Gold & trade update, its fear premium & positioning

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SUMMARY

- **The US decision to delay 10% tariffs on some imports is not a gamechanger but a small pullback in rhetoric that is enough to stem the aggressive inflows into "trade-off" havens such as Gold, Silver, US Treasuries and JPY & CHF; it should slow the ascent of Gold but does not change its course or the view that its in the early stages of it next cyclical run.**

- **Hong Kongs protests, Italys unlikely coalition government unraveling & Argentinas default risk soaring after primary elections, merely adds geopolitical & political fuel to some of the core drivers that emerged this summer that allowed gold to break free through $1350**

- **Gold continues to evolve between various hedges; that ability - to deftly internalize new (or recycled!) bullish drivers, while ignoring or bouncing back from the head-winds (extreme positioning, de-escalation in trade) - is usually a hallmark of bull markets.**

- **Investor holdings of Gold is at a peak of 100m oz (or $150bn worth), with the *pace* of accumulation since the China/US deal collapse also a record (+2.7m oz / week, and 8% above the past peak pace in 2016), posing some risks around positioning saturation.**

- **Bullish investors - fresh ETF & gross COT longs *(not short covering)* - are driving price action for the first time in 2 years; recent inflows are well ITM and long at a weighted average price of $1462 (3.3m oz of ETFs) & $1466 (4m oz of gross COT longs).**

- **The annual correlation since 2009 between Golds performance and investor inflows is +0.83; a simple regression model indicates that the current YTD Gold rally of 17% is a pretty fair price response to +24m oz of net investor inflows, in turn highlighting that the typical physical de-hoarding & selling is not much larger vs previous rallies.**

- **An estimate for Golds "fear premium" - the price for a rate cuts, trade & geopolitical risks - has risen to $160/oz from $110 after the July FOMC (given current US$ and real US yields); this 'fear premium' peaked at $700 in 2011 *(presumably with Golds nominal price peak of $1920, as markets priced in a European debt crisis, fear of inflation due to Global QE policies, and the US losing its AAA credit rating)***

1. GOLD & TRADE UPDATE:

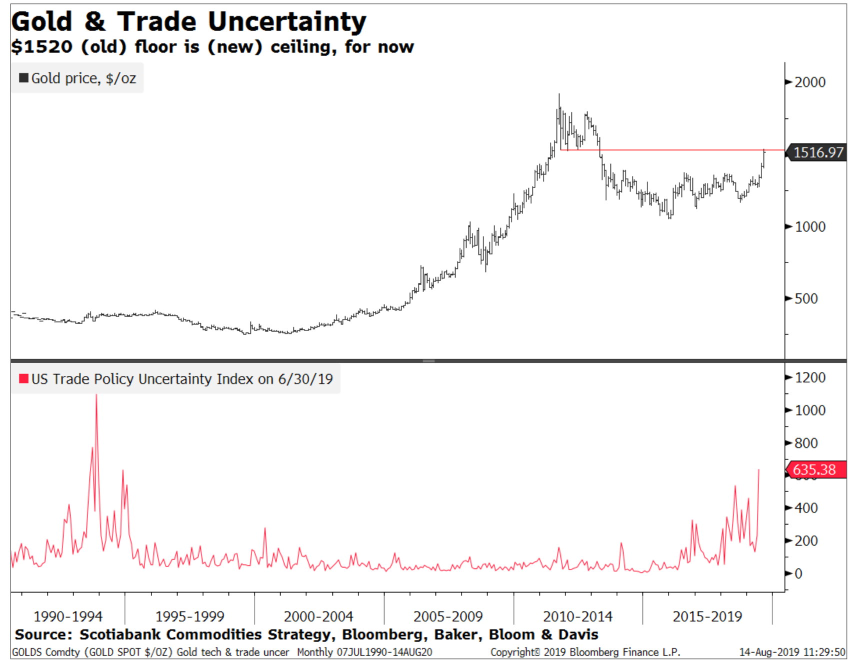
- The US decision to delay 10% tariffs on some imports is not a game-changer; it prompted a relief rally in risk assets (and arguably a cheaper buying opportunity in the traditional havens). Its a small pullback in rhetoric that is enough to stem the aggressive inflows into havens (for now?), but its unlikely to both solve deeper structural trade issues and to dramatically alter expectations over the larger impact on global growth and the Fed rate cut trajectory because:

  I. So far, key asset prices are saying so; US Treasuries and Gold haven't broken trend with 10yr yields not close to inflection point (~1.80%) and Gold bouncing off its short term support (at $1480)

  II. There are large differences between now and past instances of positive trade (e.g: G-20 Nov '19), given renewed geopolitical/ political risks (HK, Argentina/EM, and Italy) and the threat of a currency war (a much weaker yuan; other CBs aggressively counteracting the Fed)

  III. The medium - thee tweet itself - is increasingly more powerful (and the problem), because of the uncertainty it creates around whether, at any second, it could upend supply chains. That in and of itself, weighs on investment and hiring decisions

- Hong Kongs protests, Italys unlikely coalition government unraveling & Argentinas default risk soaring after primary elections, merely adds geopolitical / political fuel to some of the core drivers that emerged this summer that allowed gold to break free out of its 6-year bear cycle. See our recent note here. Gold continues to evolve between a trade policy hedge (the collapse of US/China trade deal in May 2019), a rate cut hedge (the lead-up to the July FOMC providing the green light for other CB to follow suit), a currency war hedge (earmarked by the yuans 7-breach) and finally a geopolitical hedge (10 weeks of Hong Kong protests which have morphed from opposition of an extradition bill to broad-based anti-government/pro-democracy protests); that ability - to deftly internalize new (or recycled!) bullish drivers, while ignoring or bouncing back from the headwinds (extreme positioning, de-escalation in trade) - is usually a hallmark of bull markets. Gold has hit that mark, up 21% since its Q2'19 low.



2. GOLD POSITIONING

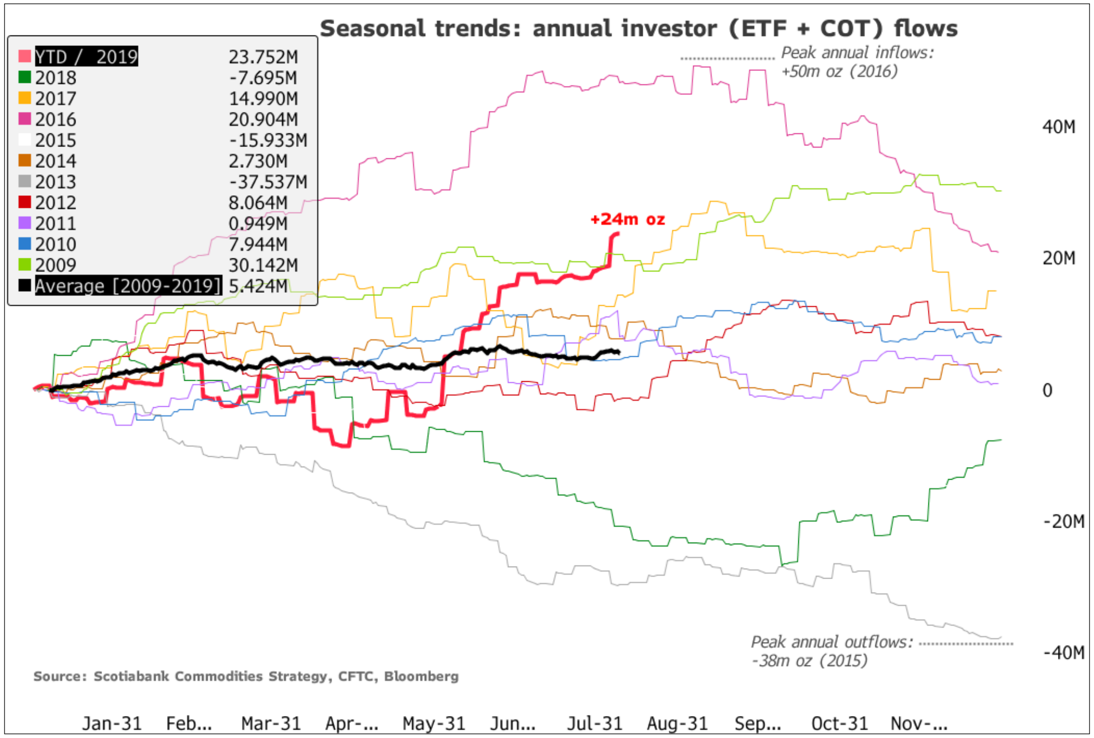
- Recent investor inflows into Gold has been stellar and a core driver behind prices rallying through $1500 to new 6-year high, with currently 100m oz sitting in ETF and net COT* holdings (~$150bn), a record high. Given both the strong inflows and peak holdings, the below explores a few themes related to the risks around positioning saturation and analyzes whether the price response was fair as a clue into other unknown (OTC) flows. Graph 2

- So far in 2019, investors (ETF + COT) have accumulated almost 24m oz. All of these strong inflows occurred since the end of May 2019 with 27m oz being bought, bringing net investor holdings back into positive territory on the year, as exchange participants acknowledged gold as a viable trade & geopolitical tension hedge ahead of an expected Fed cut.

- The *type* of inflows were rather diverse -- ETFs accounted for ~25% (+6.6m oz) of the total ~27m oz inflows since May'19, fresh COT length/new longs for almost 49%, while short-covering represented only ~27% (or 7.1m oz) of the flows. That is both constructive (short covering rallies in Gold are historically short-lived) and interesting (bullish investors - fresh ETF & gross COT longs - are driving price action for the first time in 2 years). The recent inflows into Gold over the past month highlights that ETF holders are long at a weighted average price** of $1462 (3.3m oz), while paper longs (COT) own Gold at an average of $1466 (+4m oz).

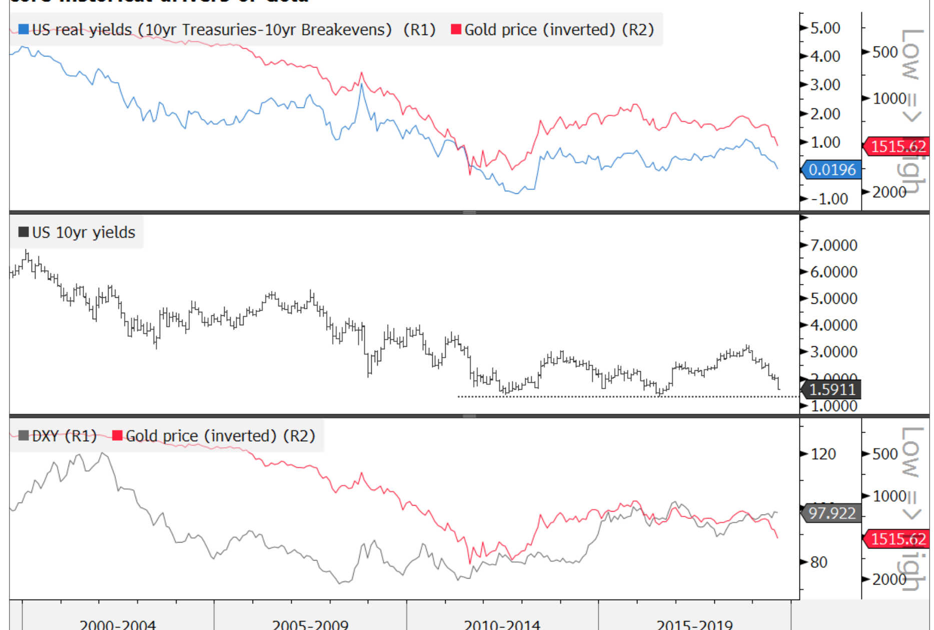
- The *pace* of 27m oz being accumulated over 10 weeks is also a record; investors have accumulated on average +2.7m oz / week, 8% more than the 2nd largest pace of investor accumulation seen in Q1'16. However while this recent ~3mo pace of Gold accumulation is extremely strong, its still half of much as peak annual inflows seen in 2016 (where ~50m oz was accumulated over a similar time period)

- A simple regression model of data from 2009 - 2018 shows that 1) the annual correlation between Golds annual performance and investor inflows is +0.83, 2) given YTD/2019 inflows of 24m oz, Gold prices should rise by 19%. Gold is up 17% YTD, and thus through this lens, is a pretty fair price response, highlighting that the typical physical de-hoarding & selling is not much larger than previous rallies.



3. FEAR PREMIUM UPDATE:

- In a recent note we attempted to roughly quantify how much of a "rate cut/ trade/geopolitical" fear premium Gold is pricing in, using only its two long term core drivers (the $, and real US yields***). After the Feds hawkish cut on July 31st, and given the $ strength and shift in real yields then, Golds "fear premium", was $110. Currently, with real yields basically flat and DXY at 97.50, this premium has shifted to $160 due to escalating geopolitical/political risks (graph 3). Table 1 outlines where this historical 'fear premium' peaked, at $700, presumably when nominal Gold prices peaked of $1920 in 2011 as markets priced in a European debt crisis, fear of inflation due to global QE policies, and the US losing its AAA credit rating.



Source: Scotiabank Commodities Strategy, Bloomberg

USGG10YR Index (US Generic Govt 10 Year Yield) 10 year real vs Gold 3 Monthly 1 Copyright© 2019 Bloomberg Finance L.P. 14-Aug-2019 11:37:57

**net managed money positioning (gross managed money longs - gross managed money shorts)*

*** weekly changes in COT & ETF flows from July 9 - Aug 13 2019, priced up against the weekly Gold settlement price*

**** DXY, and real 10 year yields (US 10yr Treasury yields - US Break evens) using a simple regression model over a 10 year time period up until May 2019*

2009 - 2011 (current)				2001 - 2011 (past Gold peak, $1920 in Aug 2011)			
	Real US 10 Yields*	DXY	Nominal Yields		Real US 10 Yields*	DXY	Nominal Yields
10year monthly Correlation with Gold	-0.71	-0.45	-0.43	10yr monthly Correlation	-0.71	-0.71	-0.70
Gold with real yields at +0.05 (current)	$ 1,420			Gold with real yields at +0.15 (Aug '11)	$ 1,431		
Gold with DXY at 97.50 (current)	$ 1,216			Gold with DXY at 74.1 (Aug 2011)	$ 1,006		
Weights Real Yields/DXY	0.61	0.39		Weights Real Yields/DXY	0.50	0.50	
Gold with DXY/10yr weighted (40% DXY, 60% real)	$ 1,341			Gold with DXY/10yr weighted (50% DXY, 50% real)	$ 1,219		
Fear premium*	$ 159			Fear premium*	$ 702		
Current Gold price	$ 1,500			2011 Gold peak price	$ 1,920		

*10yr US Treasuries - 10yr Breakevens

Source: Scotiabank Commodities Strategy

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