SPOTLIGHT | APRIL 2020

FED POLICY LAYS THE FOUNDATION FOR GOLD

Key points

- The US Federal Reserve has committed to a 'whatever it takes' approach to offset the impact of the Coronavirus on the US and global economy. The key beneficiary of this commitment will be gold.
- Since the end of February, the Federal Reserve has announced measures involving itself more deeply into US financial markets than ever seen before. This amounts to an attempt to ensure functioning of US credit markets by injecting nearly USD 2 trillion into the US economy.
- Without deep and liquid credit markets, the near USD 1 trillion in US corporate and emerging market debt financing requirements in 2020 alone will be put at risk of default, forcing the Fed to take these unprecedented actions.
- Compounding the Fed actions are similar central bank actions by the Bank of Japan and the European Central Bank as well as negative interest rates in the Euro area and Switzerland plus recently announced monetary financing of deficits in the United Kingdom.
- We see both a tactical and a strategic opportunity for investors in gold and view gold as an anchor of value for portfolios with a challenge to the all-time high of USD 1,920 likely looking ahead.
- With financial variations of gold (via ETFs or structured access) growing more and more common, investors should increasingly prefer and hold physical gold rather than these synthetic exposures that ultimately represent unsecured promises to deliver physical gold.

Global Investment Committee

UBP
Union Bancaire Privée

Central banks lay the foundation for gold

The moves by the US Federal Reserve since the COVID-19 crisis hit the shores of the United States in early-March have highlighted a growing resolve on the part of America's central bank to mitigate the impact of the spreading infection not only on the US economy but also on the functioning of US capital markets.

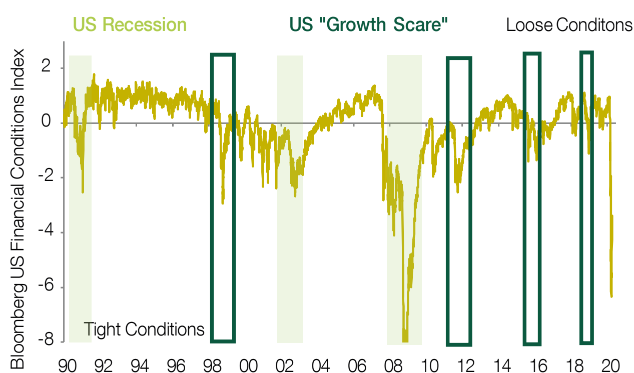
Indeed, having begun using measures introduced in the 2008-09 Global Financial Crisis including purchases of US Treasury and mortgage backed securities, the Fed is prepared to venture into US municipal, asset backed securities, as well as lending to small and medium-sized business and low quality corporate bond issuers via the high yield bond markets.

With COVID-19 infections and their associated lockdowns ravaging demand across sectors of the US economy, these Federal Reserve actions and the USD 2 trillion in fiscal measures that followed are the key bulwarks between no longer a simple economic slowdown and recession but instead, a recession and a 1930s-style depression.

Indeed, at its trough in March, US financial conditions – the ease in securing financing in the US economy – had approached levels of tightness not seen since 2008-09.

Compounding this problem is the fact that US companies – both highly rated and high yielding – as well as emerging market borrowers in US dollars are estimated to require as much as USD 1 trillion in new or maturing financing needs for the remainder of 2020 alone. This brings exceptional urgency to the Fed's mission to loosen conditions.

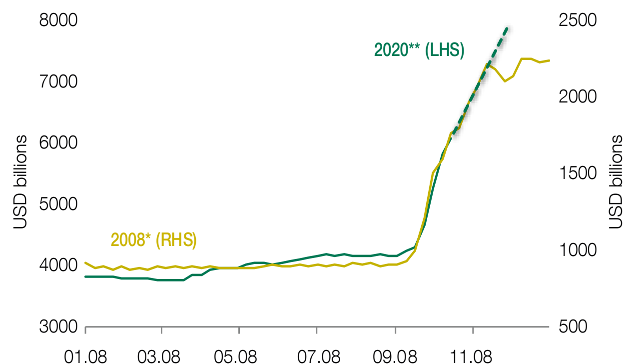
The US economy was on the verge of a 2008-09 style financial crisis until the Fed took action in March



Sources: Nat'l Bureau of Economics Research, Bloomberg Finance L.P. and UBP

The Fed is on schedule to exceed its efforts during the 2008-09 Global Financial Crisis

Federal Reserve Balance Sheet (2008 vs. 2020)



Note: dotted line represents full implementation of announced measures by the Federal Reserve
* from Jan 2008-December 2008
** from June 2019 to April 2020

Sources: Federal Reserve Bank of St. Louis and UBP

Indeed, in recognition of this need, aggregating the programmes announced by the Federal Reserve, if fully utilised, could see the Fed balance sheet, having already grown by nearly 50% in the past six weeks, expand by a further 30% to over USD 8 trillion in the months ahead (chart) as the Fed itself takes on the role of lender of last resort for much of the American economy.

Gold – a primary beneficiary of Central Bank largesse

With the Fed committed to extraordinary measures to expand its balance sheet to support the US economy, the US central bank joins the European Central Bank and the Bank of Japan in adopting a 'whatever it takes' approach towards assisting their respective economies.

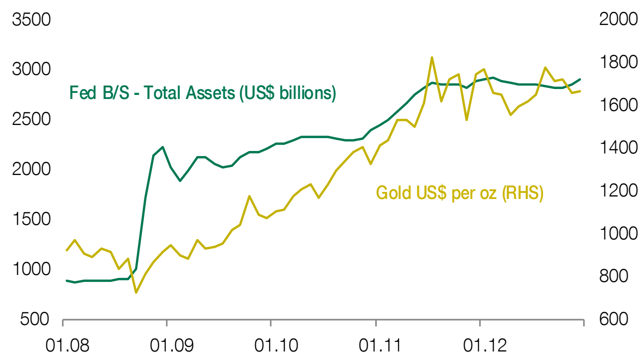
Furthermore, much like the US Federal Reserve's 2008-09 efforts to save the global economy with a near tripling in the size of its balance sheet by the end of its quantitative easing programmes which led to a near tripling in gold prices from their 2008 lows (chart 3), we expect that gold will likely be the primary beneficiary of global central bank largesse not only in the months, but also the years ahead.

In fact, just as seen in 2008-09, gold investors have recently questioned its safe haven credentials as the yellow metal tumbled nearly 15% during the height of the March sell-offs in risk assets.

Both in 2008-09 and again in 2020, these temporary sell-offs were due to the leveraged positions held in futures and options markets which needed to be unwound as liquidity became tight and as margin calls across other asset classes forced liquidation of those positions that still retained value such as a gold. With this forced unwinding of positions substantially behind us now, we look set to see a challenge to the all-time gold price high of USD 1,920 per oz.

Gold may repeat its 2008-09 trajectory as central banks support the global economy

Fed Balance Sheet vs. Gold



Sources: Federal Reserve Bank of St. Louis, Bloomberg Finance L.P. and UBP

As the COVID-19 demand shock serves to depress inflation expectations around the world, investors should expect interest rates to remain under pressure even once recovery comes.

With the amount of debt in the global economy even before the coronavirus crisis of 2020 combined with the trillions of dollars committed in the past weeks alone, we anticipate that negative real – adjusting for inflation – interest rates will be a characteristic of markets well into the future. These will facilitate a gradual deleveraging of overstretched balance sheets around the world.

Historically, falling inflation adjusted interest rate environments have offered a tailwind for gold. With such a backdrop, negative nominal interest rates in the euro area and Switzerland combined with pressure on bank balance sheets should increase pressure for these negative rates to be passed on to depositors so increasing the attractiveness of gold as a store of value on the continent.

Looking forward, were the COVID-19 crisis to deepen or if a further economic shock presented itself, recent actions by the Bank of England provide a glimpse of what the next round of actions may look like to stabilise the global economy.

On April 9, the UK Treasury and the Bank of England agreed to use the standing Ways & Means facility as a standby 'overdraft' facility to provide a source of additional liquidity as the government seeks to provide support to the UK economy. In practice, this overdraft line has only ever been moderate in size, averaging GBP 370 mn. However, in times of stress like in 2008-09, it has grown to be as large as GBP 18 billion. The Bank of England has now agreed to provide the UK Treasury with an unlimited overdraft line in the current environment.

Put another way, should it be required, the UK Treasury could bypass public bond markets and source a substantial amount of funding for its fiscal spending directly from the Bank of England.

Were such measures to become commonplace among central banks around the world in the event of an additional shock to the global economy, we expect to see gold emerging once again as a primary beneficiary.

Positioning for the continued rally in gold

With central banks increasingly coordinating with their fiscal counterparts to finance economic assistance packages, we expect gold to grow in importance as a store of value in investment portfolios looking ahead, a role previously offered by high quality sovereign government bonds. With many of these bonds now yielding near to or below zero percent, a position of as much as 5-10% in gold should be a meaningful part of a broader portfolio of risk-off assets.

Increasingly, however, we believe that investors need to focus not only on how much gold they hold in portfolios, but also the form in which they hold that gold. There is a need for caution given the proliferation of financial instruments which appear to be backed by or which mimic physical gold (such as leveraged ETFs, gold certificates or gold backed bonds) because such synthetic substitutes may ultimately represent, in some cases, unsecured claims on the yellow metal. As a result, investors should focus on underlying physical gold to ensure the store of value role is fulfilled.

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