SPOTLIGHT | JULY 2020

GOLD/SILVER: THE EARLY STAGES OF A LONG-TERM BULL MARKET

Key points

- Despite the impressive 30% rally for gold and 70% rally in silver from the March lows, the precious metals are likely still in the early stages of a long-cycle bull market.
- While gold investors have already benefitted from a shift to a negative real (inflation adjusted) interest rate environment and Fed purchases of government and private sector debt, the start of a US dollar bear market, a growing scramble for physical rather than financial gold and silver, as well as coordinated, growth-focused fiscal and monetary policy should provide the next catalyst for both gold and silver.
- Indeed, even with the sharp rise in prices for the two leading precious metals, gold remains short of our estimate of fair value relative to the monetary expansion that has already taken place. Silver prices remain historically cheap relative to its precious metal cousin, with silver investors requiring nearly 78 ounces of silver to purchase one ounce of gold, compared to its historical average closer to one ounce of gold for 52 ounces of silver.
- As the US election season comes to an end in late-2020 and EU preparations for the implementation of the European Recovery Fund continue, 2021 should see both the US and European Union pivot policies away from stabilising their respective economies to attempting in earnest to avoid the deflationary trap that has engulfed Japan by conducting simultaneously easy fiscal and monetary policy on a scale not seen since World War II.
- Against this backdrop, we see opportunities for gold to continue its rally to USD 2,100/oz. In silver, we seek opportunities to build positions as the bull market in silver continues into 2021. With the scramble for physical metal intensifying, we continue to prefer physical gold and silver to their financial counterparts.

Global Investment Committee

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Gold and Silver - in the early stages of a long cycle bull market

While the rally in both gold and silver year to date has been impressive, relative to the three secular bull markets in each metal since 1971, the current bull markets in both duration and price return fall well short of their previous episodes (see tables).

Though not directly comparable to previous episodes, the rally in gold over the past year does share some similarities with each of the previous bull markets.

The 1971 bull market in precious metals coincided with a US dollar confidence shock as the then US President Richard Nixon ended the national currency's convertibility into gold spurring a rush to convert US dollars into precious metals.

The late-1970s were a period characterised by sustained negative inflation adjusted (real) interest rates similar to what the US is experiencing currently for the first time on a sustained basis in four decades.

The precious metals bull market at the start of the 21st century saw falling real interest rates, a zero-interest rate regime and Federal Reserve balance sheet expansion.

Indeed, changes in real interest rates and money printing have long been catalysts for gold. In the current cycle, money printing by the US central bank has taken place at a pace not seen since at least 1960.

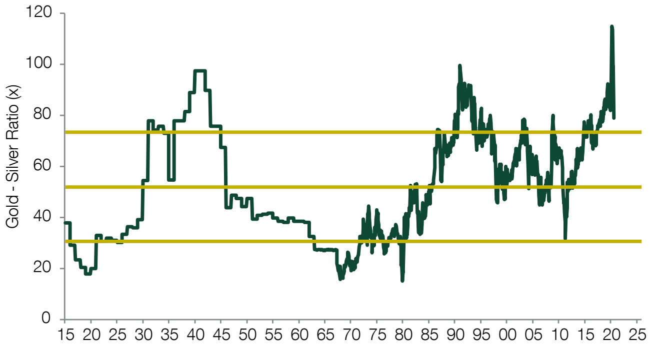
Still in the early stages of the secular bull market in gold and silver

Gold	1971-75	1976-80	1999-2011	2018-
Duration (yrs)	3.88	3.45	12.28	1.60
CAGR	50.3%	84.0%	17.8%	29.7%
Total Return	386.5%	721.3%	647.1%	51.5%

Silver	1971-74	1976-80	2001-2011	2018-
Duration (yrs)	2.48	4.14	9.55	1.60
CAGR	76.1%	69.9%	29.4%	31.0%
Total Return	307.0%	800.5%	1072.9%	54.1%

Sources: Bloomberg Finance L.P. and UBP

Even with a 30% rally since March, gold remains shy of the USD 2,100-2,300 fair value suggested by M2 trends



Sources: Macrotrends.net, Bloomberg Finance L.P. and UBP

So, while gold has been volatile around the long-term trend of M2 money growth in the United States, the M2 trend provides investors with a good long-run framework for over/undervaluation of gold. Using this approach, even with the 30% rally in gold from the March lows, gold remains short of the USD 2,100-2,300 fair value range suggested by M2 trends.

Similarly, with gold still undervalued, even with a 70% rally in silver prices, silver remains historically cheap relative to gold looking back over the past century. At just over 78 ounces of silver required to purchase one ounce of gold, this compares to a century-long average of 52 ounces of silver to buy a single ounce of gold, implying silver prices above USD 30/ounce.

However, with the US having failed to contain COVID-19 infections in its economy, it appears that a second round of fiscal support will be necessary, requiring the Federal Reserve once again to support these efforts via future bond purchases. It is worth noting that the Fed deployed more traditional quantitative easing measures primarily via purchases of Treasury bonds and mortgage backed securities in March and April.

Looking ahead, however, in addition to these tools the central bank retains nearly USD 3 trillion worth of available liquidity from the range of new liquidity facilities granted to it by the US Congress, enabling it to intervene directly in corporate credit, US state and local government markets, as well as via direct small business lending in the US economy. The deployment of these tools is likely being anticipated by markets in light of the recent rally in gold and silver following their 2nd quarter pause in their respective rallies.

The war against COVID-19 = Fiscal Deficits + Negative Real Interest Rates

However, investors should look to Europe as they prepare for the next stage in this battle to recover from the COVID-19 pandemic. While the US remains mired in a no man's area between lockdown and normalisation, Europe is beginning the slow process towards repair and recovery in light of the economic damage wrought by the global pandemic.

Having stabilised its economy via an unlimited supply of liquidity from its central bank, Europe is preparing to pivot its fiscal response away from battling the pandemic and replacing lost income for households and corporates to one of stimulus and growth in the wider economy via the European Recovery Fund.

The fund is critical as it represents the first shared debt obligations across Europe with the European Commission borrowing EUR 750 billion from financial markets and providing grants of over EUR 300 billion to member states to fund national recovery and reform plans.

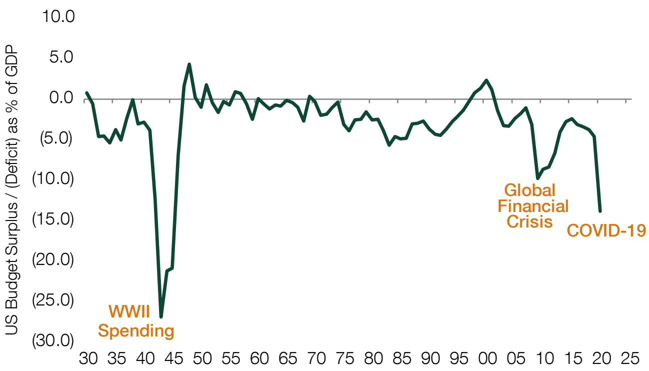
Though investors are rightly sceptical given the start-stop nature of European reform, this provides the first opportunity among major economic blocs for growth-oriented fiscal stimulus to be matched by effectively 'whatever it takes' monetary financing.

The US and Japan have to date similarly taken an unconstrained monetary approach. However, their fiscal efforts have been more designed to offset lost business revenue or replace lost household income due to shutdowns. These responses mimic the Japanese response to ongoing demand shocks since its own bubble burst in 1989.

In contrast, the European Commission may be embarking on a policy solution that is closer to the coordinated fiscal and monetary programs that characterised the American policy regime of the early-1940s as it geared up to fight in World War II. Though fiscal deficits are large compared to recent history, they pale in comparison to the 20-25% of US GDP for several years running in the early-1940s (chart) funded by a Federal Reserve which pushed interest rates down to as low as 10-15% below inflation to support the effort.

Even with a vaccine or effective treatments for COVID-19, we suspect that governments will need to resort to fiscal measures both to reshape their economies in a post-COVID-19 world and also to ease the social burdens of this economic transformation. We expect such policies to provide the next catalyst to the bull markets for both gold and silver.

Policies in the war against COVID-19 may mimic US policies enacted in World War II



Sources: Federal Reserve Bank of St. Louis

Rising demand for physical gold and silver adds another catalyst

Though the current bull market in both silver and gold shares characteristics of previous bull markets, one trait of the developing bull market is the growing demand and increasing mismatch between the availability of physical metal and the proliferation of financial claims on the metal that have been developed in recent years.

Indeed, the proliferation and interest in gold-backed exchange traded funds (ETFs) has grown from virtually zero in the mid-2000s to a situation where these financial vehicles hold nearly 3,000 tonnes of gold as of mid-2020 highlighting the spread of these gold-linked financial products.

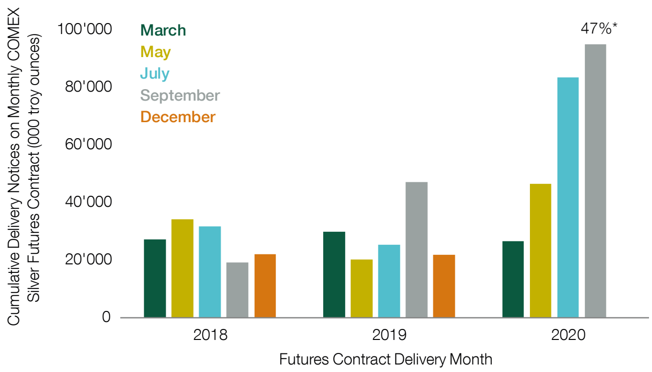
Against this backdrop, the competition for physical gold and silver has surged in the aftermath of the COVID-19 outbreak. Investors in the futures markets who historically, rarely took delivery on their gold and silver futures contracts are increasingly demanding actual delivery on the underlying contracts putting pressure on physical metal stocks held by the COMEX.

Indeed, at the height of the COVID-19 crisis, holders of the April futures contract on gold served notice for delivery of the underlying metal totaling nearly 62% of COMEX eligible inventory at the time. Though this pressure eased somewhat as inventories grew, holders of the June contract requested delivery on over 5.5m ounces of gold or over 33% of eligible inventory.

In May, the situation in silver appeared manageable with the equivalent of 22% of eligible inventory requesting delivery of the physical metal. However, with mines across Latin America (51% of global supply) shuttered through much of the 2nd quarter due to COVID-19, the scramble for physical metal intensified with over 81m ounces of silver requested for delivery in July or nearly 41% of eligible inventory.

Looking ahead, the situation in silver appears particularly acute. Assuming a similarly modest 14% of open interest in the September contract requests delivery, near the level seen in July, that would represent an additional 95m ounces of silver and over 47% of eligible inventory in COMEX warehouses.

A growing demand for physical delivery is straining COMEX inventories in gold and silver



Sources: CME Group, Bloomberg Finance L.P. and UBP
* % of eligible inventory assuming 14% of contract open interest stands for delivery as in July 2020

Investing in gold and silver in the middle of a bull market

Despite gold's over 50% gain since the Federal Reserve ended its rate hiking cycle in late-2018, gold remains in the early stages of a long-cycle bull market. As a result, even with the strong performance in recent weeks, for investors who have not participated in the rallies to date, we continue to see attractive risk-reward looking ahead with gold remaining a core part of our safe haven positioning in portfolios.

In silver, with the July rally leaving prices near to our 2021 targets, investors should look to temporary pullbacks in the metal for opportunities to build positions looking forward. With significantly higher volatility than gold, silver investors should build positions opportunistically as pullbacks emerge in the context of the longer-term bull market we expect.

For both gold and silver, we continue to prefer investments in the underlying physical metal where feasible. With the demand for physical growing amongst investors, investors in gold and silver may one day be faced with the prospect that financial gold (via ETFs, futures contracts, derivatives, etc.) lacks the full backing of the physical metals when delivery is demanded.

Though admittedly a tail risk facing investors, with gold in particular serving as a safe have asset in many portfolios, a realisation that one's safe haven asset is in fact a credit risk of a financial institution may prove to be an unwanted surprise during times of stress in markets.

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