Flashnote

HSBC Global Research

Commodities
Global

All that glitters is gold

Fiscal failures in and outside the US take gold to new highs

- **Gold hits record intraday high of USD1,719/oz as S&P's downgrade of US sovereign long-term debt triggers heavy safe-haven buying**
- **Longer term, gold will be supported by global sovereign debt concerns, accommodative US monetary policies and the gradual erosion of the USD's reserve currency status**
- **We are raising our 2011, 2012, 2013 and long-term gold price forecasts to USD1,590/oz, USD1,625/oz, USD1,550/oz, and USD1,375/oz, respectively, from USD1,525/oz, USD1,500/oz, USD1,450/oz, and USD1,250/oz, respectively**

An ill wind blows good for gold

Gold prices surged to a record intraday high of USD1,719/oz in reaction to the S&P decision to downgrade US long-term sovereign debt to AA+ from AAA. Sovereign risk has emerged as the principal driver of bullion prices in the last year and a half. Historically, heightened sovereign risk has boosted investor demand for gold. The logic of this is relatively straightforward: as gold is a widely traded hard asset and proven safe-haven instrument, investors have traditionally turned to it when faith in government policies, which can be reflected in a government's credit rating, deteriorates. Historically, gold moves positively with sovereign risk due to gold's traditional characteristics as a safe haven, rising when risks increase and falling when risks contract.

When Greek sovereign risk first emerged as a major issue earlier in 2010, the gold market rallied, after initial weakness. As the situation worsened, gold price rose significantly. At the height of the Greek crisis in May 2010, German banks sold a record number of gold coins, and gold prices surged above USD1,200/oz. The deepening and spreading of sovereign risk, as the Greek contagion impacted other peripheral EU nations including Ireland, Portugal, and Span and, more recently, Italy, was bullish for gold and as the Greek crisis mutated, gold remained generally well bid throughout the balance of 2010 and 2011.

The downgrade of US sovereign debt shows that the locus of sovereign risk has shifted to the US. This unprecedented historical event has buoyed gold above USD1,700/oz. The recent debt ceiling debacle focused attention on the unsustainably of the US fiscal situation. According to Stephen King HSBC's chief economist in *US debt downgrade: Another fine mess* (7 August 2011), the US fiscal situation was unsustainable even before the financial crisis, due to the costs associated with an ageing population and extravagant

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social security commitments. The US credit downgrade, coming so close on the heels of the debt ceiling crisis has left investors searching for a safe haven and choosing gold. The debt ceiling agreement also closes off further fiscal stimulus as an option for policymakers. This leaves monetary policy as the only weapon left to battle slow growth and high unemployment. Expectations that the Fed will keep monetary policy highly accommodative, is further boosting gold. There may also be an element of concern among investors that the Fed may monetize the debt. The inflationary consequences of such action are supportive of gold. Even if this is not policy, the fear among some investors that this might occur, should keep gold well bid.

A golden port in a storm

Gold has a lot to recommend it during times of elevated sovereign risk and financial stress. Gold has rallied since the beginning of the financial crisis in 2007, in large part because as a hard asset it has no counter party or credit risk. Unlike other hard assets, however, it is highly liquid with an active global market. Gold is also viewed as a surrogate currency. Proof of its currency-like status is evidenced by its role as an important component of central bank foreign exchange reserves. This unique combination of lack of counterparty and credit risk, ample liquidity and surrogate currency status typically makes gold attractive to investors during periods of uncertainty.

The gold rally remains intact after years of price appreciation because the global crisis, which started in 2007, has mutated but has not been resolved. Massive official intervention has only shifted liabilities, actual and contingent, from the private to the public sector. This has exposed a negative debt sustainability trend in the developed world – including the United States – that started well before the financial crisis.

Unlike other safe-haven currencies, central banks cannot effectively intervene against gold to prevent its appreciation. The “safe haven” currencies, the CHF, NOK and JPY have appreciated noticeably in recent weeks, much to the chagrin of domestic policymakers. Last week, the Bank of Japan intervened strenuously to stem the rally in the JPY and the Swiss National Bank cut interest rates to weaken the CHF. These currencies may be subject to further intervention. Gold, however, does not face the threat of intervention and may move higher unimpeded by any government. Central banks with gold reserves could sell their bullion but the countries with the largest reserves, the US, Japan, Germany as well as others give no indication of doing so. Central bankers and other policymakers make little reference to higher gold prices and they do not appear to be contrary to any sovereign country’s interests. More importantly perhaps the supply of gold is not dictated by government monetary policy. While central banks can prime the printing presses at will, the supply of gold is fixed in the near term and increases only as a function of mine output.

The US dollar is key

Historically, gold trades inversely to the USD. This is logical considering that gold is the world’s supreme hard asset and the USD the world’s supreme paper asset. Also as gold is priced in USDs, the value of the dollar impacts the demand for gold outside the dollar bloc and is an important factor governing mining costs. The relationship however is not lock step. Periodically since the beginning of the crisis in 2007 gold and the USD have moved together as investors have rushed into the USD, or more specifically US Treasuries and other USD assets during times of uncertainty, as well as gold. Thus gold and the dollar have tended to move in sync during periods elevated risk. Over the long run, however, the inverse USD/gold relationship has also been re-established.

To the degree that the credit downgrade has damaged the USD, it has strengthened gold. HSBC's chief currency strategist David Bloom in *US debt downgrade: Another fine mess* (7 August 2011) stated the US downgrade is a watershed moment for the USD even though it was already seen as a very likely development after the recent debt ceiling wrangle. Given gold's relationship with the USD, the downgrade can also be viewed as a watershed moment for gold. The USD will remain the world's reserve currency according to Mr. Bloom but its status is being chipped away. This is almost tailor-made for gold to rally. The currency most able to replace the USD is the EUR – but many would not accept it as an alternative, according to Mr. Bloom. Meanwhile the other important currencies of rapidly emerging economies, such as India, Russia, China and Brazil have less liquidity combined than the Canadian dollar. So although this downgrade has damaged the USD and will chisel away at its position at the center of the financial system, there is nothing to replace it as the world's reserve currency of the world anytime soon, according to Mr. Bloom. In this atmosphere of uncertain change, investors may turn increasingly to gold.

Conclusion

We are raising our 2011, 2012, 2013 and long-term average gold price forecasts to USD1,590/oz USD1,625/oz USD1,550/oz, and USD1,375/oz, from USD1,525/oz, USD1,500/oz, USD1,450/oz and USD1,250/oz respectively. Given the positive correlation between gold and silver, we are also raising our silver price forecasts. We are raising our 2011, 2012, 2013 and long-term silver forecasts to USD38/oz, USD32/oz, USD30/oz and USD25/oz. We believe gold prices could be volatile for the rest of the year with a trading range of between USD1,850/oz and USD1,550/oz. Silver will lag gold due to its industrial metal status and we anticipate a trading of between USD42/oz and USD36/oz for the remainder of 2012.

If history is any judge, the decade-long gold rally will not end until sovereign risks – in and outside of the US – recede. This is unlikely to occur until the US fiscal situation is on a sustainable path, the US budget deficit reduced and progress is made on reducing the growth in the debt-to-GDP ratio. Any further decline in investor confidence regarding monetary and fiscal policies is likely to translate into even higher gold prices. How confident investors will be in government to remedy fiscal and global economic challenges, and the direction of the foreign exchange markets, will be important factors in determining gold prices. Among these, the long-term decline in the USD is an important element in our expectations of historically high gold prices. In this atmosphere, traditional supply/demand factors, including mine supply, producer hedging policies, and jewelry and industrial demand may take a second place to macroeconomic and geopolitical influences and investment demand on gold. We believe that on balance, these macroeconomic factors will keep the demand for gold elevated for the rest of the year and into 2012 and keep gold prices historically high – although possibly not at current levels – for years to come.

Disclosure appendix

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