



Cam Hui, CFA
cam@pennockideahub.com

WHAT GOLD IS TELLING US ABOUT CONFIDENCE

May 25, 2020

Table of Contents

A Loss of Investment Confidence.....2
America's Sugar High5
Depressions in Europe and Japan7
Trade and Globalization in Retreat.....11
Estimating the Pandemic Fallout15
Gold: Confidence Insurance.....18

EXECUTIVE SUMMARY

Last week, we highlighted a comment by Joe Wiesenthal at Bloomberg when he focused on the stock/gold ratio as a barometer of optimism and pessimism (see [A Small Business Checkup](#)). We would go further to characterize the ratio as a barometer of investment confidence in human ingenuity.

It's such a pure and simple expression of optimism versus pessimism. When you bet on stocks you're betting on humans endeavoring to do productive things. When you bet on a shiny inert metal you're betting on a shiny inert metal.

The chart of the stock/gold ratio surprisingly revealed that it peaked in the summer of 2018 and it has been falling ever since. Since that 2018 peak, both stock and gold prices have climbed, but gold has outpaced stocks. The decline in the stock/gold ratio is worrisome for long-term equity investors.

We believe the outlook for equities faces a number of long-term headwinds, namely de-globalization, rising protectionism and a difficult growth outlook. Gold represents an insurance policy against falling investment confidence. Investors should re-evaluate their portfolio allocation policy in light of these factors affecting asset returns over the next decade.

Confidential — Do not duplicate or distribute without written permission from Pennock Idea Hub



A Loss of Investment Confidence

How badly has the pandemic affected the global economy? The United Nations Development Programme (UNDP) has some answers in a [recent report](#). It expects global human development to decline for the first time this year, and EM economies will bear the brunt of the impact. The International Labour Organization (ILO) estimates that up to half of global workers could lose their jobs.

New UNDP estimates Global human development – as a combined measure of the world’s education, health and living standards – is on course to decline this year for the first time since the concept was developed in 1990. The decline is expected across the majority of countries - rich and poor - in every region.

- *Global per capita income is expected to fall four percent. The World Bank has warned that the virus could push between 40 and 60 million into extreme poverty this year, with sub-Saharan Africa and South Asia hardest hit.*
- *The International Labour Organization (ILO) estimates that half of working people could lose their jobs within the next few months, and the virus could cost the global economy US\$10 trillion.*
- *The World Food Programme says 265 million people will face crisis levels of hunger unless direct action is taken.*

While the human development is falling this year, the market’s perceived decline of confidence did not begin with the COVID-19 pandemic. Last week, we highlighted a comment by Joe Wiesenthal at Bloomberg when he focused on the stock/gold ratio as a barometer of optimism and pessimism (see [A Small Business Checkup](#)). We would go further to characterize the ratio as a barometer of investment confidence in human ingenuity.

It’s such a pure and simple expression of optimism versus pessimism. When you bet on stocks you’re betting on humans endeavoring to do productive things. When you bet on a shiny inert metal you’re betting on a shiny inert metal.

The chart of the stock/gold ratio surprisingly revealed that it peaked in the summer of 2018 and it has been falling ever since. Since that 2018 peak, both stock and gold prices have climbed, but gold has outpaced stocks. The decline in the stock/gold ratio is worrisome for long-term equity investors.



Exhibit 1: S&P 500 to Gold Ratio



Source: StockCharts

The stock/gold ratio outside the U.S., as represented by the MSCI World xUS Index, looks even worse. The MSCI World xUS Index never recovered its pre-GFC peak. Gold, as priced in euros, has reached all-time highs. The post-GFC equity market recovery is entirely attributable to the outperformance in the U.S.



Exhibit 2: MSCI World xUS to Gold Ratio



Source: StockCharts

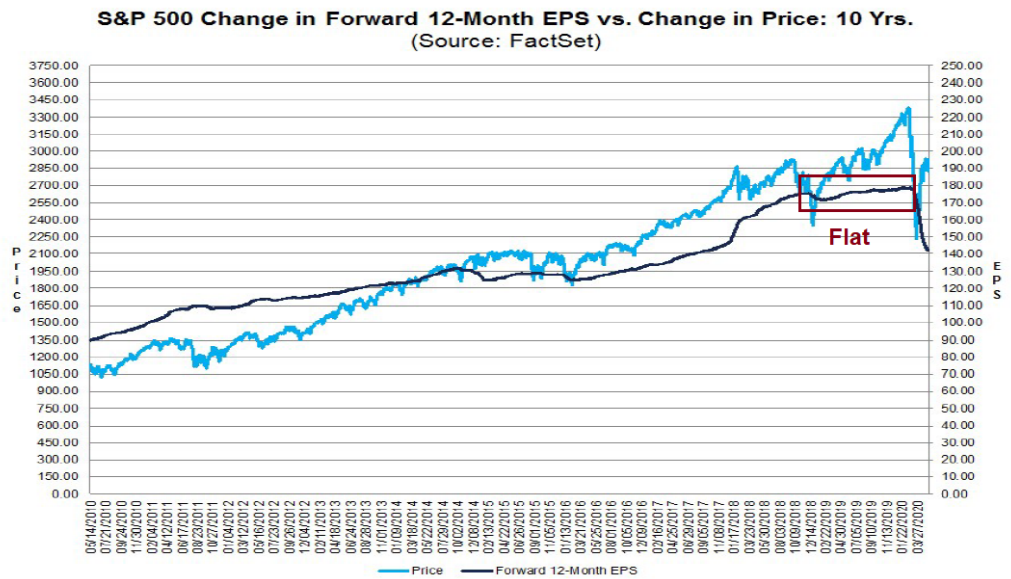
What is the market telling us about optimism and pessimism, and global investment confidence?



America's Sugar High

Arguably, the S&P 500/gold peak in 2018 is attributable to the wearing off of the sugar high of the corporate tax cuts enacted in 2017. The history of forward 12-month EPS tells the story. Earnings took a one-time jump in the wake of the tax cuts and rose steadily until late 2018. Since then, estimate growth has been mostly flat until the recent pandemic shock.

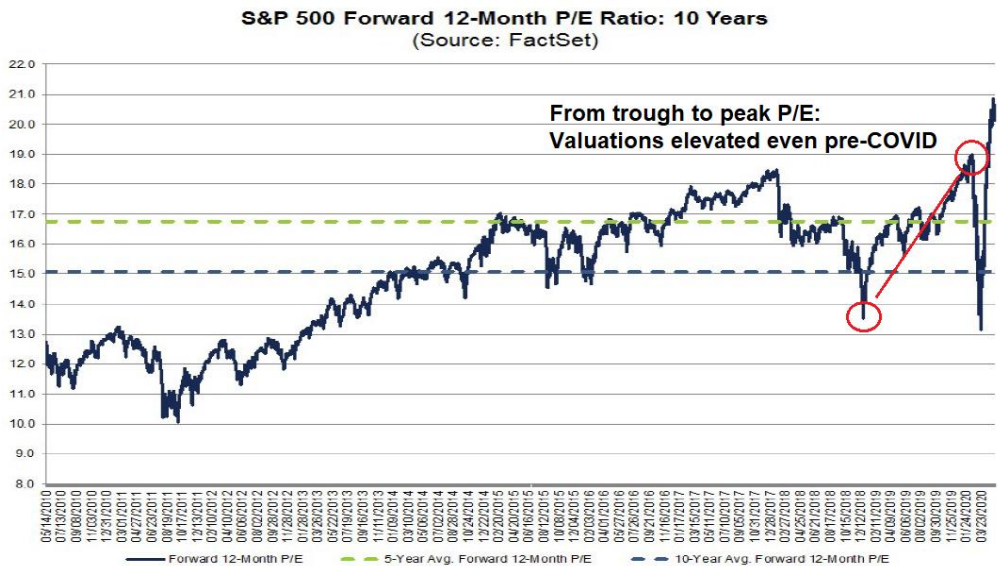
Exhibit 3: Earnings Estimates Have Flattened Since the 2018 Top



Source: FactSet Information Systems

We can see the valuation effects of the advance off the 2018 Christmas Eve bottom. The forward P/E ratio rose steadily, until it peaked at 19 just before the COVID-19 crisis.

Exhibit 4: S&P 500 Forward P/E

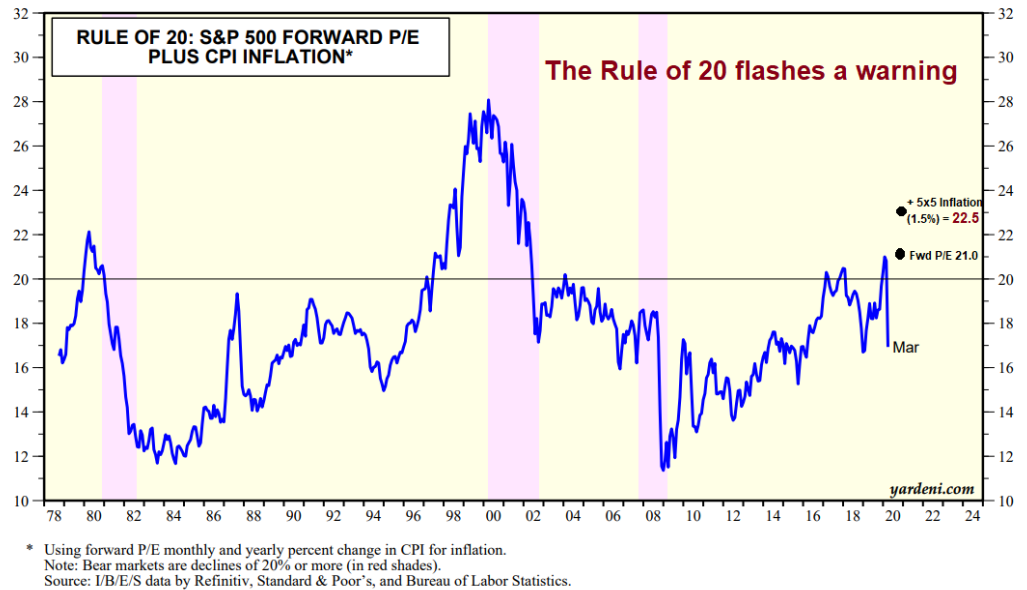


Source: FactSet Information Systems



Elevated valuations have sparked Rule of 20 warnings, which flashes a sell whenever the sum of the forward P/E ratio and inflation rate exceeds 20. The market was already overvalued based on the Rule of 20 even before the onset of the pandemic. Stock prices duly retreated as the COVID-19 crisis evolved, but the latest recovery is flashing another Rule of 20 sell signal.

Exhibit 5: The Rule of 20



Source: Yardeni Research, Inc., Pennock idea Hub

Is there any wonder why the stock/gold ratio is turning down? Earnings had been stagnant, but stock prices were rising. It is therefore no surprise that the market began to discount this negative divergence and gold price outperformed in response.



Depressions in Europe and Japan

Outside the U.S., economic depressions are evident. Jerome Powell was asked about the possibility of a second great depression in his recent [60 Minutes interview](#).

PELLEY: 25% is the estimated height of unemployment during the Great Depression. Do you think history will look back on this time and call this the Second Great Depression?

POWELL: No, I don't. I don't think that's a likely outcome at all. There are some very fundamental differences. The first is that the cause here — we had a very healthy economy two months ago. And this is an outside event, it is a natural disaster, in effect. And that's one big difference. In the '20s when the Depression, well, when the crash happened and all that, the financial system really failed. Here, our financial system is strong has been able to withstand this. And we spent ten years strengthening it after the last crisis. So that's a big difference. In addition, the last thing I'll say is that the government response in the '30s, the central banks were trying to raise interest rates to keep us on the gold standard all around the world. Exactly the opposite of what needed to be done.

In this case, you have governments around the world and central banks around the world responding with great force and very quickly. And staying at it. So I think all of those things point to what will be — it's going to be a very sharp downturn. It should be a much shorter downturn than you would associate with the 1930s.

There are a few points to unpack in Powell's response. First, he was correct that fiscal and monetary authorities were overly tight in the wake of the 1929 Crash and tightened policy, all in the name of the gold standard. It was therefore unsurprising to see the stock/gold ratio plunge in response during the 1930s.

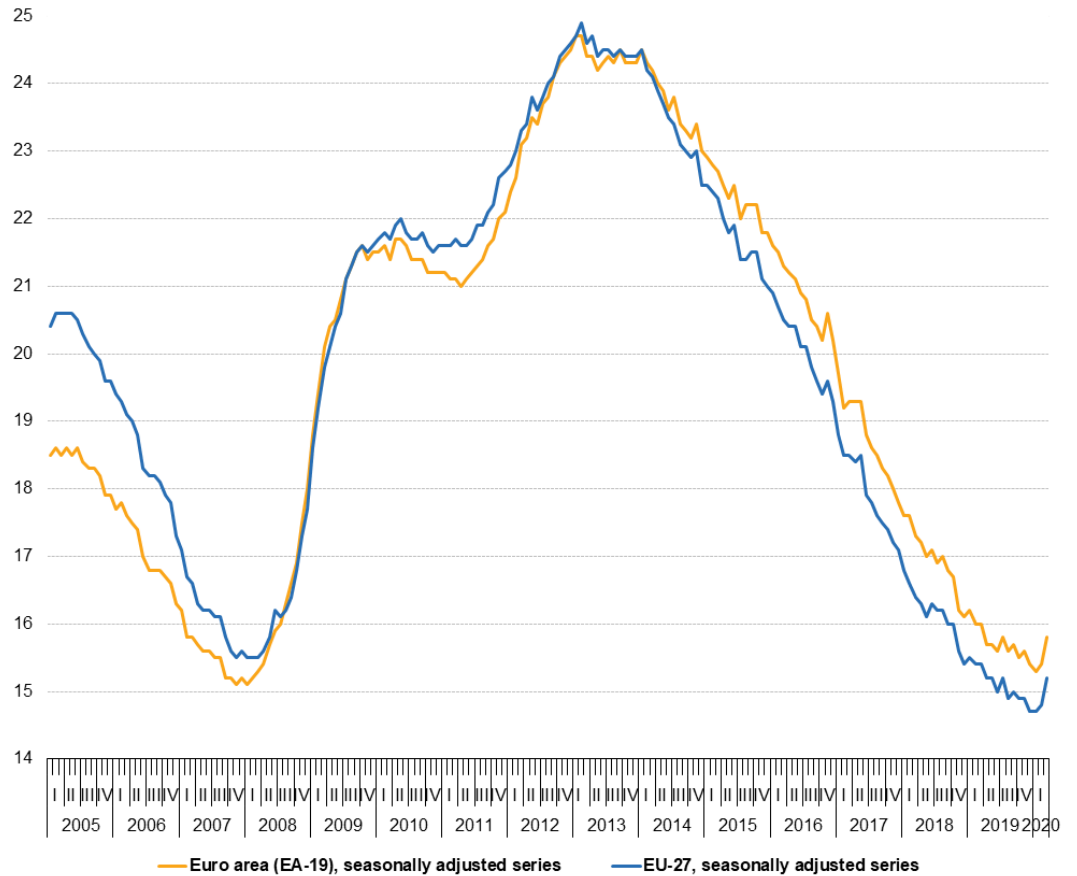
He was incorrect that the fiscal and monetary responses are always sufficient to prevent another depression. While the U.S. has not experienced a depression since the Dirty Thirties, parts of Europe have been in a depression in the last decade. The EU and eurozone unemployment rates rose steadily in the wake of the GFC. While they have recovered to their pre-crisis lows, absolute levels remain elevated. In particular, peripheral country unemployment rates are still horrendous. The adjustment in Greece was borne mainly by an internal devaluation of wages.

In addition, youth unemployment in Europe remains in double digits, and it is especially high in peripheral countries. This is creating a lost generation, which has negative effects on productivity and has the potential to create social and political turmoil.



Exhibit 6: EU-27 and EA-19 Youth Unemployment

Youth unemployment rates, EU-27 and EA-19, seasonally adjusted, January 2000 - March 2020



Source: Eurostat (online data code: une_rt_m)

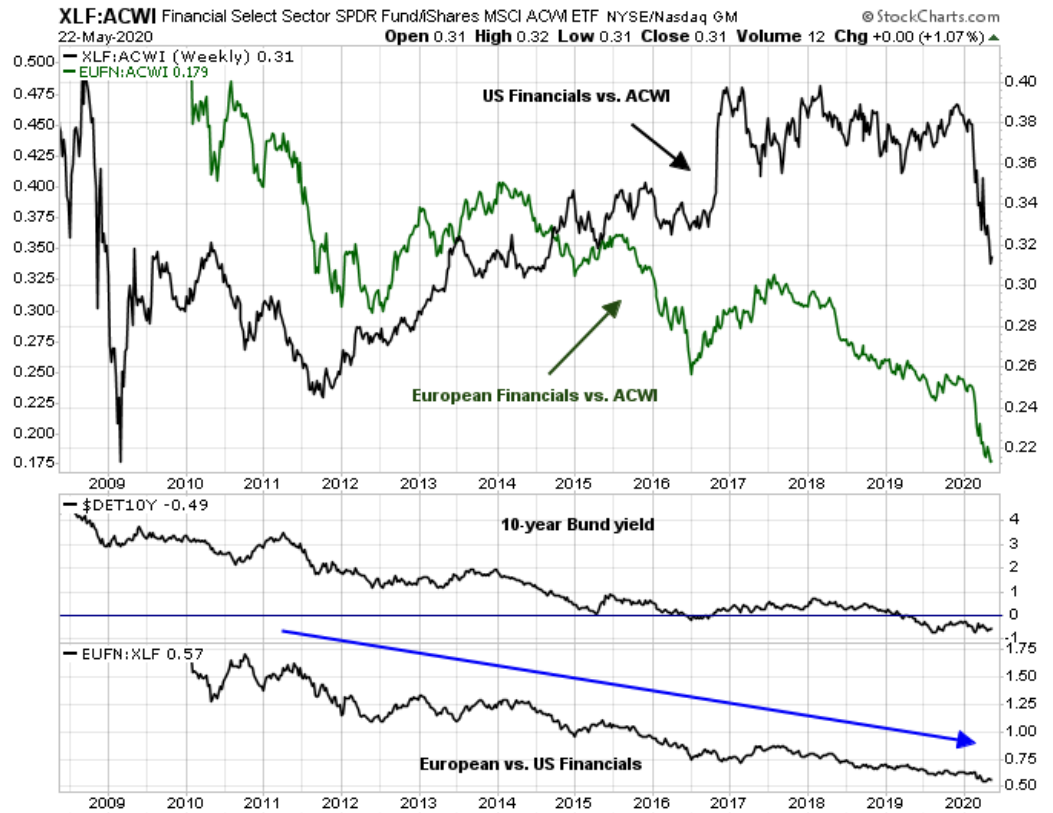


Source: Eurostat

The ECB's initial LTRO response in 2011 did take away the tail-risk of the break-up of the eurozone, and put a floor on the price of risk assets. ECB policies were designed to buy time for member states to reform and restructure their economies. At the time, Mario Draghi referred to labour market reforms to create greater economic dynamism, and to break the perception of lifetime security for the older generation, so that youth unemployment could decline. But reforms were either too slow or not forthcoming. The ECB did what it could to support markets and hold the eurozone together, but its policy of negative interest rates was a bridge too far. The negative interest rate policy has devastated the European banking sector.



Exhibit 7: The European Banking System Has Been Devastated



Source: StockCharts

While recessions are well defined, there is no standard definition of a depression. That said, it is difficult to characterize peripheral Europe as being anything but a depression since 2011.

Similarly, Japan's Nikkei Index has gone nowhere for decades despite fiscal and monetary support. Gold prices in JPY have broken out to fresh all-time highs.



Exhibit 8: Japan's Lost Decades Illustrated



Source: StockCharts

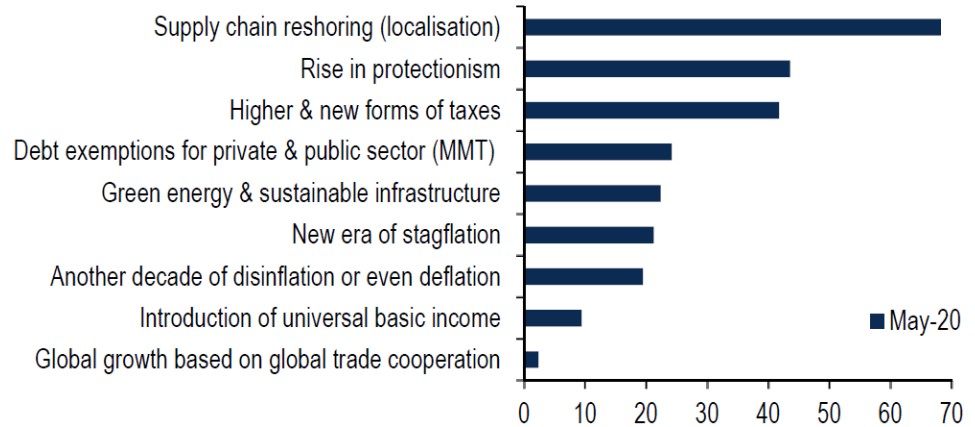


Trade and Globalization in Retreat

Looking ahead, what’s the outlook for the next decade and beyond? The crystal ball is a little hazy, but the latest BAML Global Fund Manager Survey provided some clues of investor expectations.

Exhibit 9: Global Managers Expect De-globalization and Rising Protectionism

Exhibit 9: Which of the following are the likely structural shifts post pandemic crisis?



Source: BAML Global Manager Fund Survey

The biggest theme is rising protectionism and de-globalization. The [Economist](#) devoted an entire issue on the topic.

Trade will suffer as countries abandon the idea that firms and goods are treated equally regardless of where they come from. Governments and central banks are asking taxpayers to underwrite national firms through their stimulus packages, creating a huge and ongoing incentive to favour them. And the push to bring supply chains back home in the name of resilience is accelerating. On May 12 Narendra Modi, India’s prime minister, told the nation that a new era of economic self-reliance has begun. Japan’s covid-19 stimulus includes subsidies for firms that repatriate factories; European Union officials talk of “strategic autonomy” and are creating a fund to buy stakes in firms. America is urging Intel to build plants at home. Digital trade is thriving but its scale is still modest. The sales abroad of Amazon, Apple, Facebook and Microsoft are equivalent to just 1.3% of world exports.

The flow of capital is also suffering, as long-term investment sinks. Chinese venture-capital investment in America dropped to \$400m in the first quarter of this year, 60% below its level two years ago. Multinational firms may cut their cross-border investment by a third this year. America has just instructed its main federal pension fund to stop buying Chinese shares, and so far this year countries representing 59% of world gdp have tightened their rules on foreign investment. As governments try to pay down their new debts by taxing firms and investors, some countries may be tempted to further restrict the flow of capital across borders.

[FT Alphaville](#) outlined several defenses of globalization, starting with theory of comparative advantage. The defense also offers a glimpse of what might happen if globalization were to retreat and trade barriers go up around the world.



Economics offers more rational reasons why it doesn't make sense to source everything close to your doorstep. Take, for instance, nineteenth-century economist David Ricardo's theory of comparative advantage. If England can produce cloth far more efficiently than Portugal due to mechanisation, and Portugal wine far easier due to its geography, is it not in the interest of both nations to focus on specialisms in which they can thrive? (Though this argument became somewhat overdone in the era of hyper-globalisation.)

Although the pandemic has exposed the vulnerabilities of the low-cost and just-in-time model of global supply chains, unwinding those relationships will raise costs and compress margins.

Clearly transportation is easier and less vulnerable if suppliers are close by. While this could be overcome by building up stockpiles of parts, this would add additional costs or be impossible in the case of perishable goods.

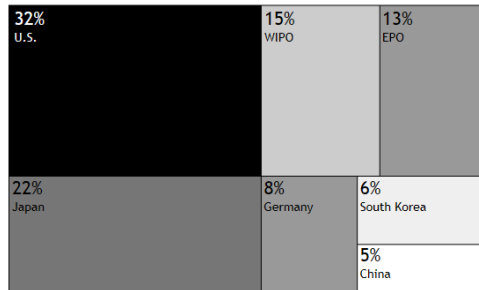
Just-in-time production has become emblematic of the pre-COVID-19 economy. Supply chains had become so efficient that goods often went straight from the delivery bay and on to shelves. That may have to be reassessed if we make a choice that we want the supply of some goods to be more robust.

De-globalization would reduce also innovation.

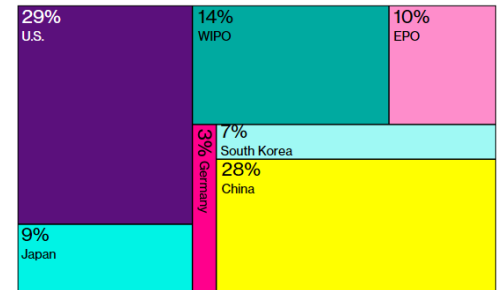
Without open borders and global networks, many innovations would cease to exist. That – say Anna Stellingner, Ingrid Berglund and Henrik Isakson of the Confederation of Swedish Enterprise – includes drugs and other medical goods

Exhibit 10: Evolution of Patent Filings from 2000 to 2014

OLD: Patents by patent office, 2000



NEW: Patents by patent office, 2014



Note: EPO is the European Patent Office. WIPO is the World Intellectual Property Organization; data show filings under the international Patent Cooperation Treaty, which applies to 154 countries including the U.S. and China. Figures may not add up to 100% due to rounding.
Sources: Questel Orbit Intelligence and Fampat Database, March 2018, via the World Intellectual Property Organization

Source: World Intellectual Property Organization

In the end, the biggest question is what price the inhabitants of the developed market are willing to pay for the supply security.

At its core, the debate about global value chains right now is not about growth. It is about how society provides goods deemed essential in times of crisis...

In times marked by fear and protectionism, there are risks to relying on borders remaining open and global value chains delivering. But it is in the best interests of us all that they do.

Current consensus opinion seems to be tilted towards greater supply security. It won't matter who wins the election in November. The U.S. view on China from both sides of the political aisle is becoming increasingly antagonistic. In addition, the COVID-19 crisis has laid bare the



vulnerabilities of global supply lines, especially in pharmaceuticals and medical equipment. At a minimum, expect greater pressure to onshore more production in all industries in 2021.

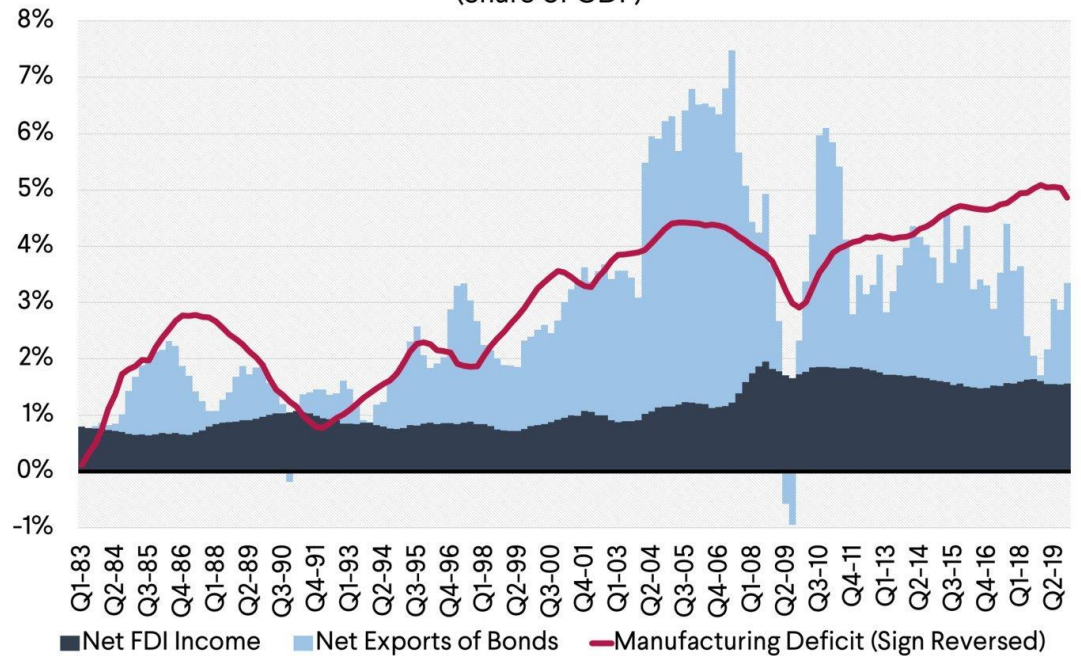
In the short run, China is falling far short of the targeted purchase of U.S. goods under the Phase One trade agreement, largely owing to a collapse in demand as the Chinese economy tanked. This has the potential to create more trade friction and spook the markets over the next few months.

From a practical point of view, [Brad Setser](#) at the Council on Foreign Relations distilled the American experience with globalization over the last 40 years.

- A rising trade deficit in manufacturing.
- Growing offshore profits (mostly in tax havens).
- And large exports of bonds to make the sums balance.

Exhibit 11: The Effects of Globalization on the U.S.

Deficit in Manufactures vs. Surplus in Offshore Income and Net Exports of Bonds (Share of GDP)



Source: U.S. Census Bureau/BEA/Haver Analytics

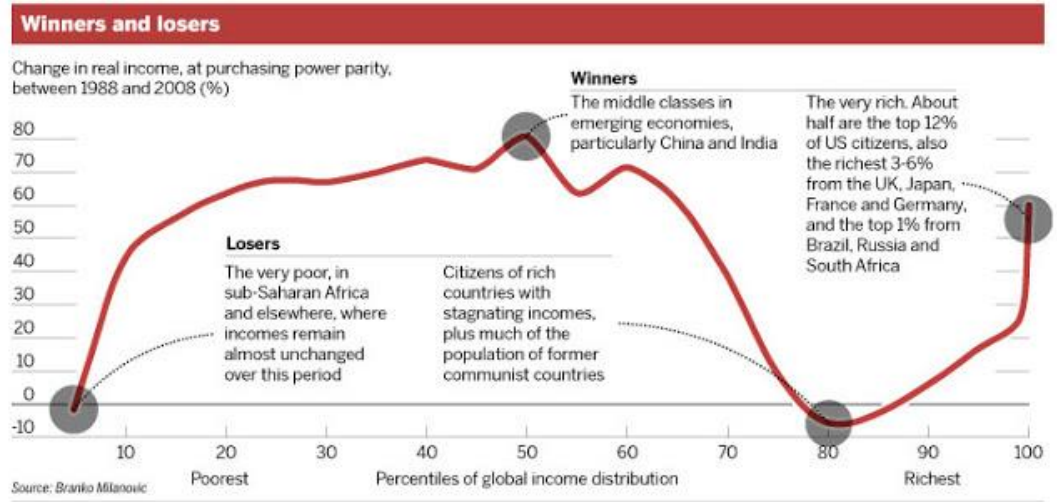
Brad Setser
blogs.cfr.org/setser

Source: Brad Setser

As shown by Setser’s analysis and by Branko Milanovic’s famous elephant graph, the benefits of globalization have accrued to the EM rising middle class, developed market manufacturers that can offshore production, and producers of intellectual capital that can offshore production and dam the profits in offshore tax havens. The main losers have been the developed market middle class.



Exhibit 12: Globalization Winners and Losers



Source: Branko Milanovic



Estimating the Pandemic Fallout

Another long-term trend to consider is the generational effects of the COVID-19 pandemic, which has the potential to create a lost generation and political turmoil. Deutsche Bank analyzed what happened during the Spanish Flu and other pandemics and found the following:

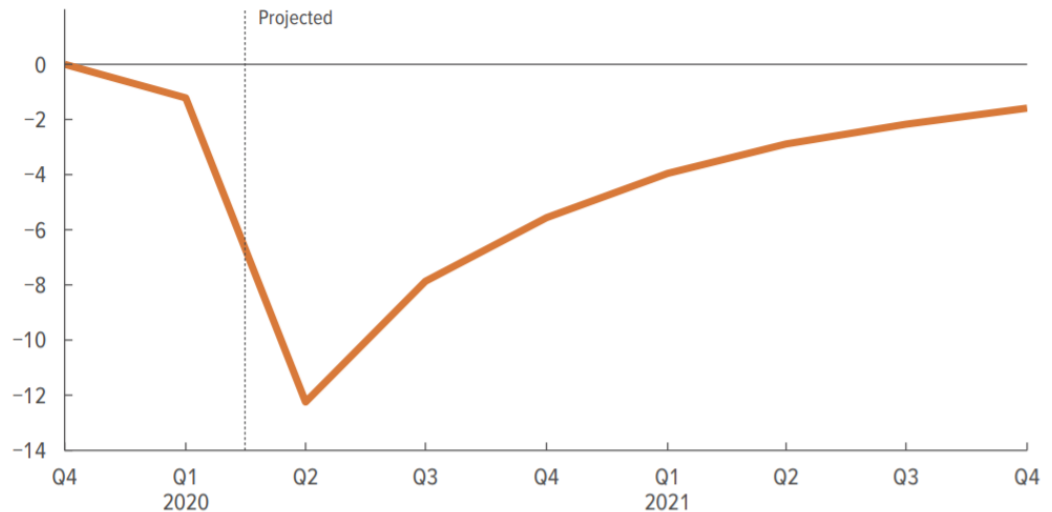
- *Studies have found that the cohort born around the time of the Spanish flu in 1919 had worse educational outcomes throughout their lives.*
- *Pandemics have long been associated with conspiracy theories, and in turn have been connected with lower levels of social trust. For example, today's conspiracy theory has been about 5G but there were suggestions that Spanish flu was spread by Germans of some form of biological weapon at the end of WWI.*
- *Meanwhile economic downturns have their own lasting legacies. For young graduates who join the workforce in a recession, it can take up to a decade before their earnings recover to where they would have been. And prior recessions suggest it could take years before employment returns to its pre-COVID levels.*

On the last point, the economy is likely to take a considerable time to recover. The latest Congressional Budget Office forecast shows that GDP will still be 2% below the Q4 2019 peak at the end of 2021.

Exhibit 13: Congressional Budget Office GDP Forecast

Real Output Measured as the Difference From the Fourth Quarter of 2019

Percent



Source: Congressional Budget Office

A [University of Cambridge study](#) projects a five year loss of between 0.65% and 16.3% of global GDP, with a mid-range forecast of 5.3% to global GDP.

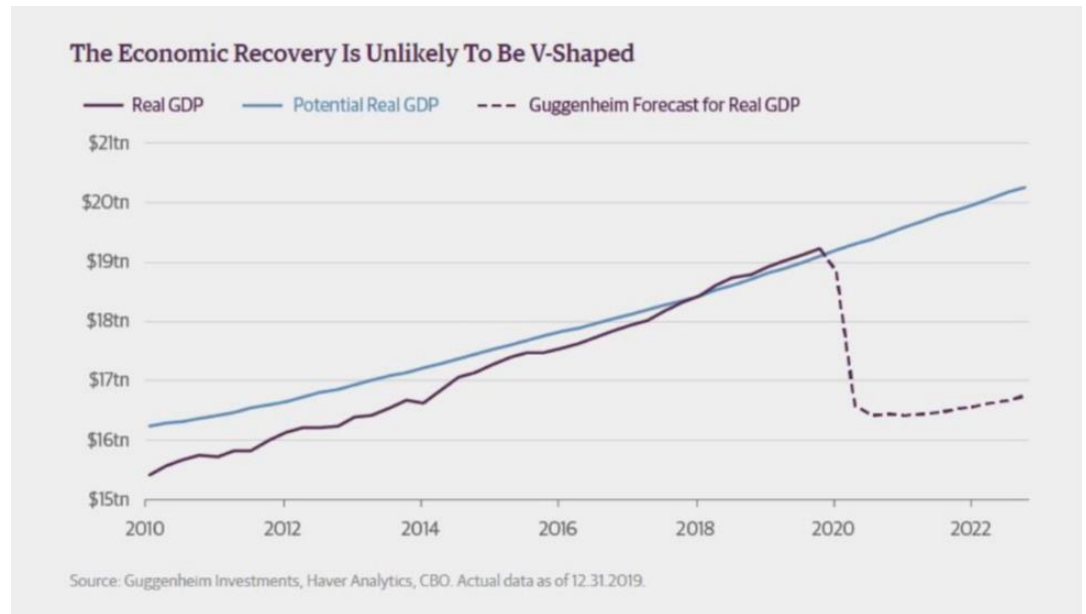
The GDP @Risk over the next five years from the coronavirus pandemic could range from an optimistic loss of \$3.3 trillion (0.65 per cent of five-year GDP) under a rapid recovery scenario to \$82.4 trillion (16.3 per cent) in an economic depression scenario, says the Centre for Risk Studies at the University of Cambridge Judge Business School.



Under the current mid-range consensus of economists, the GDP @Risk calculation would be \$26.8 trillion or 5.3 per cent of five-year GDP, says a “COVID-19 and business risk” presentation prepared by the Centre for Risk Studies.

It took about 10 years for U.S. GDP to return to potential after the GFC. How long will it take post-COVID?

Exhibit 14: How Long to Close the Output Gap?

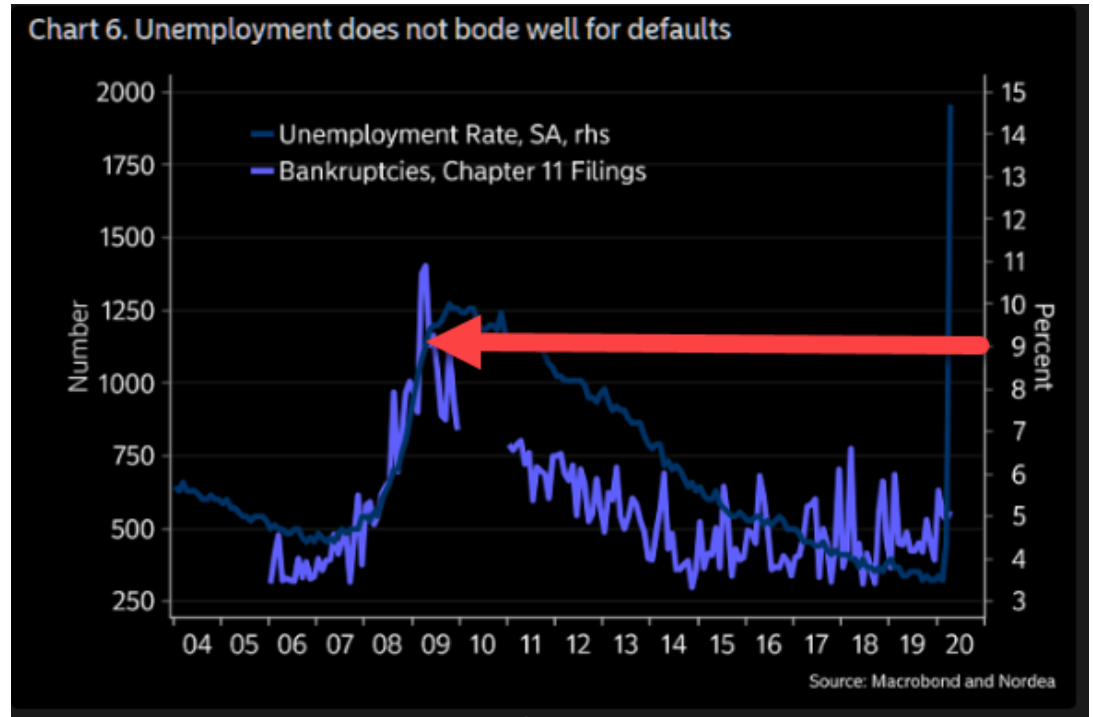


Source: Guggenheim Investments

The slowness of the recovery will have consequences. Surges in unemployment have been correlated with a spike in bankruptcies. So far, the number of Chapter 11 filings has been limited. While the Fed has offered unprecedented levels of support for the credit markets, it cannot supply solvency, or equity, if a firm were to fail. Will this cycle be any different?



Exhibit 15: Unemployment and Chapter 11 Filings



Source: Macrobond



Gold: Confidence Insurance

The combination of all these factors point to subpar equity returns over the next decade. Does that mean you should be buying gold to hedge against a decline in stock/gold ratio?

Gold can have a role in portfolios, but I believe that investors should buy gold for the right reasons. Here are some wrong ways to play gold and gold-related vehicles.

Forget gold as an inflation hedge. The chart below shows that gold staged an upside breakout in 2018 out of a multi-year base that stretches back to 2013. The price is now approaching a resistance zone, as defined by its all-time high. By contrast, the bond market inflationary expectation ETF (RINF) has been in a downtrend since late 2018. While inflationary expectations have begun to tick up, RINF is just approaching and testing a resistance zone.

Exhibit 16: Gold Isn't Behaving Like an Inflation Hedge



Source: StockCharts

During the current deflationary period marked by a collapse in demand, the world would be lucky to see signs of inflation, which would be a signal of renewed growth. If you want to bet on inflation, buy equities, as they would perform well in periods of moderate inflation. As well, companies with strong pricing power that can pass through price increases would perform well in low but rising inflation environment. One shortcut might be the shares of Berkshire Hathaway. Warren Buffett has assembled a portfolio of companies with strong competitive positions, or moats, that should have better pricing power should inflation and growth return.



Even for more aggressive investors who are seeking greater leverage in the gold price, I would advise against buying gold stocks instead of gold. Despite the commonly held belief that the stocks provide better leverage to the gold price, gold stocks have dramatically lagged gold prices in the last decade.

Exhibit 17: Gold Stocks Have Lagged Gold



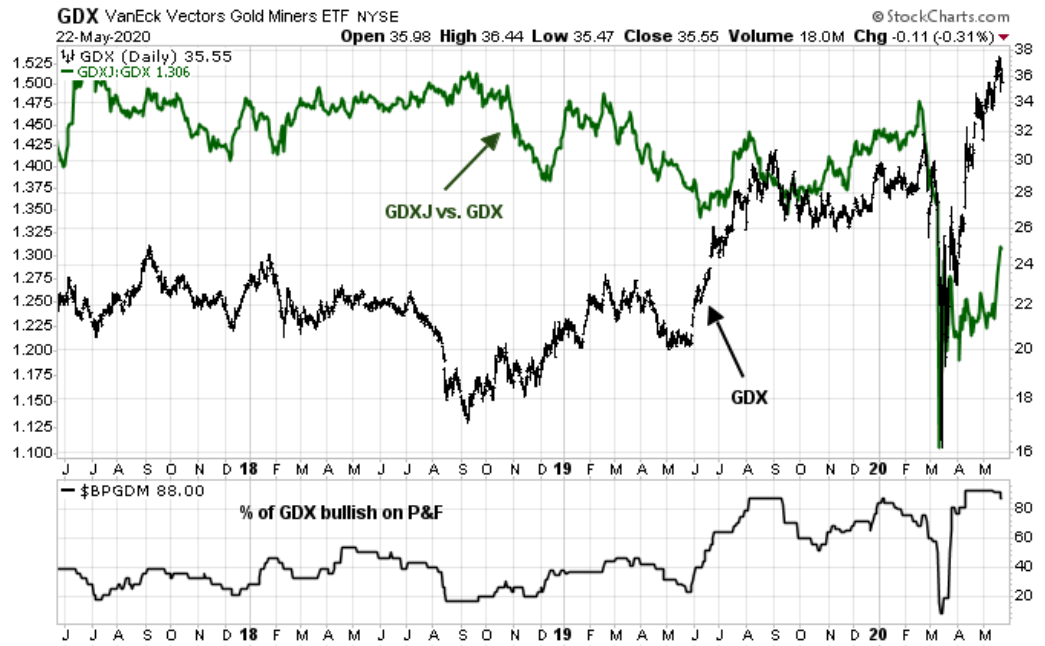
Source: *StockCharts*

Here is why. Conceptually, a gold mining company can be thought of as a call option on the price of gold, with the strike price set at the cost of production, combined with the expected amount of gold the company can mine in each year for the term of the mine life, or mine lives. The historical record has shown that as old mines become exhausted, companies have replaced production with new mines with higher production costs. In effect, this creates the effect of changing the strike price of an option upward, which reduces the value of the option. Unless the gold mining industry can find new lower-cost mines, the shares of gold mining companies are likely to continue to lag gold prices in the future.

In the short run, here is another reason to avoid gold stocks. Senior golds, as represented by GDX, have become overbought. The percentage of stocks in the ETF is over 90%. At the same time, the performance of gold funds (GDXJ) are lagging GDX, which is a negative divergence.



Exhibit 18: Gold Stocks Are Overbought and Face Negative Divergences



Source: StockCharts

In conclusion, the outlook for equities faces a number of long-term headwinds, namely de-globalization, rising protectionism, and a difficult growth outlook. Gold represents an insurance policy against falling investment confidence. Investors should re-evaluate their portfolio allocation policy in light of these factors affecting asset returns over the next decade.



Disclaimer

I, Cam Hui, certify that the views expressed in this commentary accurately reflect my personal views about the subject company (ies). I am confident in my investment analysis skills, and I may buy or already own shares in those companies under discussion. I prepare and edit every report published under my name. I depend on my colleagues for constructive criticism on my research methods and conclusions but final responsibility is my own.

I also certify that I have not and will not be receiving direct or indirect compensation from the subject company(ies) in exchange for publishing this commentary.

This investment analysis excludes any target price, and is not a recommendation to buy or sell a stock. It is intended to provide a means for the author to share his experience and perspective exclusively for the benefit of the clients of Pennock Idea Hub (PIH). My articles may contain statements and projections that are forward-looking in nature, and therefore subject to numerous risks, uncertainties, and assumptions. The author does not assume any liability whatsoever for any direct or consequential loss arising from or relating to any use of the information contained in this note.

This information contained in this commentary has been compiled from sources believed to be reliable but no representation or warranty, express or implied, is made by the author or any other person as to its fairness, accuracy, completeness or correctness.

This article does not constitute an offer or solicitation in any jurisdiction.

Confidential — Do not duplicate or distribute without written permission from Pennock Idea Hub