Gold

Rate hike and other exogenous factors

Wednesday, August 24, 2016

Highlights

- Gold is one of the best performing asset class this year. The bullion has managed to sustain above $1,300/oz, clocking a strong 27.7% growth year-to-date. The gains overshadowed the recovery in equities namely in Asia (+12.1%) and S&P 500 (+6.8%) over the same period.
- Upside surprises in US non-farm payrolls amid muted repercussion from the Brexit aftermath has lifted the implied probability for a rate hike in Dec 2016. That alone has then dragged gold prices below its critical $1,350/oz.
- Despite the improving US-centric fundamentals, we expect investors to remain long in gold given the need to insure against wildcards into the year, namely the growth risk from Brexit into 2017 and the upcoming November's US presidential elections.

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The known unknown

It was as though it was yesterday when George Soros commented that a Brexit vote would make "some people very rich, but most voters considerably poorer." By that fateful afternoon of 24th June, the results were clear. The vote to leave had caused Britain its place in the EU, as well as monetary losses of USD127.4 billion in a single day from the world's 400 richest people, according to Bloomberg.

The immediate monetary loss due to speculation by itself is a known consequence from the Brexit vote. What follows from there is perhaps a 'known unknown' aftermath from the eventual triggering of Article 50. From official rhetoric by Britain's new prime minister, Theresa May, Article 50 will not be triggered before 2017 in order to ensure a "smooth and orderly" exit. As such, the 'known unknown' does suggest that while we do know that Article 50 will be triggered in time to come, the market is relatively unsure of when, and of what consequence, will it spell for both Europe and global growth engines. Note that downside risks portrayed by the IMF (Britain faces a recession in 2017), OECD (OECD economies to see 3.3% less GDP versus Britain staying in the EU by 2020) and World Bank (Britain's trade and foreign investment will be adversely affected, and a no-trade scenario with the EU will drag trade activities down by 55%) are possible outcomes till then. At least at this juncture, it is a fact that a full-blown consequence from the Brexit is still not felt at this juncture.

With that, we approach another wildcard looming on the horizon, namely the US November presidential election. Note that the Economist Intelligence Unit placed the prospect of President Donald Trump to be one of the top 10 risks facing the world (March 2016).

Given these wildcards namely from the Brexit consequences and suspense from the US November presidential election, it is of no surprise that gold has been one of the best performing asset class this year, outperforming those of equities even. We view that these wildcards may be able to dominate potential upside in US economic data and rate hikes into 2016.

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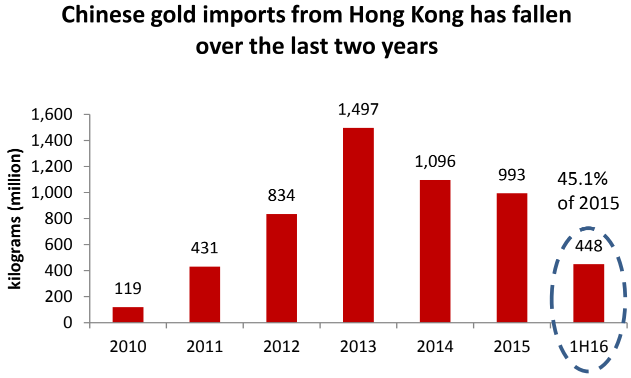
Physical demand update

Moving away from the speculative demand that may pick up given the said wildcards, the physical demand environment has also been lackluster since the start of 2016. Empirically, India gold imports have fallen 70.5% yoy in July (note that India has seen 6 consecutive months of negative growth). The hope for stronger physical demand however, may lie in the purchasing power of the Chinese, given that Chinese gold imports from Hong Kong has risen substantially to 122k kilograms (highest since Dec 2015), and clocking three consecutive months of double-digit positive growth.



Source: Bloomberg, OCBC Bank

Rate hike to occur, but gold will still rally

All-in-all, we note that the full-blown consequence from the Brexit vote has not materialized yet, owing to the delay in triggering Article 50. Elsewhere, the suspense over the US presidential elections should be monitored as well into 2H16.

As such, despite our expectation for the Fed to hike rates by 25bps in December, we think that sustained risk aversion from the suspense will continue to lift gold demand on safe haven demand. On this, we keep our gold forecast at $1,350/oz at end-year on one rate hike, or $1,400/oz if the rate hike does not materialize.

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