Gold

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Gold to remain supported for now, but less dovish FOMC may limit gains

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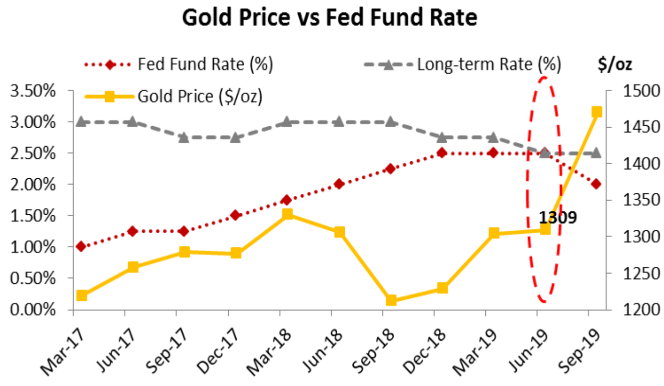
- **The September FOMC dot-plot suggests just one more rate cut at most in 2019/20, if not none.**
- **A less dovish than expected Fed is likely to limit further declines on fixed income yields, which in turn caps the ascent of gold prices.**
- **Short-term, economic and geopolitical uncertainty is likely to keep gold prices supported, possibly even lifted to $1,600/oz.**
- **Long-term, we see gold prices stabilising at $1,300/oz, higher than the 2013-18 equilibrium of $1,250/oz. This level may only be reached, however, in 2022 or beyond.**

1. $1,300/oz appears to be the long-term equilibrium price of gold, going by the Fed's downgraded natural rate of interest.

For the second consecutive quarter, the Fed is setting the long-term natural rate of interest at 2.50%, which is 50bp lower than what was forecasted a year ago at 3.00%. This gives us an interesting parallel for an analogue case study – in 1H2019, the Fed fund rate was set at 2.50%, implying that for the first time since the GFC, the Fed fund rate in 1H 2019 had already reached the long-term neutral rate. Prices of gold observed in 1H 2019, therefore, may serve as a benchmark for the long-term price of gold before adjusting for inflation.

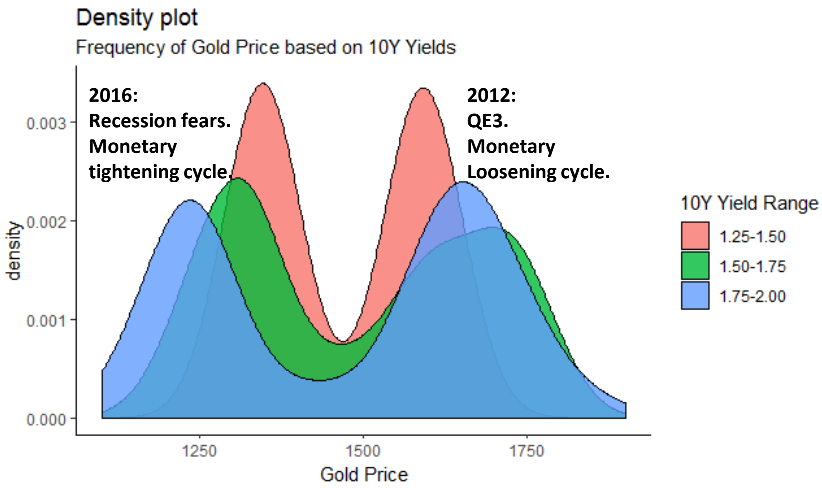
Prices of gold traded largely around the $1,300/oz level in 1H 2019, averaging $1,304/oz and $1,309/oz in Q1 and Q2 respectively. *Ceteris paribus*, this suggests that if the Fed's projection goes according to plan, gold prices would likely decline back to around the $1,300/oz level in the long-run, when the Fed fund rate matches the current projected natural rate of interest. This would be a step-up from the prior equilibrium of $1,250/oz that was observed from 2013 to 2018.



Source: Bloomberg, OCBC Bank

2. Twin peaks show gold likely to trade above $1500/oz when 10Y Treasury yield falls below 2%.

The distribution of gold prices in the past decade show a pattern of twin peaks when 10-year UST yields fall below 2%. The first peak shows gold trading in a range from $1,250-$1,375/oz, while the other peak suggests gold should be trading between $1,600-$1,750/oz.

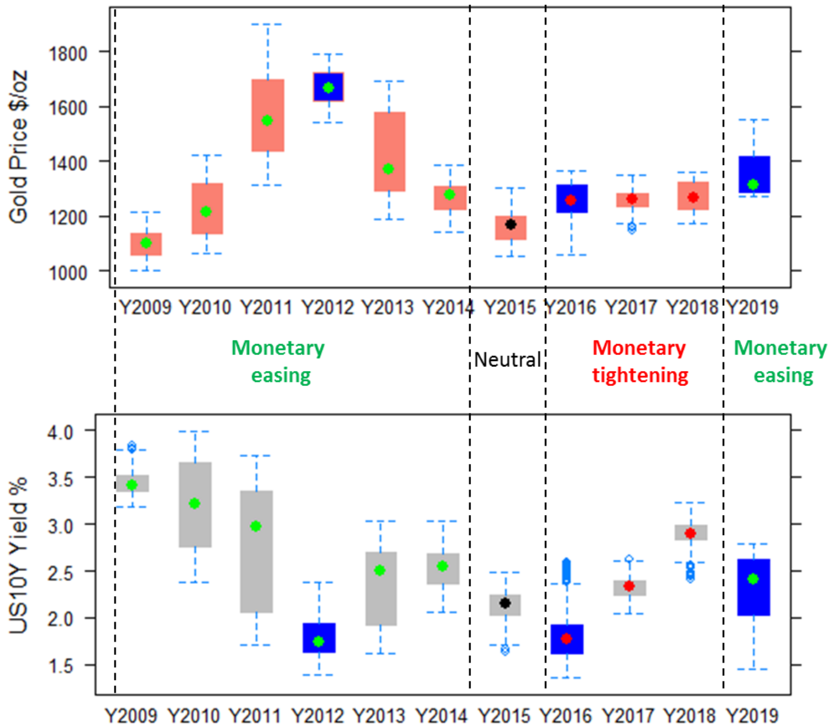


Source: Bloomberg, OCBC Bank

These twin peaks may appear perplexing at first, but when put into context of the monetary environment, it becomes more apparent that the current climate is more similar to the peak on the right ($1,600-$1,750/oz). 10Y yields sunk to as low as 1.4% on three separate occasions in the past decade:

a) **2012**, on sustained monetary loosening from the Fed and ECB;
b) **2016**, on fears of a US economic slowdown while rates are normalised;
c) and the final occurring last month, during the re-escalation of the US -China trade conflict, with the Fed on a monetary loosening cycle.

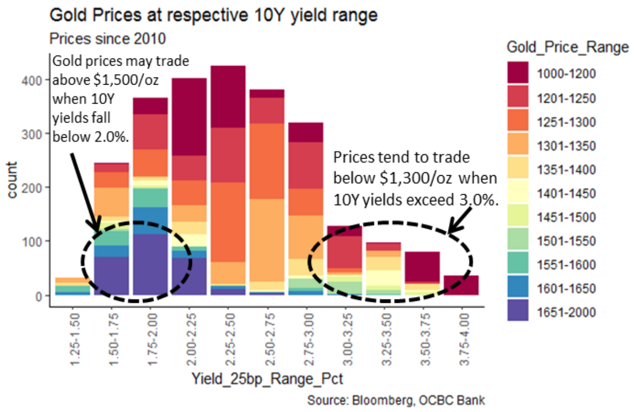
Given that the Fed is currently reducing interest rates, gold prices should resemble the 2012 QE environment more than the 2016 rate-hike climate, which means there is a higher probability that prices would fall in the peak to the right of $1,600-$1,750/oz.



Although yields currently are as low as 2012 and 2016, the monetary environment resembles 2012 more than 2016. Gold prices, therefore, are likely to follow the path Of 2012 ($1,600-$1,750/oz) more than 2016 ($1,100-$1,300/oz).

3. Prices may fall below $1,300/oz if 10Y yields exceed 3.0%, but that looks unlikely given current trade and geopolitical tensions.

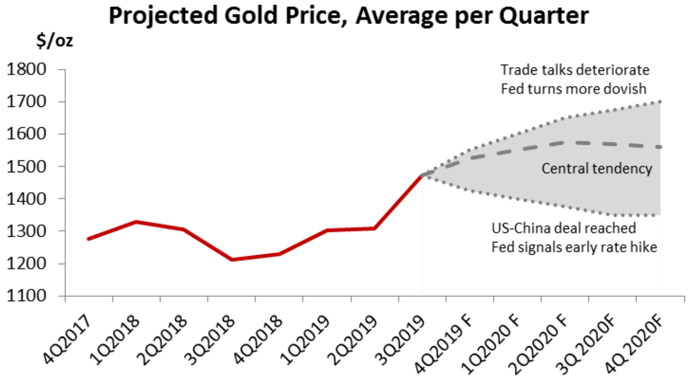
A histogram of gold prices against 10Y UST yields shows an inverse relationship between the two variables, assuming a constant monetary environment. Prices tend to rise above $1,500/oz when 10Y yields fall below 2.0%; conversely, gold prices tend to trade below $1,300/oz when 10Y yields exceed 3.0%. Given the vulnerable economic situation as well as the multiple trade and geopolitical tensions around the world, we think it is unlikely that yields would return to above 3.0% for now. This is also consistent with the Fed's lowered neutral interest rate of 2.5%.



4. Weak economic growth and trade tensions to keep gold supported in the short-term, but upside is capped by Fed's declining dovishness.

While we see the long-term price of gold at $1,300/oz, it is likely that prices may continue to stay elevated near the $1,500/oz level in the short-term, with a possible tendency to trend even towards $1,600/oz. Global economic growth remains vulnerable while markets continue to be sensitive to US-China trade tension headlines. The recent drone attack on Saudi Arabia also adds a new element of geopolitical risk into the mix, further boosting gold's appeal as a safe haven. Until there appears to be a strong case for a "complete" trade deal between the US and China, it is unlikely we will see a large downward correction in gold prices.

The upside is capped, however, as the Fed only sees the need for one more possible rate cut at this point, if not none. Without the downward pressure on Treasury yields, it is unlikely gold prices will gain much upside lift from here to rally past $1,600/oz.



Source: Bloomberg, OCBC Bank

5. **Conclusion: upside pressure to persist but Fed's stance may cap gains; reversion to long-term target of $1,300/oz unlikely for now.**

Gold prices have tended to trade above $1,500/oz when US 10Y yields fall below 2.0%, especially in a monetary easing environment. Further escalations in trade and geopolitical risks may drive prices of gold higher in the short-term, possibly to the $1,600/oz level. The Fed's less dovish than expected stance in the September FOMC meeting, however, is likely to pose challenges for gold prices to rise meaningfully beyond that level, unless a deterioration in economic fundamentals prompt a downgrade in the Fed's current stance. The presence of this uncertainty means the reversion from current price levels to our perceived long-term price equilibrium of $1,300/oz is unlikely to materialise for now. At $1,300/oz, this new equilibrium price would be an elevation from the previous equilibrium of $1,250/oz that was observed from 2013-18. Returning to $1,300/oz, however, is likely to occur only in 2022 or beyond, which assumes the Fed fund rate would have matched the natural rate of interest of 2.50% and that the US and China have reached a long-term trade deal.

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