January 18, 2024 | 19:39 ET~

BMO Global Commodities Research

New Drivers for a New Gold Era

BMO Capital Markets

IN Depth

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Bottom Line:

Given its unique set of demand characteristics, gold has always required a different framework for market analysis. However, over various periods of time, certain factors have been more dominant than others. With the correlation of gold to real rates now broken we are looking at a new era for gold. In our view, this looks to be defined by one macro factor — price-insensitive central banks — and one micro factor — Chinese household asset allocation. Both of these have been highly supporting of gold breaking into a new range above $2,000/oz. We define gold as a relatively low-volatility sub-asset class in a volatile world, which is not a bad thing to be.

Key Points

If real rates no longer drive the gold bus, what is influential? As global segmentation increases and central banks with large USD exposure start to fret about the impact of U.S. government fiscal spending and a structurally weaker dollar, the underlying push to de-dollarise and diversify holdings has shifted up the agenda. This is particularly true of emerging market institutions, and even more so those with close trading relationships with China. Notably, Russian gold reserves at end 2023 were at the highest level in history at $US156bn, more than double end-2017 levels, while those of China hit ~72Moz, or 4.3% of official foreign exchange reserves. We consider emerging market central bank net buying as a quasi-annuity for gold over the coming decade.

Macro asset allocators still use interest rates in positioning gold in portfolios. Indeed, you could argue they are more forward-looking now given the gold price now trends with interest rate expectations.

We see Chinese demand as an underappreciated driver of gold. China's influence on industrial metals is clear, but we now see this bleeding into precious markets — for different reasons. Just as seen in developed countries, China's households accumulated strong savings over the pandemic, and even over the past two years ~35trn RMB was added. However, these households have had somewhat of a dilemma as to where to put this money, something often termed the 'ugliness contest' for Chinese investors. Market surveys have shown that the proportion of Chinese households looking to save more (as opposed to invest more) has shown strong correlation to the RMB gold price. Gold exposure has become a necessity for Chinese portfolios, as they continue to expect disinflation and income uncertainty.

Given this scenario, perhaps the largest downside risk to gold price this year would come from a risk-on environment in China, such as from an equity market rally. However, with bank wealth management products still seeing large redemptions and concerns persisting over defaults at property developers and shadow banks, plus falling earning expectations at many industrial producers, it is hard to see this as a base case. The one thing we will be watching for is any sign of explicit Chinese government support for the domestic equity market, particularly given a 2024 policy objective is to "activate capital markets".

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For disclosure statements, including the Analyst Certification, please refer to page(s) 8 to 11.

Industry Research

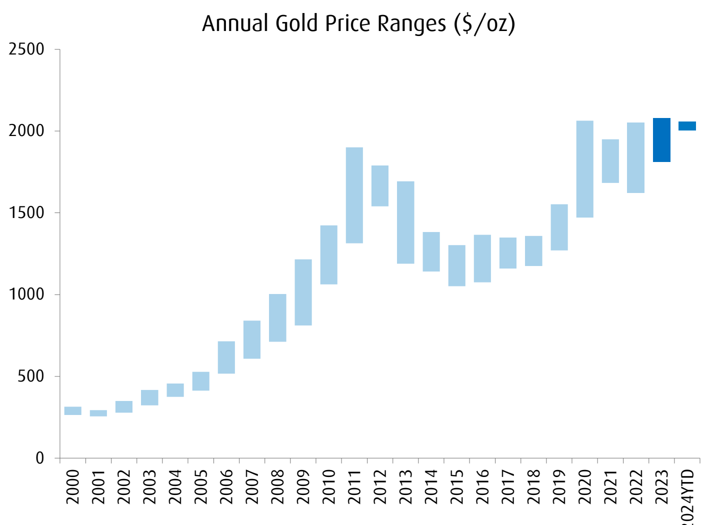
Glossary

New Drivers for a New Gold Era

Given its unique set of demand characteristics, gold has always required a different framework for market analysis. However, over various periods of time, certain factors have been more dominant than others. With the correlation of gold to real rates, which had held for the best part of a decade, now broken, we are looking at a new era for gold. In our view, this looks to be defined by one macro factor – price-insensitive central banks – and one micro factor – Chinese household asset allocation. Both of these have been highly supporting of gold breaking into a new range above $2,000/oz.

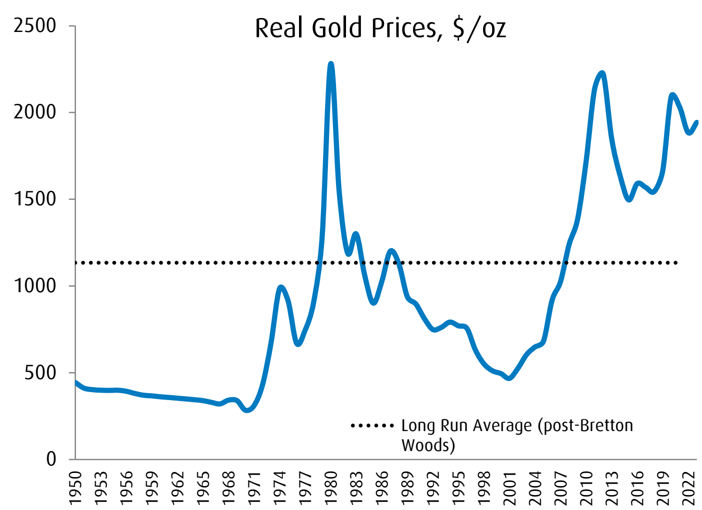
For gold, in our view the key is to assess who the marginal buyer is at any point in time, and what their motivation is. This has altered over time, but on the longer cycle gold prices have trended higher, while trading ranges have been relatively tight. This is what leads us to define gold as a relatively low-volatility sub-asset class in a volatile world, which is not a bad thing to be. 2023 saw an annual average gold price of $1,943/oz, the highest nominal level on record once more and the sixth highest in $2023 terms. Moreover, with a year-to-date average of $2,035/oz, 2024 has started well and the rising geopolitical tension, most notably in the Middle East, sees some further risk premium added.

Exhibit 1: While other commodities have cycled up and down, gold has continued to trend higher in recent years...



Source: LBMA, BMO Capital Markets

Exhibit 2: ...and despite fears over the impact of rate rises, saw both a real and nominal annual average price gain in 2023

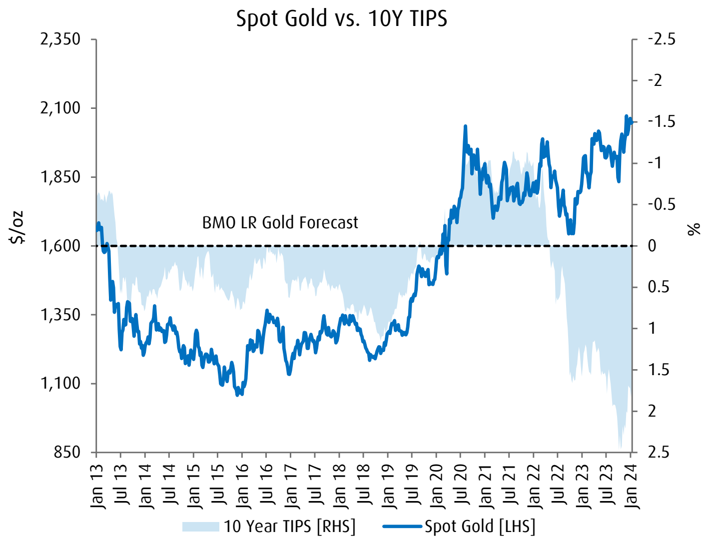


Source: LBMA, BMO Capital Markets

Historically, lasting through the start of this century, gold acted somewhat like other commodities. In this, we mean that it had price sensitive marginal buyers, most notably jewellery and bar/coin buyers in emerging markets. When gold prices went up in local currency terms, marginal purchases slowed and secondary material availability rose, and vice versa. Prices traded at levels close to the cost curve, rationing supply if necessary.

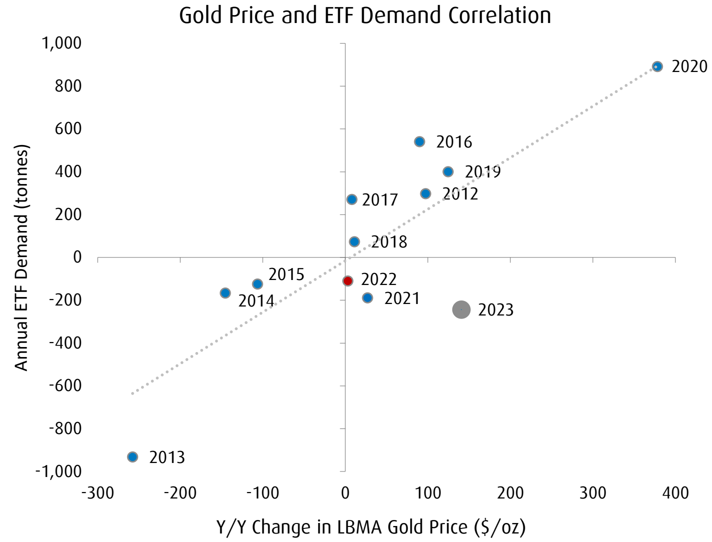
As financial sector investment in commodities grew, the macro asset allocator-led era emerged. Suddenly, physical gold was flowing in and out of ETFs, and the nature of these flows came to define price trends. Given the macro-overlay and portfolio-driven approach, gold became better correlated with wider assets under management and interest rates.

Exhibit 3: Gold's correlation with TIPS and real rates fell apart at the beginning of 2022...



Source: LBMA, Bloomberg, BMO Capital Markets

Exhibit 4: ...while that with ETF flows also moved away from the recent norm last year

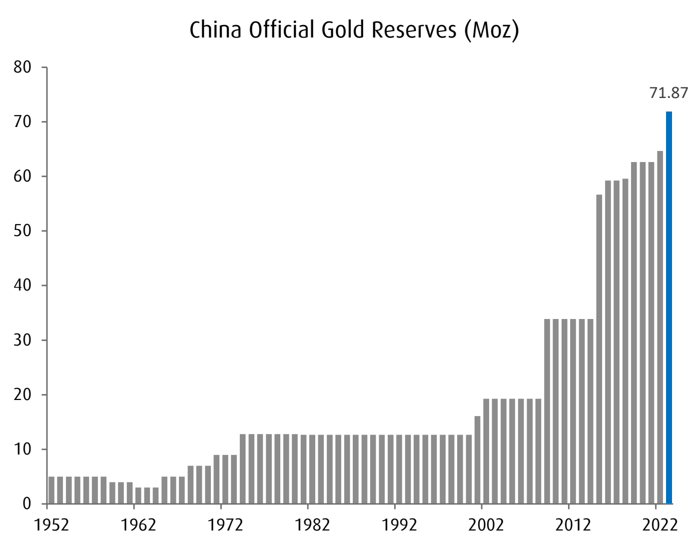


Source: LBMA, WGC, BMO Capital Markets

In our view, since 2009 of the various factors that play into the gold pricing framework, the inverse correlation to real rates (or TIPS) was the strongest. However, this fell apart amid the sharp real rate moves of 2022, and has not been re-established. It is fair to think therefore that real rates no longer matter; however with an initial U.S. rate cut expected at some point in 2024, we expect flow of funds from macro asset allocators, both into commodities as a whole and to gold specifically, will pick up.

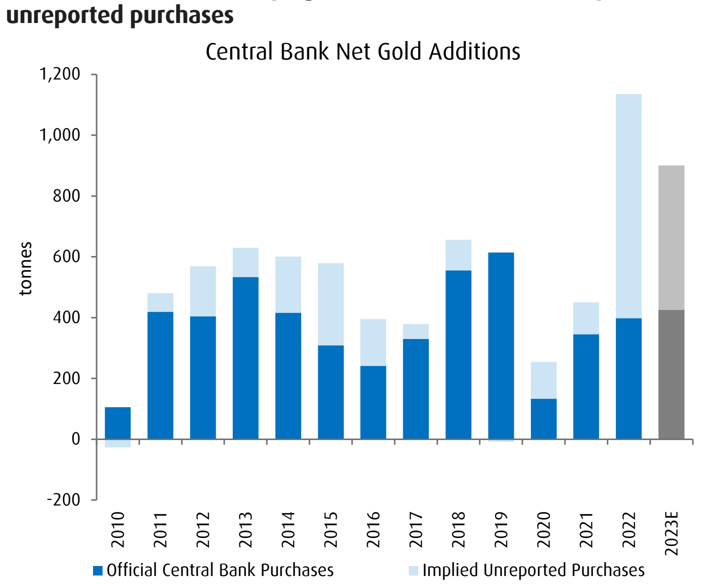
If real rates no longer drive the gold bus, what is influential? As global segmentation increases, and central banks with large USD exposure start to fret about the impact of U.S. government fiscal spending and a structurally weaker dollar, the underlying push to de-dollarise and diversify holdings has shifted up the agenda. This is particularly true of emerging market institutions, and even more so those with close trading relationships with China. Notably, Russian gold reserves at end-2023 were at the highest level in history at $US156bn, more than double end-2017 levels, while those of China hit ~72Moz, or 4.3% of official foreign exchange reserves. We consider emerging market central bank net buying as a quasi-annuity for gold over the coming decade.

Exhibit 5: China's official gold holdings have been rising relatively rapidly...



Source: PBoC, BMO Capital Markets

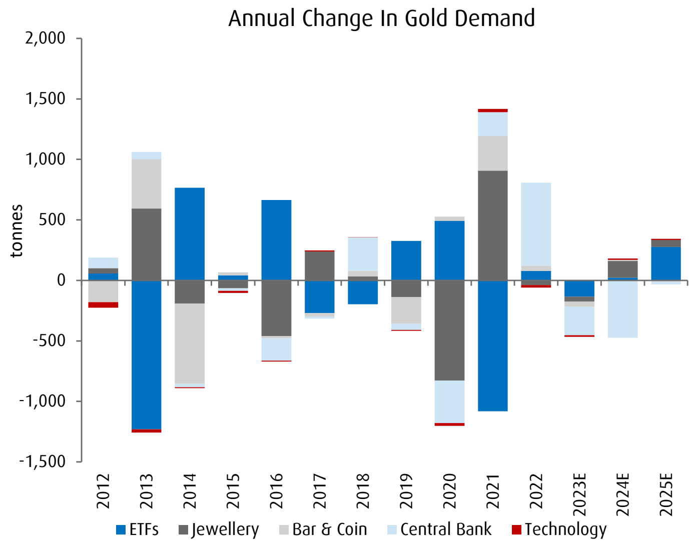
Exhibit 6: ...while industry figures also show a low of implied unreported purchases



Source: Metals Focus, BMO Capital Markets

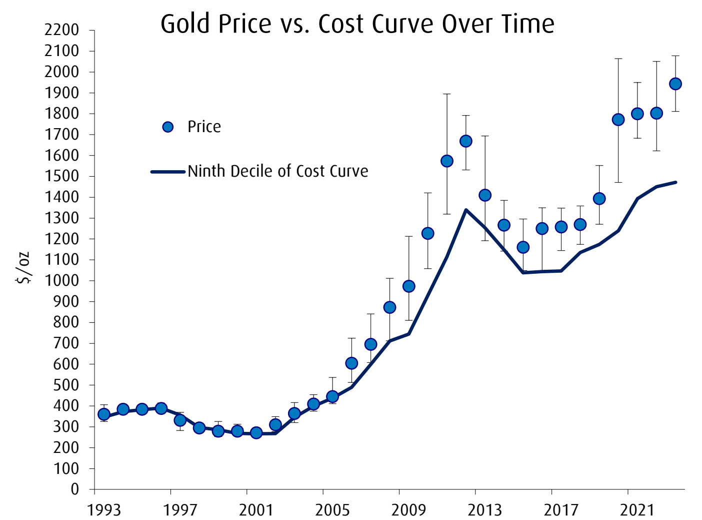
Perhaps the most important element of this is that the incremental gold buyer has moved from a price-sensitive consumer, to an AUM-sensitive asset allocator, to a mandate-driven central bank. This shift has, in our view, been a key reason in gold trading at a consistent premium to the cost curve over the past few years. Moreover, as Exhibit 8 highlights, this gap has been wider in the 2020s than seen in the previous decade.

Exhibit 7: Investors and consumers have traditionally offset each other in the gold market



Source: Metals Focus, BMO Capital Markets

Exhibit 8: Unlike other commodities, gold has continued to trade at a premium to the cost curve owing to price-insensitive buyers

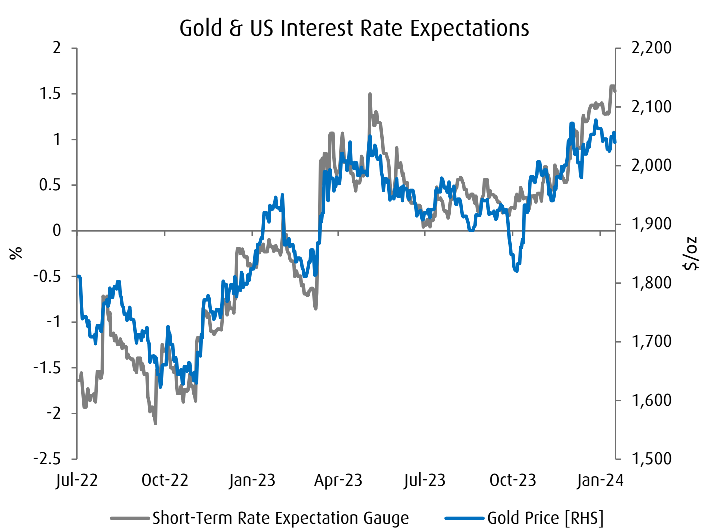


Source: LBMA, Wood Mackenzie, BMO Capital Markets

However, given central banks are relatively slow-moving beasts, we would argue that while their demand might underpin gold prices, they don't necessarily drive them in the short term. We want to highlight a couple of other factors that seem to be increasingly influential on gold price formation.

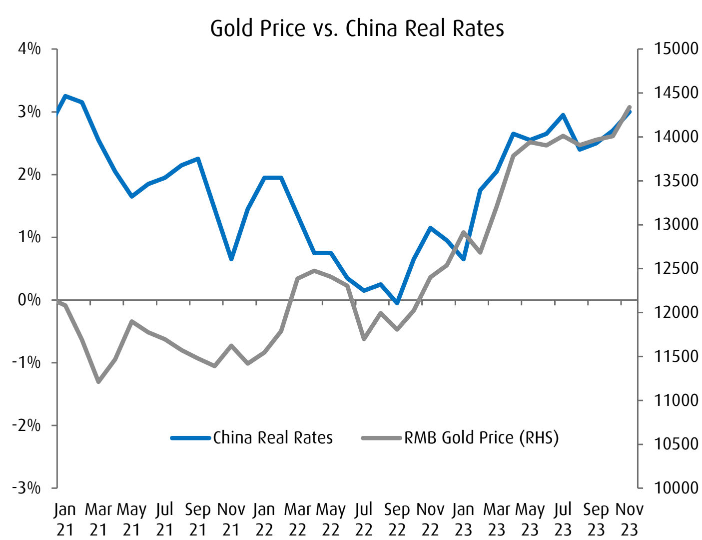
Firstly, while the correlation with real rates has broken down, that doesn't mean macro asset allocators don't use interest rates at all in positioning gold in portfolios. Rather, you could argue they are more forward looking now. As Exhibit 9 shows, the gold price now trends with interest rate expectations, as defined by the 12-month forward 30-day Fed Funds futures contract versus current levels.

Exhibit 9: Gold has now started to trade in line with U.S. interest rate expectations



Source: LBMA, Bloomberg, BMO Capital Markets

Exhibit 10: The positive correlation to real rates in China (vs. the negative one elsewhere) points to it being a disinflation hedge



Source: SGE, PBoC, BMO Capital Markets

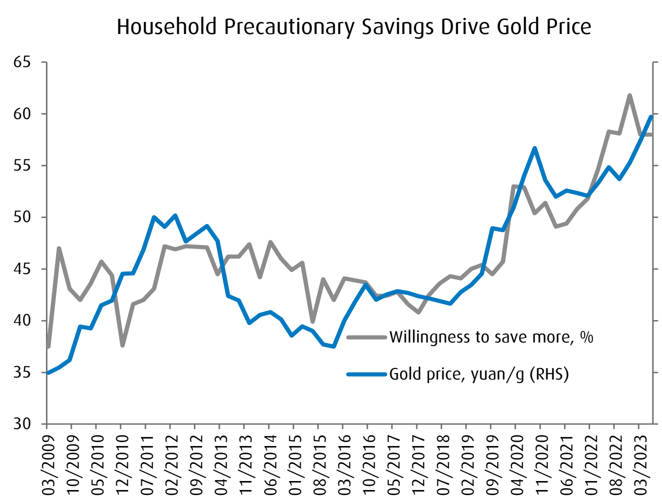
Secondly, and in our view more importantly, we see Chinese demand as an underappreciated driver of gold. China's influence on industrial metals is clear, but we now see this bleeding into precious markets – for different reasons. Just as seen in developed countries, China's households accumulated strong savings over the pandemic, and even over the past two years ~35trn RMB was added. However, these households have had somewhat of a dilemma as to where to put this money, something often termed the 'ugliness contest' for Chinese investors.

Real rates are relatively low at the banks even with low inflation, and concerns over the financial system are high. Money being held at banks is being put into longer maturity products, while faith in the financial system has been falling. The bond market remains nascent and illiquid, while the A-Share equity market performance has been both poor and volatile, particularly as foreign investors have withdrawn capital. Historically money might have been invested in property as a default position; however, as has been widely discussed, this sector continues to face major structural issues which are impacting buyer confidence, while wealth management products have yielded sub-par returns. China's households are thus not confident in the economy and, given the lack of social security safety net (and demographics), are looking to save more and invest less. As evidence of this, new loans into Chinese households dropped to a multi-year low last year (while those to businesses hit a new record high).

As shown in Exhibit 11, surveys have shown that the proportion of Chinese households looking to save more (as opposed to invest more) has shown strong correlation to the RMB gold price. Gold exposure has become a necessity for Chinese portfolios, as they continue to expect disinflation and income uncertainty. This gold demand is occurring via direct purchases and wealth management products into ETFs – while global ETF holdings fell, those in Chinese ETFs rose by ~12t last year. Moreover, the consistent premium seen for gold in Shanghai over the LBMA price shows a market with relatively strong physical demand. Interestingly, in its China 2023 gold market report released this week, the World Gold Council noted that Baidu Media Information Index for gold picked up strongly last year, as it received more extensive local media coverage. Gold prices typically move out a range when both macro and micro investors are doing the same thing at the same time (rather than the usual offset). We would say the combination of Chinese households and central bank concurrent buying has been a crucial factor in pushing gold more consistently above $2,000/oz at the current time.

One interesting thing to note is that while we are used to gold having a negative correlation to real rates in the U.S., in China gold has a positive correlation to real rates in recent times. This suggests gold is typically used as a disinflation hedge in China (as opposed to an inflation hedge elsewhere), owing to a worry over the negative wealth effect on assets rather than on cash holdings.

Exhibit 11: When Chinese households are looking to save rather than invest, the gold price benefits



Source: PRC Macro, BMO Capital Markets

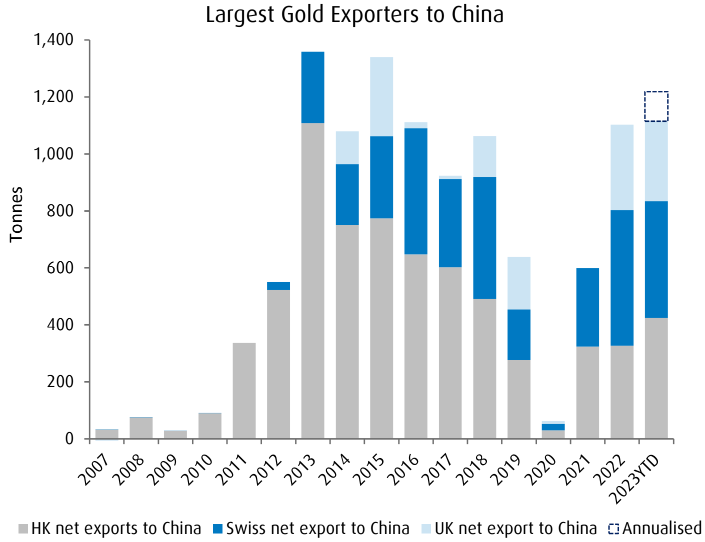
Exhibit 12: The past two years have seen a consistent premium for gold in the China market versus international prices

Source: SGE, LBMA, BMO Capital Markets

Given this scenario, perhaps the largest downside risk to gold price this year would come from a risk-on environment in China, such as from an equity market rally. However, with bank wealth management products still seeing large redemptions and concerns persisting over defaults at property developers and shadow banks, plus falling earning expectations at many industrial producers, it is hard to see this as a base case. The one thing we will be watching for is any sign of explicit Chinese government support for the domestic equity market, particularly given a 2024 policy objective is to "activate capital markets". PRC Macro expects the PBoC to launch an equity stabilization fund, and to promote buybacks and dividends to attract investors back to the A-Share markets, where many Chinese SOEs are listed. We potentially expect some impact from this towards mid-year, and hence do factor a gold drop back below $2,000/oz, though given high levels of risk we anticipate any shift out of gold will be steady rather than dramatic.

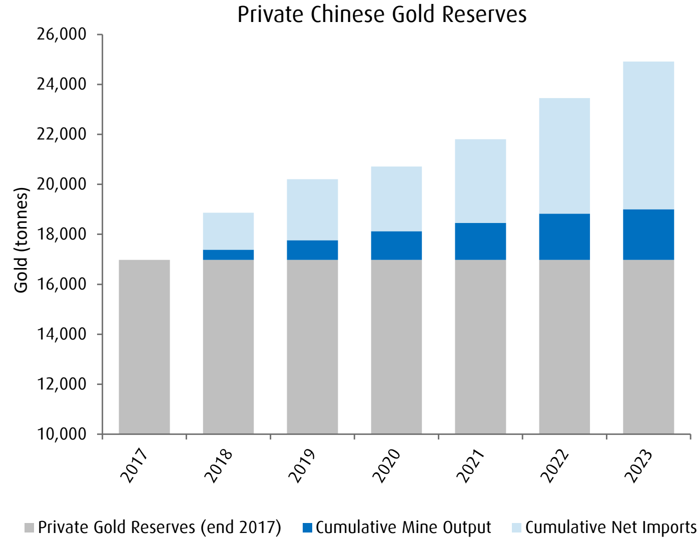
Moreover, we expect both central bank and household gold investment in China to be a multi-year thematic, with official figures likely understating actual accumulation of gold in recent years given strong cumulative net imports. We discussed this in more detail in our August 2023 report China's Gold Buying Binge Just Beginning.

Exhibit 13: Exports of gold to China from key vault hubs hit an eight-year high last year



Source: Customs data, BMO Capital Markets

Exhibit 14: Our modelling suggests consistent growth in Chinese private gold reserves in recent years



Source: BullionStar, Customs Data, SGE, CGA, BMO Capital Markets

Given high gold prices, there will naturally be some offset from consumers in terms of reduced demand; however, we now expect a prolonged period of prices trading at an extremely profitable level for most incumbent producers, providing costs can be kept in check. In the precious metals sector, stock selection is particularly important for relative equity performance. The BMO Precious Metals equity team provides recommendations across a large number of global gold equities, covering seniors, mid-caps, juniors, and developers. For full details of metrics for the companies under BMO coverage, please see the latest BMO Gold Pages publication.

Exhibit 15: BMO Gold S-D Balance

		2019	2020	2021	2022	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Supply													
Mine supply	t	3,596	3,482	3,589	3,638	3,644	3,908	3,991	4,026	4,027	4,027	4,025	3,717
Year-on-year chg	%	-2%	-3%	3%	1%	0%	7%	2%	1%	0%	0%	0%	-8%
Net producer hedging	t	6	-39	-7	-11	25	15	15	0	0	0	0	0
Recycled gold	t	1,276	1,293	1,136	1,141	1,193	1,180	1,180	1,180	1,180	1,180	1,180	1,180
Total supply	t	4,878	4,736	4,719	4,768	4,862	5,103	5,186	5,206	5,207	5,207	5,205	4,897
Year-on-year chg	%	2%	-3%	0%	1%	2%	5%	2%	0%	0%	0%	0%	-6%
Demand													
Jewellery	t	2,152	1,324	2,230	2,192	2,152	2,291	2,348	2,402	2,436	2,471	2,506	2,541
Technology	t	326	303	330	309	295	308	316	322	327	333	339	345
Electronics	t	262	249	272	252	239	250	258	263	268	273	279	284
Other Industrial	t	50	42	47	47	45	47	49	49	50	50	51	51
Dentistry	t	14	12	11	10	11	10	10	10	10	10	10	10
Investment	t	1,271	1,798	1,004	1,127	950	980	1,247	1,224	1,276	1,287	1,299	1,311
Bar and coin	t	871	905	1,193	1,237	1,194	1,203	1,193	1,199	1,210	1,222	1,233	1,245
ETFs & similar products	t	400	892	-189	-110	-245	-223	54	25	66	66	66	66
Central banks & other inst.	t	605	255	450	1,136	900	425	402	378	378	377	378	376
Gold demand	t	4,355	3,679	4,015	4,764	4,297	4,004	4,314	4,325	4,418	4,468	4,522	4,574
Year-on-year chg	%	-2%	-16%	9%	19%	-10%	-7%	8%	0%	2%	1%	1%	1%
Investment/Implied Investment	t	523	1,057	704	4	565	1,100	872	882	790	739	683	323
Total balanced demand	t	4,878	4,736	4,719	4,768	4,862	5,103	5,186	5,206	5,207	5,207	5,205	4,897

Source: WGC, Metals Focus, BMO Capital Markets

Exhibit 16: Gold SWOT Analysis

Strengths	Weaknesses
Marginal buyer is not price sensitive Very good market liquidity Highly trusted by retail investors	Supply side of industry is highly fragmented Demand side driven by macroeconomics and out of industry's control Gold is not 'consumed', viewed as having little utility
Opportunities	**Threats**
Financial market continually developing new options for gold exposure USD debasement amid loose monetary policy would boost gold	Alternate commodities now being considered for portfolio diversification High prices may attract more artisanal supply and industry scrutiny

Source: BMO Capital Markets

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Buy	Outperform	48.4 %	15.0 %	42.9 %	54.2 %	56.7 %	57.7%
Hold	Market Perform	49.0 %	17.9 %	52.0 %	44.2 %	41.0 %	37.5%
Sell	Underperform	2.4 %	27.3 %	3.9 %	1.4 %	1.4 %	4.8%

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.

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The recommendation contained in this report was produced at January 18, 2024, 19:39 ET. and disseminated at January 18, 2024, 19:39 ET.

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