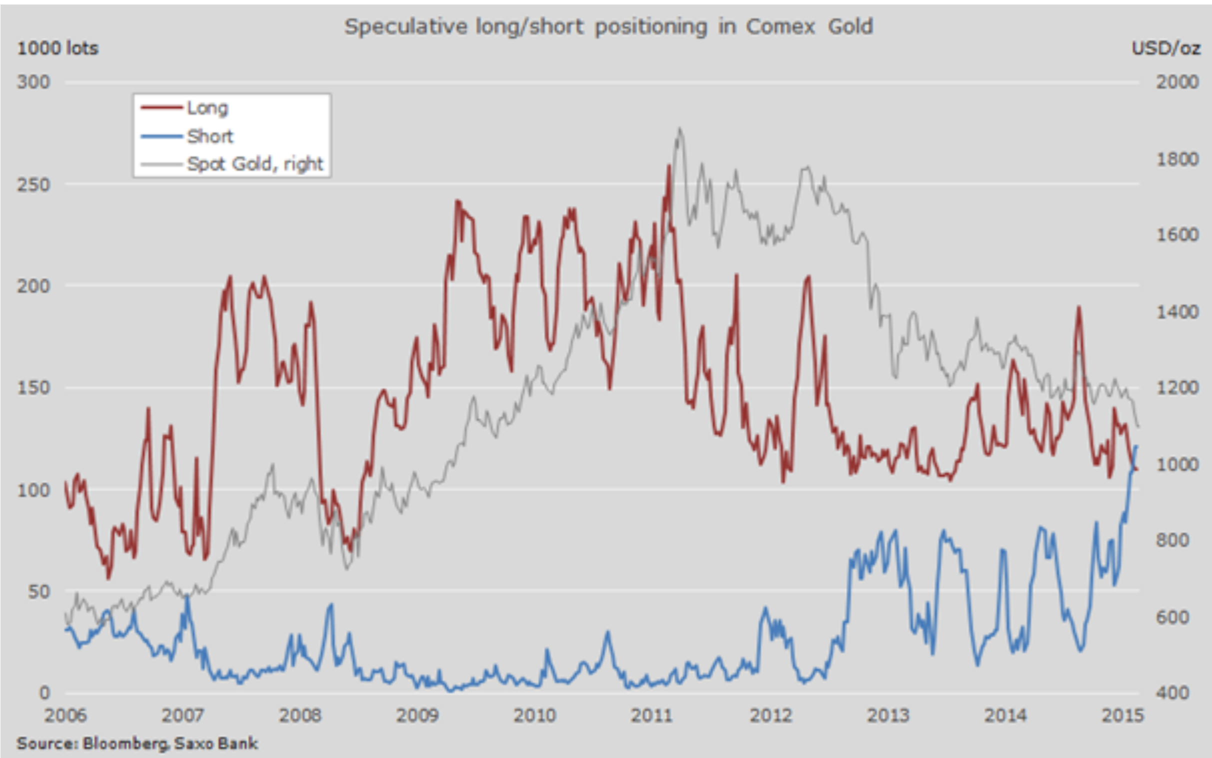
Gold spinning its wheels as hedge funds flee

By Ole Hansen, Head of Commodity Strategy, Saxo Bank A/S

The sentiment in gold and other metal markets has been turning increasingly negative during the past month. No signs of inflation combined with rising bond yields, collapsing emerging market currencies, no safe-haven demand, a rising dollar, and rising expectations of an early US rate hike have all helped trigger an exodus out of gold.

Nowhere is this clearer than in the futures market, where hedge funds during the past few months have been getting increasingly bearish. As a result we have seen the combined net position of gold futures and options turn negative for the first time since data began being collected in 2006.

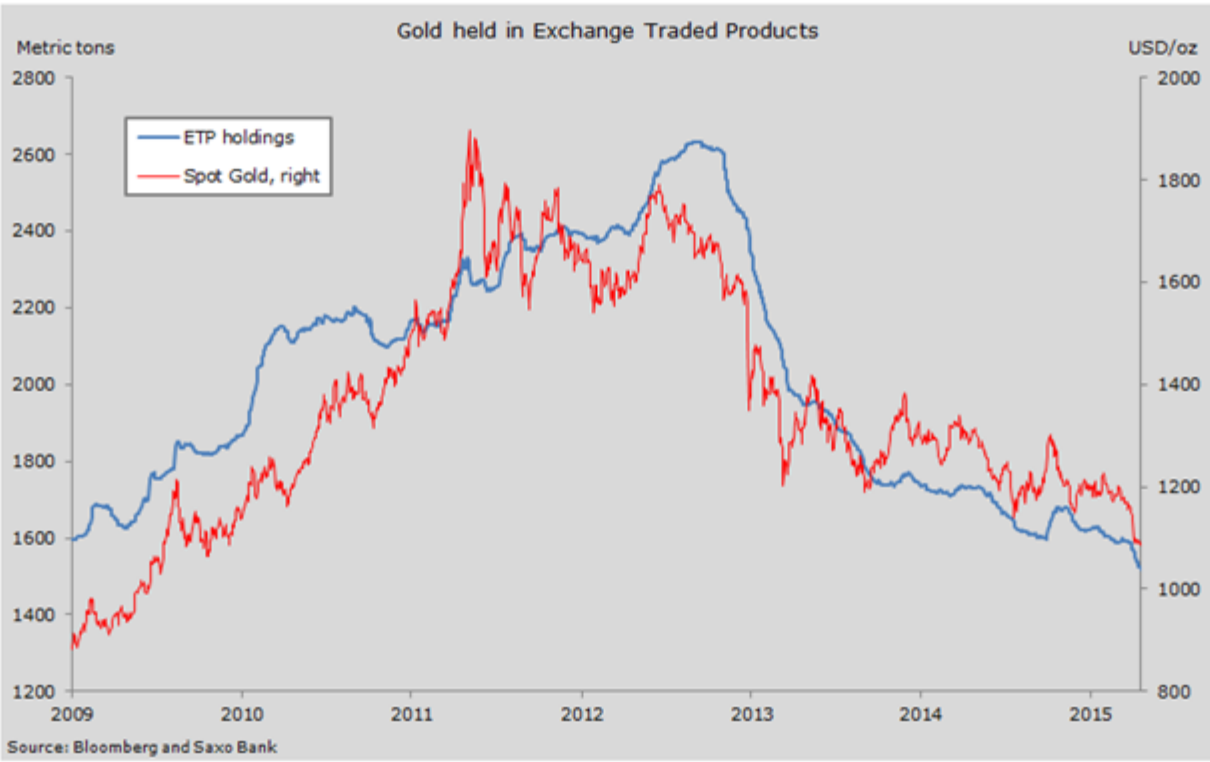
The change has not least been driven by increased short positioning which currently stands at a record 121,000 lots or 12.1 million ounces. While a reduction of this position alone could trigger a $50 short-covering rally, this will not be enough to change sentiment.



Holdings in exchange-traded funds backed by physical gold dropped by 63.6 tonnes during July. A monthly reduction of this magnitude was last recorded during Q2 of 2013 when the latest major price collapse occurred.

Long term investors as those in ETPs are often characterised as being long-term investors, the recent reduction in holdings means that many of them have decided to "pull the plug"

This was particularly evident following the break below $1,132/oz, as the breach of this level increased the risk of deeper losses — something that became abundantly clear during the "flash crash" on July 20 which took the price down to a five-and-a-half year low.



Following the aforementioned selloff, gold has been consolidating within a $1,080/oz to $1,105/oz range. A break of this range to either side will give us the next $20 to $50 move.

In **our Q3 outlook**, we highlighted the risk of some additional weakness during the early part of the quarter before eventually seeing the price move higher later in the year. We saw and still see the potential of the first US rate hike being a buying opportunity as it will remove some of the uncertainty that has been built up during the past couple of years.

A sustained break below $1,090/oz, however, will trigger a downward revision of our end-of-year forecast, which currently stands at $1,275/oz.

For the time being, short sellers remain happy below $1,105/oz and gold's best and perhaps only support seems to come from the fact that so many hate it! This could lead to a rapid bout of short covering on a wide variety of events, reasons or triggers.

For such a reaction to become a turning point, we need to see a strong response from the physical market, a change in the perception of where US interest rates are heading or a major correction in the stock market.

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