NESTOR Gold
Quarterly Report 3/2023

Herisau, October 2023

Review

On 29 September 2023, the gold price closed at USD 1,848.63/ounce, down 3.7% QoQ. The Philadelphia Stock Exchange Gold and Silver Index lost 10.5% (USD) / 7.6% (EUR), while the Nestor Gold Fund (share class –B-) consolidated by 11.3% (USD) / 8.5% (EUR).

The gold price moved sideways for the most part in the third quarter, which may seem surprising at first glance, given that long-term US interest rates rose sharply and the USD also strengthened. In addition, global gold ETF sales have intensified, which should also put pressure on the gold price. The fact that gold has held up so well in this difficult environment is due to the fact that central banks continue to buy gold on a large scale. In addition, more and more smart investors have realised that their equity/bond portfolios need protection in a future stagflation scenario and have bought gold in case of weakness. The quarterly results of the gold mining companies did not come as a big surprise and the trend towards slightly lower costs was confirmed. Thus, the companies should benefit more than average from a higher gold price.

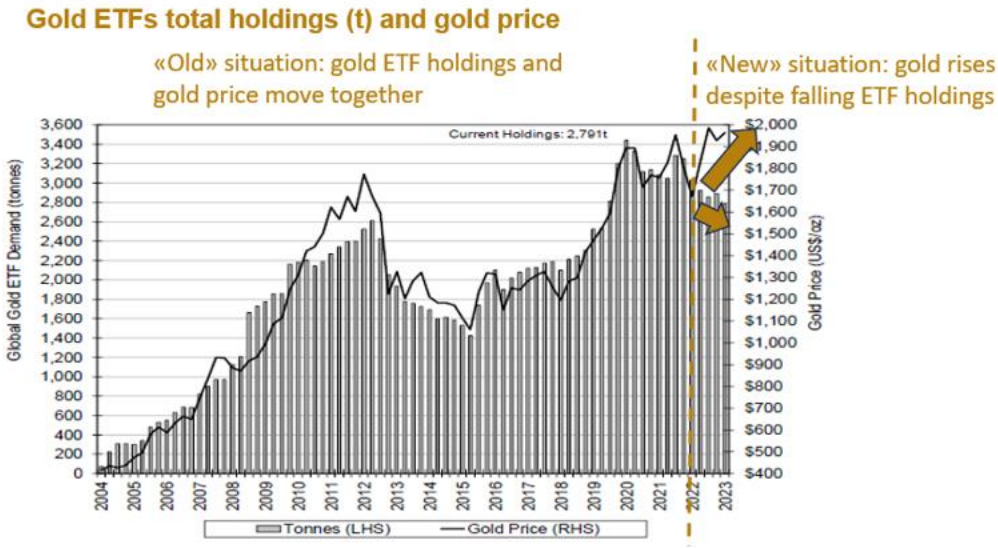
The new situation in the physical gold market

Central banks of non-NATO countries and countries that are not so well-disposed towards the US continue to diversify away from the USD, EUR and Western foreign currencies into gold, as the only currency independent of political will.

This was recently confirmed by a survey among central banks, which showed that emerging-market central banks are targeting a substantially higher allocation towards gold than their current share, i.e. 15-20%. Therefore, assuming that they continue to buy around 20-25% of the total gold supply, these will likely be a supportive factor for more than 10 years. This will make long-term gold investors much less exposed to the short-term investment demand of tactical investors.

Investors have not seen the new situation as sustainable and continue to sell gold ETFs, presumably out of a general fear of higher FED fund and 10-year rates. This might well be an unwise strategy, as we will discuss later in this report.

The major change can be seen in the chart below, which highlights the new situation in the gold market.



Quelle: Bloomberg, Scotiabank, Konwave AG

To summarize, this is the first time in almost 20 years that gold can now rise without investors piling into the gold market.

The next macroeconomic surprise

General consensus, ourselves included, have been surprised by the strength of the US economy in 2023 and all leading indicator models proved to be wrong. While the manufacturing segment of the US economy continues to be weak (as it has been since 2022), consumers have gone on a spending binge. By now, however, pretty much all of their excessive savings from the pandemic are spent and their firepower should abate soon. Furthermore, the fiscal thrust (huge increase in the deficit) supported the economy far more than expected.

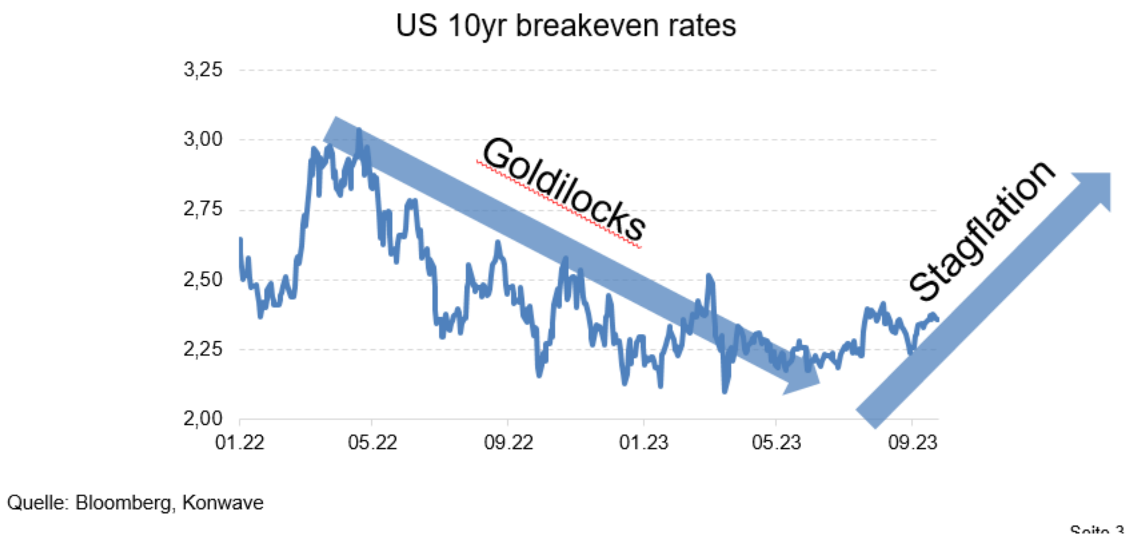
Given the sharply increased FED fund rates and the fact that these two key factors holding up the economy in 2023 will most likely slow down or disappear in Q4 2023 and into 2024, the economy can be expected to weaken in 2024.

However, given that there has been no major credit cycle nor strong capex cycle during the last few years and the fact that US consumer and corporates enjoy a relatively low interest rate sensitivity (they have hedged at low interest rates for the long term), the likelihood of a severe recession is low. This is also supported by the labour market, where only a small rise in unemployment is expected due to the demographic situation (much more retirees relative to new entrants).

To summarize, the likelihood that the US economy will ‘muddle through’ is high and the ’new normal’ will be low structural growth, which is due to over-aging, high indebtedness and consumer saturation. Therefore, the economy will unlikely be the big macro surprise during the next few quarters.

Much more relevant, and likely to have major implications on the financial markets, will be the consensus expectations for inflation.

While consensus expectations for inflation (10 years) have started to increase slightly recently (see chart below), they are still far too low.



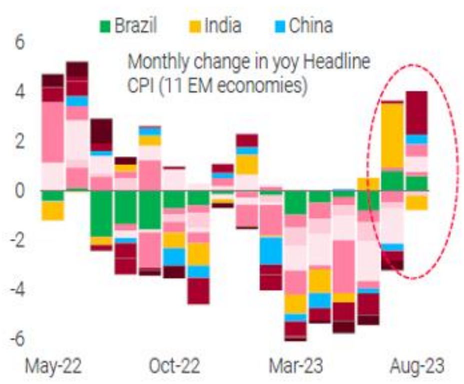
The decline in the CPI is behind us and the decline in the core CPI will likely end during the next few months.

The temporary disinflation period, which we forecasted in Q2 2022, is over, while consensus still expects inflation to continue falling. The sharp decrease was due to the base effect (which is now over), goods prices (prices of used cars and lower oil prices in particular), the big drop in health care insurance costs and recently, the slowdown of the shelter inflation rate.

All this is ending, as the PPI in China has started to rise again after falling into deflation in H1 2023; medical insurance costs are expected to increase sharply in H2, the oil price has started to rise again among low inventories, and the end of falling prices for used cars is highly likely (with signs of bottoming). In addition, rents have started to increase again, as have house prices, both leading indicators for the shelter inflation rate. Inflation surprises in emerging markets have turned up sharply (see chart below), i.e. the end of the temporary disinflation period is in sight! Super core CPI (excl. oil, excl. Shelter) was rising by 0.5% MoM (!) in August, showing the inflation pressure in services isn't abating, but may even be accelerating.

Upside inflation surprises surge (Ema's)

Broad based disinflation reversal (Ema's)



Source: Bloomberg, Scotiabank, Konwave AG

In addition, and far more important from a medium to long-term point of view, is the fact that the major turnaround in structural inflation trends such as those listed below support a higher inflation environment (3-5%) and no return to the neoliberal super cycle (1.5% average inflation):

- deglobalisation vs. globalisation
- structural labour shortage due to demographic development
- start of a structural dissaving cycle due to demographic development
- start of a structural commodity bull market due to many years of underinvestment
- Decarbonisation

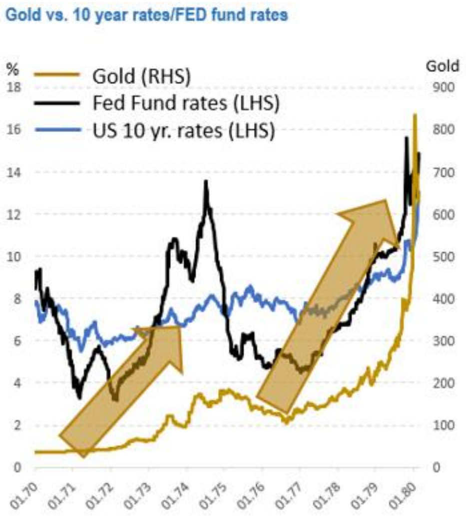
Rising inflation expectations in a low-growth ('muddle through') environment points to the end of today's priced-in 'goldilocks' scenario and the start of a multi-year period in a stagflation-like environment!

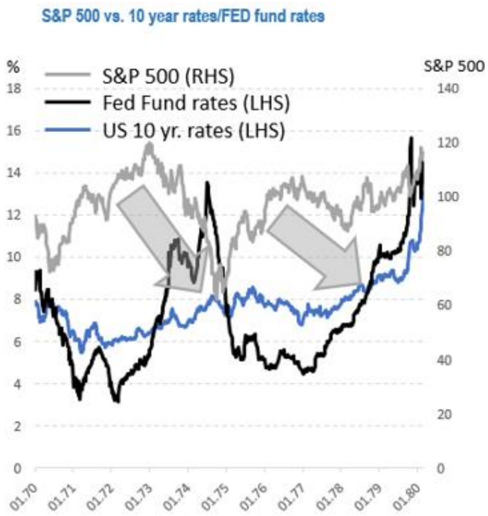
The not-yet understood implications for gold and gold miners and other asset classes

While many investors, based on the behaviour of the last 40 years, believe that higher FED fund expectations and higher 10-year yields will be a headwind for gold, this correlation no longer applies in an environment where inflation expectations rise and the US is facing stagflation.

Gold has outperformed equities significantly in the past in stagflation-like environments and increased significantly during periods of higher interest rates, as can be seen below.

Equities, however, suffered big losses during major rate increases. After adjusting for inflation, equities were the worst asset class, while gold and gold miners outperformed all other asset classes in the stagflation environment. Gold miners provided investors with huge investment returns and significant diversification benefits.





Quelle: Bloomberg, Konwave AG

This is very important, given that the new stagflation-like scenario still needs to be priced-in by the financial markets. Timing-wise, we expect it to happen within the next 3-6 months, as the temporary disinflationary trend is ending now and is not expected to remain during 2024.

Whether you assign a very high probability to this scenario, as we do, or even just a 5-10% probability is of little importance.

This is because this scenario has very negative effects on the classic portfolios, as the largest asset classes such as equities, bonds and real estate, including derivatives of these asset classes such as private equity, private debt etc. face substantial losses, especially during the early part of stagflation. (Real estate and bonds have performed somewhat better in the latter part of stagflation, once their prices have adjusted to the stagflation environment).

Thus, adding to the few asset classes that rise significantly in a stagflation-like environment, such as gold and commodities, makes a lot of sense. Such a move should be done now however, as the benefits are greatest while the currently priced-in 'goldilocks' scenario is being priced out and the stagflation-like scenario priced in.

This hypothesis is supported by historical annualised average returns in a stagflation-like environment, as can be seen below.

	Stagflation	Comment
Gold (USD / oz)	**32.2%**	**Significant positive returns, huge diversification benefits**
S&P 500 Index	**-6.6%**	**Negative returns**
EAFE equities	**-11.6%**	**Negative returns**
US Treasury & Agency Bonds	**9.6%**	**Positive returns**
US Corporate Bonds	**6.1%**	**Positive returns**
S&P GSCI Index	**17.5%**	**Positive returns, huge diversification benefits**

Source: Bloomberg, World Gold Council, as of Q2, 2021, AAAR% - annualised average (stagflation) adjusted return

Given that almost all institutional portfolios today hold between 95-100% of their assets in investments that are among the big losers and less than 5% of their assets in the big winners of the new macro super cycle, they are likely to start reallocating a share of assets to the new big winners in the next few years. This will – after the disappointing performance of gold and commodity assets in the 2010-2020 period – lead to very attractive returns in gold miners and commodity equities (like the Konwave Transition Metals Fund) in the coming years. With this in mind, despite the positive returns in 2023 from balanced/traditional portfolios, it is worth remembering 2022 as a foretaste of what investors should expect in the coming years. Considering this, and to protect investors' wealth, we recommend reallocating a notable portion of the asset allocation to gold, gold miners, commodities and commodity equities, taking into account risk budgets. These strongly undervalued asset classes, which are heavily under-represented in institutional portfolios, have a very high return potential in the coming years.

Conclusion

The gold price faced small losses during Q3 2023 despite major outflows from gold ETFs. The main reason is the new structurally attractive situation in the physical gold market, which makes the gold market much less dependent on tactical investors.

The expected rise in inflation expectations will change the behaviour of gold and gold miners in an environment of rising interest rates and will take most investors by surprise. The fact that 10-year US interest rates and FED fund expectations are higher than at the end of Q3 2022 (both big negatives for gold in the past) and that gold is up around 20%, confirms our view that the relatively stable correlation between gold and interest rates over the last 40 years is changing, so far unnoticed by consensus!

The outlook for the next few quarters as well as for the coming years in the new structural macro super cycle (low growth, structurally higher inflation) is exceptionally positive, while the expected returns of traditional investment portfolios (equities, private equity, bonds and real estate) may be described as challenging at best. With this in mind, and in order to protect the wealth of investors, we recommend taking into account the risk budgets, to increase the portfolio weight to the very few winners of a stagflation-like scenario, i.e. gold, gold mines, commodities and commodity shares. These strongly undervalued asset classes, which are heavily under-represented in institutional portfolios, have a very high return potential in the coming years.

The Nestor Gold Fund is perfectly positioned for a rising gold pricing environment thanks to the record high undervaluation of explorers and developers. It should perform particularly well in the bull market that started in October 2022, judging from previous bull market phases.

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