Gold

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Biggest fall in three years

3rd August 2016

- **Gold fell below its critical $1,300/oz support handle, to $1,266.3/oz (-3.3%).** This is the biggest daily decline since June 2013. The fall came just a day after Fed talk by Fed Bank of Cleveland President Loretta Mester and Fed Bank of Richmond President Jeffrey Lacker's for a rate hike this year. Mester was one of the Federal voting member who voted for a hike in the previous September FOMC meeting. Elsewhere, the dollar index rallied in tandem with gold's fall, while oil prices sustained its rally into early Asian trading hours, with WTI now edging towards the coveted $50/bbl handle.

- **Gold's behaviour can also be explained from crude oil's stellar performance in the past week.** The relationship between gold and crude oil is a noteworthy one, especially when the rise in crude oil prices lifts inflationary pressures across both developed and emerging economies. This includes the US, where potentially higher domestic prices may potentially influence Fed rate hike decisions. Of note, the Fed bases their rate decision on the performance of the "twin mandate", which is to promote the goals of (1) maximum employment and (2) stable prices. Amid the relatively healthier labor market already seen in the US, increased upside risks to inflation may be a persuasive driver to finally lift the FOMC rate up by another notch. Elsewhere, the rise in oil prices may had encouraged sustained search for yield behaviour (note UST 10Y yield rose 6.4bp yesterday).

- **It's all about dollar strength and oil prices?** Bringing the argument to a full circle, the potentially higher inflation pressures (from higher oil prices) amid a relatively healthy labor market seen in the US may be driving the implied probability for a rate hike higher. As of this morning, the quick rise in oil prices seen over the week has invariably lifted the implied probability for the Fed rate hike for both Nov (17.1% from a week ago to current 21.4%) and Dec (60.9% to 61.2%). **The rising oil prices, search for yield behaviour and recent rhetoric by Fed Mester and Lacker for the Fed to raise rates later this year, are compiling drivers to drive gold below the $1,300/oz handle seen overnight.**

- **Outlook:** As quickly as gold fell, as quickly could gold rally back. Gold was as dear as $1,340/oz in the last week of September, in line with our call for gold to touch $1,350-$1,400/oz at end-year. Gold's trend should depend largely on the dollar strength and the search of yield behaviour into the months ahead. We still think that uncertainties into the next 12 months horizon, including November's US presidential elections and UK triggering of Article 50 somewhere in 2017, will encourage persistent demand into safe haven assets like gold. Elsewhere, should potentially higher US shale oil production and rig-count spook oil prices lower (a phenomenon already seen in mid 2016), the revert back to weak inflationary pressures may once again lift gold prices back to its previous shine.

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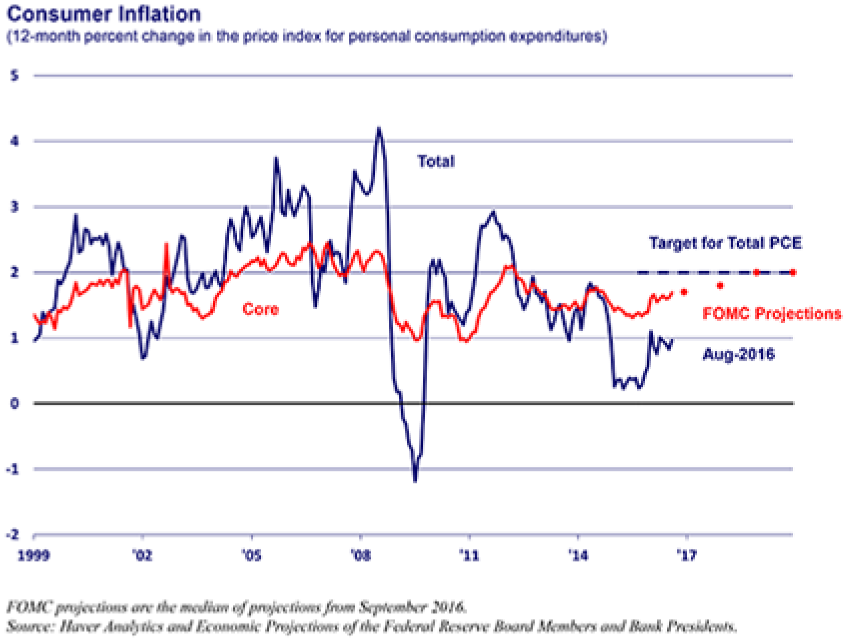

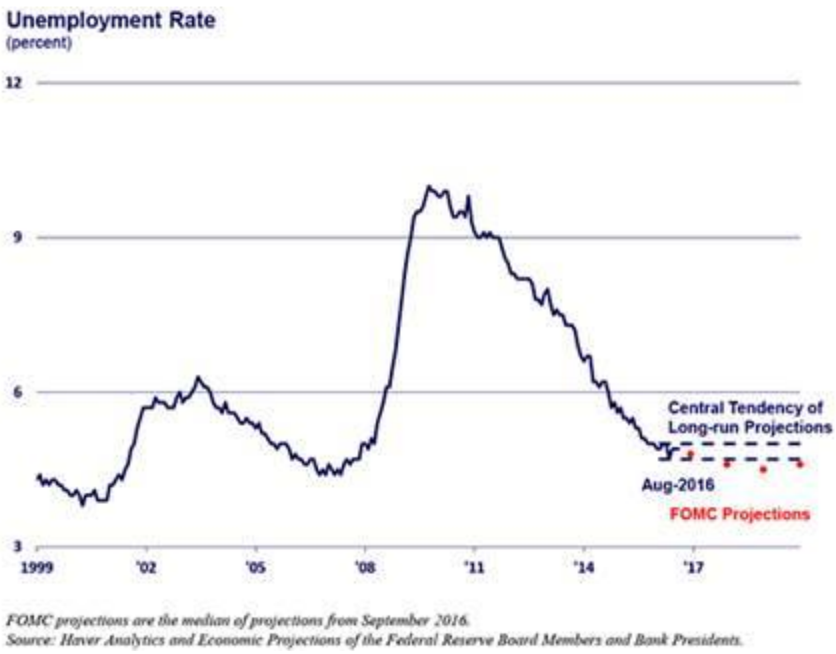

Source: Federal Reserve Bank of Chicago, Haver Analytics, FOMC Economic Projections