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Global

Commodities | Strategy

April may be as good as it gets for gold in Q2

- Treasury yields have fallen significantly over the past month, and the curve itself has flattened. This has been an important component of gold's strength.
- However, as Standard Bank's Head of G10 Strategy, Steve Barrow argues, there are a number of reasons why longer-term yields in particular may be about to bottom.
- The first of those is that the increasingly bearishness about US growth prospects is probably unwarranted.
- Easing headline inflation data has also contributed to the drop in yields but if wages continue to rise relatively strongly in nominal terms (which appears likely given the labour market tightness), the softness in CPI will be short-lived.
- If those views on growth and inflation prove to be correct, then the market is currently under-estimating the prospects of additional Fed tightening this year.
- In our note of 17 April, we talked about three pillars supporting the rising gold price: US monetary policy, physical (jewellery) demand, and geopolitics. The latter two are still likely to be strong enough to push gold up through $1300 in the short-term.
- However, there is a good chance that increasing pressure from higher rates will converge with softening seasonal demand in India from mid-May onwards.
- In which case, April is likely to be as good as it gets for gold in Q2. That said, we are talking about consolidation, not capitulation.

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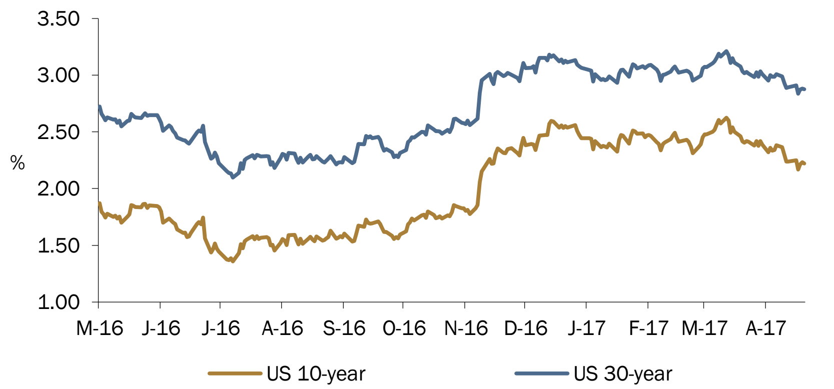
April may be as good as it gets for gold in Q2

Bearishness about US growth may be overdone

In his daily note today Standard Bank's Head of G10 Strategy, Steve Barrow, makes some interesting observations regarding Treasury yields that may well be pertinent to gold (clients with Bloomberg terminal access can view the note via ICSM <GO>, other clients please contact your sales representative).

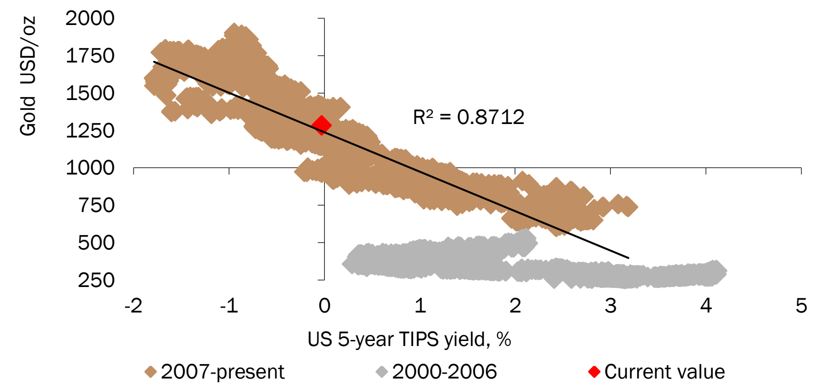
As most gold market participants will be keenly aware, Treasury yields have fallen significantly over the past month, and the curve itself has flattened. This has been an important component (though not the sole one) of gold's strength – the positive correlation between the metal and US real yields remains very high.

If the drop in US nominal yields is coming to an end...



Source: Bloomberg

...then gold is likely to face a period of consolidation



Source: Bloomberg, ICBC Standard Bank

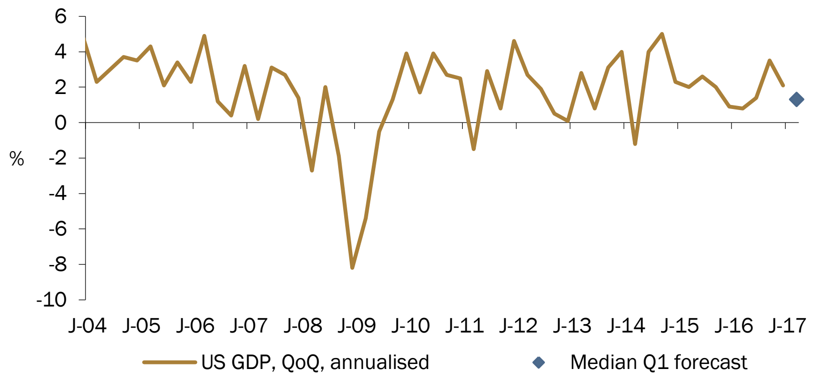
the increasingly bearishness about US growth prospects is probably unwarranted

However, as Steve argues, there are a number of reasons why longer-term yields in particular may be about to bottom. The first of those is that the increasingly bearishness about US growth prospects is probably unwarranted. The first US Q1 GDP estimate is due next week and expectations are subdued – Bloomberg puts the median of forecasts at 1.3% (seasonally adjusted annualised rate). That would be a sharp drop from 2.1% in Q4 and would put growth back into the bottom quartile for the past seven years. A weak US growth number would also reinforce concerns in some quarters about the sustainability of the equity rally and a marked lack of growth in bank lending to corporates.

It would not be surprising if Q1 again turns out to be the low point for US growth this year

Again, as Steve points out, even when adjusted for specific seasonal factors, a considerable bias remains – Q1 has been the weakest quarter of the year in 14 of the last 26 years – i.e. more than half the time. It would not be surprising, therefore, if Q1 again turns out to be the low point for US growth this year, particularly if we consider the disruption to business investment and consumer spending caused by the US election and the subsequent limbo period for US economic policy.

Weak Q1 US GDP should not be a surprise and is likely to be the low point



Source: Bloomberg

That is not just our view – the New York Federal Reserve today presented its forecast for US real GDP growth, the unemployment rate, and inflation at the spring meeting of its Economic Advisory Panel. Their economists state "Even though available data suggest that growth in the first quarter of 2017 was sluggish, we expect growth to rebound over the remainder of the year with the Q4/Q4 growth rate predicted to be around 2 percent once again, as the underlying fundamentals still look favourable."

Specifically the NY Fed highlights that households' balance sheets are sound and anticipates increased growth in real disposable income. The corporate sector is also in good shape, with the presentation noting that "Business fixed investment also is likely to grow at a faster pace in 2017 than in 2016."

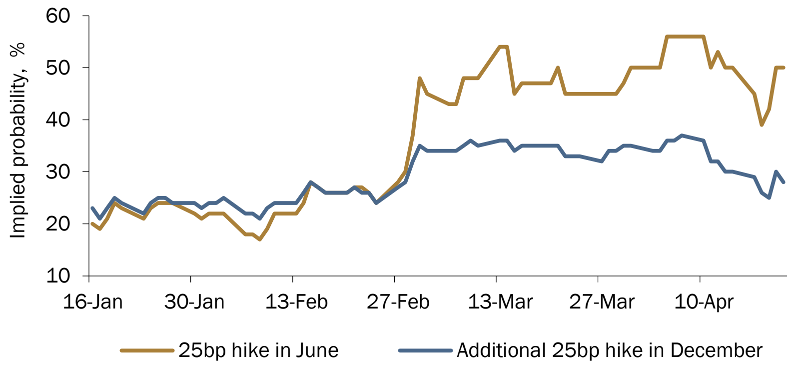
Easing headline inflation data has also contributed to the drop in yields. Fading year-on-year base effects in energy, notably gasoline, a softening in housing inflation, falling used vehicle prices, and a marked fall in month-on-month medical care services inflation were key components. However, energy effects will be transient and the fall in headline CPI helped real wages growth accelerate by 0.3% month on month and recover to 0.0% yoy from -0.6% yoy in February. If wages continue to rise relatively strongly in nominal terms (which appears likely given the labour market tightness), the softness in CPI will be short-lived.

"Underlying inflation, as measured by the core PCE deflator, should move gradually higher"

That is also aligned with the NY Fed's view: "Underlying inflation, as measured by the core PCE deflator, should move gradually higher".

Those first two factors, combined with fading expectations of imminent fiscal stimulus as the Republican Party grapples with internal differences, have influenced a sharp retreat in expectations of Fed tightening. The implied probability of a 25bp hike in June dropped from 56% to 39%, before rebounding somewhat in the last few days. Similarly, the implied probability of a further 25bp hike in December has dropped from 37% to 25%. Given our views on both growth and inflation, the market now looks to be under-estimating the prospects of additional Fed tightening this year.

Expectations of Fed tightening now too dovish?



Source: Bloomberg

we are talking about consolidation, not capitulation

In our note of 17 April, we talked about three pillars supporting the rising gold price: US monetary policy, physical (jewellery) demand, and geopolitics. The latter two are likely to be strong enough to push gold up through $1300 in the short-term, as we highlighted in our commentary last week. However, there is a good chance that increasing pressure from higher rates/a stronger USD will converge with softening seasonal demand in India from mid-May onwards. In which case, April is likely to be as good as it gets for gold in Q2, with the remainder of the quarter marked by a drop back into the mid-to low $1,200s. That said, we are talking about consolidation, not capitulation.

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