Macro Update - risk assets aren't going to be 'patient' for the Fed

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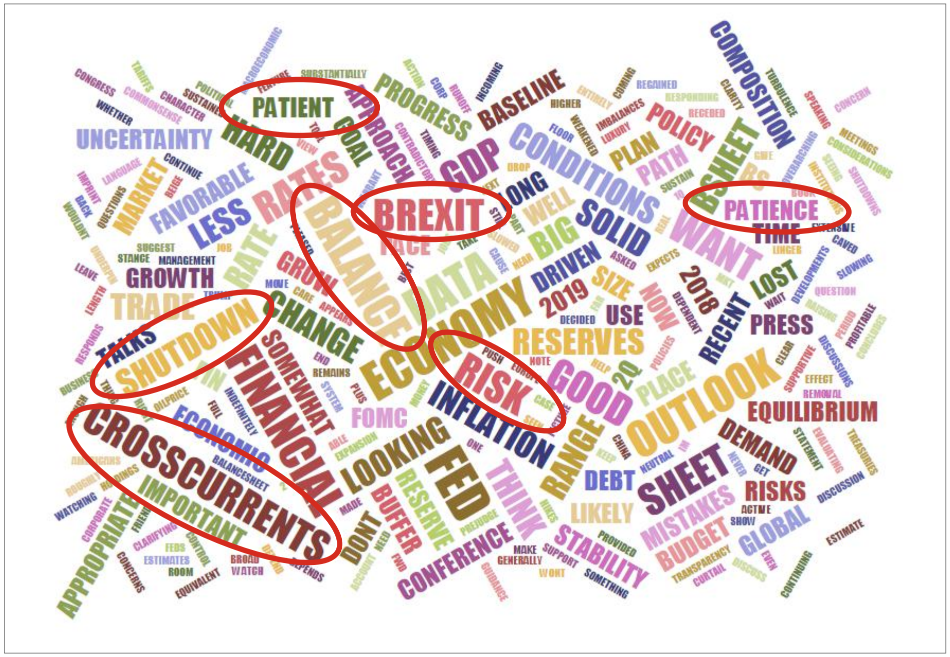
The Fed combined a dovish statement, solidified the idea of being patient (indefinitely?) on rates and confirmed they're willing to adjust the Balance Sheet reduction. Theres overall stagnation around the US government shutdown, trade tariff negotiations, Brexit and now the Fed. For a year (well, Q1'19) that was supposed to shape up to be more uncertain and more volatile than before given broad macro question marks, the Fed just put cherry-topped it by basically "getting out of the way". The market is eerily complacent despite underlying threats and unresolved disputes and that's seems OK, IF the Global CB provides the dovish greenlight in which risk and rate sensitive assets can capitalize on. Theres plenty of market commentary sifting through the Fed & statement, but below looks at this decision largely through the following lenses:

PAGE:

2. **Gold: the end of the cyclical bear market is near**
3. **Base & White Metals - > stabilization in EM/DM relative pricing aiding a floor in the more industrial / riskier metals?**
4. **2016 = 2019. Whats performed best during the last *sustained* Fed pause?**

How many times did Powell mention "patient" and "cross-current"?

Word Cloud of Powells Press Conference (Top Bloomberg headlines only*)



*80 red/top headlines analyzed (e.g..: *POWELL: FOMC DECIDED RECENT DEVELOPMENTS WARRANT PATIENCE)

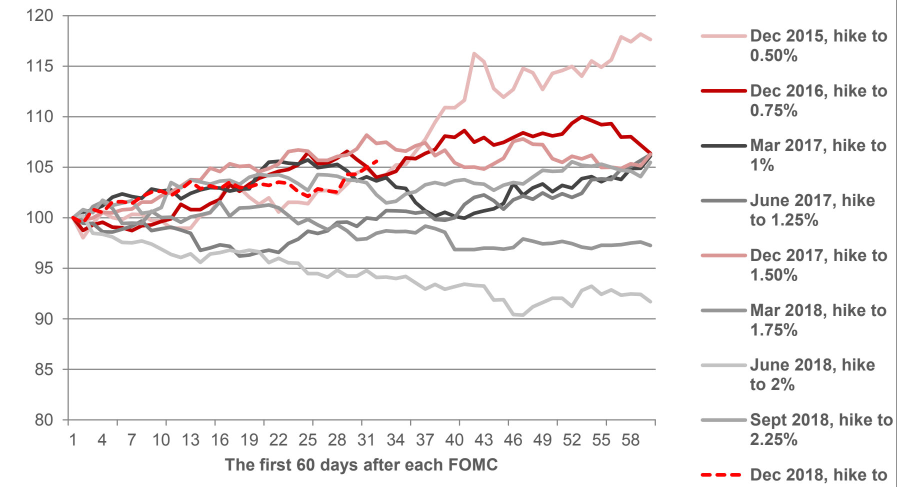
Source: Scotiabank Commodities Strategy; Jason Davies Word Cloud, Bloomberg

1. Gold: the end of the structural bear market is near?

The title above stems from a few constructive drivers and inflection points (listed below), but one needs to recognize that bull and bear markets take months (not weeks), and not 1 moment, to turn….

- Tactically, Gold has been trading rather bid INTO this past FOMC (which is unlike previous meetings, in which it weakened in the lead up to each Fed meeting and was bought after). Secondly, investor positioning has convincingly turned from flat-or -net short to net long (if Gold OI is a proxy for the missing / delayed COT data and ETF inflows). Thirdly, technical momentum is mildly bullish (not downward sloping) and holding
- Structurally, hard-to-define long-term issues, which *could* be Gold-centric, are increasingly in the limelight and now *are* being cited as soft drivers of the recent rally. Themes such as US & Global debt levels, political & trade standoffs/truces & gridlocks, backlashes over protectionism; the rise of MMT (Modern Monetary Theory) & rising taxes, inflationary policies, de-dollarization policies,and geopolitical re-alliances, etc

Golds short-term performance after each Fed hike - December hikes usually mark a bottom



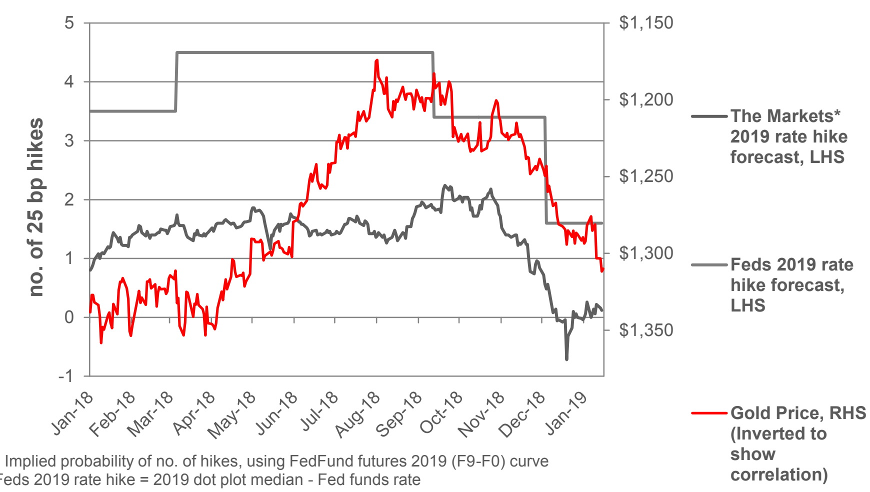
*Prices indexed at 100 at the start of every hiking FOMC

Source: Scotiabank Commodities Strategy, Bloomberg

Thus, when the Fed dovishly pauses, allowing the $ to remained contained-to-lower, all real assets rise as they begin pricing in typical late cycle plays. The 2 graphs outline some key concepts supporting the thesis of new higher floors in Gold

- **December hikes have historically been generally mildly bullish Gold** (up between 5-20% in the first 60days after a December hike). Currently, we are half way through that post 60day period and 'in line' with the pattern. Gold shifted from being in a bull market (2009-2013) pricing in *known* Quantitative easing measure, to a bear market (2013-?) pricing in unknown quantitative tightening; It now needs to decipher how to trade a prolonged (indefinite?) pause…
- The market has shifted its expectations down to zero hikes for 2019 (from 4,m 6moonths ago), which the Fed will most likely 'confirm' at their March FOMC; will rate cuts bleed into the markets 2019 forecast...
- **The Fed readily responded to a lack of liquidity and an added dose of equity market volatility (December 18), with more liquidity** (by communicating that the Fed Balance Sheet runoff is slowing and the BS normalization process can pause). Refer to last Friday piece—4 charts we're watching— showing the global CB Bal Sheet 'pause' (and potential re-swelling) is supportive Gold and highly corrected with sticky ETF inflows.

Pre-FOMC 2019 hike expectations: The Fed (~2hikes) vs the Market (no hikes) .... The Fed follows



* Implied probability of no. of hikes, using FedFund futures 2019 (F9-F0) curve
Feds 2019 rate hike = 2019 dot plot median - Fed funds rate

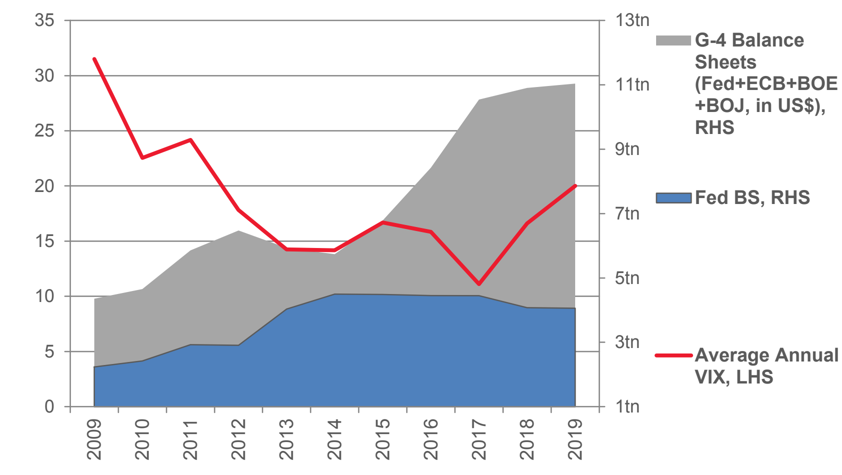
Source: Scotiabank Commodities Strategy, Bloomberg

2. EMFX and Base Metals

Overall, if you're of the belief that the Feds decision is simply contingent on the last months SPX performance, the risk was for a hawkish tilt. That didn't occur and there were (unsurprisingly) quiet a few questions around the now un-implied Powell Put.

In theory, under owned high-beta assets should outperform Gold in a risk-on overreach for yield environment, in which the threat of a slower BS unwind could work to suppress average volatility (graph 1). That supports the repricing higher of EM assets (little wonder the high flying EM currencies like ZAR, TRY & BRL put in solid gains post FOMC), and graph 2 begins to hint at some stabilization in EM/DM relative pricing aiding a floor in the more industrial / riskier metals. The next section tests just how these risker metals like the whites (Silver & PGMs) and base metals should perform during the last known sustained rate pause (2016) as a simple reference.

Swelling Global CB Balance Sheets associated with suppresed volatility



Source: Scotiabank Commodities Strategy, Bloomberg

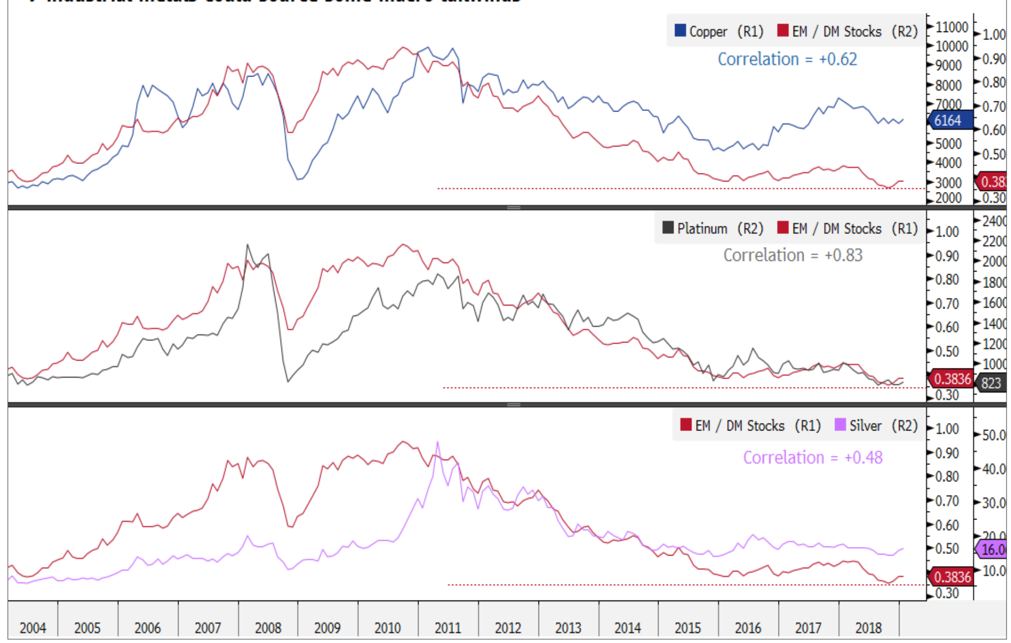
	Rolling Monthly correlation with EM / DM Stocks*
Palladium	-0.54
Zinc	-0.32
LiveStock	-0.29
Gold	0.24
Precious	0.33
Ali	0.52
Silver	0.56
Base Metals	0.56
Energy	0.58
Commodities	0.59
Copper	0.62
Ags	0.64
Nickel	0.83
Platinum	0.84

* MSCI Emerging Markets Index / SPX Index

*** All sub commodities group reference the S&P GSCI subgroups*

Source: Scotiabank Commodities Strategy, Bloomberg, MSCI, S&P GSC

EM vs DM: IF the cyclical floors are in?
--> industrial metals could source some macro tailwinds



3. 2016 = 2019?. What performed best during the last *sustained* Fed pause?

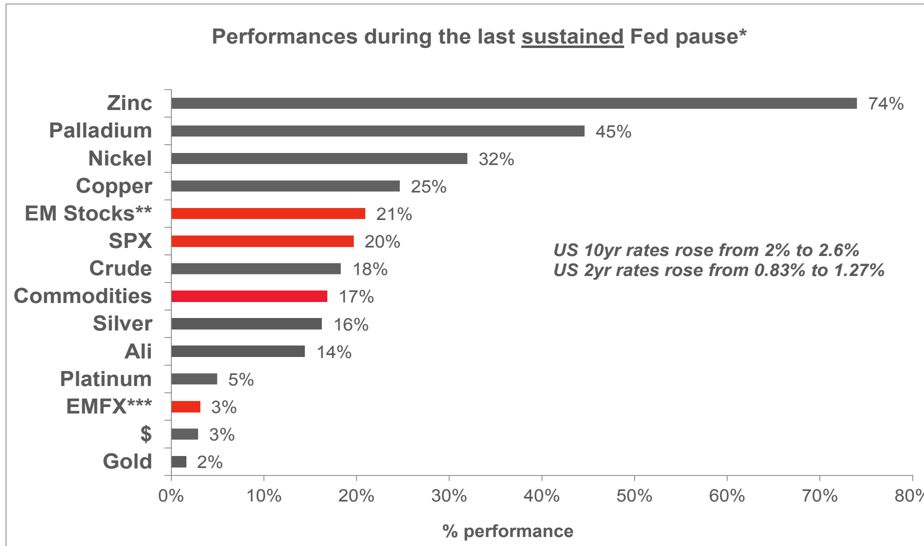
Parallels between the pullback in 2019 rate hike expectations and the sustained 2016 pause were drawn throughout Q4'18, thanks mostly to a similar price collapse in oil prices. The Fed included in their Dec FOMC statement, 2016-like cautionary statements but that wasn't enough to placate markets which deemed the 2 hikes expected from them in 2019 (vs 3 previously) as "not dovish enough". However, recent Powell & Fed speeches and yesterdays FOMC perceivably have caved to 1 "red month" (Dec'18) and Trump; now the Fed has swung from 4 rate hikes in a year to basically none (AND a lowdown in Balance Sheet unwind!). That's a similar shift in policy expectations vs the pullback in rate hike expectation seen in Q1'16 (1 Fed hike in Dec 2015; extreme equity & oil collapse in Q1'16 followed by no rate hikes until Dec 2016). Powell even implicitly called out the link, oils role (alongside other "crosscurrents") — RECENT OIL-PRICE DROP LIKELY TO PUSH INFLATION DOWN. As a sidenote, I think inflation expectations are going UP (Gold, 10/30 yield curve, more regulation & tariffs, Iron Ore), but that's a topic for another note….

Graph 1 is a simple top-down analysis highlighting the best performers during the previous sustained Fed pause (Jan 16-Dec 16):

- **High beta industrial metals were the clear winners with Copper Palladium Zinc and Nickel putting in rallies from 25-75%**
- Gold was dragged up, but hardly matched performances across riskier real assets
- Event the $ put in mild gains, and EM stocks slightly outperformed DM

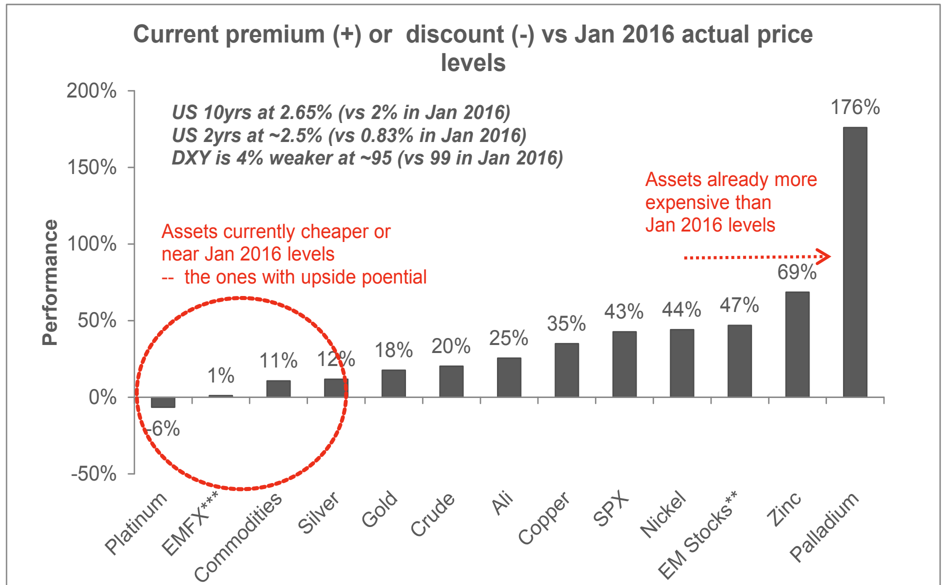
HOWEVER, this needs to be read in conjunction with graph 2, since many assets are currently not priced at 2015 deflationary levels:

- Commodities as a whole are 11% more expensive than Jan 2016 levels, but with 17% of upside potential, theres still room to extend (+6%). Specifically:
- **Platinum & EMFX are either cheaper or around Jan 2016 levels placing them as top contenders for a rally from a relative price perspective**
- Palladium has overshot Jan 16 levels (by almost 176%) and its Fed pause rally (by ~130%) arguing for a pullback (but one needs to factor in its individual fundamentals)



*Jan 27 2016 FOMC pause to Dec 18 2016 hike
** Emerging Market ("EEM") ETF
*** JPM Emerging Market Currency Index

Source: Scotiabank Commodities Strategy, Bloomberg



Source: Scotiabank Commodities Strategy, Bloomberg

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