Strategy Thoughts

April 2023

Bank runs, Gold

Is it ‘Deja Vu all over again’?

Introduction

Over the last five weeks markets have had a lot to worry about, not least one of the largest bank failures in US history and a rapid bailout of depositors by authorities. Throughout this period markets have initially panicked and then recovered, seemingly comforted by the reassurances that have been given by various figures in authority and the majority of market commentators. This entire period brings back many memories from fifteen years ago, and whilst history never repeats itself, as Mark Twain is supposed to have said, it does rhyme. Or, paraphrasing the legendary baseball player and manager Yogi Berra, is it Déjà vu all over again? This month’s Strategy Thoughts explores some of those echoes, or rhymes from fifteen years ago.

Also, this month I look into the apparently growing attraction of gold to central banks and question whether it implies that a continued rise in the price of gold is as assured as so many now seemingly believe.

Is it May 2008 all over again?

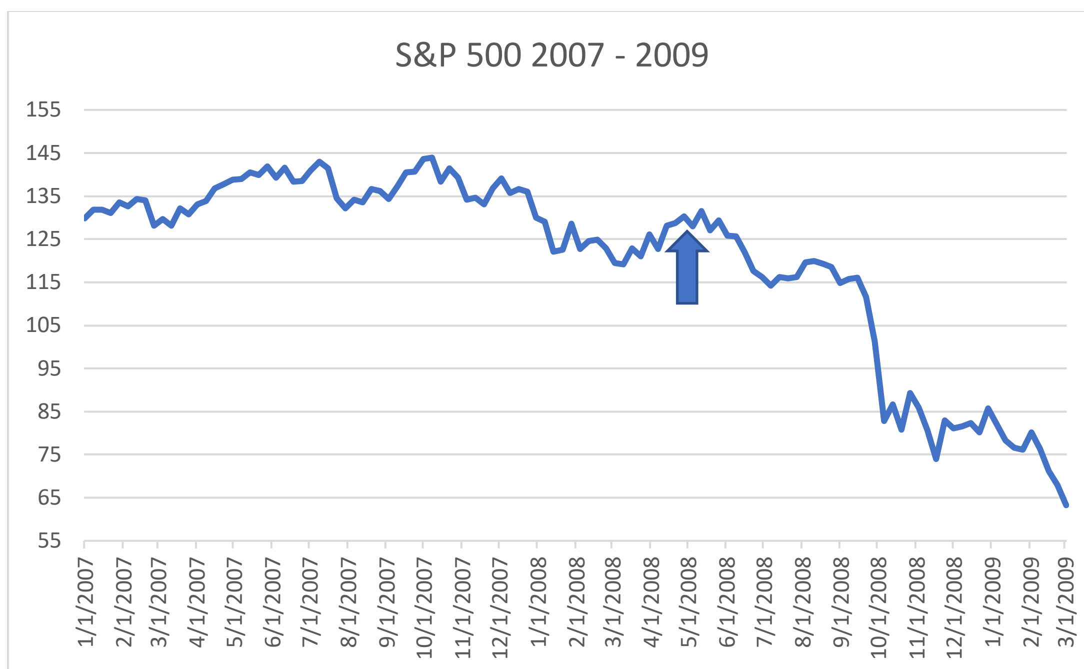
Almost fifteen years ago I titled the June 2008 edition of Strategy Thoughts, that had been written on the 27th May, “Has the eye passed over?”. I began that edition with;

> Last month’s Strategy Conclusions was titled “The Eye of the Storm” and concluded that the current respite world markets were experiencing, along with a coincident drop in volatility, was not the start of a new bull market. Just because ‘the worst being over’ is repeatedly asserted by seemingly everyone it does not become any more true. In fact students of stock market history will know, as I pointed out in Thoughts and Observations recently, that the reverse is often the case, at least when it comes to investment markets. That is, the more a particular outcome is proclaimed to be obvious the less likely it is to actually occur and the more likely it’s hoped for occurrence has already been priced in, so leading to disappointment.

I then included a number of ill timed comments that were supposed to provide comfort to investors during the early stages of prior downdraughts. One of my favourites around that time was from Hank Paulson, then US Treasury secretary, who on the 6th May 2008 stated in an interview with the Wall Street Journal;

> "I do believe that the worst is likely to be behind us"

I have marked that point on the chart of the S&P 500 below. Far from being over, the worst was just about to begin.



Prior to Paulson's comments the market had fallen, from a high in October 2007, by 20%. It had then rallied over the next couple of months recovering half of that loss, it then continued to rally over the next couple of weeks, eking out another 2% of rally, but from there Paulson's 'Hope' was proved to be badly misplaced. Over the next ten months the US market plunged, along with the rest of the world's markets, finally bottoming out in early March 2009 more than 50% below the level where Paulson had sounded so comforting.

In the wake of the recent bank collapses expressions of 'hope' and optimism, on the part of officials have once again abounded. Interestingly these optimistic calls are coming after the market has once again recovered almost exactly half of the preceding fall, although somewhat alarmingly the preceding fall was larger, and lasted longer, than that seen fifteen years ago.

On the 21st March, less than two weeks after the first bank failure the Treasury secretary was once again providing hope, Janet Yellen said;

> "The situation is stabilizing. And the U.S. banking system remains sound. The Fed facility and discount window lending are working as intended to provide liquidity to the banking system. Aggregate deposit outflows from regional banks have stabilized."

Three days later in the UK Bank of England Governor Andrew Bailey was quoted in thisismoney.co.uk;

> But rejecting any comparison with 2008, he said: 'I'm confident that the banks in this country are in a much stronger position.'
>
> The Bank also revealed improved economic forecasts, pencilling a return to growth in the second quarter of this year after a first quarter of contraction.

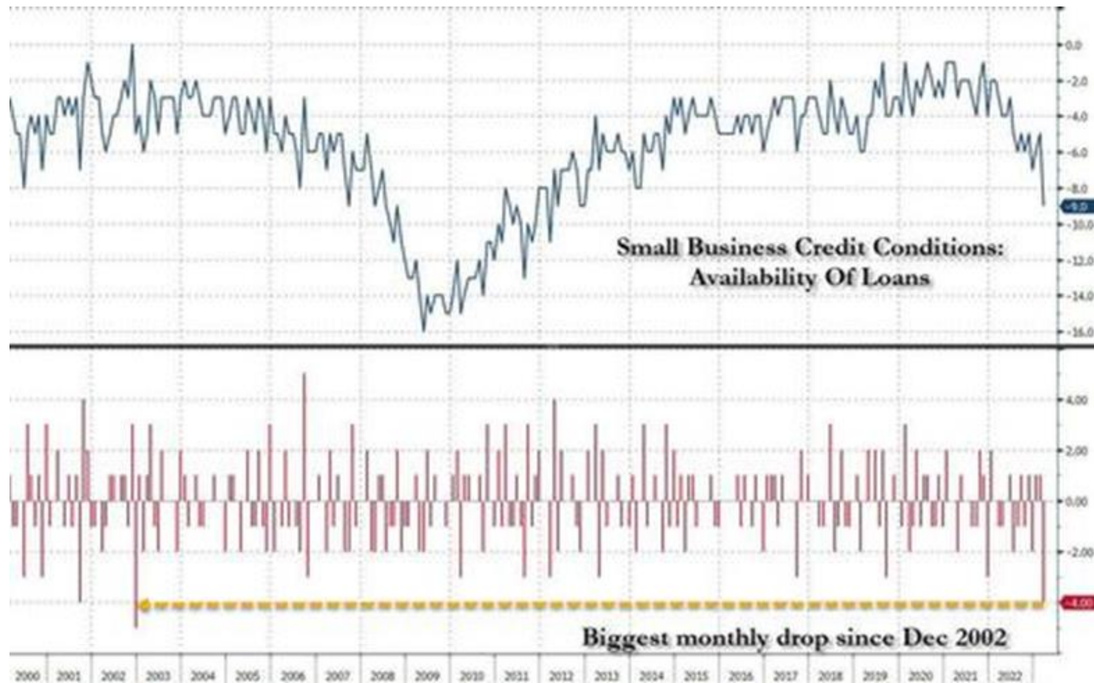
And investors are being urged not to panic and to dollar cost average into these dips;

> **Don't panic: This share market hack will beat volatility** yahoo finance AU

And it seems retail investors are following this advice;

Retail investors are buying the dip in financial stocks in unprecedented amounts CNBC March 17

Yet another echo of the first half of 2008 can be seen in the following chart of Small Business Credit Conditions;



This measure has recently fallen to a similar level last seen in the first half of 2008, having previously been at an even higher level than that enjoyed prior to the onset of the GFC. Again, none of this means that history will repeat, but those taking hope from the comforting words of those supposedly in the know and in charge should take note of what their track record has been.

After the Crash in 1929 the US market recovered about half of its crash loss by May of 1930, as this recovery in the market was occurring the following comforting statements were made;

January 1930. "Happily, we have turned our backs upon the events of this unfortunate episode" Paul Warburg, Federal Reserve Board

March 8 1930. "President Hoover predicted today that the worst effect of the crash upon unemployment will have been passed during the next sixty days." Washington Dispatch.

May 21, 1930. "Business is gradually but unmistakably coming out of the depression." Dr Julius Klein, assistant secretary of commerce.

June 28 1930. "The worst is over without a doubt, and it has been a disciplinary and in some ways constructive experience. People have learned once again that only work produces wealth." James J Davis, secretary of agriculture.

We are currently seeing a lot of these 'comforting' comments, and will likely continue to if this rally has anything left in it and even as it rolls over. But when the next great buying opportunity comes none of these comforting words will be heard. As the last major buying opportunity approached, I highlighted the extremely gloomy outlook that was pervasive in the March 2009 edition of Strategy Thoughts with the following examples of recent headlines;

> "**Cult** of **Equity**' Is Under Attack" Bloomberg
>
> Market's 'Hope Balloon' Loses Air
>
> ***Tepid Upturns Haven't Stopped the Slide; 'Hard to Make a Cheery Story'***
>
> WSJ 17th February 2009

We should also expect to see extremely gloomy economic forecasts as the bottom approaches, not just cuts in forecasts but cuts to historically bleak levels.

The IMF

A number of long time readers have questioned whether the recent caution on the part of the IMF regarding the world economy should be seen as a sign that perhaps the worst is over. They are referring to the recent cuts in GDP growth forecasts on the part of the IMF;

> ***I.M.F. Lowers Growth Outlook Amid Financial System Tremors***
> ***NYT April 11***

These headlines were on the back of the IMF cutting their global growth outlook from 2.9% to 2.8%. Admittedly this was a larger cut from their year earlier forecast, but they were still forecasting growth.

Those long term readers that I mentioned were referring back to an article I wrote in late March 2009 after the IMF, and the World Bank, had come out and actually forecast a contraction in the global economy for the first time in decades. This was after a deep recession was already obvious and markets globally had suffered their worst falls in decades. In the article I pointed out the poor record the two organisations had had at historic extremes. In 2000, at the peak of the dotcom mania and before the NASDAQ fell more than 80%, the IMF raised their global growth forecast for the coming year and if anything saw risk to this forecast on the upside. After the ensuing bear market and recession they extrapolated the then prevalent trend of stagnation with a very weak outlook. Four years later, after a great bull market, they saw a 'sea of global liquidity' continuing to lift the value of just about every asset class. This was just prior to the onset of the GFC, but interestingly long after the start of the house price decline that eventually triggered the GFC.

At major turning points forecasts from organisations like the IMF or World Bank tend to be extrapolations of what has already been enjoyed or endured, when these become extreme they can be a valuable contrary indicator. I concluded my comments fifteen years ago with;

> Now, as the IMF are forecasting the weakest global growth outlook for sixty years, may be the time to be concerned about the economy but it is probably not the time to panic about investment markets. The time for that was mid 2007 when growth estimates globally were being raised and expectations were high.

The fact that growth estimates are being cut is understandable given what has been seen, but this is likely only the early stages. At the next great buying opportunity the IMF will not be cutting growth estimates, they will be increasing the amount the economy might shrink, just as they did one and a half decades ago.

Another cause for concern is that not only are investors so keen to buy any dip, they also remain ever hopeful that a Fed pivot will spawn a new bull market;

> **Tech Stocks Rose, Bond Yields Tumbled on Hope for Fed Pivot** Mar 13, 2023 Barrons
>
> **Fed Rate Pivot Is Back in Play** Markets are predicting a change in the course of interest rates now that there is trouble brewing in the banking sector. Bloomberg 13 March

Over the last couple of editions of Strategy Thoughts I have gone to some length to illustrate the misplaced hope in a Fed pause or a pivot and the start of a cutting cycle. It is a very poor investment strategy, as I outlined two months ago, on average the market tends to fall for about a year and by 25% after a Fed pivot, that is from the first rate cut. Whilst this should not give investors any encouragement, as a pivot, almost by definition has to lie further in the future than a pause, pinning hope on a Fed pause seems an even worse idea. Over the last three cycles, going back a quarter of a century, the fed has paused on three occasions after a ramping cycle**. On average the market has been 38% lower twenty three months later.**

The lesson that should be taken from the current obsession with seeing a pause or pivot as a positive is that hope is still very much alive. When markets do finally bottom there will be no hope that anything, even by the Fed, can be done to turn things around. That is the nature of markets.

The Price of Rising Interest Rates

It has been widely reported that losses on the long term treasury bonds that Silicon Valley bank held were the prime reason for their failure, the magnitude of these potential losses over a relatively short period, in what are supposedly the safest of investments, can be seen in the chart below of the iShares 20+ year treasury etf. From early 2020 to late 2022 about 50% of the value was lost. Some of this loss has been recovered over the last few months as rates have slipped back slightly.

With even longer dated bonds the damage is even greater. A few years ago there were a number of issues of one hundred year bonds, even when long term interest rates were already at record lows. In July of 2020 Austria issued a highly sought after (at the time) one hundred year bond, it offered a yield of 0.85% but many pension funds and other long term focussed institutions piled into it. For the next few months, as rates continued to fall, the bond soared, passing $140 in November of 2020. However, with rates everywhere having dramatically reversed those same bonds now trade at $45. Perhaps the holders now take some comfort in the fact they only have to wait 97 years to get their principle back!

Its not just regional banks like Silicon Valley, or holders of century bonds that are suffering loses. As was reported early last month;

> **US banks are currently sitting on more than $600 billion in unrealised losses.** **CNN 12 March**

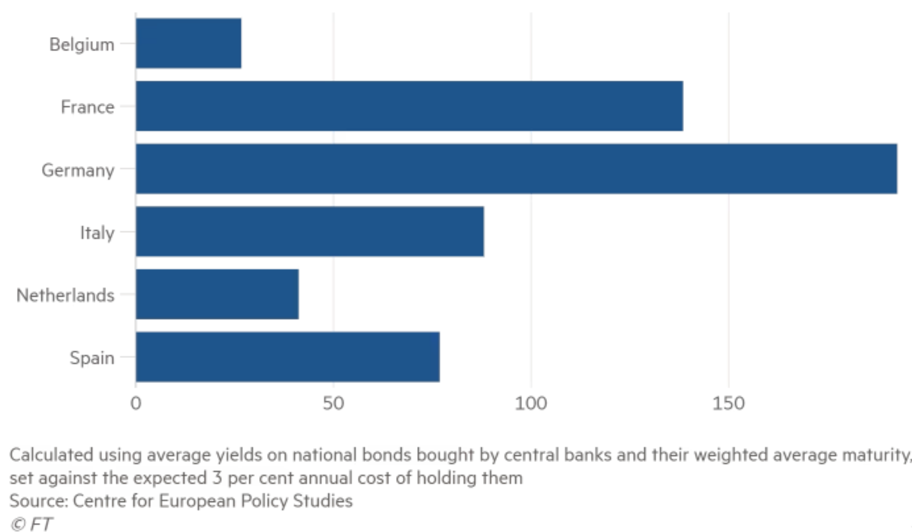
The same is true in Europe

On March 2nd The Financial Times reported;

> **Bundesbank warns losses from bond purchases will wipe out buffers**
> German central bank acknowledges provisions are unlikely to cover shortfall resulting from holdings of €1tn-worth of debt

Eurozone central banks are heading for big losses

Expected cumulative losses on PEPP and PSPP bond holdings from 2023 to 2034 (€bn)



And Japan.

BOJ's paper loss on bond holdings spikes tenfold

> Hit to Japan central bank's assets grows to $71bn as yield cap is raised Nikkei Asia 18th March

In the past it has not just been long dated bonds that central banks have managed to lose money in.

Gold

Gold has long been thought of as the ultimate store of value in times of trouble and given what has been happening in the world over the last three years it would make sense for gold to be rallying, as the following headline from Nikkei Asia recently summarised. It seems sensible that banking failures would cause concern among investors and potentially trigger a flight to safety in gold.

> Gold nears record price as U.S. bank failures fuel flight to safety Banking crisis adds to investor woes over Ukraine invasion, inflation Nikkei Asia 21 March

With this in mind it is worthwhile considering all the other reasons for a flight to safety over the last few years. In 2020 the world largely shut down in the face of the worst pandemic in more than a century, this was followed by the invasion of Ukraine by Russia and a war that has now dragged on for more than a year. More recently the world has suffered its worst inflationary shock in decades with the resultant interest hikes triggering the banking crisis mentioned by Nikkei. With that back drop it

would be easy to rationalise that the gold price should have catapulted higher with each crisis that hit and should now stand at $5,000 or even more, and yet that is not what has happened.

The five year chart of gold above shows that over the last six months or so the price has risen but it is still below where it was in the second half of 2020 at the height of the pandemic.

Now there is apparently another reason for gold to soar, central bank buying. As CNBC breathlessly reported two months ago;

> **Gold demand surged to an 11-year high in 2022 on 'colossal' central bank buying**

And Yahoo Finance recently reported;

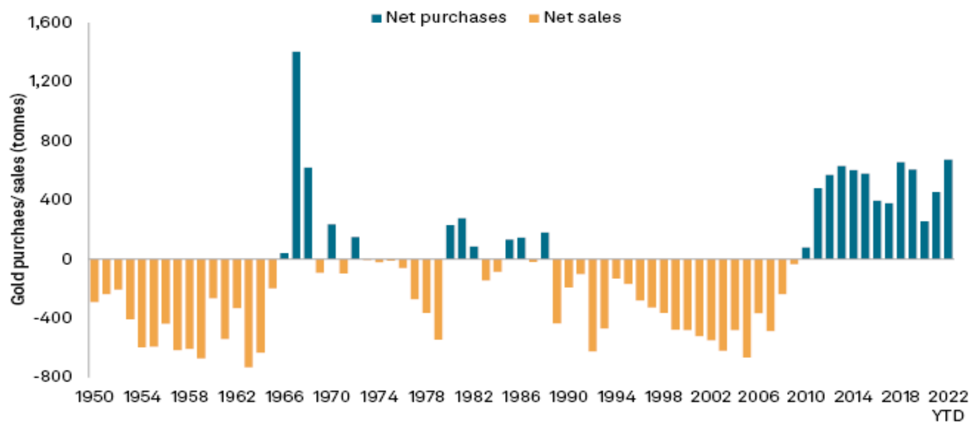
> According to the World Gold Council, there are two main drivers behind central bank gold buying — its performance during times of crisis and its role as a long-term store of value.
>
> It's hardly surprising then that in a year scarred by geopolitical uncertainty and rampant inflation, central banks opted to continue adding gold to their coffers and at an accelerated pace."

Simplistically this relationship seems to make sense, unfortunately the relationship has just not worked historically.

Seven years ago in 'Investing-The Expectations Game', I included the following anecdote;

> On the 7th May 1999 Gordon Brown, then the UK's Chancellor of the Exchequer, announced that he would be instituting a programme that would see the sale of a substantial portion of the UK's gold reserves. Over the prior nineteen years the price of gold had collapsed by more than 65% from a peak value of over $800, sadly for the British tax payer when the programme was complete the Chancellor achieved an average selling price of just $275 an ounce. With the obvious benefit of hindsight this sale can now be seen as one of the single worst investment decisions in history as over the subsequent decade the price of gold rocketed to over $1,800 an ounce.

It may be a little unfair to pick on Gordon Brown, however, the British sale was the most high-profile at the time.



The long term chart of aggregate central bank purchases and sales of gold, that accompanied one of the many recent articles celebrating the 'colossal' central bank demand, is worthy of some study to see whether central banks are in fact a contray indicator of the gold price, a leading indicator, or merely a coincident indicator.

Throughout the fifties and sixties, when the price of gold was fixed, central banks on balance dumped gold holdings, then in the late sixties very early seventies, as the price of gold doubled, they became buyers for a few years, before reverting to selling as the price of gold rocketed higher into 1980. At that time, as gold set what would be a long term price high central banks bought again and on balance continued to buy, albeit a small amount, throughout most of the eighties as the price of gold drifted sideways to down. Throughout the '90s and more so in the 2000s central banks sold big time while gold was tripling in price to touch $1,000 for the first time, then the selling became buying.

https://www.macrotrends.net/1333/historical-gold-prices-100-year-chart'>Gold Prices - 100 Year Historical Chart

It may be a little unkind to say that central banks are contrary indicators of the gold price, even though Gordon Brown so famously demonstrated they can be. However, it is very difficult to say that they are in any way a leading indicator. Taking comfort in central bank buying continuing and using that as a reason to buy more gold as it approaches a record high may not be the soundest strategy.

Conclusions

There currently exists a lot of 'hope'. Hope that central banks will continue to buy gold, hope that the Fed will pivot or pause, hope that authorities will contain the current banking crisis, and hope that all of this will continue to justify still very high valuations. None of this presents the kind of back drop typically seen at a long term bottom or buying opportunity. When that does arrive, there will be a dramatic absence of hope and extrapolations of the recent declines in both economic activity and stock market performance will dominate. Markets bottom not when the news backdrop turns better, rather they bottom when expectations are so dire that almost whatever happens it will not be as bad as the majority feared, that will then be a positive surprise.

Another way of describing a bottom was provided by Jeremy Grantham, and I used it in my conclusion to the April 2009 Strategy Thoughts;

"*Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a shade less black than the day before.*"

Kevin Armstrong

14th April 2023

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The Expectations Game

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