14 February 2017

Trump's policies: A positive factor for gold in 2017

Chaotic first weeks in the White House. Inflation reaches 2.5% in the US. Increased investment demand. Market thrown off balance. Rise in gold prices.

Key points

- Donald Trump's policies strengthen bullish prospects for gold in 2017
- Most key factors now favourable to rise in gold
- Significant increase in systemic, political and geopolitical risks
- Deflation is forgotten, inflation returns in the US and exceeds the Fed's target
- Interest rates will not penalise gold
- Global liquidity still growing
- Rise of the dollar slackening
- Increased volatility favourable to gold prices
- Strong increase in investment demand
- Surge in demand for jewellery
- Global supply, market thrown off balance
- Speculative positions are low once again

Donald Trump's policies strengthens bullish prospects for gold in 2017

Last year will have been a turning point for gold, while this year should witness a clear revival of bullish trends. This turnaround was particularly evident in the first half of the year, thanks to the steepest rise recorded since 1986 in Q1 (+16.4%) and a further sharp increase in gold prices in Q2 (+7.2%). After such progress, gold prices finally fell in November and December following the appreciation of the dollar and the implementation of the normalisation process with regard to the Federal Reserve's key rates.

The fundamentals of the gold market had already improved in 2016, but they are likely to strengthen and further support an increase in gold in 2017.

The key factors in the gold market already seemed favourable before a crucial new element began to emerge in the last few weeks, thereby strengthening the probability of an increase in gold in 2017.

Indeed, although a few months ago we deemed that the systemic, political and geopolitical risks would probably not turn out to be factors that could significantly impact gold prices in 2017, we reckon Donald Trump's election and his first weeks in office may now actually constitute new factors of uncertainty and increased risks. For the time being, financial markets are still concentrating on the expected positive effects of a future tax policy that will clearly be favourable to US companies to drive up stock prices. Since 8 November, US stocks (+10%) have gone up in line with expectations, while gold prices (-3%) have slightly weakened in this rather optimistic stock market climate.

Donald Trump's policies will gradually develop into a key factor supporting the demand for gold for investment, hedging and risk diversification purposes.

Gold and silver prices (2000-2016)

Sources: Bloomberg, BBGI Group SA

Most key factors are now positive for gold prices

Among the main key factors, let us note the favourable influence of a probable rise in inflation; persistently low interest rates as well as negative real interest rates; a tight supply and demand market; as well as the persistent growth of investment demand. **However, the key element in these last few weeks is without a doubt the emergence of new geopolitical and political risks as well as new uncertainties triggered by Donald Trump's chaotic start in office.**

Significant increase in systemic, political and geopolitical risks

This risk factor, which had supported the rise in gold prices until 2012, then became a negative element. The reduced risk of the euro zone breaking up had indeed changed investors' tolerance to risk and reduced their need for insurance policies, as which gold positions had until then clearly functioned. This factor had then lost significance again before the British vote supported the demand for gold due to the possible consequences of a Brexit for the UK, Europe and the global economy. This risk remains present, as does the risk of the 2017 European elections, but we reckon it has now been overshadowed by Trump's election.

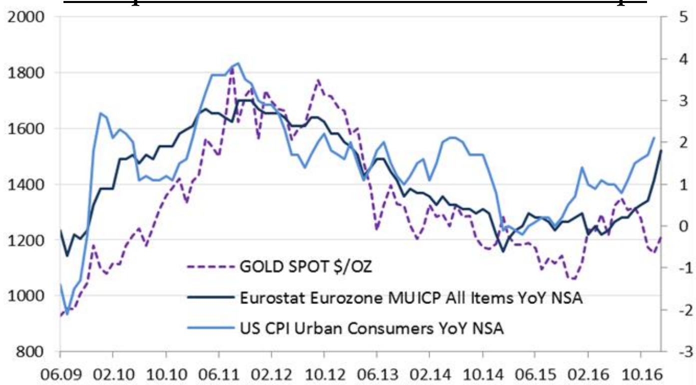
Investors who hoped his attitude would change when he took office now have to face the facts: For the moment, the new president's style of governance follows the candidate's approach. On an international level, these first weeks in office have not reassured observers, to say the least. After the initial shock, there seems to be a widely shared concern among the public and many governments, including those that have traditionally been key partners throughout history. We may still hope that the American political and legal system can play an effective role as a counter-power to ensure that Trump's governance remains consistent with what we might expect from the leading democracy and global economic power. We may actually have seen this counter-power in action in the case of the 'Muslim ban', which prohibits citizens from seven predominantly Muslim countries from entering the US and which was blocked by American judges, as well as in the case of National Security Advisor Michael Flynn, who was forced to resign because of his discussions and ties with Moscow. However, this humiliation will probably have no effect on the president's style of governance, who still seems to favour provocation and confrontation. It is thus a safe bet to say that American diplomats will have to be creative and subtle in the following months to maintain a peaceful dialogue with the US' partners.

In this context, the risks of political blunders appear very much underestimated, and their implications for the financial markets and the gold market in particular should gradually be taken into account. This factor clearly appears to as a new and significant risk factor for 2017, which to our minds will positively affect demand for physical gold as safe-haven.

Deflation is forgotten, as inflation returns in the US and exceeds the Fed's target

This factor has become positive again since 2015, as inflation went from 0% to over 1% in December in the US. It now stands at +2.5% yoy. The recovery in the price indices has put an end to the deflationary trends that appeared in 2011 (fall from 3.9% to 1% in the US and 3% to 0% in Europe), which had gone hand in hand with the correction phase of gold prices.

Gold prices and inflation in the US and Europe



Sources: Bloomberg, BBGI Group SA

Gold retains its protective particularity against that risk. The correlation, which has been observed since 2008, is strong. The recent movements of price indices suggest a continuation of bullish trends for 2017 as much for inflation as for gold. The probable upswing in economic growth and the rebound in oil prices will help sustain the inflationary effects induced by future tightness in the US job market. Gold has always outperformed inflation in the long term, even more so in extreme periods. **Although we don't necessarily expect a sharp rise in inflation, we believe that 2017 will be marked by a recovery in price indices. The 'inflation' factor will contribute to an upward trend in positive expectations for gold.**

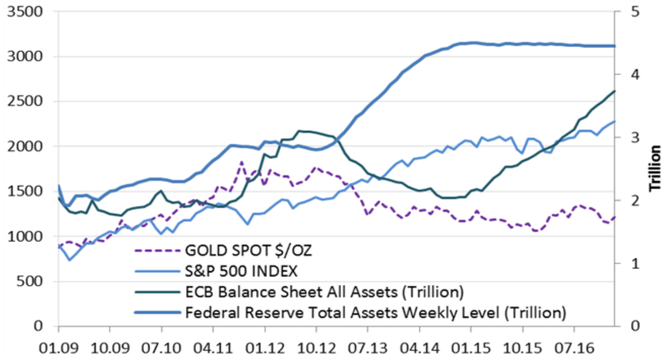
Interest rates will not penalise gold

The 'interest rates' factor has recently been linked with the opportunity cost of physical gold holdings, although to our minds this argument remains marginal in times of recovery of inflation especially. Moreover, real rates have become negative due to a rise in inflation often superior to recoveries in long-term rates. However, gold prices have reacted negatively in the short term to the rise in nominal rates. Yet, price indices in January suggest that real rates may well remain low as much in the US as in Europe and Switzerland. Even if ultra-accommodating monetary policies have not reached their goal of boosting inflation to 2% – with the notable exception of the US – inflationary expectations are progressing and the increase in commodity prices paves the way for economic recovery.

Global liquidity still growing

The 'liquidity' factor is a significant underlying factor in the evolution of gold prices, in particular through the inflationary effects induced by the massive growth in the money supply.

Money creation (USA-Europe), SPX and gold



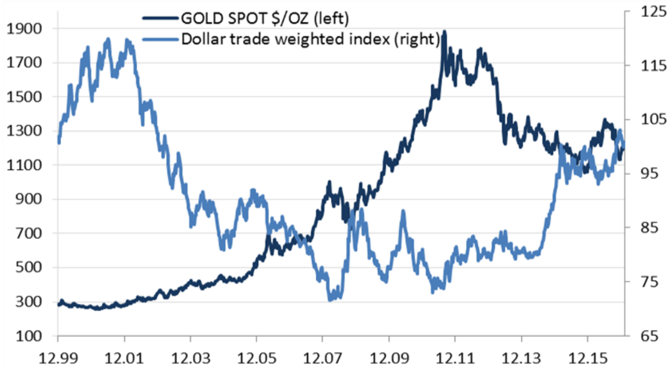
Sources: Bloomberg, BBGI Group SA

Although in the US the three-fold increase in the Fed's balance sheet has indeed been accompanied by a rise in gold prices (+127%) between 2008 and 2011, the second wave of quantitative easing between 2013 and 2014 (+55%) actually coincided with a -35% price adjustment. Some might think that this factor lost some of its significance during that period, but it should be noted that at the same time, the ECB's balance sheet contracted by one trillion euros. Ultimately, the intersection of these two trends had a rather negative net effect. Since 2016, the Fed has stabilised its balance sheet, while the ECB and BOJ's have expanded significantly. In 2017, central banks will likely continue to increase the money supply while supporting an increase in liquidity.

Rise of the dollar slackening

The 'dollar' factor is often mentioned as a key factor, yet even if the negative correlation with the dollar has been proven over a very long period, it is unstable and varies between -0.1 and -0.6. Between June 2010 and June 2011, the price movements of gold have contrasted with the dollar, yet between 2014 and 2015, the +20% rise of the dollar occurred although gold prices had stabilised between $1,200 and $1,250 an ounce. More recently in 2016, the increase in gold prices occurred despite the US currency remaining relatively stable. Still, the dollar's rise in Q4 did weigh on gold prices.

Dollar trade weighted index/gold



Sources: Bloomberg, BBGI Group SA

We reckon the dollar's rise has already been quite significant since the summer of 2014. It is likely that a further appreciation of the dollar will be undesirable for the US economy – such is the US President's position anyhow, who considers it to be a threat to the sustainability of economic growth.

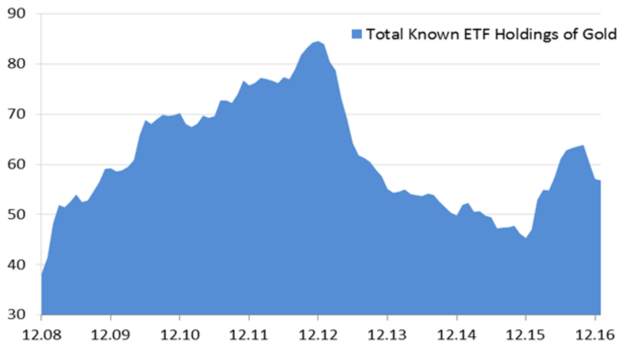
Increased volatility favourable to gold prices

The 'safe haven' factor had not been very positive for gold, due to the decline in volatility in the equity markets. The central banks' actions, the cyclical upturn and more recently the optimism triggered by tax reform expectations have played a part in reassuring investors and creating an improved investment climate for risk taking, favouring a reallocation of assets out of safe havens and into equities. **We will certainly see an increase in volatility in 2017 in the equity markets, which will once again be favourable for gold.**

Increase in investment demand

The massive return of investors after the first step in normalizing US monetary policy and almost 12 quarters of continuous disinvestment is certainly a significant phenomenon. The demand for ETFs has been exceptional in 2017, as apart from November and December inflows have been positive, representing a total of some 660 t. The normalisation of the exposure of private and institutional investors, who are currently almost completely absent from this asset, will have lasting and positive effects on gold prices.

Total ETF holdings of gold

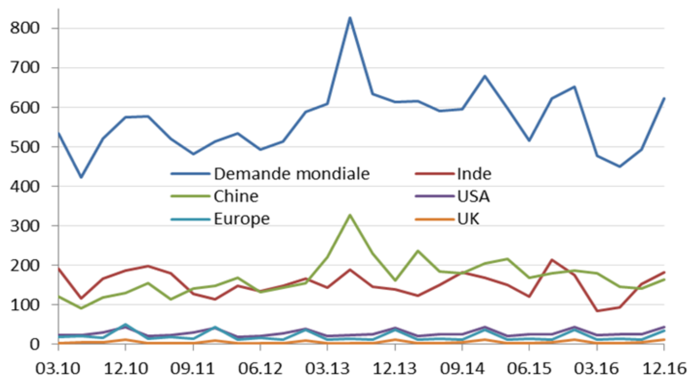


Sources: Bloomberg, BBGI Group SA

Surge in demand for jewellery

Because of increasing prices, demand for jewellery slowed down in 2016, contracting by about 15%, i.e. a decrease of about 347 t in global demand for jewellery. Indian and Chinese demand should recover in 2017 and have a significant positive impact on market equilibrium.

Demand for jewellery



Sources: Bloomberg, BBGI Group SA

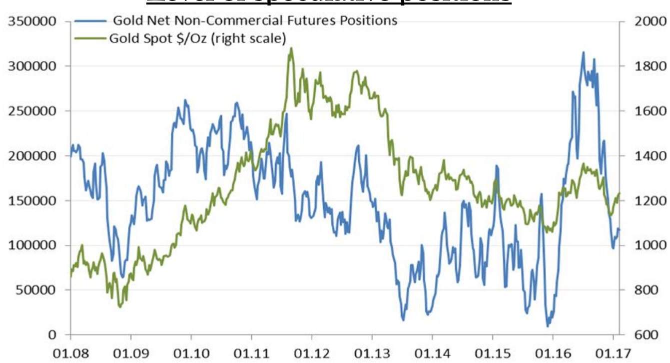
Global offer to remain stable

Global supply has grown slightly by +2% in 2016. It should remain relatively unchanged in 2017 due to the ailing recycling industry and the cautious activity of producers, always concerned by the rationalisation of their production processes, the quest to reduce costs and operations focused on the most profitable mines rather than more poorly performing assets. We do not expect an upturn in the capex cycle yet, which might support an increased supply. Global supply should therefore remain unchanged and inferior to demand.

Conclusion

In 2017, the gold market will be characterised by demand outstripping supply. The current low level of speculative positions suggests that this will have a particularly favourable impact on gold prices.

Level of speculative positions



Sources: Bloomberg, BBGI Group SA

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