TD Securities

Market Musings

Global Rates, FX & Commodities Strategy

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Who is the Mystery Gold Buyer?

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- The rally in gold prices over the past two months has defied analyst expectations for continued weakness, including TD Securities'. Yet, we see little evidence that the rise in gold prices is associated with a changing macro narrative. Given the bearish macro backdrop, speculative interest in gold has remained exceptionally lackluster as the world barrels towards a recession, especially after accounting for recent shifts in CTA positioning. Still, gold prices have continued to firm, retracing more than 50% of their significant drawdown from 2022 highs.
- This begs the question: who in the world is this mystery buyer driving prices higher? Armed with a flows-based approach, we present strong evidence that behemoth Chinese and official sector purchases may have single-handedly catalyzed a $150/oz mispricing in gold markets. What is less clear is what has driven these massive purchases.
- We investigate whether a sanctions-evasion war chest associated a potential invasion of Taiwan, China's reserve currency ambitions, massive pent-up demand associated with the Chinese reopening, or Chinese New Year demand could be consistent with this extreme buying activity. Chinese demand appears unrelenting for the time being, but barring a grandiose geopolitical regime change, we find that it would likely subside towards normal levels in coming months. This would leave gold prices vulnerable to a steep consolidation lower, given gold's lack of alternative buyers and its current mispricing relative to its recent historical relationship with real rates. We turn to our tracking of positioning for the top ten gold traders in China to scour for nascent signs of peaking Chinese demand, which could present a tactical signal for a noteworthy repricing lower.

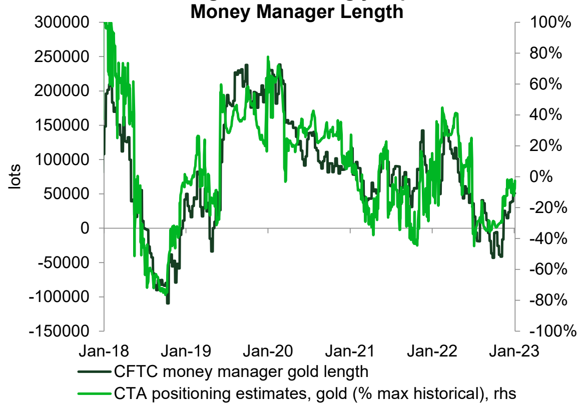
The rally in gold prices over the past two months has defied analyst expectations for continued weakness, including TD Securities'. The Fed continues to grasp onto its hawkish rhetoric despite evidently peaking inflation, as US policymakers shift their focus to service sector inflation amid a persistently tight labour market. Our 2023 inflation outlook expects that wages will cause services sector prices to keep rising at an elevated pace, which Chair Powell explicitly tied to the outlook for interest rates. Meanwhile, quantitative tightening continues to sap liquidity and money supply growth, in favor of our view for lower gold prices. This should continue to constrain investment appetite for precious metals. And yet, gold prices have continued to firm, retracing more than 50% of their significant drawdown from 2022 highs, despite the bearish macro backdrop. This begs the question: who in the world is this mystery buyer driving prices higher?

Investment Appetite for Gold Still in the Gutter

Certainly, money managers trading Comex gold have contributed to the buying activity. CFTC non-commercial net length, which encompasses all speculators trading Comex gold futures, has notably risen. However, our proprietary daily estimates of CTA positioning still overwhelmingly explain the rise in CFTC money manager net length. In other words, we find that short covering from algorithmic trend followers is overwhelmingly behind the rise in money manager positioning, which has likely exacerbated the rally. Still, the continued strength in price action remains inconsistent with solely a positioning squeeze, and instead points to an underlying buyer.

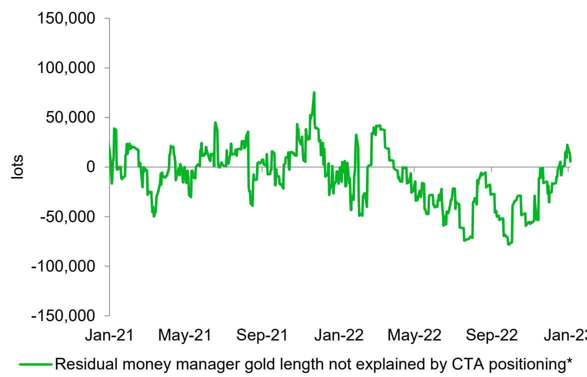
Market participants have pointed to narratives ranging from peaking inflation, expectations for an imminent recession and a subsequent central bank pivot as providing fundamental support for the yellow metal. Yet, at the same time, we do not see much evidence of a commensurate increase in investment appetite from discretionary money managers.

CTA Positioning Overwhelmingly Explains Rise in Money Manager Length



Source: TD Securities, Bloomberg

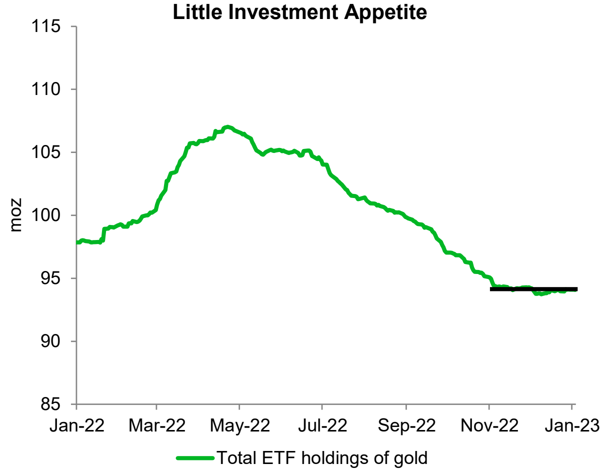
Discretionary Comex Gold Length is Now Flat



*based on a 260d rolling regression of CFTC money manager positioning and CTA positioning estimates

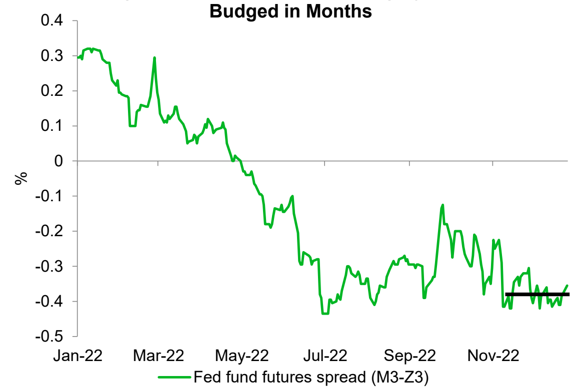
Source: TD Securities, Bloomberg

Unchanged ETF Holdings Corroborate View for Little Investment Appetite



Source: TD Securities, Bloomberg

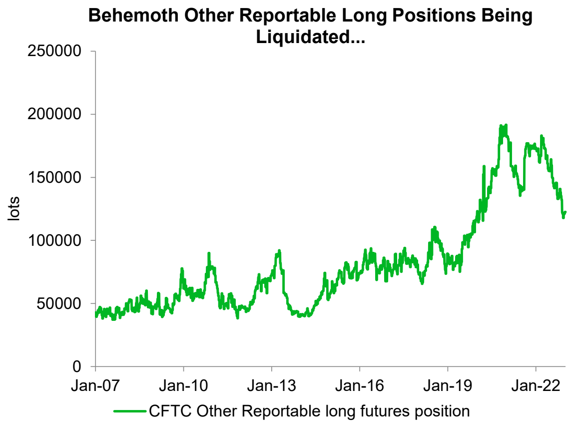
Pricing for an Imminent Rate Cutting Cycle Hasn't Budged in Months



Source: TD Securities, Bloomberg

We estimate discretionary interest in Comex gold as the residual of a 260d rolling regression of CFTC money manager length and our proprietary CTA positioning estimates, and find that any discretionary short covering that may have occurred over the past months has likely run out of steam since the early weeks of November. This is further corroborated by ETF holdings of gold, which have remained muted across the globe, whereas rates market pricing also remains inconsistent with rising expectations for a rate cutting cycle. Fund flows into broad commodity funds and into precious metals funds have remained equally lackluster.

Overall, we still don't see sufficient evidence of substantial buying activity from money managers. However, it is worth recalling that there's a new sheriff in speculative gold markets. Other reportables, which typically refer to proprietary traders and family offices, have become the dominant holders of Comex gold length. On a per-trader basis, other reportables continue to hold onto bloated position sizes. However, total long positioning from this cohort has meaningfully declined over the past months, driven by a decline in the breadth of traders long, which suggests that the new sheriff is on the offer as prices rise as opposed to the bid.



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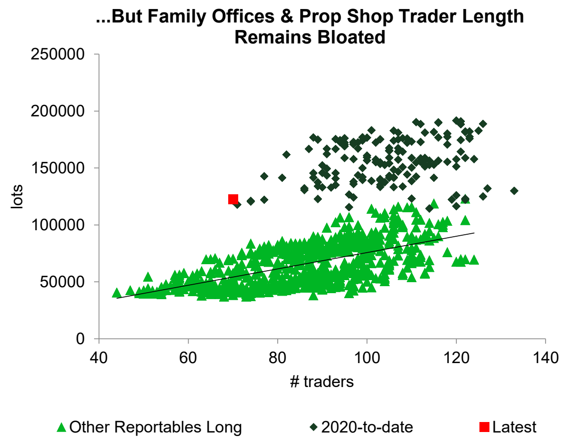
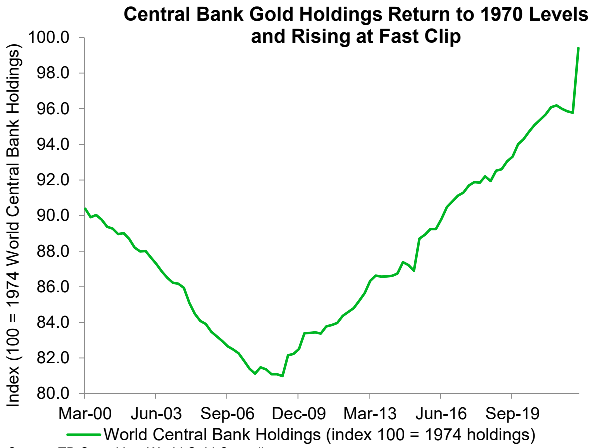


Source: TD Securities, Bloomberg

Largest Official Sector Purchases Since Bretton Woods

Gold prices aren't rising to reflect a change in macro narratives that have bolstered investment demand. Instead, the official sector has overwhelmingly been the single most significant buyers of gold. The World Gold Council's estimate of official sector gold holdings suggests that central bank purchases have lifted gold reserves to their highest level since November 1974. This is particularly notable as the date shortly follows the change in the zeitgeist towards the current currency regime, based on floating fiat currencies, which replaced the Bretton Woods system that tied the value of the US dollar to the precious metal.

Official IMF data points to substantial purchases from Turkey, Uzbekistan, and Qatar, but fall far below the more elevated estimates from the World Gold Council. However, the latter additionally includes government agencies aside from central banks in Russia, China and other nations that can buy and hold gold without reporting them as reserves. In turn, market participants have mused about stealthy purchases from both Russia and China at a massive scale.

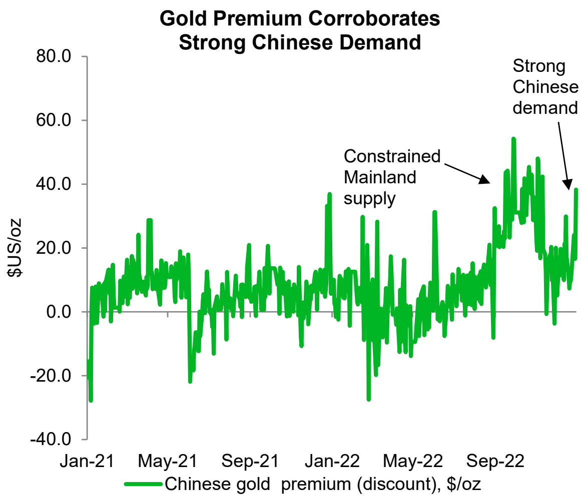


Source: TD Securities, World Gold Council

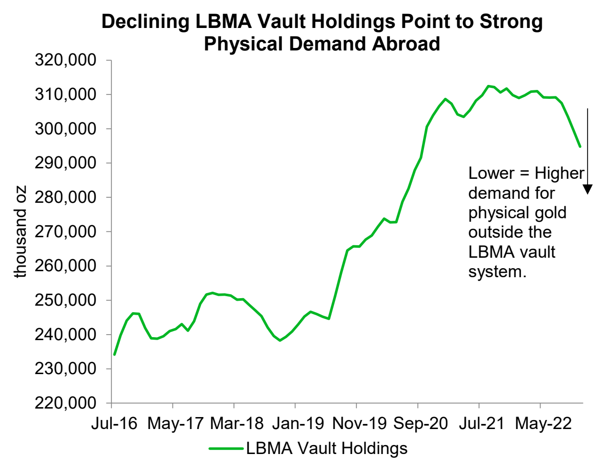
Source: SHFE, TDS Commodity Strategy

While this follows reports of massive purchases from China's official sector, which participants speculate were to the tune of 300 tonnes over the past months, it also fits with our tracking of Chinese trader activity. In fact, Chinese traders have been the only directly observable underlying buyers. Our tracking of the top ten participants in Shanghai highlights a notable increase in net length from this cohort, equivalent to 100 tonnes in notional gold since December 20th. This was primarily driven by more than 16k SHFE lots of new longs acquired over this timeframe, continuing the trend of notable rise in Shanghai gold length since early November. The pace of gold purchases from Shanghai traders has yet to show any sign of slowing as traders' net length approaches last-twelve-month highs.

Further, signs of Chinese interest in gold are also apparent in the yellow metal's microstructure. Chinese gold premiums remain extremely elevated by historical standards, which points to strong underlying demand for the yellow metal. While premiums are below the extreme levels seen over the summer of 2022, when Mainland gold supply was constrained by lackluster quotas, their recent strength is rather a symptom of outstanding demand.



Source: TD Securities, World Godl Council



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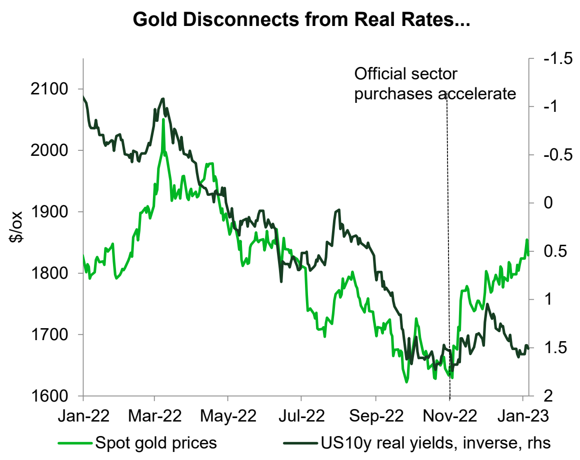

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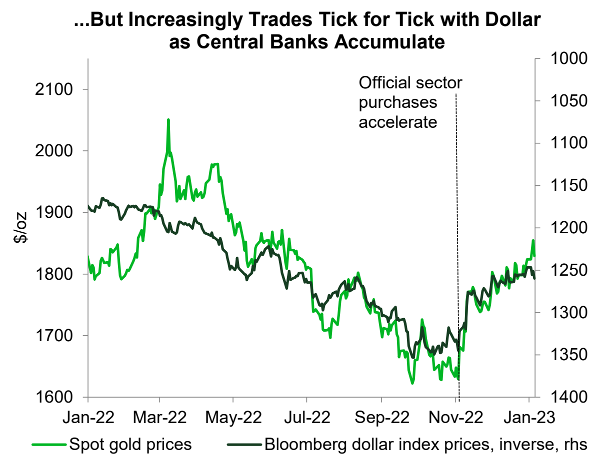


Source: TD Securities, Bloomberg

In turn, rather than viewing gold's resilience as a function of a changing macroeconomic narrative, Chinese demand at a massive scale is likely the main culprit behind the strong price action that has defied analyst and trader views over past months. This helps to explain the disconnect between gold and real rates, in favor of a tighter relationship with currencies.

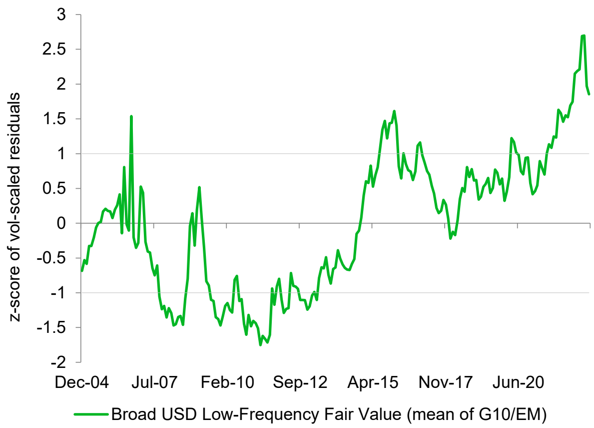
Without this significant buying activity, gold prices would undoubtedly have traded lower as a function of rising real rates amid a hawkish central bank regime. After all, real rates are the primary driver behind investment appetite for gold, which we have shown has remained depressed despite the rally in prices after accounting for CTA trend follower flow. In fact, we estimate that gold's fair value based on its recent historical relationship with real rates is closer to $1700/oz, which implies that Chinese purchases have catalyzed a $150/oz mispricing in gold markets.

Yet, as opposed to a mispricing, one could argue also that gold's recent trading behavior has shifted in favor of a stronger relationship with currencies. However, this assumes that this massive Chinese buying is sustainable over coming years and months. And, we still have not addressed a crucial question for gold's outlook: what is driving these large-scale Chinese purchases?

We investigate a few possibilities below:

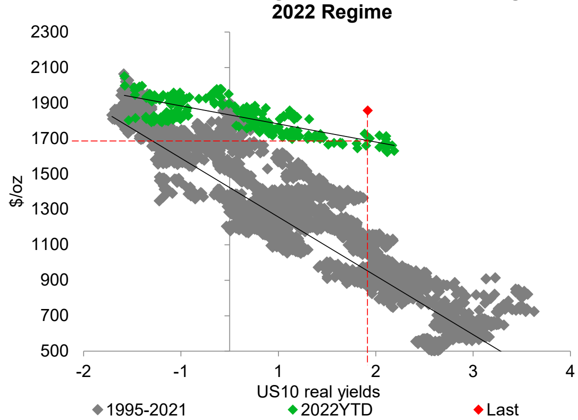
- **Reserve Currency Ambitions:** A contingent of market participants has suggested that gold is gaining market share as a reserve asset. After all, USD valuations have moved to extremes following the build-up in USD cash and associated stagflation hedges. European data surprises are surging with growth expectations on the rise as extremely mild weather helped the region fare with the ongoing energy shock, at the same time as a fast-paced Chinese reopening bolsters rest-of-world growth — factors which are all in support of a cyclical peak in USD value. Most importantly, however, is the rise in perceived sanctions risks associated with USD reserves held in the East, following the introduction of Western sanctions on Russia this year; these have likely bolstered official purchases. This is consistent with official purchases announced by Turkey, Qatar and other nations. Market participants have pointed to the rapprochement between China and Gulf nations to support the thesis that demand for USD reserves is indeed declining. President Xi attended the very first China-Arab States Summit in history, seen as an echo to FDR’s meeting with King Abdul Aziz Ibn Saud in 1945 which cemented a new paradigm amounting to US security guarantees exchanged for oil sold in US dollars. Today, US incentives to provide security are likely to decline over the coming decade along with Western oil demand, whereas China's growing demand for energy is likely to solidify trade with GCC nations over this timeframe. President Xi also spoke of a new paradigm — one of all-dimensional energy cooperation, which will entirely rely on RMB settlement for oil and gas trade over the next five years. While the long-term resilience of this thesis is difficult to rank in the present, this narrative is certainly consistent with price action associated with a steep accumulation of gold in support of the renminbi.

Broad USD Valuations Have Reached an Extreme



Source: TD Securities, Macrobond

Gold Overvalued Against Real Rates Even Against 2022 Regime

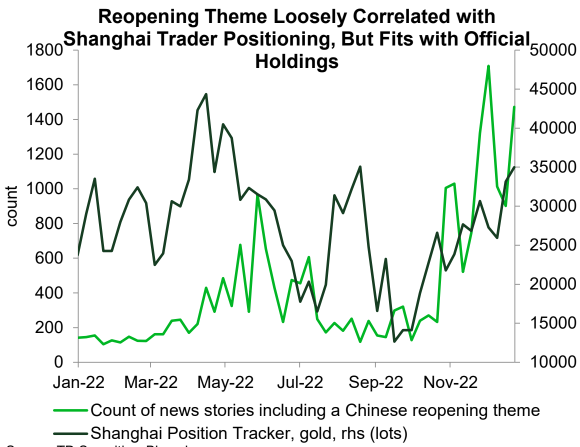


Source: TD Securities, Bloomberg

- **Hedging Sanctions:** We previously discussed the rise in perceived sanctions risks associated with USD reserves held in the East, following the introduction of Western sanctions on Russia this year. A less likely scenario worth considering is whether a steep increase in gold reserves could be associated with the building of a sanction-evasion war chest tied to China's geopolitical ambitions. Tensions between China and Taiwan have come to a boil over the past year with a heightened sense of fear of a military confrontation since the war in Ukraine. In turn, some market participants could plausibly fear that the steep accumulation of gold is preceding a military confrontation, but there is little concrete evidence to support this. Further, one could argue that this is inconsistent with an apparent *détente* with the West, highlighted by the recent lifting of China's embargo on Australian coal and a notable shift in China's foreign policy communications.

- **Chinese Reopening Demand:** Our tracking of Shanghai gold positioning appears to loosely correlate with the frequency of Chinese reopening-themed news stories. Official sector purchases, however, are likely to have correlated more closely. After China's widespread Q2 lockdowns had depressed jewellery, bar and coin demand, it is plausible that the comeback in sales observed during Q3 has gathered steam amid robust pent-up demand. While this is less appealing than a grandiose narrative about a change in geopolitical regimes, it is also consistent with the sharp recovery in gold demand observed with urban Indian consumers over the past year and with price action associated with a surge in Chinese demand. However, this thesis would clearly be more transient and would likely imply that gold prices are subject to a steep consolidation once Chinese pent-up demand is satiated and reverts to normality. This scenario would increase risks of a consolidation towards $1700/oz or below, given gold's steep overvaluation relative to its recent historical relationship with real rates.

- **Restocking for Chinese New Year:** Similarly, Chinese New Year has tended to seasonally buoy gold prices. Several market participants anticipate this trend, and it's plausible that large pent-up demand for gold associated with Chinese New Year celebrations are tied to the end of Zero-Covid. Over the past five years, gold prices have rallied from November to year-end in every single instance, averaging a 3.25% gain. The exceptional 10.7% gain in gold prices observed in this time horizon for 2022 could plausibly be tied to extremely elevated demand tied to these celebrations. Unfortunately, we find little concrete evidence to support this view. Nonetheless, this scenario would also likely be associated with a sharp slump in demand as Chinese New Year approaches.



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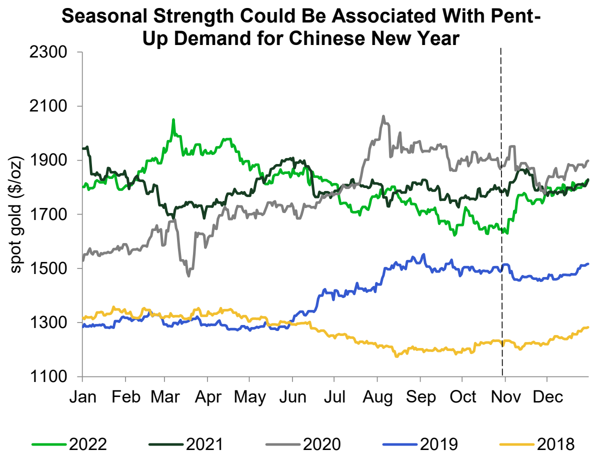

Source: TD Securities, Bloomberg

Lacking additional data, we don't find sufficient evidence at this time to bolster our conviction on what has driven Chinese purchases. The massive demand impulse from the official sector certainly fits with China's reserve currency ambitions and with the accumulation of a sanctions war chest, but the latter appears inconsistent with an apparent *détente* in foreign policy. Strong demand from private Chinese firms could also be tied to the retail and investment sector, associated with the Chinese reopening, which may also have been buoyed due to upcoming Chinese New Year celebrations. However, barring a grandiose geopolitical regime change, it is likely that Chinese demand will subside towards normal levels. This would leave gold prices vulnerable to a steep consolidation lower given gold's current $150/oz mispricing relative to its recent historical relationship with real rates. In turn, we will look to our tracking of positioning for the top ten gold traders in China to scour for nascent signs of peaking Chinese demand, which could present a tactical signal for a noteworthy repricing lower. For the time being, the pace of gold purchases from Shanghai traders has yet to show any sign of slowing, even as traders' net length approaches twelve-month highs

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