Gold outlook: gold to flatline out to June 2019 in the absence of shocks

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Despite high levels of geopolitical tension in 2018, gold is currently trading close to where it was trading at in early January. And looking ahead, we believe gold's price is likely to flatline until mid-2019, unless unexpected shock events result in a sudden drive towards safe-haven assets.

Recently, we updated our forecasts for gold, assuming that the US Federal Reserve (Fed) is on track to raise to interest rates at least four times by the end of June 2019. In our base-case scenario for gold, inflation is likely to remain above-target, providing some support for the precious metal, yet rising interest rates and US dollar appreciation will weigh on performance. Our base case also assumes that we see no unexpected shock events between now and mid-2019.

Below, we explain the rationale behind our gold price forecasts, and also look at how gold could perform if events were to unfold in a different manner.

The model

Our outlook on gold is shaped by the framework first described in the report "Policy mistakes provide upside potential for gold", published in January 2016. We have recalibrated the model using data to April 2018 in order to incorporate key turning points in gold's price since the original framework was published. One notable development was that in 2016, speculative positioning in the gold futures market hit a new high of close to 350,000 contracts net long, and we have incorporated this into our model. The variables used in the original model are still valid and the overall ability of the model to explain the variation in actual gold prices remains very high (an adjusted R-squared of 0.58).

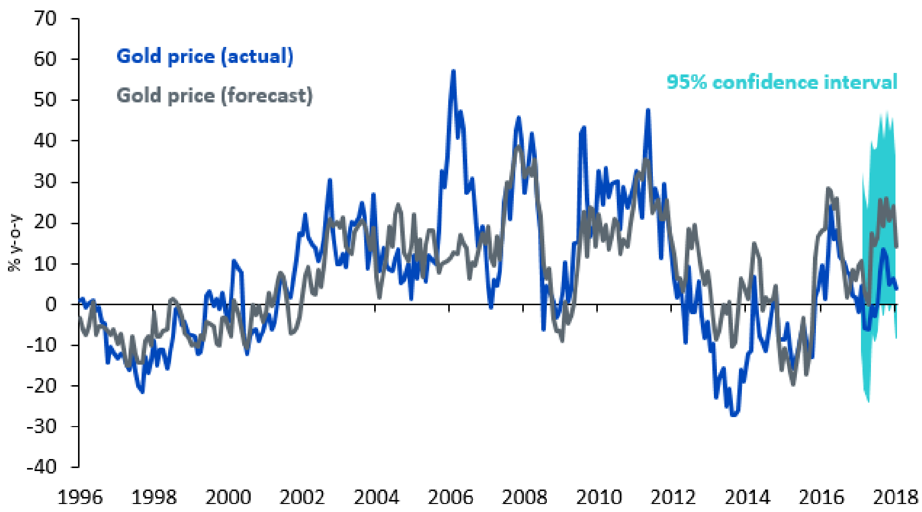
To recap, the variables in our gold model are (direction in parenthesis):

- Changes in the trade-weighted value of the US Dollar (-)
- Changes in nominal yields on 10-year US Treasuries (-)
- CPI inflation (+)
- Investor sentiment measured by speculative positioning in the futures market (+)

We chose to use both inflation and nominal yields in the model as a proxy for real yields, rather than real yields directly, so that we could use a longer data set (Treasury Inflation-Protected Securities have only been around since 1997). We calibrate a model that goes back to 1995, when the Commodity Futures Trading Commission (CFTC) first began publishing data on speculative futures market positioning.

The model performs well in out-of-sample tests. In a test in which we calibrated the model using data up to May 2017 and then let the model predict prices to April 2018, the model performed reasonably well, with all forecasts sitting comfortably within the 95% confidence interval.

Figure 1: Gold price model in out of sample test



Source: Bloomberg, WisdomTree, data available as of close 30 May 2018
Model calibration: April 1996 to April 2017. Out of sample period: May 2017 to April 2018
Past performance is not indicative of future results. You cannot invest directly in an Index.

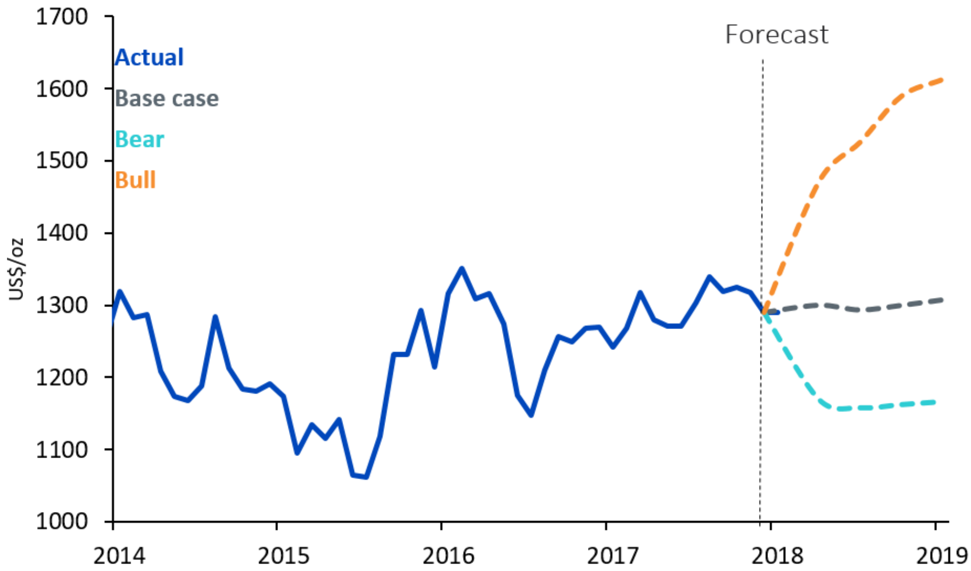
The aim of our exercise is not to accurately forecast gold prices. Instead, it's to develop a framework that identifies the key drivers of gold prices, and to eliminate variables that are not statistically relevant (see Policy mistakes provide upside potential for gold for further discussion of this exercise). To generate a fair value for the gold price, the model requires our views on the development of key variables, such as exchange rates, Treasury yields, and inflation. The accuracy of our model, therefore, depends on the accuracy of such views.

In addition to our base-case view we present some scenarios that illustrate how gold prices could evolve under alternative developments.

Base case

In our base-case scenario, gold is likely to flatline out to the end of June 2019, ending the period at a price of $1,307/oz, close to gold's price of $1294/oz gold, at the time of writing. Here is a closer look at the inputs in our model.

Figure 2: Gold price forecast



Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. You cannot invest directly in an Index.***

US Federal Reserve policy decisions: We expect the Fed to increase interest rates four times between now and the end of June 2019. Additionally, the Fed will continue with its balance sheet runoff programme, subject to the caps it announced last year. This policy normalisation is driven by rising inflation pressure but we believe that the Fed is comfortable in allowing inflation to rise above its 2% target, rather than risk putting the breaks on the economy too forcefully.

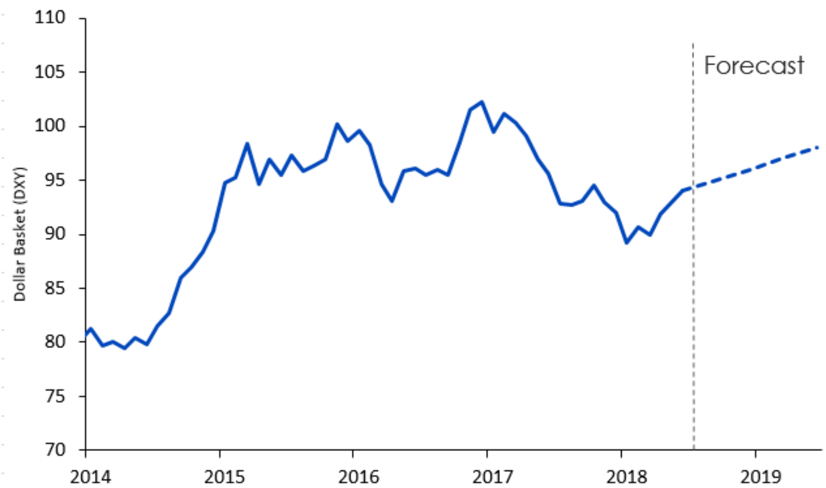
US Treasury yields: We believe that higher Fed fund rates will drive US Treasury yields to 3.6%, up from 2.9% today, factoring in some degree of curve flattening. We believe that at this point in the economic cycle, a bear-flattening is more likely than a bull-steepening.

Figure 3: Nominal US 10yr Bond Yields Forecast

Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. You cannot invest directly in an Index.***

US Dollar: Despite interest rate differentials between US and G10 currency countries widening, the US Dollar has depreciated over the past year. However, over the past month we have seen the US Dollar appreciate in line with rising Treasury yields and signs of economic weakness across Europe and Japan. We expect the US dollar to continue to appreciate through the forecast horizon as the US economy continues to perform well. We acknowledge that our view is not in line with the consensus view, but we believe that the era of US dollar underperformance in the face of US economic outperformance is over. In our base-case scenario, we expect the US Dollar basket to appreciate to 98, up from 94 at the time of writing.

Figure 4: US Dollar Exchange Rate Forecast

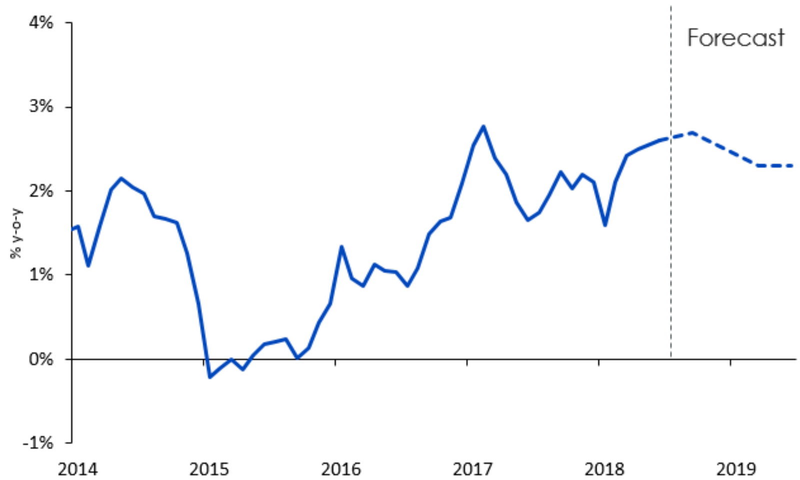


Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. You cannot invest directly in an Index.***

Inflation: US inflation is rising as a result of higher oil prices and tight labour markets. We acknowledge that labour markets have been tight for some time without any significant impact on core inflation, but we do not believe this situation can last forever. Wage growth has been subdued despite unemployment rates falling markedly behind the so-called non-accelerating inflation rate of unemployment (NAIRU). Weak productivity gains in the face of low investment may be one of the drivers behind this divergence.

Yet, as the economic recovery continues, we suspect that it will be difficult to maintain tight labour market conditions without any inflationary impact. We expect US inflation to peak at 2.7% in Q3 2018, before declining as interest rate rises reduce aggregate demand and provide some disinflationary pressure. We believe that US inflation will settle at 2.3% in June 2019, clearly above the level that the Fed has historically been comfortable with, but acceptable given the Fed's current stance of favouring price risks to the upside rather than those to the downside.

Figure 5: CPI inflation forecast

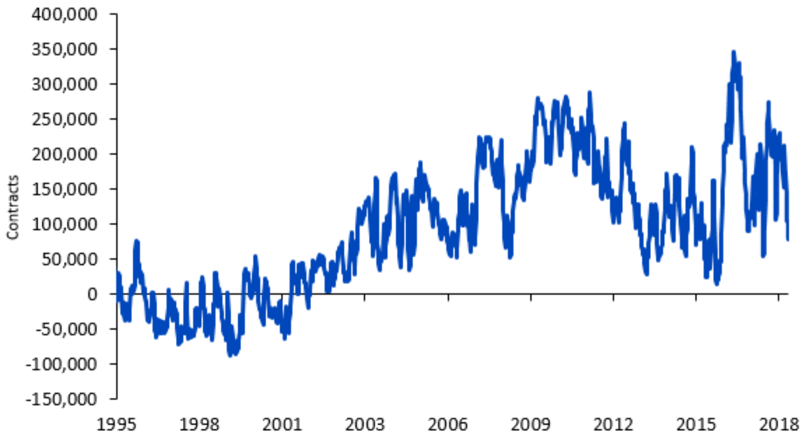


Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. You cannot invest directly in an Index.***

Investor sentiment: Forecasting sentiment towards gold is particularly difficult. Gold is seen as a safe-haven asset and as a result, demand for gold often increases in times of uncertainty. We measure sentiment towards gold by looking at the speculative positioning in gold futures. For example, net positioning in gold futures rose to an all-time high after the UK voted to leave the European Union in 2016. Predicting shock events such as this is not possible though, unfortunately.

Geopolitical risk remains elevated at present, but we believe the market is not currently pricing this risk in. This is possibly due to fatigue, as there have been high levels of geopolitical risk over the past few years, without any significant fall-out in cyclical assets. At the time of writing, speculative positioning in gold futures has fallen below the series average of 92,000 contracts net long. In our base-case scenario, we anticipate that positioning will recover slightly to 100,000 contracts net long.

Figure 6: Gold Futures Speculative Positioning



Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Past performance is not indicative of future results. You cannot invest directly in an Index.***

Bull case

In our bull-case scenario, gold could rise to $1,613/oz by the middle of 2019.

Our bull-case scenario assumes that the Fed is more relaxed about inflationary pressures, extrapolating this period of tight market conditions without wage and inflationary repercussions. In this scenario, less rate tightening results in inflation rising to 2.9% by June 2019 with Treasury yields falling to 2.8%. We also revert to the consensus view of the US dollar depreciating, with the DXY basket declining to 86, from 94 currently.

We raise investor positioning in gold futures to 200,000 contracts net long for the entire forecast horizon in the bull case. This, combined with a softening US dollar, is one of the main drivers of the higher gold forecast, compared to the base case. There are numerous risks that could push demand for gold futures higher, including:

- Continued tension between US/Japan/South Korea and North Korea
- An escalation of the proxy war between Saudi Arabia and Iran, with Iran withdrawing from the Joint Comprehensive Plan of Action (JCPOC) and resuming its nuclear programme
- A disorderly unwinding of credit in China
- Italian policy paralysis as a result of the country’s inability to form a functional government
- Market volatility, with the VIX (equity) or MOVE (bonds) indices spiking as yield trades unwind

Bear case

In our bear-case scenario, gold falls to $1,166/oz by June 2019.

Our bear case assumes that the Fed becomes more aggressive in tackling inflationary pressures. In this scenario, the Fed tries to anchor inflation expectations amid rising headline figures that it fears could be mistaken as persistent. 10-year nominal Treasury yields rise to 4.1% by mid-2019, while the DXY appreciates to 99 and inflation falls back to 1.6%.

In this scenario, we assume the absence of any geopolitical risk premia or adverse financial market shocks, with speculative positioning in gold futures falling to 40,000 contracts net long.

Alternative scenarios

We acknowledge that our base case, bull case, and bear case for gold may not cover all scenarios. We also note that our view on the US Dollar is not in line with the consensus view and that the gold price is particularly sensitive to levels of speculative positioning in the futures market.

With that in mind, we provide the following scenario table, which takes our base-case scenario and adds a range of inputs for the US Dollar exchange rate and for the amount of speculative positioning in the futures market.

Figure 7: Gold price forecast (US$/oz), June 2019

	Level of dollar basket (DXY)								
Net spec positioning	74	78	83	87	92	97	101	106	110
-	1442	1396	1351	1305	1260	1214	1169	1123	1078
50,000	1495	1449	1404	1358	1313	1267	1222	1177	1131
100,000	1548	1503	1457	1412	1366	1321	1275	1230	1184
150,000	1601	1556	1511	1465	1420	1374	1329	1283	1238
200,000	1655	1609	1564	1518	1473	1427	1382	1336	1291
250,000	1708	1663	1617	1572	1526	1481	1435	1390	1344
300,000	1761	1716	1670	1625	1580	1534	1489	1443	1398
350,000	1815	1769	1724	1678	1633	1587	1542	1496	1451
400,000	1868	1823	1777	1732	1686	1641	1595	1550	1504

Source: Bloomberg, WisdomTree, data available as of close 30 May 2018. ***Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. You cannot invest directly in an Index.***

Conclusion

Our model suggests that gold's price is influenced by a number of key factors, including the value of the US dollar, inflation rates, changes in nominal yields, and investor sentiment towards the precious metal. Looking ahead, in our base-case scenario, we expect gold's price to flatline out to June 2019, assuming an absence of sudden unexpected events that shock global financial markets.

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