

Precious Update: A price breather & repo stresses

This note will cover:

- Precious metals weakness recently; overdue correction not a reversal in fortunes (page 2)
- An overdue (but not irrelevant) update on the recent repo market stresses and its implications for Gold/Precious (page 3, graphs page 4)

Gold prices rallied consistently ~\$280 over 3 months to reach a peak of \$1557, only to tread water the past month remaining rather comfortable within \$1480-\$1550 range. That was aligned with US rates—its recent core driver—in which 10 years remained structurally low (~1.40-1.90%). Golds sustained gains also provided the necessary support for its high beta (albeit structurally oversupplied) sisters, Platinum & Silver, to attempt similar technical repricing's (Silver toward \$20 and Platinum toward \$1000 in early September); investors simply searched for “the next best” precious exposure as negative yielding debt reached unfathomable levels (~\$17tn globally) and the insatiable demand for havens continued given the uncertain macro backdrop with precious putting in overall solid gains in Q3'19 (Gold +5%, Silver +11%, Platinum +6%, Palladium +8%) **However, over the last few days, new 1 month floors were carved out in Precious metals (ex-Palladium). That shouldn't be surprising in light of a consistently stronger US\$ that's attempting to breakout of its 2 year compression. However, it is surprising given that:**

1. There's been a range of potentially very bullish Gold catalysts the past 2 weeks (Saudi Oil attacks, rising impeachment risk, risks of trade escalation with the threat of shutting Chinese companies out of US financial markets*)
2. US bonds have remained in favor and within contained ranges, and risk assets (SPX) have not reset higher through recent target ceilings.
3. Global data hasn't improved enough to warrant an unwind of haven length (e.g.: signs of the manufacturing mini-recession infiltrating Europe's services sector, US ISM Factory index falling to 10yr low today signaling further contagion)
4. The threat of geopolitics/politics and trade has not subsided substantially (there is no US-China trade deal with negotiations only restarting next week; focus has potentially shifted to US/European relations**)

*this was somewhat walked back this past weekend as a U.S. Treasury official said US has no plans “at this time” to limit Chinese companies from IPOing on US exchanges

**Trump rhetoric on US-China trade last week was very confusing/mixed; the WTO just gave the greenlight to slap tariffs on \$8bn of European imports, after ruling that Airbus was unfairly subsidized.

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DXY - compressed despite outsized moves in other mkts can't decidedly break out



Source: Scotiabank Commodities Strategy, Bloomberg

DXY Curcy (DOLLAR INDEX SPOT) DXY bull flag2 Daily 11MAR2010-01OCT2019

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01-Oct-2019 17:00:53

Thus what explains the \$70+/-5% purge in Gold in 5 days (or ~10% in Silver and ~9% in Platinum), taking it through an important technical ledge (the \$1480 floor) and the 50DMA (which Gold has held since its major summer'19 repricing); is this a correction or a start of a larger unwind. Drivers behind the reset lower include:

- 1. Repo stresses, lack of liquidity/US\$ leading to the belief Fed is not as dovish as is priced in, expected or hoped & positioned for.**
 - Recall, we recently cited 4 key drivers required for upside Gold — 1. Sustained equity market volatility (*), 2. A negative U.S. Dollar catalyst / US\$ weakness(*) 3. Lower yields for longer (✓), and 4. A dovish Fed (?). Throughout summer 2019, only 2 out 4 drivers (#3 & #4) were arguably “on” and contributed to Golds \$280 rally as softer data and geopolitical/political uncertainty triggered a global CB response. However, currently #4 (“a dovish Fed”) is now debatable - at least versus very dovish/aggressive expectations and positioning—given the recent funding pressures and the focus on the general lack of short-term liquidity. Overall, Gold is ultimately a liquidity product and thus the lack thereof (of US\$, short-term funding, general access when required), ensures many of those recent bullish geopolitical catalysts (outlined above) were overlooked; these recent funding stresses (albeit much improved) simply induces additional lending and/or selling of high-quality discretionary collateral, including Gold. See page 3 for further details/implications
 - (✓) Achieved. (?) Undecided; TBD. (x) Not achieved
- 2. Seasonal quarter-end US\$ strength capped most metals leading to typical de-risking and profit-taking in winners (Precious).** Market will remain nimble and capitalize on outsized gains, and given that gold positioning is jam-packed and overextended (ETFS + COT hold ~99m oz), some quarter-end & month-end downsizing is rational. Ultimately, the purge of fast money and/or weak longs is a necessary development for the longer-term health of the structural gold trade. The argument, some have made, was that the retracement wasn't deep enough (\$1450 is first core support line with ~\$1430 near the 100DMA next).
- 3. The lack of key liquidity as China heads into Golden Week.** Historically this has not been a bullish event in the lead up to their week-long national holidays (with Gold on average posting 1% losses in the 10days over Golden Week the past 7 years while Platinum historically has a tougher time with the lack of liquidity supplied by SGE participants) and it only worked to showcase the where the positioning pain levels laid (through \$1480)
- 4. The hope (or desperation?) from investors for reflation/risk-on to emerge,** for positive trade rhetoric ahead of US/China talks on Oct 10/11th: There was some notable asymmetric responses in risk/trade-sensitive assets last week to Trump rhetoric (markets downplayed his anti-China comments at the UN but reacted positively to any positive talk around being as ‘close as ever’ to a trade deal). Investor appetite for minor positive news, even a mini-trade deal, is large, leading to a downsizing in havens and into cyclical upside optionality.
- 5. DM monetary policy hitting limits with 1) growing calls for fiscal policy (ECB) or 2) direct further intervention (cuts to longer dated bond purchases) to steepen yield curve (BOJ):** The general theme of (mostly DM) CBs questioning the effectiveness of further monetary easing, instead putting the onus on fiscal stimulus is a net negative for Gold in the short-run (it removes the *certainty* of rate cuts/additional liquidity ‘at any cost’ i.e.: into further negative territory). However, it is a positive in the long-run for rate-sensitive assets like Gold/precious — that’s confirmation that the current policy toolkit is ineffectual and that the next phase of alternative monetary policy tools (eg: MMT), or alternative reaction functions (e.g.: responding to [climate change](#)) could be considered. Gold is usually a very responsive to major monetary policy regime shifts: from known QE (2009-2015) marking a bull Gold market era, to unknown QT (2015-2019) coinciding with a Gold bear market, to now CBs while they ‘rely’ on the meagre 200bps left in the Global Feds-toolkit.
- 6. Technicals: it goes within saying** —> selling begets selling once key levels are broken (\$1480, 50DMA)

Implications for GOLD & SILVER from recent funding issues:

There are plenty of articles/coverage on why short-term money markets witnessed a year-end like squeeze in the middle of September (the structural steady decline of the Fed's Balance Sheet together with the idiosyncratic issues with Treasuries settlement, corporate tax payments, quarter-end and higher regulatory standards for liquidity etc). Overall, repo agreements are the grease that keep financial markets operating by allowing market participants to borrow and lend to each other to cover short-term cash needs, in exchange for Treasuries and other high-quality collateral. Thus, while recent strains have been somewhat downplayed by Fed officials, the streets outlook on implications for the larger economy is wide-ranging (thus scary) —some simply note it's a low-grade hiccup triggered by the hoarding of cash reserves (FT: "We have plenty of liquidity, we are just choosing not to lend it out overnight to hedge funds") to others calling it a warning sign raising concerns that the Fed's attempt to unwind its interventionist policies has gone too far/awry ensuring these recent cash injections are baby step toward QE. Please see our FI strategists "US Repo: Follow-up on Last Week's Spike in Rates" for an in-depth view [here](#)

Short term bearish precious:

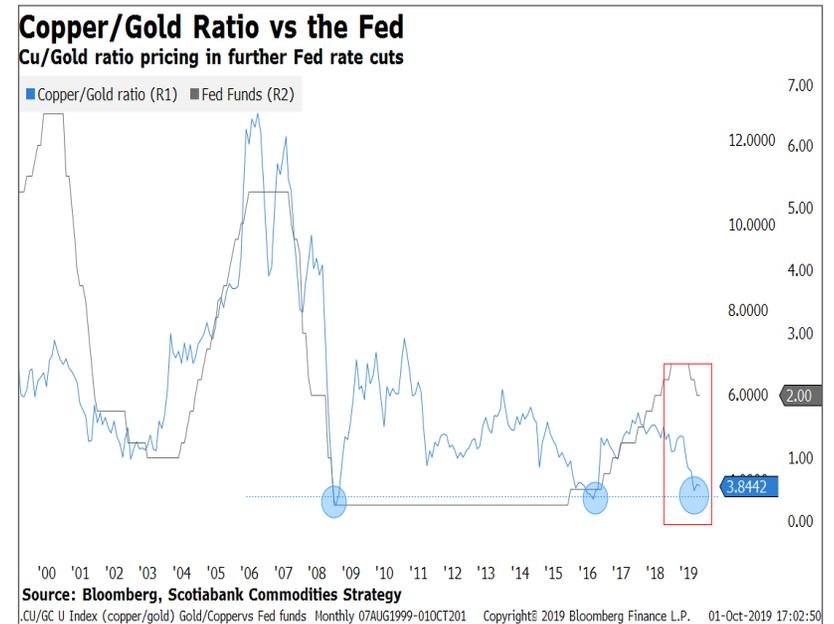
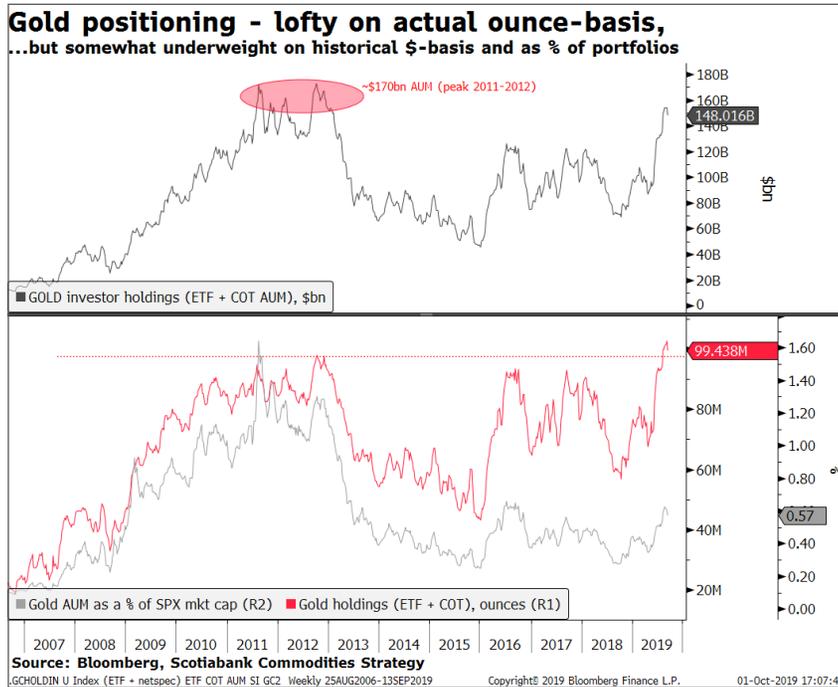
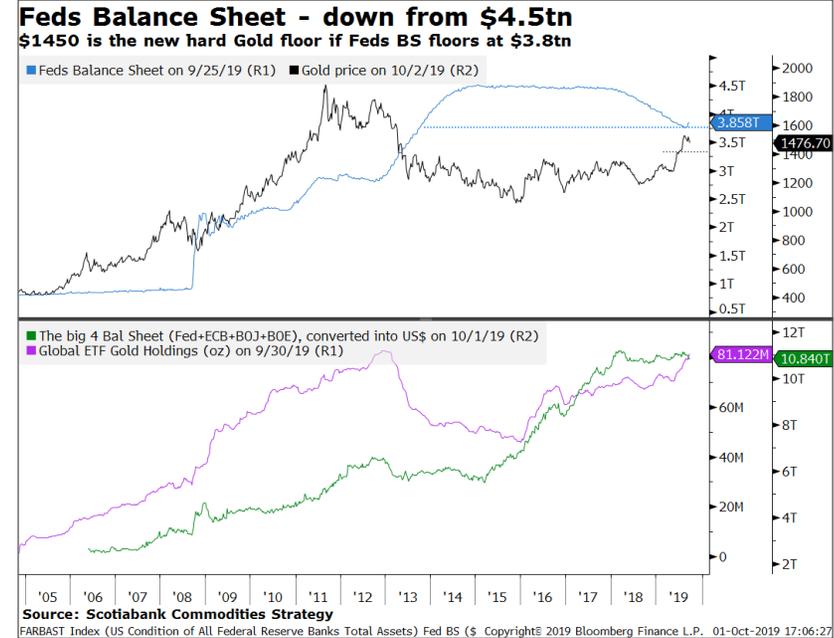
- US\$ / cash generally is king during any liquidity crisis, leading participants to lend, or in extreme situations simply deleverage collateral (including Gold/metals) that are perhaps sub-par to the high quality liquid assets (HQLA such as US Treasuries). Recent extreme funding strain episodes (when the gold market was running long, not short as has been the case in previous years!) was over yearend in December 2016 (ETFs deleveraged a chunky 3.5m oz and Gold fell 2% over MoM) and in Dec '11 (ETFs sold 1.1m oz and Gold was down >10% MoM). There's also the negative feedback loop, in which the lack of US\$ liquidity / supply (whether it's perceived and/or simply a bottleneck) leads to general US\$ strength, which negatively affects precious metals pricing.
- Recent Gold weakness is simply pricing in the idea that Fed that's too tight; well a Fed that perhaps won't meet dovish/aggressive expectations and positioning. Its overlooking the fact that these temporary cash-injections/daily repo operations is a net additive of liquidity, or the fact that it's now more likely the Fed introduces a standing repo facility, and/or on further measures. The market should continue monitoring the NY Fed operations and Fed communications (there are plenty of Fed speakers this week),

Longer-term (potentially) bullish:

- The irony is despite lower global interest rates (which should ensure ample short-term liquidity), the 1) structural unwind of the Fed's Balance Sheet (as it shifts from known QE measures to unknown QT measures), and 2) regulation (larger banks have to meet stricter regulatory standards for cash, particularly for same-day liquidity ensuring a preference for reserves), is/was enough to show up the supply-demand imbalance due to idiosyncratic factors (payment of taxes, large bond settlements in mid Sept, to the anticipation of typical quarter-end funding needs). The idea of a funding squeeze with global interest rate low (or zero) is perverse, but it perhaps showcases the excesses/unintended consequences of ultra low interest rates (the market is overly long collateral/assets/"things" and short cash/USDs)
- The fact the NY Fed has intervened in the first place and the idea that they have lost control of the front end of the curve with market forces overwhelming the Fed's desired/lowered interest rate, is generally supportive Gold. Gold is the hedge against the ability of the Global CBs own control
- While some stability has returned to the repo market after the temporary NY Fed operations, the upside risk for liquidity assets like Gold is if they take additional steps and find a more permanent solution, by either introducing a standing repo facility (which, as its titled, is a standing pressure valve that provides when needed) and/or they expand the targeted level of reserves to keep up with the pace of currency growth and US Treasury cash increases (QE-lite or some degree of Balance Sheet expansion).
- If lenders continue to be reluctant to use balance sheet over the coming quarters (due to regulation, and/or merely uncertainty), that'll tighten funding further and continue to slow the growth profiles of already weak economies

SUMMARY:

The series of would-be sizably bullish catalysts the past few weeks (impeachment risk, Oil attacks, renewed trade risks) were overlooked due to a persistently strong US\$, short-term liquidity/funding stresses and seasonal related profit-taking (quarter-end, Golden Week). The purge of length is a necessary development for the longer-term health of the structural gold trade, and with most of those headwinds now faded, Golds short term direction is slightly less bullish (down from \$1500-1600) but dependent on plenty of upcoming event risk including 1) NFP on Friday (especially after weak US PMIs today), 2) Trade talks next week, 3) October FOMC which is increasingly in play (potential for further permanent interventions like standing repo facility and/or Balance Sheet expansion e.g: QE-lite). The \$1450 floor wasn't revisited and dips remains a buying opportunity.



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