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2017 Mid-Year Stock Market Outlook: 4 Charts Show It's Time To Buy Gold

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That noise you hear is the gold bugs banging their heads against the wall. Gold prices fell to a five-week low this week as the greenback strengthened on expectations of another Federal Reserve interest rate hike this year. But there could be a silver lining. Here are the top three fundamental reasons and four charts that show why it may be time to buy gold.

1. Gold is due for a mean reversion.

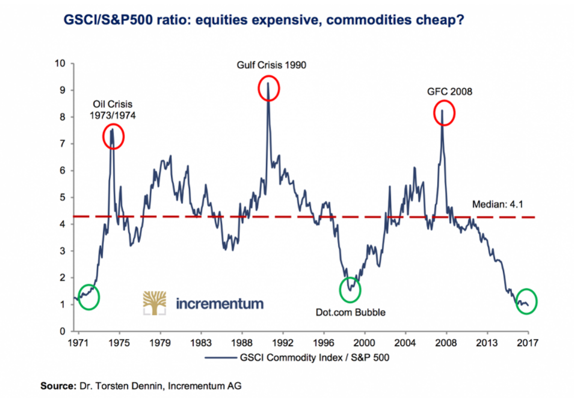
The theory of mean reversion suggests leaders eventually become losers and vice versa as prices return to the mean or average in the long run. Perhaps it's because of investors selling winners to book profits and redeploying money in bargains or out-of-favor areas.

Gold prices, as tracked by SPDR Gold Trust ETF rose 8% year to date, through June 20, while losing 4% in the trailing year, according to Morningstar. By contrast, SPDR S&P 500 climbed 10% so far this year and 19% in the past 12 months.

SPDR Gold Shares ETF fell 5.4% annualized over the past five years while SPDR S&P 500 surged 15% annually on average over the same period. Going back 10 years, gold rose 6% annualized while the S&P 500 increased by 7 % annualized, according to Morningstar.

After underperforming the stock market for five years, gold and other commodities are arguably undervalued compared with the stock market.

"In relation to the S&P 500, the GSCI commodity index is currently trading at the lowest level in 50 years," Ronald-Peter Stoeferle and Mark Valek, of the Liechtenstein-based investment firm Incrementum, wrote in the "In Gold We Trust" report. "Also, the ratio sits significantly below the long-term median of 4.1. Following the notion of mean reversion, we should be seeing attractive investment opportunities."



GSCI/S&P500 ratio

What's more, the U.S. stock market is overvalued on many metrics as the bull market celebrated its eight-year anniversary in March, suggesting a pullback is long overdue.

"Regardless of which version of the S&P 500 price-to-earnings ratio (P/E ratio) you look at – generally accepted accounting principles (GAAP) earnings, operating earnings, median P/E or Shiller P/E – stocks are expensive on an absolute basis," says Rob Breed, senior vice president and portfolio manager at F.L.Putnam Investment Management Company in Portland, Maine. "These P/E ratios now stand at 23.7, 21.7, 23.6 and 29.6 versus their long-term medians of 16.3, 14.8, 17 and 16 respectively. Any shock to today's confidence – some might call it complacency – could lead to a significant decline."

The stock market is "significantly overvalued" in terms of its historical ratio to gross domestic product, or GDP. The ratio is closer to the historical high of 148% last seen during the 2000 tech bubble than in a fairly valued range at 75% to 90%, considering the stock market capitalization-to-GDP ratio printed at 133% as of Tuesday, according to Guru Focus,

Total Stock Market Capitalization-to-Gross Domestic Product Ratio

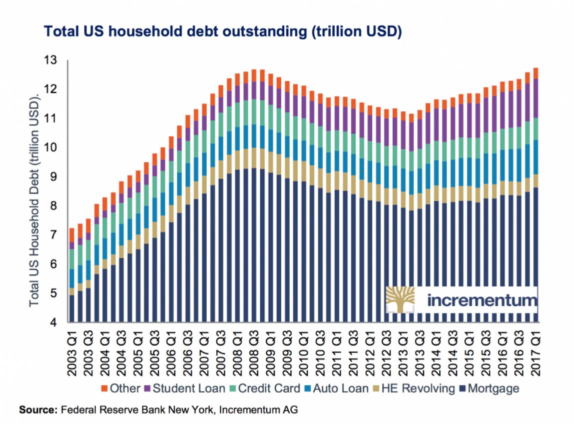
The Ratio of Total Market Cap to US GDP.

2. The economic party eventually has to come to an end.

No one wants to be a Debbie Downer. But the economic upswing in the wake of the Great Recession (from December 2007 to June 2009) — the longest since World War II — is arguably growing weak. Another recession will eventually rear its ugly head. When it does investors will likely flock to gold as a safe haven.

"There were 49 economic expansions since the founding of the United States, which lasted 36 months on average," Stoeferle and Valek wrote. "Looking exclusively at the 12 post-war expansion phases, the average duration of an upswing was 61 months. As of June 2017, the current expansion has lasted 96 months, making it the third-longest in history."'

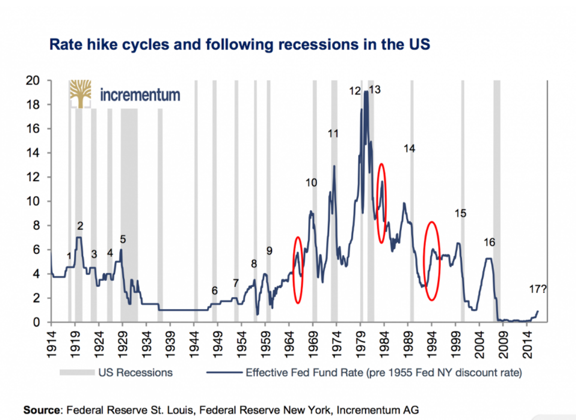
Stoeferle and Valek contend a major warning sign is the fact that Americans are swimming in red ink from mortgages, car payments and student loans. U.S. household debt topped its pre-crisis level in April for the first time, totaling [$12.73 trillion] in the first quarter. U.S. household indebtedness is $150 billion higher than the end of 2016 and $50 billion above the prior peak seen in 2008.



Total U.S. household debt outstanding in trillions of U.S. dollars.

Economic growth driven by consumer debt is unsustainable because banks will eventually have to stop lending to reduce their risk. Against this backdrop, the Federal Reserve is raising interest rates, making debt more expensive.

"As a long-term chart of the federal funds rate reveals, the vast majority of rate hike cycles has led to a recession and every financial crisis was preceded by rate hikes as well," Stoeferle and Valek wrote in the In Gold We Trust report. "The historical evidence is overwhelming – in the past 100 years, 16 out of 19 rate hike cycles were followed by recessions. Only three cases turned out to be exceptions to the rule."



U.S. interest rate hike cycles and recessions.

Frank Holmes, CEO of U.S. Global Investors, recommends investors hope for the best but prepare for the worst.

"No one can say what the future holds," he wrote in a client note last week. "It's prudent to have a portion of your portfolio in gold, gold stocks and short-term, tax-free municipal bonds, all of which have a history of performing well in volatile times."

Investors have no incentive to invest in risk-free Treasuries when they're yielding zilch after accounting for inflation, Holmes added.

> “Why would investors knowingly lock in guaranteed losses for the next two or five years, or near-zero returns for the next 10 years?” Holmes wrote. “Minus inflation, the two-year Treasury yielded negative 0.96% in April; the five-year, negative 0.38%; and the 10-year, a paltry 0.10%.
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> “When this happens, investors tend to shift into other safe-haven assets, including municipal bonds and gold.”

3. **Gold supply and recycling are falling.**

Global gold mine output in the first quarter of 2017 was about the same as the year-ago period, 764 tons versus 767.8 tons, according to the World Gold Council. But total supply fell 12% year over year as recycling plunged 21%, albeit recycling was exceptionally strong in first quarter 2016. The World Gold Council forecasts production to significantly decline over the next five to 10 years owing to the lack of new gold discoveries and capital spending cuts in response to weak prices over the past several years in the face of falling prices.

> “Lower prices in the late 1990s and early 2000s also negatively impacted production and exploration in the years that followed,” the World Gold Council wrote its first quarter 2017 Gold Demand Trends report published on May 4. “And while there are signs of renewed interest in brownfield development and extending the life of existing mines, these are not yet sufficient to offset the steep cuts in project development spending of recent years. Inevitably, the supply pipeline will be squeezed.”
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> “The speed at which production will fall is uncertain,” the WGC added. “As existing reserves are depleted, the current project pipeline will be unable to replace them fully. Over the long-term, the global production profile will depend on the trajectory of the gold price and potential exploration upside, particularly the speed with which brownfield exploration can be brought into production.”

Ky Trang Ho is a business/financial writer and content strategist. She founded Key Financial Media, which produces marketing content and thought leadership for financial services firms.

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