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PRECIOUS METALS: GOLD AND SILVER

BEWARE OF WEAK INVESTMENT DEMAND

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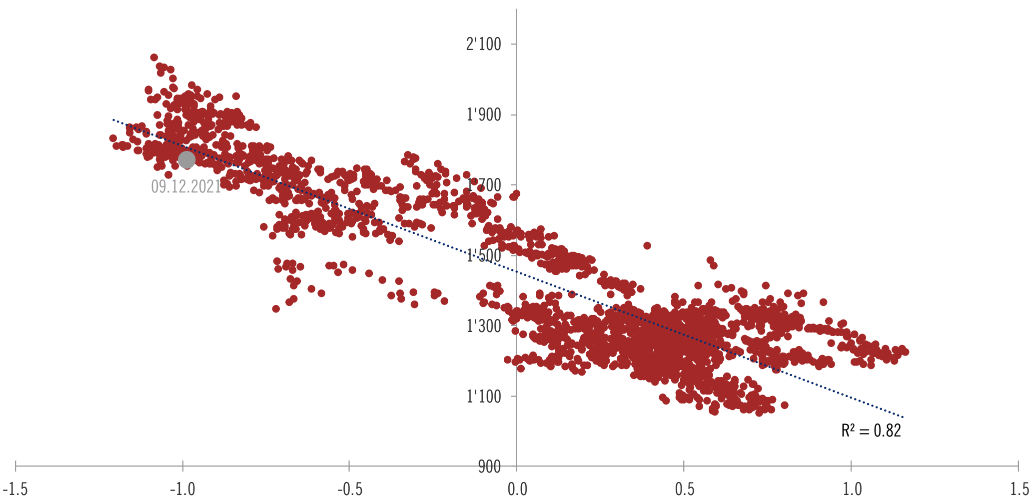
SUMMARY

- An environment of rising rates (both long- and short-term) is likely to weigh on investment demand for gold and silver by raising the opportunity cost of holding these non-yielding assets in the next few quarters.
- In the longer term, however, our belief that the Fed is stuck in a debt-dominance monetary regime suggests that interest rates should remain low, limiting the downside risks for gold and silver while in the short term, higher jewellery demand is likely to provide some support to both precious metals.
- The structural shift toward green energy should lead to a structural increase in industrial demand for silver, although the timing and the magnitude of this increase are hard to quantify.
- Our three-month projection for gold stands at USD1,770, our six-month projection at USD1,680 and our 12-month projection at USD1,800 per troy ounce. Our projections for silver are, respectively, USD24.0, USD24.0 and USD26.0.

CHART 1: GOLD VS. US 10-YEAR REAL RATE



Source: PWM - AA&MR, Bloomberg, 9 December 2021

Rising rates to weigh on gold

We have long argued that investment demand is the main driver behind big moves in the gold price and that the US 10-year real rate is the key indicator of this type of demand.

US real rates are defined as US nominal rates less market-based inflation expectations (we use the breakeven inflation rate for expectations). The resilient global growth outlook and upcoming Fed tightening could put some upward pressure on the nominal rate and weigh on inflation expectations. Overall, our central scenario (see '[Room for yields to rise again](#)') is for a moderate rise in US real rates in 2022, which provides a less-than-ideal environment for the gold price.

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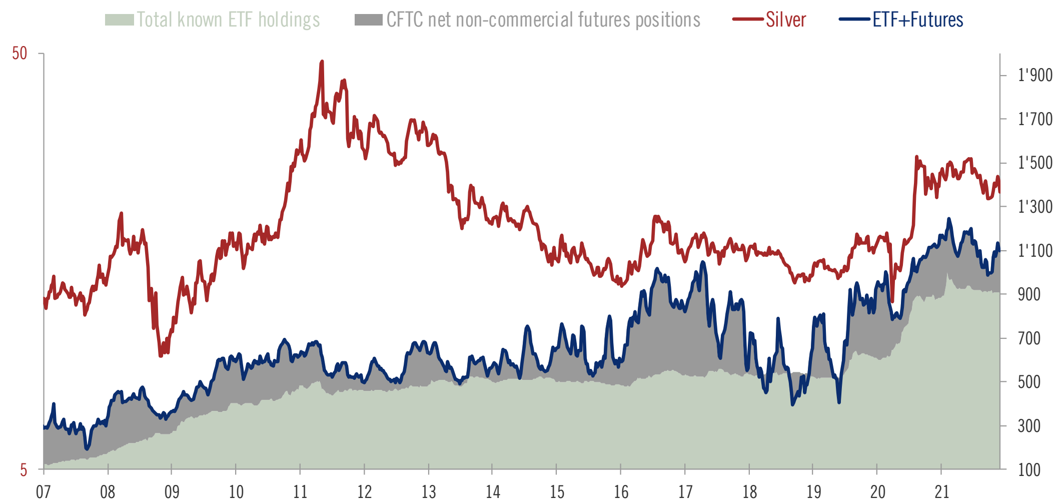
Already, gold does not show any significant premium or discount compared to US 10-year real rates. Based on the long-term relationship (since 2012), gold seems more or less fairly valued based on the current rates (*see chart 1*). Using this relationship, the 'fair value' for gold would be about USD1,600 per troy ounce when the 10-year real rate is -0.4%. A real US 10-year rate of -1.0% on 9 December and gold at USD1,775 explain our relatively cautious outlook for gold over the coming months.

That said, we also see some factors that could support the gold price. First, jewellery demand remains well below its pre-pandemic levels. Jewellery demand is particularly sensitive to the affordability of gold in India and China (the two countries account for slightly more than 50% of global jewellery demand). A decline in the gold price could stimulate jewellery demand, with scope for a significant rebound in Indian demand in particular. Second, bold fiscal and monetary policies in the US since the pandemic remain a long-term support for gold. In particular, we believe that the Fed is stuck in a debt-dominance monetary policy regime (see 'This ain't your 1980s tightening'), which means that rates could remain low for a long time to avoid a debt-driven recession. Third, the US business cycle is likely past its peak, and while a recession is not imminent, we could see renewed interest in gold as a safe-haven asset as we come closer to the end of the business cycle.

Our three-month projection for gold stands at USD1,770, our six-month projection at USD1,680 and our 12-month projection at USD1,800 per troy ounce.

CHART 2: SILVER VS. ETF AND FUTURES DEMAND



Source: PWM - AA&MR, Bloomberg, 9 December 2021

Silver awaits higher industrial demand

Investment demand for silver is sensitive to the same factors as gold, so rising rates are likely to take a toll on investment demand for the metal in the coming months. Historically, silver prices perform well when ETFs are buying (*see chart 2*), but higher US rates may weigh on this source of demand. By contrast, as in the case of gold, we could see an improvement in jewellery demand on the back of the global economic recovery. Otherwise, a key question for silver is the prospect for industrial demand. While we expect this to increase in the next few years, backed by the structural shift towards green energy (solar panels and electric batteries), it remains to be seen whether industrial demand will be enough to offset probably weak investment demand in the coming months. However, this is a support factor for silver that gold does not have. In recent years, photovoltaic and electrical demand has averaged around 320 million ounce (Moz) per annum, while average physical demand has been around 1,000Moz. Silver also looks cheap relative to gold based on historical trends in the gold-silver ratio and the recent performance of industrial metals in general.

So, while silver should perform better than gold in the next months, assuming further abatement in global supply-chain disruption, this may not translate into significant absolute price performance if our scenario of weak investment demand proves correct. Our three-month and six-month projections alike for silver stand at USD24.0 and our 12-month projection at USD26.0 per troy ounce.

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