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CIO remains cautious and suggest investors avoid chasing the rally in gold. (UBS)

Gold retreats from all-time highs

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Gold prices hit a fresh record this week, reaching an intraday high of USD 2,135 per ounce on Monday amid growing confidence that rates have peaked and cuts could soon follow. Federal Reserve Chair Jerome Powell said on Friday that "the risks of under- and over-tightening are becoming more balanced."

Relatively dovish comments from historically hawkish Fed Governor Christopher Waller added to the upward momentum for gold. A dovish rate outlook is helpful to gold prices, since it reduces the opportunity cost of holding non-interest bearing assets.

Against this backdrop, we recently upgraded our price forecast for gold. However, Monday's rally went into reverse, with gold trading at USD 2,025 at the time of writing, and we think the immediate upside for the metal remains limited, for various reasons:

Markets have gone too far in pricing a swift run of rate cuts from the Fed next year, in our view. The US economy is slowing from the above-trend 5.2% annualized pace in the third quarter. However, markets have moved quickly to price in easier monetary policy, implying around 150 basis points of rate cuts in for 2024, and a 60% chance the first reduction comes in March. This looks too aggressive to us, with current conditions more consistent with 50 to 75 basis points of cuts, most likely beginning in the second half of 2024.

Safe-haven demand for gold arising from geopolitical risks could become less pronounced. Gold often serves as a hedge in a risk-off environment, and it rallied in the wake of the Hamas attack on Israel on 7 October. However, many investors appear to have become less worried that the conflict will escalate and disrupt oil supplies. This is evident in other markets. The price of Brent fell 5.2% in November and is down a further 5.2% so far this month. The VIX index of implied US equity volatility, a common measure of fear among investors, is trading at 13—well-below the average of 20 since the 1990s. While gold remains a useful hedge in the event of an escalation, such demand is likely to become less pronounced.

A further rise in gold would likely require strong inflows into exchange traded funds. Our short-term model suggest gold's "fair value" is now closer to USD 1,950/oz. However, the more than 12% rally this quarter has been built on fairly light market positioning. Central bank buying has been part of the reason for the climb in gold prices, tracking at a record annual addition of around USD 1,180 metric tonnes this year. A further rise from current levels, however, would likely require a more convincing increase in ETF inflows, compared with the more modest ebb and flow of trade seen in recent weeks..

So, in the short term, we remain cautious and suggest investors avoid chasing the rally in gold. At the same time, we have raised our forecast by 100 USD/oz across all tenors, and now see prices trading as high as USD 2,250 per ounce in a year's time. Gold performance in the wake of the Israel-Hamas war supports our view of its importance in long term portfolios, and we think a percentage allocation of around mid-single digits is appropriate within a balanced portfolio. Ultimately, we favor adding exposure on dips below USD 2,000.

Alongside gold, we see several ways investors can hedge against various risks. Investors worried about the potential for an escalation in the Israel-Hamas war, or the war in Ukraine, can consider adding to oil market investments or energy stocks. Protecting portfolios against equity market sell-offs has become more affordable too. Low implied equity volatility generally results in better terms for structured investments with capital preservation features. Finally, macro hedge funds can take advantage of volatility generated by shifts in the economic landscape, central bank policies, and market conditions.

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