Gold Watch

Georgette Boele, Senior Precious Metals Strategist
georgette.boele@nl.abnamro.com

Impact of the Ukraine war on gold prices

- **Gold prices have rallied by 10% since the end of January**
- **The rally reflects inflation fears, the war and concerns about currency debasement**
- **However, gold's behaviour as safe haven is erratic**
- **Inflation fears could continue to support gold prices, but market panic could send prices lower**
- **We expect volatile gold prices**
- **Our new forecasts for end 2022 and 2023 are USD 2,000 per ounce**

Introduction

Gold prices had a weak start to the year as rate hike expectations increased (in the US and other countries), US real yields rose (less negative), and the US dollar performed well. However, when the tensions between Russia and Ukraine became to the fore, these earlier mentioned drivers slowly but surely lost their influence on gold prices. Gold prices started to bounce higher. Since the end of January, gold prices have rallied by 10%. When Russia invaded Ukraine, higher oil, gas, wheat and other commodity prices triggered a considerable rise in inflation expectations. These expectations have outpaced the rise in nominal yields resulting in lower real yields in the major economies. This has supported gold prices.

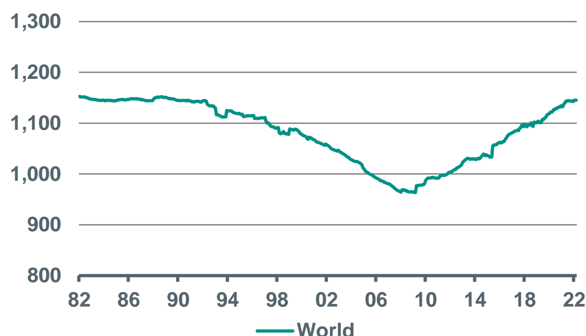
But there is more. Gold has started to behave like a safe haven asset again. It now has a positive relationship with US equity market volatility and the US dollar. We have held the view that gold's safe haven appeal is erratic and not stable and that there are periods that it behaves like a safe haven and other periods like a risk asset (more on this below). As is the case with a number of other commodities, gold's fortunes have changed for the better as result of the war in Ukraine. In this report we will look at the demand and supply side dynamics. We will also present our new gold price outlook.

Have demand side dynamics dominated the direction in the gold market?

Gold is like no other commodity. It has unique supply and demand features that make gold unique in commodity markets. It is used to store value, used for transactions, but also as speculation. It has all these different features and therefore different types of investors are interested in gold. The first type of investors use gold to store value or as wealth preservation. Central banks buy gold to diversify their reserves. Central banks' gold reserves have increased, and they are at the level of the 90s (see the graph on the left below). Also, the People's Bank of China and the Russian central bank (see graph on the right below) bought gold. But in recent years they stopped doing so.

World gold reserves

In million ounces



Source: Bloomberg, ABN AMRO Group Economics

Russia's gold reserves

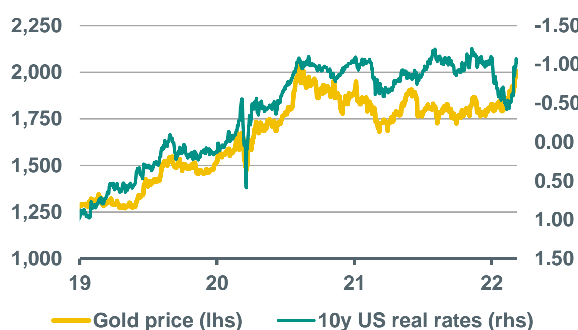
In million ounces

Source: Bloomberg, ABN AMRO Group Economics

Not only central banks have bought gold to store value and as wealth preservation, investors have also done so. They have the tendency to buy gold if they fear inflation, if there are geopolitical fears or increased tensions or even a war. If they fear inflation, they think that central banks will not tighten monetary policy fast enough to counter inflation. Then inflation expectations will rise at a faster pace than nominal yields. As a result, real yields will decline. Gold is an asset that doesn't pay a coupon or dividend, but it is not declining when inflation expectations rise (see graph on the left below). On 8 February real yields in the major economies peaked. Since then, real yields in the major economies have dropped substantially (becoming more negative) mainly because of a substantial rise in inflation expectations. Higher energy and wheat and other commodity prices have only accelerated the move. If investors fear a war or severe stress, they also prefer gold. These investors often buy physical gold like coins or bars, or futures that could deliver physical gold. There is increased interest in gold on the futures markets. Investors have increased their long positions in gold with the possibility of physical delivery (see graph on the right below). These positions are large but not excessive.

Gold prices rise due to higher inflation expectations

Gold prices 10y US real yields (inverse scale)



Source: Bloomberg, ABN AMRO Group Economics

Positions in the futures market of gold

Number of contracts

Source: Bloomberg, ABN AMRO Group Economics

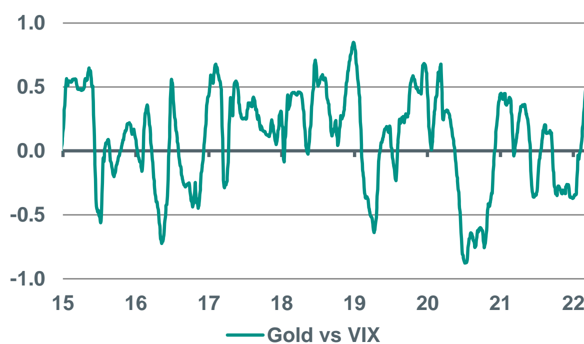
Next to being used as a way to store value, gold (and silver) could also be used in transactions to buy goods. In this sense, it has some features of a currency like the US dollar or the euro. If consumers and/or investors are expecting or are confronted with a debasement of their own currencies, they could buy gold in order to be able to buy goods – though it is worth noting that gold payments are not widely accepted. We have experienced this behaviour during the sharp depreciation of the Turkish lira, but debasement of the Russian ruble and sanctions on Russian assets could also have triggered demand for gold as transaction unit.

Finally, investors could use gold to speculate. Since 2004 this has become increasingly popular. The sharp rise in outstanding ETF positions has also resulted in a rise in gold prices and vise versa. So gold prices have become more volatile as it opened to a large group of investors. Products such as ETFs, metal-account gold make it easier to profit from movements in the gold price without holding the physical gold on your own name. Some of the funds have bought the physical gold but this will generally not be on a name of a certain investor that bought an ETF. In short, this is not the way of investing to own physical gold on your name in the end. Investors that want to profit from volatility in the gold price driven by dynamics in the dollar, expectations about central banks and other financial factors are often attracted to this way of investing. As mentioned before, gold doesn't pay a coupon or dividend. When investors expect central banks to ease and yields to decline, gold as an investment asset is attractive. If is in this environment equity markets rise and equity market volatility declines, gold tends to move in the opposite direction as equity market volatility. As a result, it behaves as a risk-on asset. When investors expect central banks to tighten policy and rates rise, gold as an investment asset is not attractive. So, when yields rise, often gold prices decline and vice versa. Next to that higher US dollar is generally not gold for gold prices.

As positions in these products have grown very large, the behaviour of these investors has more and more dominated the direction in gold prices. As a result, the effect of the gold buying driven by the storage and the transaction arguments has been overshadowed by the speculation of investors. So over time gold has become less of a safe haven asset and more a risk-on asset and gold's safe haven appeal is erratic and not stable.

The erratic behaviour of gold prices

90-day rolling correlation

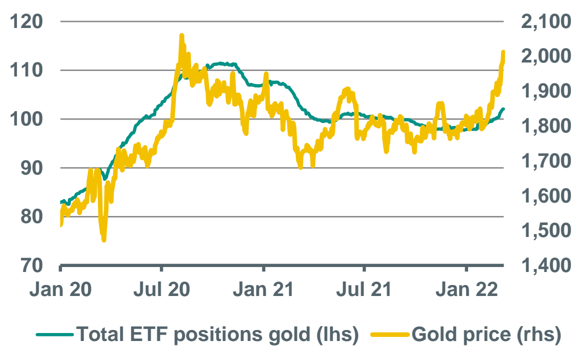


Source: Bloomberg, ABN AMRO Group Economics

The rally in gold prices is larger than the rise in ETFs

Million troy ounces

Gold price in USD



Source: Bloomberg, ABN AMRO Group Economics

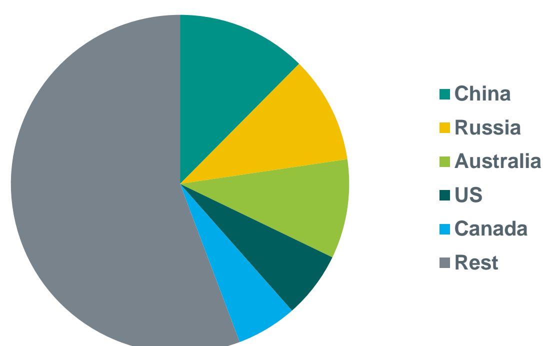
What driver has resulted in the substantial rise in gold prices? Since 8 February the relationship between gold prices and the VIX has turned positive (higher equity market volatility, higher gold prices) and the relationship between gold and real yields have remained negative (lower real yields higher gold prices). Next to that the positions in ETF have increased but not enough to justify the large rise in gold prices. This points into the direction that investors have bought gold as a store of value and probably also as transaction unit. They fear inflation and the war and the currency debasement and favour physical gold.

What about supply?

On 7 March, the London Bullion Market Association (LBMA) suspended all six Russian gold refineries from its Good Delivery List, meaning their newly minted bars (cut from a rolled strip of gold) can no longer trade in the London market. London is the biggest marketplace for gold in world by volume of trade. Could this result in shortage in the gold market? In our opinion not. First, the supply side of the gold is very fragmentated. A lot of countries mine and export gold and there is no monopolistic or oligopolistic market structure. China is the largest gold miner with 12% of the world supply, next comes Russia with 10% (see graph on the left below). So, this is a completely different picture than for palladium where both Russia and South Africa are responsible for around 40% of supply; they hold together 80%. Second, the aboveground stocks in gold in the form of jewellery are enormous (see graph on the right below). At the end of 2021 total above ground stocks stood at 203,000 tonnes while

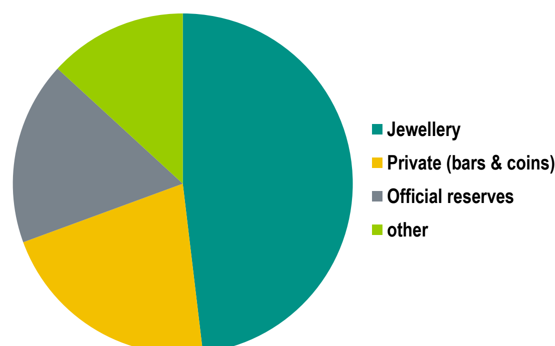
annual mine supply is around 3,300 tonnes. Therefore, it is very unlikely that the gold market will experience a shortage. Of course, the price needs to be attractive enough for the holders of gold jewellery to sell. So, the price could still rise. Even though we think ta global shortage is unlikely, there could be a temporary shortage in a certain location/country.

Gold supply is very fragmented



Source: Refinitiv, ABN AMRO Group Economics

Gold's above-ground stocks are enormous



Source: Bloomberg, Refinitiv, ABN AMRO Group Economics

Our gold price outlook

We have recently changed our view on macro-economy (see Russia-Ukraine: Sanctions trigger a lasting trade re-alignment). We now expect that supply disruptions due to sanctions or self-sanctioning will cover oil and some other non-energy commodities, and will last for around a year, as non-Russian sources of supply are secured. We expect that consumer price inflation more broadly will spike further, weighing on confidence and consumption. We think that growth will be weaker, inflation will be higher and central banks will react differently to these new challenges. While a delay to ECB tightening and potentially a continuation of asset purchases is looking more likely, we do not foresee a significant easing in policy of the kind we witnessed during the pandemic. For the Fed, given that the US economy will be facing higher inflation but less of a growth hit (as it is much less dependent on Russian commodity imports), the calculus shifts even more in favour of rate hikes. As a result of this new outlook, we expect that real yields to remain under pressure. In addition, we expect a risk off environment in markets and a higher US dollar due to safe haven demand.

What is the impact on gold prices? We expect that gold prices are supported in the current environment but that there also will be a lot of price volatility. Reasons behind this view are as follow. Higher inflation expectations and lower real yields are positive for gold as mentioned above. So, investors will continue to buy gold as an inflation hedge. But as the Fed will continue to hike and we also expect a higher dollar, gold's fortunes will mainly be positive versus other currencies than the dollar. They will likely prefer physical gold to non-physical gold. But severe risk off and even market panic is usually not a positive environment for gold prices (remember the aggressive sell-off during the covid panic in March 2020). When there is market panic, investors liquidate most positions and buy the most liquid assets such as US Treasuries, the US dollar and the Japanese yen. They will likely also sell speculative gold positions such as ETFs and other instruments and these positions are extremely large. Meanwhile some investors will continue to buy physical gold or gold positions with physical delivery for storage and transaction argument. It is likely that the impact of the position liquidation of the speculative gold positions is larger than the physical buying of the other investors. Despite lower gold prices, the premium between physical gold and non-physical gold is expected to increase. Finally, we think that a shortage in the gold market is very unlikely, so runaway prices like seen in other commodities is unlikely in the gold market in our view.

Taken all together we expect price volatility in the gold market and our new gold price forecasts for the end of 2022 and the end of 2023 stands at USD 2,000 per ounce.

DISCLAIMER

This document has been prepared by ABN AMRO. It is solely intended to provide financial and general information on economics. The information in this document is strictly proprietary and is being supplied to you solely for your information. It may not (in whole or in part) be reproduced, distributed or passed to a third party or used for any other purposes than stated above. This document is informative in nature and does not constitute an offer of securities to the public, nor a solicitation to make such an offer.

No reliance may be placed for any purposes whatsoever on the information, opinions, forecasts and assumptions contained in the document or on its completeness, accuracy or fairness. No representation or warranty, express or implied, is given by or on behalf of ABN AMRO, or any of its directors, officers, agents, affiliates, group companies, or employees as to the accuracy or completeness of the information contained in this document and no liability is accepted for any loss, arising, directly or indirectly, from any use of such information. The views and opinions expressed herein may be subject to change at any given time and ABN AMRO is under no obligation to update the information contained in this document after the date thereof.

Before investing in any product of ABN AMRO Bank N.V., you should obtain information on various financial and other risks and any possible restrictions that you and your investments activities may encounter under applicable laws and regulations. If, after reading this document, you consider investing in a product, you are advised to discuss such an investment with your relationship manager or personal advisor and check whether the relevant product –considering the risks involved- is appropriate within your investment activities. The value of your investments may fluctuate. Past performance is no guarantee for future returns. ABN AMRO reserves the right to make amendments to this material.

© Copyright 2022 ABN AMRO Bank N.V. and affiliated companies ("ABN AMRO)