Liquid Real Assets Research

April 2023

Special Report | Gold & Precious Metals

Overview

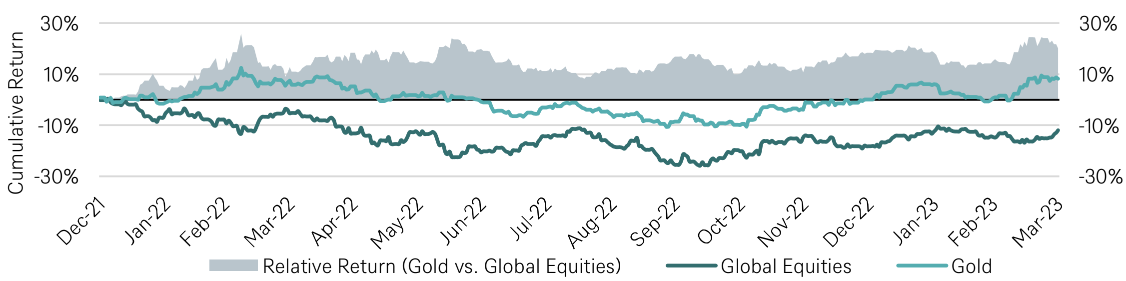
IN A NUTSHELL

- Commodities and natural resource equities notched impressive gains in 2022, widely outstripping broader equities.
- In the near-term, gold prices will likely exhibit some headline sensitivity as central banks consider policy adjustments.
- We see significant upside potential from here given a multitude of bullish factors which could offer incremental price support.

Gold has continued to outperform broader equities

While rising rates and slowing growth prospects initially proved a formidable headwind for the metals space during 2022, a late-year about face from China on "zero-COVID" ushered in price support, and precious metals commodities such as gold, platinum, and silver mounted a strong recovery, along with their precious metals and mining counterparts. Gold has continued to outperform year-to date.

Cumulative Total Return: Gold vs. Global Equities



Source: Bloomberg, DWS. Global Equities = MSCI World Index. Gold = Bloomberg Gold Commodity Sub-index. As of March 31, 2023.

In the near-term, gold prices will likely exhibit some sensitivity as the U.S. Federal Reserve (Fed) considers adjustments to its tightening agenda and amidst a resurgence in U.S. dollar strength. However, we view this as increased upside potential for gold as market expectations for the end of the Fed's current hiking cycle have simply shifted (rather than evaporated).

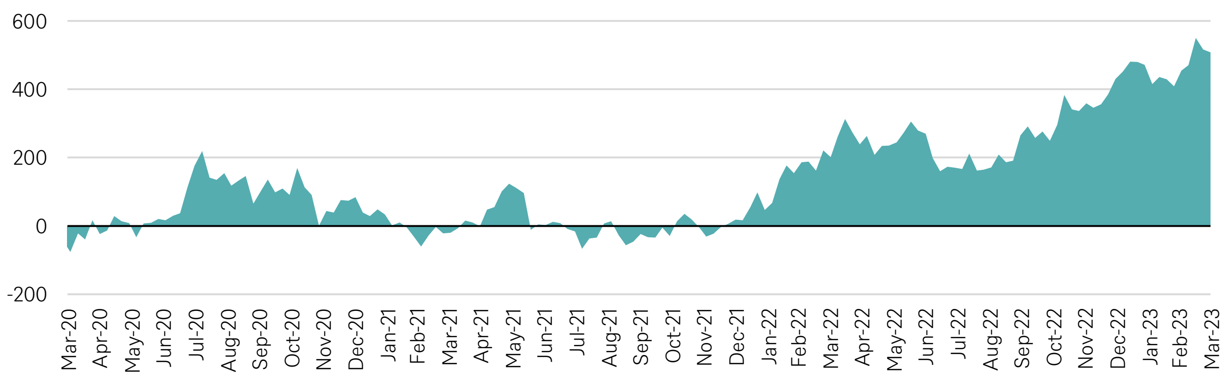
- Interest in gold appears to be rising and several central banks are increasing their inventory. Investor participation could increase should central banks slow the pace of rate hikes in 2023.
- We consider a recent pickup in the increase of the global money supply, which exhibits high correlation to gold, as a strong factor supporting gold prices against still-elevated real yields.
- Environments of high and rising geopolitical risk tend to drive demand for risk-hedges, such as gold. Geopolitical risk premium in gold is elevated and we expect this to persist throughout 2023.
- For the miners, key themes include China's re-opening, slowing demand due to policy tightening, and dearth of capacity growth due to low capex levels.

Gold & Precious Metals – Key Themes

The curious case of elevated real yield premiums

During 2022, gold began trading at a premium to real yields as interest rate hikes contributed to a rising rate environment. Given the traditionally inverse relationship between gold and real yields (gold provides no yield, so rising yields increase the opportunity cost of holding gold), this might read as a negative for gold, suggesting it is overvalued. However, other factors offer explanations for why we might expect this situation to persist for some time, as well as reasons to be optimistic about the future

Gold implied premium/discount to real yield

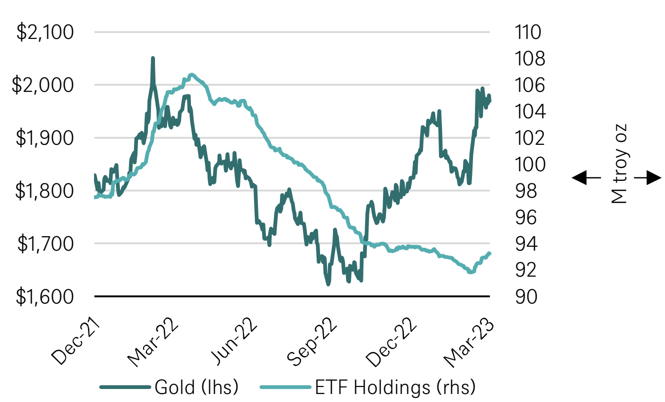


Source: Bloomberg, DWS. Real yield = 10Y real yields represented by U.S. Federal Reserve H15 constant maturity 10-year real yield curve rates. As of March 31,2023.

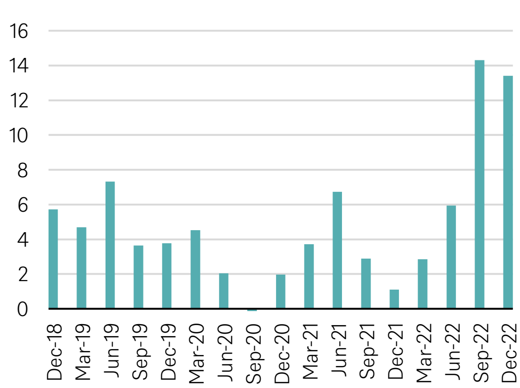
Central bank buying has ramped up while ETF holding are stabilizing

For starters, despite some obvious headwinds (U.S. dollar strength and rising rates), the gold price has been remarkably well-bid. While ETF flows turned negative in April 2022, total holdings appear to be bottoming. Meanwhile, other sources of physical demand have offset, keeping premiums to yield elevated. Chief among these drivers is central bank buying, which picked up significantly during 2H 2022 driven predominantly by China and Russia as they seek to diversify their balance sheets given the current geopolitical climate. We expect other central banks may follow suit, which would provide further support.

Gold price vs. gold ETF holdings



Central bank purchases of gold

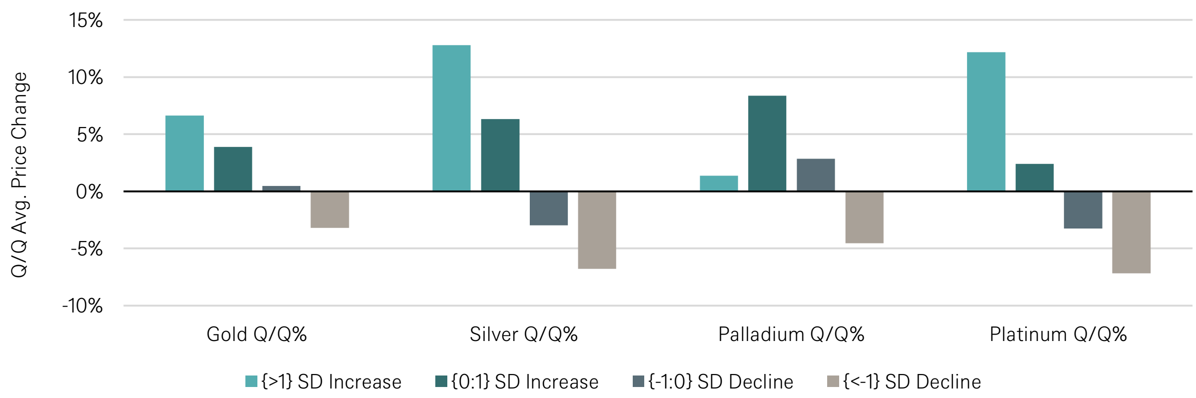


Source: Bloomberg, DWS. As of March 31, 2023 or latest available. Gold price = price per troy oz. of gold in USD. ETF holdings = total known ETF holdings of gold. Central bank purchases represents purchases of gold by central banks during each quarter. Figures represented in millions of troy oz.

The global money supply is undergoing extraordinary expansion

Additionally, we believe that gold has performed well despite high real yields due to extraordinary growth of the global money supply. Our analysis indicates a strong relationship (high correlation) between changes in the global money supply and the prices of gold and other precious metals, such as silver and platinum. Since March 2003, for each quarterly increase in the global money supply greater than 1%, gold has seen an increase of 6.6% (on average). Given that we expect this trend to continue, precious metals could benefit significantly, particularly if headwinds abate later in 2023.

Average price change per standard deviation of money supply expansion

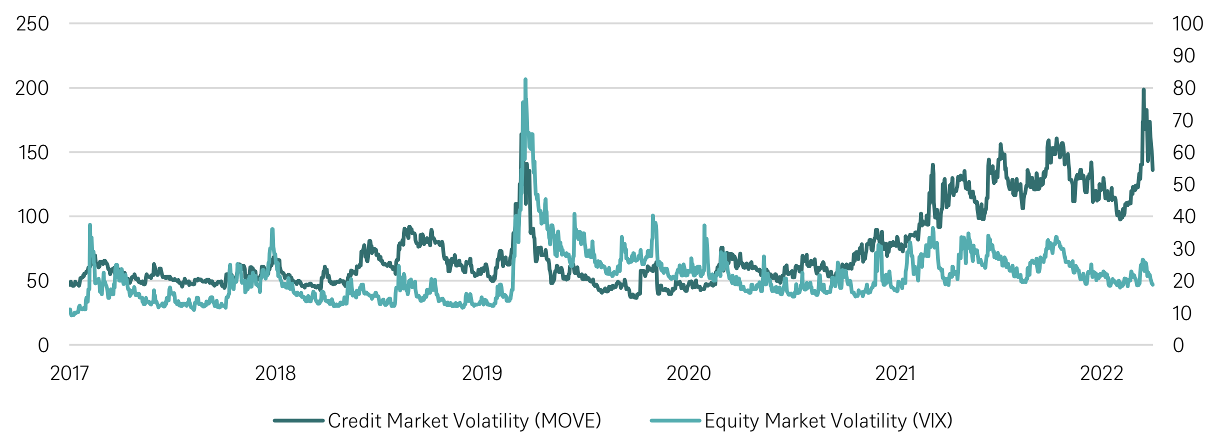


Source: Bloomberg, DWS. As of 12/31/2022. Represents average price change in each respective commodity during varying degrees of global money supply expansion (>1) or contraction (<1) based on standard deviation where SD = standard deviation.

Higher market volatility implies a higher risk premium for gold

Uncertainty remains high across equity and credit markets, which has translated into more market volatility. Post COVID-19, the "new normal" for equity markets (as measured by the VIX) is above the 20 level while credit markets have shown more acute signs of distress, particularly in recent weeks. This environment should be supportive of portfolio diversifiers and risk hedges, such as gold.

Market volatility



Source: Bloomberg, DWS. Credit Market Volatility = ICE Bofa MOVE Index. Equity Market Volatility = VIX Index. As of March 31, 2023.

Strength out of China is helping to stabilize global manufacturing PMI

While manufacturing PMI in developed economies continues to show weakness, Chinese PMI has taken a turn for the better in February. As a result, global manufacturing PMI has stabilized. Non-manufacturing PMI has also shown strength recently, lead by China and India which are the driving force behind improvements in global PMI. As global PMI stabilizes, we expect similarly outsized contributions from China and India to boost momentum in consumer demand for gold.

Manufacturing PMI breakdown by region

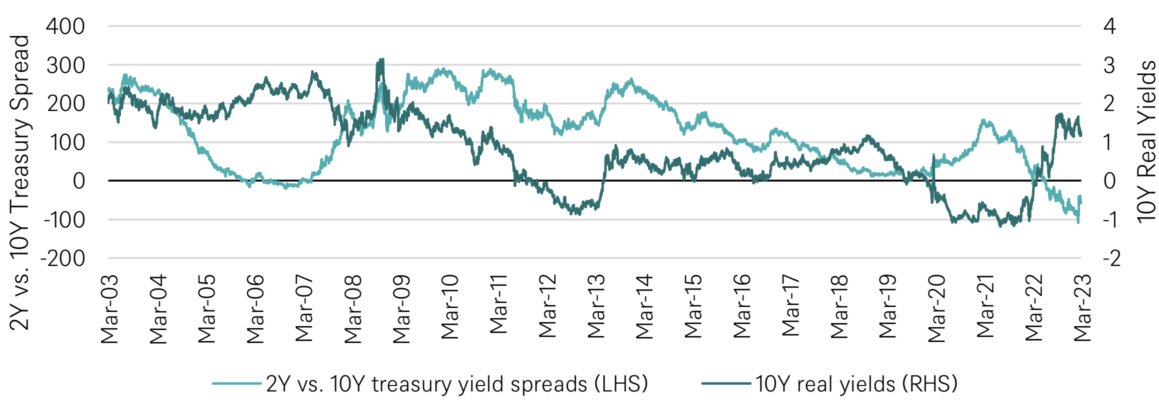
	Mar 2022	Apr 2022	May 2022	Jun 2022	Jul 2022	Aug 2022	Sep 2022	Oct 2022	Nov 2022	Dec 2022	Jan 2023	Feb 2023	Mar 2023
U.S.	58.8	59.2	57.0	52.7	52.2	51.5	52.0	50.4	47.7	46.2	46.9	47.3	49.2
Germany	56.9	54.6	54.8	52.0	49.3	49.1	47.8	45.1	46.2	47.1	47.3	46.3	44.7
France	54.7	55.7	54.6	51.4	49.5	50.6	47.7	47.2	48.3	49.2	50.5	47.4	47.3
Italy	55.8	54.5	51.9	50.9	48.5	48.0	48.3	46.5	48.4	48.5	50.4	52.0	51.1
U.K.	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9
Japan	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7	49.2
Taiwan	54.1	51.7	50.0	49.8	44.6	42.7	42.2	41.5	41.6	44.6	44.3	49.0	48.6
South Korea	51.2	52.1	51.8	51.3	49.8	47.6	47.3	48.2	49.0	48.2	48.5	48.5	47.6
China	48.1	46.0	48.1	51.7	50.4	49.5	48.1	49.2	49.4	49.0	49.2	51.6	50.0
India	54.0	54.7	54.6	53.9	56.4	56.2	55.1	55.3	55.7	57.8	55.4	55.3	56.4
Brazil	52.3	51.8	54.2	54.1	54.0	51.9	51.1	50.8	44.3	44.2	47.5	49.2	47.0
Global Manufacturing	53.0	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6
Global Non-Manufacturing	53.4	52.2	51.9	53.8	51.0	49.2	50.0	49.2	48.0	48.1	50.0	52.6	54.4
Global Composite	52.8	51.3	51.3	53.5	50.8	49.3	49.6	49.0	48.0	48.2	49.7	52.1	53.4

Source: Bloomberg, DWS. Table shows select countries/regions from Markit PMI Headline Release data tables as of March 2023.

Real yields have historically peaked when yield curves invert

Coming full circle on our discussion surrounding real yields, history suggests that we might be approaching a peak. An examination of 10-year real yields during periods where yield curves approached and/or entered into inversion territory suggests that real yields could begin their descent in short order. Already in the aftermath of the recent market turmoil within the U.S. banking system, we have seen a substantial flattening of the curve and corresponding move lower in 10Y real yields.

Yield spreads vs. real yields

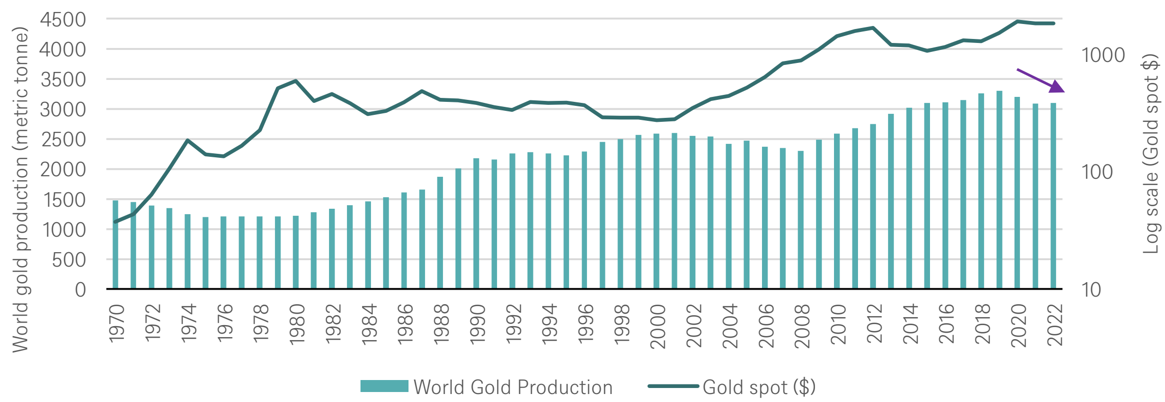


Source: Bloomberg, DWS. As of March 31, 2023. 2Y vs. 10Y treasury yield spreads represents the spread between 2-year and 10-year U.S. treasury notes. 10Y real yields represents U.S. Federal Reserve H15 constant maturity 10-year real yield curve rates.

Gold prices have exhibited an inverse relationship with gold production

Perhaps intuitively, gold spot prices have tended to rise following periods of falling gold production and decline or encounter resistance when production rises. History suggests we are entering a favorable period for gold prices as evidenced by falling production levels since 2017. Such favorable supply dynamics could help provide further price support for gold well into 2023 and beyond.

Gold spot prices vs. world gold production

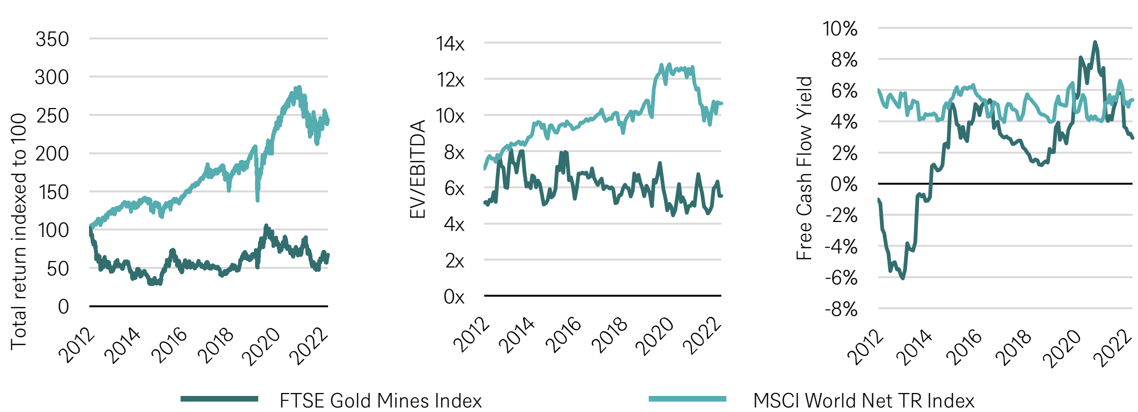


Source: Bloomberg, DWS. As of December 31, 2022. World gold production as reported by the United States Geological Survey.

Gold and precious metals equities are well-positioned for growth in 2023

Performance for firms with falling capital investment and rising cash flow has improved since 2021. We see the most favorable conditions for companies with the best combination of cash flow and near-term growth. Given that miners deplete available reserves with each year of production, regimes of extremely low levels of capital investment, such as the one we have been in for several years, are not sustainable over the long term. We have already seen miners begin to announce growth and replacement initiatives after many years of contracting budgets. Additionally, rising operating are costs driving a decline in margins as inflation makes its way through the business. We believe the best opportunities exist for companies which can deliver shareholder returns, fund development activities from ongoing cash flows, and offer downside protection due to superior margins and declining cost profiles. In the current environment, we have a positive view on gold vs. silver and platinum group metals (PGMs). Additionally, at present, gold miners are going through consolidation, which should favor mid-tier and junior minors with quality mining properties.

Performance gap has narrowed | Mean reversion is underway | Yields have increased



Source: Bloomberg, DWS. AS of March 31, 2023.

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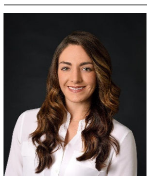

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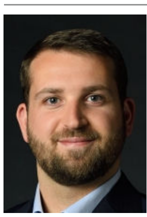

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Important information