Gold: Rate cuts are on

CONTACTS

Nicky Shiels
Commodity Strategist (Metals
212-225-6724
Commodities Derivatives
nicky.shiels@scotiabank.com

The Fed is preparing for its first rate cut in over a decade on Wednesday, marking an important macro week as they try to further explain why they have flipped from peak hawkish (envisioning 4 hikes in 2019), to an easing cycle (with 3 cuts priced in 2019), in just over 8 months. Gold & silver should remain supported (albeit rather jittery) into the FOMC, given the outlook and strong expectations of a 25bp cut alongside hopes of a 50bp cut. With 25bp essentially a done deal, but no dot-plot to guide a market that is pricing in 2 additional cuts this year, the narrative around the path of easing, alongside the timing around the end of Balance Sheet normalization, will be key.

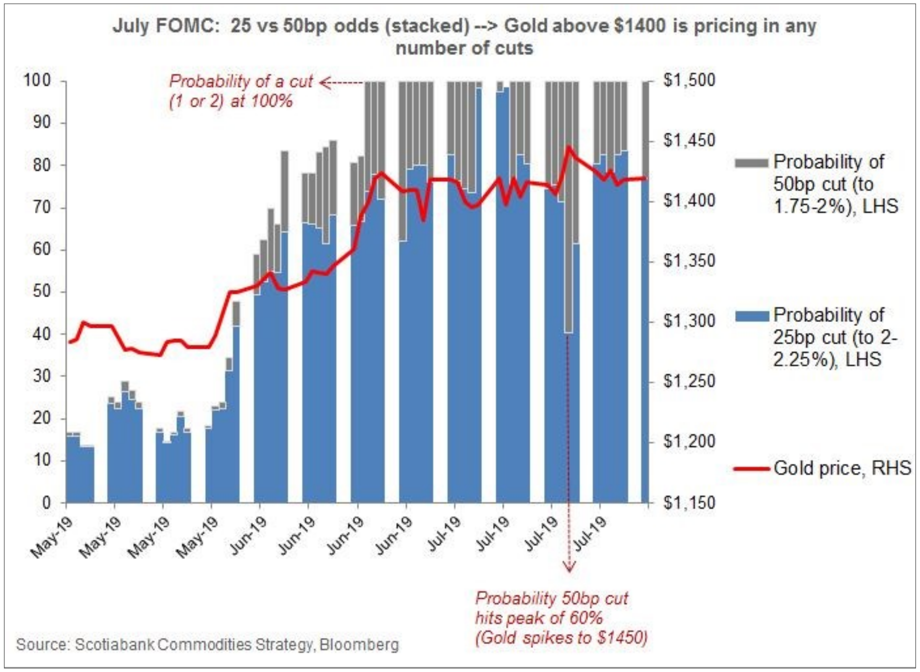
SUMMARY

- **Downside Gold risks = no hint of further 2019 cuts, more than a few hawkish dissents, outlook dependent on US data . That hawkish interpretation would be worth some weakness through $1400 (-2%), but is *not* a game changer (at least too early to tell) for Gold to revert to bear-market status as 1) Trade/ geopolitics - arguably the Feds new reaction function - has not been resolved, 2) A large Fed disappointment will inject macro fear & fresh Gold inflows, 3) "Gold is smart" & technical repricings aligned with a cyclical shift in Fed policy should be respected**

- **Upside Gold & Precious risks = An early BS runoff, dovish Powell to overcompensate any dissenters, language & outlook trade (not data) dependent. A dovish Fed cocktail is good for Gold, but tactically great for white metals; they could attract in the 'FOMO crowd' who missed the last $100+ (in Gold) seeing better risk-reward profiles in reflation metals, especially given the likely Goldilocks scenario for risk assets (US equities to extend gains). Thee outlier - an 'all-in' 50bp cut - would ensure $1450 is the new Gold floor.**

- **Gold rate cut positioning: Since a 50bp cut shifted from being a small tail-risk to a credible risk, its drawn in strong Gold inflows (~19m oz); participants are long at an average of ~$1410, providing some downside risk & caution.**

- **The divergence between US$ strength and precious (resiliency) is becoming notable and stretched. However, the $ and gold *can* rally together when yields are low, theres macro fear and/or currency-specific drivers (Brexit, global easing, threat of FX intervention etc)**



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Downside Gold risks = no hint of further 2019 cuts, more than a few hawkish dissents, outlook <u>US data</u> dependent

- The downside risk for Gold, given the recent strong investor inflows (see pt 3) on super dovish 50bps 'hopes', is that they lean toward *one* insurance cut (a "one-n-done") and play up being US data dependent *(which arguably isn't the case!)*. The expectation & positioning – of another 2 rate cuts in 2019 - would be unwound, pushing yields higher, Gold lower & $ higher, initially.

- Graph 1 highlights a rough $1400 floor associated with 100% odds of any - 1 or 2 - cuts. Thus any hawkish interpretation could be worth some weakness through $1400 (-2%), but into a buying opportunity; i.e: a slightly hawkish Fed is *not* a game changer for Gold (enough for Gold to revisit the old bear-market range below $1350), for now, because :

    ⇒ **Trade/geopolitics - arguably Feds new reaction function - has not been resolved.** Even with US /China trade talks kicking off this week (for the first time since the US/China deal collapsed in May) adding to headline risk over FOMC, expectations are extremely low for any concrete positive progress to be made; the two superpowers are still far apart on structural issues. Arguably then, if the Fed provides an 'insurance cut' in response to global uncertainties/trade, the US has little incentive to work out a deal before November 2020. That was the message hinted at last Friday - a US/China trade deal is the carrot that is potentially held over voters (and the Fed) until after US elections -> Trump: "China will sign deal 'almost immediately' after 2020 win"

    ⇒ **A Fed that (really) disappoints this time around will inject macro fear:** Markets have consistently set a high dovish bar for the Fed this year, BUT they have repeatedly met expectations *(SPX is your barometer)*. However, in the event theres a risk tantrum (as was the case in December 2018 after Powells hawkish commitment to further rate hikes and "autopilot" QT) after tomorrows FOMC, any sustained equity market volatility will fire up the larger under-invested generalist investor.

    ⇒ **"Gold is smart" / "what does the Fed know":** the dovish Fed pause in January 2019 (flipping from the Dec '18 FOMC) was arguably well timed ahead of a further slowdown in the global economy, especially in the manufacturing sector *("did what the Fed know")*. A similar example is Gold prices preemptively broke down sharply out of its bull market cycle in Q2 2013, 1 month before Bernankes pledge to taper QE, triggering the bond market taper tantrum *("Gold was smart").* Technical repricings, in an asset class that is contingent on unknowns that seem to show up after the fact, should sometimes be respected. Graph 2.

Golds technical break

Monthly GLD chart; $1350 the new $1520?

Source: Scotiabank Commodities Strategy, Bloomberg

2. Upside Gold & Precious risks = An early BS runoff, dovish Powell to overcompensate any dissenters, language & outlook trade (not data) dependent

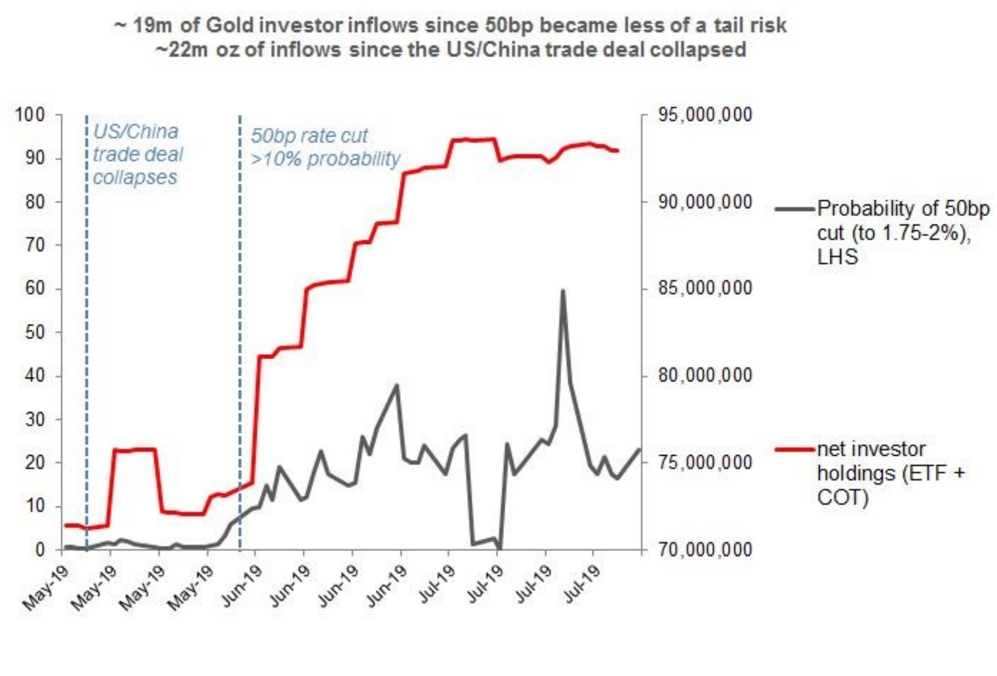
- **A dovish cocktail good for Gold, great for white metals:** That would entail something like a 25bp cut, language guiding to further cuts this year and an early Balance Sheet runoff. The current shrinking of the Feds BS (which is set to end in September) is a form of tightening and runs counter-intuitive to a rate cut, so ending this early to align with the general easing bias makes sense. That invites the Fed back as a persistent buyer of Treasuries in the open market, adding fuel to the "lower for longer yields" mantra. A dovish cocktail supports a structural bullish Gold (and precious) story; however, given this is likely a Goldilocks scenario for risk assets with US equities likely to extend gains, tactical upside potential is more visible in high beta Gold proxies like (under-owned) Platinum & (oversold) Silver, as they attract in the 'FOMO crowd' who missed the last $100+ move in Gold. Improving data (in 2H'19) and ultra dovish global CB policies simply support being long reflation precious metals while the overhang of trade uncertainty trumps any optimism in the base complex, for now.

- **Thee 'all-in' 50bp would ensure $1450 is the new floor:** The reasoning for a big 50bp cut is 1) it'll have a larger impact, if front-loaded given the current low rate environment, 2) its not uncommon for the Fed to begin an easing cycle with 2 cuts (2007, 2000), 3) while US data has improved since the last FOMC (GDP, jobs, core PCE, financial conditions/US stocks at ATHs), trade risks and global growth has deteriorated (IMF recently downgraded global growth, no headway being made in US/China talks worsening the manufacturing outlook), and 4) a sense of "what does the Fed know" (the dovish Fed pause in January 2019 was well timed ahead a further global economic slowdown).

3. Gold technicals, positioning, & rate cut premiums

- **Strong inflows long at ~$1410:** There has been ~19m oz of (known) Gold investor inflows* since the 50bp cut shifted from being a small tail-risk (<10% probability before June 19) to a credible risk (20-60% probability mid June to mid July '19). Graph 3. These investors are long at an average of $1409/oz and thus are still mildly ITM, but not by much. While we believe generalist investor is underweight, strong fast money inflows ahead of the FOMC provides some downside risk if $1410 breaks, opening up the series of recent lows and support at $1380/90.

- **Strong $, strong Gold, weak fiat:** with the DXY remaining perky and DXY through 98 (almost YTD highs), the divergence between US$ strength and precious (resiliency) is becoming stretched. Running a simple regression over a 10 year time period up until May 2019 (the geopolitical turning point we've cited), indicates Gold is pricing in a $110 "rate cut/trade/geopolitical" premium**. The Gold/$ divergence (and Gold 'premium') can probably be sustained as long as 1) US yields remain subdued, 2) the driving force behind $ strength is a risk-off micro currency story (risk of a no-deal Brexit rising), 3) global CB collectively ease / turn dovish in response to tomorrows decision, diminishing the appeal of most fiat currencies, 4) the threat (albeit low) of US currency intervention continues to overhang the market, 5) theres the potential threat of macro fear/equity market volatility



Source: Scotiabank Commodities Strategy, Bloomberg

**Cumulative ETF and net COT holdings*

*** Monthly Correlation between Gold & DXY, May 2009-2019 = -0.71. Regression formula: Gold = 2243.5 - 10.5(DXY)*

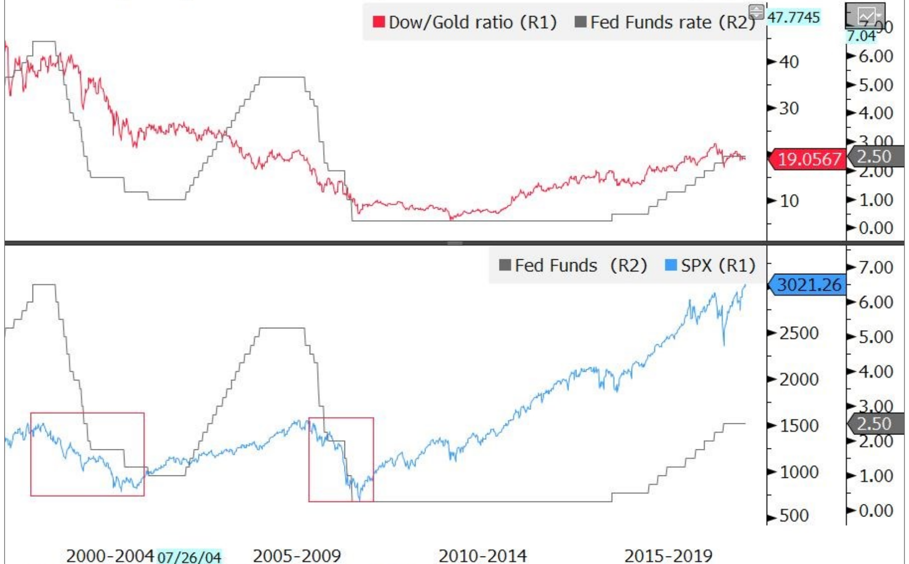
4. Past easing cycles: what happened to macro/risk assets in 2000 & 2007

- Comparisons are tough given there are more macro-economic, geopolitical/political and market structure *differences* than *similarities* now vs previous cycles (outside of the simple fact that the Fed is entering an easing cycle). Nevertheless, it has not gone unnoticed that the previous 2 times the Fed embarked on an easing cycle (2000, 2007), risk markets weren't happy (graph 4). This time is different in that the Fed is not patient, awaiting an equity meltdown before acting; whether equities retain their bull market self preferring to find any reason to extend gains ("sustain the expansion"), or concede to their historical performances (by piggybacking rates to the zero bound) will be interesting; the former is more likely as/if US data remains relatively robust

- Nevertheless, Graph 5 outlines the performances of Gold, SPX & the $ in the 90 days following the 2 previous Fed cuts that marked the start of an easing cycle. On average (and while its only 2 data points), Gold is up 10%, SPX is down 6% and the $ puts in mild gains (+3.4%). The $ and gold can rally together when yields are low and/or theres macro fear.

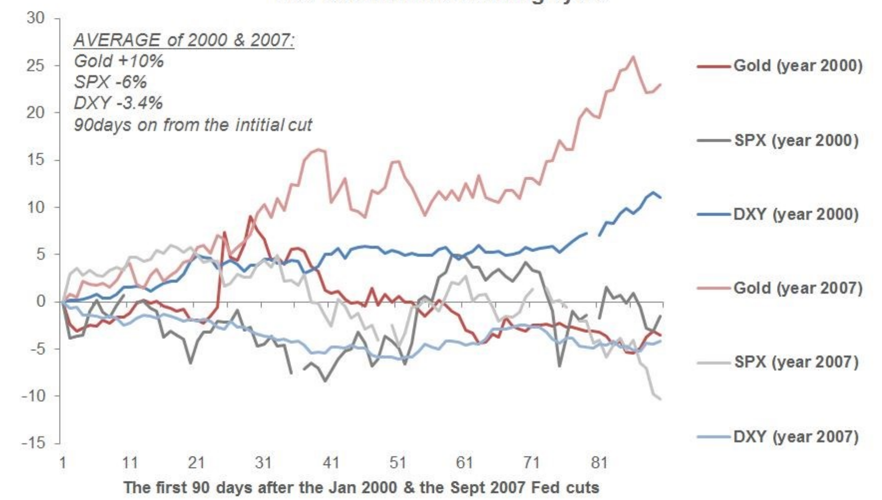
Fed cycles vs Dow/Gold & SPX

Historically tough for risk to outperform havens in an easing cyle



Source: Scotiabank Commodities Strategy, Bloomberg

SPX, DXY & Golds performance in the 90 days following the 1st Fed cut within an easing cycle



*Prices indexed at 100 at the start of the last 2 easing FOMCs

Source: Scotiabank Commodities Strategy, Bloomberg

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