The Markets

Why Gold Is Expected to Rise to Record Highs

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Chris Hussey: This is The Markets. I'm Chris Hussey, and today is Wednesday, September 2nd, and I'm joined from the Goldman Sachs trading floor in London by Tony Kim, who is our global head of metals trading within fixed income currencies and commodities. Tony, hey, thanks so much for joining us on The Markets.

Tony Kim: Thanks, Chris.

Chris Hussey: All right. I want to get to what's happened with gold this year, because we had a peak earlier in January. August was actually a pretty good month for gold, but we're still 20% off that peak. Have we seen the peak behind us now, or is there more to go in gold?

Tony Kim: Yeah, so that's a great question and something our clients have really been focusing on, I would say, over the last few weeks.

From our perspective, this isn't the end of the bull market, it's an elongated pause. And why elongated? I would say it's really two factors that we're looking at, and they kind of happen simultaneously, so it's hard to disaggregate what's causing what. But number one is the nomination of Warsh and the ultimate confirmation of him as the new Fed chair, and I think the market's trying to understand what his reaction function and policy tilt is going to be, especially within the context of the Trump administration and, and a lot of the headlines surrounding Trump's view of Fed policy.

And then the other aspect is really the conflict between the US and Iran. And what happened there was how does the energy market disruption, but not just energy, for agriculture, for metals, how does this ultimately impact not just inflation, and therefore the policy response in gold, but how has it impacted the reserve accumulation or lack of reserve accumulation, as a lot of these energy markets have been disrupted?

And so a lot of those reserves that would historically recycle some amount into precious metals markets has certainly been disturbed. So at the moment, I think we've seen a huge reduction of positioning across large amounts of our franchise. The one flow that does remain, which we can get into later, is the central bank accumulation.

But high level, we think it's a pause, and ultimately the bull trend will resume and new highs are going to be in the future.

Chris Hussey: All right. So there are a lot of factors, as you point out. You have inflation coming off the Strait of Hormuz, you have that geopolitical risk coming off the Strait of Hormuz.

You've also got higher rates for longer though. And for a metal that carries no coupon, gold, I would imagine there's competition there from those higher rates. How much of a role is that playing? Which role do you think is the most important going forward in terms of how gold's going to perform?

Tony Kim: So, I think the notion of debasement and there are a lot of words and, and phrases around this, de-dollarization. Really the way I would characterize this is there's been a cheapening of fiat currency versus gold that's been a trend that we've been in for now several years. And if fiscal sustainability becomes the real driver of whether people want to allocate into gold, and fiscal sustainability is a concern not just in the West, but in Japan, then you might actually start to see the correlations break down a little bit.

So in other words, higher backend bond yields because of concerns about the fiscal situation could lead to allocations going into gold. Now, look, locally we do think these rates and gold

correlations will hold, but the longer-term trajectory is certainly being called into question. And what I would point out is this has really been driven by a lot of policy changes, especially over the last month.

If you look at the intervention into currency markets, in particular with dollar yen, as well as the US Treasury repurchasing larger amounts of the long end of the curve and trying to potentially change the dynamics of the yield markets. I think any time you see official policy intervention, people tend to buy gold.

Chris Hussey: Yeah, that's such a great point. I mean, you can make an argument that we've already seen some of those correlations break down because we do have this higher for longer rates environment, and yet gold did pretty well in August even as that happened. So, are investors starting to talk about that, that the correlations are breaking down and the old playbook doesn't work anymore?

Tony Kim: You know, there are certainly some that believe that's the view, and then there are others that are trying to hedge their portfolio in case that does become the new prevailing, sentiment globally. And what I would say is over the last month, we've had a very active client franchise despite the fact that we've been in the summer post the July FOMC, then with these policy interventions, and then post Jackson Hole.

A lot of clients are looking at expressions to put on some sort of convexity plays, and tweaking them as the data roll in terms of how they want to position themselves. Look, the challenge always is going to be not only is it the reaction function, but the data itself. And so obviously we still have a few of those releases as we approach the September FOMC.

Chris Hussey: Yeah, no. And, and the data of course, inflation's a big part of that data. It's a component of real interest rates. If we go to the conventional correlations, you know, gold tends to trade with real rates. And when I'm talking about real rates, I'm talking about a risk-free rate less inflation expectations. Tony, how is that relationship holding up in this market?

Tony Kim: Look, in the short term, I think it certainly holds. The day-to-day trading has, um, been correlated, but I think that breakdown really occurred on a longer-term trend in 2022 when we had the Russia-Ukraine conflict and the confiscation of Russian Central Bank reserves. And what we've seen from that point on has been a sustained long-term accumulation of physical gold from mainly emerging market central banks.

But just to put rough numbers around this, we mine about 3,500 metric tons of gold a year. Prior to Russia-Ukraine, central banks used to purchase around 400 to 500 tons a year. They're now purchasing something closer to 1,000, 1,100 tons a year. What that means is the amount of gold remaining for all other purposes, jewelry, backing up the ETF, bars and physical investment, is much a smaller funnel.

And so you don't need as much investment capital to drive prices materially higher.

Chris Hussey: That's a great point. Let me drill down on that a little bit because, you know, Asia has always been a big source of that demand for both the jewelry side and the central bank side. How is that holding up, given everything that's happened with the energy crisis?

You pointed out that reserves are being redirected. Talk to us a little bit about what you're seeing in terms of demand out of Asia.

Tony Kim: Sure. Look, so I think end of last year coming into this year, we were seeing everything firing on all cylinders on demand. You had China retail demand, you had Indian physical demand, you had central bank demand.

And I think the Iran conflict actually challenged a lot of those sources of demand. Number one, you have a lot of reserves that are not getting generated because of the disruption in energy markets out of the Middle East, and you do have some emerging economies, India being a prime example, where they need to defend currency in order to obtain energy security and, you know, accumulating gold is not maybe top of mind for them right now.

And we've seen some policies in India that are trying to restrict the amount of domestic demand to keep control of the currency there. So, you know, I think it's certainly challenged the demand side of the equation in Asia, and you would probably need to see a longer-term normalization of energy markets and the conflict in Hormuz for that flow to return in the magnitude that it did.

Again, another reason why we're in a pause, not necessarily the end of a cycle.

Chris Hussey: Yeah, such a great point. Okay, before I get onto the best trade here, I want to ask you the Rudolph the Red-Nosed Reindeer question, which is silver. Cause where there's gold, there's silver. And what's going on with silver? Because that was up a lot in August, but boy, has it been volatile this year.

What are you seeing in the silver market?

Tony Kim: Yeah, it's, a lot of people are probably not going to like my answer, both the bulls and the bears. Look, at the end of the day, silver is a much smaller market. About half of the demand side balance sheet for silver is industrial demand, but ultimately the 20% of investment demand is going to determine where this clears.

The silver market can clear at $50 an ounce, $80 an ounce, or $100 an ounce, depending on what that retail demand and physical demand and investment demand is doing. And when you saw all of those things come together at the same time, where Indian physical demand was very strong, Chinese retail, ETFs in the West, you saw what could happen in January.

Usually when you start to see vol accelerate higher with the price going higher, you're in a very unstable setup, and then you had these massive down days of 20%, 30% lower. That's the way silver has been and, and probably always will be. So, you know, for me, if you have a sense that retail is going to get a hold of this theme again, they're going to deploy in silver, it's certainly a higher beta outcome in a higher gold market.

But for me, the fundamental trade still remains gold. That's where the institutions are deployed, that's what central banks are buying. And as I always say, central banks so far, to my knowledge, aren't actively accumulating silver, so you kind of have to bet on the retail reaction function.

Chris Hussey: Yeah, no, such a great point.

Central banks they're gold buyers. All right, let's put a bow on it, Tony. What's the trade?

Tony Kim: Look, we're still bullish gold. I think the challenge here is post Jackson Hole, we need some data to come out and obviously wait to see what the Fed does. But in terms of a level that we like 4,000 is a pretty solid floor.

We see sovereign buying at those levels. We see institutional sponsorship at those levels. And so I think if you get a chance to scale in between now and the FOMC with some of the volatility around the data, closer to 4K, you want to scale into a long position there.

Chris Hussey: All right, let's talk a little bit about that data between now and the, uh, FOMC.

What are you looking for most closely in the data side?

Tony Kim: I think for us it's really the inflation data that's going to come out, so CPI next week, before we actually see the Fed. And what I'm really curious about is there are a lot of different moving pieces. What's the market's reaction function to the print?

In other words, is it gonna try and predict that the, the Fed is going to then, you know, for sure hike in September and flatten the curve? Are you actually going to see some uncertainty about what the Fed's reaction function would be? And I think depending on how the market is interpreting the data, we'll get a better sense of which way gold's going to be leaning.

Chris Hussey: That is terrific. Appreciate that, Tony. Thanks so much for joining us.

Tony Kim: Thanks, Chris. Appreciate it.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey. Thanks for joining us.

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