PRECIOUS METALS: GOLD

ETF DEMAND TO THE RESCUE

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SUMMARY

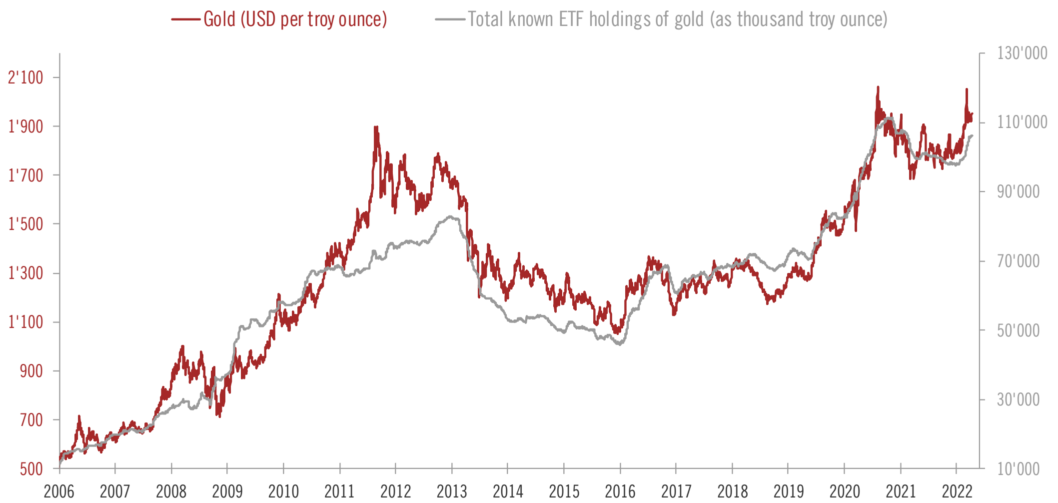
- The gold price has been resilient to the recent sharp rise in US real rates.
- Ongoing high inflation and increasing risks of a policy mistake by the US Federal Reserve have likely led to an increase in demand from exchange-traded funds (ETFs).
- A resilient US economy and a hawkish Fed may weigh on gold over the next few months, especially at a time when the yellow metal is deemed expensive relative to real rates.
- In the medium term, gold looks more attractive as the upside in US rates looks limited in our view, while inflation may stabilise at a higher level than in the last decade.
- Our three-month projection for gold stands at USD1,870, our six-month projection at USD1,790 and our 12-month projection at USD1,850 per troy ounce.

Gold proves resilient to rising US real rates

Since the US 10-year real rate reached a trough on 8 March 2022, gold has lost roughly 5% of its value. While this may seem a disappointing performance, it is actually much less so in view of the massive rise in US 10-year real rates since then (+93bps) and the decline in global risk aversion. In view of past patterns of its sensitivity to US 10-year real rates, gold should have dropped by USD330 after such a rise in rates rather than USD97.

The main reason for the relative resilience of the gold price stems from the rise in investment demand, especially ETF demand. Since March, ETFs have purchased around 100 tonnes of gold, indicating that investment demand remains strong.

CHART 1: GOLD PRICE VS. ETF GOLD DEMAND



Source: PWM - AA&MR, Bloomberg Finance L.P., 12 April 2022

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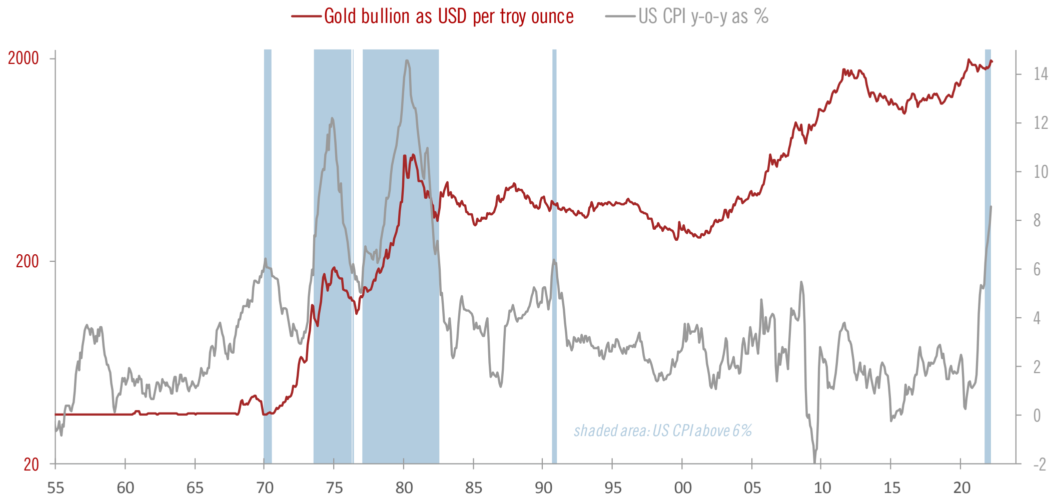
High inflation to support gold

While holding gold has an opportunity cost, investment demand is being driven by the fear of US dollar depreciation and high inflation as well as by safe-haven considerations. We think that a desire to build a hedge against inflation and market risk is behind the latest increase in investment demand for gold.

The war in Ukraine and harsh new lockdowns in China to deal with covid outbreaks may keep inflationary pressure high due to sustained commodity and global supply-chain disruption, therefore supporting gold. Over the longer term, efforts to 're-shore' some supply chains may also prove inflationary. Although inflation may soon peak, it could stay comparatively high. Overall, gold's status as a hedge against inflation could support gold, especially in the short term.

CHART 2: GOLD PRICE VS. US CONSUMER PRICE INDEX (CPI)



Source: PWM - AA&MR, Refinitiv, 12 April 2022

Strategic demand replaces speculative demand

Since 8 March, the decline in global risk aversion, as proxied by the implied volatility of the US stock market, has not led to a drop in gold's price premium over what real rates would imply. This is probably linked to sustained geopolitical uncertainty, including the effect of international sanctions on Russia and higher commodity prices. That said, the resilient global risk appetite and the recent highs reached by gold have led to some reduction in demand on futures markets. Such demand is particularly volatile and tends to be driven by short-term considerations (interest rose significantly at the beginning of the year and started to decline a week after Russia invaded Ukraine). However, the decline in speculative interest for gold (i.e. futures) in March has been offset by a rise in interest from more strategic investors (i.e. ETFs), which could make gold more resistant to any short-term shift in sentiment. Persistently high inflation as well as growing concerns of a policy mistake by the US Federal Reserve (Fed), can explain the sharp rise in strategic interest in gold and therefore its resilience to higher rates.

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Muted central bank demand in February

Data from the World Gold Council (compiled using International Monetary Fund statistics) show that central banks sold a net six tonnes of gold in February. While high inflation may help support central banks' interest in gold, we doubt they will rush into gold as an alternative to the US dollar, even after the partial freeze of the Bank of Russia's FX reserves.

Short-term upside could be limited but so too could be downside

We are relatively cautious on gold's prospects in the short term as we see the US economy remaining resilient in the next months, prompting a further decline in speculative demand for gold as the Fed continues to hike rates. In the longer term, the increasing risk that the US economy finds the Fed's aggressive monetary stance hard to stomach may cap the rise in rates and therefore provide some support to gold. This translates into our three-month and six-month projections of USD1,870 and USD1,790 per troy ounce for gold, and our 12-month projection of USD1,850. In terms of risk to these estimates, a Fed that shifts to "Volcker mode"—in other words, acting even more aggressively than suspected to curb inflation at all costs—may weigh on gold, although the probability that global risk appetite declines in such an event may cushion such a fall. By contrast, a prolonged period of high inflation would be a clear positive factor for gold. At this stage, we see it as more probable that gold will move above our projections than below them.

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