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Gold's new record - Its all about real interest rates - Paul Walker

"if you deconstruct the last ten years in the gold market, the one underlying common denominator has been the search for yield in a world of negative real interest rates"

Paul Walker, chief executive of GFMS, joins us. Well, Paul, a regular contributor to the Moneyweb cause over the years and man, it's been good news all the while, better news still today with the gold price getting through USD1600 an ounce, one wonders where it's going to end?

PAUL WALKER: Well, the case for gold has been a strong one, an increasingly strong one for a number of years now and we've been the cheerleaders of this, in spite of what a lot of people out there would say about my apparent bearishness in this market. Yes, I just think what we've seen in the last couple of weeks in the European zone, in the US and elsewhere, just talks to a very strong investment case for gold. The primary driver, if you like, the underlying current that's been supportive of this for the better part of eight or nine years now, has been an environment of negative real interest rates. So, you've got this common glue that holds the story together in the interest rate space and then layer on top of this the uncertainty about debt. They're all manifestations, in many respects, of the same thing. But what's transpiring in the States at the moment, the standoff in Congress, the standoff in Europe, just speaks very strongly to a bull market for gold continuing for some time.

ALEC HOGG: Let's go back a little, let's try and get some longer-term perspective, it was in early 2001 that with hindsight the gold price, in fact, bottomed out round about USD250 an ounce. If you'd bought then, you would have made a handsome return on your money, not many people did but, in fact, if you'd bought pretty much any time in the ten years thereafter, you'd be sitting pretty.

PAUL WALKER: Well, it's true and I would remind your readers that GFMS went bullish on gold in 2002 and it's there in the public record if you care to dig it out. Part of the reason for this is we'd watched that period from 1998, 1999 through to that time where gold really hadn't moved much; it had gone from USD270 up to about USD300 or so. The catalyst for our change of view and I've said this many times before is a research meeting that Phillip Klapwijk, my business partner, did to Switzerland, where for the first time in 25 years, one of the banks reported a large family office had bought a chunk of gold. I remember at the time being a little perplexed by this, I had probably bought into the great moderation argument at the time that we were in a period of low interest rates and low inflation and what a load of bunkum that's turned out to be. As we started to really analyse the underlying trends in this market at that time, we became increasingly bullish. I'll be the first one to admit when gold is at 300 bucks, to talk about USD700, USD800, USD900 gold seemed hell of a long way away and at the time I would have probably said it's quite difficult to imagine gold getting there. But the steady incremental growth in the gold price has just built a solid platform, changes expectations in markets like India and elsewhere and generated a very solid platform for gold to grow on. I don't think even the gold bulls back in 2003 would have been saying 1600 bucks, so I'm not in good or bad company when I say that I wouldn't have anticipated us getting to where we are back then but have a look at what we've been saying consistently for the last couple of years, we've said USD1600 is very much on the cards. I said it in Johannesburg a couple of months ago and we said it when we did the update in January. So, all the conditions are there for continued growth as far as we see it.

ALEC HOGG: Paul, just looking between 2001 and 2005, it was a steady upward drift from around USD250 to USD400 and then mid-way or towards the end of 2005,

something happened and thereafter from USD400 it's just rocketed to where it is today, in under six years. What's caused that? Has that been the continued fears about fiat currencies and so on?

PAUL WALKER: I'm not sure this is all about fiat currencies, I think this has also got a lot to do with the search for yield. My recurrent theme that I talk to our clients about is that if you actually deconstruct the last ten years in the gold market, the one underlying common denominator has been the search for yield in a world of negative real interest rates. If you look at the real interest rate environment in the US and the euro and elsewhere, effectively it's either been zero or negative for much of the last ten years. This is played to a theme of people searching out yield and initially the yield was sought in places like equity markets, in housing and other asset classes, where in a sense it was familiar territory and what's happened, I think, since 2005 is the creation of the ETF, creation of vehicles and let's just say a greater degree of publicity. You and I didn't talk that often back in 2003, 2004, certainly not as often as we have in the last few years. As gold has gained currency in the popular imagination, so you've seen this more rapid appreciation of the gold price but the common underlying theme here has been low interest rates and back in 2004, 2005, I think the really astute investors, and I take my hat of to them, were guys who were saying there's something unsustainable here. The primary focus at that time was the US trade deficit and that this was unsustainable and that the dollar would weaken. That was the kind of primary argument and as we've moved on from then, still against the backdrop of negative real interest rates, we've had people saying, well, not only do we have these imbalances, which will lead to a weaker dollar but we've got systemic problems and then, of course, all hell broke loose in 2008 and we're picking up the pieces now. Well, trying to and very ineffectively picking up the pieces both fiscally and in the monetary arena and this is why investors are moving back into gold.

ALEC HOGG: It's interesting you brought up 2008 because that was an interesting year, that was the year that the gold price first hit USD1000 an ounce and then came all the way back to USD700 before really catapulting.

PAUL WALKER: Well, this speaks to a very important theme here and it's something I repeat regularly, if you believe that gold is an asset of last resort, which is often the argument one hears about gold, I ask people repeatedly try and explain to me then what happened in 2008. We hit above a thousand bucks and then before we knew it we were down USD200. If gold, in the collective psyche, is an asset of last resort; why on earth did that happen in 2008? I think the answer to this is that, in fact, it's been the search for yield that has underpinned gold and on top of that you can layer on, at periods of time, heightened uncertainty and so on and so forth. But what happened in 2008 speaks to a very...the data is there, it's irrefutable that gold prices went down. It's all very well saying, well, people were getting out, it was a complex period. I'm saying if it were an asset of last resort, why on earth did it fall? It does suggest that gold has a much broader underpinning and my view here is that the search for yield was the primary thing. Then people went to safety in the dollar and let's be honest about it, it was the dollar at the time and gold suffered on the back of that. Now what we're seeing is, again, the bedrock of negative real interest rates underpinning gold and layering on top of that is occasionally a risk argument, sovereign debt issues and so on and so forth. I'm not underplaying those as important drivers but I don't think one should lose sight of the fact that the reason we are where we are today is because of negative real interest rates and how that's manifested itself across the entire range of asset classes and 2008 does speak to the idea. This is not an asset of ultimate last resort but everybody views it that way, otherwise gold prices should have gone significantly north of where they were at the time. Indeed, they went down.

ALEC HOGG: Paul, July has been a golden July, the gold price was round about USD1475 as we started the month and now above USD1600 an ounce, what in the ultra short-term has caused this?

PAUL WALKER: Well, I would argue that it may appear somewhat in contradiction of what I've just said but I think the rising debt crisis has focused people's minds in the last month and a half. What's happened to Italy suddenly coming on to the radar screen, yields starting to move up in Italy, that really has heightened people's sense of risk, regarding both the euro and, of course, we've been playing out this debacle in Congress where there isn't a resolution yet to the US debt ceiling. So, I think that short-term data flow has played out very well against the bedrock of USD1470 gold, which the only reason we're there, the primary reason, I'll remind you and your readers, is it's about negative real interest rates globally and the demand and the search for yield. That has provided the bedrock and then you get this flurry of activity on the back of the news flow that we've had for the last five or six weeks and quite rightly so. If you are sat there as an investor worrying where to put your cash at the moment, I'm certainly getting out of equities. We have a policy here at GFMS of not holding physical positions in the metals markets, so we can look our clients in the eye and say we're not players in this market. But where you're sat today, looking for yield, looking for security, gold looks very attractive.

ALEC HOGG: Where to from here? There are the theorists who say that because of QE1, QE2, possibly QE3, quantitative easing and, really, the printing of money, we are building up to a tipping point where gold could absolutely explode. Do you go along with that?

PAUL WALKER: Look, I think there's a possibility of this. It certainly wouldn't be my base case. Those who've been following my pronouncements over the years, I've been on the record as saying, I just believe the monetary and fiscal authorities, sooner or later, have to grasp the nettle here. I think the catalyst for this is not necessarily going to come from them but from the bond market just deciding they won't fund debt at these rates and it will force all of the corrections that should have been allowed to take place, post 2008, balance sheets and so on and so forth. I think this will be forced upon the market by the bond market. That is really the thing that is going to underpin attitudes to gold going forward, is where the yields are. If we see a blowout on yields, that's going to be the turning point for gold but it will take a long time for that to play out. So, the possibility that the fiscal and monetary authorities don't do anything about this, one has to countenance that this is a possibility. Economic history is replete with examples of governments and monetary authorities not grasping the nettle when it's required and then you have Armageddon. In that case, yes, USD2000 gold, USD3000 gold, you wouldn't say it's an impossibility. But one has to, and I still have, belief in the institutions that are out there that sooner or later they are going to have to grasp the nettle and that will start to signal the end of the gold bull rally.

ALEC HOGG: But not in the immediate future?

PAUL WALKER: Well, looking at what's happening in the United States and Europe at the moment, definitely not in the immediate future. I would've argued that 2012 was the turning point but the longer this debacle plays out, the longer you've got a bull market in gold, USD1700, USD1800, you just can't write that off at the moment, until the authorities actually make the hard decisions. The bottom line of all of this, Alec, is something I've repeated countless times over the last few years, you have to have one of the key economic variables that normalises and keeps us all sane and rewards savers, investors and everything, is to have an environment of positive interest rates. Have a look at any period in economic history where you've had a dislocation, where there's been extended periods of low or negative real interest

rates and you start to generate problems, inflationary problems, balance sheet problems, asset bubbles, the whole lot and that's where we are today.

ALEC HOGG: Paul Walker is the chief executive of GFMS.