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Gold: Fall in yields but still no thrills

The drop in Treasury yields saw gold return to $1300/oz briefly last week but was cut short by a burst higher in the dollar. A lull in fund flows, and easing geopolitics may prevent much upside in the shadow of the June rate hike. But, failing a trade war, we think physical demand will provide support until the funds return

Source: Shutterstock

Real and nominal yields drop but no thrills for gold

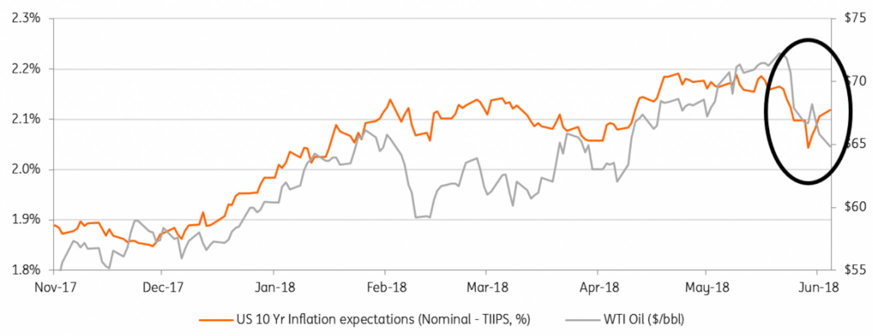
Since it's peak two weeks ago (May 16th) US treasury yields have fallen hard, boosting gold's appeal as a non-yielding asset and supporting a brief break above $1300/oz. The ten year has dropped from a high above 3.1% to a low of 2.78%, before recovering slightly but still remains below the psychological 3%.

This yield collapse would have been more positive for gold, except that inflation expectations also fell. That can be seen clearly from the narrowing spreads between the nominal ten year and TIIPs (i.e. real yields) which touched YTD lows and have only recovered half of its losses since. A collapsing oil price (WTI -9.5% since May 16th) seems to be the prime culprit. Perspective is needed though. The yield spread still remains well up on December, so our longer-term view for higher gold prices based on higher inflation remains unchanged. Indeed, the 3.8% unemployment in latest US jobs report reinforces our economist's central view of a tightening labour market will drive higher inflation.

To gold's advantage, yields have also retreated, but less so. Largely this was driven by a flight to quality amid Italian and euro uncertainties although gold's safe haven appeal underperformed once again and attracted little in the way of inflows. Also, while a June rate hike is all but certain, the FOMC minutes show an increasing tolerance towards inflation above 2% and continued concern towards the flattening yield curve. Any potential for derailing the future path of Fed rate hikes are positive for the longer term allure of holding gold as a non-yielding asset and help form our view that gold will shine brighter this time next year. We forecast prices averaging $1400/oz in 2Q 2019 as the dollar resumes a decline and US twin deficits return to the foreground.

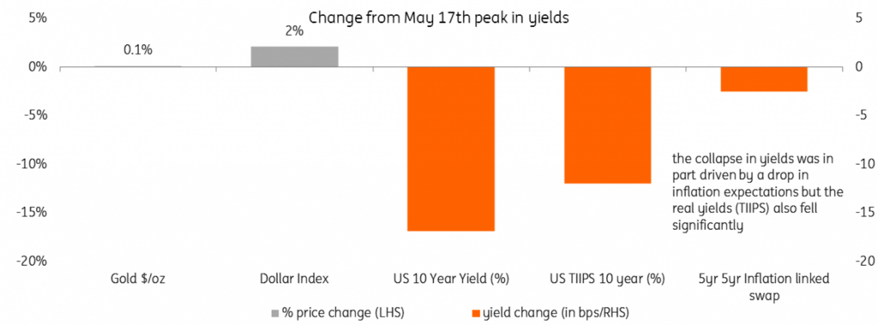
Although gold did manage to cross above the significant $1300/oz mark, given a sizeable 14 basis point drop in the TIIPs rates, the momentum was still on the soft side. This highlights both the simultaneous unraveling of geopolitical tensions and golds ongoing difficulty this year for attracting and sustaining decent fund flows.

Inflation expectations dropped with oil: Negative for gold



Source: Comex, Bloomberg, ING Research

But still gold's gains were mild vs. the drop in real yields



Source: Bloomberg, ING Research

Currency reigns king

Gold only managed to close above $1300/oz for two days until it was pressured lower by the weight of the dollar index on its way to a six-month high of 94.8. This was mostly on the back off the fall of the euro, but even as the Italian situation stabilised, and the euro came off, the damage was done for Gold, and the bounce in real yields restored the $1300/oz barrier. Our FX strategists think the worst seems to be over for the euro with support likely to come from domestic data this week.

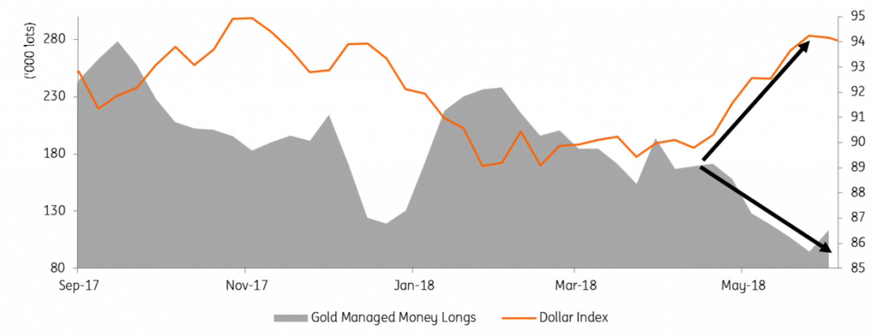
What started as a short squeeze for the dollar has now established itself in a higher range, but our FX team still see pain for the greenback which they think will begin to set in from Q3. As the resurgent dollar caps, gold's returns this year it is unsurprising that money manager long positions continue to lull (-50% from the Feb peak). We are not expecting fund flows to drive prices higher until we get a currency or geopolitical induced kick start especially in the shadow of a June rate hike.

Nonetheless, the options skew is evidence that an upside bias remains in the gold market albeit still reserved from taking outright positions. Calls six-month forward have been at a higher premium to puts consistent since late March, but a sharp drop in the skew for nearer dated tenors since Gold fell below $1300/oz has also proved to be short-lived.

At the same time as recognising a fund lull, we do expect limited downside at these levels. We don't see much geopolitical risk being priced in: Italian politics has stabilised, Spain's presidential exit is all but confirmed and the North Korean - US summit is back on.

At the same time, Gold's reaction to the US tariffs for EU, Mexico, Canadian steel and aluminium was especially mild considering the growing risks. Our FX strategists now see the global trade war threat moving to DEFCON 4, a scenario where retaliation from trade partners could significantly derail both the US and global economies. These tensions are expected to come to a head at this week's G-7 leaders summit and any escalation ought to play to Gold's haven qualities receiving a double whammy for any confidence taken out of the greenback.

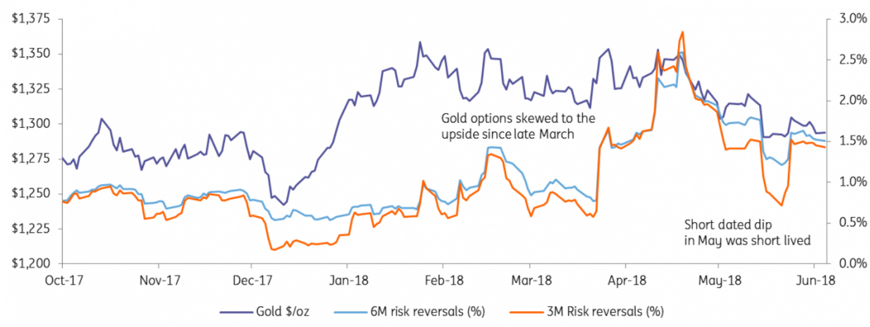
Post the USD rebound speculative gold longs dwindled



Source: CFTC, Bloomberg, ING Research

Funds keep the faith: Gold options skewed to the upside (Risk Reversals: %)

Risk reversal (RR) = 25 delta calls - 25 delta puts, i.e premium paid for upside vs downside at 25 delta. 3 months and 6 months forward



Source: Bloomberg, CME, ING Research

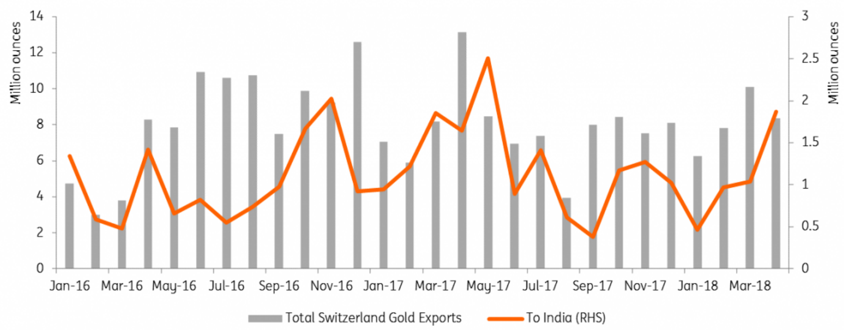
Lets get physical

Currencies and financial flows are the ultimate drivers of gold prices, but we are also looking to the physical fundamentals to provide support now that prices have dipped.

Swiss gold export data for April was a particularly bright spot with the first four months registering a 2% YoY increase but wholly driven by an increase of shipments to China. Shanghai Gold Exchange (SGE) withdrawals were up 8% YoY those first four months which typically correlates with consumption; jewelry spending is also up 7.5% YTD showing some bargain stimulation as CNY prices are down 5% compared to this time last year. India had an awful Q1 for gold demand but as we flagged in our last note is expected to start improving. The Swiss –India gold trade jumped to a nine-month high in April which is an encouraging first sign.

Testing the stickiness of ETF holdings through a softer price environment will prove to be key though. Year-to-date total holdings are up 2.8Moz, but the gains have certainly stalled since April, and we would be concerned should we see more sharp declines like the past two days (-444koz).

Swiss gold exports, strong on China with signs of India rebound (Moz)



Source: Swiss Customs, Bloomberg Intelligence, ING Research