Market Insight

Gold Outlook to Q3 2023: The hedge against inflation and slowing economic growth

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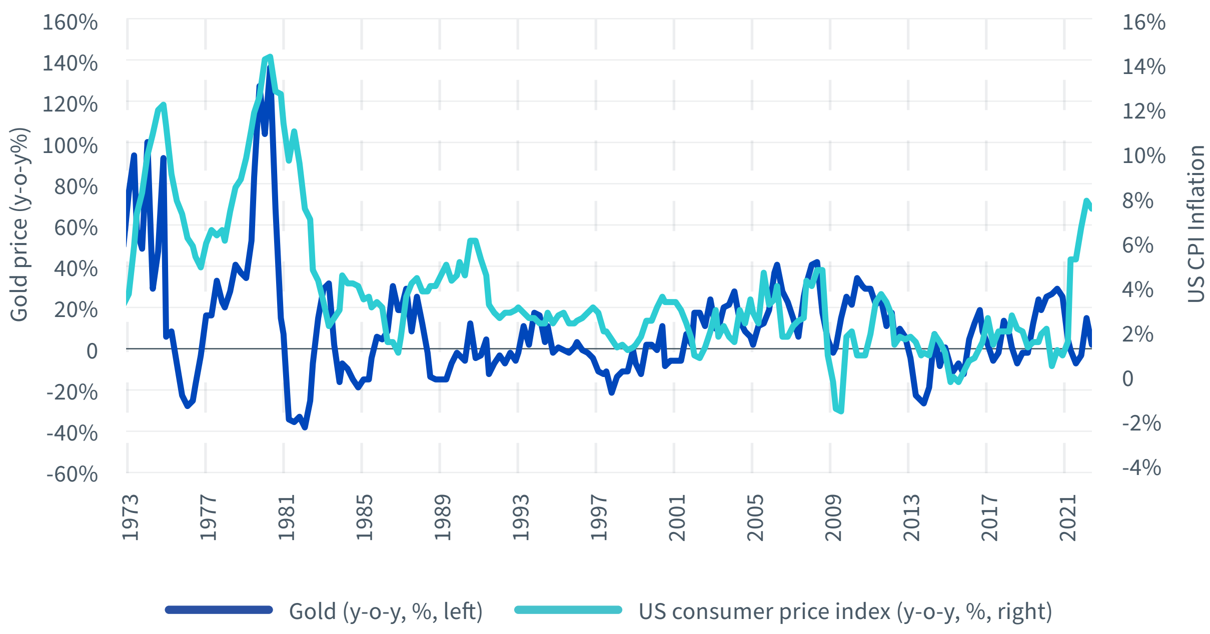
Many commentators have expressed disappointment in gold because it hasn't risen as much as it has done in previous periods of elevated inflation (Figure 1).

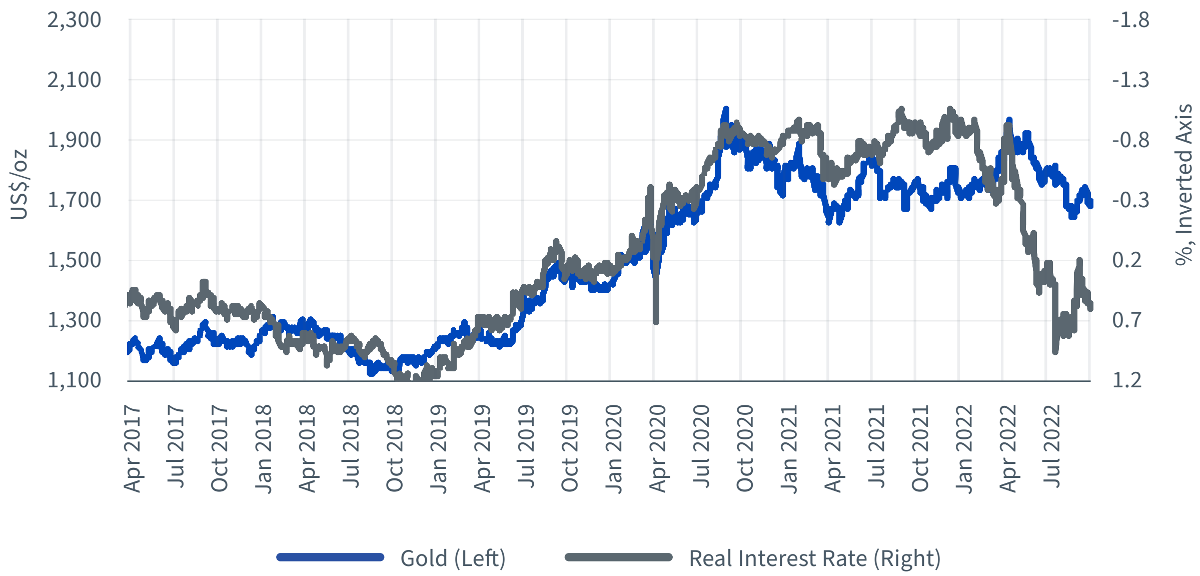
Figure 1: Gold price vs US inflation



Source: Bloomberg. Quarterly data from Q1 1973 to Q2 2022. **Historical performance is not an indication of future performance and any investments may go down in value.**

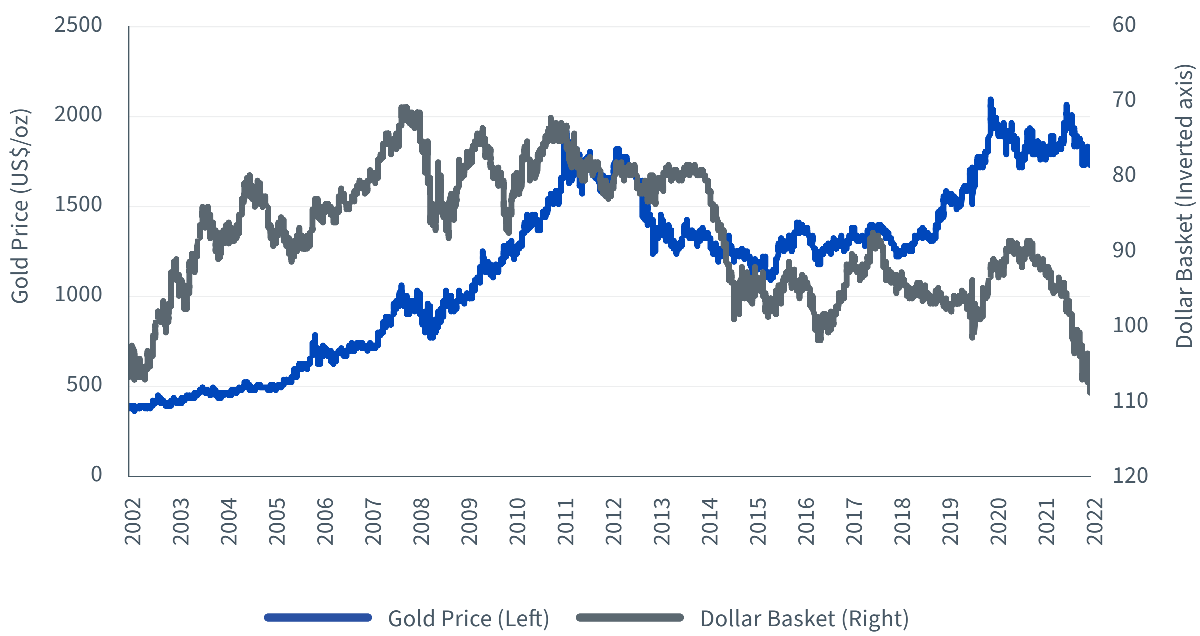
However, gold is facing headwinds from a strong dollar (Figure 2) and a bond sell-off (Figure 3). On both counts, gold appears to be holding value a lot better than historic (univariate) relationships would indicate.

Figure 2: Gold vs real rates (Treasury Inflation-Protected Securities yield)



Source: Bloomberg, WisdomTree. April 2017 to August 2022. **Historical performance is not an indication of future performance and any investments may go down in value. Source: Bloomberg.**

Figure 3: Gold and dollar basket



Source: Bloomberg, WisdomTree. 24 June 2002 to 9 September 2022. **Historical performance is not an indication of future performance and any investments may go down in value.**

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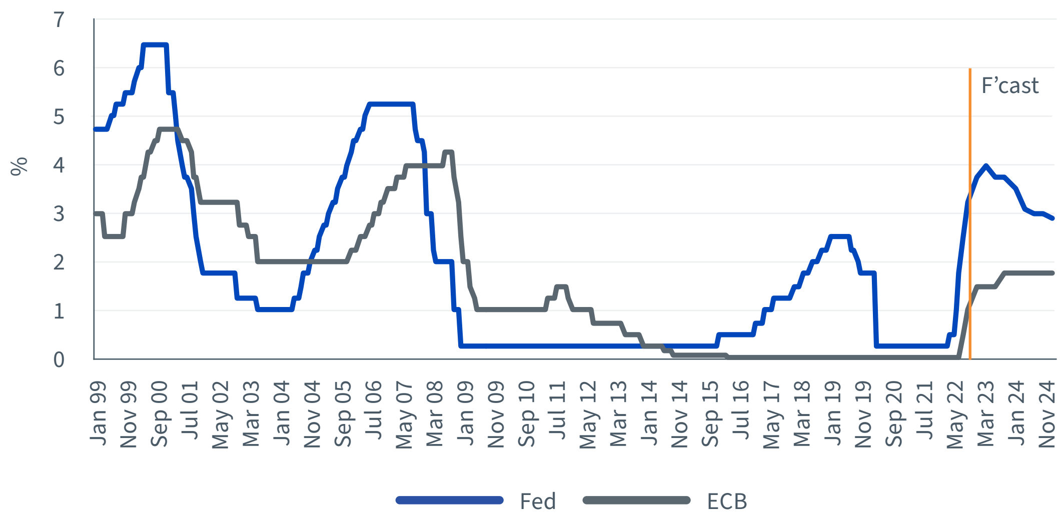
Looking at historic monthly data going back to 1980, in periods when inflation has been above 3.5%, gold has averaged 9% year-on-year gains. However, if we filter that data for months when the US dollar has appreciated more than 10% year-on-year, we find that gold had only averaged -16%[1]. Dollar strength, like we are experiencing today, is rarely associated with gold price strength, even in times of elevated inflation.

The US dollar has the potential to keep appreciating. The Federal Reserve (Fed) has increased interest rates more, and at a faster pace, than the European Central Bank (ECB), while the Bank of Japan is resisting any monetary tightening (see Navigating the Uncharted Waters Between Growth and Inflation). That has widened interest rate differentials between the US and its major currency pairs. Moreover, interest rate differentials are likely to continue to widen for several months if consensus rate expectations are right (Figure 4).

Figure 4: Fed and ECB Rate expectations



Source: WisdomTree, Bloomberg. Actual data from January 1999 to September 2022. Forecasts from September 2022 to December 2024, taken from Bloomberg consensus surveys. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

[1] Source: Bloomberg data, WisdomTree calculations. Data from January 1980 to August 2022.

Gold does well in times of economic deceleration or recessions, as indicated by its performance during periods of strongly negative composite leading indicator (CLI) as shown in Figure 5.

Figure 5a: Average monthly performance depending on CLI

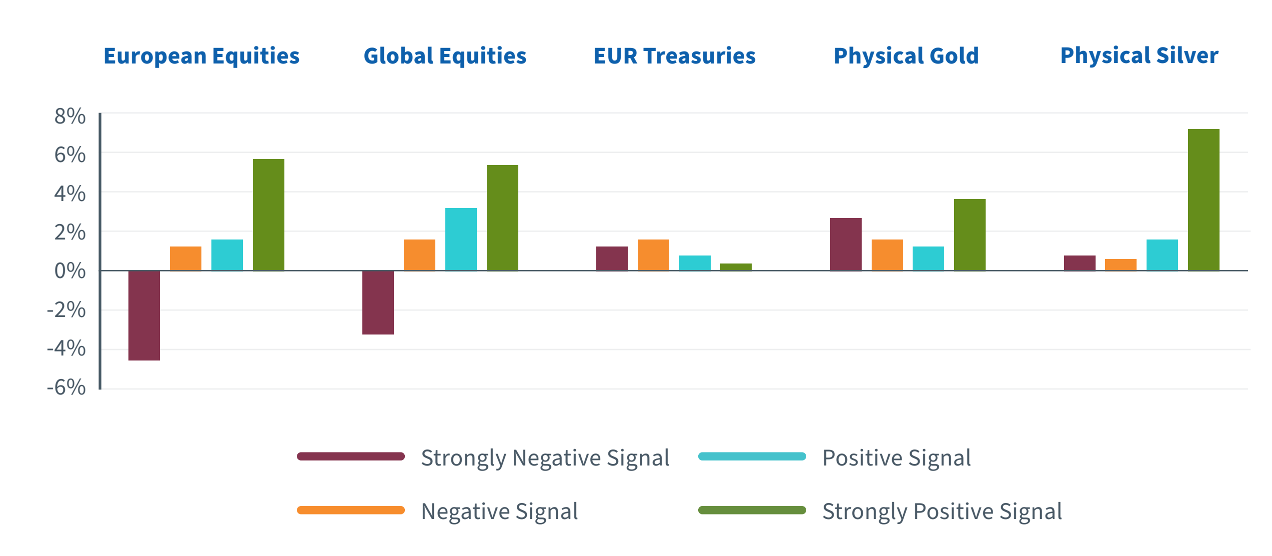
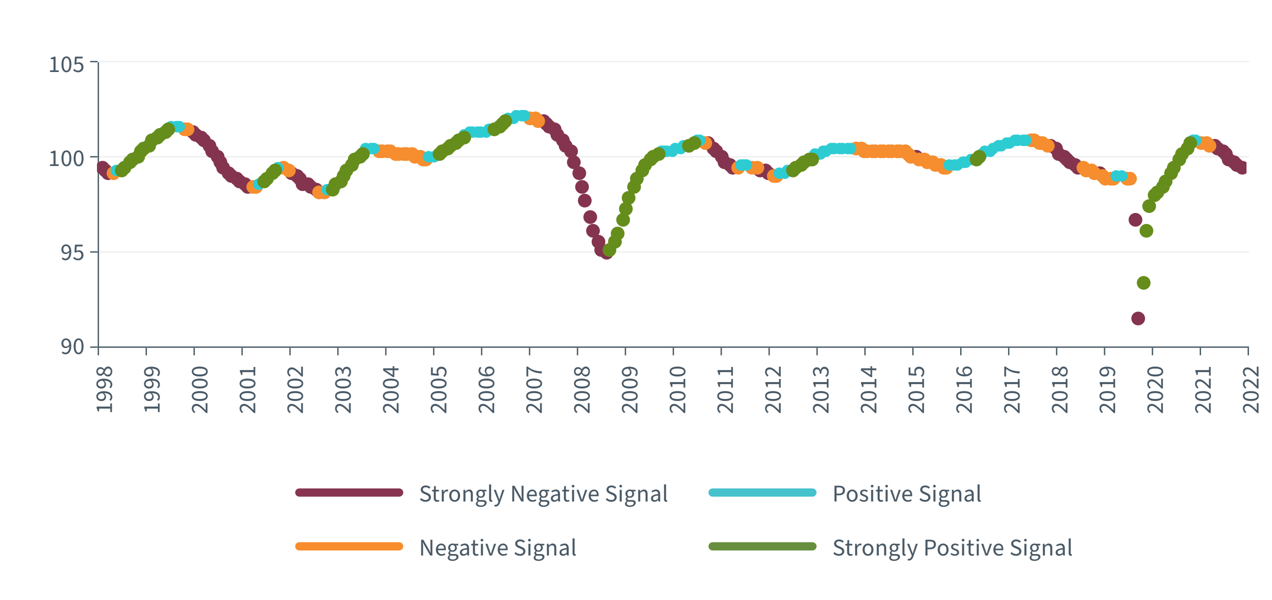


Figure 5b: OEDC composite leading indicator is used to define 4 market regimes



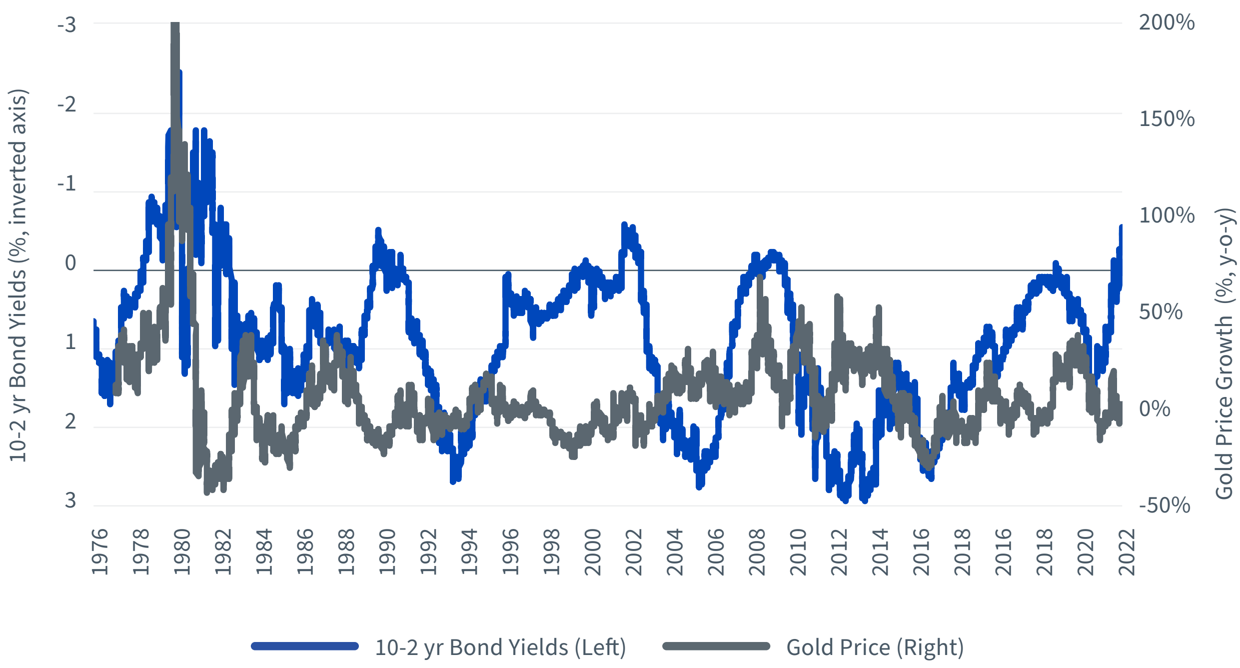
Source: WisdomTree, Bloomberg. Period July 1998 to June 2022. OECD is Organization for Economic Cooperation and Development. Calculations are based on monthly returns in USD. **Historical performance is not an indication of future performance and any investments may go down in value.**

As we highlighted in our broader outlooks, recession risks are rising. One measure of that risk is the bond yield curve inversion. Today, we are in one of the strongest bear-flattening inversions we have seen since 1981 (Figure 6). That points to a source of strength for gold we have not seen in decades.

Prominent examples of past bear flatteners include:

+ between August 1978 and July 1982, curve inversion was gold price positive (with a cumulative nominal return of 66%)
+ between June 2006 and June 2007, curve inversion was gold price positive (with a cumulative nominal return of 10%)

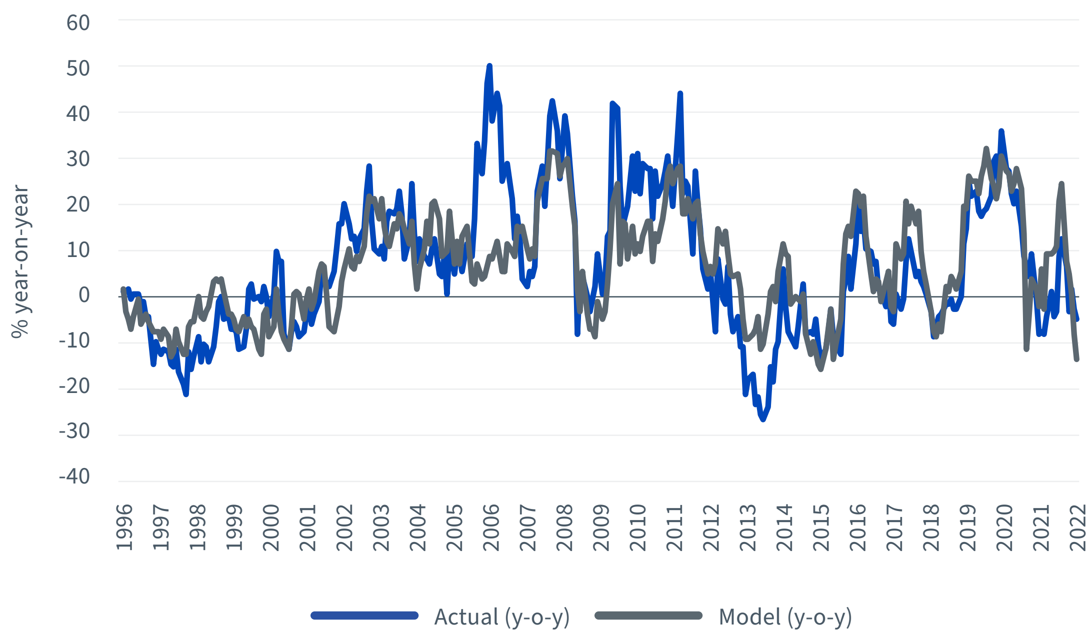
Figure 6: 10-2yr US Govt Bond Yields vs Gold



Source: WisdomTree, Bloomberg. Period: June 1976 to September 2022. We define yield curve inversion as the 10-2yr US Government Bond Yield being negative. When the 2yr is rising faster than the 10yr we define it as a bear flattening. When 10yr is falling faster than 2yr we define it as a bull flattening. **Historical performance is not an indication of future performance and any investments may go down in value.**

Yield curve inversion is not something that is explicitly in our internal forecast model but may account for why gold is faring better than we would have expected. Our model (as described in Gold: how we value the precious metal) indicates that gold should have fallen 15% year-on-year in August 2022, under the weight of an appreciating US dollar and falling bond prices (Figure 7). Yet, gold only fell 5%. We may find that the recessionary risk continues to support gold more than our model suggests going forward.

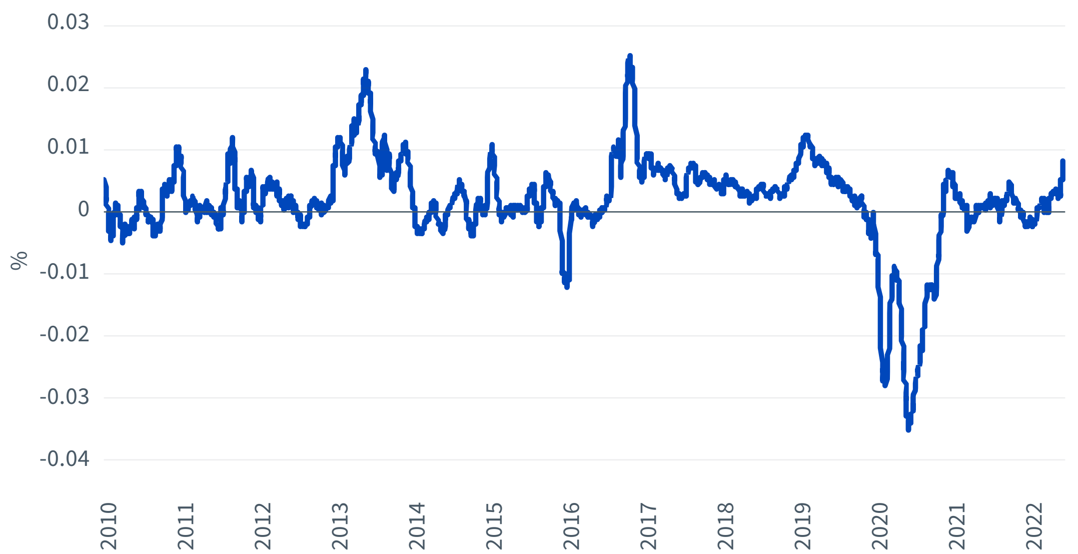
Figure 7: WisdomTree Gold Model



Source: Bloomberg, WisdomTree price model. March 1996 to August 2022. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

When developing our forecasts model, we found that once you control for exchange rates, bond yields, inflation and investor sentiment, movement in physical supply and demand does not have a statistically significant impact on prices. However, this does not mean that the physical market does not have any influence on prices, and strong physical demand may help provide some floor to gold prices in certain circumstances. In 2013, when there was a brutal investor sell-off in gold, consumer demand for gold rose substantially in China (low prices spurred substantial consumer demand). That led to the spike in the Shanghai gold premium (that is, % above spot prices that gold in Shanghai trades on). We are starting to see the Shanghai gold premium rise again (Figure 8), which could indicate strong retail interest in China again.

Figure 8: Shanghai Gold Premium



Source: Bloomberg, WisdomTree. 1 January 2010 to 14 September 2022. **Historical performance is not an indication of future performance and any investments may go down in value.**

Gold outlook using WisdomTree's forecasts model

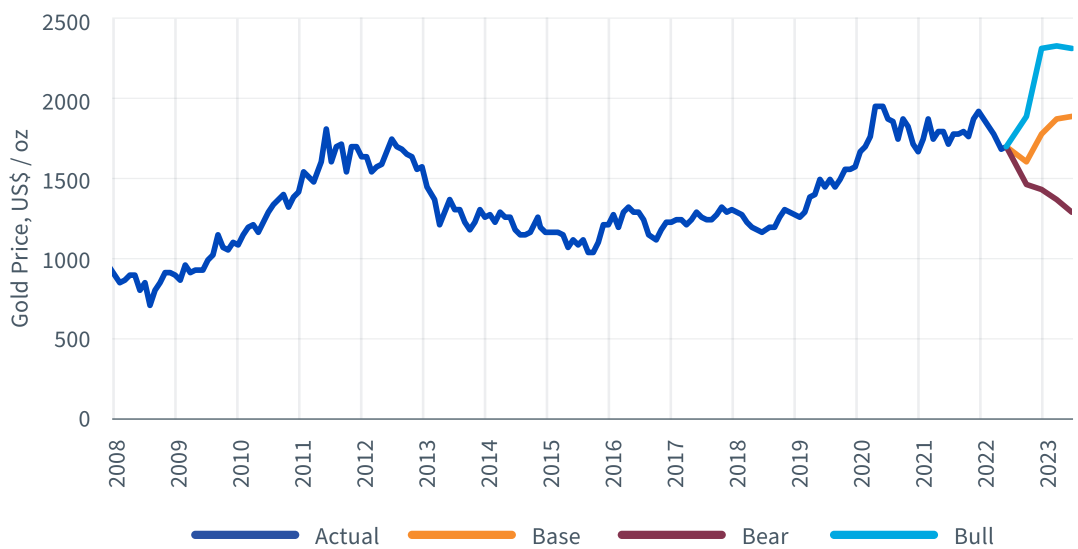
Based on the macroeconomic views presented in our broader outlooks, we produce a consistent outlook for gold (base case) using the model described in Gold: how we value the precious metal. We also present bull and bear case scenarios.

+ **Base Scenario:** In our base case, we expect the US dollar to continue to appreciate through the forecast period to Q3 2023. We also expect US 10-year Treasury yields to rise until Q1 2023, after which they will fall as the rate tightening by the Federal Reserve comes close to completion. We expect the Federal Reserve to raise the fed fund target to 4%. That is notably higher than where we think US 10-year Treasury yields will go. That will likely keep the bond-yield curve inverted – a sign of forthcoming economic weakening. Gold tends to perform well in recessionary scenarios. Also, we have an above-consensus view on inflation. By Q3 2023, inflation will be stubbornly high at 5% in the US. That should also lend support to gold prices. We maintain net speculative positioning in gold futures around current levels, as of September 2022 for the whole forecast period. In this scenario, gold could rise to $1910/oz by the end of September 2023 from $1720/oz at the beginning of September 2022.

+ **Bull Scenario:** In this scenario (which is a less likely scenario), the Federal Reserve stops raising interest rates earlier. That eases the upward pressure on 10-year bond yields. It also reduces the interest rate differential between the US and other countries, helping the US dollar to depreciate. Stopping the rate tightening cycle early will, however, let inflation run higher than we expect in a base case scenario. In this bull scenario, investor sentiment toward gold picks up from relatively subdued levels to 150k net long for the forecast horizon. In this scenario gold could rise to $2330/oz by the end of September 2023 from $1720/oz at the beginning of September 2022.

+ **Bear Scenario:** In the bear scenario, the Fed moves much more aggressively and, in doing so, pushes 10-year bond yields much higher. The Fed will be successful in bringing inflation down below 2% and so gold will no longer have any inflationary support. The US dollar will also appreciate (marginally) faster than in the base case, as the Fed is more hawkish than other central banks. Investor interest in the metal falls further to roughly half the net long positioning seen in September 2022.

Figure 9: Gold price forecasts



Source: WisdomTree Model Forecasts, Bloomberg Historical Data, data available as of close 31 August 2022. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

Base				
	Q4 2022	Q1 2023	Q2 2023	Q3 2023
Inflation forecast	8.0%	7.0%	6.0%	5.0%
Nominal 10-year yields forecast	3.30%	3.50%	3.40%	3.35%
US$ exchange rate forecast (DXY)	111	112	113	114
Speculative positioning forecast	100k	100k	100k	100k
Gold price forecast	$1635/oz	$1805/oz	$1895/oz	$1910/oz

Bull				
	Q4 2022	Q1 2023	Q2 2023	Q3 2023
Inflation forecast	10.0%	9.5%	9.0%	8.0%
Nominal 10-year yields forecast	3.0%	3.0%	3.0%	3.0%
US$ exchange rate forecast (DXY)	108	105	104	99
Speculative positioning forecast	150k	150k	150k	150k
Gold price forecast	$1910/oz	$2340/oz	$2352/oz	$2330/oz

Bear				
	Q4 2022	Q1 2023	Q2 2023	Q3 2023
Inflation forecast	7.0%	5.7%	3.9%	1.8%
Nominal 10-year yields forecast	3.70%	4.30%	4.68%	4.74%
US$ exchange rate forecast (DXY)	112	113	114	115
Speculative positioning forecast	100k	90k	75k	50k
Gold price forecast	$1480/oz	$1460/oz	$1390/oz	$1315/oz

Source: WisdomTree. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

Conclusions

Gold is facing US dollar and bond market headwinds but is supported by strong inflation. In our base case, we expect the pace of further gains in the dollar and bond yields to slow (but, never-the-less, rise). Meanwhile, inflation remaining above the Fed's target by quite some margin will lend support to gold, and investor sentiment toward the metal may not fall further. That could drive a meaningful rise in gold from close to $1650/oz at the time of writing (20 September 2022) to $1910/oz by Q3 2023 (+15%).

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