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The right ingredients to a bullish bullion

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Highlights

- The general risk-off environment led by the Chinese growth concerns and lower oil prices had left market-watchers yearning to park funds in safe haven assets. Needless to say, they found safety in an asset widely known for such a role – the bullion.
- Gold did rally back to its $1,200/oz, as risky appetite turn acrid. We also recognise that the low gold prices seen in 4Q15 had in-turn persuaded lovers of physical gold to resume gold buying. Elsewhere, some weakness in the greenback seen from the start of 2016 also contributed to gold's shine.
- The key factor underpinning our bearish view for gold prices will still be the FOMC rate outlook for the year. Although global economic conditions still remain relatively austere, US-centric prints remains hopeful especially on the labor front, while inflation is likely to tick higher in 2H16 as transitory effects from low oil and import prices dissipate then.

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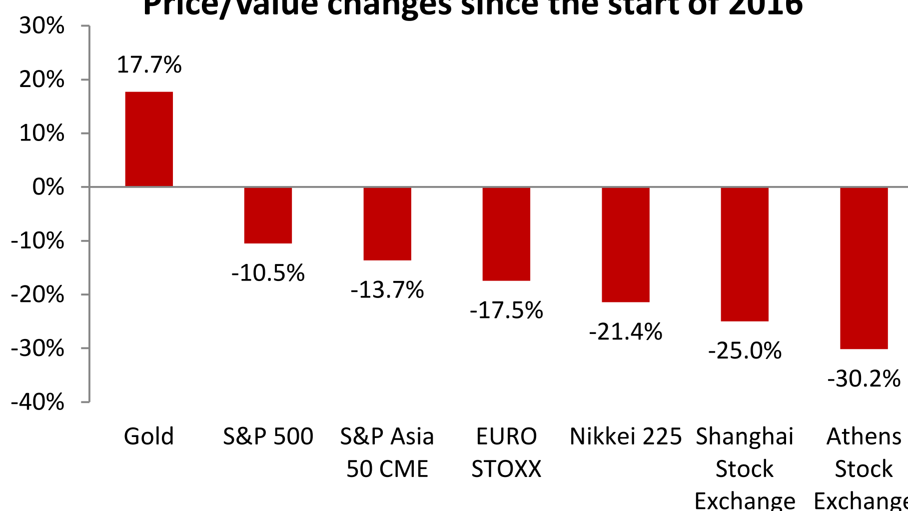
Gold, the superhero

Amid the global equity downturn, very low oil prices and magnified risk aversion seen since the start of the year, one hero stood up strong, providing shelter to those who believed in its safe haven characteristic. The asset in question is none other than the bullion, the yellow metal well known throughout history as a viable store of value, a hedge when all other asset classes lose their value. Essentially, it can be argued that gold as a currency, cannot be manipulated by the interest rate of any one government.



Source: Bloomberg, OCBC Bank

In this aspect, it is unsurprising that gold has rallied by almost 20% from the start of the year, to above $1,250/oz within the first six weeks of 2016 even as major equity bourses globally turn south. The statistics by itself is startling to the naked eye: Greek banks fell by a horrifying 60% (thus dragging the overall fall of 30.2% in the Athens

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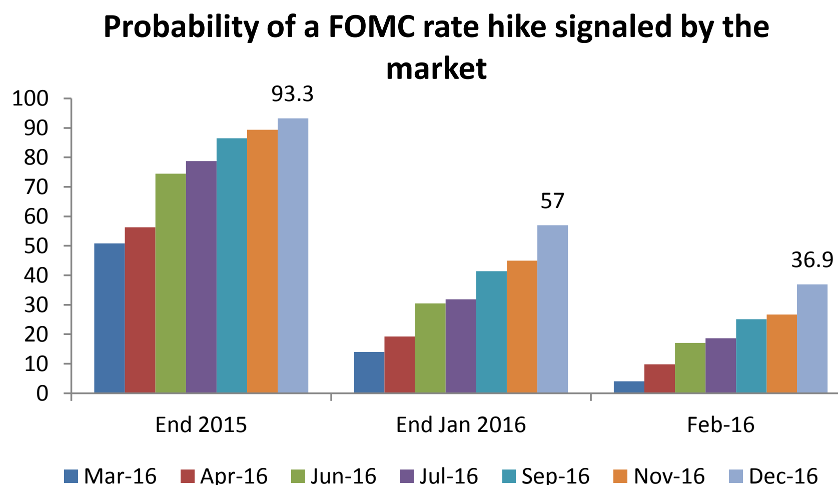
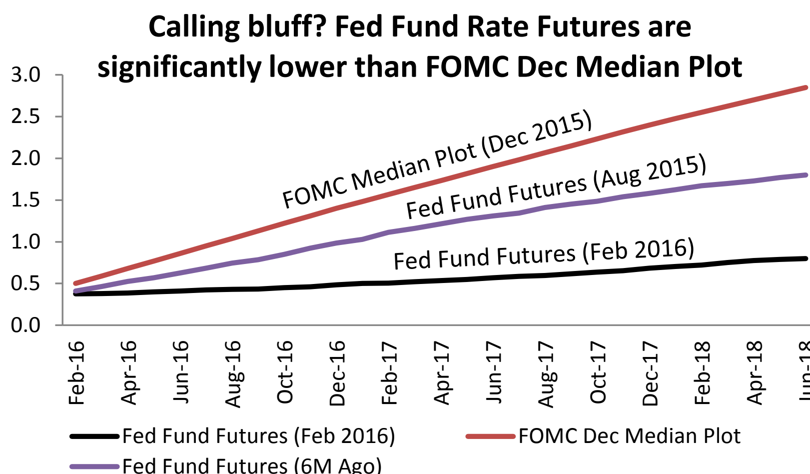
Stock Exchange), while financial stocks belonging to the US crashed 19%. Asian stocks were not spared either, dragging the S&P Asia 50 index[1] down by 13.7% while China's Shanghai Stock Composite lost a quarter of its value since the start of the year.

It is then, a simple behavior that has persisted through history – the amplification of risk aversion is expected to trigger sell-offs in growth-related assets like equities and crude oil, while traditional safe haven assets such as gold, the US dollar and the Japanese Yen are favored upon. At this juncture, though largely similar, has one key difference – gold has reigned to be the preferred safe haven asset while the dollar and the yen are ignored, stemmed from the recent monetary easing move to negative interest rates by the Bank of Japan (joining Denmark, Euro Area, Sweden and Switzerland for that matter) and weakening probability for the US Federal Reserve to hike rates further.

Still calling bluff!

The bullion has arguably seen a huge turnaround since the end of 2015, when expectations for further FOMC rate hikes were high, coupled with the actual pulling of the rate hike trigger in the December FOMC meeting. However, global growth concerns, weaker equity bourses, and overall weak oil prices had invariably shifted market expectations for further rate hikes in 2016. Statistically, back in late 2015, the market was pricing in a high 93.3% probability for a FOMC rate hike in their December 2016 meeting. The probability, signaled by the Fed Fund Rate forward curve, has shifted considerably lower to 36.9% in the latest reading.

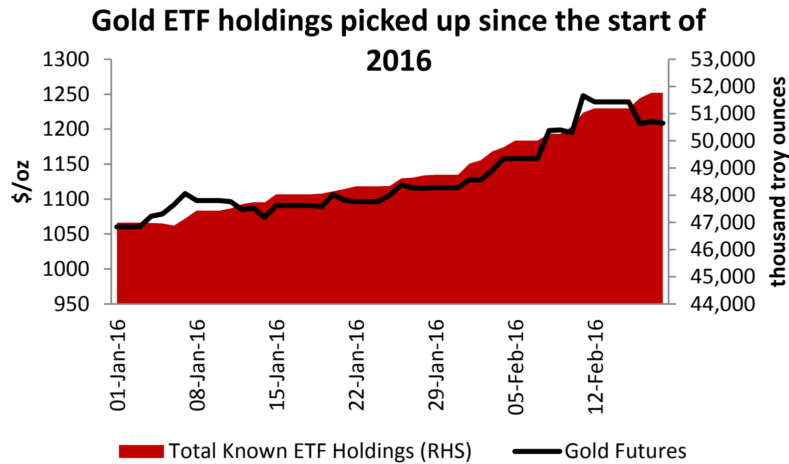




Source: Bloomberg, OCBC Bank

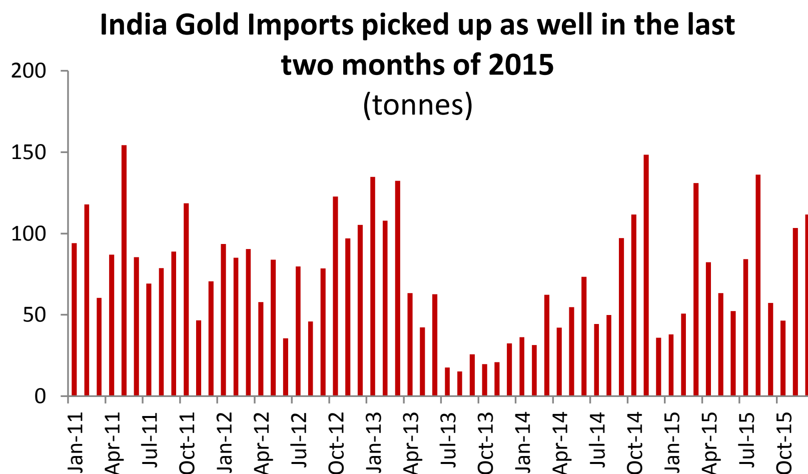
[1] The S&P Asia 50 Index constitute large blue-chip companies from Hong Kong, Korea, Singapore and Taiwan.

Needless to say, the ingredients for higher gold prices are almost tangible now, owing to the lower probability for a FOMC rate hike, weaker greenback and overall global growth uncertainty. Thus, the demand for gold as a safe haven has been strong, seen from the pick-up in ETF holdings as well as net-long speculative positions highlighted by CFTC.



Source: Bloomberg, OCBC Bank

Importantly as well, the relatively cheaper gold prices seen at end 2015 had persuaded higher physical gold buying in both China and India, the two largest gold consumers in the world.



Source: Bloomberg, OCBC Bank

Still bearish maybe?

It is true that our bearish outlook for gold is largely underpinned by our expectations for further FOMC rate hikes into 2016. Given the relatively rosier economic environment we once faced back at end 2015, we had expected that the Fed would inject three more rate hikes to an eventual 1.25% at end 2016. Should that come to pass, the higher interest rate environment and eventual stronger greenback were very persuasive drivers to drag gold prices to our year-end outlook of $950/oz.

On this, we recognise that there is a greater hurdle for the FOMC to hike three more times as per our initial expectation made in late 2015. The key wildcard is on global growth prospect, following the FOMC minutes' comments that "uncertainty surrounding (growth and inflation) outlook had increased as a result of recent financial and economic developments," while "medium-term projection for real GDP was only slightly lower" and "forecast for inflation in the near term was revised down slightly." These suggested that the increasing possibility for a downward revision in economic projections by the FOMC in their upcoming March meeting, and thus highlighted greater hurdle to raise rates into 2016.

Optimistically however, the recent FOMC minutes cited that "labor market conditions had improved further in late 2015", while "economic activity would expand at a moderate pace over the medium term and that the labor market would continue to strengthen." More importantly, the Fed chairman Janet Yellen revealed the need to be pre-emptive about rate hikes in her statement in Feb 2016, citing that any delay in policy normalization may result in the abrupt tightening of policy in the future.[2]

All-in-all, given the need for the Federal Reserve to remain pre-emptive over rate hikes, coupled with tangible economic growth seen in its labor conditions, we still expect the Fed to hike at least one rate hike this year, and possibly one to two more rate hikes following that should economic data prints favorably. Thus, together with the intensified global growth concerns and distinctively higher physical and paper gold demand seen since the start of 2016, we upgrade our gold forecast to between $1,000 (three rate hikes) to $1,150 (one rate hike).

[2] Statement by Janet L. Yellen, Chair Board of Governors of the Federal Reserve System, Feb 10, 2016.

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