MOTILAL OSWAL
Investment Services

Precious Metals Quarterly

19th September, 2022

Synopsis

Central bank the primary focus

Central banks policies continue to be one of the driving factor in market. Major central bankers globally have announced an aggressive policy tightening measures to control the inflationary pressure.

Investment demand

Investment demand for gold eased in the previous quarter hurting market participant's sentiment. Any revival in the ETF flows and overall demand good bring back some confidence in market.

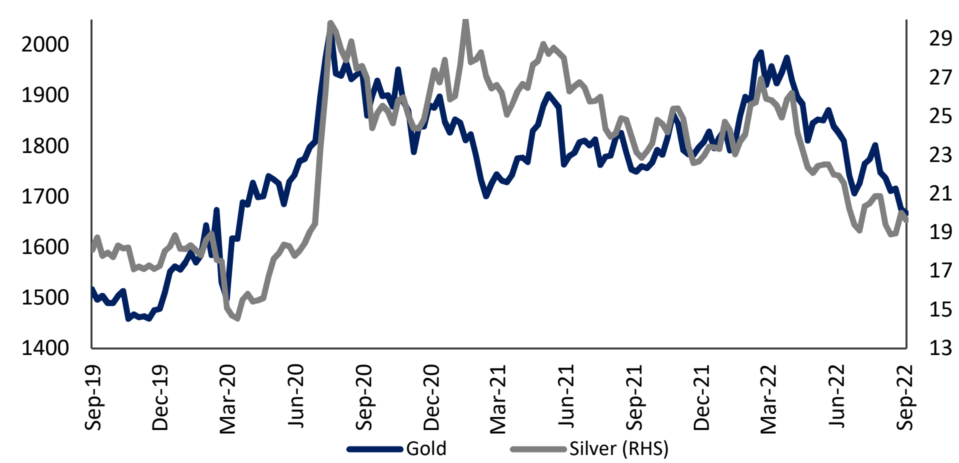
Outlook

Decision and statements coming from Central banks will continue to play an important role in future direction of the metal. Volatility in Dollar Index and Yield will also be a key factor. Inflation data along with other economic data points showing health of the economy will also be in focus.

Gold performance table- COMEX	
Year	*%*
CY 2018	*-1%*
CY 2019	*17%*
CY 2020	*25%*
CY 2021	*-5%*
YTD 2022	*-9%*

SWOT Analysis for Gold	
Strength	**Weakness**
• Geo-Political Tensions	• Volatile oil prices
• A global trade war/emergence of protectionism	• Dollar and Yields Strengthening
• Slower global growth	• Major central Banks hawkish stance
• Gold: hedge against inflation	• Strong economic data
• Recessionary Fears	• Negative ETF flows
• Hike in import duty on Domestic Front	• Sell off in speculative positions
• Continued central bank gold buying	• Strong U.S. labour market
Opportunities	**Threats**
• Emergence of further slowdown	• Ease off in global tensions
• Reversal in speculative positions	• Increase in risk appetite
• Festive and Wedding season demand	• Aggressive rate hike expectations
• Shift in Central Bank stance (from Tightening to Easing)	• Ease off in supply chain disruptions
• Gold/Silver Ratio near two year highs	• Sharp spikes in U.S. Dollar and Yields
• Further upside in USDINR	

COMEX Gold and Silver Prices ($)



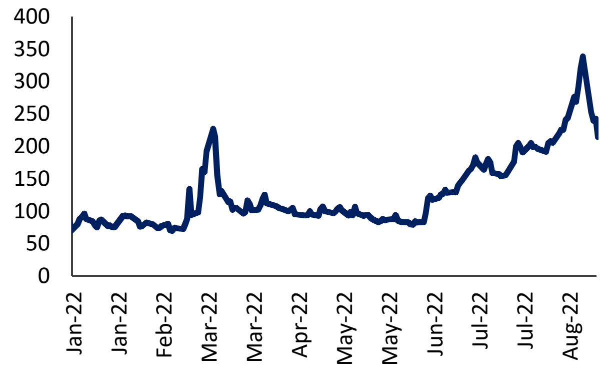
Fundamentals

Russia-Ukraine, Covid updates, Central Banks policy tightening action, slower global growth fears, sharp move in U.S. Yield and Dollar are just a few variables that are simultaneously affecting the market sentiment. At start of the year both gold and silver witnessed a sharp rally, with market participants grabbing opportunity and booking some profits near multi year highs. Central banks action was on the forefront, while geo-political tension took a back seat thereby pressuring metal prices.

Ease off in overall war, political game plan and sanctions are leading to a spill over effect on various commodities - primarily energy prices. For a year, Europe has lived under the shadow of an energy blockade as Russian President threatened to turn off the gas taps to the continent. Now the threat has become reality and the prospect of a cold, dark winter is hitting Europe. Russia announced shut down of its Nord Stream pipeline for as long as Western sanctions are in place, sending the already elevated European gas prices up by another 30%, thereby taking the total gains for the year to over 200% on YTD basis.

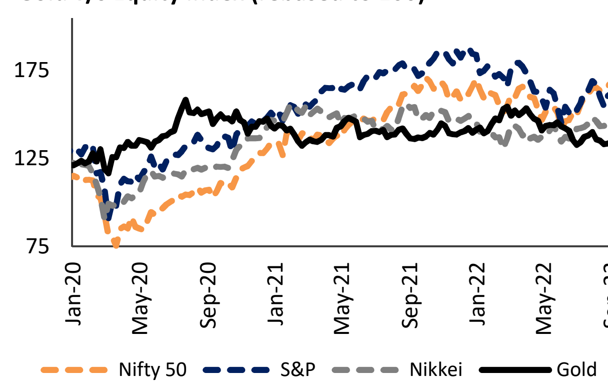
Multiple build-ups in the macro economic scenario has increased the pressure in the metals complex. Rising inflationary concerns is still a theme in the market and with major central banks having changed their stance to hawkish and announcing actions to control price pressures. Aggressive move by fed is also giving rise to chatters regarding global growth slowdown and recession. Let's take a look and understand these fundamentals and how it will further give direction to gold and silver prices.

TTF Monthly Energy Future (€)



Source: Reuters

Gold v/s Equity Index (rebased to 100)



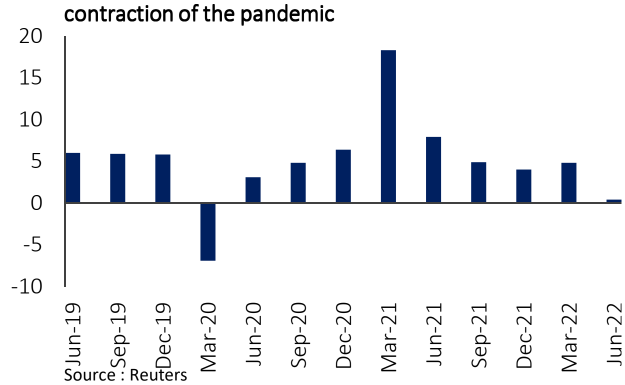
Source: Reuters

Geo-Political Tensions

Let's take a glance at the geo-political tensions which was the highlight of previous quarters and created quite a stir in market. We witnessed Russia announcing attacks on Ukraine at the initial stage to force the latter into not joining NATO, which was followed by full blown attacks on Ukraine to capture the nation. It's been almost 200 days of Russia-Ukraine war, and there have been lots of sanctions, threats and other measures taken by Russia and other major economies to increase pressure tactics, but Ukraine seems to be holding the fort well.

Let's talk about one more important event that has and is still impacting market especially China, i.e. pandemic. Globally most economic data points are back to pre-pandemic levels and are recovering well, although in China, where it all supposedly started is at the mercy of the Covid spread once again. They were quick to announce strict lockdown measures and mass testing for citizens. This swift action helped them to control the spread although lockdown measures have impacted the demand and supply dynamics, further disrupting commodities.

China's economy has avoided a second contraction of the pandemic



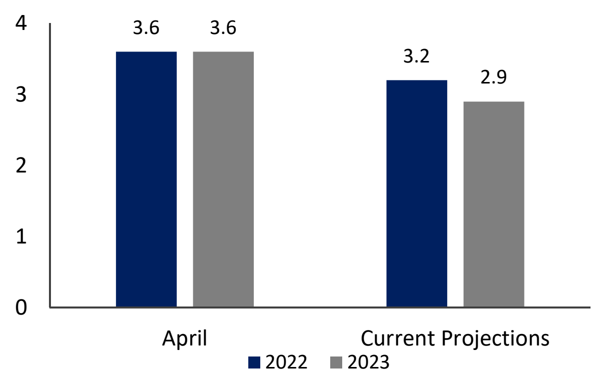
Source : Reuters

Growth Concerns

There are a lot of concerns regarding the global growth prospects as post pandemic, inflationary concerns, geo-political tensions one after the other are continuously affecting the market sentiments. After a sharp surge in Crude Oil there was a lot of noise regarding rise in recessionary fears. With various institutions revising their growth forecast lower, market experts are expecting a stagflation like scenario developing in the market.

The IMF has slashed its global growth forecasts to 3.2% in 2022, down 0.4% from its April estimates and to 2.9% in 2023. They also raised their projections for inflation to reach 6.6% in advanced economies and 9.5% in emerging markets , warning that risks to economic outlook are "overwhelmingly" tilted to downside.

IMF Global Growth Forecast(%)

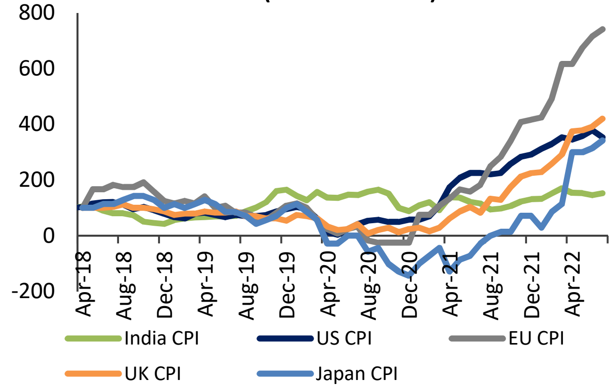


Source: IMF

Inflation v/s Recession

Rising Inflationary concern still is a big concern for the market, in the previous quarter we were ~5% w.r.t headline YoY inflation number from the U.S. whereas currently we are around 8%. Russia - Ukraine has definitely been a big drag on global food production. The Ukraine conflict came in at a time when food prices were already being pushed upwards by a range of factors, mainly droughts affecting key crop producing countries and supply chains dealing with residual effects of pandemic. In poorer countries whose economies have been left in tatters by Covid-19 lockdowns, the war only exacerbated a grim situation.

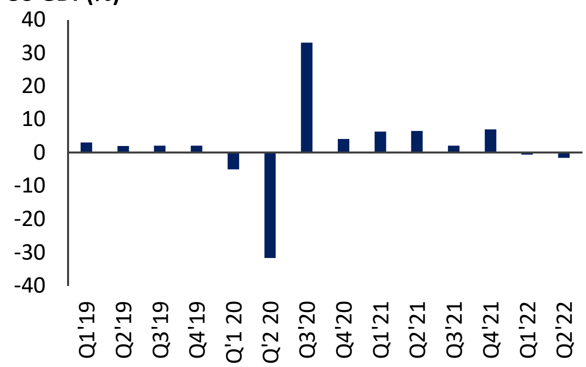
Global Inflation Trends (rebased to 100)



Source: Reuters

Economic data in U.S. are sending mixed messages, complicating the answer to a seemingly simple question: ***Is the world's largest economy in a recession?*** We recently witnessed Q2 Advanced growth number which increased the debate regarding recession even further. The NBER characteristics recession as a significant decline in an economic activity that is spread across the economy and lasts more than a few months.

US GDP(%)

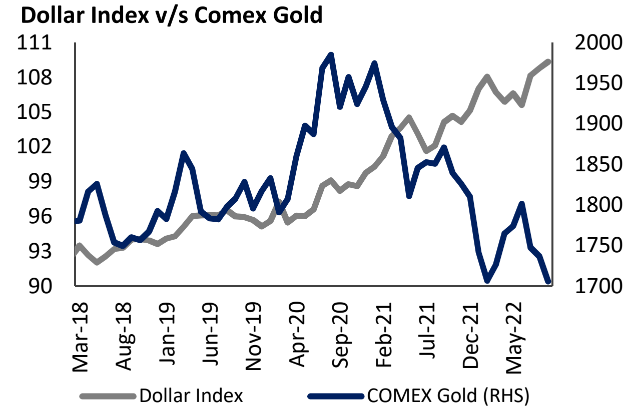


Source: Reuters

Dollar Index and Yields on the Rise

Since the beginning of 2022 we are witnessing sharp volatility in Dollar Index and Yields. Investors took shelter under Dollar which is rising against its major crosses and is also gaining momentum as a safe haven currency. Dollar and gold have an inverse correlation; but this is not a thumb rule as it moved in sync during the Russia-Ukraine war. Dollar gained momentum as the Fed announced its monetary policy tightening action and plans to reduce liquidity in the market. Dollar index was hovering below 100 mark at start of year, and has added over 10% gains over the last few months backed by above factors.

Dollar Index v/s Comex Gold



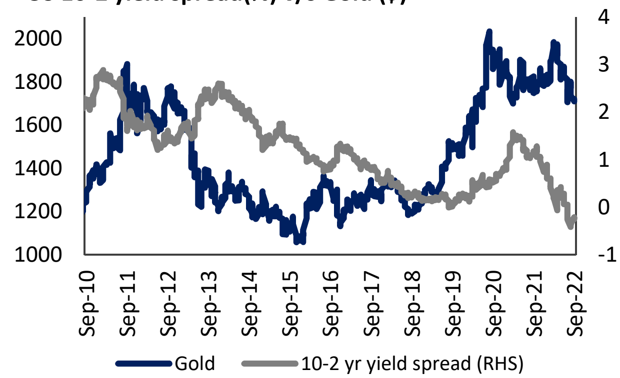
Source: Reuters

U.S. yields have been another interesting aspect to watch for in this kind of market situation. Taking an e.g. of U.S. benchmark 10 year yields was ~1.7% at start of this year, while currently it is hovering around 3.4%.

Growth and recessionary concerns are on the rise and it is very important to understand the Yield curve and its significance on the market. During the pandemic, yield curve did invert for a brief period giving away the recession risk, although it did not sustain and the growth numbers bounced back. In 2022 we are again facing similar circumstances with newer challenges, which is putting pressure on global growth and this is reflecting on the Yield curve as well. Yields of benchmark 10-year yield has been increasing ever since the Fed has announced the interest rate hike in the month of March of 2022.

In the month of April, the difference between 10-2year yield spread touched the zero mark raising fears in the market, although it reversed from there. Towards the end of Q2, we saw an aggressive stance from the Fed and other major central banks, while Yield curve has inverted once again and many are predicting a recession lying ahead of us in the next year. These fears of global growth slowdown will only subside once yield curve normalizes. It is interesting to see that, in that past 40 years, every time 10-2 year spread has gone below zero, recession has followed.

US 10-2 yield spread(%) v/s Gold ($)



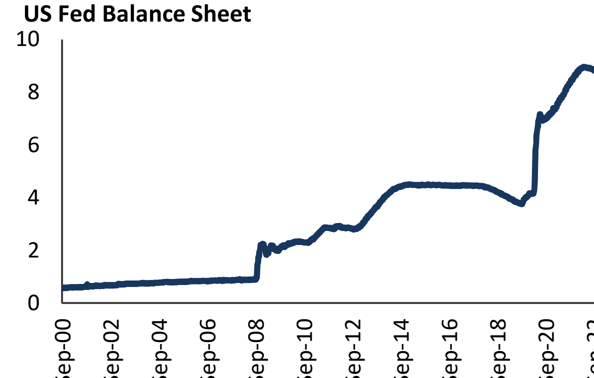
Source: Reuters

Central bank the primary focus

Central banks policies continue to be one of the driving factor in the market. We have seen a sudden change in stance from major central bankers who took the global market by a storm. After emergency rate cuts and stimulus measures, inflation was starting to become a concern and market participants were expecting central banks to act on it more quickly.

U.S. annual inflation is currently around 8% which is way higher than Fed's target rate of 2%. Federal Reserve has picked up an aggressive pace and as along with tapering of the $120bln asset purchase programe, the U.S. central bank has also announced a steep hike in interest rates along with balance sheet trimming. Fed in 2022 has increased rate by ~225bps and are expected to raise rates further. Fed officials in their comments keep mentioning that next interest rate decision will be based on future economic data points and overall impact on inflation. Market participants are discounting third 75bps rate hike in the September meeting and along with increase in pace of balance sheet of trimming with an objective to tame rising

US Fed Balance Sheet



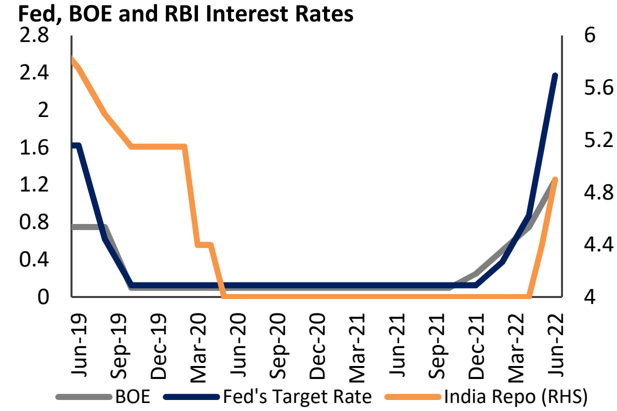
Source: federalreserve.org

inflationary pressures. With growth concerns rising, we need to keep an eye on whether the Fed budges a bit in their aggressive rate trajectory or will it continue to focus on inflation?

On other hand, BOE continue to raise rates by another 25bps to 1.25% underlining its resolve to fight soaring infaltion. CPI inflation is expected to rise more than forecast in the May Report, from 9.4% in June to just over 13% in 2022 Q4, and to remain at very elevated levels throughout much of 2023, before falling to the 2% target two years ahead.

It will be very important this year to keep an eye on the central banks actions and its impact on inflation. Governor Powell continue to signal an hawkish stance w.r.t interest rate, whereas other central banks like ECB are also joining this boat.

Fed, BOE and RBI Interest Rates



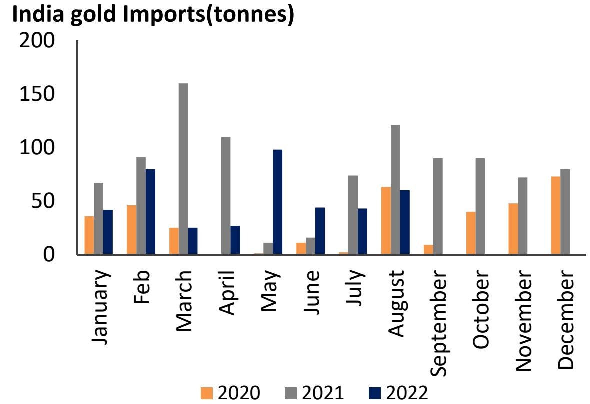
Source: Reuters

Import trends

India's trade deificit widened to $125.22 bln in Apr-Aug this ficsal as against $53.78 bln in same period last year, whereas rupee since the 2022 has deprciated by more than 5-6%. This including the global factors have increased the reasons to worry on domestic front. Even though there is a steady demand for the metal especially when the prices are lower, portoflio of market participants is getting diversified, as interest rate from major central bank pick up an aggressive stance. Last year after the pandemic, we witnessed good import data, ~1000 tonnes.

This year also we are witnessing good inflow since the start, we are sitting fairly above 300 tonnes in this half year. Although to reduce the deficit and control currency volatilty, GOI announced rate hike in gold by 5% and abolishing the Social welfare cess bringing the total duty to 15% (incl. to Agri cess of 2.5%). This decision will put a dent on demand in the short term, although lower prices, wedding and festive season will keep the demand elevated.

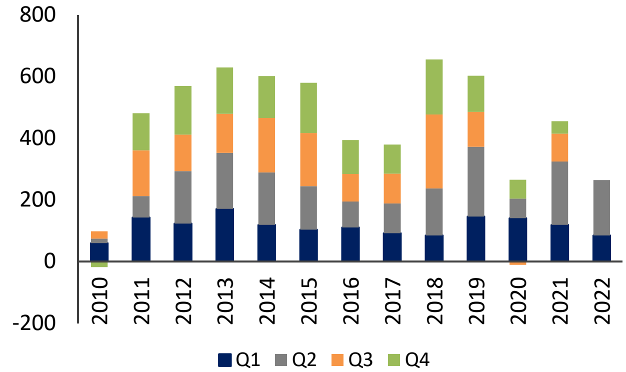
India gold Imports(tonnes)



Source: WGC

Rising trade deficit and current account deficit has been a common problem for the indian economy. Along with gold and crude we are witnessing a sharp rise in import number of silver. As the prices have dropped in the near term, market participants are extending their investment in the white metal as well. In CY'22 total import of silver are slated to more than triple over 2021. India's total import till now in this year is expected to jump by 8200 tonnes; we are already more than 5000 tonnes. Hence, strong demand from industrial sector and substitution demand for gold and other metals will keep the prices supportive.

Central Bank net Gold purchase (Tonnes)



Source: WGC

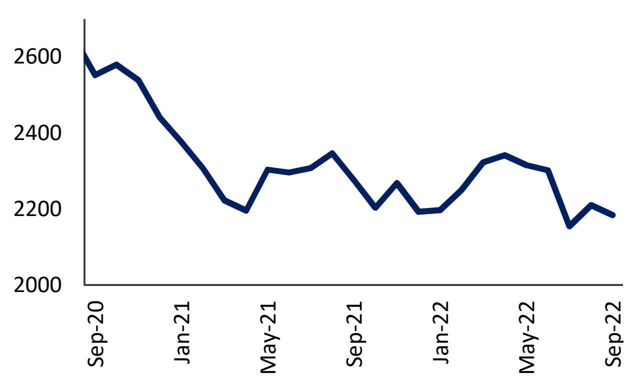
Central banks continue to accumulate gold

After the pandemic, few central banks were on back foot in terms of increasing their gold reserves. As mentioned in our previous report, we did see some slowdown in the pace of buying although we could still see some consistency in the overall buying trend. Central banks bought 180t of gold in Q2, lifting H1 net purchases to 270t. Gold's performance during a crisis and its role as a store of value are key drivers of central bank demand for gold.

According to WGC, H1'22 net purchases of 270t are virtually in-line with the five-year H1 average of 266t, illustrating the strength of buying amid global instability. A small number of central banks were responsible for the vast majority of purchases made during H1, Turkey was the biggest buyer during the first half of the year, adding 63t to its gold reserves (32% of total reserves). Egypt was the second largest purchaser in H1, reporting a 44t (+54%) increase in March. The country now holds 125t of gold, or 21% of total reserves. Meanwhile, India continued its buying throughout H1, with gold reserves rising by 15t over this period.

With questions rising everyday regarding global growth and rising uncertaitnies influenced selling in many countries to keep up with the volatile market sentiment. Several central banks reduced their gold reserves during H1. Kazakhstan was the largest seller YTD, with gold reserves dropping 18t to 384t. Most of selling occurred in Q1, followed by a switch to net buying of 16t in Q2.

Gold ETF holdings (Tonne's)



Source: WGC

Demand and supply activity

According to WGC, Gold demand was 8% lower YoY at 948t. Combined with Q1 this took H1 demand to 2,189t, up 12% YoY. As gold price fell in Q2, gold ETFs lost 39t, giving back some of strong Q1 gains. Net H1 inflows totalled 234t compared with 127t of outflows in H1’21. Bar and coin investment (245t) was unchanged from Q2’21 as a sharp drop in China was offset by growth in India, Middle East and Turkey. Q2 jewellery consumer demand reached 453t, 4% higher YoY, although comparison is with a fairly weak Q2’21. Total H1 jewellery demand of 928t was 2% below H1’21.

Total H1 supply increased 5% YoY to 2,357t on higher mine production and recycling supply. Preliminary estimates suggest the industry hedgebook was unchanged in H1. Mine production in H1 increased 3% YoY to a record level as volumes in China recovered following safety stoppages last year and higher grades were mined in large operations elsewhere. Recycled gold volumes in Q2 rose by 5% YoY, lifting H1 recycling to its highest level since 2016.

For gold and silver, a key price driver lately hasn’t been supply and demand, but uncertainties. Although, trends in ETF and CFTC and other investment demand flows cannot be ignored. We are near lows of these net positions and historically it has seen a reversal, especially in gold, providing a sentiment booster.

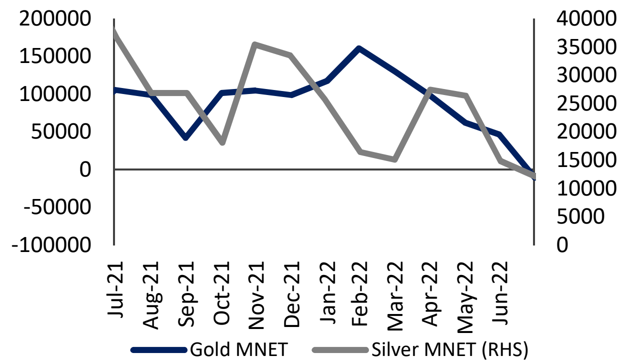
According to world silver survey 2022 report from silver institute, global silver mine production is expected to grow further in 2022, with output forecast to rise by 2.5% y/y to 843.2Moz (26,226t). Recycling is set to increase for a third straight year in 2022 with a 4% gain forecast. Just like base metals, investment in further silver exploration and development will be needed to sustain mine production.

Industrial demand is expected to rise 6% to a new record high this year. On top of global GDP growth, end-use in the green economy will benefit from rising vehicle electrification and as the geopolitical conflict also boosts investment in renewables, especially photovoltaic. Jewelry fabrication is expected to rise again this year, by 11% and surpassing 2019 level. Silverware demand is forecast to see another year of Indian-led recovery in 2022, although the 23% rise still leaves the total 15% down on 2019.

Silver Fundamentals

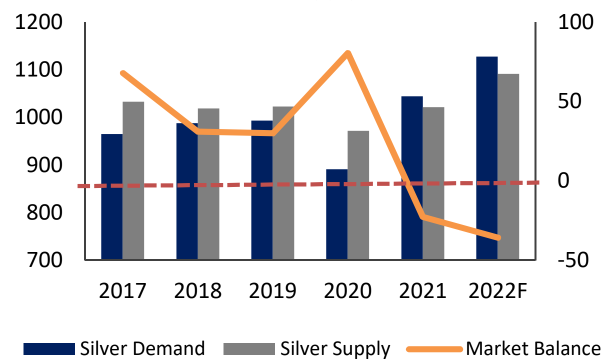
We have talked about different variables changing the market sentiment, which has forced the silver price to change its course in

Speculative Positioning



Source: Reuters

Global Silver Demand and Supply



Source: silver institute

the recent times. Falling at the mercy of swift Dollar moves and chatters regarding slower global growth and issues regarding china's economy hurt market mood triggering a selloff in silver. Not only did we see a shaky momentum in investment demand, but also an increase in net short positions.

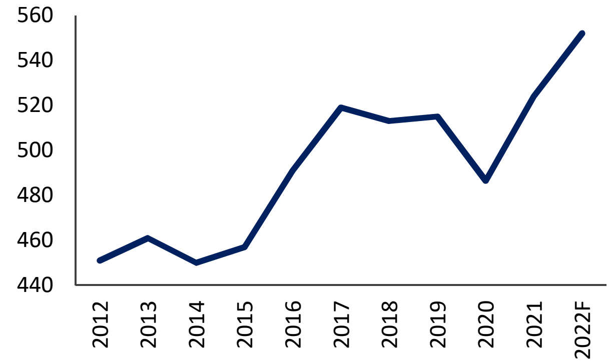
Silver is both a precious metal as well as industrial metal. More than 50% of silver is used for industrial purposes, hence any slowdown in global economy impacts the base metals along with silver. We are currently at such a stage wherein raising interest rates to bring down inflation has become very necessary. Just to paint a scenario, aggressive rate hikes and other measures are sucking out liquidity from the economy pushing growth numbers to the lowest levels, while higher inflation amidst rise in wage, food, oil price, supply chain issues and strong jobs number is sending mixed signals to the market.

MCX Silver has seen two recessionary periods till now i.e. 2008 and 2020, in both cases silver prices witnessed a severe fall initially as the industrial demand was hit and later on it picked up pace posting even strong return in that particular year. In 2008 and 2020 silver initially fell by around 40-45% respectively, although the immediate rally after that was at an average~50%+. If such a scenario plays out where we enter a recessionary phase we could witness history repeating with silver posting gains as a safe haven asset.

In another scenario, where recession does not hit the market and growth starts to pick up with inflation calming down and fed also easing their pace of rate hike, this would not only give an industrial push to silver, but also lift its safe haven appeal.

PBoC reduced their medium term lending rate through which it provides one year loans to the banking system by 10 bps to 2.75%, and highlighting anxiety in Beijing over shrinking consumer demand. There are a lot of concerns that China is facing simultaneously, country's economy barely escaped contraction in Q2, while a consumer and factory activity faltered in face of repeated pandemic lockdowns. Chinese investors, hit by market sell off and widespread defaults in country's stricken property market. Strict quarantine and zero Covid policy however remain main drivers of overall pessimism in the market. With rising energy costs and inflationary concerns globally there is a big question regarding the demand scenario. Most

Silver Industrial Demand



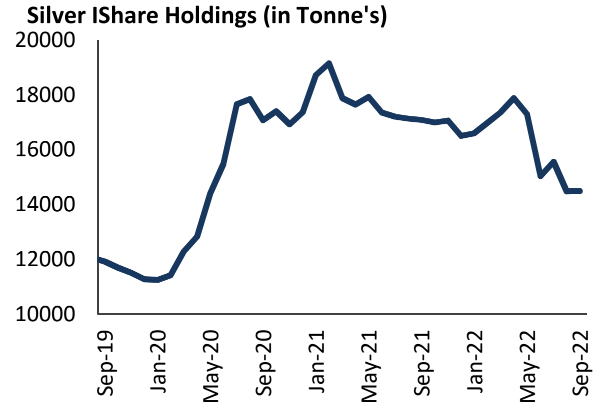
Source: silver institute

MCX Silver Price

Source: Reuters

of Industrial metals along with silver, are struggling amidst the concerns in world largest consumer.

Silver ETF witnessed an outflow of ~1935 tonnes since start of this year. In Q1'22 saw an inflow of ~860 tonnes, although later on amidst fall in prices, some pressure in the sentiment was seen. Silver ishares was at ~16600 tonnes at the start of this year, and currently is marked at ~14500 tonnes.



Source: Reuters

Silver also has a strong story on Industrial demand and green technologies front i.e. development in Auto, Solar and 5G technologies shows a promising support for silver. On a longer term scenario, demand consumption from renewable sector could start to pick up as well. The whole story around de-carbonization and whole ESG transition that's taking place in the economy will push demand for green technologies. According to silver Institute a supply deficit for silver market in 2022 could be seen, amidst the efforts regarding the de-carbonization push and rise in overall industrial demand.

Source: Reuters

A quick look at Gold/Silver Ratio is also very important as from the highs of ~127 in 2020 it made a low of ~65 last year and was hovering ~75-79 till the previous quarter. Towards the end of August'22, this ratio again tested important resistance of ~97 abd again started its journey lower, currently hovering near ~86, creating a good picture for silver.

Outlook

The recent trend in gold has been negative feeling the pressure from Fed's aggressive interest rate stance, volatility in Dollar and fluctuation in bond Yields. As the Fed moves to raise interest rates with an attempt to lower inflation, it will also be important to witness the move in Real Yields. These factors could continue to be a hindrance for the prices keeping market participants interest off the safe haven asset. Along with these factors, revival in ETFs inflows and rise in net long positions for both gold and silver will be important for a boost in sentiment. We continue to maintain a neutral stance for gold, as along with negative factors like geo-political tensions, fears regarding slower global growth, central banks gold buying activity, increase in demand ahead of wedding season and upside in USDINR, could lend support to prices.

For the white metal, along with above mentioned factors which could impact its safe haven traits, we have to also keep an eye on the movement in Industrial metals, which have fallen by almost 30-40% this year. Currently global growth slowdown is impacting the demand prospects for silver. As explained above, we could witness a sharp reversal if we enter a recessionary phase amidst increase in safe haven appeal. Whereas, a revival in growth kind of a scenario could initially be a con for prices, but could later on support the industrial metals demand. For a longer term play, we also have the green technology development which could lend support to prices.

To summarize, till the time Fed's aggressive pace doesn't ease up a bit and panic overall does not settle, we could see this consolidation keeping market participants on edge; hence for this quarter, we continue maintain a neutral stance for gold. Similarly, keeping in mind the various discussed scenarios, silver's stance is kept as side ways to positive. Both metals are still testing waters and could give better entry levels to market participants in the coming quarters. On longer term horizon market participants should look to create fresh positions on buy side once overall panic cools off in market.

We have tabulated our accumulation zone and medium to long term targets in the below table along with critical negation points which if breached could turn the trend for the metals.

Commodities	CMP	Accumulation Zone	Negation Zone	Medium Term Target*	Long Term Target**	Expected Upside (%)
Gold (Rs.)	49200	46800-47500	45500	53000	58000	8-17
Gold ($)	1665	1590- 1610	1540	1750-1810	1980	
Silver (Rs.)	56800	53500-54000	50000	64500	73000	13-28
Silver ($)	19.30	18.30	17.30	22	25	

*Medium Term: 1-2 years **Long Term: Above 2 years

Parity Price of Gold in Rupees at various dollar levels

Gold in $ / Rs/$	1550	1600	1650	1700	1750	1800	1850	1900
75	42895	44276	45657	47038	48419	49800	51181	52562
76	43467	44866	46265	47665	49064	50464	51863	53263
77	44038	45456	46874	48292	49710	51128	52546	53963
78	44610	46047	47483	48919	50355	51792	53228	54664
79	45182	46637	48092	49546	51001	52456	53910	55365
80	45754	47227	48700	50174	51647	53120	54593	56066
81	46326	47818	49309	50801	52292	53784	55275	56767
82	46898	48408	49918	51428	52938	54448	55958	57468
83	47470	48998	50527	52055	53583	55112	56640	58168

Most Probable path

Alternative levels on weaker USD:INR correlation to gold

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