ICBC Standard Bank

07 March 2019

Commodities | Strategy

Global

Gold: The long & the short of it

Near term pressure belies structural positives

- Following our previous note on January 11th, gold initially outperformed our expectations, rallying towards its 5-year range highs. Subsequently, however, it has corrected back to trade around $1,300/oz, despite February's weak non-farm payrolls figure.
- We view this latter move as consistent with gold's primary price drivers and see potential for further downward pressure in the near-term.
- The strong rebound in risk assets in Q1 has diminished the immediate appeal of gold's defensive characteristics and the potential for a re-pricing of Fed hike probability – we think it is currently too low – opens up the possibility of additional downside.
- Beyond this, however, we think that the structural appeal of holding gold is increasing. Specifically because the global decline in equilibrium short-term real interest rates (r*) appears to be secular in nature, reducing the opportunity cost of holding gold as a non-yielding asset.

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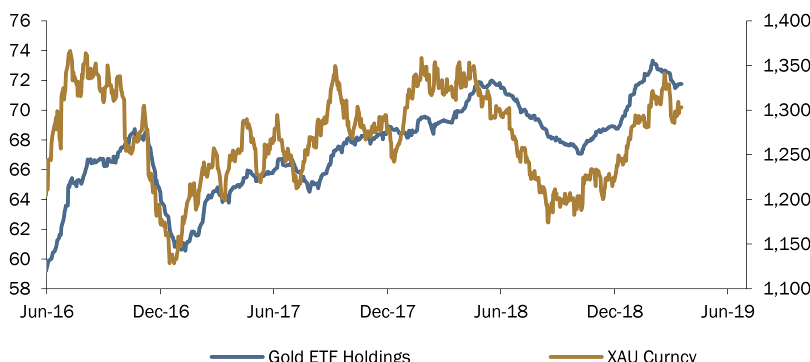
Gold – The long and the short of it

Near term pressure belies structural positives

Following our previous note on January 11th – *In a New York (Fed) Minute*[1] – gold initially outperformed our expectations, rallying towards the top of its five year range and printing a high just shy of $1,350/oz.

The problem for this rally, however, was that it lacked a fresh catalyst to justify gold breaking through its range high

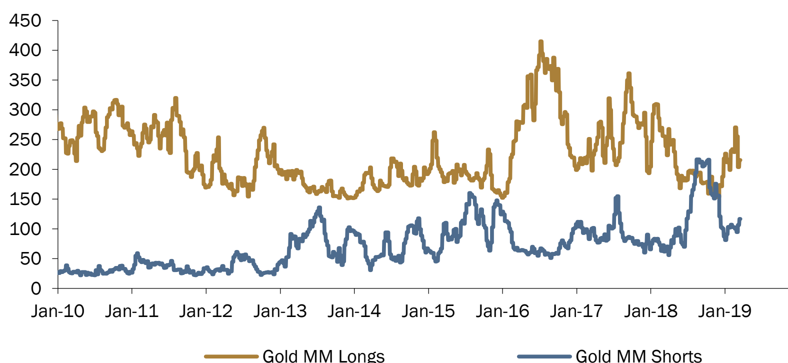
ETF holdings consolidate, after sizable Q4 inflows



Source: LBMA, Bloomberg, ICBC Standard

This move was driven by the addition of 1.48 Moz of length to ETFs, as well as continued net investor buying of futures – firstly short covering, followed by a round of fresh length.

Net positioning increase driven by both short covering and fresh length



Source: CME, CFTC, Bloomberg, ICBC Standard

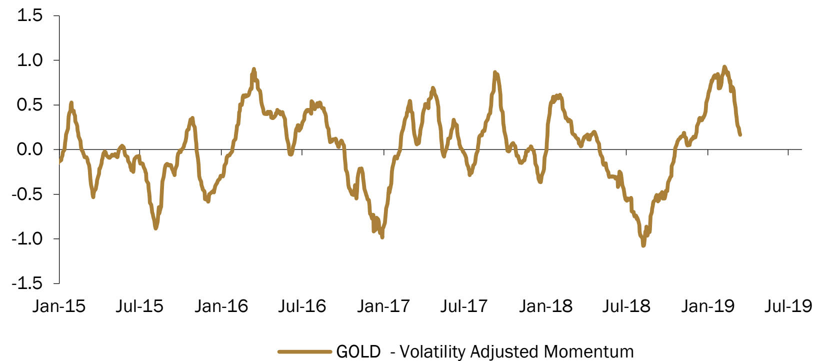
In the futures market, we believe that a significant portion of this length will have been systematic in nature, as gold's strong momentum and low realised volatility should have triggered further purchases through to early February. The problem for this rally, however, was that it lacked a fresh catalyst to justify gold breaking through its range high.

As we argued on January 11th, that would likely "require the combination of… cross-asset risk off trading conditions, including DM equities, as US growth stalls and the FOMC ceases hiking or begins to cut."

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

The Fed's policy pause underpinned a continued rally in risk assets, reducing the near-term attraction of gold as a defensive asset

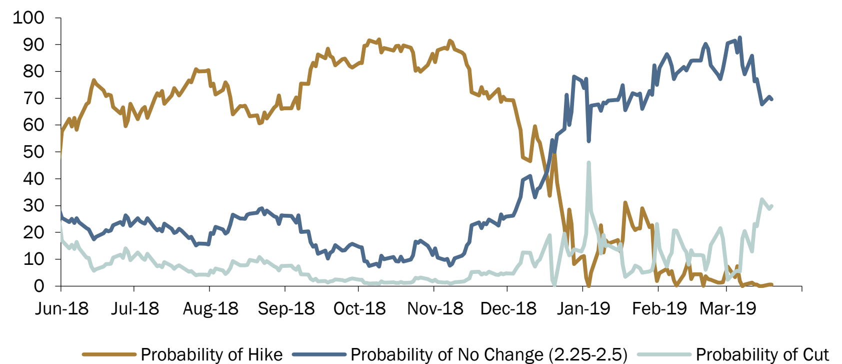
As momentum stalls, systematic positions likely being liquidated



Source: CME, Bloomberg, ICBC Standard

Although the FOMC's subsequent January 30th meeting underlined their dovish *volte-face*, this had already largely been priced by the Fed Funds futures market. The limited scope for comparatively tighter monetary policy or likelihood of faster growth in other major economies also diminished the scope for US dollar weakness. Moreover, the Fed's policy pause underpinned a continued rally in risk assets, reducing the near-term attraction of gold as a defensive asset.

Fed Funds futures price 0% probability of a hike by December 2019



Source: CME, Bloomberg, ICBC Standard

We have maintained the view that gold prices were more likely to consolidate than break out of their range

Prices more likely to consolidate than break higher

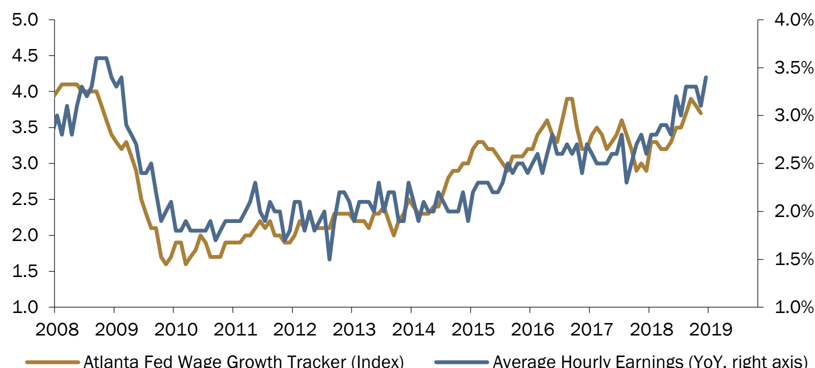
This is why we maintained the view that gold prices were more likely to consolidate than break out of their range, and believe that the subsequent correction below $1,300/oz was consistent with broader market dynamics.

Although NFP's significant headline miss for February – an actual figure of 20k jobs vs. consensus expectations of 180k jobs – provided some immediate support for gold, we would caution against reading too much into this figure both because of its inherent volatility and because of its propensity for significant backward revisions. To take December's release, for example, the headline figure of 312k significantly beat consensus of 184k and even exceeded the Bloomberg survey's highest estimate of 225k. Yet in February, that figure was down revised down to 225k.

This 20k figure may be the start of a significant slowdown in job gains but we think it will more likely be reversed and/or significantly revised. In addition, from an inflation perspective, it is worth recognising that the jobs report also showed some

signs of life, with the unemployment rate declining to 3.8% and average hourly earnings growth accelerating to 3.4%.

Wage growth finally accelerating, introducing potential inflationary pressure



Source: US BLS, Atlanta Fed, Bloomberg, ICBC Standard

Near—term risk skewed to the downside

In the short-term we still therefore see risk of further downside for gold, likely to technical support around $1,275, but do not believe that gold will re-enter the bear market conditions of H2 2018.

The reasons for this are threefold:

- Although ETF investments are likely to be relatively sticky, we expect continued length liquidation from momentum investors, now that gold's uptrend has broken.
- We think markets are now under-pricing the risk of additional rate hikes in 2019/20.
- But, given the Fed's apparent increase in sensitivity to "tightening of financial conditions"[2], the fact that current short-term real rates are approaching estimates of r*, and that r* itself remains depressed; we do believe that this hiking cycle is nearing its apogee.

Tackling these points about the FOMC in turn, it should not be ignored that January's minutes contained the comment, "Several other participants indicated that, if the economy evolved as they expected, they would view it as appropriate to raise the target range for the federal funds rate later this year"[3].

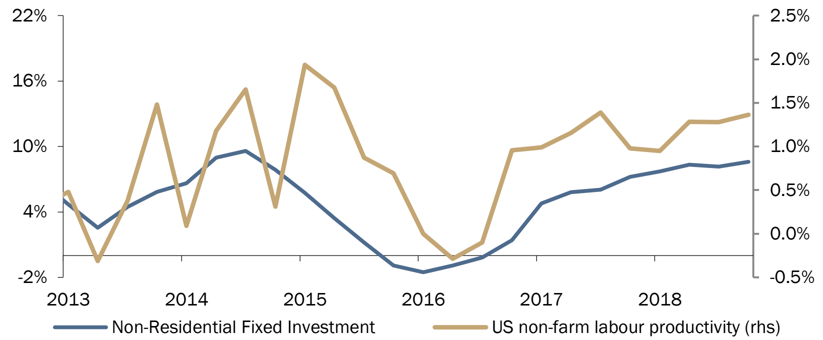
We think there is a significant risk that the gold market is under-pricing the probability of further hikes during 2019/20

As recently as November 2018, futures were pricing >90% probability of at least one further hike by December 2019. At time of writing they imply 0% probability of this occurring and actually price 30% chance of a rate cut. This scepticism may ultimately prove to be right but we think there is a significant risk of market implied probability rising in the coming months.

One potential justification for this is the ongoing acceleration in US non-residential fixed investment, which has also supported a commensurate improvement in labour productivity growth. Although consumer spending has been under pressure in recent months, increased investment would be a clear way to extend the business cycle for a little longer yet.

[2] https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20190130.pdf
[3] https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20190130.pdf

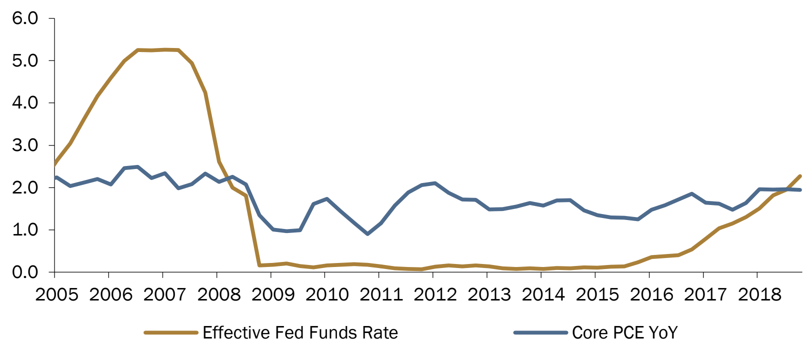
US fixed investment has picked up in recent quarters



Source: US BEA, US BLS, Bloomberg, ICBC Standard

Furthermore, it should be recognised that by historical standards, this would be an abnormally low level for a hiking cycle to finish at. Indeed, in real terms, rates have only just entered positive territory.

Short-term real rates are only just in positive territory

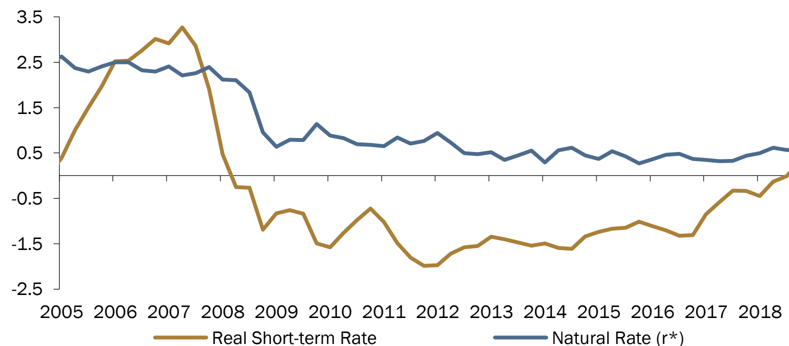


Source: Federal Reserve, US BEA, Bloomberg, ICBC Standard

Although it could be argued that structural changes to inflation dynamics mean a real rate just above zero is a plausible peak for this hiking cycle, a comparison between current real rates and estimates of the short-term equilibrium real rate (r*) also implies that conditions remain relatively loose.

It is plausible that rates are already at their equilibrium level but historical comparison still suggests this to be an unusually low level at which to finish a hiking cycle

Real rates approaching r*



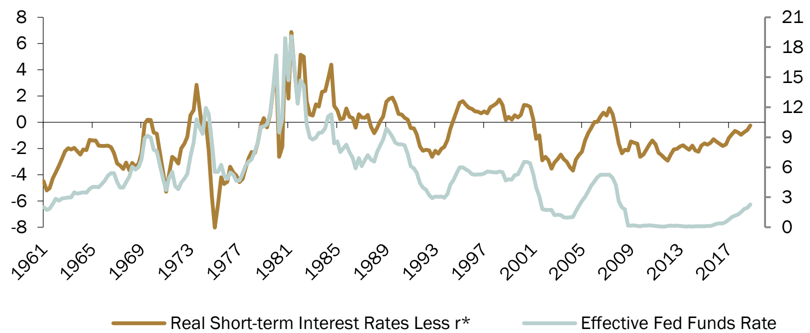
Source: Federal Reserve, US BEA, NY Fed, Bloomberg, ICBC Standard

On this measure, current real rates are still one 25bp hike short of the New York Federal Reserve's current estimate of r*[4]. Given the margin for error around these

[4] https://www.newyorkfed.org/research/policy/rstar

estimates (as discussed in our 7th September 2018 note – *It's written in the r**[5]), it is possible that rates are already at their equilibrium level but an historical comparison still suggests this to be an unusually low level at which to finish a hiking cycle. Indeed, not since the late 1960s has a hiking cycle finished without real rates surpassing r*.

Prior hiking cycles have peaked above r*

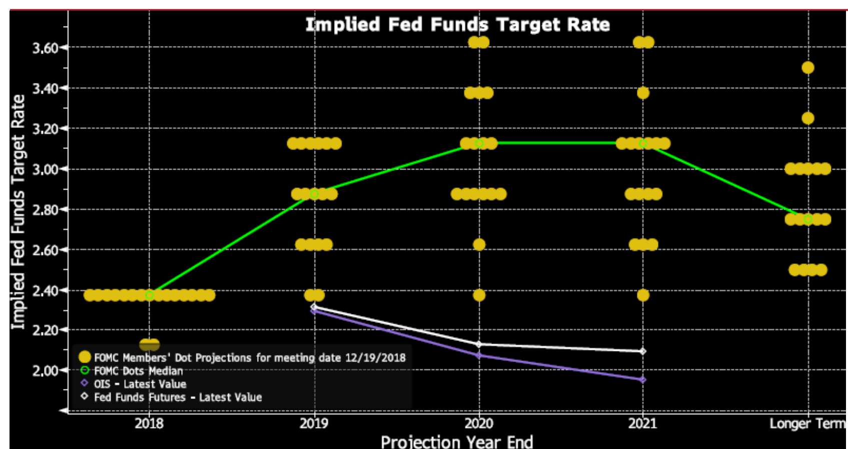


Source: Federal Reserve, US BEA, NY Fed, Bloomberg, ICBC Standard

It may be that secular changes to inflation dynamics or geopolitical disruptions – such as US-China trade tensions – mean that this cycle has already peaked but we believe that the possibility of further hikes is currently under-priced. And this could present a further headwind to gold in coming months.

Tomorrow's FOMC meeting will prove a key test. Comparing current Fed Funds futures pricing to the December dot plot underlines how far the market has now diverged from the FOMC. Given the FOMC's own rhetorical shift, the dot plot is widely expected to move down but there is a clear risk that it will fail to paint as dovish a picture as the market is currently pricing.

How much of a dovish shift will the new dot plot deliver?



Source: Federal Reserve, CME Bloomberg, ICBC Standard

But the medium and long-term outlooks are improving

As noted earlier, however, we view this as a period of consolidation for gold rather than expecting a trend reversal lower. Despite this argument about the potential for additional hikes, we do accept that the hiking cycle is nearing its completion. In particular, we would highlight that the committee's recent caution around tightening financial conditions – as a potential source of negative spill-overs to the

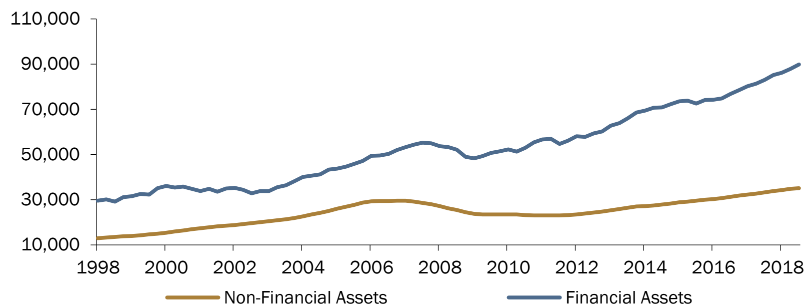
[5] https://www.icbcstandardbank.com/CorporateSite/ResearchStrategy/Reports

real economy – makes sense in the context of US households' high level of exposure to financial assets.

In many ways this is a positive story, reflecting the growth of household wealth on the back rising asset prices in the post financial crisis era but it also means that, in combination, US households and non-profit organisations hold c.$90trn of financial assets. Of this, 61% is held in a combination of corporate equities, mutual funds and pension funds; meaning that a stock market collapse would have a direct impact on household wealth and, potentially, consumer behaviour. As much as anything, this helps to explain why the "Fed put" seems to be back in play.

US households and non-profit organisations hold c.$90trn of financial assets

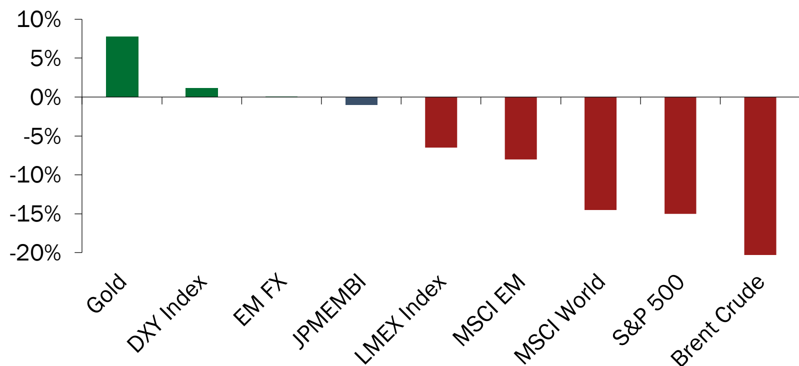
US household and non-profit sector balance sheet (US$ bns)



Source: Federal Reserve, Bloomberg, ICBC Standard

Away from interest rates, we would also highlight that Q4 underlined the value of gold as a defensive portfolio holding. When developed market equities finally came under pressure, gold performed exactly as many investors would have hoped, not only rallying but also maintaining relatively low realised volatility. Therefore, on a Sharpe ratio basis, it was a particularly good time for investors to have an allocation to gold within their portfolio.

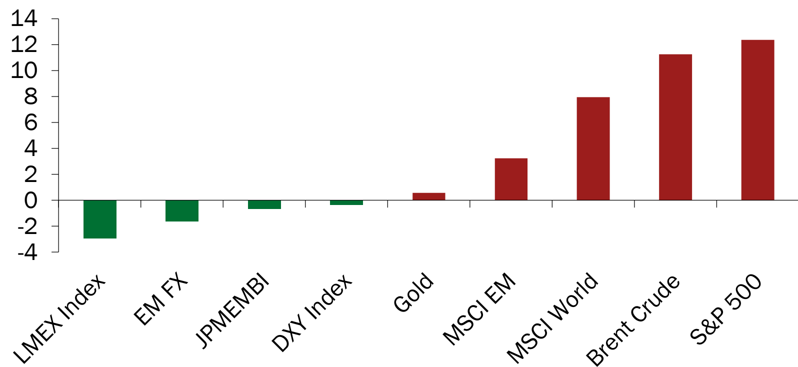
Relative performance during Q4 2018



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

The Q1 recovery in risk assets diminishes gold's near-term attraction but this Q4 performance debunks the idea that gold offers few portfolio benefits. It also suggests that that long-term investors are likely to view dips as an opportunity to increase their holdings at more attractive levels, supporting the idea that gold's downside is relatively limited.

Percentage point change in 90 day realised volatility during Q4 2018



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

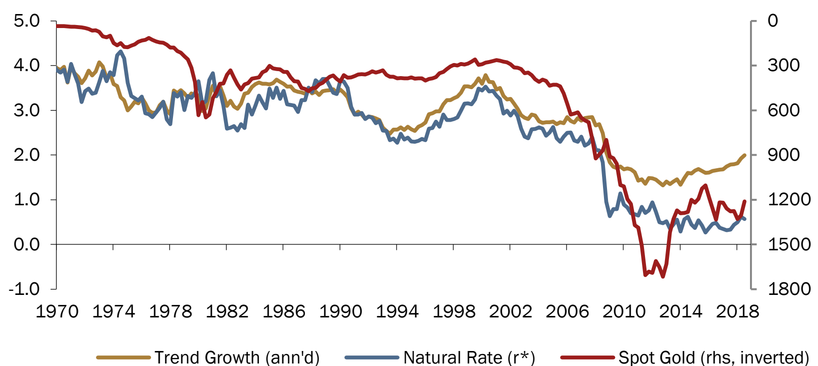
Given the global backdrop, we are sceptical about the potential for a material increase in r* at this time, supporting the case for gold as a defensive portfolio holding

Finally, revisiting gold's relationship with r* to consider the long-term picture, recent work on *Global Trends in Interest Rates*[6] by the New York Fed goes some way to arguing that equilibrium rates will remain subdued for the foreseeable future. Indeed, they highlight that "… the secular decline in real interest rates is an eminently global phenomenon, with the trends in real rates falling by very similar amounts in all advanced economies."

Although trend growth remains a key determinant of r*, the report argues that convenience yields – "the amount of interest that investors are willing to forgo in exchange for the liquidity and safety benefits of high-quality securities" – have also played a key role in reducing real global interest rates. This suggests that r*'s ability to play catch-up with trend growth rates, even if increased business investment does support them in the US, will be relatively limited.

Specifically, the paper argues that "whatever forces might lift real interest rates in the future must be global, such as a sustained pickup in world economic growth, or a better alignment of global supply and demand with respect to safe and liquid assets." Given the global backdrop, we are therefore sceptical about the potential for a material increase in r* at this time.

Gold's long-term position supported by structurally subdued r*



Source: NY Fed, LBMA, Bloomberg, ICBC Standard

In light of gold's inherent long-term relationship with r*, this further supports the case for gold as a defensive portfolio holding, especially against a backdrop of structurally subdued interest rates and hence diminished opportunity cost of holding a non-yielding asset.

[6] https://libertystreeteconomics.newyorkfed.org/2019/02/global-trends-in-interest-rates.html

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