Is a previous gold bull scenario repeating itself?

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Gold has historically had a clear inverse relationship with US real yields (Figure 1). Investors typically consider both gold and US treasuries defensive safe-haven investments and turn to them when they perceive geopolitical and macroeconomic risks to be elevated causing their prices to move with a high degree of correlation.

Source: WisdomTree, Bloomberg. Monthly data from 31/01/2010 to 31/01/2020.

Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.

Real yields are a function of nominal rates and inflation. If we isolate the two factors historically and observe the behaviour of nominal US treasury yields relative to consumer price index (CPI) inflation, we notice something interesting. Nominal yields for US treasuries have fallen across the curve in recent months causing almost all points on the curve to be close to or below the current rate of inflation (Figure 2). Last time this happened was in 2011/2012 when the curve remained below inflation for a protracted period. Concurrently, speculative positioning on gold futures exchanges remained elevated keeping the price of gold high. A similar situation may be manifesting today with low yields and speculative positioning for gold at record highs.

Source: WisdomTree, Bloomberg, Federal Reserve Bank of St. Louise. Data from 13/02/2010 to 13/02/2020. Generic nominal treasury yields for (1,3 and 6) months and (1,2,3,5,7,10,20 and 30) years used. Calculation shows the proportion of these contracts that are below US CPI YoY, e.g. 100% means that all 11 points on the yield curve noted above are below CPI at the time.

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Going forward, we project three scenarios for 2020 with inflation, nominal rates and speculative positioning being key variables in our gold model. We outline this framework in our 2020 gold outlook. In our base case, which we believe to be conservative, we expect the US Federal Reserve to keep its monetary policy on hold, yields to rise moderately from current levels and speculative positioning for gold to return to average historic levels. Gold's price forecast in this conservative scenario is US$1640 for the end of the year, which means that we view the downside risk to gold's price to be limited in the current environment. In a bear case, speculative positioning drops considerably and the Fed tightens policy causing bond yields to rise

and inflation to pull back. In this scenario, gold ends the year at US$1470/oz. In a bull scenario, yields fall further due to Fed easing and speculative positioning remains elevated. This takes us to a gold price of US$2030/oz at year end.

Now, if speculative positioning remains elevated and the Fed keeps its monetary policy on hold i.e. conditions remains broadly similar to how they are today, we could end up somewhere between our base and bull scenarios. This would keep bond yields suppressed and gold prices elevated as we witnessed in 2012, and potentially at even higher levels. Is history repeating itself?

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