AEGON Asset Management

Monthly outlook – September

Ádám Halóka: Gold price approaches new record high

Investors rejoicing over July's excellent performance were in for a cold shower in the following month, as August held no pleasant surprises in store. The S&P500 index fell by 6.8% and the emerging equity markets by 4.23% in dollar terms, and even holders of Hungarian state bonds had no cause for celebration, as the value of their investments dropped 0.27%. The EMBI, or Emerging Markets Bond Index, was virtually the only good performer, and rose by 1.81%. In our outlook for August we turned our attention to maize, which in line with our forecast, and on the back of the Russian export embargo, managed to maintain its upward trend and gained almost 8% in price over the last months of the summer.

Unfavourable and favourable macro data alternated with each other in August, and we even witnessed a new low in the US residential real estate market. (In July 3.83 million used and 276 thousand new homes had changed hands, against a backdrop of falling prices). Interestingly, according to ISM data, the American manufacturing industry gained new momentum in August, as the index rose from the previous month's 55.5 to 56.3. The indicators that usually reflect the state of the economy offer no clear guidance, as the equity markets continue to be characterised by turbulent price movements and trading patterns display no firm trends, so there is still good reason to err on the side of caution. We recommend slightly overweighting European, Japanese and Asian stocks, while in the case of the US and emerging markets we maintain a neutral position relative to the benchmark. We prefer regional peers over Hungarian bonds, as the positive shift in the EUR/HUF exchange rate and their more favourable government borrowing situation suggest that they could outperform.

It's been a long time since we wrote about gold, a situation that I think it would be appropriate to rectify in the light of the latest near-record prices. The spot price of the precious metal rose by 5.63% over the month, reaching close to USD 1,248 at the close of August, or 13.69% more expensive than at the start of the year. Whether as a hedge against inflation, a means of averting other economic difficulties, or simply as a speculative instrument, investors the world over are trading in the yellow metal. From exchange-traded funds (ETFs), future derivatives and other innovative financial solutions, through the buying and selling of physical gold, countless opportunities are available to anyone interested in joining the legion of gold investors.

Here, we will examine the precious metal from four different angles: to give an overview we will compare supply and demand in the second quarter of 2010 with the corresponding period of 2009, then attempt to draw conclusions from the net positions accumulated in the futures markets, and the change in contract numbers. To measure the daily yield of gold we will use the correlative coefficient of its co-movement with the American S&P index, which will answer the question of just how much protection gold investment really affords in times of equity-market uncertainty. And finally, we will subject the gold price chart to technical scrutiny, identifying the signs of overbuying and the better-known candle formations.

Taking the classic approach, as is the case with all market prices, the traded price of gold is also shaped by the relationship between supply and demand, regardless of whether that demand is underpinned by speculation, long-term investors or people who want to possess physical gold. If we examine the supply-demand relationship over a given period, significant differences can be discerned between the various currencies, as exchange-rate movements relative to the dollar can have a notable impact on the indicators. For this reason it is best to conduct the analysis in terms of dollars or tonnes. Demand for gold is customarily classified into four categories: jewellery, small investor interest, ETF and similar institutional demand, as well as industrial demand.

1.) According to reports published by the World Gold Council, the demand for jewellery, measured in tonnes, fell by 8%, while ETF and institutional demand rose by 414% in the second quarter of 2010, in comparison to the corresponding period of 2009. Adding up all the segments that make up overall demand reveals that the global demand for gold has risen from 781 tonnes to 1,047 tonnes, or by 34.06%. In the meantime, supply has increased by only 18%, from 936 tonnes to 1,131.6 tonnes. For the time being, mining and recycling output is, in absolute terms, greater than the jewellery-related and investor demand stemming mainly from the Far-Eastern and other emerging markets; however, due to the uncertainties surrounding the equity markets, the European debt problems and the general flight to quality, the gap is narrowing, while the price of gold is moving in an upward direction.

2.) According to the 7th September summary of the Chicago Board of Trade's regularly published portfolio of futures contracts (Commitment of Trader Report), the mining companies have substantial short positions (249,144 short and 62,019 long), which, due to the high exchange rate, suggests the hedging of sales revenues through forwards. Meanwhile, the portfolio in the investor category is the other way round (217,437 long and 21,221 short), which represents a serious accumulation of bets on a continued rise in the price of gold, especially in view of the fact that in comparison to the previous, 31st August summary, the investors have expanded their long positions with a further 1,806 contracts.

Due to the development of the above-mentioned portfolio of futures contracts, besides the spot market data it's also worth taking a look at the contract sizes at the various maturities traded by the hedge funds and larger investment fund managers. In the commodities section (COMEX) of the world's largest physical commodities exchange (New York Mercantile), the most widespread contract size in the futures market is 100 troy ounces, which is out of reach for most small investors (1 troy ounce = 31.103 grammes). The initial margin for this is around USD 5,700, so it's plain to see that with futures it's easy to build up substantial positions with relatively little capital.

3.) We examined the co-movement of gold prices and the daily yields of the S&P500 index over a YTD, one-year and three-year horizon. It's clear that over the long term, daily gold prices and daily share-index yields display only a very slight degree of correlation, while over the shorter term, it's equally clear that an upswing in the equity market coincides with a considerable rise in the price of gold. It's safe to say that if an investor bought gold as well as shares, this would have had a major risk-reducing effect in the long run, in terms of the portfolio as a whole. There appears to be truth in the adage that in times of uncertainty, when there are no discernible trends in stock prices, investors who crave security seek refuge in gold.

Co-movement of daily yields

	3 years	1 year	YTD
Correlation	0,02	0,23	0,16

Source: AEGON Fund Management

4.) In a technical analysis, it's clear that the price of gold is moving in an upward trend. Under a trend-following strategy, this means that the only correct course of action is to establish a long position. However, finding a good entry price – always a key factor – is critical here. Based on the RSI indicator, the rare metal is showing signs of being overbought, and this has previously been indicative of local peaks. Since the price has broken through a number of key resistance levels, with some substantial intra-day increases (Marobozu Candle), and since there are signs that the metal is overbought, I would delay establishing a long position until after the likely correction. In my opinion, for those with an appetite for risk, the 1,235-1,240 levels are suitable for the placing of relatively small bets, setting narrow stop-loss limits.

Gold spot daily prices

Source: Stooq

To summarise, although gold production increased during the period under review, the extent of this rise did not match the growth in demand. Besides this, those making deals in the forward market for investment purposes agree that they would like to profit from a rise in the price of gold, while the mining companies are no longer counting on a sharp increase, and are therefore locking in their profits. The analysis shows that gold represents a long-term sanctuary in times of equity-market uncertainty, since the degree of correlation in the daily yields over time is only slight. In a technical analysis I regard gold as overbought, and for this reason, making use of the support and Fibonacci levels, I would put off establishing long positions until later. Small investors who would like to participate in the rising price of gold but don’t have the time to search for an entry point with a favourable risk-to-yield ratio, or who would simply prefer to entrust the compilation of the appropriate speculative portfolio to a specialist, can do so cost-effectively by buying into an absolute yield derivative investment fund, such as the AEGON Atticus Alfa and Vision Derivative Investment Fund.

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