

Gold: a quiet beneficiary of the 3D Reset

James Luke, Fund Manager, Metals at Schroders

Shifts in geopolitical and fiscal trends set the scene for sustained demand for gold, and gold miners may be poised for a major recovery.

Despite almost non-stop selling by Western investors over 2023 and into 2024, gold has easily breached previous all-time-highs, and is currently trading above US\$2,300/oz. Western liquidations have been overwhelmed by, primarily, buying from Eastern central banks, investors, and households. These shifting dynamics have been led by China, but this has not been solely a China story, with significant demand increases also seen in the Middle East and elsewhere.

Geopolitical and fiscal fragility – trends directly linked to the demographic and deglobalisation legs of the 3D Reset – are today combining to forge a path towards a sustained and multi-pronged global pull on gold supplies. This could trigger, we think, one of the strongest bull markets since President Nixon closed the gold window in November 1971, ending the convertibility of the US dollar into gold.

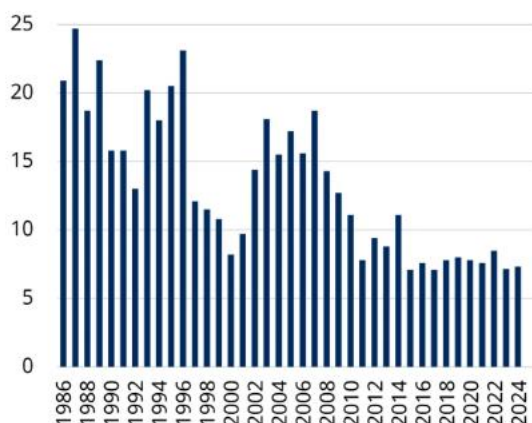
Gold equities now have very strong cashflow but still trade at close to secular low valuations

Yet while gold prices have been rallying, gold equities have lagged the bullion price. Despite strong financial fundamentals, driven by this Eastern-led gold bull market, valuations are close to 40-year lows driven by dismal Western sentiment on gold and poor operational delivery from some sector “leaders”. What might change this?

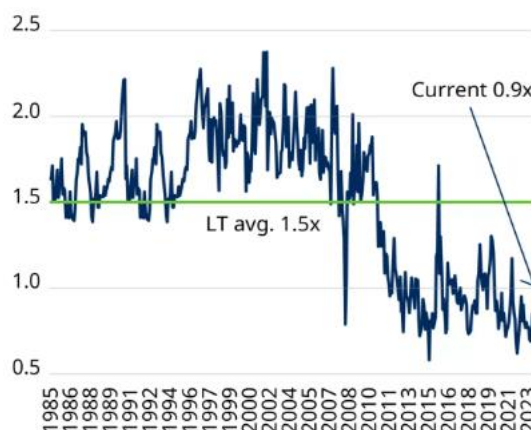
The phrase “markets make opinions” could be adjusted to “margins make opinions” for gold miners. With gold prices averaging ~\$2,200/oz year-to-date and our view that cost inflation is set to slow considerably means we expect to see very strong margin expansion and cash flow generation as we progress through the year. We think strong cashflow and financial discipline will become hard to ignore and in time will begin to shift the negative sentiment.

After all, it isn't hyperbole to say the gold mining sector could rally 50% and still look inexpensive. At c.US\$300 billion total market cap, the gold equity sector has been basically ignored - but we think that will change. If there was ever a point to include gold equities in a multi-year precious metals allocation, we think it is now.

Current average sector EV/EBITDA multiples at 7x vs. 15x average in the 1985–2013 period



Sector P/NAV multiples average 0.9x vs. 1.8x average in the 1985–2013 period



Source: (LHS) Scotiabank, Schroders. Based on North American producers, May 2024.
 (RHS) Scotiabank, Schroders. Based on North American producers, May 2024.

Gold’s strength mirrors a shift towards a more multi-polar world

The hardening geopolitical fault lines around the US-China rivalry, and the sanctions imposed on Russia post the 2022 invasion of Ukraine, have driven record central bank purchases of gold as a monetary reserve asset. US\$300 billion of frozen Russian reserve assets say loudly what US dollar “weaponisation” – dollar hegemony if you like – can really mean. Vast US Treasury issuance to fund never-ending deficits also trigger whispers about long run debt sustainability. Central banks – China, Singapore, Poland the largest in 2023 - have been listening, though record purchases have so far only taken gold reserves as a share of total reserve holdings from 12.9% at the end of 2021 to 15.3%% at the end of 2023.

Looked at through a long run lens, central bank purchases mirror well the evolution of global geopolitical and monetary/fiscal dynamics. Between 1989 to 2007 Western central banks sold as much gold as they practically could, limited after 1999 by central bank gold agreements to keep sales orderly. In that post Berlin Wall / post Soviet Union world, with US led liberal democracy ascendant, globalisation accelerating and US debt metrics frankly quaint compared to today, “de-monetising” gold as a reserve asset looked entirely logical.

The 2008 financial crisis, the introduction of quantitative easing and nascent geopolitical stress were enough to put a stop to Western selling and bring emerging market central banks quietly into the gold market to the tune of an average of 400 tonnes a year between 2009 and 2021. Large numbers (>10% of annual demand) but not seismic.

The >1,000t of gold (20% of global demand) bought by central banks in 2022 and 2023, a rate that continued in 1Q 2024, potentially is seismic. It seems entirely plausible that today’s tense incumbent/rising power dynamics, combined with fiscal fragility that looms over not just the reserve currency issuing US but the entire advanced economic bloc, can trigger a sustained move towards gold.

Put bluntly the gold market is not really large enough to absorb such a sustained move without much higher prices, particularly if other global actors also try to enter at roughly the same time.

Changes in central bank net gold demand reflect major changes in the global geopolitical and debt backdrop



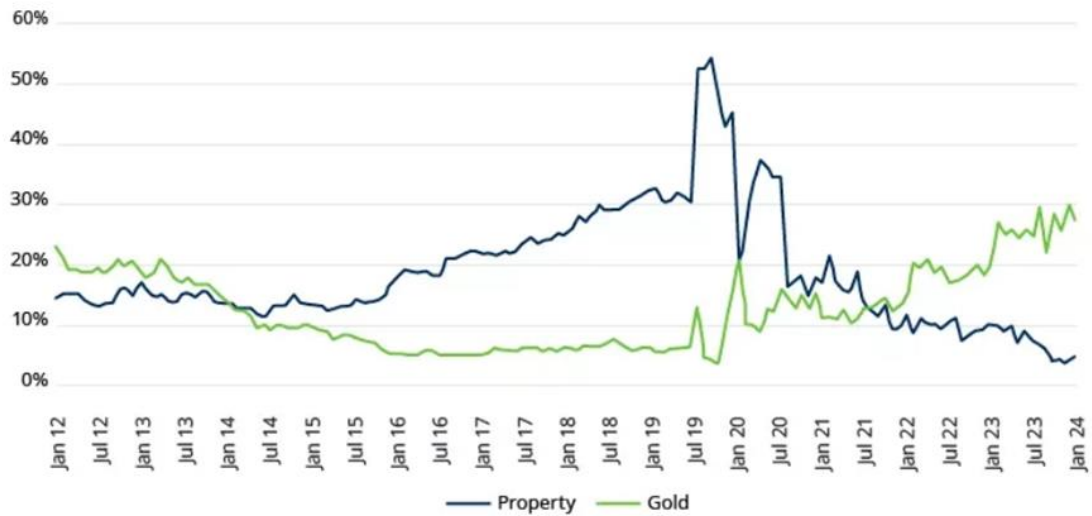
Source: World Gold Council, Metals Focus, Refinitiv GMS, February 2024. 612452

Growing demand from Chinese investors as real estate's lustre fades

Chinese households, who have added trillions (in US\$) to an already record savings glut over 2022 and 2023 are one such actor. The end of the thirty-year property bull market has been key to triggering a huge change in attitude to gold. The rise in investor preference for gold has mirrored the decline in real estate. We doubt stronger household gold demand is a temporary phenomenon.

Chinese household preference for gold has mirrored the end of the real estate bull market

China investment preferences - which asset will perform the best in the next 12 months?



Source: CLSA, Schroders, February 2024. 612452

Western investors, whose selling has not been enough to stop record gold prices, are a further key participant that could well switch from seller to buyer in the next few quarters. Western investment buying (and selling) has reliably followed inflections in monetary policy. Cyclical easing still looks likely this year and a fiscally dominated future suggests Federal Reserve intervention will be needed to keep the Treasury market solvent/liquid. Gold will remain a relevant hedge against central bank and broader sovereign fiscal credibility that Western investors will utilise.