

Record highs for gold, but where next?

Spot gold prices have hit a new all-time high, surpassing the previous highs seen in 2011. Growing safe-haven demand, renewed weakness in the USD, falling real yields and buying momentum have all provided a boost to the yellow metal. However, we still believe there is room for more upside to prices



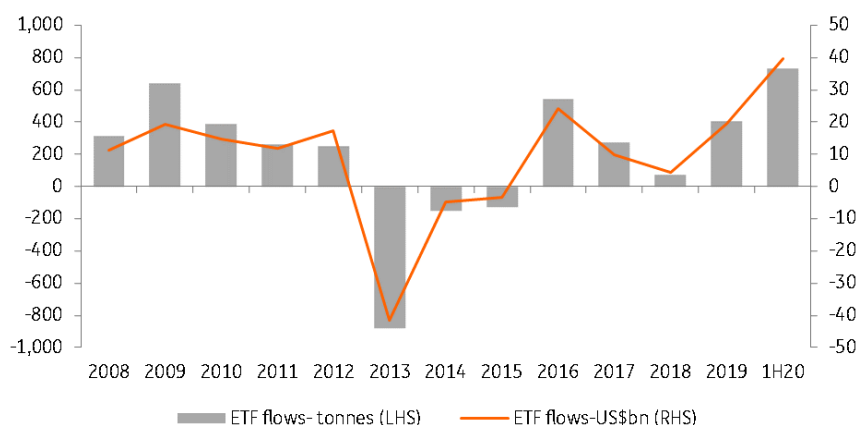
Saf haven appeal

Given the current environment, and the uncertainty over the path towards recovery following the Covid-19 outbreak, we have seen significant inflows into gold ETFs over the course of the year. Meanwhile a recent ratcheting up in tensions between the US and China continues to support these inflows.

World Gold Council (WGC) data shows that ETF inflows over the first half of this year totalled 734t, a record increase, and in fact exceeds the annual record of 646t seen in 2009. This buying into gold ETFs appears to have only continued over the course of July, with Bloomberg data showing that total known holdings over the month increased by around another 4moz or basically 120t.

As golds record prices grab headlines, we wouldn't be surprised to see some further momentum buying from retail investors, providing some additional upside to the market.

Gold ETF inflows hit record levels



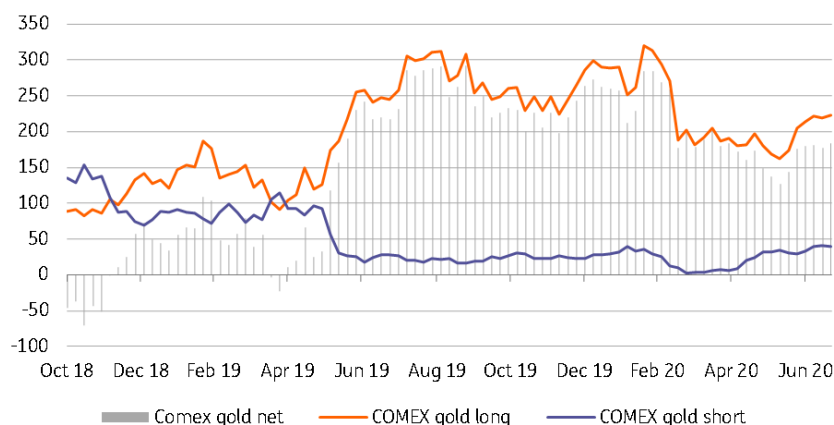
Source: WGC, ING Research

Speculators yet to jump fully onboard

Interestingly, speculators have not been as active in COMEX gold futures, with the speculative net long position still some distance away from the record levels seen over the course of last year. This suggests, particularly in the current environment, that speculators have quite some room to increase buying in gold futures, and in doing so providing further upside for gold prices. The speculative net long peaked at around 292k lots in September last year, whilst at the moment, they are holding a position of around 184k lots. This data is lagged, and so the actual current position is likely somewhat higher given the more the recent rally we have seen in the market

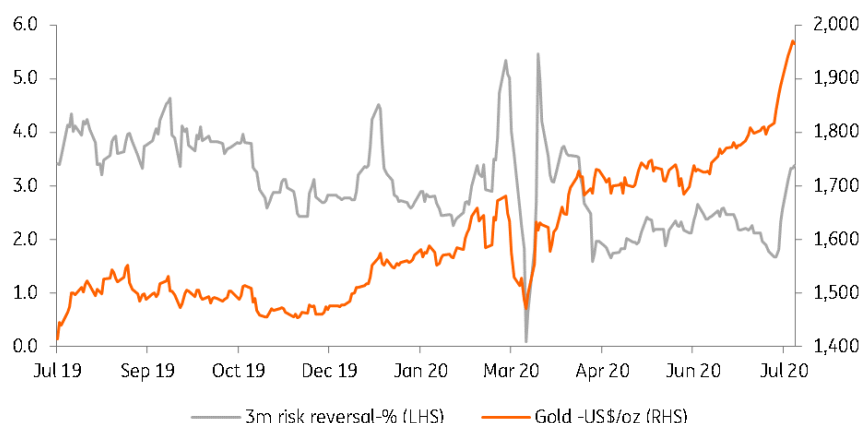
Meanwhile, if we look at the 3-month risk reversal for gold, it suggests that the demand for call options continues to outweigh the demand for put options, and has in fact picked up in recent days, with the rally in gold, suggesting that investors are positioning for further upside in gold prices.

Comex gold managed money position (000 lots)



Source: CFTC, ING Research

Gold 3 month 25 delta risk reversal (25 delta calls minus 25 delta puts)



Source: Bloomberg, ING Research

USD weakness

The USD has not had the strongest relationship with gold for much of the year, with both gold and the USD serving as a haven over parts of the year so far.

However, the USD weakness over the last month or so has been another bullish factor, with the inverse correlation between the two having strengthened.

Our house view on the USD is for more weakness over the remainder of the year, and so this is one factor which shouldn't provide too much resistance to potentially higher prices.

Central bank easing

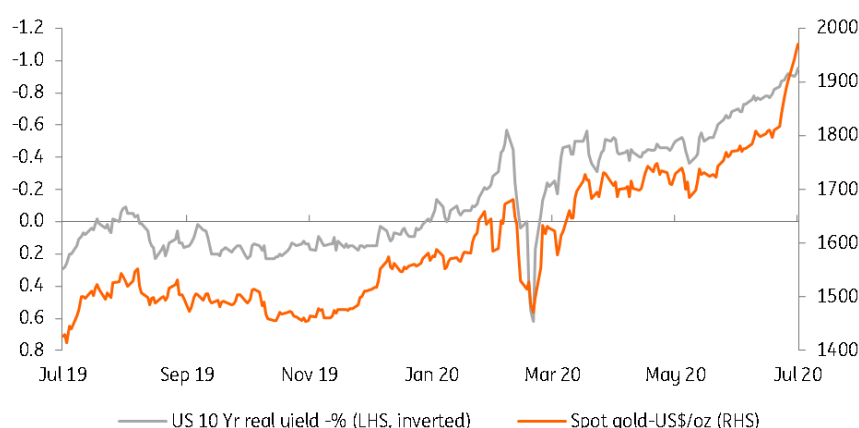
Globally, central banks have eased this year, lowering policy rates in an attempt to help weather the impact from Covid-19. It also does seem in the absence of a pickup in the recovery, the environment of zero to near-zero policy rates will continue for the foreseeable future.

This, along with quantitative easing, has seen longer-term yields coming under significant pressure, with the 10 year US treasury yield remaining below 60bps, having entered the year at around 190bps. Given that QE is likely to continue for some time, yields are likely to remain under pressure. Meanwhile, real yields, which factor in inflation, are firmly in negative territory, increasing the attractiveness of non-yielding assets, such as gold.

Meanwhile, money supply has grown at unprecedented levels over the last few months. US Fed data shows that over June, M2 money supply grew by 22.9% YoY, this far exceeds the 10% YoY growth that we saw over stages of 2011 when spot gold hit the previous record high.

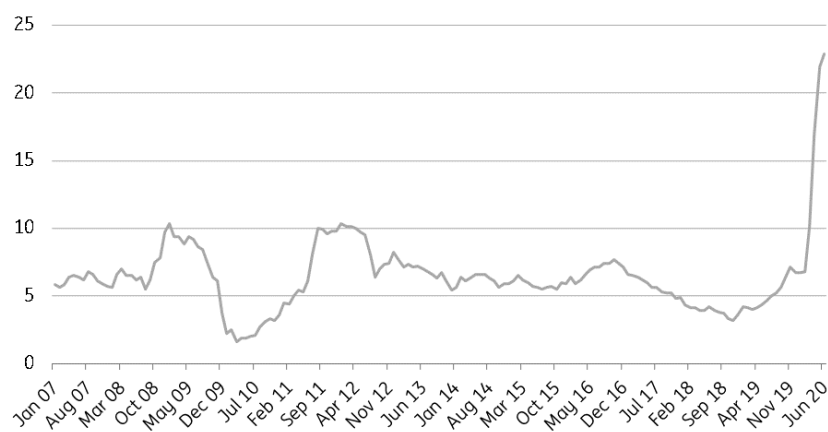
In the Eurozone, we have also seen significant growth in money supply, with M2 supply growing by 9.1% YoY in May, levels last seen in 2008.

US real yields vs. gold



Source: FRED St Louis Fed, Bloomberg, ING Research

US M2 money supply growth (% YoY)



Source: US Fed, ING Research

Inflation expectations

Growing money supply and significant stimulus from governments logically leads to the view that we will see a pick-up in inflation moving forward.

While we are likely to see some level of inflation as we move through the recovery, significant levels of inflation are not a given. Whilst money supply has grown substantially thanks to QE, the velocity of money has slowed significantly. Latest data from the St Louis Fed through until the end of 1Q20 shows money velocity is at the lowest levels going as far back as 1960, and given that 2Q20 was the peak of lockdowns, it's likely that this has only fallen further in recent months.

However regardless of whether we see a significant rise in inflation or not, there clearly is a large portion of the market who holds the view that inflation will pick up, and as a result, are looking at gold as a long term hedge.

Quarterly velocity of US M2 money stock



Source: FRED St Louis Fed, ING Research

Physical demand remains weak

Latest numbers from the WGC show that global gold demand over 1H20 was down 6% YoY, whilst jewellery demand over the same period was down 46% YoY. Gold demand from the two largest consumers, India and China has been weak as a result of Covid-19 lockdowns. China's jewellery consumption over 1H20 was down 52% YoY to total a little over 152t, the lowest demand number since 1H07. Meanwhile, for India, jewellery consumption totalled just 117.8t, down 60% YoY, and an all-time low according to WGC data.

The stronger prices we are now seeing will also do little to support demand in the months ahead. But as we know, it really is financial flows which drive the market but continued weak physical demand can always start to drag on sentiment, particularly if gold-backed ETFs buying starts to slow in the months ahead.

What are the downside risks?

Whilst we believe there is further upside to the market, there are a number of risks which could stand in the way of this.

Firstly, a swift rolling out of a Covid-19 vaccine, which sees economies around the world re-opening at a quicker pace, and returning to a form of normality, would likely provide a boost to risk assets, and as a result, weigh on havens, such as gold.

Secondly, a swift turnaround in the USD would likely weigh on gold prices.

Thirdly, as we hit record levels, investors will become increasingly tempted to take profits, which could not only cap the market but possibly put downward pressure on it. The market for the moment is clearly in overbought territory, given the scale of the move we have seen recently.

Finally, while a renewed sell-off in risk assets should provide upside to gold, there is the potential that we see a repeat of March, where a selloff in other asset classes, saw investors liquidating gold positions in order to meet margin calls.

What does this all mean for price?

Clearly the bulk of drivers are telling us that there is further upside to the market, and we believe it is only a matter of time before the market breaks through the US\$2,000/oz level.

We expect prices to face some resistance as it approaches this level like we saw earlier this week. Meanwhile, by year-end we expect prices to trade up towards US\$2,100/oz.

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