Commodities Research: Gold

# No one understands gold

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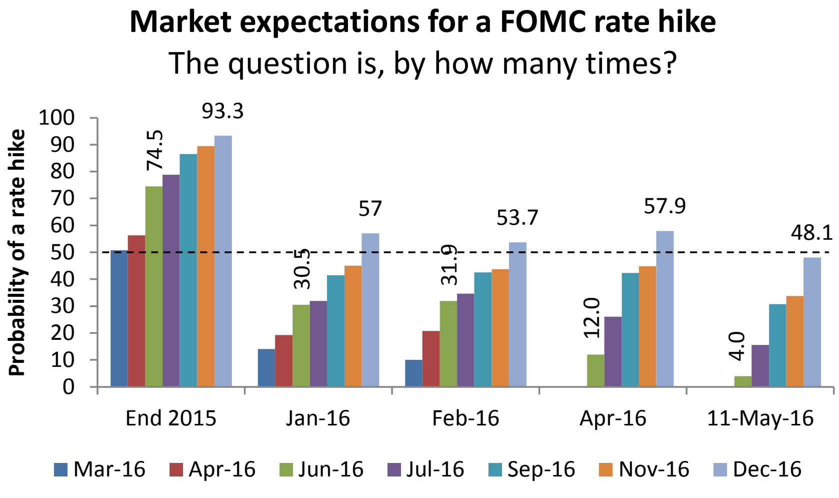
## Highlights

- A confluence of factors amassed to bring more glory to gold, chief of those is clearly attributed to the market's deteriorating expectations for a Federal Reserve rate hike this June. On this, paper demand seen from the surge in ETF holdings drove gold price higher.
- The 'sell-in-May and go-away' syndrome may increasingly take hold into late May (and spill-over to June), given the many wildcards in June, including the FOMC meeting, OPEC conference, and the Brexit referendum.
- All-in-all, despite the many moving parts, gold still remains as a quasi FX-commodity asset. As such, gold in value terms, would take substantial cues from how the dollar may trend, and the latter would be influenced largely by the prospect of the rate hikes that may pan out in 2H16.

### Whatever that glitters is good

The story for gold has not changed much since the start of the year. The bullion has maintained its strength, defying the calls by market bears for the yellow metal to fall in tandem with improving global economic fundamentals and consequently, higher interest rate environment. Indeed, gold, being a safe haven asset which yields no interest, would surely be shunned upon by interest-chasing behavior.

On the contrary, global economic fundamentals have not performed to how we had expected, leading to the surge in demand for safe haven assets. For one, the stock market volatility, led by Chinese growth concerns, falling global trade activity and weaker Asia-centric manufacturing space injected risk-off emotions. Elsewhere, the prospect of higher interest rates faltered, given the sustained negative interest rates policy by both the European Central Bank (ECB) and the Bank of Japan (BOJ). To seal off gold's fate as one of the top performing commodity since the start of the year would be the down-play of a Federal Reserve rate hike in June this year.

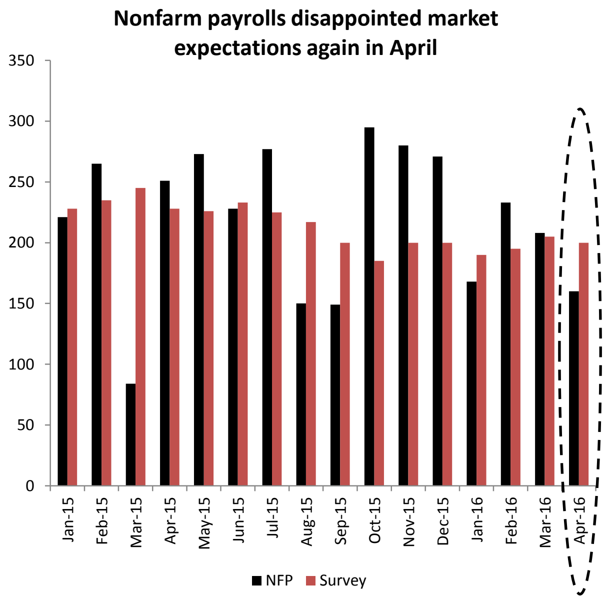


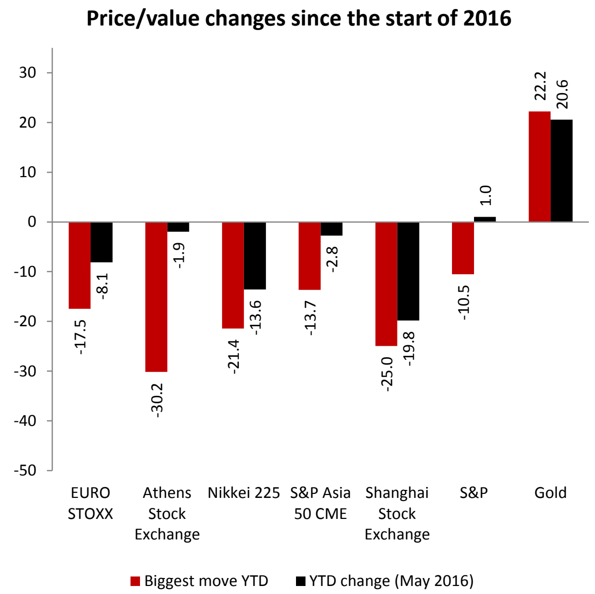

Source: Bloomberg, OCBC Bank

Suffice to say, the market has been increasingly discounting the probability of a Fed rate hike this year, seen from the latest implied probability by the Fed Fund futures curve in May. Statistically, a rate hike in June this year has fallen from a high of 74.5% back at end 2015, to a mere 4.0% at this juncture. Moreover, what was seen as an almost certain hike in December 2016 (93.3% probability back in end 2015) now has market-watchers penciling a less than 50% probability for a hike at the end of this year. This has clear implications for gold prices, given that the (1) the strength of the US economic growth has tapered somewhat as seen from a rather flattening Fed Fund futures curve, and (2) relatively weaker greenback as a natural consequence from lower for longer rates has left gold glimmering. Myopically speaking, with the FOMC meeting now around the corner, the increasing expectation for the Fed to stay pat on rates would almost certainly give gold a credible support level above its $1,250/oz handle.

**Wearing new glasses**

Given how dynamic (and unpredictable) the markets can be, we constantly need to don new glasses in order to re-evaluate future market conditions. As seen from the (1) recent poorer-than-expected US non-farm payrolls and higher unemployment rate, (2) slow recovery in global equity markets, and (3) sustained Chinese growth concerns, it is unsurprising to see the continued need for investors to yearn for safe haven assets.




Source: Bloomberg, OCBC Bank

Moreover, the various wildcards in June should also inject further risk-off sentiments into the global economy, and thus allowing gold to perhaps see some interim support at $1,250/oz. In this, we identify two wildcards that may continue to sustain gold prices till then.

First off will be the 169th OPEC meeting in June 2, an event that market-watchers would likely closely monitor. On this, much of oil prices would depend largely on the decision (or inaction) of the OPEC members to curtail the falling oil prices. Note that low oil prices at its sub-$30/bbl back in the start of the year had economic-recessionary undertones given that oil prices are generally considered as a barometer for economic health. Thus, the lift of oil prices, should OPEC members deem it necessary in June, may further alleviate growth concerns, encourage risk appetite and promote yield-seeking behavior once more.

Secondly, concerns over the Brexit outcome and the negative spillover effects into the global economy should increasingly take hold when we approach June 23 when the referendum is slated to take place. At the very least, many would agree that there are many negative consequences surrounding a Brexit scenario, given the loss of many benefits the EU brings to UK, including the risk of the UK losing its role as a gateway to EU as a financial and trade hub. Moreover, the global spillover effects are of a concern as well, with IMF commenting that the exit of Britain could "deal a damaging blow to the fragile global economy if it votes to leave the European Union". Bringing the argument back to gold, should a Brexit scenario occur, immediate growth concerns surrounding the UK and the negative spillover effects into the global economy would certainly lift gold prices on safe haven demand.

Annual impact of leaving the EU on the UK after 15 years (difference from being in the EU)

| | EEA | Negotiated bilateral agreement | WTO |
|---|---|---|---|
| GDP level (%) – central | –3.8 | –6.2 | –7.5 |
| GDP level (%) | –3.4 to –4.3 | –4.6 to –7.8 | –5.4 to –9.5 |
| GDP per capita – central[a] | –£1,100 | –£1,800 | –£2,100 |
| GDP per capita[a] | –£1,000 to –£1,200 | –£1,300 to –£2,200 | –£1,500 to –£2,700 |
| GDP per household – central[a] | –£2,600 | –£4,300 | –£5,200 |
| GDP per household[a] | –£2,400 to –£2,900 | –£3,200 to –£5,400 | –£3,700 to –£6,600 |
| Net impact on receipts | –£20 billion | –£36 billion | –£45 billion |

[a] *Expressed in terms of 2015 GDP in 2015 prices, rounded to the nearest £100.*

Source: UK Treasury

**A new outlook**

As what the former US Federal Reserve Chairman, Ben Bernanke said, "Nobody really understands gold prices and I don't pretend to understand them either," the yellow metal has many contradicting factors occurring at the same time. On one hand, gold has rallied substantially given the increased safe haven demand following market volatility and the wildcards in June. On the other hand, the market may also be under-pricing the Fed rate hike into 2016, given that the US economic growth still looks sustainable, while concerns over the managed slowdown in Chinese growth is perhaps overly-magnified.

At the very least, we continue to stay bearish on gold prices, given that our bearish view is largely underpinned by the expectations for the FOMC to hike rates further. Still, we concur that the probability for two rate hikes in 2016 is diminishing as we speak, as the timing get trickier as we approach June (given the wildcards mentioned) as well as November (US elections). On this, we perceive that the Fed will likely hike at least once this year given the information pieces we have at this juncture. Should the US labor market holds up amid healthier global economic cues, we may then see a possible second hike into the end of 2016.

All-in-all, we upgrade our gold price forecast to $1,200/oz at end 2016, from our initial outlook of $1,100/oz, given the diminished probability for the Fed to inject two rate hikes as indicated by the Fed fund futures. Moreover, the many events into 2016 may inject risk-aversion sentiments, led by the Brexit referendum, OPEC's June meeting and November's US election, thus giving safe havens like gold a shine.

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