Gold Views: In search of a new reserve currency

Jeffrey Currie
+44(20)7552-7410 |
jeffrey.currie@gs.com
Goldman Sachs International

Mikhail Sprogis
+44(20)7774-2535 |
mikhail.sprogis@gs.com
Goldman Sachs International

Daniel Sharp
+44(20)7774-1875 |
daniel.sharp@gs.com
Goldman Sachs International

Damien Courvalin
+1(212)902-3307 |
damien.courvalin@gs.com
Goldman Sachs & Co. LLC

Michael Hinds
+1(212)357-7528 |
michael.hinds@gs.com
Goldman Sachs & Co. LLC

1) The recent surge in gold prices to new all-time highs has substantially outpaced both the rise in real rates and other US dollar alternatives, like the Euro, Yen and Swiss Franc (see Exhibit 1 and Exhibit 2). We believe this disconnect is being driven by a potential shift in the US Fed towards an inflationary bias against a backdrop of rising geopolitical tensions, elevated US domestic political and social uncertainty, and a growing second wave of covid-19 related infections. Combined with a record level of debt accumulation by the US government, real concerns around the longevity of the US dollar as a reserve currency have started to emerge. We have long maintained gold is the currency of last resort, particularly in an environment like the current one where governments are debasing their fiat currencies and pushing real interest rates to all-time lows (the US 10-year TIPs at -92bp is 5bp below the 2012 lows). With more downside expected in US real interest rates, we are once again reiterating our long gold recommendation from March and are raising our 12-month gold and silver price forecasts to $2300/toz and $30/toz respectively from $2000/toz and $22/toz. These forecasts are consistent with a 5-year TIPs of -200 bp.

2) This relentless decline in real interest rates against nominal rates bounded by the US Fed has caused inflation breakevens to rise (see Exhibit 3) in an environment that would ordinarily be viewed as deflationary, i.e. a weakening US labor market as the country re-enters lockdown. Ironically, the greater the deflationary concerns that policymakers must fight today, the greater the debt build up and the higher the inflationary risks are in the future. The deflationary shock caused by the pandemic drives the need to expand balance sheets to support demand today, as seen in the latest US $1.0 trillion Phase 4 stimulus and the €750 billion pan-EU recovery fund. The resulting expanded balance sheets and vast money creation spurs debasement fears which, in turn, create a greater likelihood that at some time in the future, after economic activity has normalized, there will be incentives for central banks and governments to allow inflation to drift higher to reduce the accumulated debt burden. Indeed, this has already been seen in recent FOMC minutes, as discussions of explicit outcome-based forward guidance raises the prospect for Fed-sanctioned overheating of the economy (see Exhibit 4). Despite the longer-term nature of these risks, asset managers have real concerns today about persistent unanticipated shifts in inflation that can create large discrepancies between current expected real returns and actual realized returns.

3) The key point from a hedging perspective is that asset managers care about the level of inflation, not the changes in inflation, and from a level perspective, inflation

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hedges like commodities and equities are likely far cheaper today than in the future when inflation could arrive. When discussing the drivers of investment demand for gold and commodities, it is important to distinguish between debasement and inflation. The key is that the current debasement and debt accumulation sows the seeds for future inflationary risks despite inflationary risks remaining low today. While debasement in many cases leads to inflation, it is not always the case as witnessed over the past decade. Equally, the best debasement hedge (gold) is not always the best hedge against inflation (oil). Indeed, the word debasement comes from adding base metals like tin or copper to the precious metals that acted as hard currency; therefore, owning the pure precious metal is then the best hedge against debasement. However, this does not mean gold is the best hedge against inflation — a common misconception of many investors. Gold doesn't appear significantly in any CPI anywhere in the world. As a result, oil and other commodities that drive the items actually found in different CPIs are the best hedges against inflation. But today the risk is from debasement of fiat currencies that sows the risk for inflation and gold is the best hedge against debasement. Further out as inflation risks rise, oil and equities hedge unexpected and expected inflation respectively better than gold (see Exhibit 5), and given the size of the bond portfolios built over the past decade that will need to be hedged against inflation risks, the sheer size of investment demand for commodities is likely to be massive, underscoring the need to act today.

4) As a result of growing debasement risk, DM investment demand strength has continued with ETF additions in both Europe and US running high (see Exhibit 6). We see this trend persisting for some time as investment allocations into gold increase inline with allocations to inflation protected assets, similar to what happened after the financial crisis. Following the GFC, inflation fears peaked only at the end of 2011 as the bounce back in inflation ran out of steam, bringing the gold bull market to a halt. Similarly, we see inflationary concerns continuing to rise well into the economic recovery, sustaining hedging inflows into gold ETFs alongside the structural weakening of the dollar, we see gold being used as a dollar hedge by fund managers. Indeed, decomposing our gold forecast, with returns of 18% over the next 12 months, we estimate 9% of the growth is driven by 5yr real rates going to -2% over the next 12 month, (an est. elasticity of 0.1), while the second 9% comes from the 15% increase in the EM dollar GDP (an est. elasticity of 0.5) (see Exhibit 7). On top of these known flows, a large share of physical investment demand in gold is non-visible, in particular vaulted bar purchases by high net worth individuals. Looking at net Swiss imports one can see that gold stocks in Switzerland, where most of these private vaults are located, have been building at close to a record pace (see Exhibit 8). In addition, the stretched valuations in equities, low real rates and high level of economic and political uncertainty all point toward continued inflows by high net worth individuals, in our view.

5) Beyond inflation-driven DM investment demand, EM physical gold demand remains depressed; however, it is less concerning than what the headlines would suggest. EM consumers are being squeezed out of the market as opposed to opting out. Nonetheless, Indian gold imports are still down 80% yoy in June and the Chinese gold premium is beginning to turn negative again (see Exhibit 9). More recently, however, the weakness in EM demand has been driven more by gold's high price, as consumers

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cannot afford to buy gold products at those levels. However, EM currencies are no longer under pressure and India has begun to see the rupee strengthen over the past month. EM growth is also beginning to recover with EM activity entering positive YoY territory in June for the first time since January and our economists seeing the worst of the EM outlook behind us (see Exhibit 10). EM retail investment demand is also boosted by easier monetary policy together with continued inflation driving EM real rates down. In India, policy rates fell below the YoY inflation rate for the first time since 2013. Taken together, we believe these factors create a perfect setup for a rebound in EM demand akin to 2010-11. We will likely see this demand materialize when price stabilizes somewhat and DM investment purchases slow down, creating more room for EM consumers. We feel that for now, investors should not be concerned by weak EM demand prints.

6) We are also raising our silver forecast to $30/toz on a 3/6/12 month horizon, pulled upward by higher gold prices and better prospects for silver industrial demand, particularly in solar energy (c.15% of silver demand). Both the European Green Deal and Biden's war on climate change plans imply a doubling every year of solar panel capacity installations in both the US and Europe. At the same time, silver demand in consumer electronics is benefiting from the transition to working from home as it is heavily used in consumer items such laptops, mobile phones and televisions. Even housing demand, where silver is used in light switches, looks to be better than expected with property sales in both US and China rebounding strongly. Silver has rallied almost 30% over the past few weeks but its ratio with gold is only back to its level at the beginning of this year of 80 (see Exhibit 11). Historically there has been a tight relationship between silver industrial demand and the gold-silver price ratio (see Exhibit 12). If silver industrial demand next year is 5% higher versus its 2019 level, the gold-to-silver ratio would fall further to 77. Assuming this ratio, our $2300/toz gold target would imply a $30/toz silver price.

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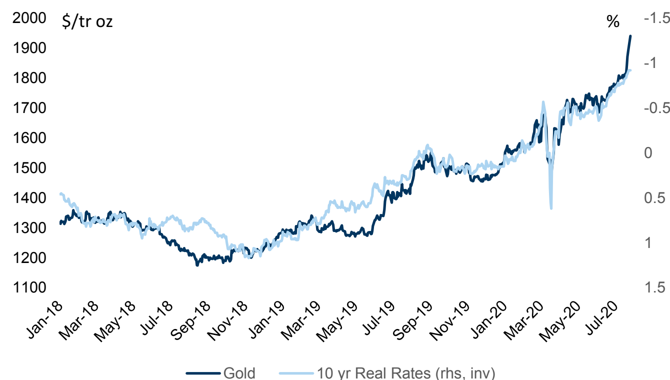
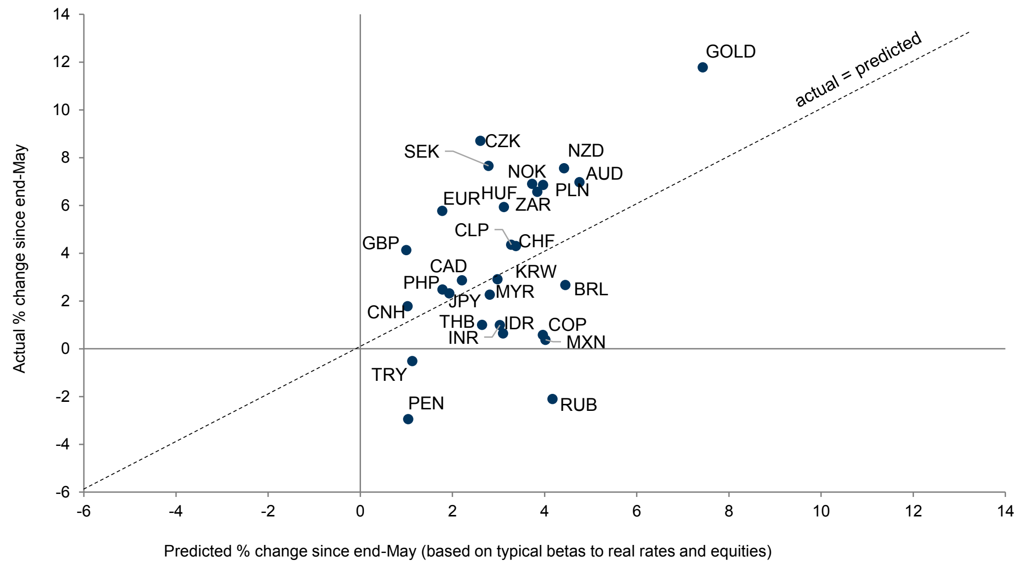
Charts

Exhibit 1: Gold has broken away from real rates



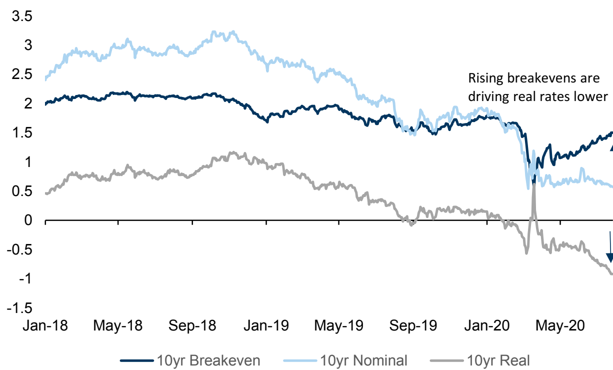
Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 2: Gold has outperformed other dollar alternatives



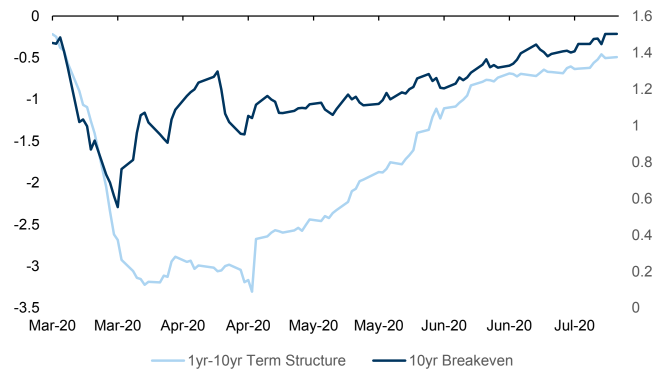
Source: Goldman Sachs Global Investment Research

Exhibit 3: Inflation expectations have driven real rates lower
USD Treasury Real and Nominal Yield, and Breakeven Inflation



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 4: The recent rise in inflation expectations has come from a structural, rather than cyclical repricing of inflation
US T-bill break-even inflation, %



Source: Bloomberg, Goldman Sachs Global Investment Research

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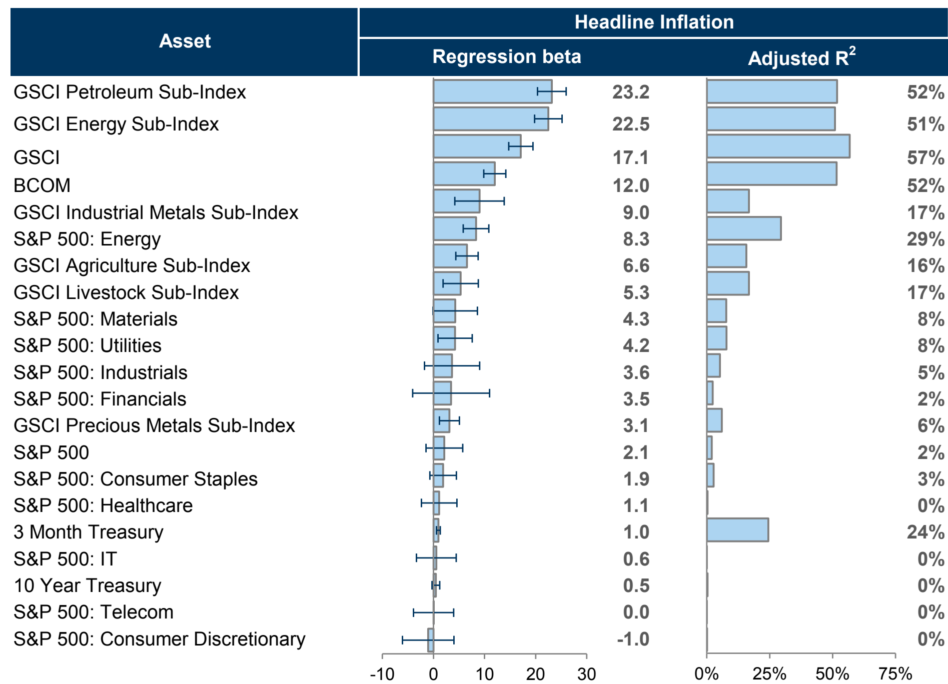
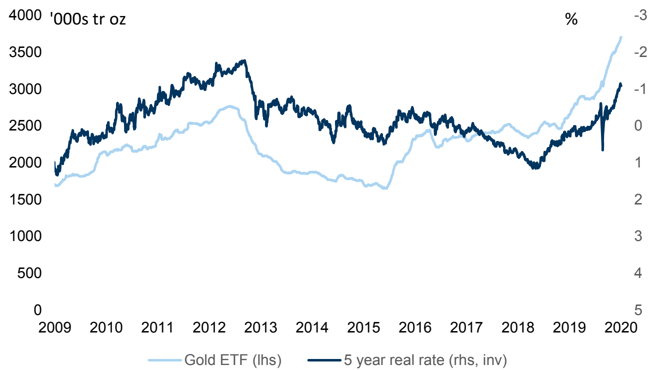
Exhibit 5: Oil remains the best hedge against realised inflation

Regression betas against monthly realised US CPI - All Items Index



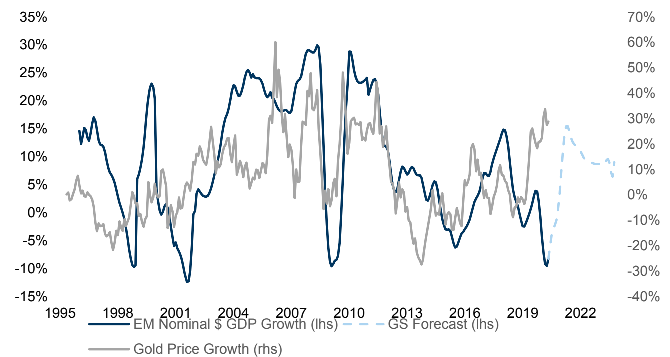
Source: Goldman Sachs Global Investment Research

Exhibit 6: Gold ETFs have seen their sharpest inflows since the financial crisis



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 7: EM demand will help drive gold prices higher, even after it has been crowded out



Source: Goldman Sachs Global Investment Research

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Exhibit 8: Net Swiss imports of gold give an indicator of how much private demand happens off-exchange
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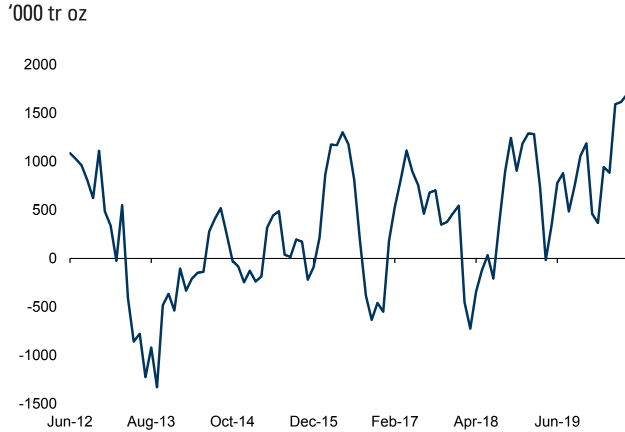
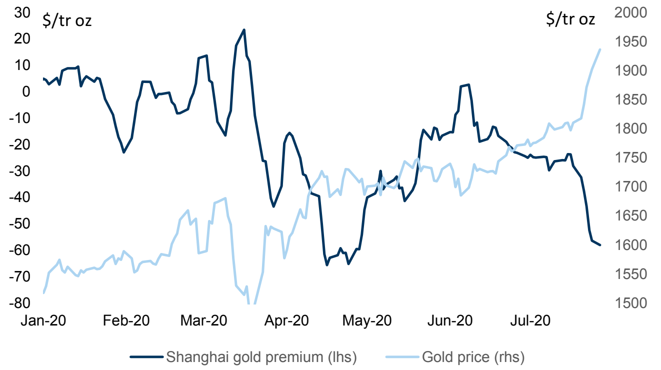


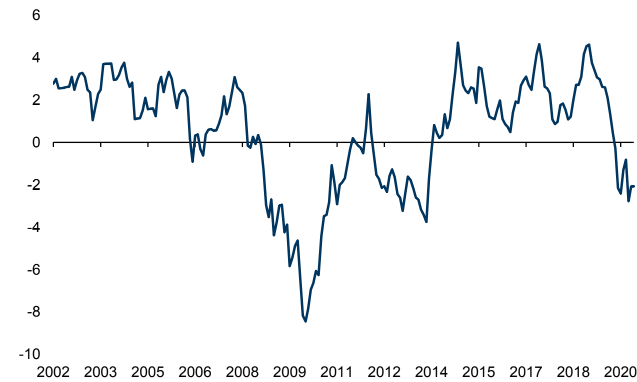
Source: WGC, Goldman Sachs Global Investment Research

Exhibit 9: The shanghai gold premium continues to fall...



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 10: ...but so do Indian real rates
Indian 1yr policy rate vs Yoy inflation



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 11: At 80 the gold/silver ratio is still at historically high levels...
The Gold-Silver price ratio

Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 12: ...and we expect this ratio to decline further as renewable-based industrial demand picks up

Source: Bloomberg, Goldman Sachs Global Investment Research

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