MARKET INSIGHT

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GOLD: TIME TO SHINE?

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Is gold still a safe haven? Some started to ask this question as prices declined despite mounting global trade tensions and a non-negligible risk of a trade war. From our point of view, the answer is "yes". While there is a lot of noise around trade tensions, their impact on the global economy and financial markets has been limited so far. For gold to benefit, their impact would need to be much bigger, causing a broader risk aversion in financial markets and triggering a flight to safety. Nevertheless, we would have expected some support for gold from the uncertainty related to the trade tensions.

What has mattered most for gold so far this year was the assessment of the US interest rate cycle. The expected number of future rate hikes has progressively increased as the US economy demonstrated stellar growth and the Federal Reserve reiterated its determination to normalize interest rates. As a result, the US dollar rebounded; investment demand softened and gold started to slide. Despite being aware of the potential rate cycle headwinds which were expected to weigh on gold, we were still surprised by the size and speed of the recent sell-off. Prices are currently under pressure at around $1,200 per ounce.

The reason why the US dollar mattered so much for gold was the lack of demand. Gold has traded in a "currency mode" rather than in a "commodity mode" for most of this year. Considering the uncertainties related to trade tensions, the softness in investment demand is surprising at first sight, as is the fact that some structural buyers became sellers. Holdings of physically backed ETFs dropped sharply from their early summer peak. Most of the selling came from the US, which we believe is due to three reasons.

Firstly, US real interest rates (nominal rates adjusted by inflation) play an important role in overall holdings. Indeed, holding gold has an opportunity cost as it does not carry any coupons or dividends. Hence, in the event of a rise in real interest rates, holding gold is less attractive. As shown in the graph, US real interest rates reached a decade high in September this year (chart 1).

Secondly, as gold and the US dollar trade in a very close inverse relationship, there is little incentive for US investors to hold gold at a time when the dollar is rebounding and interest rates are rising. This correlation should not be underestimated. Looking back over the past 50 years, gold prices went down 1% on average (per quarter) when dollar appreciated, and up 5% on average when it depreciated.

Thirdly, there seems to be different perceptions about trade tensions and the risk of an escalation into a trade war. From the perspective of a US investor focused on the domestic economy and market, the perceived threat from trade tensions is much lower than in Europe. Domestic consumption is the dominant driver of the US economy, which continues to do well, as indicated by strong readings of business and consumer confidence indicators as well as equity markets close to record highs.

How the dollar drives emerging market gold demand?

While the stronger dollar discourages gold buying in the United States, it lifts prices in countries whose currencies have been weakening i.e. many emerging markets. Taking the year 2008 as a reference point, gold prices in the Middle East were around 40% higher than in the USA, while in Asia they were around 25% higher. Emerging markets account for more than 60% of global gold demand, led by China and India. High domestic gold prices cause major headwinds to price-sensitive jewelry demand, driven by the high metal-content and low mark-up of emerging countries' jewelry. Many emerging markets exhibit a very strong inverse relationship between domestic prices and per-capita jewelry demand. During the Asian crisis of the late 1990s, jewelry demand in the affected countries dropped around a third. Once more, this reveals the importance of the US dollar as a driver of gold demand and prices. China and India are exceptions, explained by the rapid increase in income of the former, and the regulated gold market of the latter. Overall, jewelry demand levels in emerging markets vary by a country's income level; richer emerging markets, the Middle East for example, tend to have a higher per-capita demand than poorer ones.

Likewise there is a negative relationship between domestic prices and investment demand in emerging markets. This is due to gold's safe-haven characteristics, which make it attractive in times of turmoil and provides emerging market investors with a store of value and an inflation hedge. Excessive inflation often is a consequence of severe currency depreciation, increasing the attractiveness of investment in foreign assets, e.g. the US dollar, US equities or US Treasuries.

For non-dollar investors, gold also needs to be considered as a foreign asset. Aside from supply and demand imbalances, e.g. import restrictions such as tariffs or quotas, local prices are simply benchmark dollar prices converted into local currencies. Comparing average annual inflation rates across various emerging markets to the performance of the currency component of a gold investment, i.e. the depreciation of the local currency versus the US dollar, we find a strong positive relationship. Hence, it is not gold which hedges against inflation but the exposure that it provides to the US dollar. This also implies that investments in other foreign assets such as US treasuries or US equities would have provided about the same inflation hedge as gold.

Another topic which has been making headlines in the gold market over the past few weeks is the stability of gold

prices in China, and an unusually strong co-movement between gold and the Chinese yuan; the correlation between the two has never been as high. As a result, there is talk in the market that China might have pegged the yuan to gold, signaling stability and leaving gold in dollars as a derivative of the USD/CNY exchange rate. Yet, we do not see China intervening in the currency markets. Other than simultaneous slide over the past weeks, we believe there is little evidence for this talk. Put differently, gold's high correlation with the yuan is a coincidence rather than causation and the peg a myth.

We struggle to understand why China would want to peg the yuan to gold, as in today's world the stability of a currency is determined by the health of the underlying economy, the outlook for monetary policy and the credibility of the central bank. Examples of emerging market countries which have been adding to their gold reserves over the past years, such as Russia, Turkey and China, show that gold does not guarantee the stability of a currency. In the case of China, the currency volatility has been increased deliberately by the PBOC as it sought to establish the yuan as a reserve currency. Yet, increasing gold reserves in emerging markets show the desire for diversification in a time when some of these countries are increasingly at odds with the US administration and its policies. Central bank gold buying in emerging markets should thus continue.

Conclusion: Time to buy?

The environment for gold remains challenging as long as the dollar remains strong as it keeps US investors on the sidelines and emerging market consumers out of the jewelry stores. That said, against the backdrop of very negative sentiment in the futures market, a lot of bad news is currently priced in and it is very unlikely that prices will move back towards the lows reached during last year's bear market. Adding our expectation that the dollar strength should start to fade as we approach the end of the year, there should be more upside than downside even in the short term. Sustainable upside to prices should materialize once growth and inflation concerns creep into financial markets, reviving the demand for gold as safe haven.

Given our expectation of recovering gold prices and valuations on low levels, the mining sector should find a bottom as well. That said, we do not see broad-based buying opportunities and believe selectivity is key. Mining shares are no substitute for physical gold.

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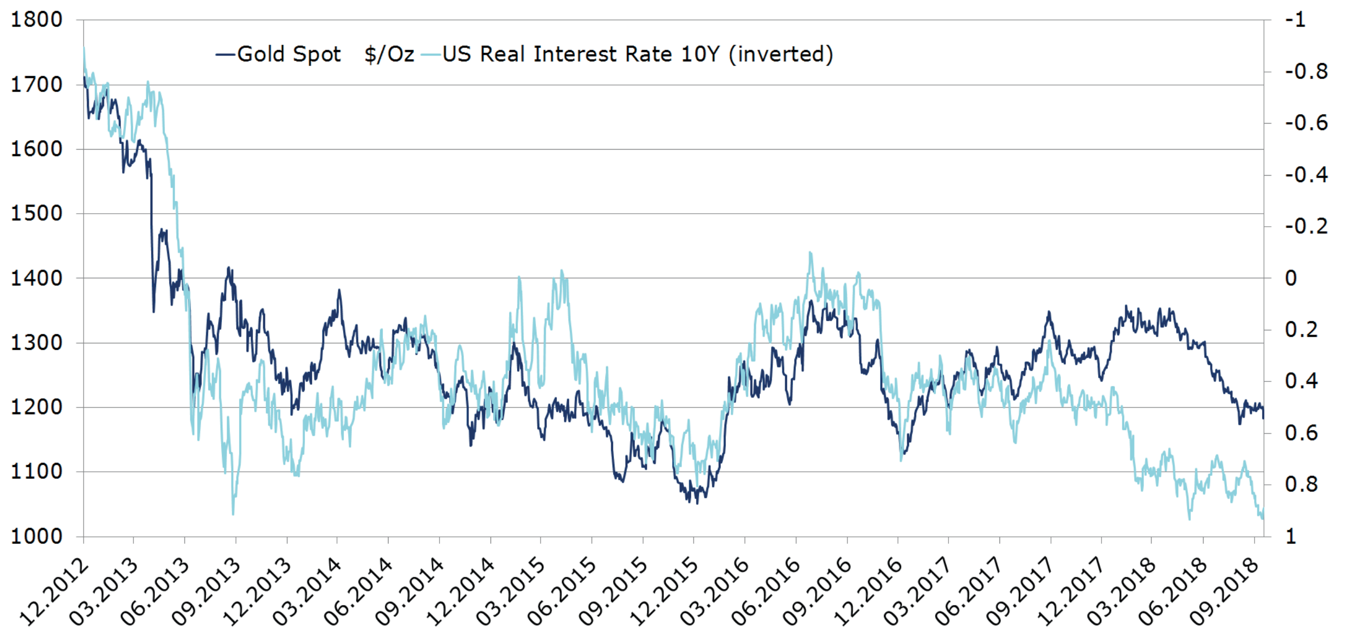

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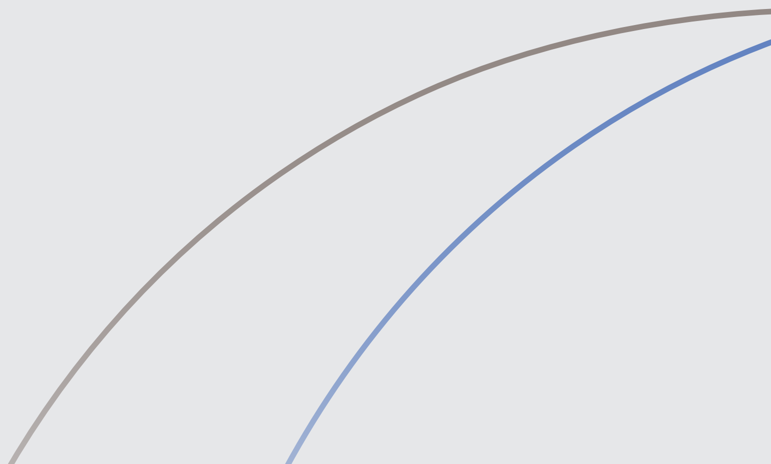

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