MarketWatch

Opinion: Five reasons why gold is still worth owning

By Michael Brush
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The yellow metal has cooled, but there are catalysts that will keep prices buoyant

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An road access ramp runs through an open pit gold mine in Western Australia.

Gold GC00, +0.63% has performed well since we suggested it in late February and late July.

The precious metal is up 13% and 6%, respectively, from those dates, compared with an increase of only 3.4% in the S&P 500 SPX, +1.16% since February and a 3.8% decline in the index since late July.

Given the big outperformance in gold, it's time to check back in with my gold gurus for a read on what you should do with gold now.

The bottom line: In the near term, gold may cool off, as more positive economic data calms recession fears. In the medium term, there are still many solid reasons to own the yellow metal and gold miners in exchange traded funds, such as the VanEck Vectors Gold Miners ETF GDX, -1.06% and the VanEck Vectors Junior Gold Miners ETF GDXJ, -1.55%.

Let's take a closer look.

Wither recession

In the short term, the next move in gold really comes down to what happens with the economy.

"If economic reports calm people down about imminent recession, I don't see where gold is going to be a great investment," says Leuthold Group chief investment strategist James Paulsen.

But we aren't going to see a recession near-term so gold prices may remain flat or even fall — for three reasons.

1. President Trump needs a strong economy to get re-elected. Like him or not, he has a lot of influence over business and consumer confidence and the economy. Impeachment proceedings won't hurt sentiment because Democrats are 20 votes shy in the Senate of the two-thirds majority they need to remove him from office.

2. The inverted yield curve signal is a head fake. It's not telling us recession is at hand. Yields at the long end of the curve are artificially suppressed by foreign buyers of U.S. debt trying to avoid negative yields in their home markets. Yes, it's different this time.

3. The U.S. economy has been showing signs of a rebound. Hard economic numbers show strength — like industrial production, capacity utilization, employment, home sales, auto sales, personal income and retail spending, notes Paulsen.

This undercuts the significance of the National Association of Purchasing Managers (NAPM) Index's manufacturing numbers that spooked investors this week. So does the fact that these numbers are merely "soft" survey-based data. They matter, but they are less meaningful since they are based on opinions in surveys.

“I can see why people are skittish,” says Paulsen, citing headlines about impeachment and ongoing bad news on the China trade front, including possible U.S. restrictions on capital flows to China. “You can certainly understand how people might not feel good about the world. But that is different from how the world is doing.”

What he means is the NAPM survey data is weak because of all the scary headlines. But the hard economic data is good.

The key takeaway: No recession nearby, so gold flat-lines.

Still, it’s worth owning some gold and gold-mining shares for five reasons.

1. Gold helps you play defense

A big risk now is that people talk the economy into recession by damaging business and consumer confidence. It would not be the first time that worries about recession became a self-fulfilling prophesy. “I give it 25% odds that we scare ourselves into recession. I do think it is a risk, but I don’t think it is the most likely outcome,” says Paulsen.

Gold also offers investors a safe haven against political headline risk and uncertainties spawned by U.K. leadership changes, Brexit and the U.S.-China trade dispute tensions, says Chris Terry, a gold and metals analyst at Deutsche Bank.

2. Central banks love gold again

Central banks are purchasing gold in volumes not seen in 50 years, points out Tom Winmill, who manages the Midas Fund MIDSX, +2.26%. Given that the dollar has been so strong, central banks are diversifying away from the greenback. The biggest buying is coming from Russia, China and Poland.

3. The U.S. may be on course to debase the dollar

As both political parties throw caution to the wind on deficit spending, the U.S. is now borrowing almost a trillion dollars a year. About 22% of the federal budget is financed by debt. The U.S. debt-to-GDP ratio could hit nearly 100% over the next decade, from around 78% now, according to government estimates.

Typically governments resort to inflation to reduce debt burdens like these, says Winmill, and he thinks the U.S. is now on that course. Gold usually performs well when inflation heats up and the dollar weakens.

Even if that does not happen right away, the tight labor market may produce wage growth-based inflation that spikes gold.

"I would not be surprised to see gold at $2,000 an ounce in two years," says Winmill. Near-term he's neutral on gold in part because a fourth of gold demand comes from jewelry purchases, which cools when gold prices rise as much as they have this year.

4. Gold has momentum

Money flows into gold mutual funds managed by U.S. Global Investors GROW, -2.00% shot up considerably in August and September, says Ralph Aldis, a co-portfolio manager at the fund group. Based on what these kinds of flows have suggested about investor sentiment in the past, "this may indicate sustained interest in gold going forward," he says.

Aldis co-manages the U.S. Global Investors Gold and Precious Metals Fund USERX, +2.53% and the U.S. Global Investors World Precious Minerals Fund UNWPX, +0.64%

"It seems like a bigger pool of money is chasing the space right now," Aldis says. "People are reloading when gold falls. There is good net accumulation." But the flows are not so high that they indicate a frothy top. "This gives me confidence that we are in the early stages of a gold mining cycle," he says.

Aldis thinks the interest in gold makes sense because he believes a recession is possible next year. He also doubts Trump really wants to resolve the U.S.-China tariff and trade conflict, because Trump's endgame is to rebuild the U.S. manufacturing sector.

5. There may be supply shortages

At the Denver Gold Forum in September, Barrick Gold GOLD, -1.22% cautioned that mining production could fall by 45% over the next 10 years barring an increase in investment in new mines, given how much mining companies cut these kinds of investments during the past six years when gold was weak.

Stocks

Winmill, at the Midas fund, prefers mining companies with long-lived reserves and decent free cash flow. He thinks the stocks of many of these kinds of companies still look cheap despite the strength in gold.

"There are some really interesting bargains," he says.

Winmill singles out Alacer ALIAF, +0.00%, which trades on the Toronto exchange as Alacer Gold ASR, -0.51%. Alacer sells for a discount because its mines are in Turkey, but Winmill doesn't think the political risks are elevated.

Next, he singles out Pretium Resources PVG, -1.82% because it has promising assets in Canada that will increase production significantly over the next few years. He also highlights Roxgold ROXG, -2.88% and B2Gold BTG, -1.72%. Larger-cap favorites in his Midas fund include Barrick Gold and Agnico Eagle Mines AEM, -0.35%.

Aldis, at U.S. Global Investors, singles out Wheaton Precious Metals WPM, -1.45% and Wesdome Gold Mines WDOFF, -3.66%. He thinks smaller mining companies are takeover candidates by larger mining companies looking to build out their reserves.

At the time of publication, Michael Brush had no positions in any stocks mentioned in this column. Brush has suggested GDX in his stock newsletter Brush Up on Stocks. Brush is a Manhattan-based financial writer who 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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