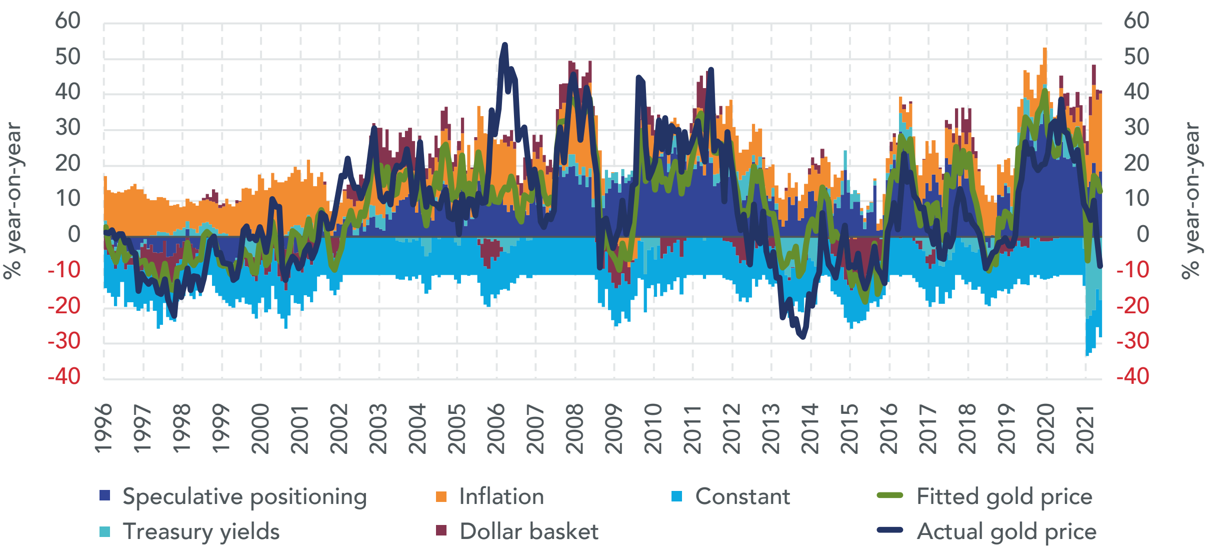
GOLD OUTLOOK TO Q2 2022: NEEDS TO CATCH UP WITH INFLATION REALITY

August 2021

After staging a recovery for most of Q2 2021, a mid-June 2021 wobble in gold prices has been hard to overcome. Based on our modelling framework, gold looks severely under-priced. Red-hot inflation - currently above 5%[1] - should point to a gold price above US$2000/oz, yet we are currently languishing around the $1785/oz handle[2]. As Figure 1 below shows, our model indicates that in July 2021, gold prices should have risen close to 12% year-on-year, when in reality it fell 8% year-on-year.

FIGURE 1: WISDOMTREE GOLD MODEL: ATTRIBUTION OF GOLD PRICES



Source: Bloomberg, WisdomTree price model, data as of 31 July 2021. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

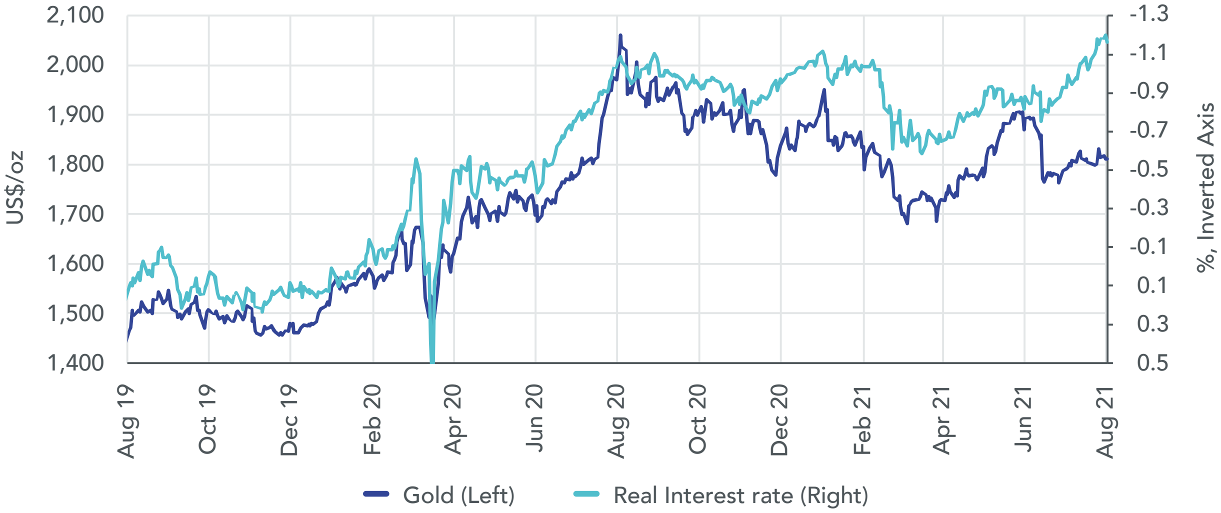
The fitted gold price is the price the model would have forecast. The constant does not have an economic meaning, but is used in econometric modelling to capture other terms. It can be thought of as how much gold prices would change if all other variables are set to zero (although that would be unrealistic).

1 US CPI inflation was 5.4% in July 2021

2 As of 16 August 2021

We believe that if gold regains its traditional behaviour, it should rise from today's levels and counter the headwinds of moderately rising Treasury yields and inflation cooling a little. Gold's odd behaviour of late is also highlighted in its departure from Real Rates in recent months (Figure 2). However, as we have seen in the past, these short-term departures are often corrected (e.g. in November 2019 and November 2020).

FIGURE 2: GOLD VS REAL RATES (TREASURY INFLATION-PROTECTED SECURITIES YIELD)

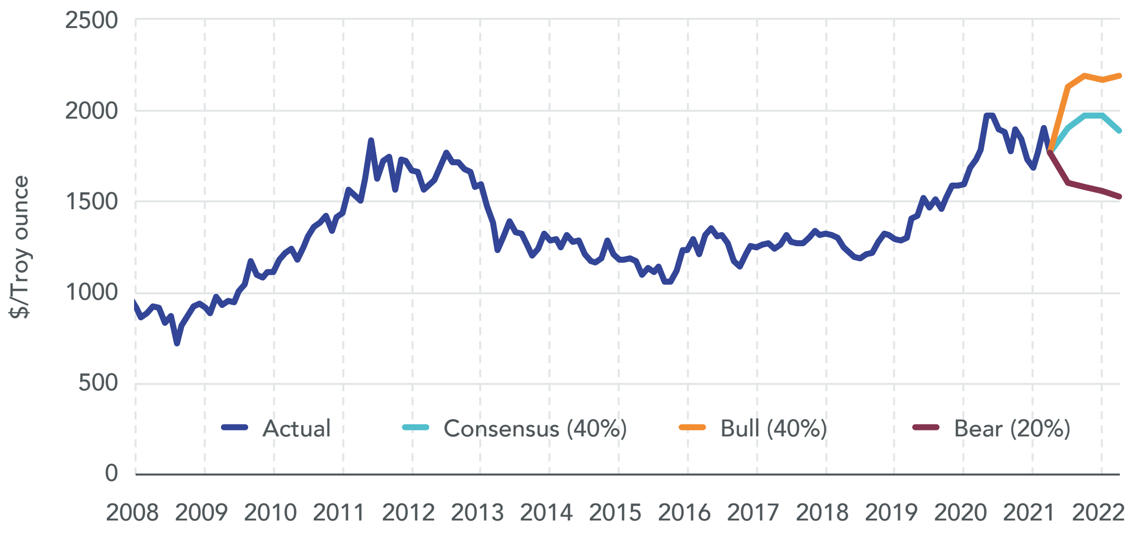


Source: Bloomberg, WisdomTree. 4 August 2019 to 4 August 2021. **Historical performance is not an indication of future performance and any investments may go down in value.**

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 Q2 2022.

FIGURE 3: GOLD PRICE FORECASTS



Source: WisdomTree Model Forecasts, Bloomberg Historical Data, data available as of close 31 July 2021. **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 130k contracts net long.
- Bull case – inflation remains higher defying the "inflation is transitory" mantra central banks are trying to convince the market of. Treasury yields don't pick up as fast as in consensus scenario as the Federal Reserve takes a more dovish stance. US Dollar resumes a depreciating trend that started in 2020.
- Bear case – If the Federal Reserve raises rates, inflation could be battened down, Treasury yields would rise faster and the US dollar would appreciate.

We place roughly a 40% probability on the consensus case, a 40% probability on the bull case and 20% probability on the bear case.

CONSENSUS

Consensus opinion is for inflation to fall from 5.4% in July 2021 to 2.6% in Q2 2022. It appears consensus is broadly following central bank guidance that elevated inflation is transitory and largely driven by base effects.

Consensus also expects Treasury yields to rise, reversing most of the decline in yields that we have seen over the last three months by the end of the year and then driving higher to a level we haven't seen since 2019.

US dollar remains quite flat over the forecast horizon, declining slightly from 92.6 at the time of writing (16 August 2021) to 91.0 at the end of the forecast.

To be consistent with the scenario of easing inflation concerns and rising Treasury yields, we expect speculative positioning would decline from current level of 200k contracts net long to 130k net long.

Factoring these assumptions into our model, we get to a gold price of US$1890/oz by Q2 2022, but could peak out at US$1970/oz by the end of the year. Despite the headwinds of moderating inflation and rising Treasury yields, gold in this scenario is still correcting on the upside after having been underpriced.

CONSENSUS SCENARIO				
	Q3 2021	Q4 2021	Q1 2022	Q2 2022
Inflation forecast	4.4%	4.3%	3.8%	2.6%
Nominal 10-year yields forecast	1.68%	1.80%	1.89%	1.96%
US$ exchange rate forecast (DXY)	91.5	90.6	91.4	91.0
Speculative positioning forecast	170k	150k	140k	130k
Gold price forecast	US$1905/oz	US$1970/oz	US$1970/oz	US$1890/oz

Source: WisdomTree, data available as of close 31 July 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 CASE

In the bull case, we explore what happens if inflation doesn't drop as fast as consensus expects. What if the central bank mantra that inflation is transitory is not true? Indeed, looking through recent inflation prints, the sources of inflation seem to be very broad and it is reasonable to believe that supply bottlenecks could persist for longer. If the source of inflation is supply driven, tightening monetary policy could be counter-productive and therefore central banks may decide to sit pat on monetary policy. In this scenario, while inflation may not remain at the current 5.4%, if it only falls to 3.5%, we are still in a period of relatively elevated inflation.

In this scenario, while Treasury yields may rise from the current 1.2% to 1.5% across the forecast horizon, the rise in yields is quite contained.

If the Federal Reserve doesn't tighten rates (or indicate it's in a hurry to do so) interest rate differentials are unlikely to provide upside US dollar pressure. Indeed, the widening of deficits, both on the budget and current account, that were the source of US dollar depreciation in 2020 may resume.

We believe in an elevated inflationary environment, investor sentiment towards gold will remain firm. Therefore, we maintain a net positioning in gold futures at 200k - similar levels to where we are at the time of writing.

In this scenario, not only does gold remain above US$2000/oz for the whole forecast horizon, it pierces through the all-time high gold price of US$2075/oz reached in August 2020.

BULL CASE SCENARIO

	Q3 2021	Q4 2021	Q1 2022	Q2 2022
Inflation forecast	5.0%	4.5%	4.0%	3.5%
Nominal 10-year yields forecast	1.50%	1.50%	1.50%	1.50%
US$ exchange rate forecast (DXY)	88.0	88.3	87.9	87.6
Speculative positioning forecast	200k	200k	200k	200k
Gold price forecast	US$2130/oz	US$2190/oz	US$2170/oz	US$2190/oz

Source: WisdomTree, data available as of close 31 July 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 CASE

In the bear case scenario, we explore what would happen if the Federal Reserve acted pre-emptively to tighten monetary conditions. The lack of monetary accommodativeness could suppress demand and bring inflation down to its 2% target.

Yields on nominal Treasuries would rise more aggressively in anticipation of a tighter monetary stance.

US dollar would appreciate, presuming that the Federal Reserve is acting more hawkishly than other central banks.

Positioning in gold futures would decline as the inflationary threat diminishes and presuming that the economy is healthy enough to withstand a period of monetary tightening.

We believe that this is the least likely scenario given that economic growth is so interlinked with the pandemic and raising rates too soon could recklessly undo the hard work of the Fed in this crisis so far. However, if the Fed comes to the conclusion that inflation is not transitory (i.e. reverses its own mantra), it could act early. We will get more insight into the central bank's thinking later this month at the Jackson Hole Economic Policy Symposium[3].

In this scenario, we could see gold prices fall to US$1550/oz at the end of the forecast horizon.

BEAR CASE SCENARIO				
	Q3 2021	Q4 2021	Q1 2022	Q2 2022
Inflation forecast	3.0%	2.5%	2.0%	2.0%
Nominal 10-year yields forecast	1.80%	2.20%	2.50%	2.75%
US$ exchange rate forecast (DXY)	91.8	93.1	92.7	92.9
Speculative positioning forecast	100k	75k	50k	50k
Gold price forecast	US$1600/oz	US$1580/oz	US$1560/oz	US$1550/oz

Source: WisdomTree, data available as of close 31 July 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.**

CONCLUSIONS

Gold is currently under-priced relative to our model forecast. If gold's behaviour snaps back, there is upside potential for the metal. So even in the consensus scenario where there are headwinds of inflation moderating and Treasury yields rising, gold prices should head higher from today's levels. In a bull scenario, stubbornly high inflation and a central bank that doesn't stand in its way, should drive gold even higher to an all-time high. In the Bear case scenario, a hawkish move by the Fed could lead to gold prices falling to US$1550/oz.

3 https://www.kansascityfed.org/newsroom/2021-news-releases/2021-jackson-hole-economic-policy-symposium/

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