

## Gold struck by rotation without reflation

The gold price has corrected sharply in the last two days, now trading close to \$1800/toz. The move happened despite 5- and 10-year real rates actually trading lower and weakening of the dollar vs. major gold consumer currencies. We believe it is due to a combination of pro-cyclical rotation in equities combined with lack of increase in breakeven inflation expectations, which drove gold higher in late spring/summer. Therefore, gold suffered from strong rotation without reflation.

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**Exhibit 1: Gold price sell off happened without move in 10-year real rates or ...**

lhs \$/toz, rhs %



Source: Goldman Sachs Global Investment Research

**Exhibit 2: ... or move in 5-year real rates**

lhs \$/toz, % rhs

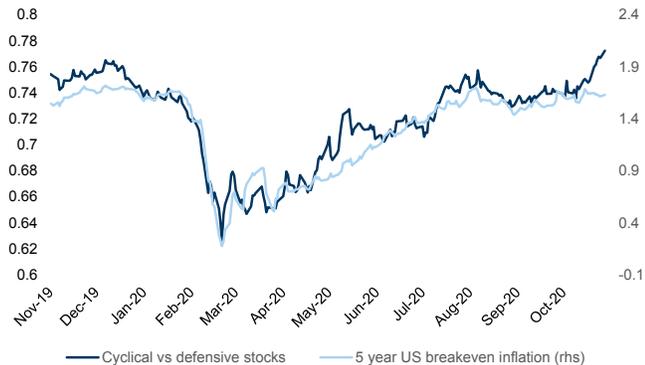


Source: Bloomberg, Goldman Sachs Global Investment Research

The lack of reflation is likely explained by the concerns about near-term growth risks facing DM economies as well as concerns over delays in the next round of US stimulus. Inflation has also underperformed the move higher in oil and weakening on the US trade weighted dollar. Our strategy team highlighted that at the beginning of the month cyclical to defensive equities looked cheap vs. inflation expectations and therefore there was room for a cyclical rotation with flat expectations. However, with the most recent cyclical rally around 2/3rds of the gap has been closed. This implies that while catch-up rotation can continue to put pressure on gold the bulk of it should be behind us.

**Exhibit 3: Rotation towards risky assets happened without an increase in inflation expectations**

lhs ratio, rhs %



Source: Bloomberg, Goldman Sachs Global Investment Research

**Exhibit 4: Breakeven inflation was also immune to increase in oil prices**

lhs \$/bbl, % rhs



Source: Bloomberg, Goldman Sachs Global Investment Research

Nevertheless, our medium-term bullish view on gold is unchanged. Our rates strategists still see material downside for real rates, particularly in near-term maturities. Inflation is likely to move higher once US fiscal hurdles are solved and US YoY inflation prints turn more positive early next year. Higher oil and commodity prices would also support the increase in breakevens. Our rates team notes that under our economists inflation outlook and our current oil price forecast near-term US real rates can average -2.1% over the next 5 years. This compares with -1.2% currently being priced by the market.

We also think that from valuation perspective gold is starting to look compelling relative to real rates and EM economies. If we look at the ratio of value of mined gold supply to EM dollar GDP, which is our preferred measure of wealth, we see that the most recent move makes gold look relatively cheap. Given that GS expects EM dollar GDP to increase by an additional 13% over the next year, we should also see a strong wealth-effect boost to gold prices. Given that simultaneously we see real rates going lower, at \$1800/toz gold price will not be sustainable, in our view.

**Exhibit 5: Gold beginning to look cheap vs. both 5-year real rates and ...**

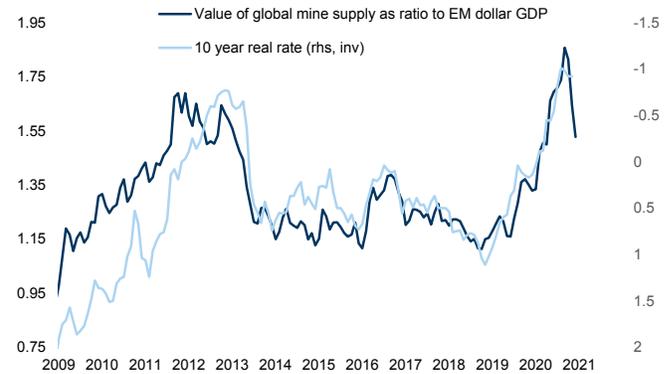
Lhs index, rhs %



Source: Bloomberg, Goldman Sachs Global Investment Research

**Exhibit 6: ... and 10-year real rates**

Lhs index, rhs %



Source: Bloomberg, Goldman Sachs Global Investment Research

Therefore, we think that the correction in the gold market was a churn vs. a turn and expect gold to go higher when more evidence of inflation emerges. It may, however, take some time for this to materialize as the market may need a few solid CPI prints in the US or a large move in oil to reprice inflation higher. Until then gold may continue to face pressure from reflationless cyclical rotation. Our medium-term bull thesis is unchanged, and we maintain our 12m \$2300/toz target.

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