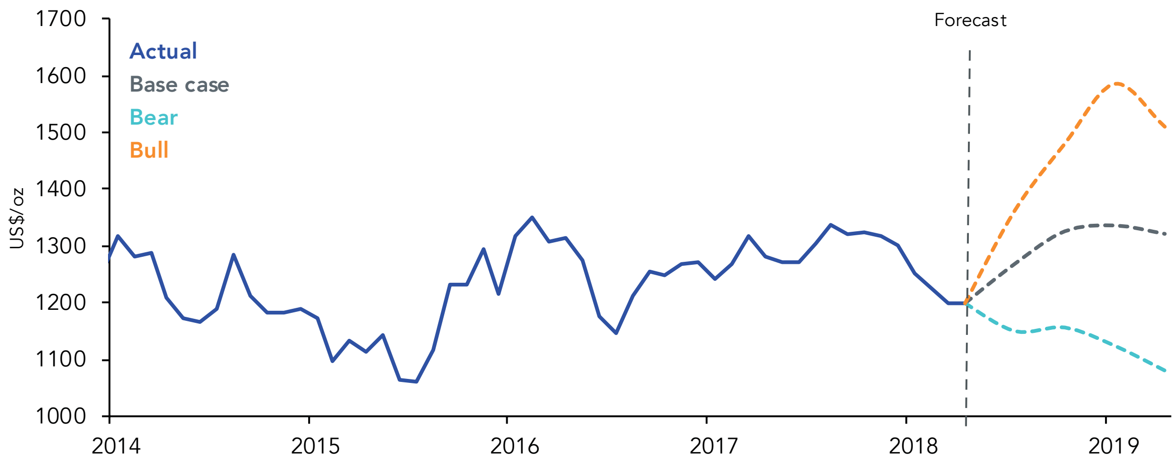
GOLD OUTLOOK: UPSIDE CORRECTION DUE

Gold has performed badly in the past quarter. We had expected the yellow metal to flatline amid a rising interest rate environment and US Dollar strength (see Gold outlook: gold to flatline out to June 2019 in the absence of shocks), but a decline of 4% since 30 June 2018 appears excessive. An upside correction may be overdue. We expect gold to end this year close to US$1270/oz and reach US$1320/oz by Q3 2019, up from US$1200/oz at the time of writing.

FIGURE 1: GOLD PRICE FORECAST



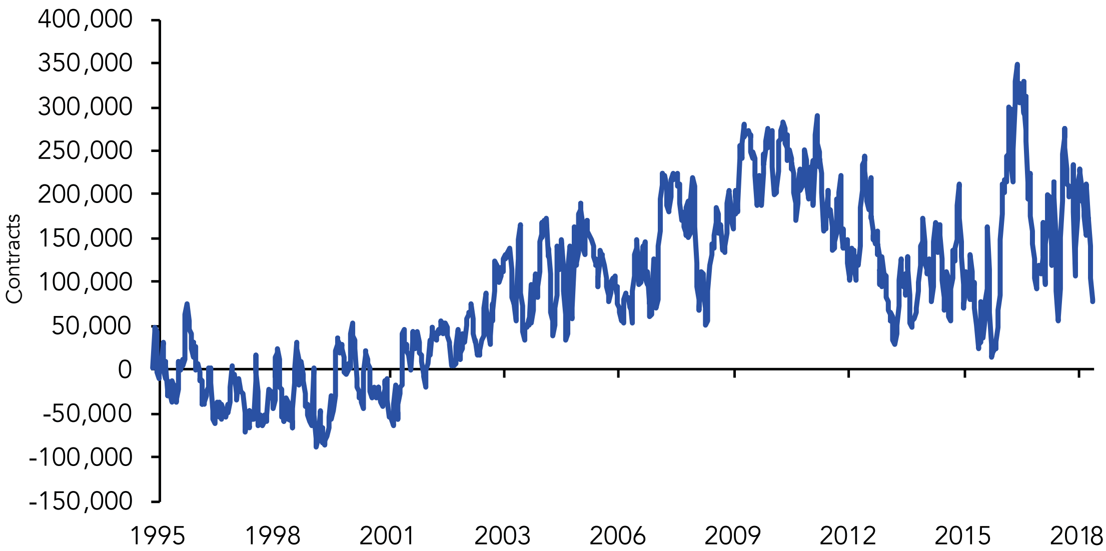
Source: WisdomTree Model Forecasts, Bloomberg Historical Data, data available as of close 12 September 2018.

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

What accounts for recent price decline?

Using the framework we outlined in our paper Gold outlook: gold to flatline out to June 2019 in the absence of shocks, we observe that the increase in bond yields (11bps) and US Dollar appreciation (0.4%) since last quarter are not enough to justify the decline in gold prices. Rather it is the collapse in sentiment towards gold (measured by speculative positioning in the futures market) that has been responsible for the price declines. Speculative positioning in gold futures has declined to the lowest level since 2001.

FIGURE 2: GOLD FUTURES SPECULATIVE POSITIONING



Source: Bloomberg, WisdomTree, data available as of close 13 September 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

A short-covering rally on the horizon?

A frequent narrative heard in the market is that some investors have lost faith in gold as safe-haven asset after its lack of positive price performance during the recent emerging markets sell-off. But given how much developed market equities maintained strong performance during that period, it should be unsurprising that gold prices did not rise. Gold appears ripe for a short-covering rally as today's pessimism looks excessive.

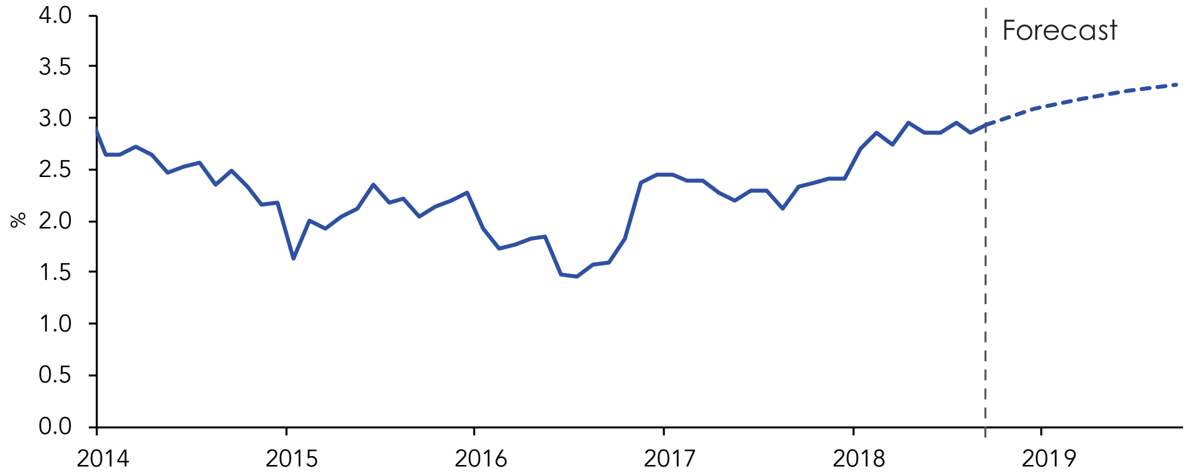
Fed to continue to tighten policy

We expect the Federal Reserve (Fed) to raise rates once more in 2018 and then twice in 2019. Inflationary pressure is still present in the US economy and labour markets remain tight. The Federal Reserve will continue to let assets run-off its balance sheet subject to the US$20bn per month cap for mortgage-backed securities and US$30bn per month for Treasuries. However, most of the Fed's moves are priced into the US Dollar and US bonds.

US Treasury bond yield curve to invert

Although we expect a total 75 basis points of rate rises in policy rates by Q3 2019, we think that 10-year bonds yields will only gain 40 basis points to 3.3% in that time horizon. 2-year bond yields are likely to capture more of the gains in policy rates, but further out in the curve, we are likely to see less yield increases. That's because the Fed's holding of a large stock of bonds is likely to hold yields back from rising too aggressively. Also, recent tax cuts are likely to have most impact in the very short term. As the growth impact peters out over longer horizons, the uplift to yields at the longer end of the curve will be less than at the short end. We don't believe that a yield-curve inversion is a precursor to an economic recession though. Although many people see yield curve inversion as a financial signal of impending economic downturn, we believe that an inversion can occur for the less benign reasons outlined above. If anything, we believe the Fed will err on the side of dovishness, as it will be reluctant to drive policy too far from other central banks. That could prove to be supportive for economy over the coming year.

FIGURE 3: NOMINAL US 10YR BOND YIELDS FORECAST



Source: Bloomberg, WisdomTree, data available as of close 17 September 2018.

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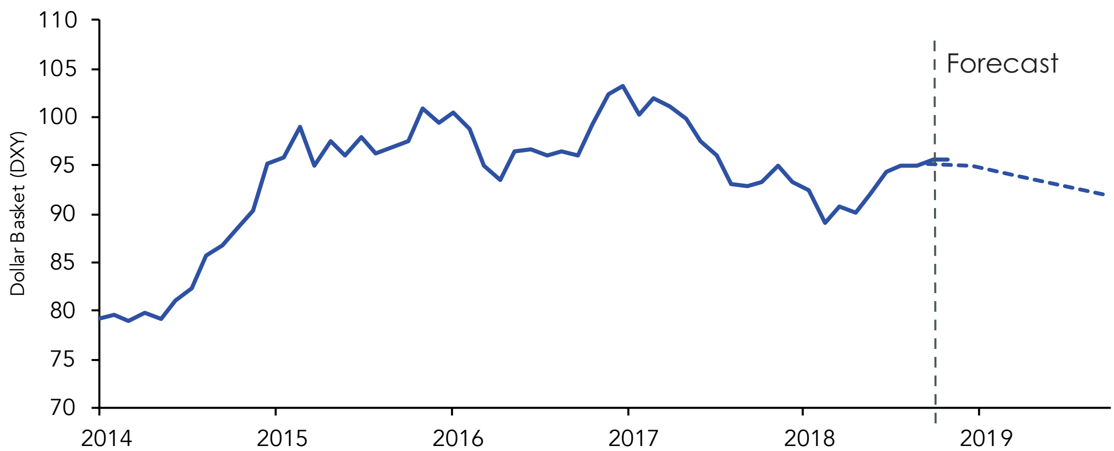
US Dollar to depreciate as rate increases are priced-in?

We don't think that three Fed rate increases over the coming year will surprise the market. Fed Fund futures are more closely aligned with the Fed's own policy guidance today than in the past few years. There is a risk that other central banks – the European Central Bank, Bank of Japan, Bank of England for example – could tighten their policy setting. So, the risks to the Dollar are on the downside. Additionally, with growing indebtedness in the US - exacerbated by recent tax cuts - we expect a depreciation in the US Dollar.

FIGURE 4: US DOLLAR EXCHANGE RATE FORECAST



Source: Bloomberg, WisdomTree, data available as of close 17 September 2018.

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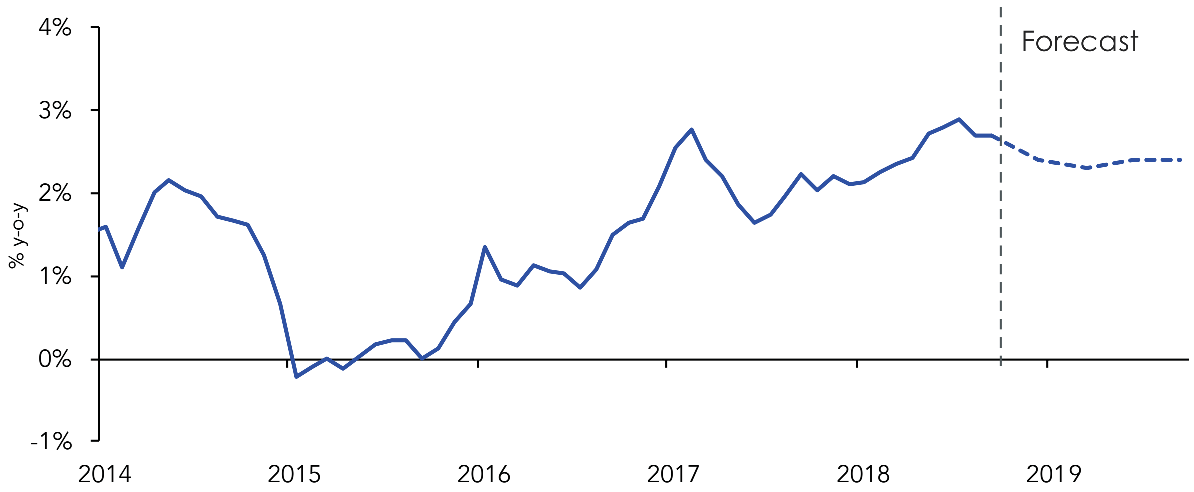
Inflationary pressures to persist, but remain contained by Fed's policy

US consumer price index (CPI) inflation peaked at 2.9% in July 2018 and declined to 2.7% in August 2018. High energy prices were a catalyst for the elevated reading. However, soon the gains in oil price will fall out of the year-on-year comparison. Moreover, depressed agricultural prices are likely to pressure food prices lower. Tightening policy rates will aid inflation lower. However, we expect the Fed's dovish bias to allow the economy and inflation to run a little hot, and so we don't see inflation declining back to 2% on the forecast horizon. We expect US inflation to decline to 2.4% by Q3 2018.

FIGURE 5: CONSUMER PRICE INDEX INFLATION FORECAST



Source: Bloomberg, WisdomTree, data available as of close 17 September 2018.

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What will help sentiment toward gold improve?

Summarising the monetary/economic drivers of gold: rising interest rates and easing inflationary pressure should be gold price negative, while a depreciating US Dollar should be gold price positive. But none of these changes will move the dial much for gold. We believe that that gold prices will end the forecast period higher mainly as a result of sentiment towards gold snapping out of an excessively depressed state.

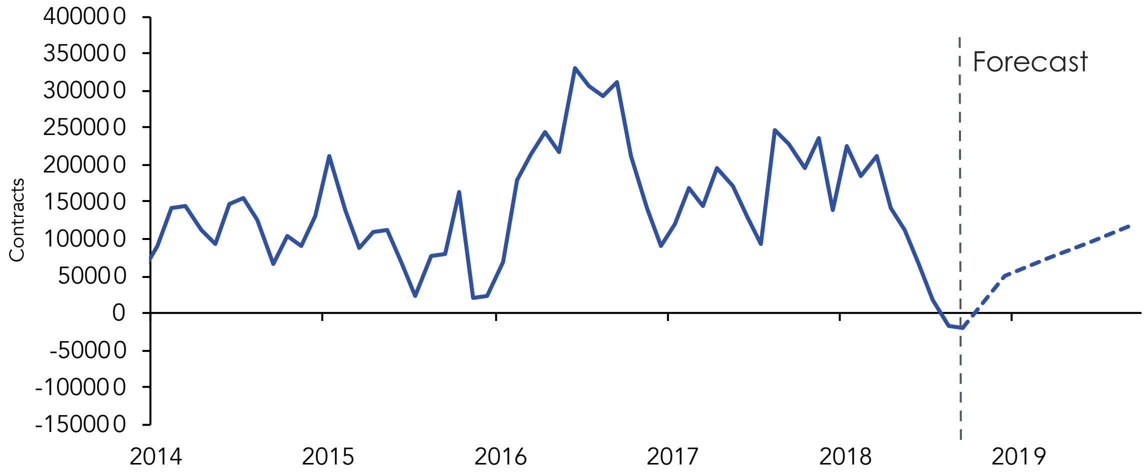
But what will drive this change in sentiment? It's hard to be overly prescriptive here, but we believe that negative net speculative positioning is unusual. We expect that even in a flat to mild price recovery, many shorts will be covered. Covering shorts tend to exacerbate price gains and could set in motion a rally. There are a number of underlying risks in the market that could draw attention to gold's historical safe-haven status, should a risk-off sentiment return.

+ Trade-wars – Our working assumption is that rising protectionism in the US is not going to damage global economic demand. But if tit-for-tat protectionist measures escalate, the market could be driven into a risk-off mindset.

+ Brexit negotiations – With a March 2019 deadline looming for the UK's departure from the European Union, there are plenty of details to be ironed out. Failure to negotiate a trade agreement could be quite damaging for the UK and EU alike.
+ Financial tensions – We have had multiple bouts of equity market volatility this year, but for most part developed world equities have remained resilient. That does not guarantee resilience in the face of the next shock. If there is any contagion from the emerging market sell-off to developed markets, we believe that faith in gold could be restored. We note that the last time speculative positioning in gold was this low was in 2001 – the year when an Argentine debt crisis was brewing, and an overvalued technology sector was imploding. Gold reacted to the stress scenario but with latency. Gold prices rose 25% in 2002 (compared to 2% in 2001). As markets remember how stress events, what is thought of as the periphery can migrate to the core and we could see the demand for gold as an event hedge rise. Obviously if a stress event at the core of financial markets were to crystallise, we would expect our monetary/economic forecasts also to change significantly. But we simply highlight how the presence of risk should be enough to drive gold demand higher.

In our forecast, we normalise speculative positioning in gold futures back to levels consistent with what we have seen in the past five years.

FIGURE 6: GOLD FUTURES SPECULATIVE POSITIONING



Source: Bloomberg, WisdomTree, data available as of close 17 September 2018.

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Alternative scenarios

We have also forecasted alternative scenarios for gold as summarised below. Most of the sensitivity comes from our measure of sentiment and speculative positioning. But even in our bear case, we increase positioning into positive territory. In our bull case scenario, we assume the Fed will allow the economy to run hot, not raising rates as frequently as in the base case scenario, which will put less pressure on bond yields to rise, aid US Dollar depreciation and keep inflation elevated at 2.9%. In the bear case, conversely, we assume the Fed acts in a more hawkish way and has more impact on the longer bond yields. The US Dollar appreciates as the Fed surprises the market with its hawkishness.

FIGURE 7: FORECASTS TO Q3 2019

Q3 2019	Base	Bear	Bull
Fed policy forecast	1 more rate increase in 2018 Max of 2 rate increases in 2019	1 more rate increase in 2018 3 rate increases in 2019	50pbs total rate increase from now until Q3 2019
Inflation forecast	Inflation likely to have peaked at 2.9% in July 2018. To decline to 2.4% in Q3 2019.	1.6%	2.9%
Nominal 10-year forecast	3.3%	4.0%	2.8%
US$ exchange rate forcast (DXY)	92	99	86
Speculative positioning forecast	120k	20k	200K
Gold price forecast	US$1322/oz	US$1080/oz	US$1511/oz

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CONCLUSION

In our base case scenario, we expect gold prices to rise to over US$1320/oz by Q3 2019, mainly as a result of speculative positioning in the futures market restoring. It is unusual to have positioning so pessimistic in the presence of many underlying market risks and we expect speculative shorts to be covered, helping gold prices rise.

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