11 January 2019

Gold

In a New York (Fed) Minute

- In our December 6th Gold Market Outlook we argued that the current dollar bull market was peaking and that there was potential for a short covering rally back towards $1,300/oz.
- In the event, gold has rallied faster than anticipated, benefiting from pervasive risk-off trading conditions into the end of 2018.
- Accordingly, there has been a degree of physical gold buying – visible in rising ETF holdings – but futures market short covering has not yet been followed by the addition of significant length.
- Although, this does present an opportunity for gold prices to move higher still – if investor length now comes into the market. We think this would require a continuation of recent risk-off trading conditions and deterioration in the hard US economic data.
- This, however, is not our base case and, with prices having moved so far so fast, we think a period of consolidation is more likely.
- Indeed, if risk assets stabilise on the back of an incrementally more dovish tone from the Fed, this should take some of the recent wind out of gold's sails. Albeit, as this would likely go hand-in-hand with a softer dollar, we would not expect a significant correction in the gold price.
- Looking beyond these short-term dynamics, a recent paper by New York Fed President John Williams and Thomas Mertens runs through a discussion about changes in the FOMC's reaction function when in a tightening cycle versus in a loosening cycle.
- The issue of asymmetry between a zero lower bound for rates but no equivalent higher constraint opens up the potential for inflation expectations to become anchored below their target level.
- Which consequently raises the question of the extent to which the FOMC might tolerate above target inflation, so as to hit their target "on average" and consequently better anchor expectations around the target level.
- There is no clear answer at this stage but it does raise the possibility of slower real rate rises, especially as short-term rates approach estimates of r*. This, in turn, would fit with a flatter yield curve, weaker US dollar, and higher medium-term gold prices.

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Gold

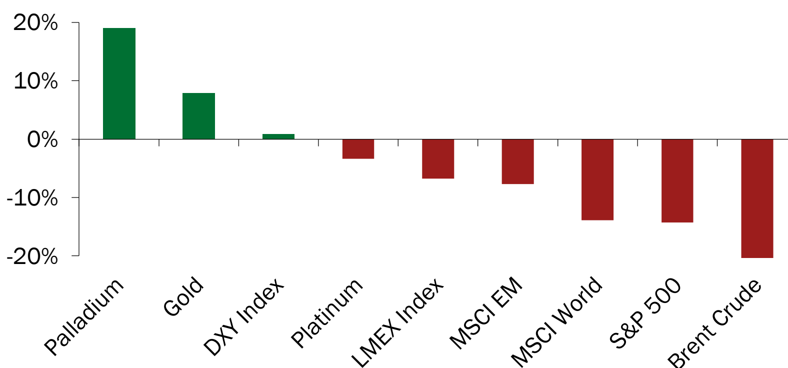
In a New York (Fed) Minute

In our December 6th Gold Market Outlook we argued that "the current dollar bull market is peaking, which will provide gold with room to rally… Specifically, we believe that the FOMC will hike at a slower pace than implied by the dot plot, becoming more cautious as real short-term interest rates approach their estimated equilibrium level (r*). Given investors' current gold futures market positioning, this creates the potential for a short covering rally back towards $1,300/oz."[1]

In the event, gold has rallied faster than anticipated, benefiting from pervasive risk-off trading conditions into the end of 2018.

Gold outperformed in Q4, benefitting from risk-off trading conditions

Q4 2018 asset class performance



Source: CME, LME, MSCI, S&P, ICE, Bloomberg, ICBC Standard

Accordingly, there has been a degree of physical gold buying – visible in ETF holdings rising by 4.35Moz since the start of Q4. However, initial futures market short covering has not yet given way to the addition of significant length.

Investors have added 4.35Moz to their ETF holdings

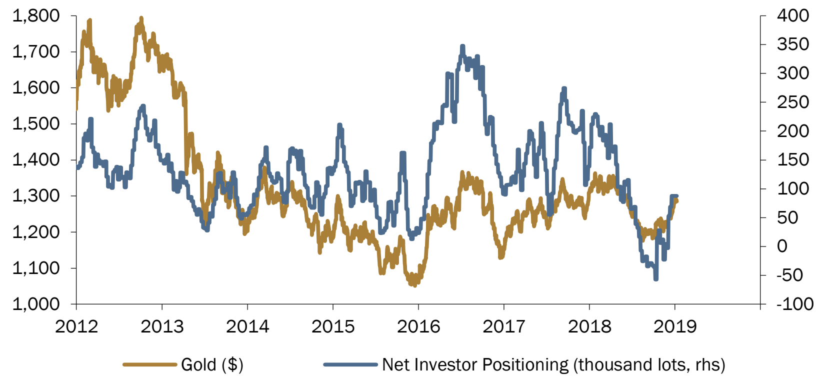
Investors have been adding to ETF holdings

Source: Bloomberg, ICBC Standard

Indeed, although the CFTC's Commitment of Traders report shows net investor positioning moving from a low of -5.7Moz in early October to a latest position of +8.7Moz, the composition of this swing underlines that significant financial length is yet to come back to the market.

[1] https://www.icbcstandardbank.com/CorporateSite/ResearchStrategy/Reports

And net futures exposure has increased

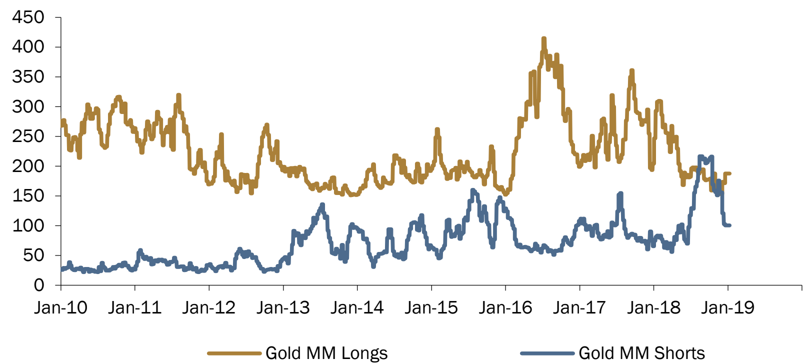


Source: CME, CFTC, Bloomberg, ICBC Standard

Futures positioning changes have been short-covering rather than the addition of fresh length

Specifically, the number of short contracts held by investors fell from 21.6Moz to 10Moz, while the number of long contracts only rose from 15.9Moz to 18.8Moz.

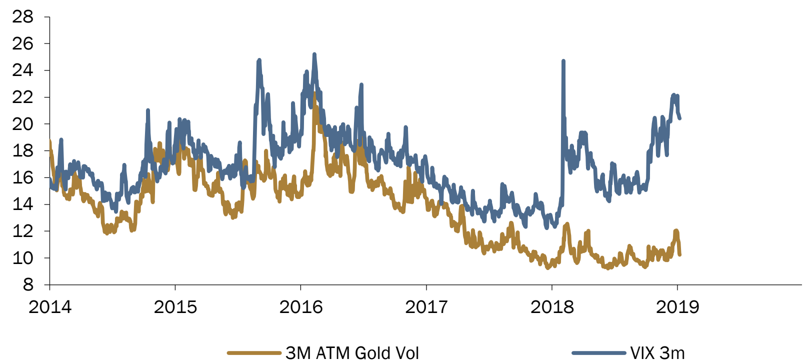
But this is more short-covering than fresh length



Source: CME, CFTC, Bloomberg, ICBC Standard

And, in keeping with this relatively muted investor interest, gold's volatility has remained subdued, especially when compared to other asset classes.

Volatility remains comparatively subdued



Source: CME, Bloomberg, ICBC Standard

On the one hand, this does present an opportunity for gold prices to move higher still, if investor length now comes into the market. However, on the other, it begs the question as to why this has not yet happened, given the number of catalysts

already present? Moreover, if any of the recent tailwinds for gold were to abate, it increases the likelihood for a period of price consolidation.

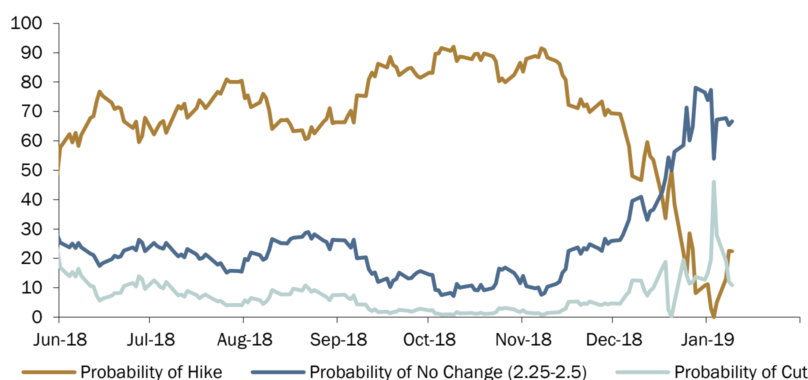
For the former to occur, creating the potential for gold to challenge its five-year range highs above $1,375, would still likely require the combination of conditions that we described in our December 6th outlook, namely: cross-asset risk off trading conditions, including DM equities, as US growth stalls and the FOMC ceases hiking or begins to cut.

Risk-off trading conditions and a re-pricing of the interest rate outlook have been supportive for gold prices

Markets have already endured a bout of this first condition during Q4 and into the turn of the year have also begun to price in the latter two. Looking at the fed funds futures implied probability of further rate hikes occurring by December 2019, the market slipped from a high of 92% in November to a trough of 0% on January 3rd. At the same time, the likelihood of a cut by the December 2019 meeting rose from 0.3% as of December 20th to peak at 46% on January 3rd.

In sum, short of the FOMC explicitly signalling that they were considering a rate cut, the recent market backdrop has been about as supportive for defensive assets and, hence, gold prices as it could have been.

Fed Funds Futures have dramatically repriced the interest rate outlook



Source: CME, Bloomberg, ICBC Standard

After dramatic swings in December, we expect a period of consolidation

Although we have questioned the likely longevity of current US growth outperformance in recent notes, the speed and extent of this swing in market pricing – effectively indicating recessionary expectations – does appear excessive. While a continuation of recent dynamics is far from impossible, it is not our base case. On balance, we think prices have overshot and that a calmer market backdrop will usher in a period of price consolidation.

Nevertheless, we do not expect a significant correction lower in the gold price because:

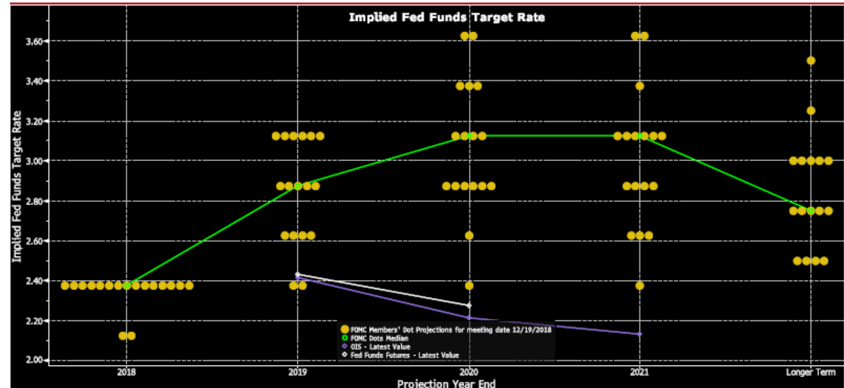
- A more dovish tone from the FOMC should support risk assets and soften the US dollar, cushioning gold prices.
- Our constructive medium-term view on gold is unchanged. The argument here is not that the underlying rationale for recent market moves is unjustified but rather that prices have moved too far too fast.

Regarding the FOMC, following Chair Powell's comments about policy flexibility and data dependence as rates approach their equilibrium level (r*), recent speeches from the Atlanta, Chicago and Boston Fed presidents have similarly delivered a more cautious tone on the likely pace of rate hikes. The December meeting minutes also indicate that financial market volatility is on the FOMC's radar:

“With an increase in the target range at this meeting, the federal funds rate would be at or close to the lower end of the range of estimates of the longer-run neutral interest rate, and participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate extent and timing of future policy firming less clear than earlier. Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressure, the Committee could afford to be patient about further policy firming.”[2]

If markets calm, Fed Funds Futures and the dot plot may well align on one hike for 2019

Recent rhetorical softening may precede a shift in the dot plot

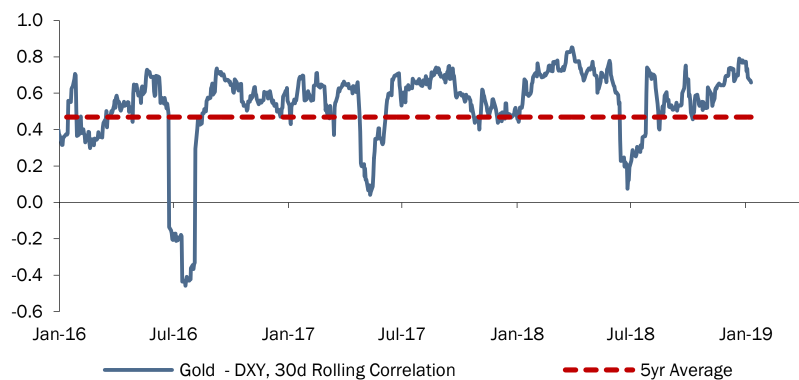


Source: FOMC, Bloomberg, ICBC Standard

This shift in rhetoric may well preceded a shift lower in the dot plot, which still implies a median of two 2019 hikes. Nevertheless, unless the hard economic data takes a significant downturn, we would only expect the median dot to fall by one hike, still keeping it above current futures pricing.

If risk assets stabilise, this leaves scope for futures pricing and the dot plot to come back into line – a scenario which would take some of the recent wind out of gold’s sails. As mentioned above, however, it would likely go hand-in-hand with a softer dollar and so we do not expect a significant correction in the gold price.

Gold remains closely correlated to the dollar and DM FX



Source: Bloomberg, ICBC Standard

Looking beyond these short-term dynamics, a recent paper by New York Fed President John Williams and Thomas Mertens runs through an interesting discussion about changes in the FOMC’s reaction function when in a tightening cycle versus in a loosening cycle, given the fact that interest rate policy becomes constrained at the zero-lower bound. This asymmetry means that “under a

[2] https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20181219.pdf

standard inflation-targeting approach, inflation expectations will become anchored at a level below the inflation target."[3]

In their paper, they assume that interest rates are a central bank's only policy tool, whereas in practice, of course, this constraint can be offset to varying degrees by other forms of unconventional monetary policy. Nonetheless, from a gold market perspective, the issue of asymmetry opens up the question of the extent to which the FOMC might tolerate above target inflation, so as to hit their target "on average" and consequently better anchor expectations around the target level.

There is no clear answer at this stage but it does raise the possibility of slower real rate rises, especially as short-term rates approach estimates of r*. This, in turn, would fit with a flatter yield curve, weaker US dollar, and higher gold prices. In contrast to the downside medium-term risk of rising equilibrium rates that we discussed in our previous gold outlook, were this scenario to gain traction, it would present a material upside risk to medium-term gold prices.

[3] https://www.newyorkfed.org/research/staff_reports/sr877

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