Fear and Wealth

Gold's role as portfolio diversifier resurfaces

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- Over the past month gold has rallied by 4% reaching its highest value since July. The rally coincided with the stock market sell-off and represents the return of "fear" related demand for gold, in our view. But with US growth still strong and rates still rising can gold continue to act as an effective hedge?
- Firstly, we find that "fear" is a more important driver of gold investment demand than the opportunity cost of holding gold measured by short-term US rates.
- Historically 10-year real rates have been a good proxy of "fear", but when the Fed is hiking its signal can be distorted. Instead the market assessment of the probability of US recession becomes a more meaningful measure.
- Recession worries have increased recently. Going forward falling unemployment rate in the US and continued trade tensions should keep these concerns elevated. At the same time, next year our economists forecast slowdown of US growth from 2.9% to 2.6% and a pick-up of US core inflation from 2.2% to 2.5%. This could make the US economy look increasingly like it is entering late-cycle inflation overshoot and further support gold investment.
- Another bullish catalyst is growing interest in gold by central banks driven by: the desire to diversify their holdings; rising geopolitical tensions; and the "de-dollarization trend". Increasing numbers of countries are returning back to buying gold for the first time since 2008-2012.
- Finally, our economists expect EM dollar GDP to stabilize and begin to grow again, which should boost their gold demand through the "wealth" channel. But they highlight that trade tariffs, sanctions and policy action create some short-term risks to the downside.
- To sum it up, our Fear and Wealth framework suggests solid fundamentals for gold. A low and falling US unemployment rate combined with slowing growth and rising inflation should boost "fear" related DM gold demand. A rebound in EM dollar GDP increases their gold demand through the "wealth" channel. On top of this, rising geopolitical tensions create upside risk to central bank gold demand. However, we also highlight some short-term headwinds related to volatility in EM currencies and the CNY in particular. We keep our 3, 6 and 12m forecasts at $1250/toz, $1300/toz and $1350 but see upside risks once US growth begins to slow.

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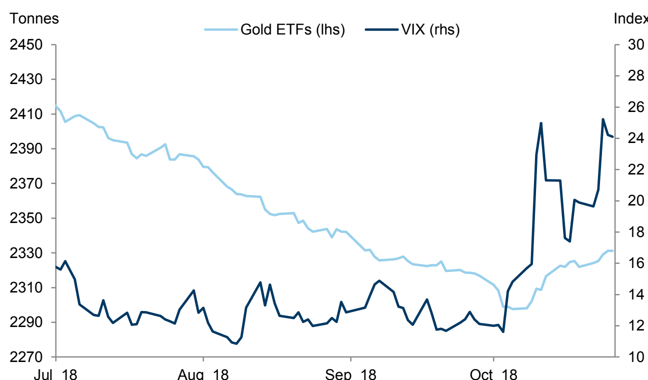
Gold's role as portfolio diversifier resurfaces

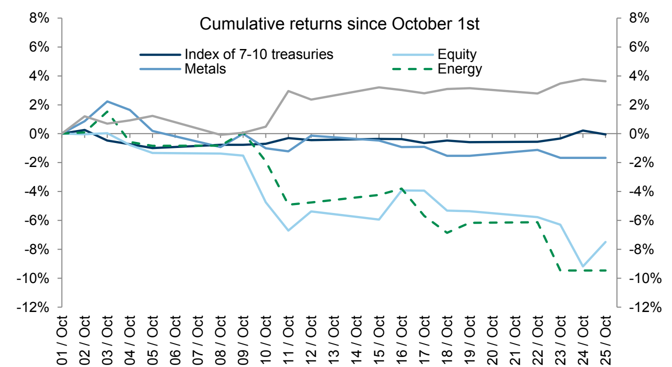
Over the past month gold has rallied by 4% reaching its highest value since July. The rally happened on the back of the market sell-off and spike in volatility. In our view it represents a rebound in fear-related demand for gold with ETFs beginning to build after several months of declines (see Exhibit 1). During the sell-off gold outperformed not only cyclical assets, such as equities, base metals and oil, but also traditional "safe haven" assets such long-term bonds (see Exhibit 2). But with US growth still strong and interest rates expected to increase further can gold continue to act as an effective hedge?

Exhibit 1: Gold ETFs rebounded as the market sell-off led to return of "fear"



Source: Bloomberg, Goldman Sachs Global Investment Research

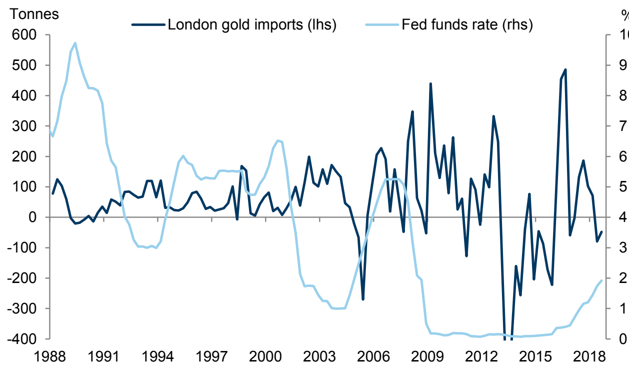
Exhibit 2: Gold has outperformed both cyclical and defensive assets over the past month



Source: Goldman Sachs Global Investment Research, Bloomberg

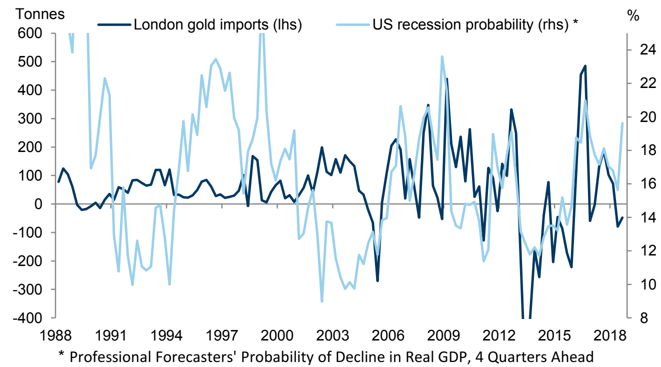
First, we find that "fear" is currently a far more important driver of gold investment demand than the opportunity cost of holding gold measured by short-term US rates. To measure investment demand for gold we use net gold imports into the UK, which is a proxy for wholesale investor demand for gold given the that LBMA vaults which store most of physical gold backing ETFs are located in London. Looking at Exhibits 3 and 4 one can see that over time gold investment has been become increasingly less sensitive to the federal funds rate and more tightly linked to "fear" captured by an assessment of probability of US recession risk. One possible reason for this trend is gold investment gradually becoming more institutionalized especially post introduction of ETFs in 2003. Another explanation is the end of the "great moderation" a period of suppressed macro volatility and low perceived systematic risks post 2008 which made a larger share of global investors look at gold as a hedge against systematic risks.

Exhibit 3: Investment demand for gold has gradually become less sensitive to interest rates and ...



Source: Bloomberg, UK Customs Statistics

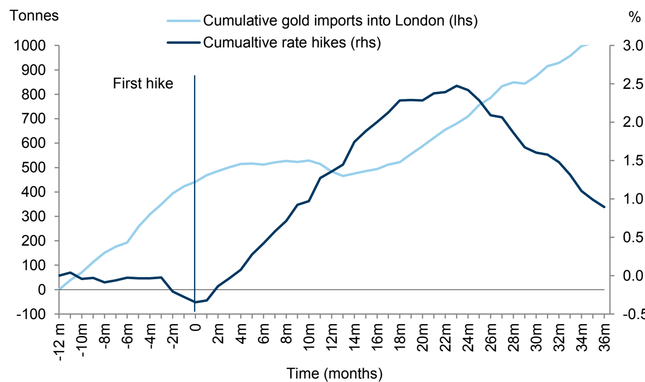
Exhibit 4: ... more sensitive to changes in "fear"



Source: Federal Reserve Board, UK Customs Statistics

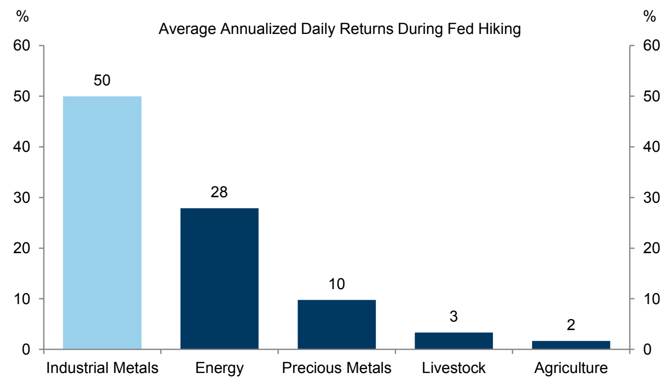
We also examined the typical path of gold investment during the past 3 hiking cycles. We find that while on average London gold holdings tend to take a dip at the mid-point of the cycle, they start building again before the rate hikes are over (see Exhibit 5). A likely explanation is that as the rate cycle progresses investors become concerned that higher rates will lead to a growth slowdown and buy gold as a hedge. This dynamic would explain why precious metals historically tend to increase during the rate hiking cycle (see Exhibit 6) even though its returns are weaker than for base metals and energy (see Commodities shine when the Fed hikes).

Exhibit 5: Gold investment tends to pause midway through the hiking cycle but begins to build again before hikes are over



Source: UK Customs, Goldman Sachs Global Investment Research

Exhibit 6: In the past gold and precious metals went up during period of rate hikes

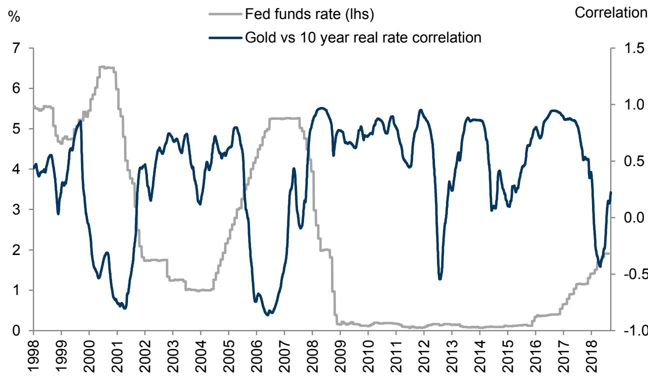


Source: Bloomberg, Goldman Sachs Global Investment Research

Historically we used 10-year real rates as a proxy of "fear"-related demand for gold as they were extremely sensitive to the risk-on, risk-off dynamic. But during fed hiking periods 10-year real rates temporarily become a poor barometer of "fear" and its correlation with gold tends to fall significantly (see Exhibit 7). This is because when the Fed is hiking, long-term rates can continue to rise even if markets are increasingly worried about growth due to tighter monetary policy. This once again suggests that the positive correlation between long-dated US bonds and gold is primarily driven by their safe-haven character rather than a negative exposure to Fed Funds rates. In fact during the hiking cycle higher rates can lead to weaker prices of risky assets (see The return

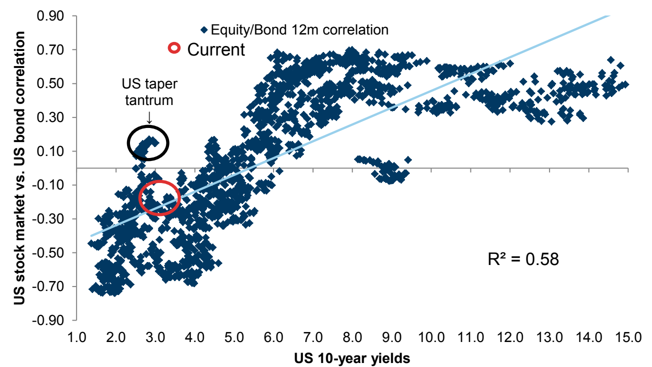
(again) of the great rate debate) and hence more "fear" (see Exhibit 8). This implies that until the hiking cycle ends the 10-year real rate correlation with gold can remain depressed and we need an alternative measure of "fear".

Exhibit 7: Correlation between gold and 10-year real rates tends to weaken during the hiking cycle



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 8: As rates go up they can lead to weaker prices of risky asset and hence more "Fear"

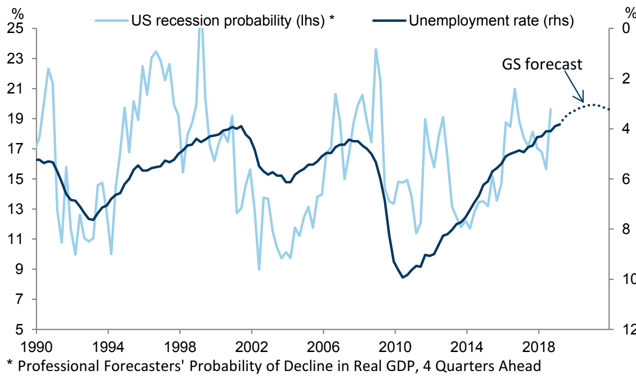


Source: Goldman Sachs Global Investment Research

Instead we think that the market assessment of the probability of US recession is a more relevant measure of "fear" for gold investment demand. Most recently there has been a spike in market worries regarding the possibility of a US recession. These worries have in our view been the primary reason behind the rebound in gold investment demand. The assessment of recession probability over the next 12 months by a sample of professional forecasters has increased from 16% to 20%. Moreover, during the recent market sell-off cyclical stocks underperformed defensive sectors indicating that concerns over US growth were one of the primary drivers (see October Requiem). These concerns in turn were likely driven by the growing belief that US economy is late cycle given how low the unemployment rate is and the potential negative effects of trade wars on industrial growth.

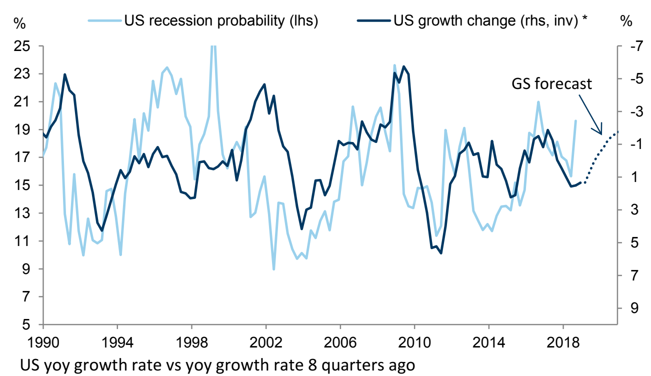
While we think that the US cycle still has room to run it doesn't mean that markets will not worry about it coming to an end. In fact, going forward we expect market "fear" of a US recession to strengthen given our economists expect the unemployment rate to fall further (fueling the late cycle narrative) and trade tariffs are expected to remain beyond the US mid-term elections (see Exhibits 9 and 10 and The Midterm Election: One Month to Go). Recession worries and gold investment may increase further after US growth begins to slowdown. Our economists expect this to happen mid-next year as the effects of fiscal stimulus begin to wear off.

Exhibit 9: Falling US unemployment should continue to push market's assessment of recession risk higher



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

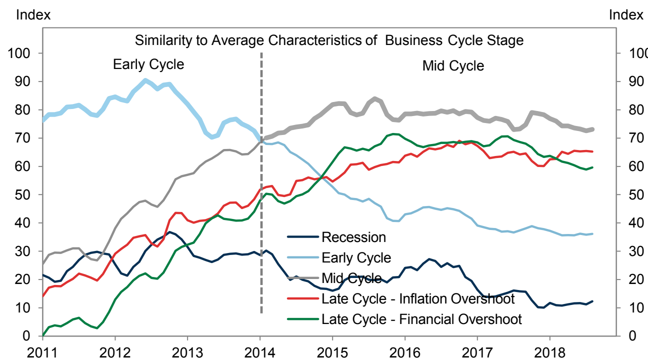
Exhibit 10: Deceleration of US growth in mid next year should add to recession worries



Source: Federal Reserve Board, Goldman Sachs Global Investment Research

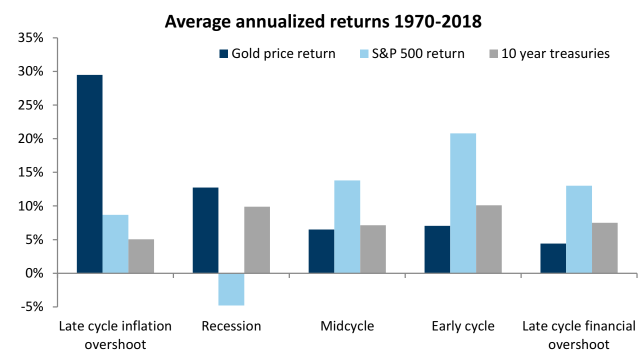
At the same time, our economists see potential for a pickup in US core inflation next year as the US unemployment rate is expected to go significantly below 4%. Our economics team estimate this to be the inflection point after which wage inflation tends to accelerate. Combined with decelerating growth, this could make the economy appear it is entering a late cycle inflation overshoot for the first time since 1988 (see Exhibit 11 and Still Mid-Cycle). Historically, gold has been the best performing asset in this environment as investors become concerned with currency debasement and rising macro uncertainty and interest rates hurt equities and bonds returns (see Exhibit 12).

Exhibit 11: We believe that the US is still mid-cycle but getting closer to inflation overshoot late cycle stage



Source: Goldman Sachs Global Investment Research

Exhibit 12: Gold tends to outperform equities and bonds during both the inflation overshoot late cycle stage and during recessions

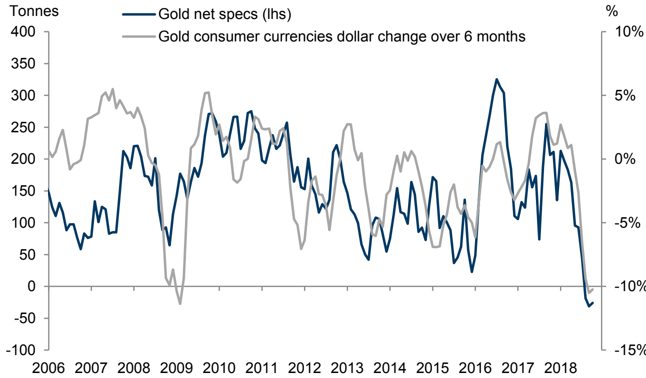


Source: Goldman Sachs Global Investment Research, Haver

So why then have gold ETF flows been so weak this year despite the rising late-cycle fears? We think that the ETF liquidation was not the beginning of persistent outflows due to falling demand for gold as a defensive asset, like it was in 2013, but rather a temporary cleaning up of speculative positions due to stronger dollar capping gold's short-term upside. The ETF liquidation occurred in parallel with a fall in net-speculative positions on the Comex, which happened off of strong dollar momentum vs. major gold consumer currencies (see Exhibit 13). Most of the ETF liquidation since August was concentrated in the SPDR ETF. Quarterly reporting data shows that the 1st half of liquidation in SPDR ETF was mainly driven by hedge funds and banks, while other

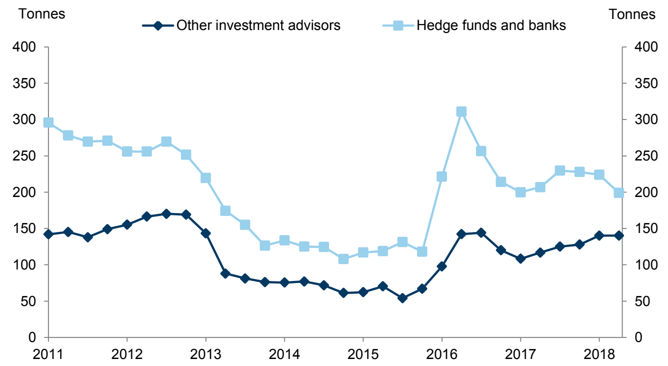
investment advisors holdings (which tend to be held by more long-term investors) have basically remained flat (see Exhibit 14).

Exhibit 13: Strong dollar capped gold's short-term upside and led to a correction in gold net speculative futures positions



Source: Bloomberg, Goldman Sachs Global Investment Research

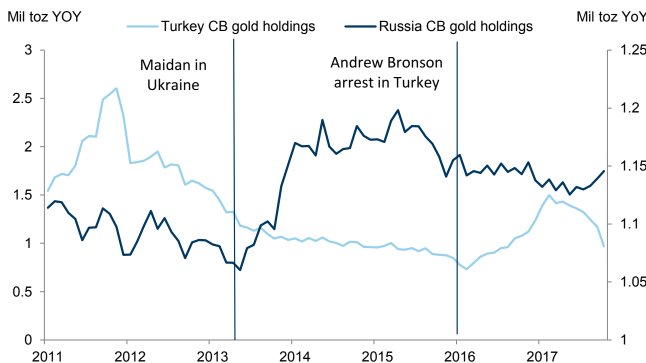
Exhibit 14: The ETF liquidation was also driven by more speculative holdings



Source: Thomson Reuters, Goldman Sachs Global Investment Research

Another bullish catalyst can come from central banks. An increasing number of countries are returning back to buying gold for the first time since 2008-2012. For some CBs, such as India, the shift towards gold is likely driven by the desire to diversify some of their exposure to US treasury holdings in a rising interest rate environment. For many others, however, political reasons may drive their gold accumulation. Russia and Turkey increased their gold purchases after tensions with the US increased (see Exhibit 15). Poland has also recently begun buying gold for the first time since 1998. Most recently Hungary announced that it has increased its gold reserves 10 times to 31.5 tonnes. For both Poland and Hungary the purchases coincided with rising tensions between these countries and the European Commission. That said, while the medium-term outlook for central bank gold demand is solid, in the short term it could face risks from continued dollar strength. For example, Turkey (or rather Turkish commercial banks which hold their gold in the central bank) was forced to liquidate part of its gold holdings during its currency crises early this year (see Exhibit 16).

Exhibit 15: Russia and Turkey CB gold purchases increased after rise in tensions with the US



Source: IMF, Goldman Sachs Global Investment Research

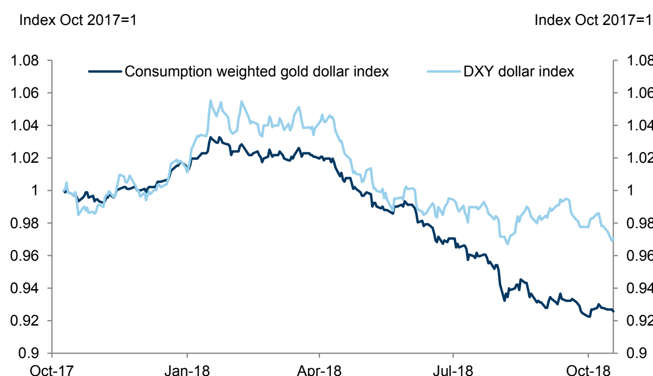
Exhibit 16: Gold holdings in Turkish CB fell after it experienced a currency crisis

Source: Bloomberg, Goldman Sachs Global Investment Research

Finally, as we have demonstrated in our "Fear and Wealth" framework, EM wealth can be as important (and in the long run is more important) a driver of gold prices as changes in safe haven demand. EM dollar purchasing power, particularly in the short run, is heavily impacted by EM currencies which have been very weak this year. Going forward our economists expect EM growth and currencies to stabilize given only a handful of countries, namely Turkey and Argentina, have structural problems. Our FX strategy team highlights (see EM FX – Back to assessing value) that EM currencies now appear to be undervalued vs. the USD. In addition, in China, they argue that premier Li's comments "One-way devaluation will do more harm than good to China's economy. China will by no means stimulate exports by devaluing the yuan" suggest that although policy makers are likely to continue a broad-based policy loosening to offset the effects of trade tensions, a sharp weakening of the CNY is less likely—for now—to be part of this mix (see Global FX trader).

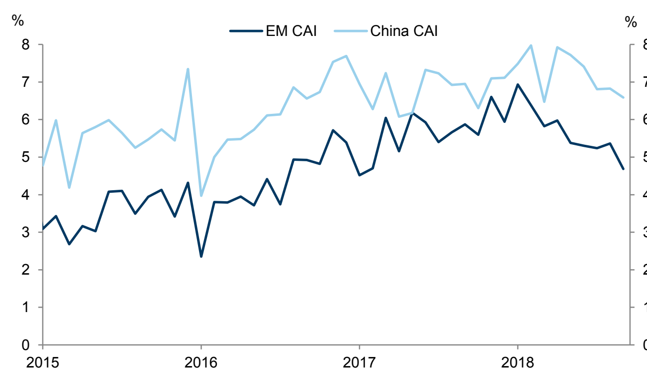
Therefore in our base case we expect the EM "wealth" effect to switch from being a drag on the gold price to a tailwind like it was in 2017. With that said our FX strategy team highlights that risks remain for their dollar outlook, as Turkey could reverse the tightening course and if tensions between China and the US continue to deteriorate, some weakening in the CNY is possible (see here). While the DXY has stabilized the consumer weighted dollar index continues to weaken (see Exhibit 17). At the same time EM CAI continues to slow driven by China which is the largest gold market in the world (see Exhibit 18). This creates some short-term risks to our forecasts.

Exhibit 17: While dollar stabilised vs. developed market currencies (DXY index) it keeps on strengthening vs. the basket of gold consumers



Source: Bloomberg, Goldman Sachs Global Investment Research

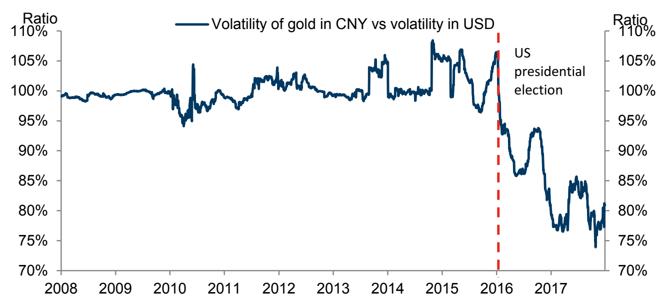
Exhibit 18: EM CAI continues to decelerate driven by China



Source: Goldman Sachs Global Investment Research

The CNY exchange rate is of particular significance to gold given that since the end of 2016 the gold price has been much more stable in CNY terms vs the dollar (see Exhibit 19). Indeed we find that post-November 2016 Swiss gold exports to China have become much more sensitive to both the dollar gold price and the CNY exchange rate (see Exhibit 20). The change in gold purchasing pattern coincided with the election of President Trump, who promised to get tough on China during his election campaign. Given that our economists don't expect the US China trade tensions to go away anytime soon we would expect the CNY sensitivity of Chinese gold purchases to remain elevated.

Exhibit 19: Since US presidential election in 2016 gold has been much more stable in CNY terms vs. dollars



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 20: Post November 2016 Swiss gold exports to China have become much more sensitive to changes in both CNY and the gold price

Swiss net gold exports to China and Hong Kong		
Explanatory variable	Coefficient	T-stat
Sample: Jan 2013 - Nov 2016		
Constant	14.16	2.59
Gold price change over the past two months	-175	-2.92
CNY change over the past two months	-292	-0.93
Lagged gold exports to China	0.75	9.73
Sample: Dec 2016 - Aug 2018		
Constant	71	5.7
Gold price change over the past two months	-1270	-4.1
CNY change over the past two months	-1148	-2.4
Lagged gold exports to China	-0.28	-1.5

Source: Swiss Customs, Goldman Sachs Global Investment Research

To sum it up, our Fear and Wealth framework suggests solid fundamentals for gold. A low and falling US unemployment rate combined with slowing growth and rising inflation should boost "fear" related DM gold demand. A rebound in EM dollar GDP increases their gold demand through the "wealth" channel. On top of this, rising geopolitical tensions create upside risk to central bank gold demand. However, we also highlight some short-term headwinds related to volatility in EM currencies and the CNY in particular. We keep our 3, 6 and 12m forecasts at $1250/toz, $1300/toz and $1350 but see upside risks once US growth begins to slow.

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