Seeking Alpha α

Investors Need To Hedge With Gold

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Summary

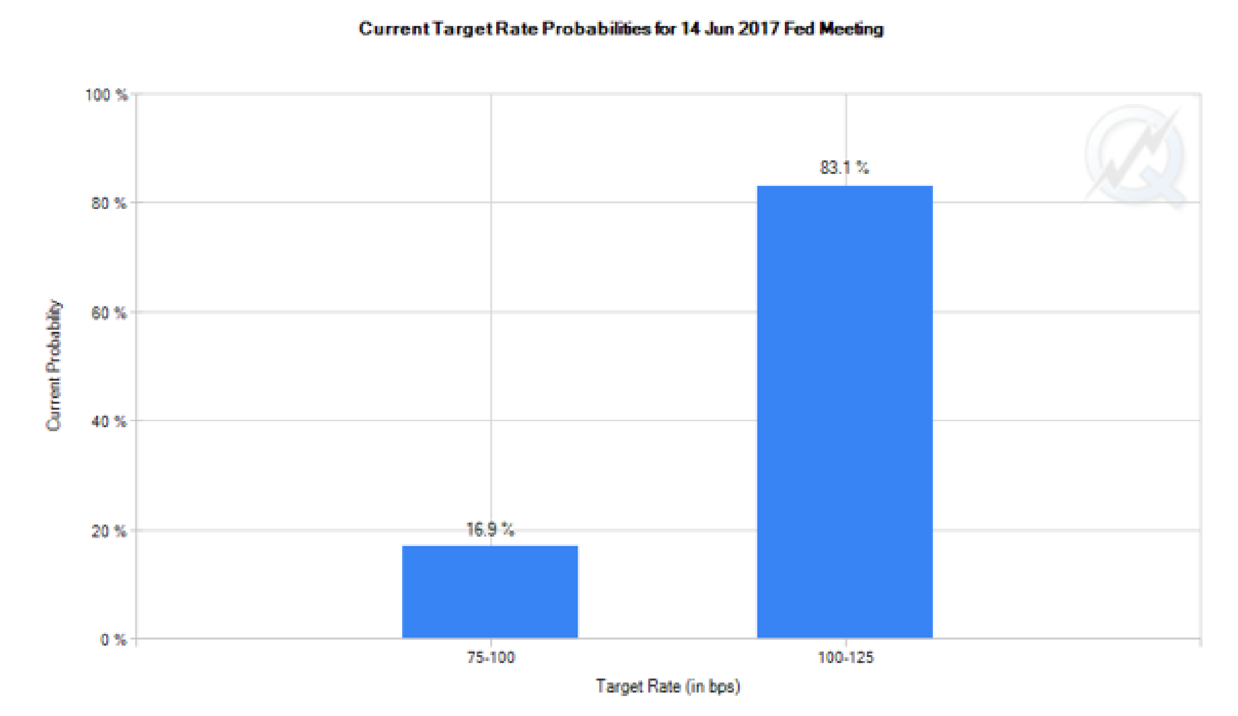
- Investors should consider building a hedge in GLD as political uncertainty in the United States continues to drag on, causing dollar weakness.
- The euro and pound are both up considerably YTD, adding to the dollar's weakness.
- The second rate hike of the year at the June FOMC is almost fully priced in now, leaving minimal roadblocks for gold to rally over the coming weeks.

Determining where gold will go in the next week and whether or not investors should allocate capital to the SPDR Gold ETF (NYSEARCA:GLD) is rooted in expectations. There are many fundamental factors that investors have to weigh, perhaps the most important being the second rate hike of the year at the June FOMC. Fortunately for gold bulls, this second rate hike is nearly priced in, so the gates are wide open for gold to rally in the coming weeks. This is especially true as major G7 counterparts to the dollar continue to rally. As equity markets in the United States hit all-time highs, I believe it is a wise decision to take on a short-term hedge with GLD, which provides direct exposure to gold from the long side.

Source: Colorado State University

Is The Second Rate Hike Baked In?

Determining whether or not the second rate hike is priced in or not is a matter of what the current probability the market expects is. For that, we go to the CME Group's FedWatch tool, where the probability of a rate hike is 83.1%. This means the current Fed Funds rate will be increased from the 75-100 bp range to the 100-125 bp range at the June FOMC meeting, which occurs June 13-14. This probability is up close to eight percentage points week over week, so it's a good sign that as we near closer to the meeting, the market is becoming more confident in expecting a second rate hike to happen.



TARGET RATE (BPS)	PROBABILITY(%)			
	CURRENT *	1 DAY 25 MAY 2017	1 WEEK 19 MAY 2017	1 MONTH 27 APR 2017
75-100	16.9%	12.3%	26.2%	29.5%
100-125	83.1%	87.7%	73.8%	67.6%
125-150	0.0%	0.0%	0.0%	3.0%

* Current data as of 27 May 2017 06:53:32 CT

Source: CME Group

This is a meeting that will move markets. So, while investors are basically expecting a second rate hike, and that may have a minimal impact on gold over the next two weeks, we have to remember that Chairwoman Janet Yellen will give a press conference with her economic outlook. That conference is going to be critical and, in my opinion, will move the needle for gold, equity, and bond markets. The possibility of a third rate hike this year would be bullish for the equity markets and highly negative for gold upon announcement.

So, what factors are investors going to be looking to over the next couple of weeks as this second rate hike becomes priced in? First, the weakening dollar. The dollar has experienced a tough 2017, after holding considerable ground above 100 in the index. But with the weakness at home with immense political uncertainty, coupled positivity from other G7 pairs like a stronger euro and pound, the dollar has been selling off for the better part of 2017. Perhaps the current dip is the bottom and, of course, that's something to consider when looking at an investment in GLD.

Source: StockCharts

Just to focus on other pairs doing well for a second, the GBP/USD and EUR/USD are both up this year, 3.71% and 6.30%, respectively. The only major risk I see on the table, which would lead to dollar is strength, is the elections in the United Kingdom next month, and if Theresa May loses to Jeremy Corbyn, then the pound could get routed and the dollar could pop. Another way this changes is if the government can start to ramp up the timeline for its agenda and implement deregulation as well as a quality tax plan. Until such time, there's not ample support for the dollar because all of the "talk" has been priced in over the last few months. A weaker dollar is better for gold, but it is important to watch the dollar's movements as we near that June FOMC meeting to make sure the thesis does not change.

Gold itself has seen a renewal in positive momentum, after there were concerns that a strong roll-off in volatility at the beginning of the month would cause the precious metal to decline in value. Yet, as we can clearly see by the chart below, gold continues to put in progress on a higher upward channel and it's not out of the question that we see gold hit $1,280/oz by the end of the week if key risk factors remain on the table.

Source: StockCharts

Is GLD A Buy At This Time?

I said last week that there is a multitude of macro risks on the table, but that it's difficult to imagine any significant upside for gold ETFs like GLD because of the June rate hike. Now that it appears that the market is almost fully expecting a second rate hike at the June FOMC, traders will be looking to other factors like the relative strength of the dollar and continued uncertainty in American politics as they relate to President Trump's agenda. I think that fares well for GLD in the very short term and allows GLD to serve a quality role in a portfolio as a hedge.

Source: StockCharts

Perhaps just to be cautious, as well, a stake in gold is warranted here. Equity markets are at all-time highs, with the S&P 500 closing at a new all-time high at the end of Friday's session. While this is backed by the strongest growth rate for corporate earnings since 2011, at 13.9%, it's not a bad strategy to take on a hedge while retaining long exposure.

This is where it's a bad idea for investors to get greedy and, rather, hedging and focusing on current income in a politically uncertain environment should be the proper way to manage one's portfolio.

Additionally, if we don't get guidance from Yellen for the 3rd rate hike later this year, then gold may close out Q2 on an uptrend past $1,300/oz and GLD will look like a great buy relative to now, where it could push to $125. A more dovish outlook from Yellen would be the perfect fundamental fodder to keep this upward channel in gold going and would allow GLD to end up increasing a few percentage points by the end of the quarter. A dovish outlook wouldn't necessarily come counter to recent economic data, like nonfarm payrolls and housing starts; but it would come contrary to other items like the positive earnings from Q1 and the fact that GDP is still underperforming, at just 1.2%, creating a need for the third rate hike this year.

Investors should note that even on a one-year timeline, GLD has ground to make up and that makes it an even more compelling hedge at this time. Prior to the summer slide, GLD was trading towards $130 and that's not an unrealistic NTM price target. For this price target to be reached, we're going to have to see global risks swell from their current standing. I reasonably see this happening if there are any more delays by the U.S. government from achieving reform, whether it be tax or financial regulatory, as this will create a setback in equity markets.

Source: StockCharts

Conclusion

Considering the volume of global political risk, it's advisable to have an allocation to GLD in your portfolio at this time. It provides direct exposure to the precious metal and while the upside isn't immense over the coming weeks, perhaps just a few percentage points, it'll help to compensate for losses should equities experience a pullback. All things considered, both equity markets and gold ended this past week higher, so the relationship isn't a perfect inverse and investors may get lucky with their hedge in GLD.

Disclosure: I/we have no positions in any stocks mentioned, but may initiate a long position in GLD over the next 72 hours.

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