Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Gold Bull Market to Continue

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Gold may seem vulnerable after its rapid +30% rise since last fall (over +45% since the late-2015 trough), with many indicators suggesting increased investor enthusiasm.[1] However, we think the one- to two-year outlook for gold remains attractive, and expect gold to reach $2000, supported by a weaker dollar and the increasing likelihood of wider budget deficits and looser monetary policy globally *(Display 1)*.[2]

Since 2006, gold has slavishly followed the fluctuations of real yields and the U.S. dollar. Gold's recent rise can almost entirely be attributed to just one factor—the decline in real U.S. yields since November 2018. The U.S. 10-year TIPS (Treasury inflation-protected securities) yield has fallen from the peak of 118 basis points in November to about zero at the end of August 2019. We believe this explained most of the rise in gold prices over this time period, somewhat offset by a mildly stronger U.S. dollar. The fall in TIPS yields has been fairly consistent with the slowdown in global growth during this time.[3]

In the mild slowdown scenario that we expect over the next 18 months (we expect global GDP growth to end at 2.5% in the fourth quarter of 2020), further downside to the TIPS yield is likely limited—we expect it to fall to -0.15% from roughly zero today, and thus to provide only modest support to gold prices going forward.[4] Although inflation remains subdued globally, it will not likely remain dormant indefinitely. Labor markets continue to tighten in G-4 economies, and evidence of this translating into higher wages remains compelling. However, cyclically insensitive prices such as those that are regulated or state-administered (e.g. health

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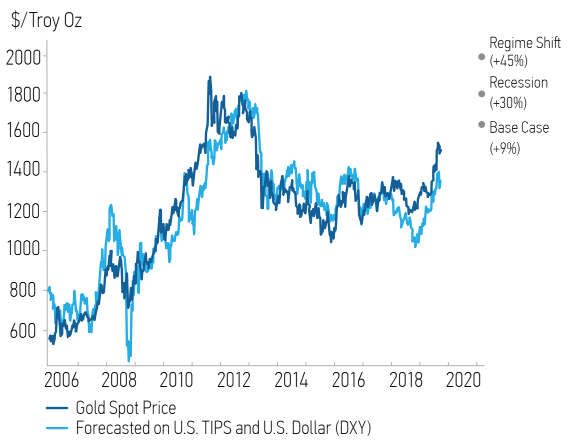
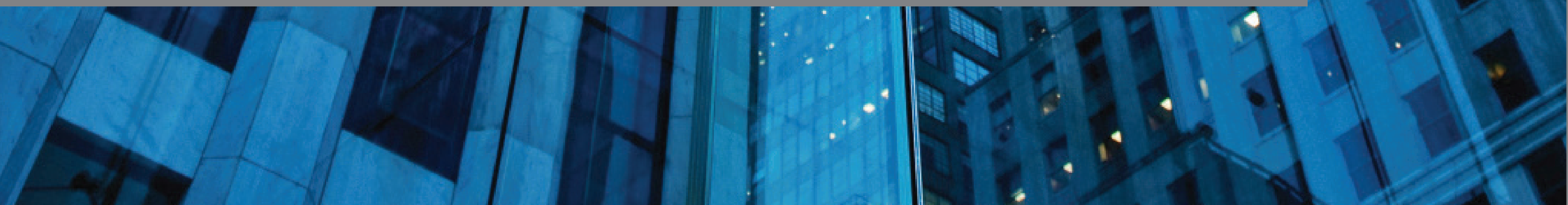
Display 1: **Lower Real Yields & Dollar to Drive Gold Higher**
Gold Modeled on TIPS & U.S. Dollar (DXY)



Source: MSIM Global Multi-Asset Team Analysis.
Data as of September 17, 2019.
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.



care in the U.S.) have remained depressed, dampening overall inflation. In our view, U.S. inflation is likely to gradually increase over the next 18 months, from 1.6% to 1.9%, contributing to lower real yields.[5]

The U.S. dollar has remained resilient despite nominal and real rate differentials moving against the U.S. in the past 10 months, but we expect the U.S. dollar to weaken from here, supporting gold prices. The dollar is currently 6-7% above what would be implied by real rate differentials, is expensive as measured by the long-term real effective exchange rate (REER),[6] and positioning is near overbought, suggesting its resilience may have run its course, especially as rate differentials move further against the U.S. as the U.S. Federal Reserve cuts interest rates. We expect one additional rate cut before the end of the year, and see the dollar depreciating by -7% by the end of 2020.[7]

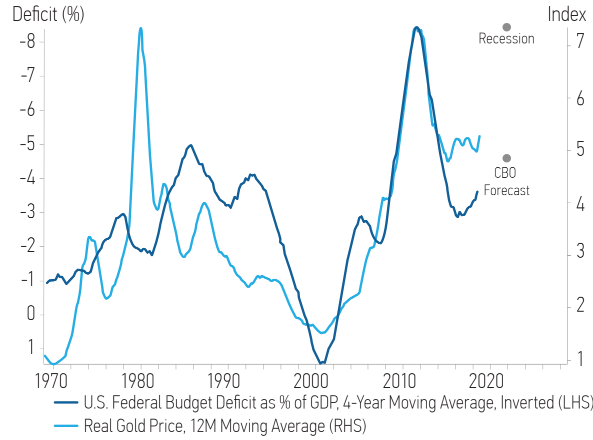
In the benign slowdown scenario we see as our base case, gold can go up 9%, or to $1650, over the next 18 months. In a recession scenario, where the U.S. policy rate is cut to zero, TIPS yields could go lower, to negative 100-150 basis points. This would likely lift gold a further 10-20% to $1800-$2000, assuming the current relationships hold.[8]

But there would be little reason to invest in gold if it were merely a direct play on other financial assets. Just like prior to the mid-2000s when gold's links to real rates and the U.S. dollar were somewhat less pronounced, we believe gold is likely to break from its recent relationship to real rates and the dollar. The gold price is already about $200 per ounce higher than what is suggested by the TIPS yields and the U.S. dollar, in what is likely to be the beginning of a larger deviation in the medium term. As other factors, such as monetary policy regime shifts and budget deficits, begin to be taken into consideration, we believe gold will offer additional upside, in excess of what is implied by real rates and the U.S. dollar.[9]

Widening budget deficits have been structurally supportive of prior gold bull markets (e.g. 1970s and 2000s). From an elevated level of 4.5% at present, the U.S. fiscal deficit will likely widen to 8-9% of GDP in a recession *(Display 2)*.[10]

Display 2: **Higher Budget Deficits Supportive for Gold**

U.S. Federal Budget Deficit vs. Real Gold Price



Source: MSIM Global Multi-Asset Team Analysis.
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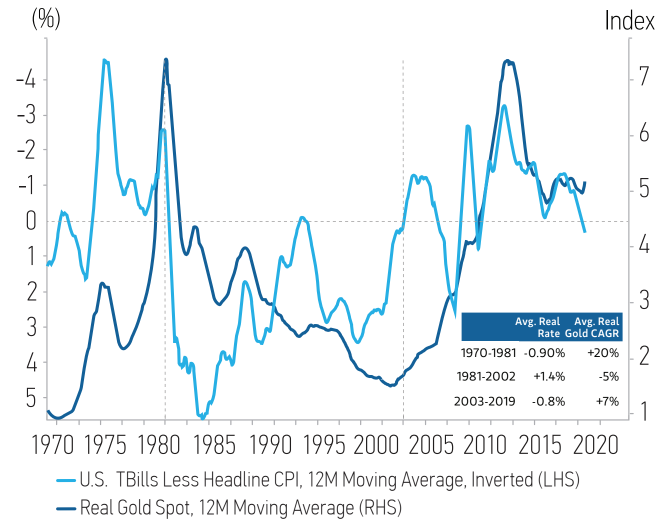
But the outlook for wide fiscal deficits is not just a cyclical phenomenon. It is also potentially a structural problem, as established academics and policy makers are increasingly coalescing around the view that ongoing government deficit spending is needed to counter the so-called `secular stagnation'. Although it seems highly likely that the cure will be worse than the disease, support for muscular Keynesianism from figures such as International Monetary Fund (IMF) Research Director and MIT professor Olivier Blanchard, former U.S. Treasury Secretary and current Harvard professor Larry Summers, and a host of others suggests the likelihood of such a policy turn is high. The challenge for investors is to determine when these discussions will begin to matter for markets in general and gold specifically. Thus far, the discussions have remained largely theoretical. In the case of the U.S., it seems unlikely that any additional fiscal spending legislation will be passed before the 2020 presidential election. On the other hand, beyond two years out, large fiscal deficits appear extremely likely, recession not being a necessary condition. Gold will likely begin to gradually discount this eventuality over the next one to two years.

Display 3: **Real Rates Main Driver of Gold Performance Regimes**

Real Rates vs. Gold



Source: MSIM Global Multi-Asset Team Analysis.
Data as of September 17, 2019.

The evolving behavior of major central banks will also likely be supportive of gold. Unconventional policy measures are being discussed at present and are likely to be implemented in a downturn. In addition to cutting policy rates to minimal levels, we believe quantitative easing and asset purchase programs will be reintroduced. Already the European Central Bank is resuming quantitative easing. A push into even more unconventional policy will likely occur in the form of the much-discussed average inflation targeting, allowing inflation to overshoot target to make up for periods of below-target inflation. This should lower real rates as nominal policy rates remain restrained. And although currency market intervention has not been made an explicit goal of any major central bank, this also may change. During a deflationary downturn, with policy rates constrained by the lower bound, currency depreciation may turn out to be the most effective stimulus tool available. While it is unclear what the ultimate effect on exchange rates will be if all major countries pursue similar beggar-thy-neighbor policies, these efforts will likely lead to further expansion of central bank balance sheets and liquidity. We expect that the prospect of these measures being undertaken will provide additional support for gold, in excess of what would be suggested by its recent drivers alone.

We see gold as an effective diversifier in traditional portfolios due to its historical low and unstable correlation to equities and bonds, as we have discussed in previous research. In the context of historically high valuations of traditional assets, we believe the need for greater diversification will increase.[11] Although inflation has yet to come back to life in a meaningful way, the prospect of greater fiscal activism coupled with non-conventional accommodative monetary policy measures makes its eventual resurrection probable, though difficult to forecast precisely. Despite being a useful diversifier and an attractive inflation hedge, gold plays a relatively modest role in investor portfolios. Since 2009, investors have put only $23 billion dollars into mutual funds investing in gold bullion, as compared to $295 billion into equity funds and $2.3 trillion into bond funds, according to EPFR.[12] The ratio of mined gold to financial assets is near cycle lows, suggesting the potential for higher gold prices and allocations. At present, the value of above-ground gold is roughly 20% of the global equity market capitalization. As recently as 2011, this ratio was nearly 40%, and at the peak in the late 1970s it approached 200%. Relative to the value of equities and bonds combined, above-ground gold's value is currently approximately 9%, as compared to nearly 15% in 2011 and over 17% in early 1990s. Including private assets, gold allocations represent about 3% of public and private equity and fixed income assets.[13] It appears there is ample room for greater allocations to, and substantial outperformance of, gold relative to other financial assets. One important segment of the market is increasing allocations to gold. Global central banks remain net buyers of gold and, from a low of 963 million troy ounces in 2009, have increased their holdings to 1.11 billion troy ounces today.[14]

Although we recognize that gold's positioning is stretched after the recent large move, we believe it still has substantial further upside potential. In a benign scenario of stabilizing growth (2.5% global GDP by end 2020) and quiescent inflation (1.9% in the U.S. by end 2020), we believe gold should rise to $1650 over the next 18 months as real rates fall somewhat more and the U.S. dollar finally depreciates. Although we don't forecast a recession next year, if such a scenario is discounted ahead of 2021, the gold price could reach $1800-2000 by end 2020. Recession aside, even in a benign scenario the upside to gold is likely to be more substantial than the traditional model suggests as investors begin to discount medium-term risks of structurally higher fiscal deficits and more aggressive unconventional monetary and fiscal policies. We expect gold to rise to $2000 over the next 18 months.

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FOOTNOTES

[1] MSIM Global Multi-Asset Team Analysis, Bloomberg.

[2] MSIM Global Multi-Asset Team estimates.

[3] MSIM Global Multi-Asset Team Analysis, Bloomberg (whole paragraph).

[4] MSIM Global Multi-Asset Team estimates.

[5] ibid

[6] Real Effective Exchange Rates is a measure of the value of a currency against a weighted average of several foreign currencies, divided by a price deflator (or index of costs/inflation). Weights are determined by trade flow between the two countries.

[7] MSIM Global Multi-Asset Team analysis and estimates.

[8] ibid

[9] ibid

[10] MSIM Global Multi-Asset Team estimates, Haver Analytics.

[11] Diversification does not eliminate the risk of loss.

[12] MSIM Global Multi-Asset Team Analysis, EPFR Global.

[13] MSIM Global Multi-Asset Team Analysis, FactsSet, BIS, Preqin.

[14] MSIM Global Multi-Asset Team Analysis, IMF.

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