Technical Analysis: Gold

Shinning bright like a diamond

28 March 2017

COMMODITY | GOLD | TECHNICAL ANALYSIS

- Both Gold and Silver should continue to do well in a highly inflationary and rising uncertainty environment
- Hold firm on our belief that Gold and Silver have entered into a new secular bull market
- Our long term target for Gold and Silver is $1920 and $49 respectively

Gold price sank in 2H 2016 despite Trump's victory as it fell from a high of 1375 to a low of 1122 but we believe the secular bull market is still intact. With the benefit of hindsight, we reiterate our view that gold has found a defining bottom at the end of 2015 at the low of 1046 as explained in the "8 year cycle report" and "Gold Silver ratio report".

Chart 1. 8 year cyclical bottom

Source: Bloomberg

The recent recovery since December 2016 has returned Gold back into an uptrend trajectory from both the immediate and long term perspective. Rising inflationary pressures and global economic and political uncertainties will be two main forces pushing Gold price higher in 2017 and beyond.

Inflation

Rising inflation will be the main driver for Gold price moving forward with multiple inflation data pointing toward an escalating trend. Inflation has been slowly creeping higher since September 2015 and both the headline Consumer Price Index (CPI) data and Core CPI data have breached above the 2% Fed's target for the past 3 and 15 months respectively. Moreover, headline CPI currently stands at 2.7% which is the highest since 2012.

Moving forward, we believe the uptrend in inflation will continue as the base effect from oil gets priced in.

Tradable instruments:

SPDR GLD US$ – (SGX:O87)
SPDR Gold Trust – (AMEX:GLD)

SPDR Gold Shares (GLD) is an exchange-traded fund (ETF) that offers investors an innovative, relatively cost efficient and secure way to access the gold market. SPDR Gold Shares are intended to offer investors a means of participating in the gold bullion market without the necessity of taking physical delivery of gold, and to buy and sell that interest through the trading of security on a regulated stock exchange.

GLDUSD (Phillip Futures)

Ishares Silver Trust – (AMEX:SLV)

The Ishares Silver Trust (SLV) is an exchange-traded fund (ETF) that seeks to reflect generally the performance of the price of silver

SLVUSD (Phillip Futures)

CNMC Goldmine Holdings Limited

Jeremy Ng (+65 6212 1857)
Investment Analyst
jeremyngch@phillip.com.sg

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Chart 2. Inflation Data rising since October 2015

Source: Bloomberg

Fed is behind the curve

The simpler way to illustrate the rising inflation environment would be to look at the Taylor rule in comparison to the Fed Funds rate (FFR). Taylor rule takes into account inflation and output to deduce the optimal interest rate where the Fed used to follow wholeheartedly since 1970s. However, the relationship snapped since 2008 after the Fed left interest rate flat at 0.25% to counter the Subprime Crisis. Notice how nicely the FFR tracks the Taylor rule until 2008.

Chart 3. Taylor Rule vs FFR

** Vertical line demarcates the start of the rate hike cycle* *Source: Bloomberg*

Looking at chart 3, the bottom panel depicts the spread between FFR and Taylor rule. Since 1970s, whenever the FFR is below the Taylor rule (shown by the negative spread), the Fed would have to play catch up eventually to match the Taylor rule interest rate and ultimately taking the FFR above the Taylor rule (shown by the positive spread). The clearest observation here is negative spreads will inevitably be followed by positive spread suggesting the Fed raising interest rates to chase inflation.

Take for example in 1974, when the FFR and Taylor rule spread went negative (FFR below Taylor rule), the spread stayed negative for 28 consecutive months before the Fed realized they were way behind the curve and started the rate hike cycle in November 1976 where they took the FFR from 4.75% to a whopping 20% over 39 months.

VanEck Vectors Gold Miners ETF – (AMEX:GDX)

The VanEck Vectors Gold Miners ETF seeks to replicate as closely as possible, before fees and expenses, the price and yield performance of the NYSE Arca Gold Miners Index. The Index in intended to track the overall performance of companies involved in the gold mining industry.

The NYSE Acra Gold Miners Index is a modified market capitalisation weighted index primarily comprised of publicly traded companies involved in the mining of gold and silver.

VanEck Vectors Junior Gold Miners ETF – (AMEX:GDXJ)

The VanEck Vectors Junior Gold Miners ETF tracks a market cap weighted index of global gold and silver mining firms, focusing on SMALL-CAPS.

GDXJ covers precious metals mining firms below the market cap cutoff for GDX.

Its portfolio sometimes has more market risk due to the risker nature of these smaller miners.

PureFunds ISE Junior SIL ETF – (AMEX:SILJ)

The PureFunds ISE Junior Silver ETF tracks a modified market cap weighted index of small cap silver mining and exploration companies.

It took the Fed a total of 33 months before they hit the Taylor rule inferred interest rate of 11% as they continued to raise rates further even after hitting the Taylor rule target, moving rates up as high as 20% in 1980.

A more recent example happened in 2001 where the spread went negative for 36 months before the Fed decided to take action. They began the rate hike cycle in May 2004 and brought rate up from 1% to 5.25% essentially overshooting the Taylor rule target once again at the end of the cycle.

To reflect the severity of the issue on how far the Fed is behind the inflation curve, in current times, it took the Fed a staggering 47 months before they started raising rates from the 0.25% low base in December 2015. To make matters worse, the Fed only hike another 25 basis points one full year later in December 2016 to 0.75%.

The most recent rate hike in March 2017 shows that the Fed might have realized that they are late in the game for chasing inflation according to Taylor rule and two more rate hikes this year is almost a certainty based on the FOMC Dot plot projections.

If this thesis stands, there is a very high chance that the Fed would even hike three more times this year to do their best to offset the rising inflation.

Taylor Rule suggesting an interest rate of 3.8%

According to the current Taylor rule interest rate, the FFR would have to be at 3.8% in order bring the interest rate back to equilibrium. In other words, FFR would have to increase 2.80% which translates into a total of 11 more hikes assuming the Fed only hikes 25 basis points per meeting.

This is not even pricing in inflation moving forward which would continue to drive the Taylor rule above the current 3.80%.

In all previous rate hike cycles, the trajectory of the rate hikes were steep and aggressive where rates were usually raised in all Federal Open Market Committee (FOMC) meetings. There are 8 FOMC meeting a year.

If the Fed were to follow the aggressive stance and hike rates in every other FOMC meeting, then the FFR would only hit the equilibrium in early 2018. However, this aggressive stance is very improbable as by doing so, the Fed would most definitely pop the equity bubble and at the same time, the bond bubble with US national debt at a record high of $20 Trillion.

The more conservative scenario the Fed would likely follow would be to hike only during the FOMC meetings with press conference which only happens 4 times a year, at the end of every quarter. Using the conservative scenario, that would take the Fed three more years before they reach the Taylor rule interests rate.

Rate hike cycles do actually benefit Gold

Contrary to conventional wisdom where rate hike cycle would be detrimental to Gold, our historical study shows otherwise especially when the Fed is hiking rates to chase inflation. In chart 2, the vertical line shows the start of the rate hike cycle associated with the Fed chasing inflation, the results are obvious. Gold performed spectacularly well during inflationary period shown by the 256% and 401% appreciation during the 1972 and 1976 rate hike cycles. The most recent rate hike cycle in 2004 where rates increased from 1% to 5.25% did not hamper demand in Gold and instead, Gold rallied a noteworthy 72% during that period.

With the current brand new rate hike cycle that began in December 2015 in play, we believe Gold should continue to benefit well in the inflationary environment as suggested by the inflation data and Taylor rule and we stick with our long term target of 1920 for Gold where it acts as an inflationary hedge.

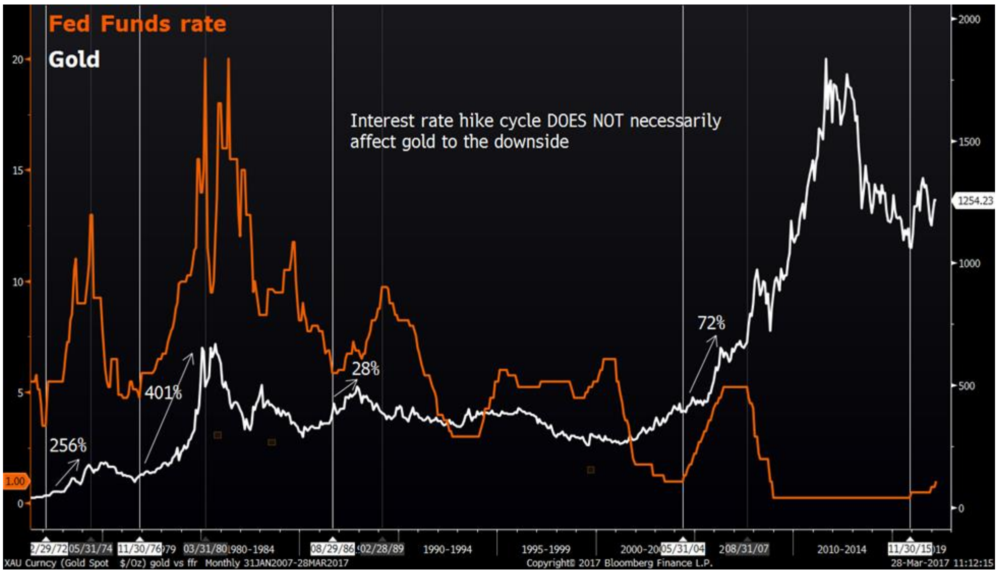

Chart 4. FFR vs Gold

** Vertical line demarcates the start of the rate hike cycle* *Source: Bloomberg*

Raising rates into economic weakness

Digging deeper into the health of the US economy, the Fed appears to be raising rates into economic weakness. Chart 5 shows the GDP YoY with the FFR and throughout history, the Fed has always stayed on the safe side and only hike rates when GDP is showing an accelerating trend shown by the highlighted box.

However, the Fed seems to be breaking the rule now to chase down inflation as GDP growth is weakening which makes a recession more likely. GDP YoY peaked out in Q1 2015 at 3.30% and the latest reading of Q4 2016 stands at 1.90%. Additionally, the Q1 2017 GDP number is forecasted to come in at 1% according to Alanta Fed forecast underscoring the lacklustre trend.

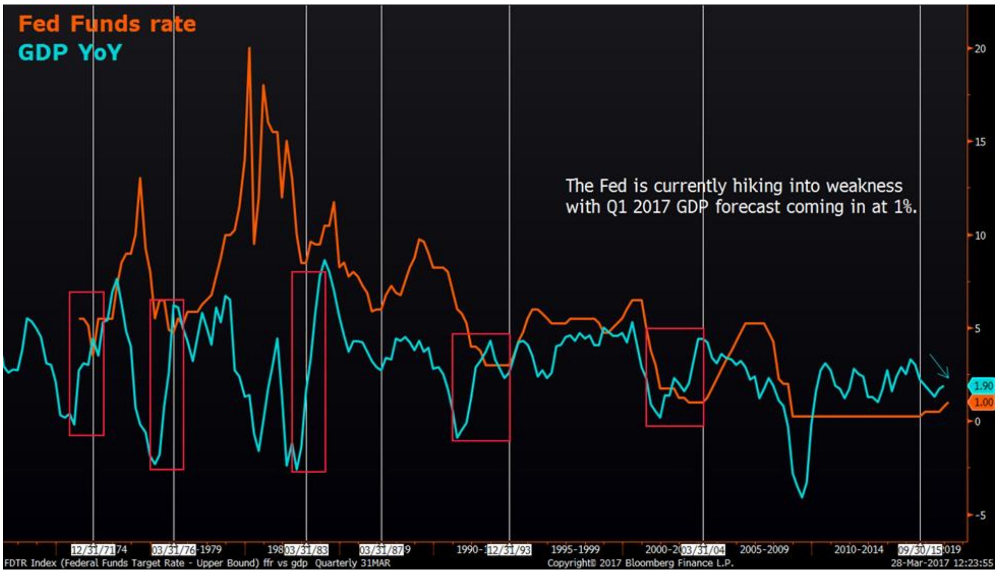

Chart 5. GDP YoY vs FFR

** Vertical line demarcates the start of the rate hike cycle* *Source: Bloomberg*

Tying this together with how far out we are in this economic expansion makes a recession very probable in 2017. We are currently in the third longest economic expansion in history with 93 months of economic expansion, way surpassing the previous cycle of 73 months of economic expansion since 2001.

Economic Expansion	**Duration of Economic Expansion**	**Economic Contraction**	**Duration of recession**
1933 - 1937	51 month	1937 - 1938	12 month
1938 - 1945	81 month	1945 - 1945	7 month
1945 - 1948	38 month	1948 - 1949	10 month
1949 - 1953	46 month	1953 - 1954	9 month
1954 - 1957	40 month	1957 - 1958	7 month
1958 - 1960	25 month	1960 - 1961	9 month
1960 - 1970	**107 month**	1970 - 1970	10 month
1970 - 1973	37 month	1973 - 1975	15 month
1975 - 1980	58 month	1980 - 1980	6 month
1980 - 1981	12 month	1981 - 1982	16 month
1982 - 1990	**92 month**	1990 - 1991	9 month
1991 - 2001	**119 month**	2001 - 2001	8 month
2001 - 2007	73 month	2007 - 2009	18 month
2009 -?	93 month and counting	?	?

Source: Bloomberg

The longest economic expansion was 119 months during 1991 – 2001 before the Dot-com bubble bursts, resulting in a 50% correction in the S&P 500 index and the recession that followed lasted for 8 months. No economic expansion last forever and some degree of correction is bound to happen.

History has also shown that every rate hike cycle is being followed by some sort of a crisis event and recession. Once the Fed stops the current rate hike cycle and enters a period of easing cycle that would be the red flag for an impending crisis event and recession. Under such scenario, Gold would act well as a safe haven asset.

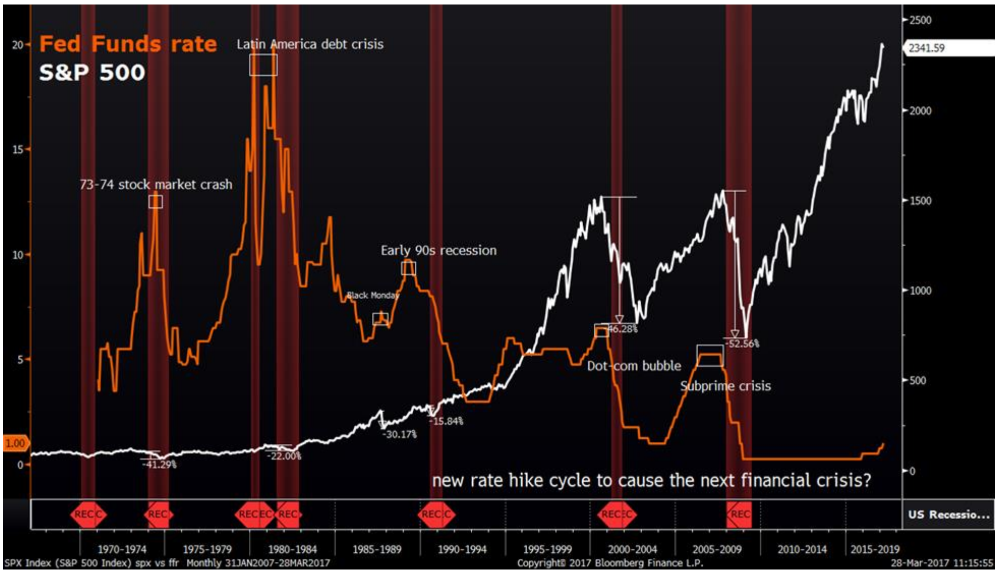

Chart 6. FFR vs S&P 500

Source: Bloomberg

Political Uncertainty

There's growing concern with the political uncertainty within U.S. and Europe. The market has been living on the edge with President Trumps' policies, especially on the hype up expectations of the tax cuts and infrastructure spending even though nothing concrete has been released.

President Trump has recently failed to pass the much talked about Republican Healthcare Bill due to the lack of support from fellow House Republicans where he told Paul Ryan to pull the Republican Healthcare Bill on 24 March, 2017 and warned that ACA would "explode" on its own. During the press conference, President Trump shifted the attention away from the ACA and instead mentioned that he would move on to tackle the Tax reform next which we doubt would be an easy task. Trump should continue to face more opposition and roadblocks from the freedom caucus members moving forward in terms of tackling the tax reform, infrastructure spending and raising/suspending of the debt ceiling.

If the tax reform gets delayed once again, then the recent equity market rally will come crumbling down back to reality, stirring up volatility.

In Europe, with the anti-establishment movement winning the battles in 2016 where the unexpected happened, Brexit and Trump victory, there will be brewing uncertainties arising from the upcoming French election in April – May 2017 and German Election in September 2017.

Extremes in GEPUI

The growing uncertainty is clearly reflected in the global economic policy uncertainty index (GEPUI) shown in chart 7. The extreme level in the GEPUI seems to around the 185 points where the elevated level above 185 points signals rising turmoil. For example, in September 2001(9/11 attack) when the GEPUI overshoots the 185 points, as it reverts back to norm, the GEPUI provided a good signal to accumulate Gold where Gold rallied 33% subsequently. Similar pattern pan out perfectly in March 2003(Iraq war) where Gold rallied 117% subsequently, in October 2008(Subprime crisis) where Gold spiked 165% and the most recent example in September 2015(China Yuan devaluation) where Gold subsequently formed its bottom in December 2016 and rallied 26%. It is only in August 2011, in the depth of the euro debt crisis where the GEPUI failed to push Gold price higher.

Chart 7. Gold vs GEPUI

Source: Bloomberg

The GEPUI provides a good sensing of the political and economic environment of the world and we are currently in unprecedented levels. The GEPUI recently hit a record high 289 points due to Trump's victory and its currently hovering around 220 points, way above the 180 extreme. As the political landscape in U.S. and Europe remains heated, uncertainty as a whole should continue to stay elevated and thus provide more tailwind for Gold as it acts as a safe haven asset.

In conclusion, with the 8 year cycle and gold silver ratio signalling the start of a whole new secular bull market in Gold and the rising inflationary pressures, rising global uncertainty and higher likelihood of the U.S. economy slipping in a recession, we believe Gold will perform very well as an inflation hedge and safe haven asset moving forward. We remain bullish on Gold in the long run with a target of 1920.

Bonus chart

The last two times the Fed raise rates in December 2015 and 2016 by 25 basis points, Gold formed an immediate bottom one day later and rallied 29% and 11% respectively. The current price action does suggests the similar pattern playing out once again after the most recent rate hike in March 2017. Gold has been trending higher since March 15, 2017 with 4% gain. If this pattern holds, then expect Gold to retest the 1307 resistance area next followed by the 1370 resistance area in the short run.

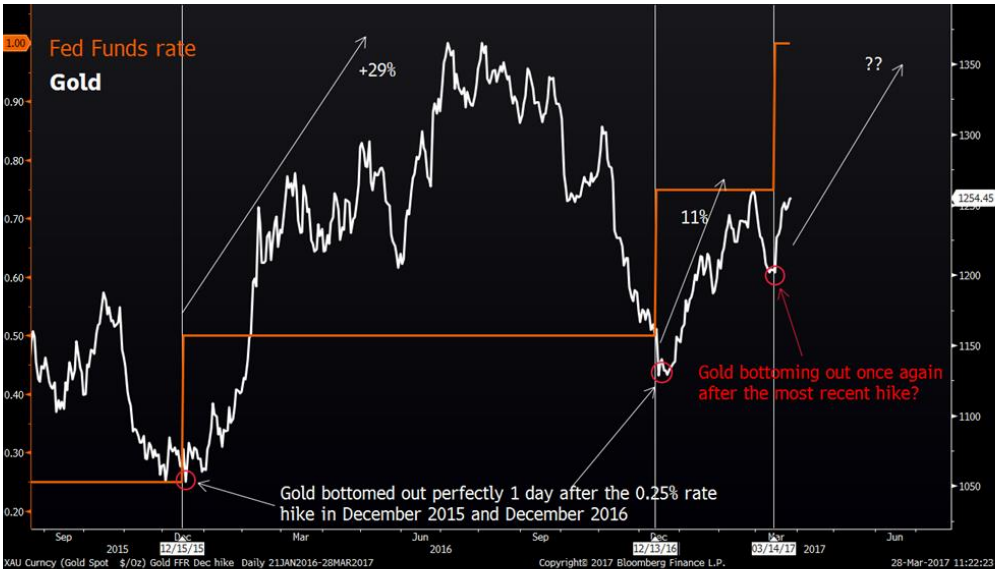

Chart 8. Gold vs FFR

Source: Bloomberg

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Contact Information (Singapore Research Team)

Research Operations Officer
Mohamed Amiruddin - amiruddin@phillip.com.sg

Consumer | Healthcare
Soh Lin Sin - sohls@phillip.com.sg

Property | Infrastructure
Peter Ng - peterngmc@phillip.com.sg

Macro
Pei Sai Teng - peist@phillip.com.sg

Transport | REITs (Industrial)
Richard Leow, CFTe, FRM - richardleowwt@phillip.com.sg

REITs (Commercial, Retail, Healthcare) | Property
Dehong Tan - tandh@phillip.com.sg

Technical Analysis
Jeremy Ng - jeremyngch@phillip.com.sg

Banking and Finance
Jeremy Teong - jeremyteongfh@phillip.com.sg

US Equity
Ho Kang Wei - hokw@phillip.com.sg

Oil & Gas | Energy
Chen Guangzhi - chengz@phillip.com.sg

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel +65 6533 6001
Fax +65 6535 6631
Website: www.poems.com.sg

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel +603 2162 8841
Fax +603 2166 5099
Website: www.poems.com.my

HONG KONG
Phillip Securities (HK) Ltd
11/F United Centre 95 Queensway
Hong Kong
Tel +852 2277 6600
Fax +852 2868 5307
Websites: www.phillip.com.hk

JAPAN
Phillip Securities Japan, Ltd.
4-2 Nihonbashi Kabuto-cho Chuo-ku,
Tokyo 103-0026
Tel +81-3 3666 2101
Fax +81-3 3666 6090
Website: www.phillip.co.jp

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel +62-21 5790 0800
Fax +62-21 5790 0809
Website: www.phillip.co.id

CHINA
Phillip Financial Advisory (Shanghai) Co Ltd
No 550 Yan An East Road,
Ocean Tower Unit 2318,
Postal code 200001
Tel +86-21 5169 9200
Fax +86-21 6351 2940
Website: www.phillip.com.cn

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel +66-2 6351700 / 22680999
Fax +66-2 22680921
Website www.phillip.co.th

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel +33-1 45633100
Fax +33-1 45636017
Website: www.kingandshaxson.com

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel +44-20 7426 5950
Fax +44-20 7626 1757
Website: www.kingandshaxson.com

UNITED STATES
Phillip Capital Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1-312 356 9000
Fax +1-312 356 9005
Website: www.phillipusa.com

AUSTRALIA
Phillip Capital Limited
Level 10 330 Collins Street
Melbourne, Victoria 3000, Australia
Tel +61-03 9629 8288
Fax +61-03 9629 8882
Website: www.phillipcapital.com.au

SRI LANKA
Asha Phillip Securities Limited
2nd Floor, Lakshmans Building,
No. 321, Galle Road,
Colombo 03, Sri Lanka
Tel: (94) 11 2429 100
Fax: (94) 11 2429 199
Website: www.ashaphillip.net

INDIA
PhillipCapital (India) Private Limited
No.1, 18th Floor, Urmi Estate
95, Ganpatrao Kadam Marg
Lower Parel West, Mumbai 400-013
Maharashtra, India
Tel: +91-22-2300 2999 / Fax: +91-22-2300 2969
Website: www.phillipcapital.in

TURKEY
PhillipCapital Menkul Degerler
Dr. Cemil Bengü Cad. Hak Is Merkezi
No. 2 Kat. 6A Caglayan
34403 Istanbul, Turkey
Tel: 0212 296 84 84
Fax: 0212 233 69 29
Website: www.phillipcapital.com.tr

DUBAI
Phillip Futures DMCC
Member of the Dubai Gold and
Commodities Exchange (DGCX)
Unit No 601, Plot No 58, White Crown Bldg,
Sheikh Zayed Road, P.O.Box 212291
Dubai-UAE
Tel: +971-4-3325052 / Fax: + 971-4-3328895

CAMBODIA
Phillip Bank Plc
Ground Floor of B-Office Centre,#61-64,
Norodom Blvd Corner Street 306,Sangkat
Boeung Keng Kang 1, Khan Chamkamorn,
Phnom Penh, Cambodia
Tel: 855 (0) 7796 6151/855 (0) 1620 0769
Website: www.phillipbank.com.kh

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