

Global Precious Metals Comment

Upgrading gold expectations

FX

Global

We think gold has entered a new phase

Gold has likely entered the early stages of the next bull-run. We upgrade our gold price expectations across the entire forecast period, lifting our 2016 annual average forecast to \$1280 from \$1225 previously. YTD average is currently at \$1222 – our new forecast therefore implies an average of \$1340 for the second half of the year. We also lift our short-term target to \$1400 from \$1250 previously (published back in April). Key drivers include: 1) low/negative real rates, 2) the view that the dollar has peaked against DM currencies, and 3) lingering macro risks. We expect the next leg to be driven by an extension of the trend of strategic portfolio allocation into gold from a diverse set of investors. This trend should now deepen, attracting more participants and encouraging those who have been hesitating to get more involved. Relatively orderly retracements, which have typically been shallow and brief indicates strong buying interest. This suggests that gold's floor is likely higher now given an even stronger fundamental argument for holding gold. ([See Global FX Atlas: Which views remain after Leave?](#))

Gold macro story more compelling than ever

We have been flagging the upside risks to our views for some time now on the back of stronger-than-expected investor sentiment and flows. The extent and breadth of the interest has meant that gold positions have more endurance and stability. The UK's vote to leave the EU further underpins gold's macro narrative, reinforcing the themes of further dovish shifts in monetary policies, consequently lower yields, and heightened uncertainty. We continue to expect US real rates to fall from here and ultimately for equilibrium real rates to settle lower and have limited upside. These factors justify strategic gold allocations across different types of investors and we expect this trend to continue. Upside risks include the trend broadening further and market perception shifting towards more aggressive policy easing expectations. Downside risks are mostly hinged on a significant shift in the macro story, but a violent gold selloff due to a sharp equities correction could also significantly tarnish gold's reputation.

Putting positioning into context

Comex data shows that gold speculative length has been making new highs this year. While positioning has been a concern for many market participants and could periodically warrant some near-term caution, ultimately investors are more willing to look through these levels given the current macro backdrop. A couple of things to note here: 1) Looking at notional values also matter – at current spot prices, gold net longs in USD value terms are still around 85% of the 2011 highs despite recently reaching record volumes; and 2) If gold has indeed entered a new phase, then it would be understandable that the market would have to acclimatise to higher levels of positioning along with higher prices.

Figure 1: Gold price forecasts (annual averages, US\$/oz)

period	old	new	new vs old
2016E	1225	1280	5%
2017E	1250	1400	12%
2018E	1300	1450	12%
2019E	1325	1475	11%
2020E	1400	1500	7%
LT price (real 2015)	1300	1300	0%

Source: UBS

Joni Teves

Strategist

joni.teves@ubs.com

+44-20-7568 3635

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Has gold entered a new bull-run?

We think so. Key drivers for gold include: 1) low/negative real rates, 2) the view that the dollar has peaked against DM currencies, and 3) lingering macro risks. The UK's vote to leave the EU reinforces these themes – further dovish shifts in monetary policies, consequently lower yields, heightened uncertainty. We expect US real rates to fall from here and ultimately for equilibrium real rates to have limited upside. These factors justify strategic gold allocations across different types of investors and we expect this trend to continue.

Q: Is the gold trade overly crowded?

No, we think there is still room for more. Gold's performance has been driven by very broad-based participation in gold as a portfolio diversifier and hedge. Our sense is that individual positions are not particularly large, but rather the extent of involvement has been quite expansive. It's also worth noting that despite the very strong inflows into gold ETFs YTD, global holdings are still some distance away from record highs. And although Comex positioning reached record volumes, notional values are still not as extended.

Q: Are the risks to the base case symmetric?

No, we think the risks are skewed to the upside. There could be a stronger move if participation broadens even further and if the private wealth community decides to change allocations. Another upside risk is if policies are expected to head towards the 'helicopter money' route and inflation starts becoming a concern again. On the downside, apart from a shift in the macro story, a violent gold selloff on the back of an equities correction could damage gold's reputation and significantly slow the trend in gold allocation.

UBS VIEW

Strategic gold allocation is warranted given low/negative real rates and macro risks. An environment of low and negative rates narrows the gap between holding gold vs other assets, making having gold in a portfolio an attractive proposition amid heightened global macro uncertainty. Current regime of risk aversion also highlights gold's role as a diversifier, acting as a safe haven when risk aversion is high yet also managing to do well when risk aversion moderates on the back of policy accommodation. Broad-based participation should extend the uptrend.

EVIDENCE

Strong sentiment and resilient positions on the back of a compelling gold macro story.

Relatively orderly retracements, which have typically been shallow and brief indicates lurking buying interest. There's an acknowledgment that the floor is likely higher now, amid frustration on the lack of buying opportunities and an even stronger fundamental argument for holding gold after the UK's 'leave' vote. Despite the build on Comex, anecdotally it seems many market participants are still looking to build positions further.

SIGNPOSTS

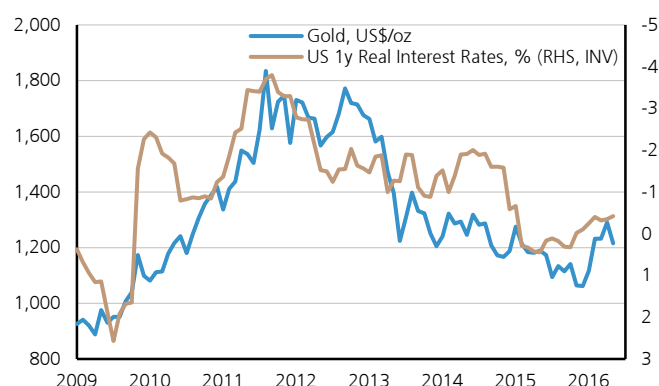
We will be watching factors that could affect real rates – this would include monetary policies at the Fed and other key central banks, nominal yields, oil prices, inflation prints, among other things. We will also monitor physical trends in physical markets by looking at trade data, differentials between local and international gold prices, changes in the loco swap rate between Zurich and London, as well as scrap and hedging flows.

UPSIDE / DOWNSIDE SPECTRUM



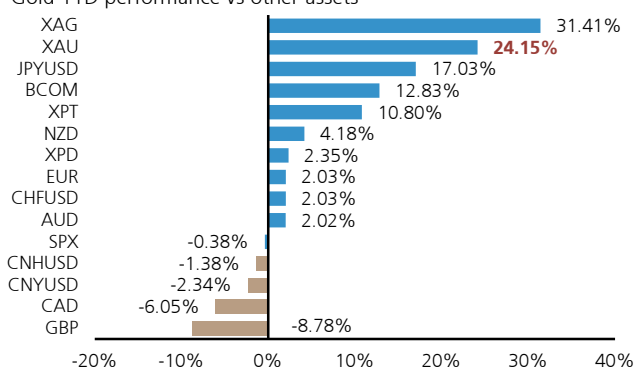
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OUR THESIS IN PICTURES

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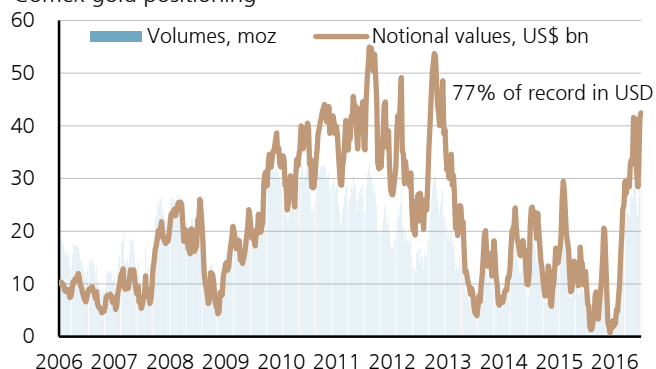
Real rates are the key driver for gold, in our view. As policy relief lifts inflation expectations and limits the upside to nominal yields, real rates are likely to stay low/decline, supporting gold. A dovish shift in policy on the back of higher uncertainty after the UK voted to leave the EU, particularly expectations for lower US real rates, should extend the trend of strategic gold allocation.

Gold YTD performance vs other assets



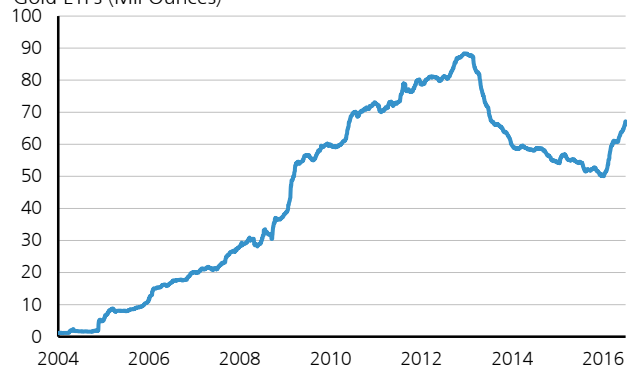
Gold has been a top performer YTD amid its attractiveness as portfolio diversifier and hedge. The compelling macro story – especially after the UK's 'leave' vote – implies positions have more endurance. Although a stronger dollar could also pose a challenge, the overall macro picture should allow both assets to rally. Nevertheless, given the extent of the recent gold moves, we think a brief period of consolidation would be healthy at this point.

Comex gold positioning



The build in positioning on Comex has been a source of concern among market participants, and does warrant some near-term caution. Nevertheless, to put into context, although volumes have reached new highs, notional values are not as extended from a historical perspective. A new phase in gold also suggests that the market could potentially start to acclimatise to a higher base.

Gold ETFs (Mil Ounces)



ETF inflows have been very strong and resilient, contributing to evidence that gold positions this year are more strategic in nature. That inflows continued in May, despite a decline of 8% in prices was encouraging and highlights the strength in sentiment and durability of positions.

Sources for exhibits above: Haver, Bloomberg, UBS.

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