M&G Investments

M&G Insights

Gold may be shiny, but we're not buying: M&G Investments

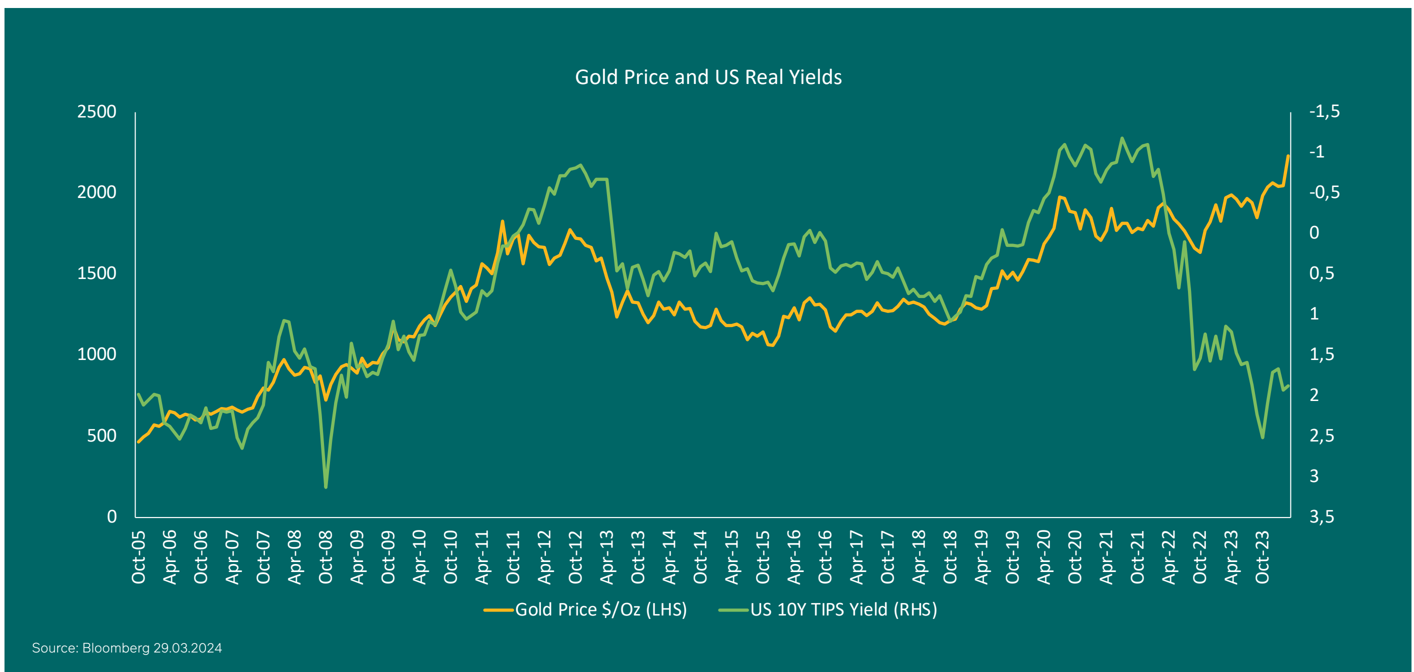
May 2024

Aeysha Samsodien
Portfolio Manager at M&G Investments

The gold price has defied investor expectations in the first quarter (Q1) of 2024, outperforming global equities and gaining some 10% to hit a new record high of US$2,251.37 per ounce on the last day of March before going on to break through the US$2,400 level on 12 April 2024.

Traditionally, gold has an inverse relationship with real global yields – as global yields rise (as they have since March 2022 in the US), demand for gold theoretically should wane as its non-interest-paying nature hurts its competitive position against cash in the short term (due to carry trade opportunity costs). Instead, during this long rate hiking cycle gold has risen from lows of around US$1,600 per ounce in October 2022 (albeit with some corrections) to new records, as shown in Graph 1. Now, with interest rates having plateaued but still likely to remain high for longer than most had projected, the gold price continues to behave rather anomalously, still attracting good support.

Graph 2: Stronger central bank demand underpins higher gold price



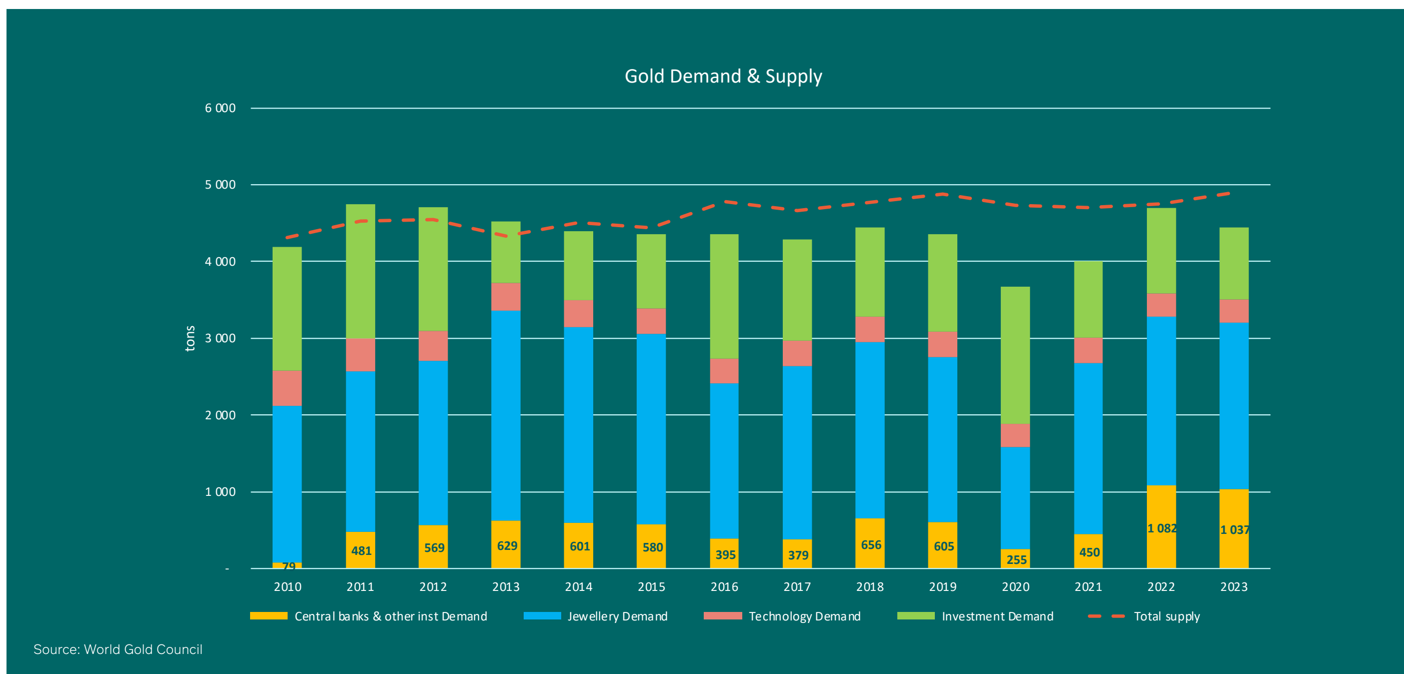
Source: Bloomberg 29.03.2024

What has happened to break the traditional relationship between the gold price and global yields? First, there has been an obvious increase in geopolitical risks due to the ongoing wars, starting with the Russian invasion of Ukraine and then the outbreak of hostilities in the Middle East, both of which have the potential to escalate. This has helped sustain the demand for gold, which is traditionally a safe-haven asset. Another factor has been the macroeconomic uncertainty created by high global inflation and concerns over the global recovery from the pandemic lockdowns, and more recently,

worries over the outcomes of the numerous national elections taking place in 2024.

As Graph 2 illustrates, unusually high central bank buying of gold has also contributed to the precious metal's record highs, notable among them the People's Bank of China (PBOC), Central Bank of Turkey, Reserve Bank of India, National Bank of Kazakhstan and Central Bank of Jordan. In both 2022 and 2023 there was over 1,000 tonnes of gold purchased, compared to the historical average of around 400 tonnes. Their reported primary reasons for purchases have been gold's value in times of crisis, and its benefits of diversification and being a long-term store-of-value/inflation hedge.

Graph 2: Stronger central bank demand underpins higher gold price



Source: World Gold Council

Stand-out buyers have been the PBOC and Chinese investors during the period from November 2022 to date, when the PBOC resumed reporting on its gold reserves. The Chinese central bank saw its official gold tonnage increase by some 14% over this period, including strong buying in Q1 2024. At the same time, Chinese investors have turned to gold investments like ETFs and gold coins amid the country's economic slowdown and financial instability resulting in a crisis in the property sector, a weaker yuan and equity market losses: Chinese and Hong Kong stocks lost nearly US$5.0 trillion in market value in the past three years (according to CNBC).

Meanwhile, this Asian demand for gold ETFs appears to have helped offset sales of gold ETFs from Western investors. Historically, the rising price of gold has generally corresponded with higher ETF purchases in developed markets, but this has noticeably not been the case in the most recent period, resulting in another breakdown of historic relationships.

The M&G view

In our view, gold bullion can be viewed as a default, uncorrelated and unanchored asset whose value is not driven by fundamental characteristics such as supply/demand dynamics or cash flows. This does give it a role to play as a portfolio diversifier, but its lack of cash flow tends to preclude gold bullion from our valuation-based investment approach. Also, it lacks leverage to the gold price that is one of the benefits of gold mining shares.

And while gold equities can be valued on cash flow (in theory at least), their fundamental driver, being the price of gold, undermines this. Equally, SA gold mining companies have historically low returns on capital and poor cash flows (due partly to the relatively short life span of gold ore bodies which require constant reinvestment or new asset acquisitions), which further impair our view of the investability of gold mining shares.

M&G's underweight portfolio positioning reflects this somewhat skeptical view of gold; however, given the uncertainties mentioned above, the prevalence of central bank gold buying and the outlook for possible interest rate cuts, there is a

probability that the gold price will remain high. Therefore, given our focus on risk management, our house-view portfolios do have exposure to the sector, but are underweight, and we are constantly re-assessing this positioning.

Within the sector we prefer to hold Anglogold and Gold Fields, and are cautious on Harmony. AngloGold has the encouraging profile of improving production combined with lower costs over the next few years; this will be driven by the operational recovery of their Obausi mine in Ghana and in the medium-term, organic growth from their North-American assets, which have a low cost base.

Gold Fields, meanwhile, will benefit from their Salares Norte project that is currently ramping up. We are more cautious on Gold Fields over the medium term, as the company will need to acquire new projects to maintain their production profile, and this increases capital allocation risk.

Harmony is highly exposed to the rand gold price, given that the majority of its gold is produced in South Africa. Over the last few years the quality of its asset profile has improved, with higher-cost, older mine production coming out and newer, lower-cost assets being embedded in the portfolio. Unfortunately, Harmony has a pipeline of projects, both local and international, that they need to invest in over the next decade, and these will offset the cost decline in its current core operations.

Disclaimer.

This document is for information purposes only and is not an offer to or solicitation for investors to invest in any of the capabilities or products offered by MandG Investment Managers (Pty) Ltd [M&G Investment Managers] (Registration no. 2013/051515/07) and MandG Investments (Namibia) (Pty) Ltd (Registration no. 1996/85) [M&G Namibia] or any of their associates, being MandG Investments Unit Trusts South Africa (RF) Ltd (Registration no 1999/005242/06) and MandG Investments Unit Trusts (Namibia) Ltd Registration no. 2007/609. M&G Investment Managers is an authorised discretionary financial services provider by the Financial Sector Conduct Authority of South Africa [FSP45199] in terms of the Financial Advisory and Intermediary Services Act, and has it's registered offices at 5th Floor Protea Place, 30 Dreyer Street, Claremont, 7708. M&G Namibia is an approved person in terms of section 4 of Stock Exchanges Control Act and has it's registered offices at 6 Feld Street, Windhoek, Namibia. Information given in this document has been obtained from, or based upon sources believed to be from an accurate and timely source but M& Investment Managers and M&G Namibia make no representations or warranty, express or implied, with respect to the correctness, accuracy or completeness of the information and opinions. This information is not intended to constitute a basis for any specific investment decision. Investors are advised to familiarise themselves with the unique risks pertaining to their investment choices. Investors should seek the advice of a properly qualified financial consultant/adviser before investing. The value of an investment will fluctuate and past performance is not necessarily an indication of future returns.