

Three uncertainties that cloud gold's outlook

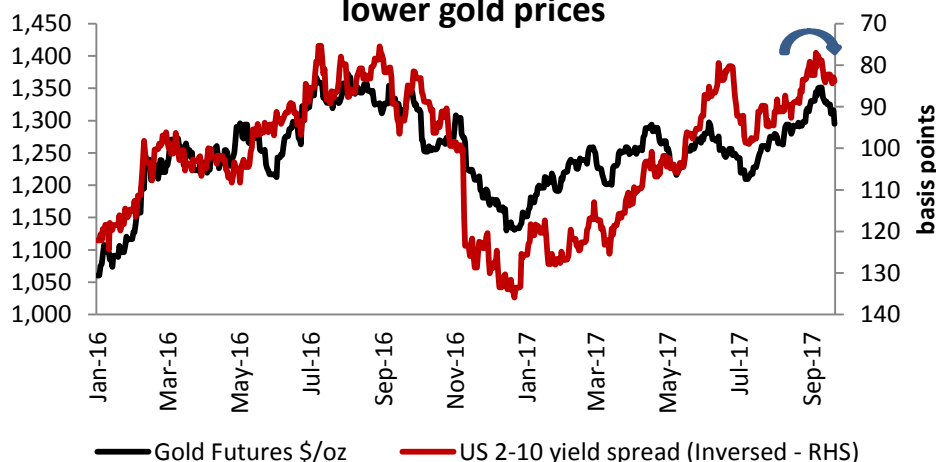
Monday, September 25, 2017

Highlights

- Gold prices trended below its \$1,300/oz handle, and for good reasons. At this juncture, the Fed's decision to start its balance sheet reduction act and indicating another 25bps rate hike before the year is up were likely the reason for gold's decline. Meanwhile, fresh sanctions against Pyongyang also suggest the global leaders' preference for a peaceful resolution.
- Still, gold's decline may be capped by ongoing uncertainties. These include (1) the extent of duration in which the Fed balance sheet reduction may run, (2) the future composition of the US Federal Reserve Board of Governors, and (3) potential intensification of geopolitical tensions.
- We keep to our year-end outlook of \$1,250/oz (and \$1,100/oz at end-2018). Our bearish view is still underpinned by ongoing global economic strength seen especially in growth and trade. However, gold prices may range-trade around current levels until further clarity is seen on the mentioned uncertainties.

It is a well-known fact that gold prices are driven primarily by market's risk appetite and dollar value. When risk aversion was heightened over the past weeks especially on geopolitical tensions, market-players flocked into safe haven assets, gold included, thus lifting gold prices to its highest in over a year. For that matter, yellow metal prices nearing the end of September however, paints a starkly different picture; gold quickly fell back below its \$1,300/oz handle, suggesting the down-play of risks amid better economic prospects. Collectively, recent events specifically fresh sanctions against North Korea and FOMC's decision to taper its balance sheet starting October led gold's decline.

US Treasury yield spread widens in tandem with lower gold prices



Source: Bloomberg, OCBC Bank

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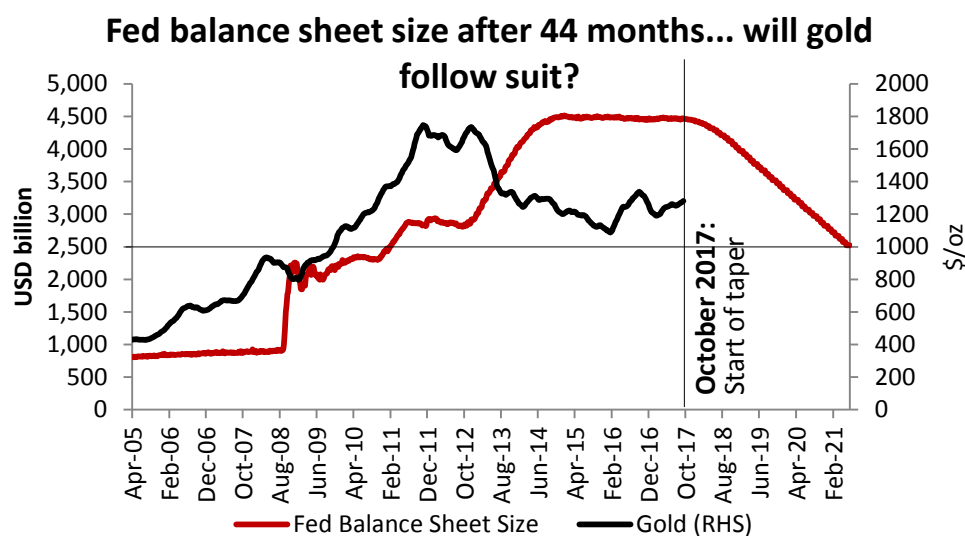
Beyond the argument on whether sanctions will ever bring Pyongyang to the negotiation table, **Trump's recent executive order to penalise any company or persons doing business with N. Korea suggested his continued preference for a peaceful resolution.** In addition, Trump also said that China's central bank had also asked its own banks to stop doing business with North Korea, with sources telling Reuters that Chinese banks were told to cease financial services to new North Korean customers and to wind down loans with existing ones.¹ In recent news, China has announced its move to ban LNG and condensates exports to Pyongyang, while also halting textile imports from N. Korea as well. This move by Chinese authorities is perhaps a historical one, given that Beijing has been long regarded as an ally to Pyongyang, according to the Council on Foreign Relations, as well as being North Korea's biggest trade partner (Pyongyang's trade with China accounted 89% of its total trade in 2016) and thus having the most leverage on Kim's regime. In a nutshell, the recent geopolitical developments do highlight global leaders' want for a peaceful resolution, and concrete steps are being taken to achieve this.

Another key factor that drove gold prices lower was perhaps the FOMC's renewed calls for another rate hike before the end of this year, coupled with an announcement to slowly shrink its huge \$4.5 trillion balance sheet starting October. The vote of confidence (11 out of 16 members preferred one hike, while one sole member called for two hikes for the rest of 2017) suggested policy-makers' view that the US economy is strong enough to stand even with further cut-backs in policy accommodation. The dot-plot chart also painted a gradual rise in interest rates (three 25bps hikes in 2018, 2.688% by end 2019 and 2.875% in 2020). As for the balance sheet tapering, up to \$10 billion per month of bonds will be allowed to mature, with a gradual step-up of \$10 billion at a three-month interval until the number reaches \$50 billion.

The key question however is, if the downward trajectory of gold prices given the fillip of risk appetite can be sustained. We do seek more certainty over the below mentioned three grey areas:

Firstly, what is unclear from the FOMC's [Addendum to the Policy Normalization Principles and Plans](#) document released in June, is the duration of the balance sheet tapering and the perceived new-normal size of the balance sheet. Should we take cues from former Fed Chairman Ben Bernanke comment in May 2017 that the "optimal size of the... balance sheet is currently greater than US\$2.5 trillion", the taper will last for exactly 44 months (or from October 2017 to June 2021) to reach at least US\$2.5 trillion (about 3 times the size of the pre-Lehman balance sheet). Note that Janet Yellen, during her press conference, said that the balance sheet normalisation will continue regardless of future unanticipated economic shock as the Fed will prefer to tweak interest rates first to accommodate economic growth, and any re-visitation back to quantitative easing act will only be considered if the lower-bound rate touches the zero handle again.

¹ Reuters, China's central bank tells banks to stop doing business with North Korea, 21st Sept 2017



Source: Bloomberg, OCBC Bank

Secondly, another pertinent uncertainty would be Yellen's replacement as the new Fed Chair, and consequently his (or her for that matter) view over monetary policy. Yellen's tenure as chairwoman expires in February 2018, in addition to the already four vacancies on the Fed's rate-setting board currently. US President Trump has openly iterated his preference for low interest rates (though keeping fairly muted on his stance over the recent balance sheet tapering decision), given his view that "as soon as [rates] go up, your stock market is going to go way down", and his influence over either retaining or replacing Yellen can give the president considerable power in reshaping the central bank's leadership. Note that the members of the Board of Governors are in fact nominated by the President, and subsequently confirmed by the US Senate,² thus giving Trump considerable voice in influencing the decision.

Lastly, we need to revisit the geopolitical arena and understand that these tensions are factors that can be entirely exogenous to financial modelling, though having a significant capability in influencing safe haven prices, especially gold. Gold prices have surged considerably in history due to the surge in geopolitical tensions, amid market-watchers concerns over tensions elevating into a war of arms. Even with today's reinforced sanctions against Pyongyang, there appears little quick resolution to the current war of words. As such, gold prices could remain elevated despite the potential positive incoming economic data, as any intensification of geopolitical tensions will possibly dominate market sentiments.

Suffice to say, the better-than-expected growth prints in many developed and developing economies in the first half of 2017, as well as recent WTO's call for global trade to grow to 3.6% in 2017 (well and above 2016's tepid 1.3%) should continue to lift market appetite and limit gold's advance. To that end, we keep our gold outlook at \$1,250/oz at end-2017, and \$1,100/oz at end-2018. However, the many uncertainties seen in the make-up of the US Federal Reserve Board of Governors may alter the rate hike outlook and balance sheet reduction plan should Yellen step down in February 2018, while ongoing geopolitical tensions may dominate market appetite should it intensify further.

² US Federal Reserve, FAQ: Who are the members of the Federal Reserve Board, and how are they selected?, 11th Jan 2017

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