Gold markets are looking exhausted

With the Fed ready for policy rate lift-off and global liquidity conditions gradually tightening, headwinds from rising US real yields may result in a bearish tilt to gold's medium-term outlook, rather than a complete reversal of the long-term uptrend

A miner in Minnesota holds up a gold nugget

Gold is on course to register its first annual decline in three years. Rising inflation pressure, along with a patient US Fed saw gold break above US$1,900/oz in May. There have been some erratic responses to high inflation numbers but sharp pullbacks have often followed these, particularly after the June dot plot from the FOMC meeting revealed growing support for rate hikes. Since then, the market has been stuck between rising inflation pressures and mounting fears of the Fed's hawkish pivot. The failure of the market to attract sustained investment inflows mean that multiple attempts to break higher proved to be short-lived.

A number of factors, including labour shortages and high energy prices, have pushed US inflation to a 30-year high. However, the breakeven curves remained inverted with most of the pressure in the front-end of the curve. This seems to be telling us that markets believe in the Fed's transitory narrative on inflation, and it has the credibility to fight against it. This could be partly why gold has failed to benefit much despite the pick-up in inflation. Moreover, despite gold's perceived attribute as an inflation hedge, the relationship between the two is better examined over a much longer time period. The short term, however, is not so coherent. In addition, with a robust underlying economy and equity market valuations, investors would prefer to put their money elsewhere to chase higher returns.

> *Investors prefer to put their money elsewhere to chase higher returns*

Physical demand for the yellow metal has recovered significantly with the return of a broadly positive Shanghai premium and stronger imports from China and India. While we continue to expect central bank flows and commercial physical buying of any dips that could cushion prices, these flows tend to be counter-cyclical to price performance, with investment flows the dominant driver. For the full year, investment in exchange-traded funds (ETFs) is set to see the first net selling since 2015. Except for some moderate inflows in the second quarter, the first quarter saw net outflows of 200tonnes, 58 tonnes during the third quarter and another 20 tonnes during the last quarter based on the most recent data, which takes full-year net outflows to over 274 tonnes. This perhaps highlights the market's inability to follow a consistent inflation narrative regarding how recently elevated inflation will play out and how the Fed will react to it while the labour market remains some way short of full employment.

In the short term, gold still trades at a premium over fair value versus TIPS due to broadening US inflationary pressure and perhaps incorporating some risk premium from the uncertainties around the Omicron variant and geopolitical risks in eastern Europe. Looking ahead, our macro team sees the risk of the Fed concluding its QE tapering program in the first quarter of 2022 with at least two rate hikes in the second half of next year.

Like the Fed, we believe inflation will gradually slow through 2022 while nominal Treasury yields should rise as US monetary policy and global liquidity conditions gradually tighten. This should result in real yields starting to rise, and as a result, weigh on gold prices. However, the ultimate goal would be to get to a zero real rate in the 10yr, but it may not be until 2023 and beyond before that happens. This, compounded with some lingering risks on the virus front, may still offer some support to gold in the next few months. Overall, we are of a directional bearish view towards gold for the medium-term, rather than a complete reversal of the long term uptrend.

ING forecasts

	1Q22	2Q22	3Q22	4Q22	FY22
Gold (US$/oz)	1,750	1,730	1,700	1,700	1,720

Source: ING Research