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PRECIOUS METALS: GOLD

REAL PAIN

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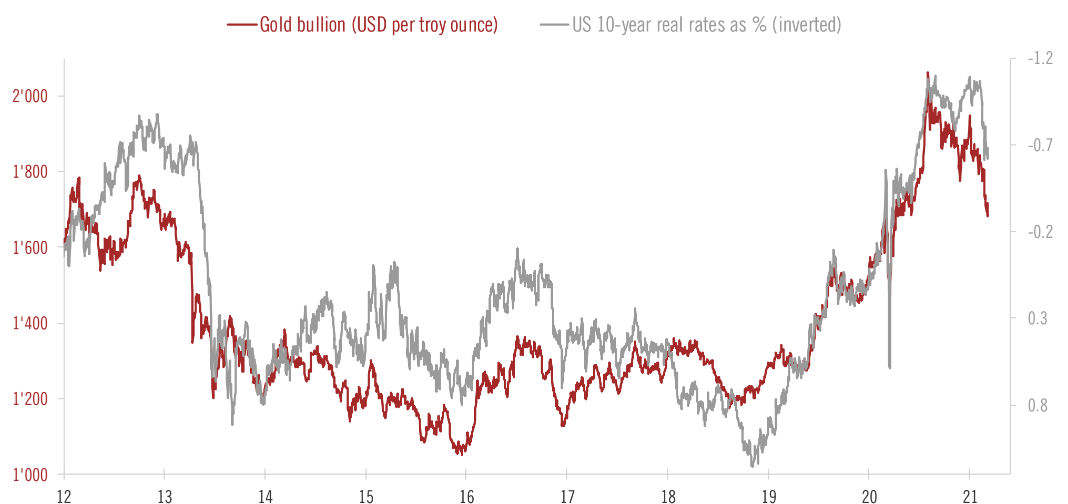
SUMMARY

- The recent sharp rise in US real rates, a key driver for gold, has significantly weighed on the price of the yellow metal.
- While our new base scenario for the US 10-year yield has caused us to lower our projections for the gold price, we see scope for current market expectations on rate hikes to moderate in the next few months.
- Stronger pushbacks from the Fed would likely moderate the current upward pressure on yields and lead to a rebound in the gold price.
- Our new projections for gold per troy ounce are: USD1,800 (three months), USD1,900 (six months) and USD1,900 (12 months).

Rising real rates are weighing on the gold price

The recent rise in real 10-year rates in the US has significantly weighed on the gold price. Indeed, just as the decline in US real rates in 2019 and 2020 (from 1.16% in November 2018 to -1.1% in August 2020) helped the performance of gold, so the subsequent stabilisation and rise in real rates has hurt (*see chart 1*).

CHART 1: GOLD PRICE AND US 10-YEAR REAL RATES



Source: PWM - AA&MR, Bloomberg, 9 March 2021

As we have argued in the past, US long-term real rates are the key driver of the gold price, since they encompass both the opportunity cost of owning the non-yielding metal and its attractiveness as a long-term store of value. The rebound in the US dollar resulting from the rise in US real rates has added to the downward pressure on gold, while the discovery of efficient vaccines against the coronavirus seems to have reduced the appeal of safe-haven assets in general. Unusually, the recent pick-up in market volatility has not led to any significant uptick in the gold price (nor, for that matter, in the Swiss franc or Japanese yen). Safe-haven flows have mostly favoured the US dollar, confirming the

strong safe-haven appeal of the greenback that was already evident at the height of the covid-19 crisis.

We have adjusted our central scenario for US rates at the end of this year to reflect recent movements (our central end-of-year projection for the US 10-year Treasury yield has been raised to 1.7% from 1.3%, while acknowledging risks are skewed to the upside), so the rationale for our bullish stance on gold has weakened. That said, the points made in our previous note on gold still holds. The Fed is unlikely to tolerate any undue tightening of financial conditions that could jeopardise the current economic recovery. While we have been surprised by the relatively relaxed attitude Fed officials have shown to rate rises, we still think that the Fed will need to curb market expectations that do not correspond to the monetary guidance it has been giving.

Indeed, market expectations for a hike in policy rates at the end of 2022 go against the Fed's and our own projections that it will not raise rates until much later. It took the Fed two and a half years from the moment it hinted it was considering tapering their monthly bond purchases in May 2013 to the time it actually hiked rates in December 2015. Having adopted an 'average inflation targeting' framework in late 2020, we believe the Fed is some distance away from increasing rates.

Finally, the strength of the US dollar will prove temporary in our view. The Fed's constantly re-iterated dovish monetary stance coupled with a robust global growth outlook should combine to weaken the US dollar again. Also, the large fiscal stimulus pushed through by the Biden administration will lead to a further deterioration of the budget deficit, while the short-term boost to the US economy may widen current-account deficit. Overall, the long-term downward pressure on the dollar stemming from the US's twin deficits is likely to grow.

Decline in gold price looks overdone

A key assumption in our relatively bullish stance on gold is that the Fed will remain very cautious. We find it hard to imagine that the Fed will raise rates at the end of 2022, given that the US economy will probably be already dealing with tighter fiscal policy by then.

While we only expect a temporary spike in inflation largely linked to oil prices, it is true that a more sustained rise would put pressure on the Fed to raise rates sooner than we expect. But a sustainable rise in inflation could eventually support gold relative to fiat currencies, especially if fiscal stimulus fails to raise productivity growth. On the other hand, should inflation remain soft after an initial spike, then the normalisation in monetary policy will likely be very slow. This too would provide support to gold, as it tends to thrive in a low-yielding environment.

But in the short term, we acknowledge there are reasons to be somewhat cautious on gold. There is a risk that the market continues to challenge the Fed's dovish stance in the absence of stronger pushbacks (for example, through bigger monthly bond purchases or a new Operation Twist). Indeed, a further rise in the short end of the curve would likely support the US dollar. And any additional rise in long-term nominal rates could be fuelled by real rates as we see limited upside potential for inflation expectations (as proxied by the inflation breakeven rate). Finally, the fast pace of inoculation in the US and the effectiveness of vaccines against variants could speed the reopening of the economy, which could put additional upward pressure on long-term real rates.

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Beyond investment demand, central banks demand may also remain rather weak in the first half of the year, with Russia and Turkey failing to add to their gold holdings lately. Furthermore, for seasonal reasons, jewellery demand tends to be weak in the first half of the year. We may have to wait for the second part of 2021 and the reopening of major economies to see jewellery demand reacting to lower gold prices.

To sum up, our new base scenario for US long-term rates is causing us to revise our projections for the gold price. However, we maintain a relatively bullish stance over the medium-to-long term on the yellow metal as we think market expectations for rate hikes are likely to be pushed back by several quarters. We continue to see gold as an attractive hedge against unforeseen market events, especially in an environment where Modern Monetary Theory gains traction. We are lowering our three-month forecast to USD1,800 per troy ounce (vs. USD1,950 previously), while our six-month and 12-month projections are now both set at USD1,900 (versus USD2,050 previously).

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