PRECIOUS METALS: GOLD

THE TAPER MENACE

Author

LUC LUYET
lluyet@pictet.com

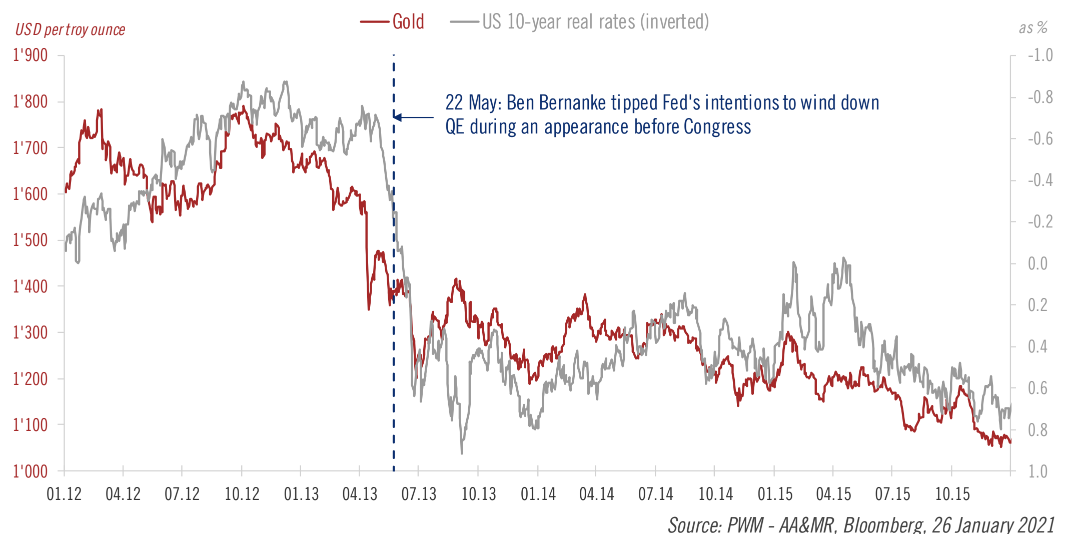
SUMMARY

- We do not expect a sharp rise in US long-term real rates of the sort that severely hurt gold prices in 2013 after the Fed hinted it was considering tapering its bond-buying programme of the time.
- Indeed, our in-house scenario remains that US 10-year real rates will stay very low, providing some ongoing support to gold price.
- However, the near-perfect correlation between the gold price and the US 10-year real rate since early 2019 has been fading since November, weakening our bullish stance on gold prices somewhat.
- While we think the Fed will likely dampen any notion of early tapering and 'normalisation' of its loose monetary policy, we have shaved our 12-month projection for gold to USD2,050 per troy ounce from USD2,150.

All eyes on the Fed

Another USD900bn fiscal package in the US in December (with the prospect of more to come) as well as the mass deployment of efficient vaccines, have induced markets to start discounting an early tapering of the Federal Reserve's bond-buying programme. This is raising the threat of another 'taper tantrum' of the sort that badly hurt gold prices in 2013 *(see chart 1)*.

CHART 1: THE GOLD PRICE AND US 10-YEAR REAL RATES (FROM 2012 TO 2015)



Source: PWM - AA&MR, Bloomberg, 26 January 2021

However, we need to place what happened to gold in 2013 in context. Gold prices had already declined by about 18% in the first months of 2013, even before Ben Bernanke testified before Congress on 22 May of that year and mentioned the possibility of Fed asset purchases being progressively wound down in the next few FOMC meetings. Gold's decline was particularly sharp in mid-April 2013, perhaps as gold price declined

below closely-watched technical support lines. But it is true that gold fell another 12% from 22 May, after Bernanke's testimony, until the end of the year.

The 2013 decline in the gold price occurred despite strong jewellery demand, confirming our long-held view that investment demand is the key driver of gold prices. In this regard, the steep rise in the 10-year US real rates from -0.7% in April to 0.9% in September 2013 (mostly due to a rise in nominal rates from 1.6% to 3.0%) made gold significantly less attractive as a safe store of value, hence depressing investment demand for the precious metal. The US dollar's subsequent surge in 2014 and 2015, which was linked to its strong yield advantage (the European Central Bank introduced negative interest rates in June 2014), further weighed on the dollar-denominated gold price.

While we acknowledge that a taper of the Fed's latest pandemic-driven bond purchases could be an issue at some stage, for a number of reasons we do not expect the same impact on rates, and therefore on gold, as we saw in 2013.

First, the Fed would like to avoid undue tightening of financial conditions. Indeed, the US central bank is likely to be very careful about any tapering decision given the US budget deficit has ballooned in recent months. Indeed, we believe the Fed is engaged in a form of implicit yield-curve control, keeping a lid on long-term US nominal rates.

Second, the Fed's monetary framework has changed since 2013. Last year, the Fed introduced an 'average inflation targeting' framework, suggesting that in the absence of strong and sustained inflationary pressure we may not have rate hikes for some considerable time—perhaps not until 2025.

Finally, as mentioned, dollar strengthening pulled down the value of gold in USD terms in 2014 and 2015. But gold labelled in euro and the Swiss franc generally reached a trough at the end of 2013. Part of the dollar's outperformance was linked to desynchronised monetary policies, as the Fed was the only major central bank in a position to normalise its monetary policy at that time. However, today monetary policies are broadly synchronised. While some central banks may take more time to normalise than others, a radical divergence in monetary policies looks unlikely in the coming quarters. Furthermore, while the greenback was undervalued in 2013, this is not the case today. In a nutshell, strong appreciation of the US dollar looks highly unlikely in the coming months.

US long-term real rate to continue to support gold in the short term

We continue to think that US long-term real rates are the key driver of investment demand, encompassing the opportunity cost of holding gold and its resilience against a rise in inflation. Our central scenario that the US 10-year real rate will stay around its current low level (-1.0% on 26 January) in the first half of the year suggests continued support for gold. Indeed, we see scope for real rates to remain in negative territory for even longer, meaning investors should maintain a healthy interest in gold.

That being said, a continuation of the global economic recovery will limit the downside pressure on long-term nominal rates. With the US 10-year breakeven inflation rate roughly five percentage point below its highest point over the last nine years, there may also be limited room for US 10-year real rates to go much lower, especially as QE tapering

PRECIOUS METALS: GOLD

THE TAPER MENACE

moves closer. Indeed, our in-house scenario is for a moderate rise in the US 10-year real rate in the second half of the year, when it could rise towards -0.7%.

Further US dollar depreciation would likely help gold. However, we see limited rationale for a sharp decline in the value of the greenback this year (we expect roughly 4% depreciation of the US dollar index from its current level at 90.2 on 26 January), so the impact on gold prices should prove quite modest. Low rates could mean official demand for gold recovers in the coming quarters. Still, this is likely to have a limited impact, especially as the Turkish central bank, an important buyer in previous years, may remain on the sidelines. Finally, while inflation could support gold, annual inflation would need to hit roughly 6% to have a strong bearing on gold—something that looks unlikely in the medium term. To the extent that a rise in inflation hastens normalisation of the Fed's monetary policies, a rise in inflation could eventually be negative for gold (although rising prices could hurt global risk appetite, which would be gold positive).

To sum up, although we expect US long-term real rates to remain broadly supportive of gold in the next few months, we are starting to be concerned about the ongoing gap between the gold price and the price implied by US 10-year real rate (*see chart 2*). While we acknowledge that this near-perfect correlation between gold price and US real rates could not last forever, it nevertheless tends to weaken the bullish rationale for gold. Indeed, despite very low US real rates, the unveiling of highly efficient vaccines against the pandemic seems to have weakened the attractiveness of the yellow metal among investors since November.

CHART 2: THE GOLD PRICE AND US 10-YEAR REAL RATES

Source: PWM - AA&MR, Bloomberg, 26 January 2021

We are sticking to our thee-month projection for gold of USD1,950 per troy ounce and our six-month projection of USD2,050, as a very cautious Fed will continue to help depress the rise in long-term nominal rates. However, we are adjusting lower our 12-month projection to USD2,050 (from USD2,150 previously), as even a moderate rise in US 10-year real rates from very low levels may weigh on the gold price.

PICTET 1805

DISCLAIMERS

We value the protection of your personal data and we are keen on ensuring that you understand and feel confident in the way we process them. For more information about personal data protection and how we protect yours, please refer to the Pictet Group Privacy Notice available at https://www.group.pictet/privacynotice

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland, Pictet & Cie (Europe) S.A., 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687, L-2016 Luxembourg and Pictet & Cie (Europe) S.A., London Branch, Stratton House 6th Floor, London, 5 Stratton Street, W1J 8LA.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) S.A. is a société anonyme (public limited liability company) incorporated in Luxembourg and registered with the Luxembourg Registre de Commerce et des Sociétés (RCS no. B32060). Its head office is at 15A, avenue J.F. Kennedy, L-2016 Luxembourg. Its London branch is registered as a UK establishment with Companies House (establishment number BR016925) and its UK establishment office address is Stratton House 6th Floor, London, 5 Stratton Street, W1J 8LA.

Pictet & Cie (Europe) S.A., London Branch is authorised and regulated by the Commission de Surveillance du Secteur Financier. Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/ or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2020.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore, 10 Marina Blvd #22-01 Tower 2, Marina Bay, Financial Centre, Singapore 018983 and Pictet & Cie (Europe) S.A., Hong Kong branch ("Pictet HK branch") in Hong Kong. The registered address of Pictet HK branch is 9/F, Chater House, 8 Connaught Road Central, Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard. Furthermore, BPCAL/Pictet HK branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved with transactions on such Investment.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility,

and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to, and effectively assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK branch to update any of them. BPCAL/Pictet HK branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are believed to be from sources believed to be reliable, BPCAL/Pictet HK branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document.

The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL has obtained an exemption from the Monetary Authority of Singapore ("MAS") under section 100(2) of the Financial Advisers Act ("FAA") for the provision of financial advisory services to High Net Worth Individuals (as defined in the MAS Guidelines on Exemption for Specialised Units Serving High Net Worth Individuals FAA-G07) (the "Exemption") and is exempted from the requirements of sections 25, 27, 28 and 36 of the FAA, the MAS Notice on Recommendations on Investment Products (FAA-N16), MAS Notice on Appointment and Use of Introducers by Financial Advisers (FAA-N02), MAS Notice on Information to Clients and Product Information Disclosure (FAA-N03) and MAS Notice on Minimum Entry and Examination Requirements for Representatives of Licensed Financial Advisers and Exempt Financial Advisers (FAA-N13).

Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK branch and any of its affiliates or related corporations to any prospectus or registration requirements.

Pictet & Cie (Europe) S.A. is incorporated in Luxembourg with limited liability. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: AQ515) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence,The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined inthe Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who isa citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contraryto law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.