UBS

Precious metals

A precious basket

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- Robust economic activity, strengthening inflation, a weaker US dollar and low-to-moderate real interest rates will support silver and, to a lesser extent, gold prices, in our view.
- Solid industrial activity indicators should drive demand for industrially linked precious metals like silver, which, within the sector, has the greatest correlation to this backdrop.
- Silver's price volatility has historically been nearly double that of gold. We think gold offers investors a hedge against flare-ups in geopolitics and sharp equity market gyrations. We recommend a basket with exposure to both metals.

Source: iStock

A version of this report is available with specific security recommendations for the US onshore investors. For a copy, please consult your UBS Financial Advisor

Our view

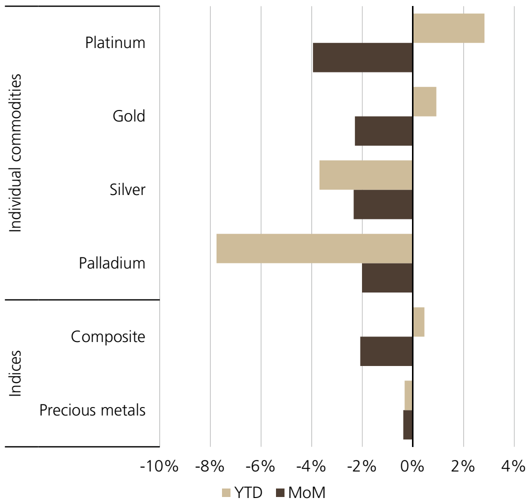
In today's world of low or moderately rising real US interest rates, real assets like precious metals should be in high demand. An environment of accelerating economic activity marks the sweet spot for industrially linked precious metals like silver, in our view. And amid ongoing financial market volatility and elevated political risks, we advise investors to hold insurance assets like gold. These factors and the weaker US dollar outlook we foresee should create a fruitful environment for the two metals.

Solid industrial demand and low speculator positioning should support silver prices, while the gold price should benefit as inflation strengthens, the USD falls and risks of trade disruptions rise. As such, we recommend holding a basket with an allocation to both metals. We expect the basket to deliver a rate of mid-to-high single-digit performance in the coming months. Adding gold helps to reduce its overall price volatility, in our view.

Downside risks for this recommendation include the US Federal Reserve becoming very hawkish and aggressively hiking interest rates this year. This would likely support the US dollar and weigh on silver and gold prices. In contrast, the precious metal basket should outperform in an environment of measured adjustments of US monetary policy.

We are not adding platinum group metals (PGMs) to the basket. While we see value in palladium after its latest price correction and much lower speculative positioning, adding it would only increase the volatility of the basket. Platinum's fundamentals remain weak and inferior to palladium's, as the metal has been suffering from falling diesel car share in Europe since the 2015 diesel-emissions scandal. The German court ruling giving German cities the right to ban diesel cars is another negative factor.

Fig. 1: Performance of precious metals
Spot returns in USD terms



Indexes refer to the UBS Bloomberg CMCI Indexes
Source: Bloomberg, UBS, as of 15 March 2018

A precious basket

The synchronized lift among world economies will continue this year, in our view. We expect global GDP to expand 4.1% this year, its fastest pace since 2011. At the same time, we forecast US inflation to rise from 2.2% currently to 2.9% by summer. New Federal Reserve Chair Jerome Powell responded to recent stronger inflation signals at his testimony by raising the prospect of four interest rate hikes this year, which is in line with our view, versus the three hikes signaled in the Fed's "dots."

Given our views on rates and inflation, we anticipate real US interest rates to stay low until this summer, and rise only moderately in 2H18. Real interest rates are an important driver for precious metals; the negative correlation is a function of their non-yield-bearing status. Finally, we also expect geopolitical tensions to flare up over the course of the year, particularly as we approach key dates in the US political calendar.

In sum, we think silver and gold prices should be supported by a number of factors in our base case and in specific risk cases over the next six to 12 months. Our base case assumes that:

- The US dollar will weaken on a broad basis as the US twin deficits erode the currency's fundamentals. We forecast EURUSD at 1.28, GBPUSD at 1.45 and USDJPY at 100 in six months. Gold and silver are highly negatively correlated with the USD at present.
- Solid economic fundamentals will support industrially oriented metals such as silver, where 55–60% of demand is driven by industrial use; the figure is only around 10% for gold.
- Silver will become less cheap relative to gold on a historical basis. The current gold-silver ratio sits at 80, just below the 20-year high of 84 hit in 2008; we target the low 70s over six months.
- Positioning from non-commercial accounts will remain far from stretched. For silver, net positioning in futures and options is close to zero and stands at the lowest level since 2014–15. For gold, net long positioning is marginally above the post-2008 average.

Under certain risk cases where the demand for traditional "safe haven" assets rises, as it did during the 2008 global financial crisis, gold and silver have performed positively, as their correlation to the USD swings into positive territory. Both metals can, in certain environments, provide hedging qualities against flare-ups in geopolitics and equity market volatility.

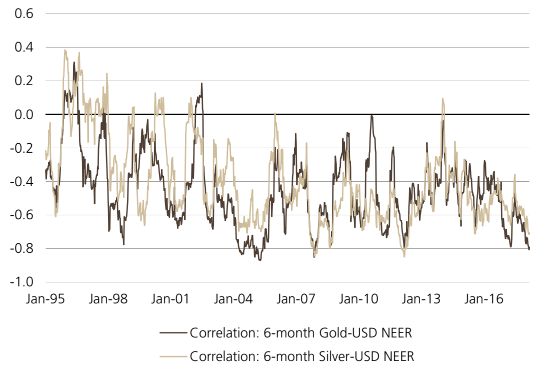
Fig. 2: Silver is cheap compared to gold

The current gold-silver price ratio has been seldom seen in the last 20 years

Source: Bloomberg, UBS, as of 15 March 2018

Fig. 3: Gold and silver negatively correlated to the dollar

Values are based on weekly returns

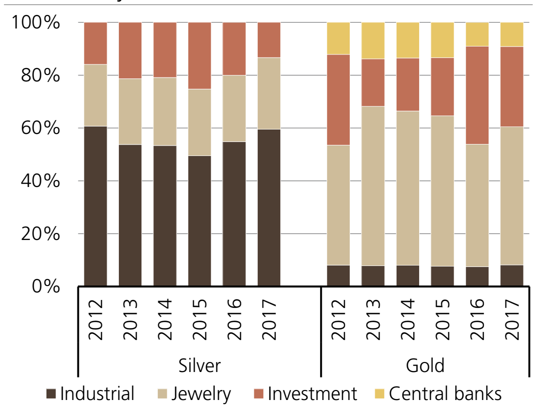


Source: Bloomberg, UBS, as of 15 March 2018

Note: USD NEER = JPM US Nominal Broad Effective Exchange Rate

Fig. 4: Silver is highly linked to industrial activity

Demand by use



Source: WGC, Silver Institute, UBS, as of 15 March 2018

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
Backwardation	When the spot price trades above the prices of futures	BCF	Billion cubic feet
BCM	Billion cubic meters	BCOM	Bloomberg Commodity Index
Bu	Bushel (1 ton = 36.7bu wheat/soybean; 39.37 bu corn	CBOT	Chicago Board of Trade
CFTC	Commodity Futures Trading Commission	CIF	Cost, insurance and freight
CME	Chicago Mercantile Exchange	CMCI	UBS Bloomberg Constant Maturity Commodity Index
CNIA	China Non-Ferrous Metals Industry Association	COMEX	New York Commodities Exchange
CONAB	Companhia Nacional de Abastecimento (Brazilian government agency)	Contango	When the spot price trades below the prices of futures
COT	Commitment of Traders	CRB Index	Index Commodities Research Bureau Index
D.O.E	U.S. Department of Energy	EIA	Energy Information Administration
ETC	Exchange Traded Commodity	ETF	Exchange Traded Fund
Excess Return (ER)	Excess return = spot return + roll yield return (rolling of futures contracts)	FAO	Food and Agriculture Organisation
FOB	Free on Board	HH Natural Gas	Henry Hub Natural Gas
IEA	International Energy Agency	IAI	International Aluminium Institute
ICCO	International Cocoa Organisation	ICE	Intercontinental Exchange
ICO	International Coffee Organisation	ICSG	International Copper Study Group
IIZSG	International Lead and Zinc Study Group	IMF	International Monetary Fund
INSG	International Nickel Study Group	JM	Johnson Matthey
JODI	Joint Oil Data Initiative	KCBT	Kansas City Board of Trade
LME	London Metal Exchange	LNG	Liquefied Natural Gas
mbpd	Million barrels per day	Mtoe	Million tons oil equivalent
NOAA	National Oceanic and Atmospheric Administration	NYBOT	New York Board of Trade
NYMEX	New York Mercantile Exchange	OECD	Organisation for Economic Co-operation & Development
OPEC	Organization of Petroleum Exporting Countries	PGM	Platinum Group Metals
RICI	Rogers International Commodity Index	S&P GSCI	Standard and Poor's-Goldman Sachs Commodity Index
SHFE	Shanghai Futures Exchange	SI	Silver Institute
TC/RC	Treatment/Refining Charges	TCF	Trillion cubic feet
Thomson Reuters GFMS	Research consultancy specializing in precious metals, base metals and steel market research	TOCOM	Tokyo Commodity Exchange
Total Return (TR)	Total return = excess return + return from the cash collateral	U.S.D.A	US Department of Agriculture
UNICA	Sugar and Alcohol Millers Association of São Paulo state	USD/BBL	USD per barrel
USD/bu	US Dollar /bushel	USD/GL	USD per gallon
USD/lb	USD per pound	USD/MMBtu	USD per 1 million British thermal unit
USD/MT	USD per metric ton	USD/oz	USD per oz, (1 oz = 31.10 grams)
USGS	U.S. Geological Survey	WBMS	World Bureau of Metal Statistics
WGC	World Gold Council	WPIC	World Platinum Investment Council
WTI Crude Oil	West Texas Intermediate Crude Oil	WTO	World Trade Organisation

Appendix

Appendix

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