MKS PAMP GROUP

Metals Strategy | Golds & Stagflation/Inflation

October, 2021

A few thoughts on stagflation/inflation, the energy crisis, and why Gold remains stagnant ahead of CPI tomorrow

Despite the growing narrative of stagflation, mostly accelerated by the recent energy crisis, Gold has failed to regain $1800 or react in any meaningful way. There's macro *concern* over inflation trends, theres no macro fear* and theres been a range of other asset classes from cryptos to US Equity Indices, and commodities (Oil & Copper) which are vying for the same inflation hedge label & competing with Gold.

To be clear, theres not much 'stagflation' in the explicit definitional sense; there's merely <u>upside</u> risks to inflation (as tapering hasn't kicked off and supply chains remain clogged) which is getting to the point that its driving <u>downside</u> risks in growth. US growth of >6% in 2021, recalibrating down to 3-4% in 2022 is hardly stagnating, but we/financial markets/media, tend to talk in extremes in order to get points across.

Two major asset classes <u>are</u> buying the idea that inflation is transitory; US bond yields have remained relatively low by historical means, and Gold has failed to regain its post COVID highs, despite US putting in 4 CPI prints of >5%. If Gold is right, this is only transitory inflation. Period.

Theres good inflation and bad inflation… The former is inflation + growth where reflation assets rise steadily *and* theres a belief the Fed will be ahead of the inflation curve. That's the current thinking and Gold – being the emotional asset as well a scorecard on the Fed – is internalizing a broad-based acceptance that Powell will seamlessly navigate a tough exit of their extraordinary measures.

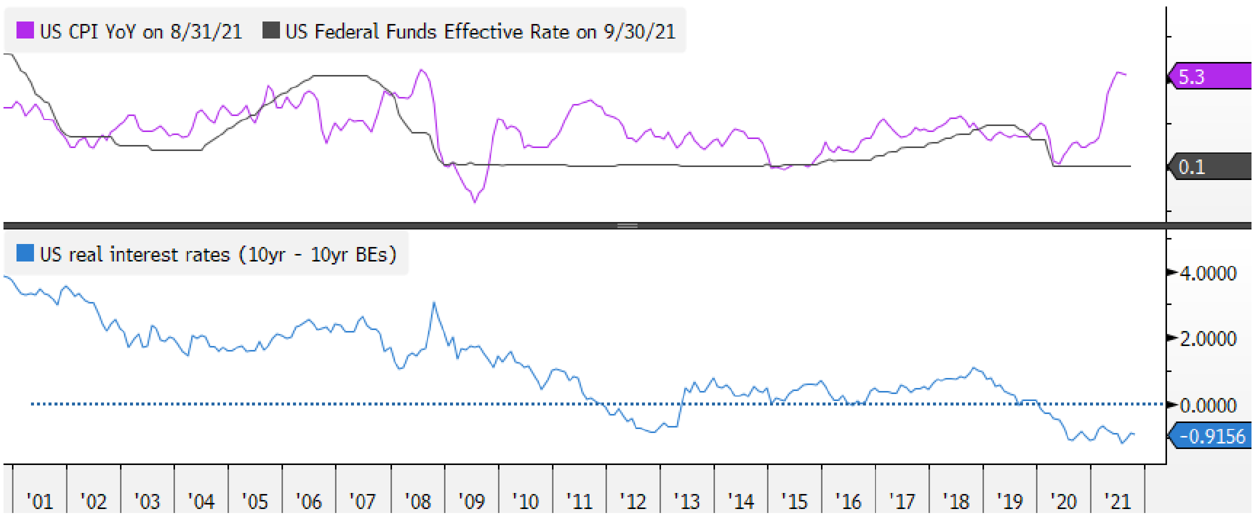
Then theres bad inflation – the statement inflation headline across newspapers, gas lines/energy shortages, but generally its when prices eat notably into growth & earnings. The recent downgrades in US growth forecasts hinges on a "decline in consumer goods spending" (i.e.: things are either simply not available, or too expensive). Ironically, the well advertised shortages of goods (and subsequent advice from US media pundits to buy their holiday goods *now*) fuels an overreach that will only accelerate price rises; inflation will accelerate if the consumer hits offers, as that implies theres a belief that prices will be more expensive tomorrow than today. Inflation expectations are already rising (consumer inflation expectations hit a new high – over 8year period history - in todays N.Y. Fed Survey). In addition, energy has repriced (NG prices in Europe/UK are at the oil equivalent of >$200/bbl!) to the point where its share of GDP (and thus influence on US stocks), is back up at 7% of GDP. Bernstein stated that "Energy costs as a percentage of GDP increased to 7% this month. History shows that the probability of a recession increases when energy costs exceed 7% of GDP for a prolonged period of time (>1 year)". Its too early for recession calls, given this energy rally is still so new/early, but its requires monitoring. See chart 2 below.

Theres equity inflation, on top of headline inflation (CPI), and inflation expectations that all together impact gold. Gold is a decent equity inflation hedge (as proxied by ETF holdings), and thus given the sideways price movement in US equities, theres no additional impulse to add to Gold holdings and thus theres been some (ETF) leakage. Headline (CPI) inflation hasn't remained elevated for long enough to really jumpstart a fear of inflation in Main Street (yet alone Wall Street), given stupendous consumer savings. And inflation expectations, while up, aren't running away. *Theres a concern for niggling inflation but that's brought forward Fed tapering and/or hiking expectations, which negates any positive tailwind. If theres a FEAR of inflation, that's likely associated with little confidence in the Feds ability to control it and only then (aka 1970s/80s) do we see runaway Gold/Silver pricing.

Short-term trading CPI tomorrow: the market is lying neutral to short, and there is confidence in the Feds exit plan. Until those 2 core underpinning change, the thinking is that any data print (Jobs or CPI) that drastically brings forward rate hike & taper expectations, is negative Gold (ie: a CPI print that is too hot/high will lure in the persistent macro selling). IF that is *not* the case, then it would be a change in sentiment that is worth respecting, marking Golds newfound sensitivity to inflation. A goldilocks (*not to hot not too cold*) CPI print ensures some inflation and a slow Fed taper, which is mildly supportive Gold. The risk is a low print (transitory inflation, no taper?), which theoretically should be positive gold, but given its preference for short-lived rallies and finding any reason to sell off, not rally, that's unlikely the case. The confusion in how to interpret Golds response during this Fed transition period is palpable making for messy trading; no wonder that confusion in and of itself, is enough to deter investment/participation.

US CPI outrunning Fed funds target rate

Negative real interest rates & looser Fed policy supportive for precious



Source: MKS PAMP Group, Bloomberg

CPI YOY Index (US CPI Urban Consumers YoY NSA) US CPI real rates infl2 Monthly

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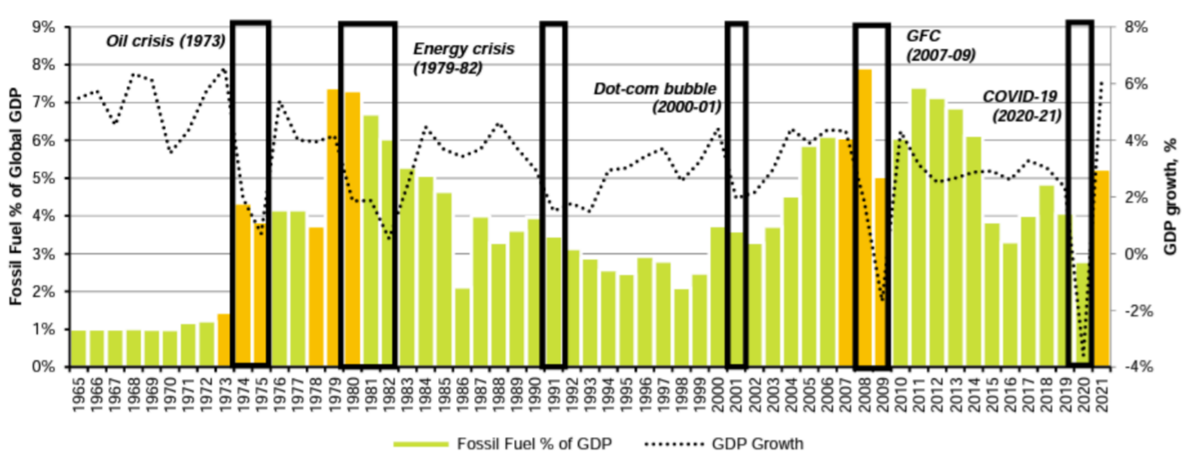
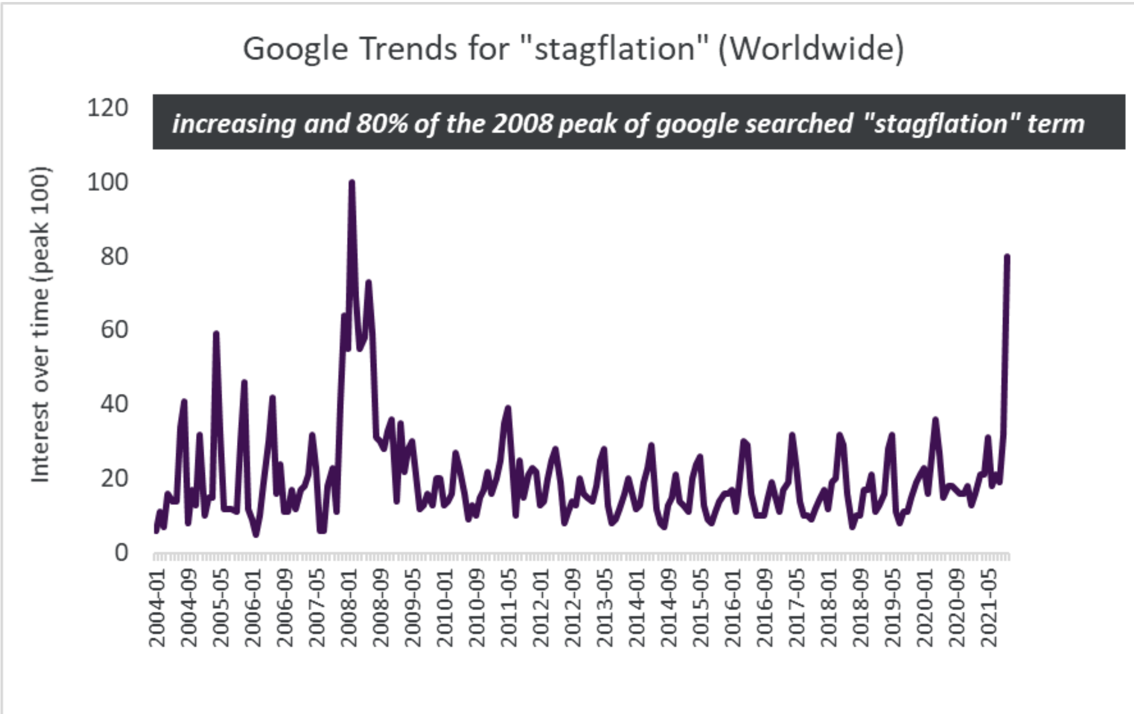
EXHIBIT 1: **Rapid increase in the cost of energy or at levels above 7% have generally coincided with recessions**



Source: BP Statistics, Bloomberg, IMF, Bernstein estimates (2021) and analysis



Source: Bloomberg, MKS PAMP Group, Google Trends