Heavy days for the heavy metal

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Despite being soft and malleable, gold is technically a heavy metal. A confluence of factors are weighing on the metal, including US dollar strength, rising Treasury yields and a waning desire for defensive assets in a period of economic growth. However, both actual and expected inflation remain elevated and should be a source of strength for the metal.

Gold misbehaving

Unfortunately, gold has not been responding to inflation in the manner that we have expected. Historically gold has been an excellent hedge for elevated inflation, but in this cycle the metal has under-delivered so far. Now facing the headwinds of the US Federal Reserve (FED) tapering its bond-buying programme, which is strengthening the US Dollar and raising Treasury yields, gold's window for catching up seems to be narrowing. As highlighted in Figure 1 below, our model indicate that gold should have been rising in the past four months, when in reality we saw its price decline. Our model indicates that rising Treasury yields and an appreciating US Dollar should have been a drag on gold in the past half-year, but that should have been counteracted by elevated inflation.

Source: Bloomberg, WisdomTree price model, data as of 30 September 2021 The fitted gold price is the price the model would have forecast. The constant does not have economic meaning, but is used in econometric modeling to capture other terms. It can be thought of as how much gold prices would change if all other variables are set to zero (although that would be unrealistic).

Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties

Time for a new model?

Our modelling work has shown that gold historically responds better to realised inflation rather than inflation expectations. Realised inflation has been a lot higher than inflation expectations lately and so gold's lacklustre performance could be indicating that it has been more aligned to inflation expectations in 2021. Using the model described in Gold: how we value the precious metal, we experiment by replacing actual inflation with inflation expectations (measured by 10-year break-evens1). We find that inflation expectations is not as good as inflation at explaining gold price behaviour historically, although it does narrow the gap between actual and fitted prices in 20212. We think it is too early to change the model specifications as we have only seen this departure for a few months and we rely on a stability of relationship across many cycles.

If gold regains its mojo, the upside could be strong

If gold's behaviour has changed, it is an unfortunate outcome as many assets provide a hedge to inflation expectations, but relatively few provide a hedge to 'unexpected' inflation. In this regard, broad commodities are doing a significantly better job of hedging against realised inflation, including unexpected components.

Should gold's behaviour snap back to normal, then we could see a strong upside correction in the short-term, but as almost every other driver of gold is tipped to the downside, its break could be short-lived.

Outlook detail

Forecasts based on our model in its original form, incorporating consensus estimates3 for Treasury yields, inflation and the US Dollar point to gold rising in the coming quarter, before easing again. At the end of the forecast horizon – Q3 2022 – the price of gold could be US$1836/oz (4% above the spot price on 18th October 2021). However, we stress that this forecast relies on gold behaving like it used to.

Source: WisdomTree Model Forecasts (original model specifications), Bloomberg Historical Data, data available as of close 30 September 2021.

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*Source: WisdomTree, *Bloomberg consensus forecasts taken in September 2021*

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Conclusions

Q4 2021 will be a key quarter for gold to prove its inflation-hedging traits. If the metal misses this opportunity, it could fall under the weight of macro conditions that won't be supportive for the metal.

1 Inflation expectation measured using 10-year break-evens (i.e. nominal Treasury yields minus TIPS yield). Data for this series starts in 1997

2 We start the data for the comparison of these two models in 1997, because that is the year when TIPS data is available. The original model presented in Gold: how we value the precious metal started in 1995. The residual (difference between actual and fitted results) is wider in original model specification compared to modified model for observations in 2021. The R-squared in original is 0.57 while the R-squared in modified is 0.54 (over the same time periods). The R-square is the proportion of gold price that is explained by the variables. The higher the number the better.

3 Bloomberg consensus forecasts taken in September 2021

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