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## Gold(s) (OW): Debunking the Bearish Case for Gold(s)

- **Gold(s) perform poorly before/after the first Fed hike.** This was true over the last three tightening cycles of 1994-95, 1999-2000 and 2004-2006 (**Figure 1**) where rate hikes were “mechanical” in nature, that is, the Fed raising rates by a 25bp increment at each meeting. But as Fed Chair Yellen repeated yesterday through the Q&A session, contrary to these episodes, the Fed does not intend to follow a pre-determined path to higher interest rates. Rather, a “gradual” or “wait-and-see” approach was reiterated. Therefore, the next few months may well look like the 1986-87 tightening cycle where golds outperformed before and after the first Fed hike (**Figure 1**, fourth panel). Interestingly, the 1986-87 experience teaches us that despite a Fed hike in December 1986, gold equities surged until the second Fed hike which occurred in April 1987. So, if the Fed were to pre-emptively hike rates in September, the Fed could take a pass in December and the second hike could only happen next year if a “gradual” approach is implemented. This scenario could maintain or open the door to a cyclical rally in gold and gold equities.

- **Inflation is low and years away.** Inflation went down to a multi-year low of 2.3% in 1993 and the gold sector rose 115%. Back to the 1986-87 episode, who would have said that in December 1986, US headline CPI would bottom at 1.2% and boom to 3.7% four months later? Interestingly, like today, the third panel of **Figure 2** shows that wage inflation was running ~2%. The bulk of the inflation increase in 1987 came from the rebound in oil prices. We calculated that if oil prices reach \$70/bbl next spring, US headline CPI would be near 2%. But like in early 1987, by moving progressively, the Fed runs the risk of allowing inflation expectations to build as headline CPI catches up to core CPI, hence the “inflation” trade on gold(s). The key points to remember here are the trend in inflation and expectations. **Figure 3** shows that no matter the starting point in inflation, gold equities historically are strong outperformers (+18%>TSX over 12 months) from historical bottoms in US headline inflation. Yesterday’s headline CPI suggests the disinflation cycle is over.

- **The US\$ is in a bull market.** True but how about a pause? As we explained in our US\$-related incubator published on [June 3](#), current account flows (**Figure 4**) and the tightening in the US-Eurozone GDP growth differential are positive for the euro currency. Investors seem willing to hug the US\$ thinking that a US economic rebound and superior GDP growth will strengthen the US\$. But as **Figure 5** shows, the DXY is weakening anew and seems on its way to test its 200-day average of ~92. This is all happening while net spec positions on the DXY are still crowded on the long side (**Figure 5**, second panel). Could it be like in H2/10 when a recovery in US economic momentum was not enough to turn the US\$ around (**Figure 5**, third panel)? Our point is not to say that the US\$ is about to crash but a phase of liquidation upon a break of the DXY below its 200-day average would likely confirm a price-range pattern for the US\$ over the next year.

**Bottom line: stay long on XGD and short on XIU. A “gradual” Fed-hike cycle, further US\$ correction/consolidation and a catch-up in headline to core inflation is a positive backdrop for gold(s) which should allow for a cyclical rally. Below are the top picks by CG analysts.**

**Large-caps:** AEM, YRI and SLW, FNV  
**Mid-caps:** P, BTO and KDX  
**Small-caps:** RMX, DNA, and TXG  
**Explorers:** BSX and KAM

Figure 1

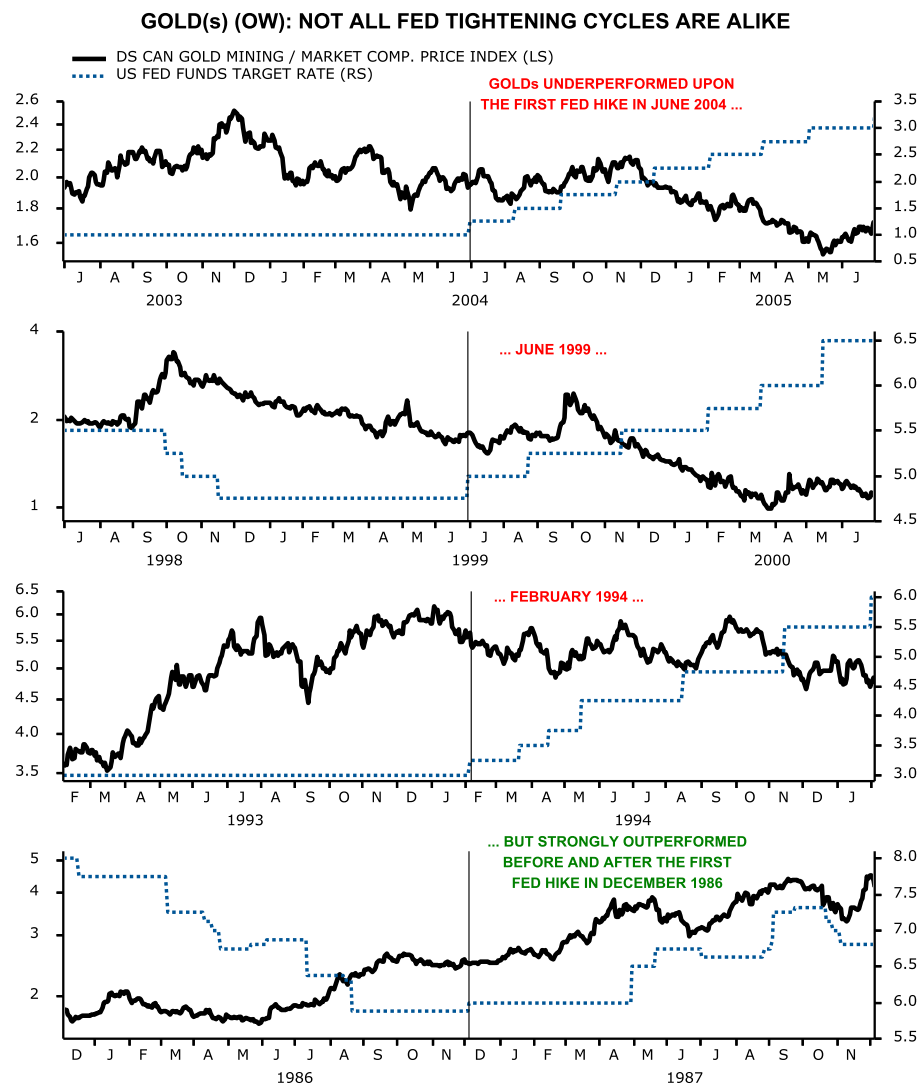


Figure 2

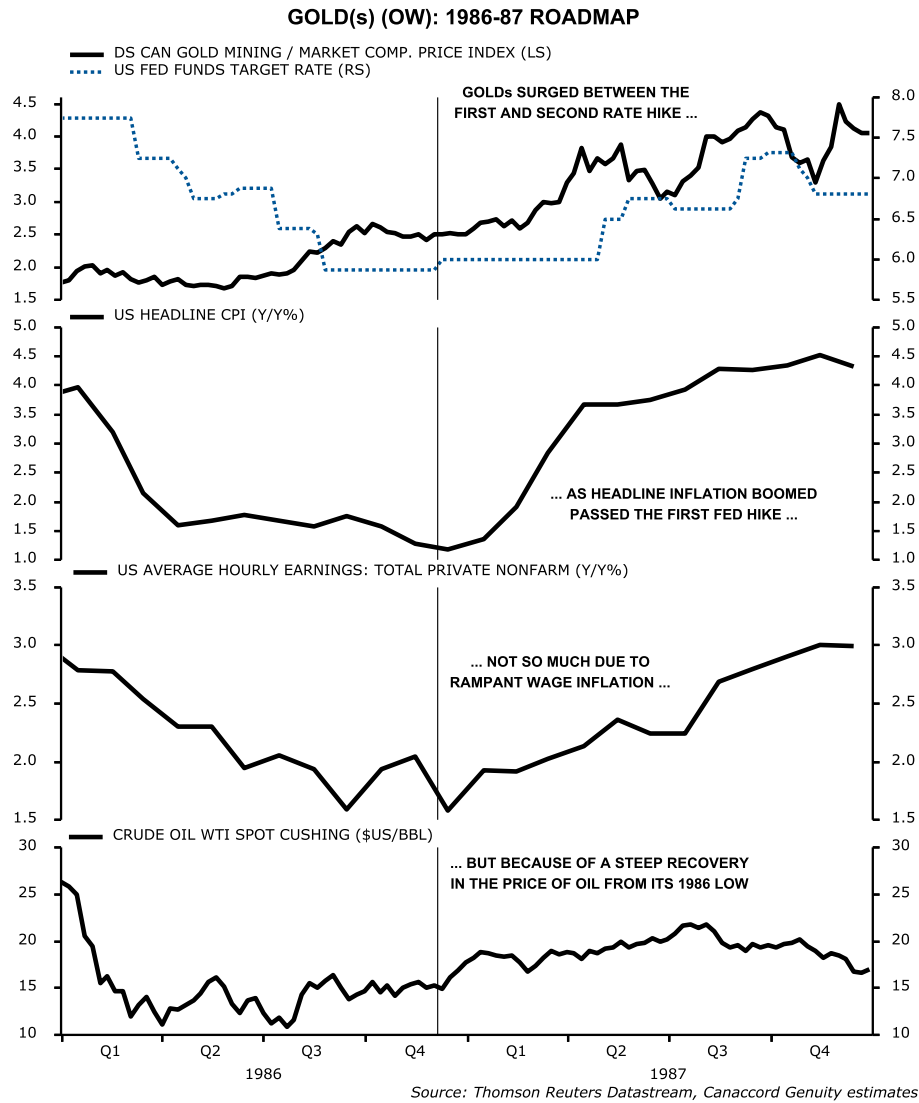


Figure 3

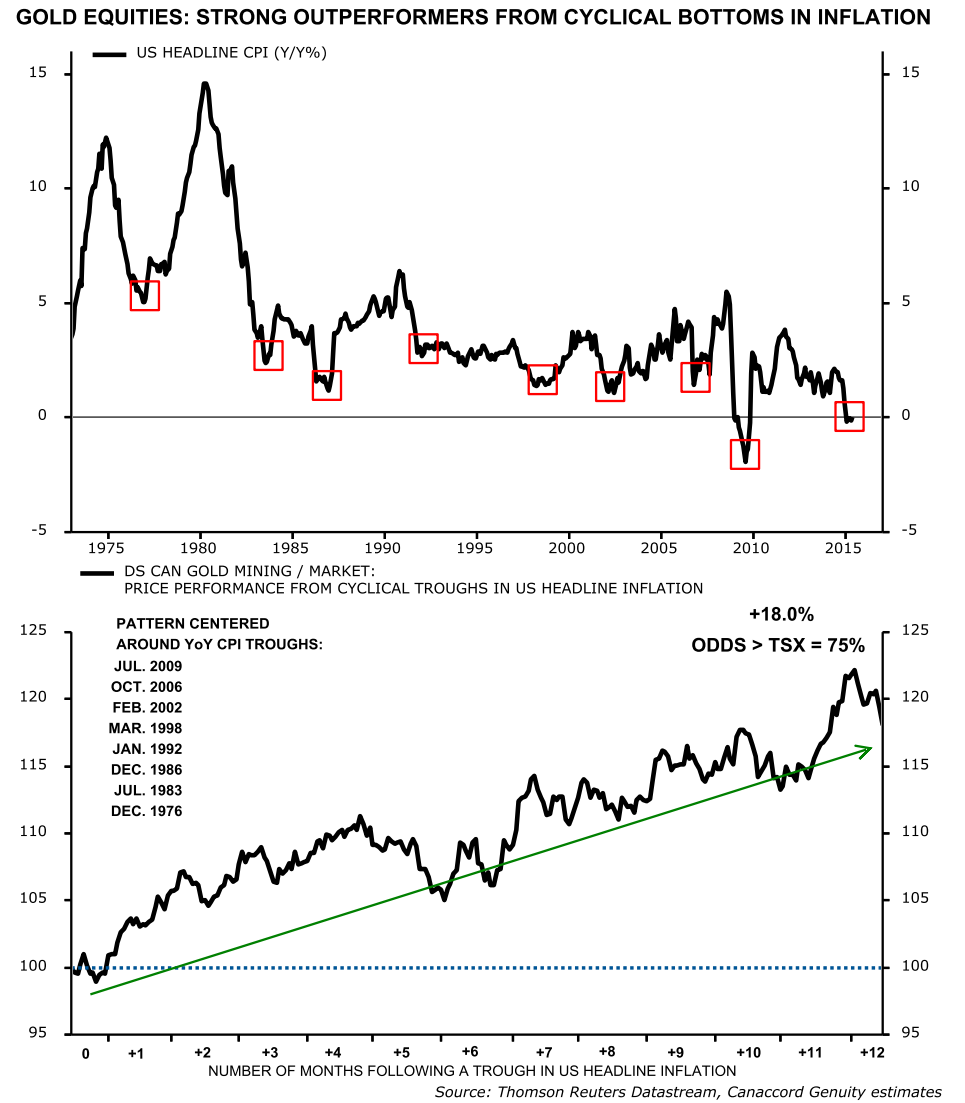
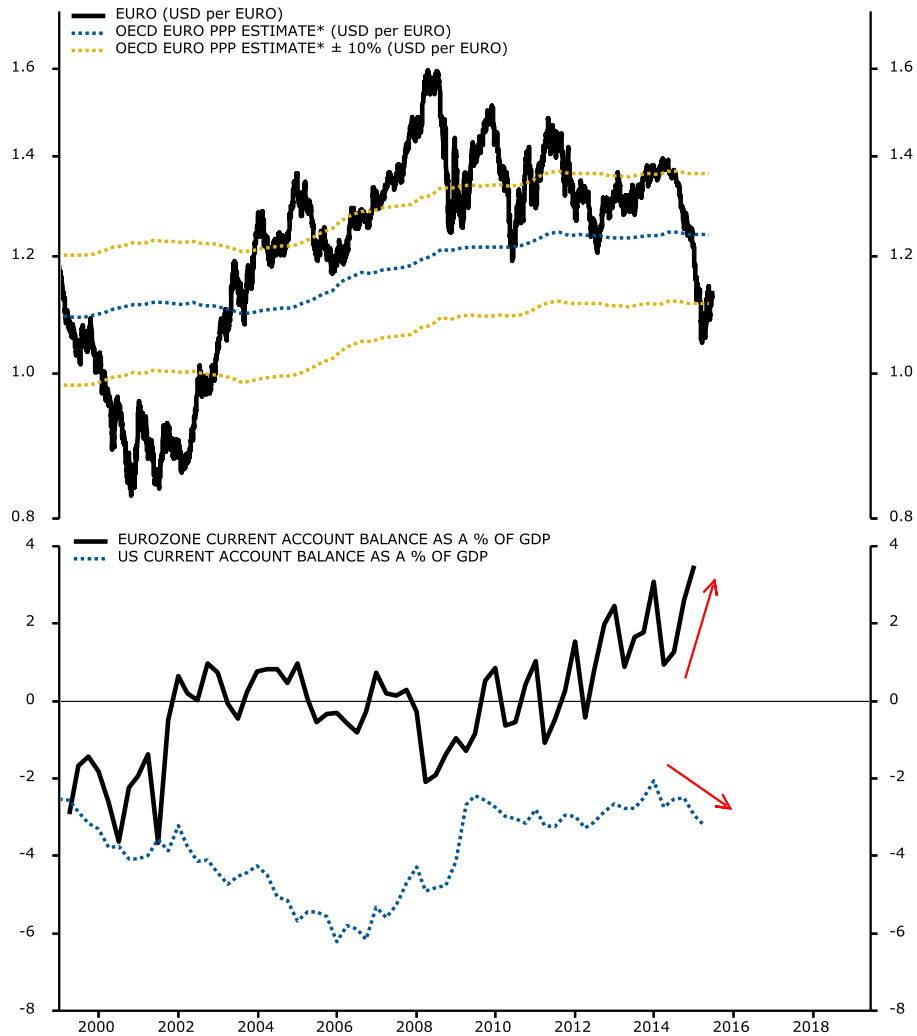


Figure 4

USD per EURO VS. PURCHASING POWER PARITY AND CA/GDP BALANCE



\* AVERAGE OF GERMANY, FRANCE, NETHERLANDS AND ITALY Source: Thomson Reuters Datastream, Canaccord Genuity estimates

Figure 5

US DOLLAR: BULL MARKET PAUSE



Source: Thomson Reuters Datastream, Canaccord Genuity estimates

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