Gold has everything in its favor

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By Michael Brush, MarketWatch

This year's rally has legs, spurred by the right economic conditions

Left for dead for almost four years, gold has suddenly made an amazing comeback: It's up over 50% this year.

Will the strength of gold continue, or is the party over?

Several gold investors who have enjoyed the ride so far believe the next move is up from here -- possibly even taking out prior highs for the metal.

Gold traded on Friday for $1,245 an ounce. It went as high as $1,895 in 2011.

"I would not be surprised to see all-time highs in this next leg of the precious-metals cycle," says John Hathaway, manager of the Tocqueville Gold Fund . He thinks that could take a few years.

"This is the first leg up," agrees Frank Holmes, who manages the U.S. Global Investors Gold and Precious Metals Fund .

"Gold will shuffle around at this level. But I can't help but think it goes higher," says Tom Winmill, who manages the Midas Fund .

Of course, no one can call day-to-day moves in any asset. So don't buy tomorrow and expect instant profits, especially after such a run. And these gold experts may all have a built-in bias, in that they make their living by offering gold investment products.

Yet their reasoning makes sense, when you look around at what's going on in the world. Here's the gist of their thinking. They also suggest five stocks and several other ways to get gold exposure, at the end of this column.

The war on cash

Interest rates on savings are negative in many places around the world. And there have been calls by central bankers like Mario Draghi and economists like Larry Summers to eliminate high-denomination bills. The drumbeat for digital cash is getting louder.

"There's a war on cash and a war on savings, and people are starting to see that," says Hathaway. "All of this drives people to think: 'What else is there? Where else can I keep my money safe?' "

One answer, of course, is gold.

Historically, gold has done well when interest rates turn negative -- like they have now in Japan and Europe, as central bankers reach for another tool to stimulate economies. Back when gold was at its peak near $1,900 in 2011, the 10-year U.S. Treasury note paid a negative 3% yield, points out Holmes. "Gold is always attractive when you have negative interest rates," he says.

Negative interest rates also remove a standard criticism of gold: the fact that it yields nothing, says Trey Reik, a portfolio manager with Sprott Asset Management. "This puts gold back on the radar."

Loss of confidence in central bankers

The use of negative interest rates by central bankers in Japan and Europe to try to stimulate growth smacks of desperation.

In the U.S., the Federal Reserve seems confused. It reversed course quickly since December, backing away from suggestions at the time that 2016 would bring four rate increases.

Fed critics say it also seems to drift haphazardly among policy objectives -- from the value of the dollar to stock market levels, and back to the traditional goals of maintaining full employment and price stability. In recent weeks, it's even offered several alternative inflation targets, and different takes on which benchmark it will use to assess progress.

Then there's the bigger question of how central banks will unwind all of their debt after years of quantitative easing in the form of bond purchases.

"One way or another, we are all lab rats in this grand experiment by PhDs running central banks," says Hathaway. "We live in an age of radical monetary experimentation. Anyone who thinks the central banks can normalize interest rates is smoking pot."

All of this has eroded confidence in central banks, says Reik. And that benefits gold. "Gold is the inverse of confidence in central banks," he says.

Gold as insurance

Gold has always played an insurance role in portfolios -- against global disaster, geopolitical meltdown or inflation. And, more recently, against the possibility that central bankers will not be able to unwind all of their debt without creating big problems.

But now that interest rates are near zero, or lower, another traditional form of insurance for a portfolio -- bonds -- cannot do their job well. The flip side of zero interest rates is that bond prices can't go much higher. So there's no room for bonds to go up if stocks fall, and thus no insurance value to them.

"Traditionally, sovereign bonds have been the no-brainer stabilizer for portfolio returns," says Hathaway. "That was great until we had zero interest rates. At zero rates, that does not work." There's another high-quality liquid asset that's uncorrelated to equities, however. That would be gold.

The gold shortage

China has been busy buying gold to build up reserves to back the yuan, which the country wants to serve as a major world currency, says Holmes. This buying supports the price of gold directly. But also indirectly, if it's contributing to the decline in the amount of gold available for trading. That may be the case.

Buying by Asian investors and the decline in mining output also contribute to a gold shortage, says Hathaway.

"The liquid inventories of physical gold vaulted in western financial centers have been severely depleted," he says. He thinks the gold "float" has declined by 67% since 2011. If so, any new net demand drives gold higher than it normally might.

A weaker dollar

The good news here, if there is any, is that you might not need a doomsday scenario for gold to advance. Gold moves in the opposite direction of the dollar. And the dollar will weaken from here, says James Paulsen, an economist at Wells Capital Management. That's because, in his view, better growth in Europe and emerging markets will attract more investment into those regions, driving their currencies higher.

There's a gloomy gold bug angle here, too, though. The theory: Central bankers are deliberately debasing currencies to reduce the value of the debt that governments and central banks around the world owe.

How to bet on gold

One way to get exposure to gold is to buy the shares of the mutual funds of gold managers mentioned above. All of them have done quite well since the start of the year.

If you do buy stocks on your own, be sure to own a lot of them, cautions Winmill, who manages the Midas Fund.

"Don't purchase any single name, because there is so much event risk. You are asking for trouble," he says. "Anything can happen when you are trying to develop a mine." He suggests owning at least five or more.

Winmill also favors companies that already have mines, since it can take so long to bring new mines online. And he likes companies with many mines, for further diversification. Three of his favorites are: Randgold Resources Ltd. (RRS.LN), in part because the company has produced consistent returns on equity over time; OceanaGold Corp. (OGC.AU), which is under new management, pays a dividend and looks relatively cheap; and Rio Tinto PLC (RIO), which broadens out your exposure beyond gold to other commodities like copper, silver and bauxite.

Holmes likes the Nevada-based Klondex Mines Ltd. (KDX.T), which he says has a "good housekeeping seal of approval" in the form of an investment by Franco-Nevada Corp. (FNV.T), a gold operator he likes because it has a knack for investing wisely in gold companies in exchange for royalty streams. Holmes thinks Klondex Mines is a possible takeover candidate, as bigger mining companies shop for assets. Another potential catalyst: the possible addition of the name to an exchange traded fund of smaller mining companies, Market Vectors Junior Gold Miners ETF (GDXJ).

Of course, the "safest" way to go here is to get exposure to gold itself. You can do this by purchasing shares of the ETF SPDR Gold Trust (GLD). Or consider the Sprott Physical Gold Trust (PHY.U.T). Unlike SPDR Gold Trust, it allows you to book lower long-term capital gains, assuming you hold it long enough, since it is a closed-end fund. You can also redeem shares of Sprott Physical Gold Trust for gold.

Hathaway thinks the best way to get exposure to gold is to buy the metal itself, and then store it in a safe place. That's because when you own ETFs or other instruments, there is counterparty risk. You are relying on other people to hold up their end of the bargain. They probably will, but you never know.

Hathaway walks the walk. He has about 14% of his portfolio in physical gold.

At the time of publication, Michael Brush had no positions in any stocks mentioned in this column. Brush is a Manhattan-based financial writer who publishes the stock newsletter Brush Up on Stocks (http://www.uponstocks.com/). Brush has covered business for the New York Times and The Economist group, and he attended Columbia Business School in the Knight-Bagehot program.

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