What's Hot: Moderating inflation could further reinforce gold and silver

Published 13 January 2023

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Let’s begin with a recap. In 2022, precious metals were down 4.4% when the S&P500 Index was down 19.4%. That is an outperformance of 13.8% for precious metals against equities. Still, many firm believers of gold were, at times, questioned why gold was not scaling new highs in a year when inflation was doing exactly that.

As Nitesh Shah outlines in his model, gold is influenced by four variables. These are:

1.Changes in the US dollar basket (-ve relationship)

2.Consumer price index (CPI) inflation (+ve relationship)

3.Changes in nominal yields on 10-year US Treasuries (-ve relationship)

4.Investor sentiment measured by speculative positioning in futures (+ve relationship)

Although inflation was supportive of gold last year, the aggression with which central banks acted to tighten monetary policy strengthened the US dollar and lifted Treasury yields creating headwinds for precious metals. As a result, investor sentiment was also weak (see figures 01 and 02).

A shift in sentiment

Although the Federal Reserve (Fed) has not yet signalled a dovish pivot, markets are beginning to expect this to happen at some point this year. With the US consumer price index (CPI) inflation falling for its sixth straight month in December and moderating to 6.5% vs 7.1% in November , this market consensus might be reinforced. Even if the Fed remains on its tightening path in the first half of this year, the pace of rate increases could slow down. If inflation figures continue to decline steadily and growth data has not become alarmingly worrying, the central bank may hold its rates at a terminal rate during the second half.

Of course, the exact trajectory of these dynamics cannot be predicted. Still, however, market consensus is at least forecasting reduced hawkishness compared to last year. As a result, investor sentiment in gold has been on the rise since November. If Treasury yields and dollar continue to pull back, inflation moderates gradually, and economic data slowly deteriorates, sentiment towards gold as a safe-haven asset could continue to improve.

Figure 01: Net speculative positioning in gold

Source: WisdomTree, Bloomberg as of 11 January 2023. Stdv is standard deviation.

Historical performance is not an indication of future performance and any investments may go down in value.

The silver lining

Silver often exhibits a leveraged relationship with gold. We experienced this in the twelve months after the March 2020 Covid crash in markets when silver meaningfully outperformed gold while both metals rallied. In 2022, things went in the other direction. As gold's sentiment deteriorated, investor sentiment towards silver fell even further (see figure 02 below).

Figure 02: Net speculative positioning in silver

Source: WisdomTree, Bloomberg as of 11 January 2023. Stdv is standard deviation.

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And once again, gold's recovery is enabling silver to bounce back even more strongly. Silver is, of course, affected by the dynamics of industrial metals as well given more than half of its demand comes from industrial applications. This was also a factor for its lacklustre performance last year as industrial metals were pricing in a slowdown in China and recessionary fears across major economies more widely.

If in 2023, China's lockdowns are lifted for good and the economic engine starts firing again, fuelled by accommodative monetary policy, this could be the catalyst for the recovery of industrial metals. It could also spur silver's rally further.

The risk to the view

If the Fed takes markets by surprise and continues to tighten into the second half of this year, our base case could be challenged, and gold and silver may face newfound resistance. If the Fed signals such intentions early this year, say, in response to inflation numbers as they become available, these challenges could present themselves sooner.

For now, it appears, that inflation is moderating steadily encouraging the markets to believe that so will Fed's hawkishness.

1 Source: Trading Economics 12 January 2023.

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