Its trading day 2 of 2020 in financial markets, WWIII is the top trend on Twitter and the optimistic tone (due to phase one deal and an improvement in some data) has flipped after a U.S. airstrike killed a top Iranian commander (Qassem Soleimani) fueling concern over an escalation in ME tensions

The knee-jerk reaction across typical havens & geopolitical proxies at one point put Oil +5% (Crude touched $64), Gold +1.4% (nearing the previous & 6 year high of $1557), the JPY +0.65% (through 108 vs the USD) and US 10yrs down 8bp (through 1.80%). Below are some takeaways mostly through a macro lens as they pertain to safe haven, geopolitical proxy Gold:

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Macro, geopolitical/political thinking & implications:

Market reactions: There was limited capacity for US Stocks and Oil to extend their overnight reaction, with both unwinding much of their losses (SPX) and gains (Oil). That was in stark contrast to Gold, USTs and JPY which all held onto their flight-to-quality gains throughout the day perhaps showcasing which assets are viewed as reliable geopolitical hedges.

This time is different: The long conflict between the US and Iran has largely been fought through proxy wars and sanctions. This has now changed as the US launched an overt strike, actively drawing a line after a series of Iranian aggression/attacks in 2019 (the unprecedented attack on Saudi Aramco in Sept after months of them harassing tankers and warships in the Persian Gulf) and most recently the attack on the US embassy in Iraq. The are consequences and scope for tensions to persist in the region with risks of a tit-for-tat retaliation cycle that ultimately argues for larger supply-side risks to be priced into Oil and for a larger geopolitical premium into Gold.

Implications for macro markets: This is both a reminder for risk assets and a lesson for 2020: the complacent, risk-on / liquidity-on narrative that has been driven by improving fundamentals, past collectively easier CB policies & positive trade rhetoric will continue to be increasingly short-lived, punctuated, and in many instances, driven by US policy actions. The pattern of a 'cold economic trade war' ("trade-war-on/trade-war-off"), that was fought by collective CB easing and liquidity in 2H'19, has now been complicated by the prospect of a 'hot war' with Iran. Additionally, risk sentiment may turn somewhat skittish if the idea that CBs don't have the necessary tools or are too slow to respond to any further escalation.

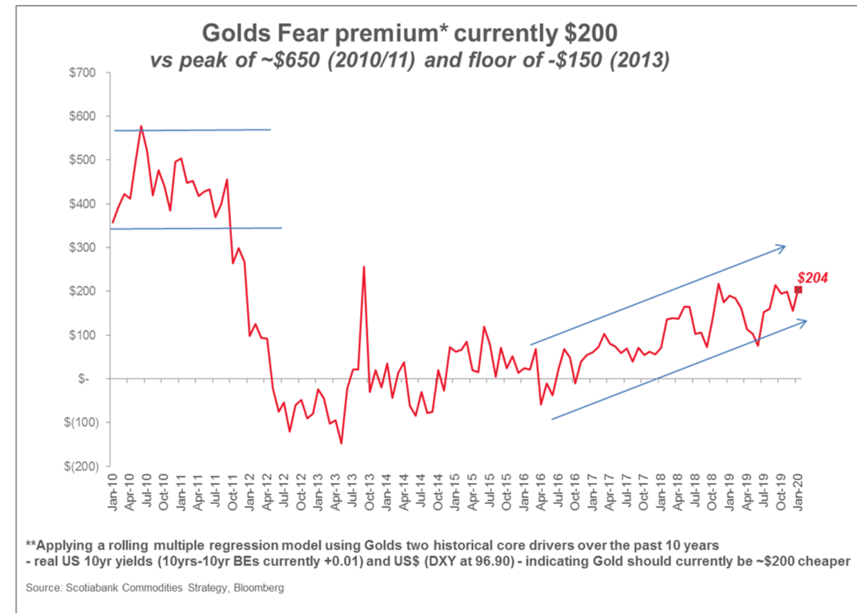
Retaliation? Iran has vowed 'severe retaliation' which is hanging over markets into the weekend. Their antiquated military is no match for the US and thus they are unlikely to pursue an open confrontation, but theres some thought that they could continue to rely on the similar tactics that Soleimani perfected (ie: striking out at vulnerable infrastructure in the Gulf, firing rockets at Israel, striking American diplomats and military personnel in Iraq and elsewhere). So much for Trump attempting to bring US troops home from the Middle East, not potentially kicking off another ME conflict (which has been denied). As markets continue to expect *some* Iranian response, continually combing through Twitter, the risk for the (fake) news cycle and unconfirmed/unofficial reports to drive whippy price action persists.

More important than bin Laden or al-Baghdadi: General Qasem Soleimani was Iran's most powerful military figure & was regarded as second to Iran's all-powerful Supreme Leader. He was the strategic mastermind behind their ambition in the ME, had bolstered Hezbollah in Lebanon (& other pro-Iranian militant groups), expanded their military presence in Iraq & Syria and orchestrated Syria's offensive against rebel groups in the country's civil war. His death is much more significant than those of Osama bin Laden (al-Qaeda) or Abu Bakr al-Baghdadi (IS), who were figureheads of diminished organizations, argues The Economist as he was "cut down in his prime, at a time when Iran still wields great power across the region"

Denuclearization is off the table: Trumps decision in 2018 to unilaterally withdraw from the nuclear agreement arguably kicked off current tensions between Tehran and the US. Attempting to find a diplomatic solution or hope of renegotiating the deal is very unlikely after this. Perversely, the attack probably bolsters North Koreas thinking for more (not less) nuclear weapons...

GOLD:

Golds $20 response seems under-priced, as does Oils 5% response. Crude put in a 14% (albeit a short-lived overreaction) to the Aramco strike in September 2019, while Gold rallied over $50 to the shoot down of the US drone by Iran in June 2019. Golds current fear premium* (graph below) vs current real US yields and US$, is ~$200. That is still under-priced versus previous bull market peaks of between $400 and $650 in 2010-2012. Golds risk reversals have also unsurprisingly spiked with short-term 1mo 15D calls trading 5 over puts (the historical high was 6.5 vols over seen in Aug when US levied more tariffs on China).

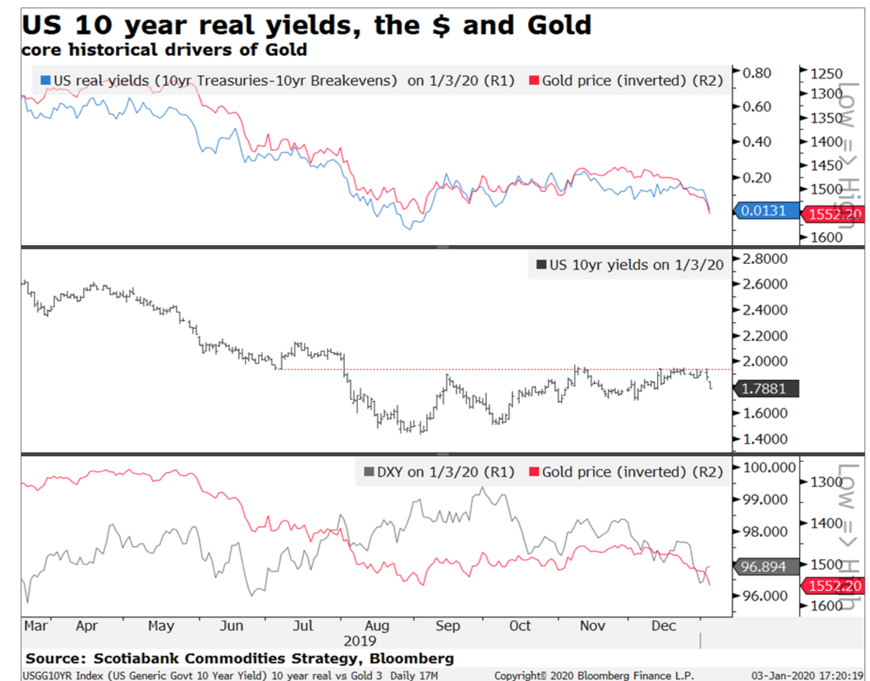


**Applying a rolling multiple regression model using Golds two historical core drivers over the past 10 years - real US 10yr yields (10yrs-10yr BEs currently +0.01) and US$ (DXY at 96.90) - indicating Gold should currently be ~$200 cheaper

Source: Scotiabank Commodities Strategy, Bloomberg

Gold (GCG0) settled at $1554.10 today - a strong close to a rather stellar run; the irony is that there was very limited macro fear given a phase 1 deal, a rebound in European & Chinese data (while US has sagged somewhat), runaway US stocks, *yet* Gold was $80 higher since announcing the phase 1 deal in mid December. Most of the rally can be attributed to 1) US$ weakness (and stronger EM currencies including the yuan which provides a positive feedback loop by bolstering Asian physical demand) and 2) limited funding issues over year-end (with the NY Fed providing ample liquidity). This created a general risk-on / liquidity-on backdrop which is generally supportive all metals as they're deemed a real asset hedge to runaway equity/paper (inflation).

In addition, st**art of the year strong seasonal investor inflows** (over the past 10 years, investors on average have bought a 2.9m oz of Gold in January) has begun and should continue. Fresh geopolitical risks will to be appropriately priced into relatively fairly priced havens (theres a rethink around negatively yielding European debt undermining their safe haven role) and global markets are only fully 'back to school' next week - mid January.



The less quantifiable reason for Golds recent 'defiance' and resilient trading above $1450 was that its smart... Golds repricing was aligned with a shift in the Fed in 2H'2019, but elevated pricing also incorporates the potential threat of 'fear drivers' such as trade, political/ geopolitical & growths risks re-emerging, which markets have learnt, can play out at the drop of a tweet at any point.

Overall, the ability for Gold to consistently adapt from internalizing old drivers (escalating trade rhetoric, negative risk appetite and moves in rates in in Q3'19) to new drivers (falling US$, upping of inflation expectations, curve steepness, EMFX & commod FX strength in Dec 19), back again to internalizing its haven qualities (today) is a constructive development for the longer-term outlook. **$1450 was the new hard floor but Gold is now firmly in a spot where the risk/reward in being directionally short is not favorable -- $1500 is increasingly looking like the new 2020 floor...**

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