Emirates NBD

Gold beating the odds

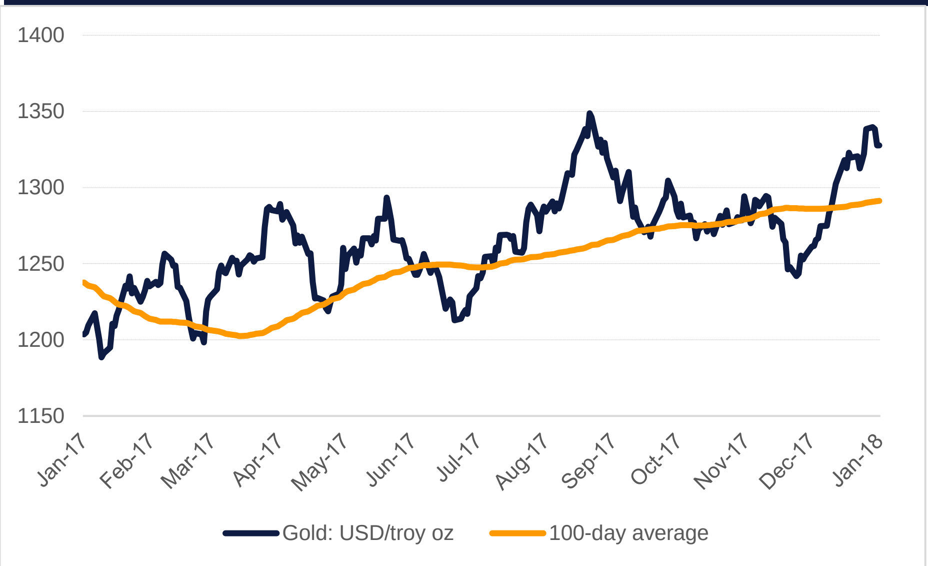
Soaring equity markets, monetary policy on a normalizing course in major economies and inflation stuck at muted levels. None of these dynamics make for a particularly compelling case for gold or precious metals. Yet gold has been trending solidly upward since December 2017—even absorbing a Fed rate hike that month without flinching. We are revising higher our outlook for precious metals as we expect the complex to benefit from investors anticipating unknown risks ahead this year.

Gold prices are up 2% year-to-date (ytd), taking silver and the PGMs along for the ride. Investors have been following gold's rise and have added considerable net long positions since the start of 2018—up 80% ytd thanks to large new long positions and shrinking shorts. Net length in gold futures in options is around 26% of total open interest, up from barely more than 4% in the middle of last year. Compared with palladium, where net longs are holding more than 70% of total open interest, gold looks far less crowded in one direction.

Commodities

18 January 2018

Gold prices moving higher



Source: EIKON, Emirates NBD Research.

What explains the improvement in gold prices in a market that should otherwise be negative for the yellow metal? We suspect a large amount of the interest shifting back into gold since Q4 2017 is due to some investors seeking to prepare themselves for an eventual correction in equity markets. Risk assets, including commodities generally, have carried over their strong 2017 performance into 2018 as economic growth in most major economies looks finally to be on a solid and sustained trajectory this year. This has helped push leading equity indices across North America, Europe and Asia into overbought territory on technical measures but identifying an inflection point for equities appears challenging while corporate results continue to outperform (see our Equity Weekly January 14 2018).

Good economic and corporate performance notwithstanding, political risks still loom large over the global economy. Geopolitical risks in the MENA region and North Asia remain high which may be catalyzing a pre-emptive flight to safety in gold. The threat of a government shutdown in the US amidst the ongoing Mueller investigation also pose negative external risk to markets. Precious metals may be the standout asset class if a black swan event takes down other risk assets, even if it remains difficult to pinpoint a single major threat to growth.

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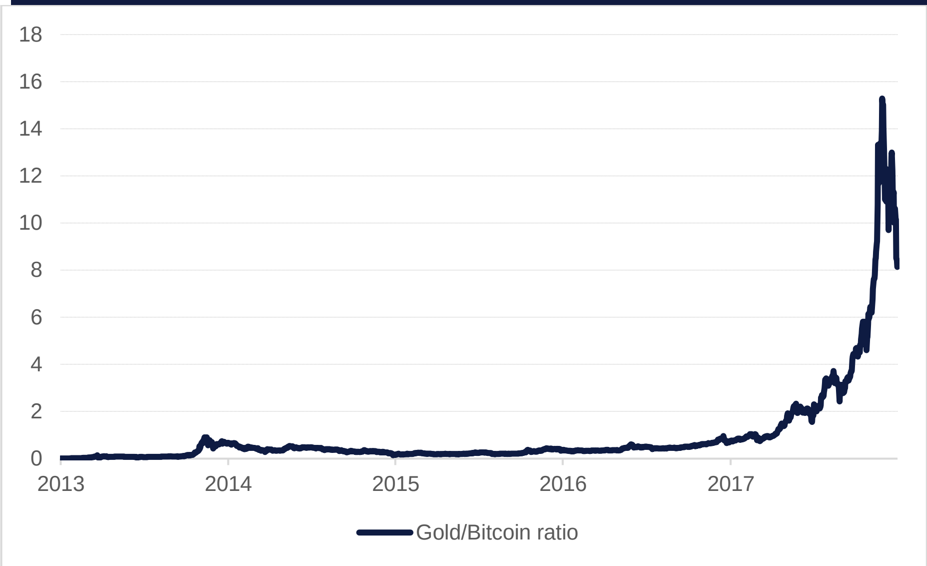
Gold, and precious metals generally, may also be getting a short-term boost from the implosion/explosion price cycle seen in cryptocurrencies. As both asset classes stand apart from traditional central bank-issued currencies, there is some cross-over in investor interest. But as a far more liquid store of value and with fewer barriers to entering (or more importantly exiting) trades, the precipitous drop in Bitcoin since the start of the year will help send some funds towards the precious metals complex.

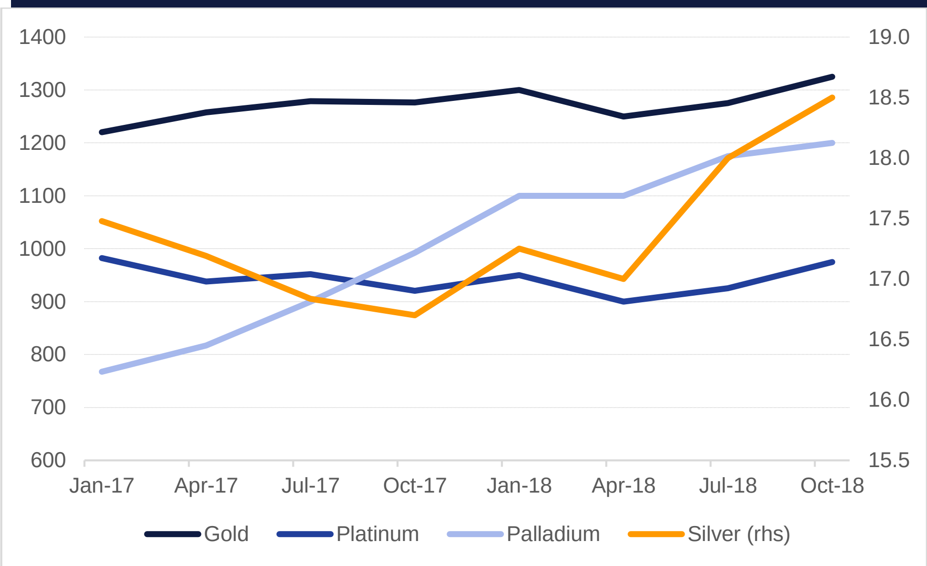
Gold to benefit from crypto declines?



Source: EIKON, Emirates NBD Research. Note: Bitcoins per troy oz gold.

We have revised higher our outlook for gold and precious metals prices in 2018, expecting to see modest gains for gold this year at an average of nearly USD 1,290/troy oz, as this trend of the market anticipating some risk event firms up over the year. We expect the Fed will follow through on its policy guidance, delivering as many as three rate hikes this year and for other central banks to move in the direction of more tightening. This is, to us, the major barrier for gold to overcome from a fundamental basis and we suspect it will drag on prices in the middle of the year.

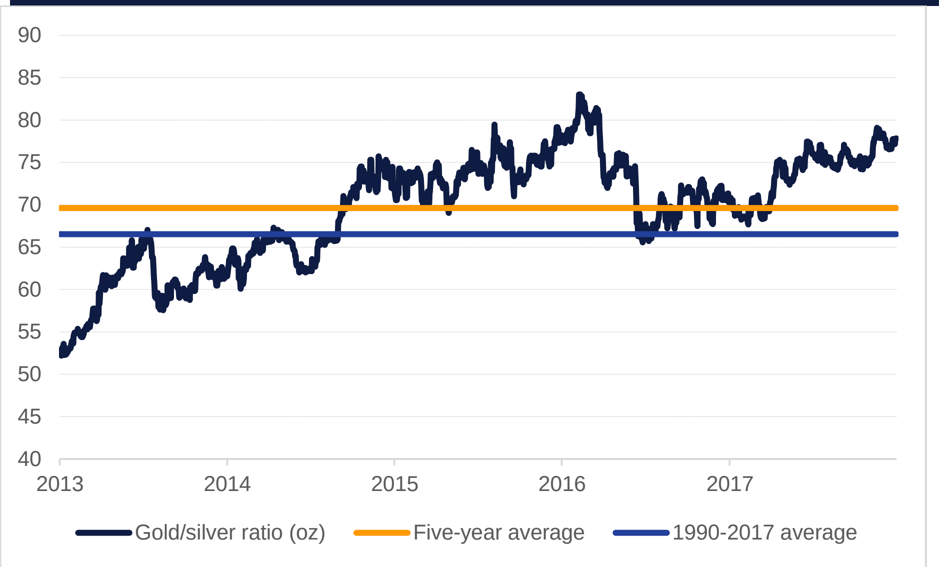
Emirates NBD Research precious metals assumptions



Source: EIKON, Emirates NBD Research. Note: Quarterly average in USD/troy oz.

There is also room for a technical correction in gold as it has moved sharply away from other precious metals, barring palladium which we see as a continued outperformer this year. The gold/silver ratio is well above historic levels, currently hovering close to 80 compared with a long-term average of around 66. Traditionally a divergence above long-term trends has been a signal gold traders are pricing in a market correction or elevated political risk: the ratio hit 83 in Q4 2008 during the height of the global financial crisis and moved to high levels during the initial stages of the 2003 invasion of Iraq.

Room for silver to catch up



Source: EIKON, Emirates NBD Research.

The current levels of the gold/silver ratio are probably more indicative of the relative undervaluation of silver which should be benefitting more from good economic performance than gold given its higher usage in industrial processes (roughly 60% of silver's demand comes from industry compared with around 10% for gold). We expect that silver will outperform gold this year, only slightly, and that it will average close to USD 17.70/troy oz for the year. We forecast that platinum will drift to an average of around USD 940/troy oz as diesel vehicles remain under pressure and switching from palladium to platinum by vehicle manufacturers will be less pronounced than the market currently anticipates.

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