RATHBONES

THE ECSTASY OF GOLD

REVIEW OF THE WEEK
17 FEBRUARY 2025

GOLD HIT AN ALL-TIME HIGH LAST WEEK, JUST IN TIME FOR VALENTINE'S DAY. BUT IT'S NOT LOVERS WHO ARE DOING ALL THE BUYING.

One of the strangest aspects of our current bull market is the soaring price of gold – you wouldn't typically expect it to perform so well in the current economic environment.

This precious metal can attract humdinger arguments and not just over mining rights or forgotten special occasions. Unlike stocks or bonds, gold doesn't come with rights to profits or interest payments. All it does is sit there and look pretty.

That makes it a bit like a sphinx: a completely blank canvas that investors can throw all sorts of theories and arguments on to. What should its price be? Difficult to know for sure when there's no cashflow that you can work from! Yet, despite that lack of obvious investment value, gold remains the store of value par excellence and has even delivered punchy gains above inflation over past decades (along with some big falls as well, mind).

We value gold because it was the most inert, very scarce metal that our forebears discovered. It doesn't react with the air nor water, nor anything really, so it never rusts like steel or tarnishes like silver or copper. And there's a very limited amount of it, making it unlikely that everyone else can just go down to the river and pick up some for themselves. So if you want to store your wealth over years and decades, and you don't have access to a computerised ledger, gold's the way to go. Still true today. That's why countries and people hoard trillions of dollars' worth of the stuff in vaults and under beds the world over.

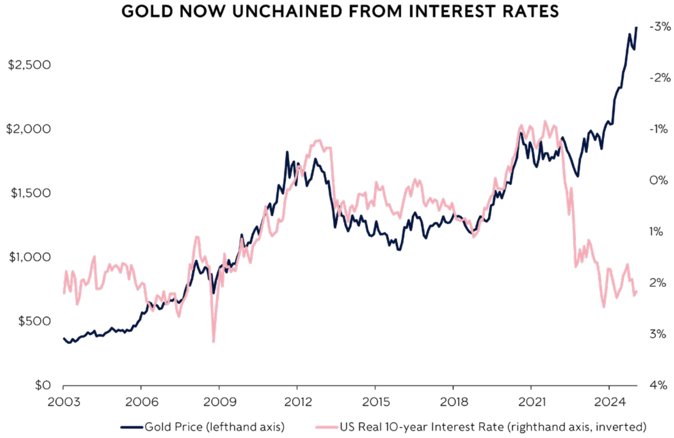
Coming back to the question of how to value something that has doesn't do anything. Essentially, if more people want to buy it than sell it, you can be pretty sure that the price will rise. If more people want to sell it than buy it, the price will drop. I'm being a little facetious, but only because this raises an interesting question: if gold is so valuable, why would people not *always* want to own more of it?

Because gold has a big old 'opportunity cost'. What that means is that by holding gold we give up the chance to own other things, and most other investments offer a return. Today, you can get roughly 4-5% risk-free by putting your money in the bank or in developed nation government bonds. If you want to push the boat out you could buy high yield corporate bonds earning roughly 8%, taking the risk that they could default and you'll lose some or all of your money. The long-term average return of stocks is a little higher than that again (although, you're taking an even greater chance that you could lose what you invest). Gold, meanwhile, delivers zip unless its price goes up. And even then, you need it to rise by at least inflation to ensure that it's still storing your wealth properly, i.e. so that you can still buy the same amount with it when you want to use it.

This opportunity cost effect tends to mean that demand for gold decreases when market rates of return rise. Essentially, people are enticed to move their money out of an inert metal and into other assets. Similarly, when market rates of return fall, there tend to be more buyers of gold. A kicker for this phenomenon is that rates of return generally drop when economies fall into recession, and recession sparks big flows into 'safe' assets, like government bonds, cash and gold.

We can see this ebb and flow in gold demand in our chart which plots the gold price against inflation-adjusted US interest rates (we use inflation-linked US 10-year government bonds as a proxy). We've reversed the interest rate axis because, as we said, the price usually rises when rates fall and vice versa.

GOLD NOW UNCHAINED FROM INTEREST RATES



Source: FactSet; New York Gold Spot and US 10-year Inflation-Protected Securities 31 Jan 2003 to 31 Jan 2025

Past performance is not a reliable indicator of future performance. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

Although, what's happened in the past few years, we hear you ask. Since early 2022, the gold price has completely decoupled from its usual behaviour. As interest rates rose rapidly, the gold price remained unbowed and then roared higher. If it had continued as normal, gold would be worth somewhere in the region of $800 today, rather than $2,800. Of course, the big even of early 2022 was Russia's invasion of Ukraine.

When looking into this phenomenon, we found that, up until the invasion, the gold price tended to be pushed up and down by the ebb and flow of investor holdings of gold through ETFs. Now, rather than mainstream investors deciding the price of gold, it's driven by huge purchases by central banks and other state actors. Data on these state actor and central bank flows are patchy and difficult to reconcile, but there appears to be a definite and deliberate shift toward gold reserves and away from the dollar. This is most acute in Russia and among its allies, both in the former Soviet Union and around the world, but most nations that aren't the US and its closest allies appear to be replacing some dollar reserves with gold.

The World Gold Council's 2024 survey of 69 central banks found that 29% planned to increase their holdings of gold this year (compared to just 3% planning a decrease). Meanwhile, almost 70% anticipated that gold's share in global central bank reserves would increase over the coming five years, with about 60% expecting a decline in the US dollar's role.

Some argue that the dollar's days as the world's preeminent currency are numbered. We think that's fanciful. Yet geopolitics are patently in a period of great change, and that appears to be having long-term impacts on the world's oldest store of value. We think this makes gold an even more useful diversifier than it was in the past. We don't advocate holding a lot of it, but it can offer ballast to a well-diversified portfolio.

US inflation heating up again

US inflation was higher than expected on almost every measure in January. Rather than remaining at 2.9%, headline inflation ticked up to 3.0%, with housing costs accounting for almost a third of the increase. Worse was core inflation (which removes volatile food and energy prices): it had been tipped to drop from 3.2% to 3.1%, instead it rose to 3.3%. That caused a brief spike in the US 10-year government bond yield from 4.5% to above 4.6%, yet by the time the week ended the yield was back to where it had started.

US Federal Reserve (Fed) Chair Jay Powell testified to both branches of Congress over two days (one of two set-pieces held each year). With unemployment at a low 4%, economic growth humming along and inflation slightly higher than his 2% target and well controlled considering past years, Powell's report card looks pretty good. Most of the questions he fielded, however, were about presidential policies regarding trade tariffs and the scrapping of some consumer protections.

We think the Fed may need to tread carefully with any further interest rate cuts if this trend continues. January can be a dodgy month statistically speaking, as it's when adjustments are made to smooth out seasonal fluctuations, yet this increase in inflationary pressure has been building for a few months now. If you take the last three month-on-month changes to inflation and extrapolate them to a year you get inflation of 4.5%, which would be significantly above target. Interest rate markets are currently fully pricing in only one more quarter-percentage-point reduction in the Fed's benchmark overnight rate this year, which would take it to 4.25%. Whether there's a second is a roughly 50/50 chance. Meanwhile, **the flood of tariffs announced by the US** are a big unknown: how many will actually be enacted? How long for? And what effect could they have on US inflation? Because of these risks, we think it makes sense to keep generally shorter-dated US government bonds whose values are less sensitive to changes in interest rates.

Here in the UK, the unemployment rate for December is expected to rise slightly from 4.4% to 4.5%, **although remember that the data is very shady** and it's impossible to know whether monthly moves are statistical noise or real trends. Inflation for January is forecast to rise from 2.5% to 2.8%, driven by higher energy costs, water bills and other regulated prices. These stats follow last week's uncommon ray of sunshine: better-than-expected fourth-quarter UK economic growth. It was forecast to fall from 0% to -0.1%, but it rose slightly to 0.1%.

This is a slight reprieve for Chancellor Rachel Reeves, who will no doubt be having a stressful winter. A Spring Forecast is set for 26 March, where the Office for Budget Responsibility (OBR) will report a six-month snapshot of the public purse and give its outlook for the economy and tax receipts. Higher interest rates and generally slower growth are eating away at the gap between tax receipts and committed spending. Reeves will also give a statement to Parliament on 26 March; however, she has pledged to make major changes to taxes and other fiscal policies only once a year (which was done at the **Autumn Budget**). The plan was to give households and businesses more stability and certainty by not tinkering every six months, but whether she can keep to that promise could depend on the OBR's report.

Another fly in the ointment could be troubled utility Thames Water. The privately held company is in a dire state, close to default and in the hands of a UK judge who will this week decide whether to allow a £3 billion emergency loan that will wipe out its existing creditors and allow time to raise more equity. If the deal is denied, the water company will almost definitely slump into administration and become the state's problem. Thames's infrastructure is a mess, requiring big sums to remediate it, and the cost of running the loss-making group could also further strain the public finances.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing ***review@rathbones.com****. We'd love to hear from you.*

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