Economics

DBS Flash

Oil/gold prices: Upside risks have not gone away

Strategy/Gold/Oil

DBS Group Research

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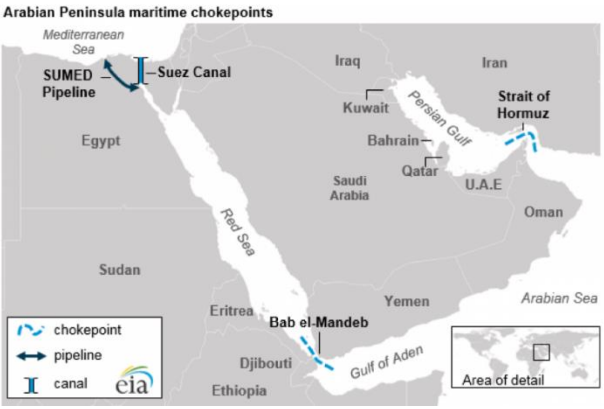
- US-Iran war rhetoric has intensified after drone and tanker attacks; a full-blown conflict could affect trading routes for oil
- Supply risks – Iran sanctions, geopolitical tensions, OPEC cuts – have been underestimated of late, eclipsed by demand worries from renewed China-US trade tensions
- Hopes for US rate cuts and an easing in China-US trade tensions could draw investors back into the equity and oil markets
- Volatility in oil prices will not go away in near-term but they are unlikely to prevent them from heading up to US$70/bbl in 2019-20, barring further shocks to global trade
- Rise in tensions between US-Iran after drone and tanker attacks drove gold prices on safe haven demand
- US Fed’s dovish policy and US dollar weakness are expected to strengthen gold prices
- De-dollarisation by central banks and ETF inflows are other positive factors
- While the recent rally is unlikely to sustain, we raise our forecast for gold prices, modestly

Oil prices have started to react to Middle East developments. Brent crude oil prices have increased, on geopolitical risks in the Middle East, to above US$64/bbl from US$60/bbl last week. The first flash point came with an attack on a couple of oil tankers in the Gulf of Oman last week. Prospects of US-Iran showdown have ratcheted with Iran shooting down a US drone, and saying they are “ready for war”. Combined with prospects of risk on in the equity markets following the dovish comments by the US Fed and some positive news on the trade front, oil prices look set to regain some lost ground.

Further geopolitical escalation in the Middle East is an upside risk for oil prices. The attack on the US drone and the two oil tankers in the Gulf of Oman between UAE and Iran just outside the Strait of Hormuz came after four tankers were attacked off the coast of Fujairah and a drone attack on a Saudi pipeline. Iran insisted no connection with the previous attacks on the vessels, while US and Saudi officials have pointed suspicions towards Iran and/ or Iranian proxies which could set the stage for confrontation in the Middle East. On the drone, Iran claimed it entered Iranian airspace while US officials said that it was in international waters when it was attacked unprovoked. Any escalation of conflict would directly affect supplies along one of the world's busiest oil trading routes and affect supplies. The daily flows of oil through the Strait of Hormuz accounts for roughly 30% of all seaborne trade of crude oil and other liquids.

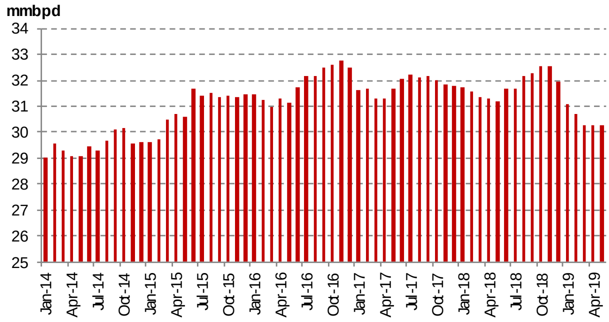
Middle East chokepoints



Source: EIA

We believe the supply risks are currently underestimated, as the supply side is already affected by stricter Iran sanctions, declines in Venezuela, outages in Libya and others. OPEC production is down a whopping 2.3mmbpd from peak levels of last October, led by declines from Iran (1.0mmbpd), Venezuela (0.4mmbpd) and cuts by Saudi (0.7mmbpd). Demand concerns have in focus since the escalation in China-US trade tensions. Realistically, we expect oil demand to only slow to around 1.2mmbpd in 2019 from 1.4mmbpd levels in previous years, which is not all bad. Nonetheless, global risk aversion and the equity market sell-off have taken the sheen off oil of late.

OPEC production trends show steep declines



Source: Bloomberg Finance L.P., DBS Bank

Risk appetite could be returning to the market. A bigger reaction in oil prices due to the geopolitical uncertainties have been thwarted by soft US economic data and trade war ramifications in the recent past. Volatility has reigned supreme as oil prices have been stuck between the pulls of two competing forces – 1) Demand concerns on the back of escalating US-China trade wars and other muted global economic data, and 2) Tighter supply concerns on the back of more stringent Iran sanctions filtering into the market and Middle East geopolitical tensions leading to fears of supply disruption. But the bearish demand side concerns have taken a beating this week, firstly from the expectations of imminent rate cuts in the US and secondly, resumption of trade talks between Trump and Xi next week in Japan, which holds out hope of a resolution again.

Near-term positives for oil prices. Given the above developments, we expect oil prices to gradually recover from current levels, though it will remain volatile in the lead up to i) US-China trade talks, and ii) the upcoming OPEC/ non-OPEC general meeting in late June/early July, where a decision on continuing production cuts into 2H-2019 looks increasingly likely. Latest inventory data from the US showed drawdowns for the first time in three weeks, and we expect inventory drawdowns to accelerate in 2H-2019 owing to a combination of seasonally stronger demand and impact of falling OPEC production and exports (both voluntary and involuntary) and further support oil price momentum. **We maintain our forecasts of Brent crude oil price average around US$70/bbl in 2019 and 2020** for now, the key risk being a complete collapse in US-China trade talks.

Gold, rising as safe-haven asset

Gold prices rallied to a 6-year high fuelled by geopolitical tensions: Gold prices soared to US$1,400/oz on Friday, for the first time since Sep 2013. This follows an escalation in tensions after an alleged Iranian missile shot down an unmanned US drone the day before. This likely stirred safe-haven demand, adding to the uptrend in gold prices that began in early-May after the Fed turned dovish and the US-China trade tensions resurfaced. Gold prices have gained 9.3% from US$1,270.7/oz on 2 May to US$1,388.4/oz on 20 Jun.

Switched to Inflow into ETFs. Despite the US Fed's decision to not raise rates this year, the US dollar has strengthened until May, with the dollar index up 2.3% to 98.0 in mid-May from 95.8 pts on 20 Mar. This encouraged profit-taking from gold's outperformance in 1Q19, triggering outflows from ETFs and related financial products. In Apr, outflows were equivalent to US$2.2bn, mainly driven by North America and SPDR Gold Shares. However, flows reversed direction since mid-May which resulted in significantly pared monthly fund outflows to US$141m in May. This was thanks to anticipation of the US dollar not strengthening further as Fed signalled a likely shift to a dovish bias. As higher interest rates increase opportunity cost of holding gold, we expect strong inflows to gold related ETFs in June, even before US rate cut expectations materialise.

De-dollarisation by central banks to persist. Central banks continued to add gold to their reserves in 1Q19, after recording a 50-year high net purchases in 2018. Uncertainties surrounding global growth spurred such demand, encouraging gold purchases by central banks. Russia bought the most gold again in 1Q19, in line with its de-dollarisation policy. We expect this trend to persist as Russia's head of central bank highlighted in end-1Q19 that it is necessary to increase gold reserves even more given the sanction risks. Central banks' gold demand is forecast to grow strongly by 10% in 2019 and provide further support to the metal.

While the recent rally in gold prices is excessive, we raise our forecasts marginally. Talks of a potential US rate cut, increasing fund inflow to gold related ETFs since mid-May and US dollar's weakening will strengthen gold prices going forward. A delayed resolution of US-China trade issues and intensifying political conflicts between US and Iran could further raise the allure of gold as a safe haven asset. While we think that recent surge in prices is overdone amidst high volatility, factoring in a more favourable environment for the metal, we raise our forecast to US$1,360 per ounce (average) in 3Q19, 3.1% higher than our 2Q19 estimate of US$1,310 per ounce.

Gold price vs. the Dollar Index (DXY Index)

Gold price vs. the US 10-year yield

Source: Bloomberg Finance L.P, DBS Bank

Gold price forecast

(US$/oz)	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19F	3Q19F	4Q19F
LBMA Gold Price(average)	1,329	1,306	1,213	1,226	1,304	1,310	1,360	1,370
Y o y %	9.00%	3.90%	-5.10%	-3.90%	-1.90%	0.30%	12.10%	11.70%
Q o q %	4.20%	-1.80%	-7.10%	1.10%	6.30%	0.50%	3.80%	0.70%

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).