35°C. Not only do mining companies have to deal with the weather but also political and environmental issues are commonplace. Unlike the proverbial widget maker which can move its factory effortlessly, the mine has to be located where the ore body is. This can make it a very easy target for governments wanting to increase their tax revenues. Since ore bodies typically are not found near cities, workers need to be found and new infrastructure has to be developed. For most mines the biggest input costs are labour and fuel.

In reality though, since 2009 the gold price (XAU) has risen by 14% whilst the share prices of large mining companies (GDX Index) returned -54% and small mining companies returned -70% (GDXJ Index). The description by Mark Twain that a mining company is "a hole in the ground with a liar at the top" appears to be quite apt.

In this period mining companies decided that expansion was the best way of increasing their future profits. They did this by enlarging their existing mines, developing new mines and the short term fix of purchasing existing mines. Unfortunately, as can be seen in the chart above, management raised money by issuing new shares, added new debt and effectively destroyed $85.6bn in value. Paulson & Co., a US based hedge fund, presented their findings at a gold conference in Denver earlier this year. Whilst this slide might have unsettled a few mining executives, the one slide which caused the commotion was was the fact that CEOs of some of the worst destroyers of value were nonetheless paid quite handsomely.

Getting royalty exposure

The third way of getting gold exposure is to invest in a company that owns a gold royalty stream. When a mining company decides to commission a new mine, the cost of construction can be well in excess of $1bn. To fund this construction, the mining company might offer an option on the minerals in return for an upfront payment. For example Wheaton Precious Metals (WPM) , an American listed royalty company, lent Vale, a Brazilian mining company, money to develop its Salobo mine which has an ore body consisting of copper and gold. In return WPM has the right to receive up to 75% of the gold produced at $400/oz over the full life of the mine. With the price of gold currently at $1,257 this equates to a $857/oz profit. This way a streaming company, like WPM, has leverage to the gold price without incurring many of the operational risks.

At Thesis we have held gold in the past. We view it as an alternative investment of which the investment properties are uncorrelated to those of equities and bonds. Despite the lack of income, history shows that in times of turbulence and uncertainty gold can help protect portfolios. In our asset allocation committee meetings we are continually evaluating the potential need and the best way of accessing the metal for our clients.

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News and views

Indices	Value as at 31/11/2017	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7326.67	-2.22%	2.57%	8.00%
FTSE All Share	4033.84	-2.04%	4.15%	9.25%
S&P 500	2647.58	2.81%	18.26%	20.41%
Dow Jones	24272.35	3.83%	22.82%	26.92%
Euro Stoxx 50 EUR	3569.93	-2.83%	8.49%	16.99%
Nikkei 225	22724.96	3.24%	18.89%	24.12%
MSCI Emerging Markets	1120.79	0.15%	29.98%	29.90%
UK Treasury 4.25% 2027	127.31	-0.15%	-1.81%	-0.08%
Sterling/US$	1.35	1.78%	9.83%	8.09%
Sterling/Euro	1.14	-0.32%	-2.91%	-3.66%

Source: Bloomberg

A combination of economic growth, rising earnings, and high confidence has constrained volatility and ensured political risk hasn't got in the way of good economic news. We still think the major source of risk remains political however, and November provided a reminder of some of the obstacles we still face. In Europe, the inconclusive German election and stalled coalition talks rattled European markets mid-month. In Italy the electoral campaign for next year's general election has revealed a fragmented picture and growing support for anti-establishment parties, while in Spain we have Catalonia's vote on the horizon, so there is certainly the potential for heightened volatility. The ongoing Brexit process in the UK is also creating concern and looking to Asia, North Korean nuclear tests continue to destabilise the region. In emerging markets the drama was unfolding in Venezuela, where the country with the largest proven oil reserves in the world finally ran out of money and defaulted on its sovereign debt. A temporary deal was agreed with Russia, allowing Venezuela to re-structure $3bn of debt. This at least gives Venezuela some breathing space but it faces the much more difficult task of restructuring about $52 billion of bonds owed to private creditors.

US

In the US the S&P 500 continues on the course of impressive gains, with the index posting positive returns for 11 of the 11 months so far this year. The markets were lifted by the Trump administration's tax reform proposal taking a step closer to approval. While offering a boost to sentiment, it prompted a rotation out of technology stocks, the year's best performing sector, and into firms seen to benefit the most from a potential reduction in the corporate tax rate. The economy looks solid, with the second estimate of third quarter GDP suggesting even stronger momentum in activity, supported by high consumer confidence, low unemployment, and easy financial conditions. All signs point to another Federal Reserve (Fed) interest rate increase at its December meeting. Markets are currently pricing in a high likelihood of a rate hike, even though inflation remains slightly below the Fed's target.

UK

Uncertainty surrounding domestic politics continues to weigh on confidence in the UK's economic outlook. The grim state of affairs was underlined when Chancellor Philip Hammond announced in the Autumn Budget that the Office of Budget Responsibility had revised down the UK economic growth outlook for this year and for the next five years. Despite a sluggish economy, the Bank of England implemented the first interest rate rise in a decade; the central bank's Monetary Policy Committee (MPC) voted seven to two to increase the UK interest rate to 0.5%. There were some positives to be taken, as the advanced reading for third quarter GDP came in firmer than expected at 0.4%, as a rebound in business services and finance fuelled strength. Towards the end of the month, we had increased hopes for a Brexit compromise, but the accompanying sterling strength weighed on large caps and overseas-focused parts of the market, contributing to the FTSE All-Share index falling 2% over November.

Eurozone

Eurozone economic trends continue along the same lines that have characterised the recovery thus far, with domestic demand strengthening but underlying price pressures lagging. Preliminary third-quarter GDP growth was revised up to 2.5%, largely due to the German economy's impressive 2.8% growth and with further positive business surveys released in November from Germany and France, we think this points to near-term upside risks for growth. Equity markets however retreated in November after two consecutive months of gains. Profit-taking after this year's gains and a strong Euro were largely to blame for the downward move, but a risk-off sentiment was compounded when talks to form a new collation government in Germany collapsed.

Japan

Japan's equity market was much more volatile in November but ended higher, thanks in part to the supportive global macroeconomic backdrop and a solid set of quarterly corporate earnings. The Japanese economy was enjoying its longest growth streak since 2001, having now expanded for seven quarters in a row. The latest figures confirmed that gross domestic product had expanded by 1.4% for the quarter ending in September. Exports and imports remained strong, while positive sentiment surveys and improving labour markets are increasing expectations for a rebound in consumption and inflation.

Emerging markets
Emerging equity markets eked out gains as a whole, with EMEA (Europe, Middle East and Africa) outperforming, while Latin America lagged as sentiment towards the region was soured by political issues in Chile and Brazil. Chinese stocks finished the month up, with consumer and technology stocks gaining more ground. However a sell-off in the second half of the month, sparked by unwinding of positions in government bonds triggered by efforts to deleverage the financial system, pushed the 10yr bond yield to 4%. South Africa's foreign and local currency ratings are now on "ratings watch negative" by Moody's. This suggests that a downgrade will become a reality within months unless material changes take place. That said, South Africa registered the strongest equity returns, in part owing to gains from large index stock Naspers. In Venezuela, PDVSA, the national oil company, confirmed that the company continues to pay coupons, but that the coupon payments are held up with financial intermediaries due to US sanctions. In Argentina, the government published very positive fiscal numbers for October, including a 20% decline in the overall fiscal deficit relative to October 2016. India's GDP growth has surprised lower recently and high-frequency indicators remain mixed, but forecasts suggest GDP growth will rebound to 6.2% in the third quarter, compared with 5.7% in the second.

Fixed income
November was a risk-off month, with higher quality (less risky) parts of the bond market outperforming more high risk areas. Credit spreads, the premium over government bonds that companies issuing in bond markets need to pay to borrow, ended the month wider. There didn't appear to be one specific catalyst for the sell-off. However, stretched valuations and some company specific events were widely viewed as contributing factors.

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