GOLD OUTLOOK TO Q1 2022: DOWN BUT NOT OUT

April 2021

After reaching an all-time high in the summer of 2020, gold has struggled in 2021. Gold prices have fallen close to 10% in Q1 2021. Falling bond yields, dollar depreciation and strength in investor sentiment that were all helping gold in 2020, have gone in reverse in the first quarter of 2021. At the time of writing (31/03/21), US 10-year Treasury bond yields have risen to a 14-month high while the US dollar basket (DXY) is close to a five-month high. Meanwhile, inflation has been very tame, with the US CPI inflation reading for February 2021 at only 1.7%. Investor sentiment towards the metal has unsurprisingly cooled. Net speculative positioning in gold futures is now close to 170k contracts net long, down considerably from over 300k contracts net long last year. As we look to the year ahead, we do expect the tactical interest in gold to remain cool. After all, demand for defensive assets like gold is likely to be muted in a moderate recovery. However, gold has demonstrated its strategic credentials throughout 2020, helping counter the drawdowns in cyclical assets in the first half of the year. Therefore, we expect gold as a strategic asset to remain firmly in place, especially as the path to recovery will continue to be bumpy.

Our models indicate that, if economic consensus[1] is correct, gold prices will resume on an upward path. Gold prices may fall a little further in the near future, but we are approaching the end of this drawdown. What has surprised the markets the most in the past quarter, is rising bond yields. Consensus opinion is that bond yields will stabilise. If that's not the case, we could see gold prices come under renewed pressure. However, it is difficult to see how the government fiscal outlays can be met with the sharply increasing cost of servicing their debt. If putting a brake on fiscal spending becomes a real threat and if that starts to cool down the recovery, we could see the US Federal Reserve (Fed) engaging yield curve control. That would indeed be gold price positive.

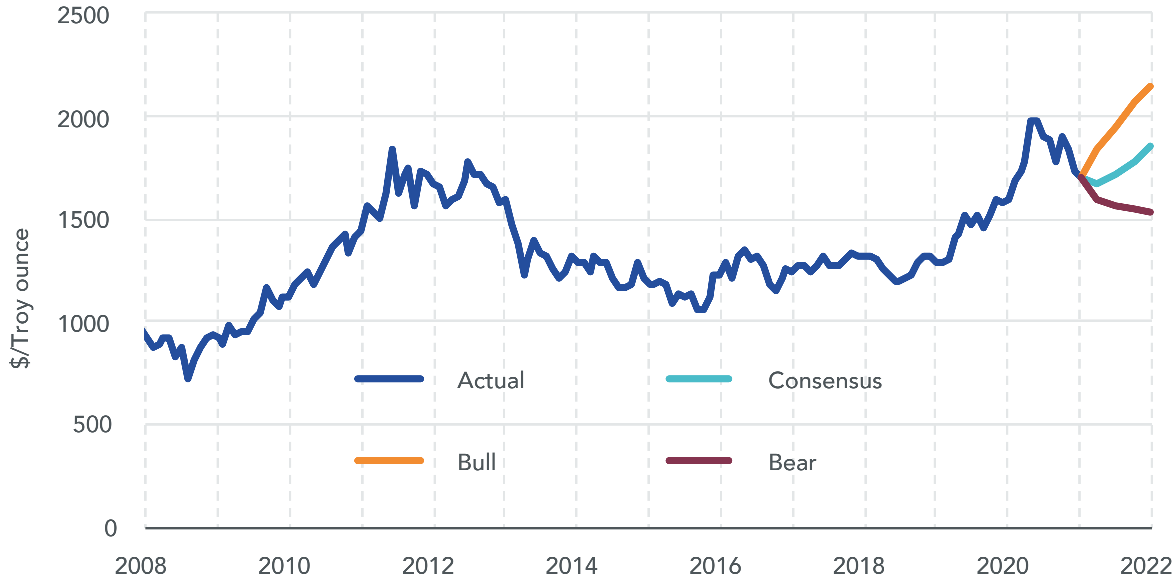
In this report, we also look at some of the drivers of gold prices beyond our normal one-year forecast. In particular, we look at some of the upside pressure on inflation and on US dollar weakness.

SCENARIOS USING WISDOMTREE'S FRAMEWORK

Using our model framework, explained in our blog "Gold: how we value the precious metal", we provide some scenarios for gold prices until Q1 2022.

1 Based on a Bloomberg survey of economists cast in March 2021, focusing on macroeconomic forecasts.

FIGURE 1: GOLD PRICE FORECASTS



Source: WisdomTree Model Forecasts, Bloomberg Historical Data, data available as of close 31 March 2021. **You cannot invest directly in an index. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

In the figure, we show 3 distinct forecasts:

+ Consensus - based on consensus forecasts for all the macroeconomic inputs and an assumption that investor sentiment towards gold drops further with speculative positioning falling to 100k contracts net long.
+ Bull case – further monetary intervention - possibly through yield curve control – drives Treasury yields down to 1.5% and the US dollar resumes its structural weakness that started in 2020. Investor sentiment towards gold strengthens in this period of greater monetary largess.
+ Bear case – what if bond yields continue to rise at the pace they have been in the past few months and dollar appreciation continues?

We place roughly a 70% probability on the consensus case, a 15% probability on the bull case and 15% probability on the bear case.

CONSENSUS

Consensus opinion is that US 10-year Treasury bond yields will hit 1.8% in Q1 2022 and dip below 1.6% temporarily before we get there. With current bond yields at 1.72%, the market is clearly expecting the worst of the bond sell-off to be behind us.

Also, consensus opinion is for the US dollar to resume its depreciating trend that started in 2020.

Inflation could peak at 2.9% in Q2 2021, largely reflecting the base effect of very weak energy prices this time year ago. Inflation is expected to moderate to 2.2% by Q1 2022.

Investor sentiment towards gold clearly been dented by weak prices and tactical investors refocusing on cyclical assets, to the detriment of defensive assets like gold. We think this trend is likely to persist and therefore we reduce the speculative positioning in gold futures assumption to 100k net long, down from close to 170k net long today. We observe that investors using market signals for allocation into gold are likely seeing weak signals. As an example, 3Fourteen Research, who has a market signal model for allocating into gold, switched to a 'Neutral' rating gold on March 7, 2021 previously from a 'Strong buy'[2]. Across their "technical", "real rates" and "asset allocation" signals, they see a Neutral readings. Only in their "positioning" signal are they seeing a "Strong buy", which basically equates to speculative length in futures having been flushed out.

Factoring these assumptions into our model, we get to a gold price forecast of US$1860/oz by Q1 2022, essentially recouping all the losses in gold so far this year.

CONSENSUS SCENARIO				
	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Inflation forecast	2.9%	2.5%	2.4%	2.2%
Nominal 10-year yields forecast	1.58%	1.62%	1.71%	1.8%
US$ exchange rate forecast (DXY)	90	89.4	89.5	89.9
Speculative positioning forecast	120k	110k	100k	100k
Gold price forecast	US$1670/oz	US$1710/oz	US$1780/oz	US$1860/oz

Source: WisdomTree, data available as of close 31 March 2021. **You cannot invest directly in an index. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

BULL

In this scenario, we explore what would happen if the Federal Reserve (Fed) were to engage in some form of yield curve control. With fiscal spending a key component of the economic recovery plan, rising bond yields could constrain the ability of the government to follow through with its plans. In turn, that could derail the economic recovery, that place downward pressure on prices and employment. The Fed, with its inflation and employment mandate, could address the situation by targeting certain levels of bond yields (at various tenors along the curve) and promise to buy unlimited amounts of US Treasuries to get there. To be clear this is not our base case assumption, and we acknowledge that the Federal Reserve has been averse to entertain the idea. In recent communications, Fed officials indicate that they are happy with the yield curve steepening, which in their opinion promotes better financial market functioning. However, the Bank of Japan has been doing yield curve control for many years and the Reserve Bank of Australia has also started. Every central bank has its pain threshold point.

We assume that the Fed targets a 10-year Treasury yield of 1.5%. Looser monetary conditions could drive inflation higher than consensus expectations, with inflation at 2.5% in Q1 2022. Looser monetary conditions may drive the US dollar lower, with the US dollar basket (DXY) falling to 83, the lowest since 2014. That would be roughly a 10% fall, marking a slightly smaller peak-to-trough dollar depreciation than what we saw in 2020 (of close to 13%). Investor sentiment towards gold could rebuild, as gold is seen as the antidote to fiat currencies and monetary largess. In this scenario, we would expect net positioning in gold futures to rise to 200k contracts long.

Gold in this scenario could rise to around US$2150/oz, piercing the all-time high of $2070/oz reached on August 6, 2020.

2 https://3fourteenresearch.com/model-updates/model-update-march-18-2021/

BULL SCENARIO				
	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Inflation forecast	3.0%	2.7%	2.5%	2.5%
Nominal 10-year yields forecast	1.50%	1.50%	1.50%	1.50%
US$ exchange rate forecast (DXY)	89.0	87.0	85.0	83.0
Speculative positioning forecast	200k	200k	200k	200k
Gold price forecast	US$1850/oz	US$1950/oz	US$2075/oz	US$2150/oz

Source: WisdomTree, data available as of close 31 March 2021. **You cannot invest directly in an index. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

BEAR

In this scenario, we explore what happens to gold prices if bond yields steadily rose to 2.5% by Q1 2022. If there is nothing standing in the way of rising bond yields, constraints on the economy could drive inflation down to just 2%. Bearing in mind that the Federal Reserve has a target of average inflation of 2%, meaning that it has to make up for periods of below 2% inflation in the past, these financial constraints will mean the Fed fails to meet its target. Such a hawkish stance by the Fed could lead to dollar appreciation if other central banks are not also maintaining such a position. The dollar basket could rise to 100 by the end of the forecast horizon, retracing back to where it was in March 2020.

If bond yields continue to rise at that pace, we expect investor positioning in gold to continue to decline, heading to 50k contracts net long.

In this bear scenario, gold prices are likely to continue to fall, reaching around US$1540/oz at the end of the forecast horizon, reaching a level last seen in December 2019.

BEAR SCENARIO				
	Q2 2021	Q3 2021	Q4 2021	Q1 2022
Inflation forecast	2.0%	2.0%	2.0%	2.0%
Nominal 10-year yields forecast	1.80%	2.00%	2.20%	2.50%
US$ exchange rate forecast (DXY)	95	96	98	100
Speculative positioning forecast	50k	50k	50k	50k
Gold price forecast	US$1600/oz	US$1560/oz	US$1550/oz	US$1540/oz

Source: WisdomTree, data available as of close 31 March 2021. **You cannot invest directly in an index. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

BEYOND THE ONE-YEAR FORECAST

We want to offer our thoughts on what the gold landscape could look like after our traditional one-year forecast horizon.

One of the key considerations is inflation. Gold has historically been a strong hedge for inflation[3]. While we have acknowledged earlier that inflation is likely to remain in a 'tame' territory in our 1-year forecast horizon, we can see that inflation expectations have risen to the highest level in eight years, based on 10-year breakevens. This is what the market is pricing-in as an expectation over 10 years and thus indicates that inflation is likely to head structurally higher. Gold tends to perform well in higher inflation scenarios (which is often coupled with strong economic growth that generates the 'demand-pull' inflation).

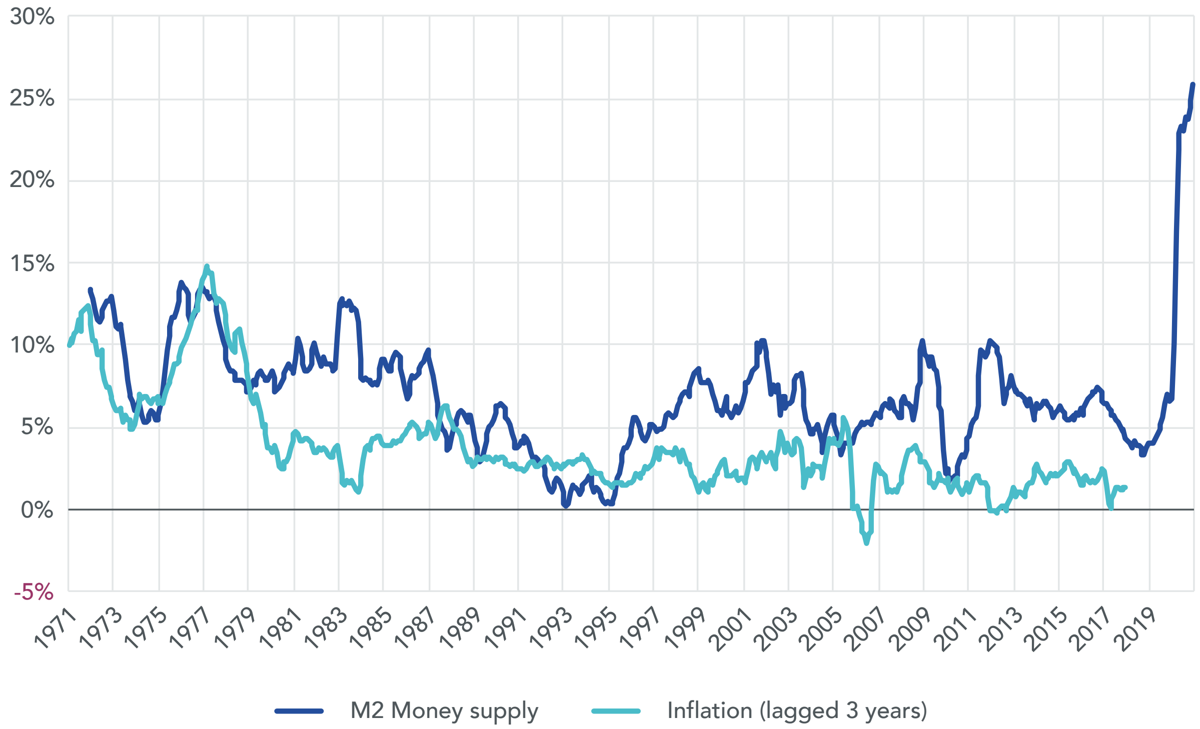
FIGURE 2: 10-YEAR BREAKEVEN INFLATION EXPECTATIONS

Source: WisdomTree, Bloomberg. Data available as of close 31 March 2021. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

We have also observed that following periods of monetary largess, inflation gain strength. That was evident in the 1970s and 1980s. However, inflation tends to be lagged by approximately three years. Today we are seeing M2 (base money) growth at levels we haven't ever seen before. That could give rise to elevated inflation in coming years.

3 See page 6 of The Investment Case for Gold, December 2020.

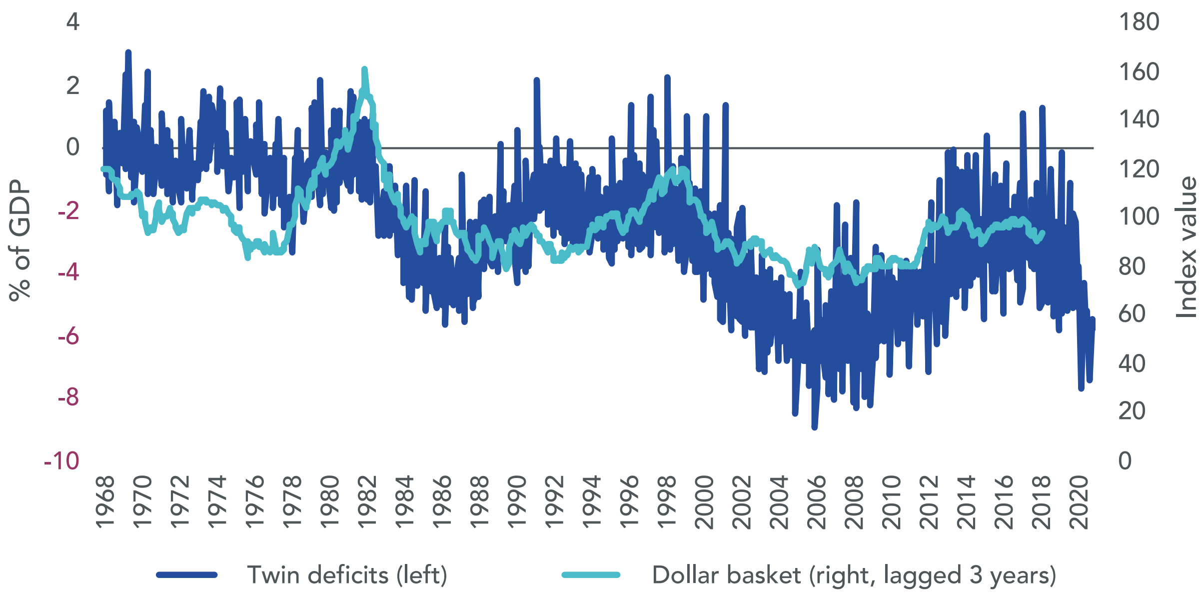
FIGURE 3: US M2 MONEY SUPPLY AND INFLATION



Source: WisdomTree, Bloomberg. Data available as of close 31 March 2021. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

The US Dollar was depreciating in 2020, but in Q1 2021, it has been appreciating. We believe that this reversal is an aberration rather than the mark of a new trend. Historically when "twin deficits" have widened, the US dollar has weakened with a lag. Twin deficits are a combination of a budget deficit and a current account deficit. Given how much the twin deficit has widened in recent years (and is likely to continue to widen given the fiscal spending plans in place), we believe US dollar weakness will resume and that the depreciating path may last for multiple years.

FIGURE 4: US DOLLAR AND US TWIN DEFICITS



Source: WisdomTree, Bloomberg. Data available as of close 31 March 2021. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

CONCLUSIONS

After a 10% year-to-date correction, gold prices could end up recouping these losses over the coming year if consensus forecasts for economic variables such as the US Dollar, Treasury yields, and inflation are correct. We place a 70% probability on such a scenario, based on our internal models. Consensus expectations are for the bond sell-off to ease. However, if bond market weakness persists, we could move in one of two paths: (1) the Fed engages in yield curve control to stem the damage on economic growth (and hence inflation and employment) or (2) the Fed lets bond yields continue rise, in which case we would see inflation fall and the US dollar continue to depreciate. The yield curve control scenario represents our Bull case for gold. While an unfettered rise in bond yields represents our Bear case. The bull and the bear cases are equally likely, with a 15% probability each.

Thinking beyond the one-year outlook, a structurally higher rate of inflation and a structurally weaker US dollar could lend strength to gold prices.

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