Perspectives

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Gold is still worth its weight.

JAHRE IHAG PRIVATBANK

More than just fairytale stuff.

Dear investor

“Whirr whirr whirr, three times the thread was drawn... and the bobbin was full” – such is the way the Brothers Grimm describe how the imp Rumpelstiltskin helped the poor miller’s daughter to weave straw into gold. She duly became the King’s consort and would have stepped straight into a life of comfort and bliss were it not for the imp’s return to demand payment of his grisly promise...

Gold has fascinated mankind since time immemorial. Nor is it just in this fairytale that people have tried to convert a humble substance into gold. Countless attempts have been made over the course of time to create gold artificially, and even though the term “alchemy” encompasses far more than the attempt to synthesise gold, it is above all this endeavour that we associate with this precursor of modern chemistry. But what makes gold so attractive? Why has it always been used as an instrument of trade, a repository of value and a currency? Why do so many safekeeping accounts contain gold deposits even though these do not generate an income stream? And while we’re at it: Why has the price of gold recently surged to new highs? We explore these and other questions in the following publication.

It’s just as well that Rumpelstiltskin ended up ruining his own plot by singing so loudly and imprudently as he danced around the fire. We would never have found out his name, and maybe gold would have remained just a simple metal – rather than one truly worth making a song and dance about.

We wish you an enjoyable read.

Christoph Boner
Chief Investment Officer

More than just an investment – the history of gold

For millennia, gold has served as a basic raw material of ritual objects of all kinds, as well as jewellery. Its colour, glitter, and apparent imperishability make this metal attractive for precisely these purposes – albeit more usually in alloyed form in today's world. Gold is also used in modern industrial processes, most notably various areas of medicine and electronics.

Almost half of all mined gold today is used in the watch and jewellery industry. Just under a quarter is held by the financial industry and by central banks respectively, while industrial use accounts for the residual proportion (less than 10%).

Most pertinently of all, however, gold has served as a means of payment ever since the sixth century BC. For it was then that the first gold coins were minted – which thanks to standardisation and general acceptance made a crucial contribution to simplifying the trading of goods. Together with their silver counterparts, gold coins have fulfilled the classic function of a means of payment for centuries. This precious metal has therefore served as a means of exchange, a unit of account, and a store of value.

With the introduction of a new international currency order following the Second World War based on the Bretton Woods agreement, the world's leading currencies were coupled to a gold standard involving the US dollar as the anchor currency. Specifically, currencies were pegged to the USD with defined bandwidths, with the USD itself being backed by gold. The paper money created by government agencies – known as "fiat money" if

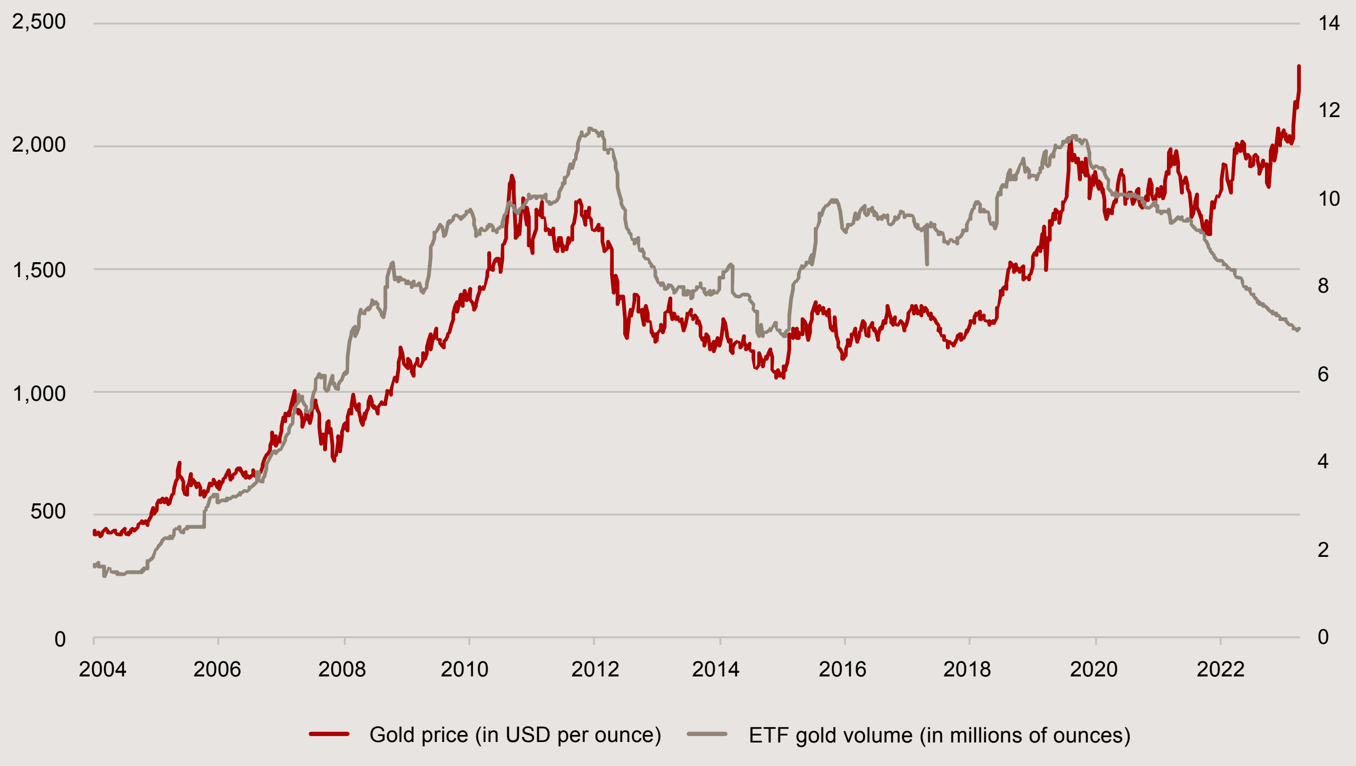
Gold has always been highly attractive. Even if there are only a few specific uses, it certainly meets the requirements for being used as a currency.

not tied to the price of a commodity – was exchangeable (at least in theory) for gold and enjoyed a high degree of value stability and the corresponding public trust thanks to the (partly indirect) link to the gold price. The official end of the Bretton Woods system in 1973 resulted in widespread flexibilisation of exchange rates and the abandonment of the coupling of the USD to the price of gold.

With the end of this "gold standard" system, a gradual process of paper currency devaluation set in. At the same time, gold acquired new significance as an investment vehicle, even if this metal – just like other commodities – should not be considered an asset class in the traditional sense. An asset class is characterised by the income stream it generates – and while gold may hold its value well, it does not generate income. Accordingly, increases in value only occur through the persistence of demand in relation to a supply that is (obviously) limited. The price of gold is therefore always simply a reflection of supply and demand, and cannot be subjected to a true valuation process, i.e. the ascertainment of an economically "fair" price.

A look at how the value of gold has developed over time reveals that it has an impressive ability to retain its value. Whereas a single-family home in Switzerland might now cost around 500 ounces of gold, the same amount of gold would have bought the equivalent building half a century ago – even though nominal prices have more than trebled over this period.

Development of the gold price and ETF gold holdings over the last 20 years



Gold price supported by persistent demand

The price of gold has surged to new highs in recent weeks. At the most recent interim peak, one ounce of gold was trading at USD 2,400. This development is surprising, as the return of a higher interest rate environment has resulted in not insignificant opportunity costs for investors holding gold. For example, the interest achievable on a USD money market investment currently amounts to more than 5%.

It is also interesting to note that the demand for gold on the part of investment funds – which often represent smaller investors – has been declining for months: While the total volume of gold held by ETFs stood at 11 million ounces as recently as the summer of 2020, these holdings have now come down to 7 million ounces.

The increased demand for gold has therefore been coming from elsewhere, namely central banks and institutional investors. But the reasons for the strong demand for gold on the part of these two buyer groups are rather different.

USD as global reference currency

To all intents and purposes, the US dollar (USD) remains the global reference currency – due to structural problems, neither the euro (EUR) nor (given recent developments) the Chinese renminbi (RMB) make them suitable for such a role. As such, a policy of diversification away from the USD necessarily also translates into greater demand for gold.

Debt problems and political situation of the US

The current level of indebtedness of the US – equivalent to 130% of total economic output – and the significant amount of refinancing required in the capital markets over the next few months point to an increase in the risk of USD investments. Similarly, the US presidential election in November is already casting its long shadow and creating uncertainty among investors.

Global tensions

Traditionally regarded as a universal safe haven, gold is once again gaining in significance against a backdrop of various geopolitical crises and the multi-polarisation of the world order. While the shift away from the USD towards gold is true of central banks generally, a particularly important player here is the Chinese central bank (PBC), which has good reasons to reduce its dependency on the USD further and replace US government bonds with gold.

6%

is the average increase in the price of gold per year over the past 30 years. This compares to a value increase of around 7% per year for the Swiss stock market. In CHF terms, the value increase is still 4% per year.

20 years

At current extraction levels, the global gold supply is likely to be exhausted in less than 20 years.

Even with interest rates remaining in positive territory and investor outflows continuing, demand for gold can be expected to persist at a high level and prop up the price thanks to the activities of national institutions. Falling rates of inflation together with a return to lower interest rates in the medium term should likewise support the price of gold, while global uncertainties will always be conducive to investments in this precious metal. In the event of crises intensifying, gold is likely to retain its status as a safe haven in the future too. So both strategically and tactically, there are good reasons why gold should remain part of a diversified investment portfolio.

Gold: still a safe haven?

Christoph Boner
Chief Investment Officer

What qualifies gold to act as a currency?
In order for a commodity to function as a currency, three criteria need to be met. Firstly it must be suitable for use as a means of exchange, secondly it must represent a unit of account, and thirdly it must fulfil a "store of value" function. The latter is ensured by the natural restriction of supply (and the impossibility of artificial replication), while gold functions as a unit of account thanks to its standardisation, e.g. in the form of coins and bars. Finally, its suitability as a means of exchange is based on cultural acceptance, which in the case of precious metals dates back thousands of years.

Why is gold not an asset class in the conventional sense?
Asset classes in the technical sense are understood to be securities such as shares and bonds – rights that provide the holder with income in the form of dividends and interest. This is what gives these investments their intrinsic value. By contrast, commodities (and therefore also precious metals) do not generate any income, and therefore cannot be technically valued. Perhaps a value could be derived from the aspect of permanence, but ultimately the price is dictated purely by the supply and demand situation. While this is true of (traded) securities too, these assets have a standalone value, at least theoretically.

Why has the gold-based valuation of currencies been abandoned multiple times?
Whereas gold originally served as a means of payment in the form of coins and bars, the metamorphosis to coins and banknotes with no actual value but a claim on gold was a logical step in the evolution of the monetary system for practicality reasons. This ensured that currency could remain gold-based from a theoretical standpoint and fulfil its intended function despite the valueless nature of the materials acting as proxy.

However, a gold standard system of this kind faces two fundamental challenges. Firstly, the exchange rates between the individual currencies of different countries in such a gold-based system are essentially fixed. In other words, the balancing mechanism needed between economies developing in different ways does not exist. And secondly, the pegging to gold basically rules out the extensibility of the money supply, which can be a major obstacle for a country in a time of crisis.

While a gold-standard currency regime was widespread in the 19th century, the extent to which currencies were backed by gold was already in decline at the end of that century, and the demands of the First World War – which included the financing of government budgets without raising taxes and the use of so-called war bonds – led to the gold standard being to all intents and purposes abolished. A new gold standard was then introduced after the Second World War based on the Bretton Woods agreement, as this was deemed an expedient way of eliminating the confusion over flexible exchange rates and the inflation crises that characterised the interwar years. However, this system collapsed in the early 1970s, as global economic growth had led to a significant rise in demand for the USD as a form of currency reserve, which essentially had to be achieved by countries running balance of payments surpluses vis-à-vis the US. But the corresponding balance of payments deficits of the US in turn threatened to undermine trust in the US dollar, prompting the Nixon government to suspend the dollar's convertibility into gold in 1971. This brought about the ongoing flexibilisation of the world's most important foreign exchange rates.

How much gold is there on the planet?

According to the latest estimates, a total of just over 208,000 tonnes – or around 7 billion ounces – has been mined, with a current market value of more than USD 16,000 billion. To give an idea of what that means, if all this gold were cast into a single cube, each side would measure just over 22 m in length.

A further 52,000 tonnes of mineable gold is currently estimated to be still in the ground, which at current extraction levels would mean the complete extraction of all remaining gold in less than 20 years from now.

What are the key problems confronting fiat money in practice?

The value of fiat money is not tied to that of a commodity such as gold or silver. In order for it to nonetheless fulfil the functions of a currency, the aspect of value retention becomes the key challenge – specifically, the money supply must remain in a stable ratio to economic output (taking into account the velocity of money) if the currency is to retain its value. In modern monetary systems, this is achieved through the legal and organisational separation of monetary policy and fiscal policy. In practice, this means segregating the central bank as the money-issuing institution from other government functions, and assigning it with the task of ensuring monetary stability. In particular, this prevents the state from financing itself through the new issuance of money, a course of action that would vastly expand the money supply and thereby jeopardise monetary stability.

Even the criterion of acceptance as a means of payment can prove challenging, as any fiat money system is heavily reliant on the trust of economic protagonists in the corresponding (typically state) institutions.

Why are cryptocurrencies sometimes described as the “new gold”?
Theoretically speaking, cryptocurrencies can fulfil the functions of a traditional currency – but with the crucial difference that they are not issued by a state monopoly. This can give rise to a different kind of trust – and indeed mistrust. Moreover, unlike fiat money, the supply of cryptocurrencies is limited by design, which potentially gives them a similar status to that enjoyed by gold. On the other hand, it should be stressed that the significance of gold has been accepted for millennia, whereas cryptocurrencies are a relatively new concept, so an established track record will take time to build up.

Why is gold often considered a good investment time of crisis?
Gold’s reputation as a safe haven is well established. So at times of elevated risk, financial securities are often discarded in favour of a “flight to gold”, which triggers the corresponding price rises. This is why gold plays such an important role as a diversification tool in a traditional investment portfolio.

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