March 20, 2014

Precious Metals

Cold, Crimea & China: Transient supports to gold prices

Goldman Sachs

Commodities Research

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The 2014 gold rally brought prices to their highest level since September before a more hawkish-than-expected March FOMC pushed prices sharply lower. Three distinct and in our view transient catalysts have driven this rally: (1) a sharp slowdown in US economic activity which we believe was weather driven, (2) high Chinese credit concerns, although ultimately bearish for gold demand through lower financing deals if realized, and (3) escalating tensions over Ukraine. While further escalation in tensions could support gold prices, we expect a sequential acceleration in both US and Chinese activity, and hence for gold prices to decline, although it may take several weeks to lift uncertainty around this acceleration. Importantly, it would require a significant sustained slowdown in US growth for us to revisit our expectation for lower US gold prices over the next two years.

Re-acceleration in US activity will push gold prices lower

While we see clear catalysts for the recent rally in gold prices, this move has been large relative to US real rates which are a key input into our forecasts and benchmarking of gold prices. As a result, we see potential for a meaningful decline in gold prices towards the level implied by 10-year TIPS yields, which our rates strategists expect to rise further this year, and reiterate our year-end $1,050/toz gold price forecast. More broadly, we believe that with tapering of the Fed’s QE, US economic releases are back to being a key driving force behind gold prices. As a result, we expect that the decline in gold prices will likely be data dependent, in contrast to our 2013 bearish gold view which was driven by the disconnect between stretched long gold speculative positioning and stabilizing US growth.

Indian and Chinese gold demand unlikely to surprise to the upside

Weak Indian gold imports and surging Chinese imports were the most important shifts in EM gold demand last year, although these trade statistics likely overestimated shifts in local gold demand given reported gold smuggling into India and the use of gold in Chinese financing deals. While we see potential for these shifts to reverse in 2014, we estimate the net impact will not be meaningful to our gold outlook as: (1) India’s potential easing of gold import tariffs will likely remain modest given how much lower gold imports have contributed to its improved trade balance, (2) we expect a gradual unwind of gold backed financing deals.

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Cold, Crimea and China: Transient supports to gold prices

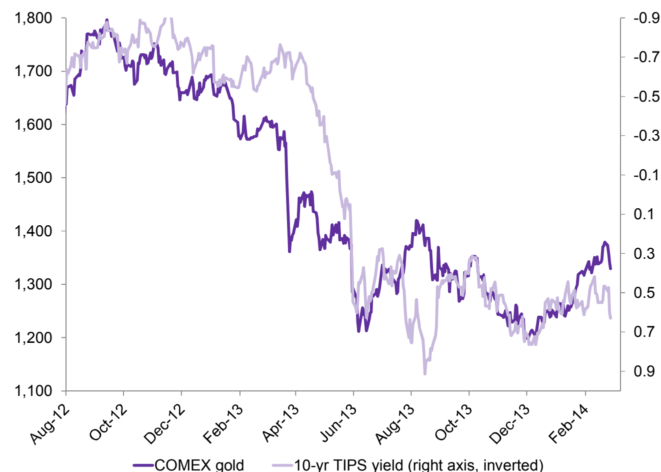
The year-to-date gold rally brought prices to their highest level since last September, at $1,379/toz, before a more hawkish-than-expected March FOMC and lack of significant escalation since Russia's annexation of Crimea brought prices back down to $1,330/toz. Three distinct – and in our view transient – catalysts have contributed to this rally: (1) a sharp slowdown in US economic activity, with concerns that its magnitude extends beyond the impact of very cold winter weather, (2) weak Chinese activity indicators compounded by credit concerns, and (3) escalating tension between Russia and the G7 over Ukraine.

Our base-case forecast remains for a sequential acceleration in both US and Chinese activity, and hence for gold prices to decline. While we believe that it may take several more weeks to lift the uncertainty around this acceleration, the more hawkish-than-expected March FOMC is likely to weigh on gold prices in the short term. Admittedly, a rebound in US and Chinese growth this spring is a consensus view and a disappointment in either would lead us to delay our expected decline in gold prices. **However, it would require a significant sustained slowdown in US growth for us to revisit our expectation for lower US gold prices over the next two years.**

As has historically been the case, escalating geopolitical tensions could provide further support to gold prices and cannot be ruled out. Interestingly, while gold prices rallied sharply into last weekend's referendum in Crimea, they sold off early this week as sanctions introduced so far fell short of expectations despite Russia's annexation.

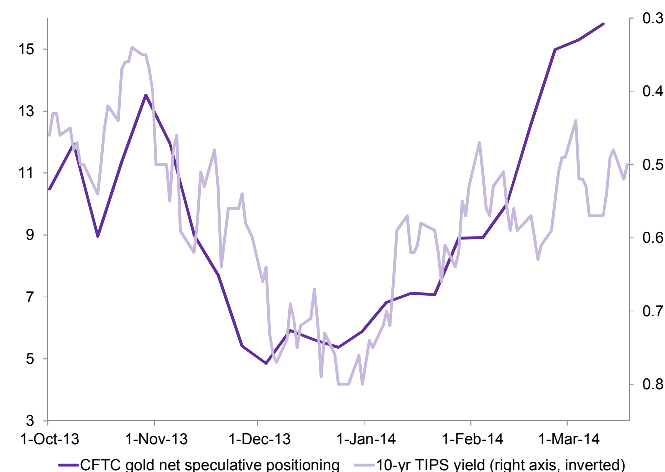
Ultimately, while we see clear catalysts for the recent rally in gold prices, this move has been large relative to US real rates which are a key input into our forecast and benchmarking of USD denominated gold prices. As a result, we see potential for a meaningful decline in gold prices towards the level implied by 10-year TIPS yields with confirmation of our expected acceleration in activity further pushing gold lower/rates higher. In turn, if we are wrong on this acceleration, we would expect lower US real rates to close the gap to potentially even higher gold prices.

Exhibit 1: The rally in gold prices has occurred despite stable US real rates…
$/toz (left); % (right, inverted)



Source: COMEX, FRB.

Exhibit 2: … with COMEX gold net long speculative positioning elevated vs. our real rate benchmark as well
mtoz (left); % (right, inverted)



Source: CFTC, FRB.

The US economy hasn't caught a cold

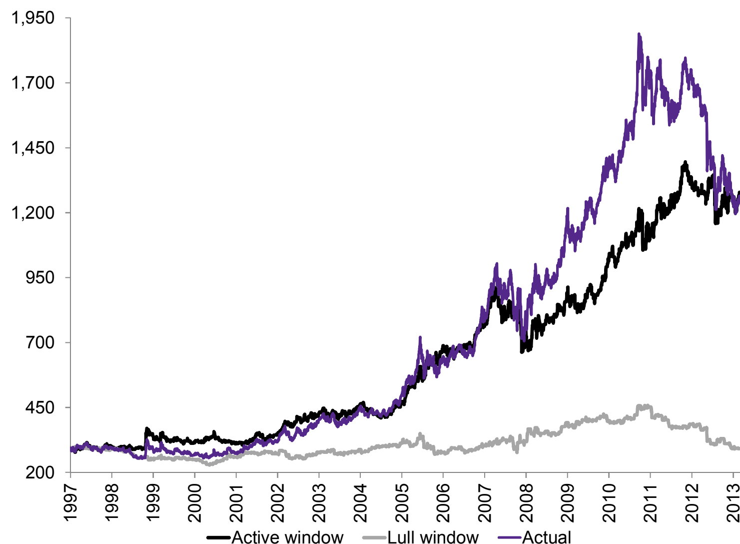
US economic data has weakened in 2014 although our economists see this as mostly weather related and expect that growth will accelerate for the remainder of the year. Nonetheless, uncertainty on the pace of economic growth will likely linger until we get confirmation of this rebound as: (1) a very cold first half of March will likely impact monthly economic indicators, (2) some data releases such as the January and February payrolls, were either weak in sectors typically not associated with weather or featured smaller weather impacts than expected, and (3) the strength in 4Q13 GDP growth was in part attributable to inventory accumulation and favorable trade data. As a result, it may take several more weeks, and until April economic data starts to be released, to get confirmation that the underlying pace of economic growth is indeed accelerating.

In the very short term, this near-term uncertainty is likely to be offset by the hawkish March FOMC which suggested that the Fed's path to a less accommodative monetary policy stance may occur faster than previously expected. More broadly, we believe that with the progressive tapering of the Fed's QE, economic releases will return to being the driving forces behind gold prices. Specifically, work from our economist Jose Ursua published last year[1] suggests that it is in fact the "active" window for US economic data releases – releases that feature meaningful new economic information – that will be the key drivers of gold prices as was the case before 2008. We illustrate this in Exhibit 3, breaking down the historical performance of gold prices between lull and active windows of US economic releases (which include scheduled FOMC releases). For the month of March, this window starts today (March 20) with the release of the Philly Fed Survey and will last for the next two weeks.

As a result, we expect that the decline in gold prices will likely be a data driven "grind lower" as we get progressive confirmation of the US growth acceleration. From a price action perspective, this stands in sharp contrast to our 2013 bearish view on gold prices which was driven by what we estimated was a disconnect between stretched long gold speculative positioning and stabilizing US growth with low inflation.

Exhibit 3: The determination of gold prices will likely go back to being driven by US economic releases

Gold prices ($/toz): Actual vs. active and lull windows of economic releases



Source: COMEX, Goldman Sachs Global Investment Research.

[1] See *Global Economics Weekly - The lull is dull: Getting the view right at the right time pays off*, March 20, 2013

A Chinese slowdown is not necessarily bullish for gold prices

The uncertainty on the macro outlook has extended to China over the past few weeks with a softening of growth indicators at a time when credit concerns are already at the fore. Specifically, with little boost from exports and efforts to slow credit growth and curb corruption/pollution crimping domestic demand, our economists estimate that sequential growth in 1Q14 has weakened to 5%. However, our economists again expect an acceleration driven by stronger internal demand, the recent easing of financing conditions and the DM growth recovery.

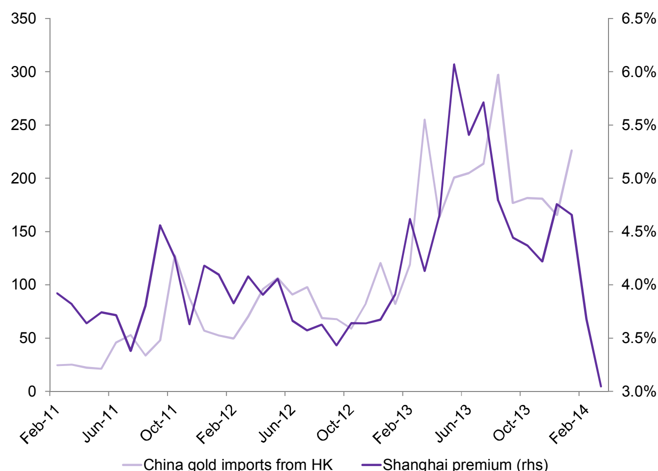
Importantly, potential support from China to gold prices hinges on the impact that a sustained Chinese growth slowdown would have on domestic gold demand and US activity. We expect, however, that the impact on gold demand and prices will be limited given:

- Weaker Chinese economic growth could slow the expected recovery in US activity and ultimately delay a decline in gold prices/rise in US real rates. However, our economists view this pass through as limited, absent a hard landing, given the limited impact of weaker Chinese imports on US exports. In fact, the potential negative commodity price impact from weaker Chinese growth could support the US recovery.
- Our base case is for a gradual unwind of Chinese Commodity Financing Deals, which we estimate are actively implemented with gold as collateral[2], based on: (1) gradually rising US rates, and (2) higher Chinese FX volatility which increases the cost of currency hedging and closes the interest rate arbitrage. Continued CNY depreciation in the short term could in fact trigger some deals to be unwound now and hence place downside risks to Chinese gold import.
- While January trade data pointed to strong gold imports from Hong Kong into China, the Shanghai over London LBMA gold premium has weakened significantly since then, pointing to sharply lower imports since (Exhibit 4). We further find that over a longer time horizon the Shanghai premium is strongly inversely correlated to COMEX gold prices, weakening on price rallies (Exhibit 5). This suggests that, as is the case for most EM gold demand and DM jewelry demand, Chinese gold demand remains very price sensitive with the 15% ytd rally in CNY denominated gold prices ultimately weighing on domestic gold demand.

On net, we believe that the pass through of weaker Chinese growth, absent a hard landing, would likely be modest both on our expected US acceleration as well as on Chinese gold demand. In fact, recent weakness in the Shanghai gold premium points to sequentially weaker domestic gold demand instead.

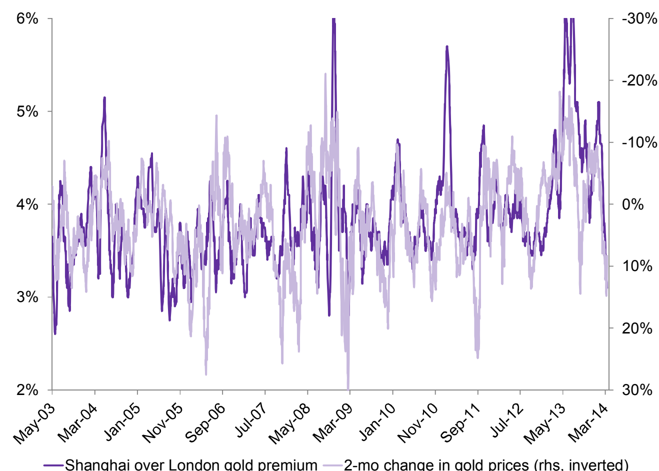
[2] *Metal Detector - Days numbered for Chinese commodity financing deals*, March 18, 2014

Exhibit 4: The sharp decline in the Shanghai gold premium points to sharply weaker sequential imports
HK exports to China (tonnes, lhs); cash premium (%, rhs)



Source: UNComTrade, SGE, LBMA.

Exhibit 5: Chinese gold demand is price responsive: the Shanghai premium is inversely correlated to gold returns
cash premium (%, lhs); 2-mo gold return (%, rhs, inverted)



Source: COMEX, SGE, LBMA.

Beyond US and Chinese economic activity, escalating tensions between Russia and the G7 as well as a potential easing of India's gold import restrictions have contributed to the recent positive sentiment. We take no view on the former and indeed believe that further escalation could provide additional support to gold prices, however we believe that a gradual easing on India's gold imports would likely only occur later this year and remain modest, limiting the upside to local gold demand.

Further escalation between Russia and G7 could support gold

As has historically been the case, gold prices have rallied on rising geopolitical tensions, this time between the G7 and Russia. In particular, recent acceleration in the gold rally coincided with the rally in wheat and corn prices, the two commodities potentially most impacted by disruptions in Ukraine[3].

While gold prices rallied sharply into last weekend's referendum in Crimea, prices sold off this week as the scope of EU sanctions introduced so far fell short of expectations despite Russia's annexation of the region (visa bans and asset freezes). This price action suggests that further escalation in tensions between the G7 and Russia would likely be required to further support gold prices.

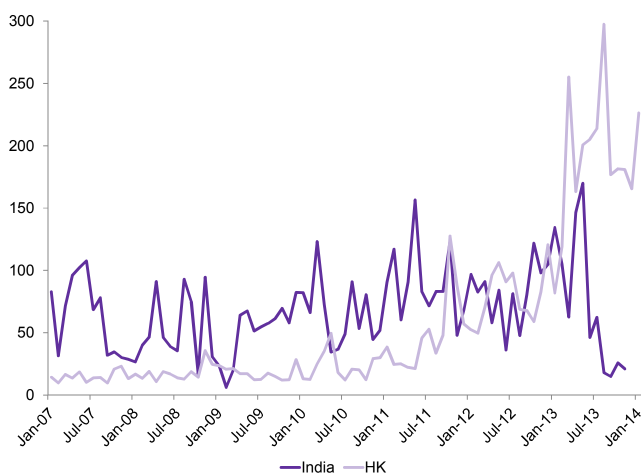
A gradual easing in India's gold import tariff likely

Some of the countries that saw the largest currency depreciations last summer, India and Indonesia, have implemented broad measures aimed at stabilizing their currencies which sharply reduces risks of weaker local gold demand. This has in turn raised the question whether the Indian government would ease its gold import tariff which has led to a 80% decline in reported gold imports, although the decline in gold demand is likely smaller given reported gold smuggling into the country. Our expectation remains that it is unlikely that the government significantly eases these constraints, with no decision until June:

[3] *Agriculture Update - Assessing the agriculture spillover from Ukraine*, March 4, 2014

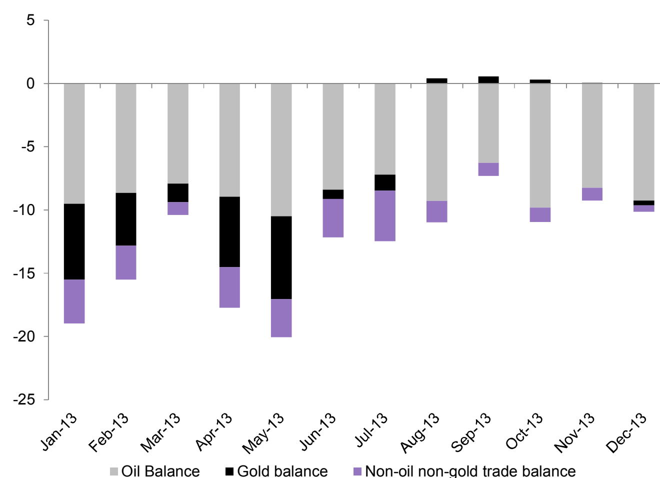
- Such decision could only be taken after mid-May as the government cannot make any policy changes during the election period ("the election code of conduct" policy).
- The decline in gold imports following the introduction of such measures has alone accounted for roughly 2/3 of the narrowing of the trade deficit since May 2013. As a result, an easing of gold import restriction would likely require a combination of a better macro backdrop or other measures to improve India's trade balance and further enhancements to fiscal and monetary policy.
- While we believe that there ultimately will be an easing of such tariffs to help limit gold smuggling, the timing will be important. Specifically, GFMS jewelry data for India shows a statistically significant seasonal increase in gold jewelry demand in 2Q (April-June), ahead of the Fall wedding season. As a result, an easing post the election would likely occur too late to significantly raise 2014 Indian gold demand.

Exhibit 6: The introduction of import tariffs last year led to a collapse in official gold imports into India
Monthly gold trade (tonnes)



Source: UNComTrade.

Exhibit 7: Lower gold import following the introduction of tariffs were a significant contributor to a lower CA
India's monthly trade balance (million USD)



Source: Haver.

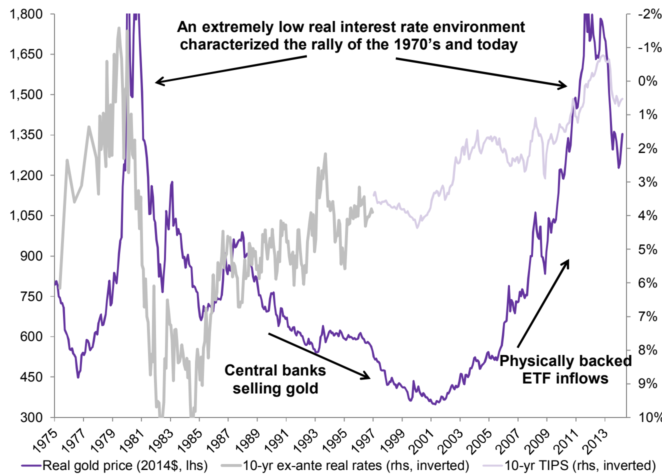
Our 2014-15 gold outlook in fourteen charts

Beyond near-term uncertainty on the pace of US growth, our base case forecast remains for a sequential acceleration in US activity. As a result, we reiterate our bearish outlook for gold prices in 2014 and 2015 and our year-end forecast of $1,050/toz. While the first quarter slowdown in activity creates risk that our expected price decline is delayed by one quarter, the more hawkish March FOMC which pointed to a potentially more aggressive path to less accommodative monetary policy is an offsetting risk.

With our gold forecast and framework unchanged, we illustrate and summarize the key drivers to our gold price forecast in our favorite charts below. For detailed discussion of our gold modelling, please refer to *Gold cycle set to turn on improving US recovery*, December 5, 2012 and *Neutral gold prices near-term but still expecting new lows in 2014*, September 16, 2013.

Exhibit 8: Our gold modeling is based on US real interest rates and monetary physical gold demand (ETF and central banks)…

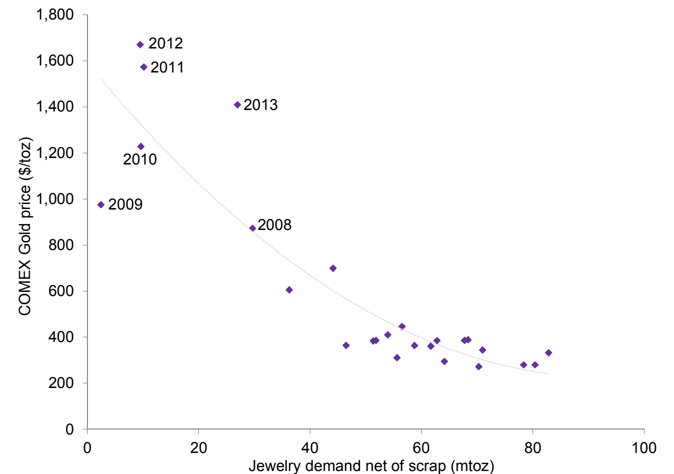
Gold prices in 2014 $ (lhs), 10-yr US real rates (rhs, inverted, prior to 1997 calculated as 10-yr US treasury yield less inflation expectations from University of Michigan Survey)



Source: COMEX, FRB, Goldman Sachs Global Investment Research.

Exhibit 9: … as we view retail demand for gold as responding to prices rather than setting prices. It should continue to grow as prices decline

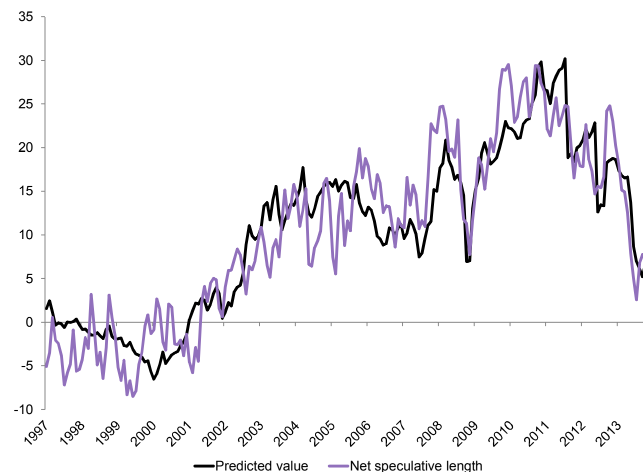
Annual average gold prices ($/toz, vertical axis); Annual global jewelry demand net of scrap (million toz)



Source: GFMS, COMEX.

Exhibit 10: For example, COMEX gold net speculative positioning is well explained by real rates and quantitative easing by the Federal Reserve…

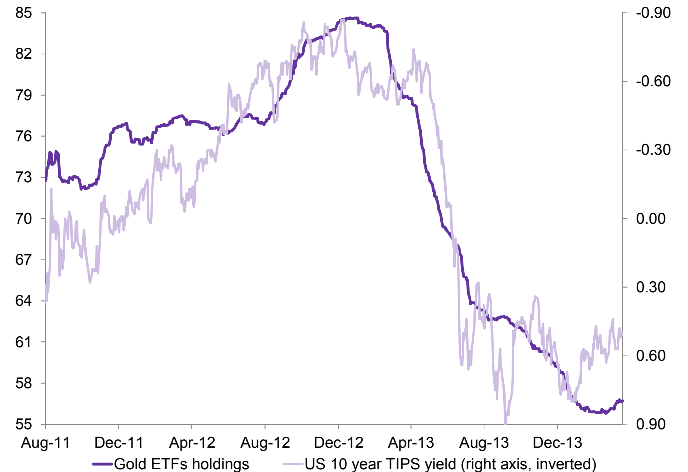
CFTC net speculative positioning (million toz)



Source: FRB, CFTC, Goldman Sachs Global Investment Research.

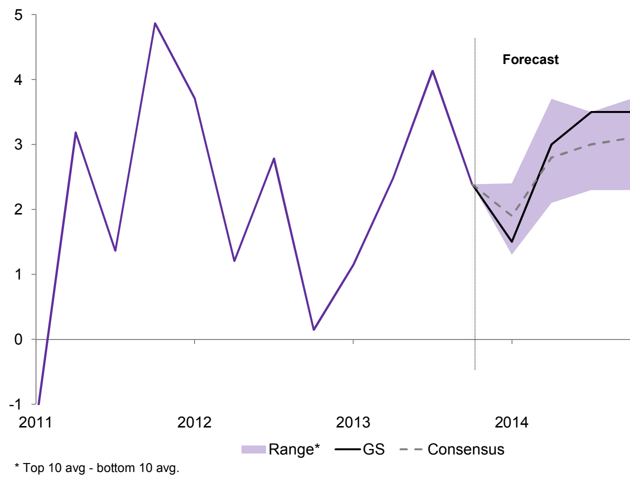
Exhibit 11: … with ETF holdings also tracking US real rates after their initial ramp up

million toz (left); % (right, inverted)



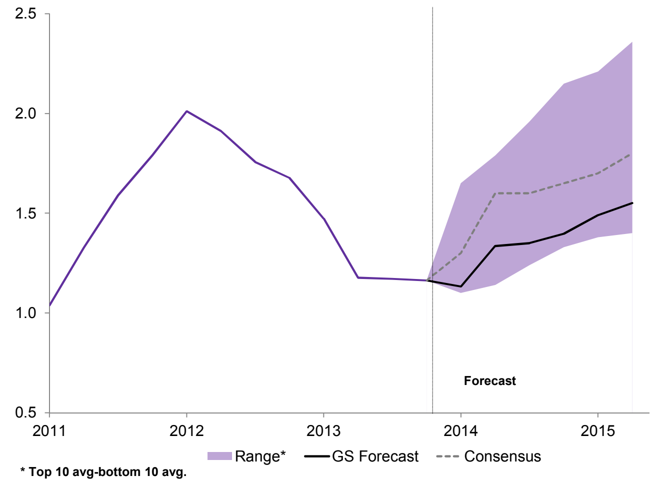
Source: Bloomberg, FRB.

Exhibit 12: Our economists forecast strong US GDP growth in 2014...
Real GDP growth (Ann. % chg.)



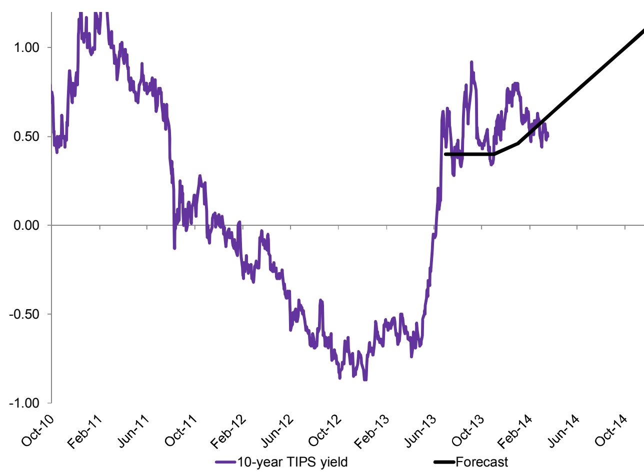
Source: Goldman Sachs Global Investment Research, FRB.

Exhibit 13: ... coupled with low inflation
Inflation (Core PCE); Percent change, year ago



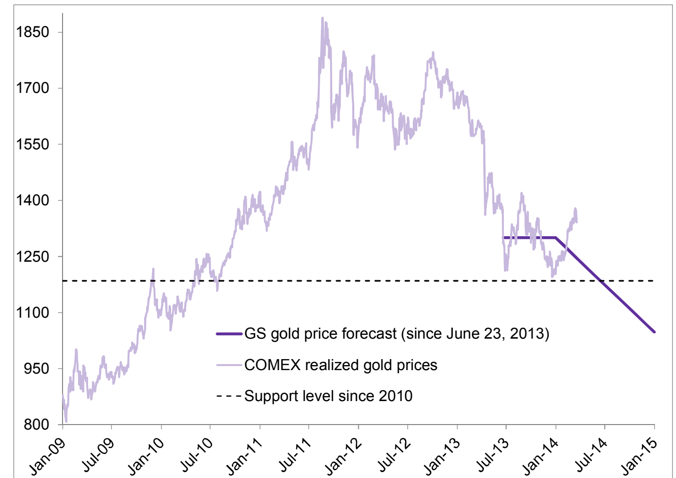
Source: Goldman Sachs Global Investment Research, FRB.

Exhibit 14: This outlook points to higher US real rates...
%



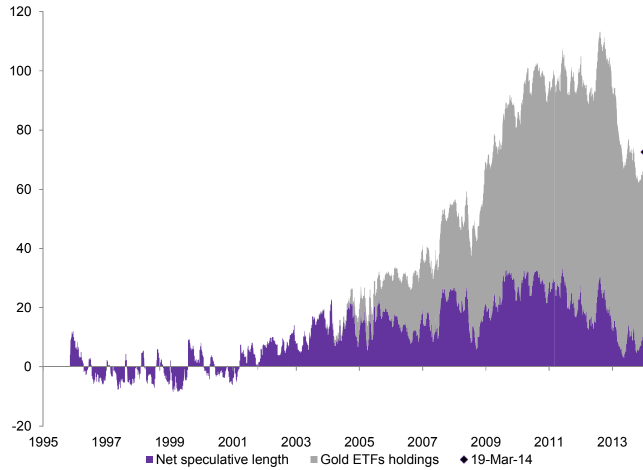
Source: Goldman Sachs Global Investment Research, FRB.

Exhibit 15: ... and lower gold prices once economic data shows an acceleration in growth
$/toz (left); % (right, inverted)



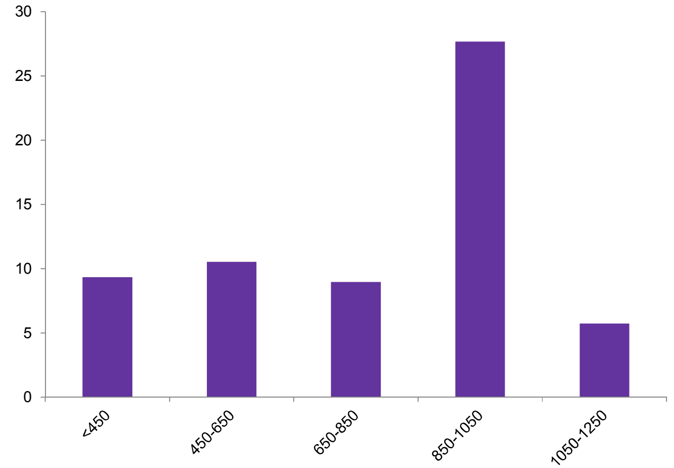
Source: FRB, COMEX.

Exhibit 16: Combined net long gold positioning is off its highs but offers sufficient ammunition for another leg lower…
million toz



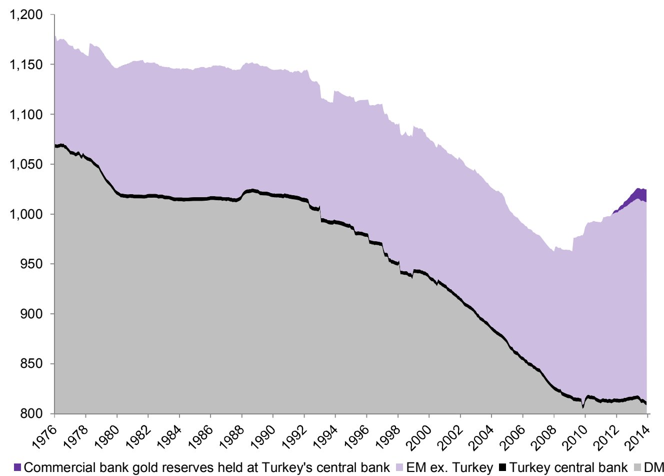
Source: Bloomberg, CFTC.

Exhibit 17: … with 10% of ETF gold holdings bought between $1,050-1,250/toz
million toz



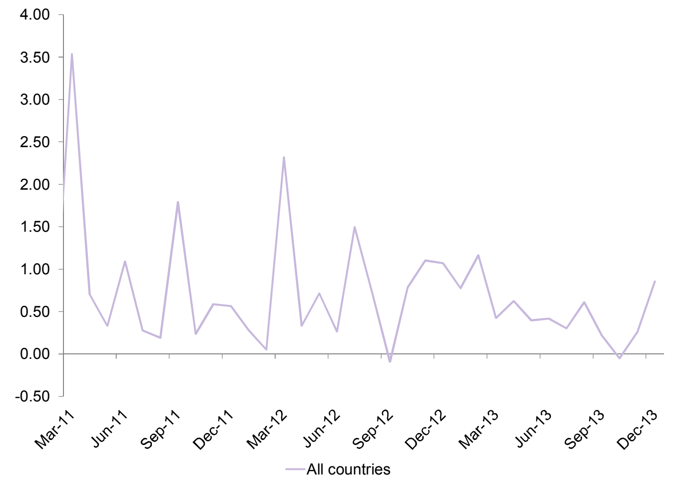
Source: Bloomberg.

Exhibit 18: While EM central banks have become steady gold buyers and DM holdings are stable…
Central bank gold holdings (mtoz)



Source: IMF.

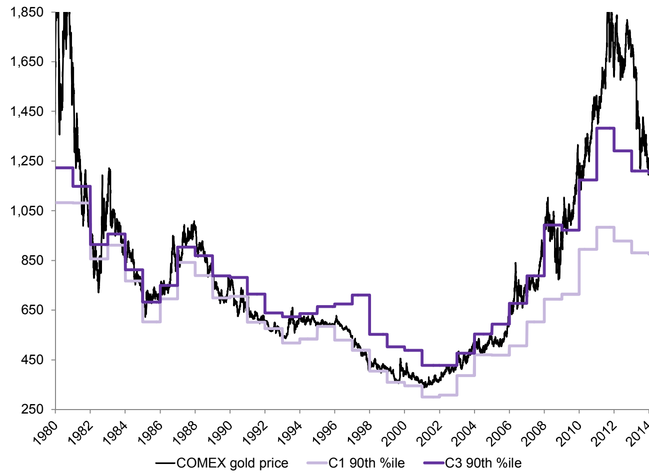
Exhibit 19: … EM central bank gold purchases have slowed in 2013 as gold prices declined
Central bank gold holdings (mtoz, monthly changes)



Source: IMF.

Exhibit 20: Our year-end $1,050/toz gold price forecast is below current marginal fully allocated production costs but the 1990s gold bear market suggests marginal cash cost is a more likely floor

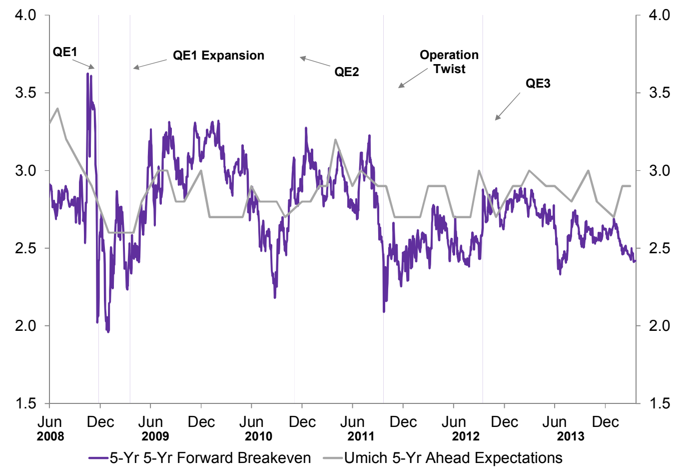
Real gold prices in 2014 $/toz



Source: Wood Mackenzie, COMEX.

Exhibit 21: The long-term gold outlook is dependent on the potential for strong inflation following significant Fed balance sheet expansion

%



Source: FRB

Price actions, volatilities and forecasts

	Prices and monthly changes[1]			Volatilities (%) and monthly changes[2]				Historical Prices						Price Forecasts[3]		
	units	19 Mar	Change	Implied[2]	Change	Realized[2]	Change	3Q 12	4Q 12	1Q 13	2Q 13	3Q 13	4Q 13	3m	6m	12m
Energy																
WTI Crude Oil	$/bbl	100.37	0.07	18.0	-0.67	19.7	5.3	92.20	88.23	94.36	94.17	105.81	97.61	**96.00**	**95.00**	**90.00**
Brent Crude Oil	$/bbl	105.85	-3.23	16.5	-0.68	16.1	3.1	109.42	110.13	112.64	103.35	109.65	109.35	**105.00**	**105.00**	**100.00**
RBOB Gasoline	$/gal	2.87	0.06	18.1	-0.18	32.6	14.8	2.95	2.73	2.99	2.83	2.91	2.66	**2.70**	**2.60**	**2.60**
NYMEX Heating Oil	$/gal	2.90	-0.18	17.6	-0.48	17.7	-18.7	3.00	3.05	3.04	2.89	3.05	2.99	**3.00**	**3.00**	**2.90**
NYMEX Nat. Gas	$/mmBtu	4.48	-0.73	30.4	-4.05	76.5	-11.9	2.89	3.54	3.48	4.02	3.56	3.85	**4.50**	**4.50**	**4.00**
UK NBP Nat. Gas	p/th	56.57	-1.89	15.5	4.31	44.9	24.4	56.92	66.12	67.58	65.08	65.45	70.16	**70.60**	**72.00**	**77.60**
Industrial Metals[4]																
LME Aluminum	$/mt	1,739	-7	16.3	0.91	17.7	3.4	1,950	2,018	2,041	1,871	1,828	1,815	**1,700**	**1,700**	**1,750**
LME Copper	$/mt	6,553	-597	15.9	1.34	19.3	9.9	7,721	7,924	7,958	7,190	7,098	7,169	**7,000**	**6,600**	**6,200**
LME Nickel	$/mt	16,325	2075	21.9	-0.65	15.8	-2.8	16,396	17,025	17,375	15,035	14,019	13,978	**14,500**	**15,000**	**16,000**
LME Zinc	$/mt	1,980	-62	16.0	-0.37	15.4	2.2	1,905	1,978	2,054	1,876	1,897	1,932	**2,000**	**2,050**	**2,100**
LME Lead	$/mt	2,078	22	16.2	0.84	14.8	1.8	1,989	2,200	2,308	2,065	2,115	2,136	**2,050**	**2,150**	**2,300**
Precious Metals																
COMEX Gold	$/troy oz	1,341	22	15.2	-0.59	14.7	0.4	1,654	1,719	1,631	1,417	1,328	1,274	**1,215**	**1,150**	**1,050**
COMEX Silver	$/troy oz	20.8	-0.6	26.7	-0.31	23.6	-0.6	29.9	32.6	30.1	23.2	21.4	20.8	**20.3**	**19.2**	**17.5**
Agriculture																
CBOT Wheat	cent/bu	716	117	26.7	3.31	33.7	11.5	871	846	739	695	650	655	**610**	**560**	**575**
CBOT Soybean	cent/bu	1,411	103	18.7	2.50	16.0	2.2	1,677	1,484	1,450	1,468	1,407	1,304	**1,400**	**1,050**	**1,050**
CBOT Corn	cent/bu	488	43	26.6	6.00	22.1	10.9	783	737	716	661	514	430	**450**	**400**	**400**
ICE Cotton	cent/lb	93	4	18.8	-1.35	19.5	0.9	73	73	83	86	86	81	**75**	**75**	**75**
ICE Coffee	cent/lb	185	45	46.8	19.84	69.6	25.8	172	152	143	132	118	110	**130**	**130**	**130**
ICE Cocoa	$/mt	3,025	91	23.9	0.65	14.8	-4.9	2,438	2,421	2,175	2,278	2,420	2,734	**2,700**	**2,700**	**2,700**
ICE Sugar	cent/lb	17.3	1.7	22.9	3.74	44.3	19.0	21	20	18	17	17	18	**16.5**	**17.5**	**17.5**
CME Live Cattle	cent/lb	146.1	3.5	8.6	0.35	13.3	2.6	122	127	128	122	124	132	**138.0**	**133.0**	**135.0**
CME Lean Hog	cent/lb	124.2	37.6	16.3	1.29	41.1	29.5	83	82	84	92	94	87	**90.0**	**100.0**	**80.0**

[1] Monthly change is difference of close on last business day and close a month ago.
[2] Monthly volatility change is difference of average volatility over the past month and that of the prior month (3-mo ATM implied, 1-mo realized).
[3] Price forecasts refer to prompt contract price forecasts in 3-, 6-, and 12-months time.
[4] Based on LME three month prices.

Source: Goldman Sachs Global Investment Research.

Disclosure Appendix

Reg AC

We, Damien Courvalin and Jeffrey Currie, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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