3 Reasons Why Having Gold Exposure Is Now Essential

Description

The case for having 5-10% allocation to gold stocks is stronger than ever, and there is no shortage of prominent names who agreed—billionaires and legendary money managers David Einhorn, Stan Druckenmiller, and George Soros have all increased their exposure to gold this year.

The case for why is fairly simple on the surface. Most other asset classes (stocks and bonds in particular) are incredibly expensive according to a variety of metrics, and are therefore higher risk. With the 10-year U.S. bond yield coming in at only 1.75% (just slightly off all-time lows and barely above the inflation rate), gold's relative appeal is greater than ever.

Gold is seen as a safe-haven asset, and in a time when risk is widespread in markets, this value grows. A survey in September found that 54% of fund managers thought equities and bonds were overvalued (the highest since 2000), and last year Warren Buffett said if he had a low-risk way of shorting long-term bonds, he would do it. Bonds are typically seen as a safe-haven asset as well, but at current levels, they are high risk.

The same can be said for stocks. **Goldman Sachs** recently stated that U.S. stocks are in the 88th percentile of their historical valuation, and P/E ratios have grown by 75% since September 2011. The other two times this happened (the Tech bubble and Black Monday), markets collapsed.

While overvaluation in other markets will make gold look more attractive, gold is also attractive fundamentally on its own for these four reasons.

1. Short-term trader positioning

Starting with the short term, there is good reason to think gold will do well. Back in July, investors were extremely optimistic on gold to the point where investors were long 440 contracts (in other words, investors bought 440,000 futures contracts with the hope gold would increase). This was the highest in nearly 20 years and is bad news for gold moving higher (since investors have little room left to buy).

Since then, however, news of a Federal Reserve rate hike in December caused gold to plunge, and many of these investors were forced to sell to prevent further losses. Now, investors are long around

340,000 contracts (equal to levels last May before gold saw a huge run-up). This gives investors plenty of room to buy.

At the same time, holdings in the **SPDR Gold Trust ETF** (NYSE:GLD)—one of the largest ways for investors to buy gold—did not fall during the recent sell-off in gold, but actually rose, which is very bullish.

2. Interest rates are likely to stay low

Gold and long-term interest rates are known to move opposite of one another (in particular, gold and the 10-year U.S. Treasury yield). When the interest rate falls, gold typically rises because the opportunity cost of holding gold decreases. In other words, as long as interest rates stay fairly low, investors can expect gold to do well.

It is true that several increases in the short-term interest rate are coming (the Federal Reserve is expected to boost its short-term rate in December), but it is ultimately the long-term interest rate that affects gold prices. Long-term interest rates should remain fairly low, since interest rates are strongly connected to GDP growth rates. Very few are expecting strong GDP growth in the U.S. or globally, and the IMF recently slashed their outlook for U.S. GDP growth down to 1.6%.

3. Gold miners look attractive

Most gold miners sold off during the recent gold-price decline, and, as a result, are trading at attractive levels. The sector as a whole focused on reducing costs, paying down debt, and focusing on mining the highest-quality, highest-returning assets, which is a large departure from the past several years.

Barrick Gold Corp. (TSX:ABX)(NYSE:ABX) and **Yamana Gold Inc.** (TSX:YRI)(NYSE:AUY) stand out. Barrick is the world's largest producer and is a safe core gold holding, and Yamana has a rising production profile, while trading at a discount to its peer group.

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1. Investing
2. Metals and Mining Stocks

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1. Editor's Choice

TICKERS GLOBAL

1. NYSE:AUY (Yamana Gold)
2. NYSE:B (Barrick Mining)
3. NYSEMKT:GLD (SPDR Gold Trust)
4. TSX:ABX (Barrick Mining)
5. TSX:YRI (Yamana Gold)

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