Precious Metals

Gold and Silver Shine

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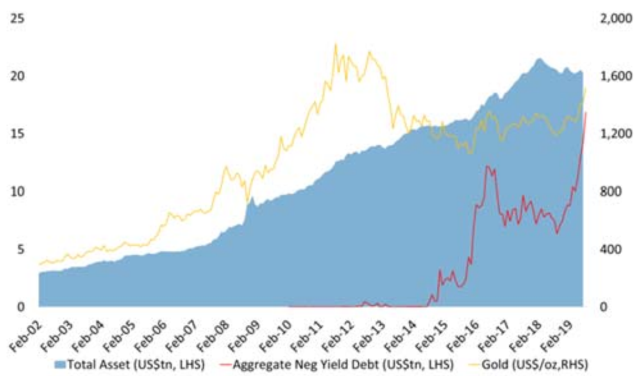
- Negative yielding debt has reached US$17tn as of August 2019, raising concerns on global economic growth and inflation prospects.
- Gold performs well during recessionary periods, returning an average of 12.1%.
- Silver is catching up to the gold run, given that the gold/silver ratio has recently peaked.
- We expect gold and silver to reach US$1,600/oz and US$20/oz by the end of 2019.

Increasing global debt with negative yield amid the expansion of central banks' balance sheet. One key market concern is the falling yield of debt, specifically for major economies such as Germany, France and Japan, where their 2-year and 10-year bond yields are negative. The rising bond prices (falling yields) are driven by the risk-off sentiment and expectations of a renewed rate cut cycle. Since the last recession in 2008, central banks have conducted quantitative easing, resulting mainly in asset inflation. Taking the combined balance sheet of the major central banks (Fed, PBOC, ECB, BOJ, and SNB) as a proxy of the overall money supply, the total asset value jumped by 314% to US$20tn in 11 years (equivalent to 11% p.a.).

Comparatively, the aggregate amount of negative-yielding debt was insignificant until August 2014 when the volume began to accelerate. The total value of negative-yielding debt jumped sharply from US$6.4tn in September 2018 to US$17tn in August 2019, implying a 164% YoY growth. This at least tells us that global capital has been pursuing risk-free or less risky returns amid the slowdown of the global economy and on concerns over the trade tensions between China and the US. Gold, widely accepted as a safe-haven asset, outperformed most asset classes with a decent YTD return of 16%. Given the expectation of more rate cuts from the US Fed this year and Fed funds rate possibly heading towards zero for this cycle, we could expect a weakening of the US Dollar. Hence, given all the points mentioned above, we are of the view that gold price has more room to rise.

Figure 1: Total assets of the five major central banks and total negative yield debt



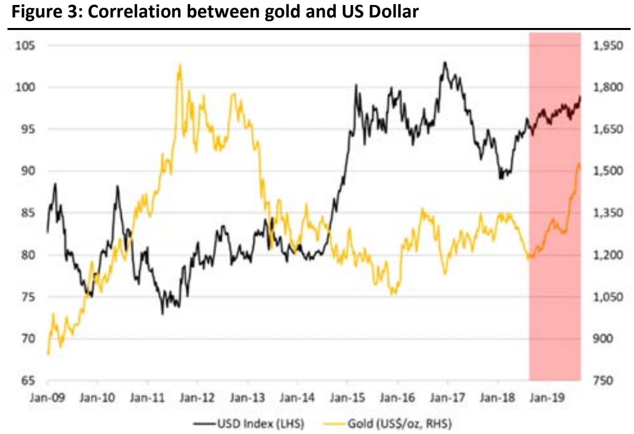
Source: Bloomberg, KGI Research

Figure 2: Return by asset class

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD
US HY Bond	-25%	16%	3%	-1%	4%	-1%	-4%	-10%	7%	1%	-7%	11%
US IG Bond	-3%	2%	4%	5%	6%	-6%	5%	-5%	3%	4%	-7%	14%
US MBS	3%	1%	0%	2%	0%	-3%	5%	-1%	-1%	0%	-2%	5%
EM Bond	-7%	9%	5%	2%	12%	-12%	1%	-4%	4%	5%	-10%	13%
US Large cap	-38%	22%	11%	0%	13%	29%	11%	0%	9%	20%	-6%	20%
US Small cap	-37%	38%	26%	-4%	16%	36%	6%	-5%	18%	16%	-11%	18%
EM Equity	-50%	66%	15%	-20%	17%	-6%	-6%	-18%	9%	35%	-17%	7%
Gold	5%	24%	29%	10%	7%	-28%	-2%	-11%	8%	13%	-2%	16%
Gold mines	-26%	36%	33%	-16%	-10%	-54%	-13%	-25%	52%	11%	-9%	30%
Silver	-24%	48%	82%	-11%	9%	-36%	-20%	-12%	15%	6%	-9%	16%
Siver mines	N/A	N/A	N/A	-22%	7%	-51%	-17%	-33%	73%	2%	-23%	18%

Source: Bloomberg, KGI Research

Figure 3: Correlation between gold and US Dollar



Source: Bloomberg, KGI Research

Gold performs well during recessionary periods. In retrospect, gold delivered a good average return of 12.1% over the past 10 recessions dating back to 1954. Comparatively, the S&P 500 suffered from a 2.4% loss during the same periods. Furthermore, gold tends to outperform during the turn of the Fed fund rate hike/cut cycle (2008, 2016, 2019 YTD). We believe this is because a directional change of interest rates translates into more market volatility, resulting in the influx from risk-averse funds.

Figure 4: Gold performance during recession periods

Begin	End	Gold	Silver	S&P 500
Nov-07	Jun-09	18.2%	-2.9%	-37.9%
Mar-01	Nov-01	3.3%	-5.4%	-8.2%
Jul-90	Mar-91	-0.5%	-21.8%	4.4%
Jul-81	Nov-82	3.3%	12.9%	6.8%
Jan-80	Jul-80	12.4%	-59.2%	15.6%
Oct-73	Apr-75	77.1%	50.9%	-23.7%
Nov-69	Nov-70	6.6%	-12.4%	-7.0%
Mar-60	Feb-61	-0.1%	0.0%	14.6%
Jul-57	Apr-58	0.4%	-1.9%	-9.3%
Jun-53	May-54	0.6%	0.0%	20.5%
Average Return		**12.1%**	**-4.0%**	**-2.4%**

Source: Bloomberg, KGI Research

Silver is catching up to gold. Gold prices broke the resistance of US$1,360/oz in June and reached a 6-year high of above US$1,500/oz in August. Historically, gold and silver are positively correlated. However, the recent bullish uptrend of gold led to the Gold/Silver ratio surging to the high of above 90 in July, which indicates that silver's performance has been lagging. The 10-year average (from 2009 to 2019) of the ratio is 68. Although the two metal prices have recently corrected, the ratio has still stayed between 1 standard deviation (S.D.) and 2 S.D. Therefore, we expect silver prices to catch up the gold bull run with the ratio between gold and silver reverting to mean.

Figure 5: Gold/Silver ratio

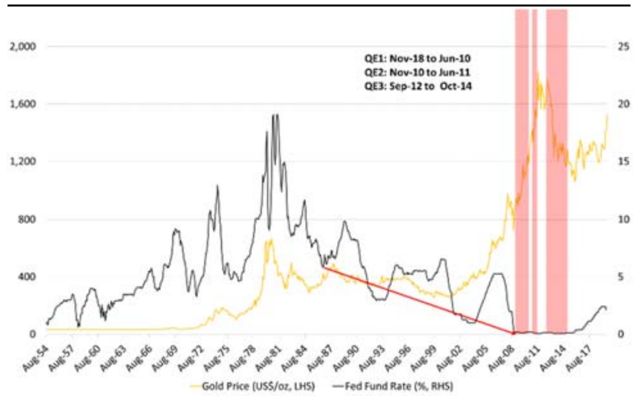
Source: Bloomberg, KGI Research

Assumptions and Forecasts. As of August 2019, the Fed funds rate stayed at 2%-2.25%. We expect this latest round of the rate cut cycle to once again bring rates back to the zero level (0 - 0.25%). Assuming that gold prices should increase US$50/oz for every 25bps cut in the Fed funds rate, we can expect gold prices to reach the all-time high of US$1,900/oz again. There will be another 50bps cut this year based on market consensus. Accordingly, gold is expected to hit US$1,600 by the end of 2019. For silver, we expect it to trade above US$20/oz by December 2019.

Figure 6: Correlation between gold and silver

Source: Bloomberg, KGI Research

Figure 7: Gold performance amid rate hike/cut cycle



Source: Bloomberg, KGI Research

Products to trade. There are four channels that investors can gain exposure to gold or silver in the list below.

Product types	Remarks
Physical gold or silver bullion	Subject to the premium charges on the spot price by bullion shops
ETF: SPDR® Gold Shares (GLD), iShares Silver (SLV)	Track performance of spot gold or silver price; Subject to ETF management fees
Mining ETF: VanEck Vectors Gold Miners ETF (GDX), VanEck Vectors Junior Gold Miners (GDXJ), Global X Silver Miners (SIL), PureFunds ISE Junior Silver (SILJ)	Track performance of a pool of gold or silver mining stocks; Subject to ETF management fees
Mining stocks	Company performance and mineral reserves magnify the profits and losses; Equity attribution could weaken the correlation to the price of the underlying minerals

KGI's Ratings

Rating	Definition
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Underperform (U)	We take a negative view on the stock. The stock is expected to underperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon
Not Rated (NR)	The stock is not rated by KGI Securities.
Restricted (R)	KGI policy and/or applicable law regulations preclude certain types of communications, including an investment recommendation, during the course of KGI's engagement in an investment banking transaction and in certain other circumstances.

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