FACTORS INFLUENCING GOLD PRICES

Renisha Chainani
Sr. Manager – Research, Edelweiss Financial Services Ltd.

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Abstract

Gold is a finite source and when global economic conditions make gold more attractive, gold demand increases, making the price of gold rise. It is used as a standard of value for currencies all over the world. Gold Price is impacted by production costs, money supply, comfort or discomfort with financial or geopolitical stability, the demand generated by jewelry and industry, value of various currencies and actions taken by central banks. Gold can also be used as hedge against inflation and diversifying tool in hard times.

Keywords: *Gold, Safe-Heaven, Investment, Jewelry, Bullion, Interest Rate, Monetary Easing, Monetary Tightening, Crisis, Geopolitical Tensions, ETF, FED, Correlation.*

Archeologists claim that people have been mining and coveting Gold for at least 5,000 years, and this precious metal is likely to remain precious even if the price fluctuates often. If you plan to buy gold, you need to understand that the *price* is impacted by production costs, money supply, comfort or discomfort with financial or geopolitical stability, the demand generated by jewelry and industry, and actions taken by central banks. In other words, gold is a finite resource and when global economic conditions make gold more attractive, gold demand increases, making the price of gold rise. But the actual *value* of gold remains fairly stable in the long run, and the price could simply reflect temporary uncertainty or simple currency fluctuation.

Below are seven significant influences on gold price fluctuations that any investor with an interest in gold trading should understand.

Supply and Demand

Like most commodities, the basic principles of supply and demand play a major role in determining the price of gold. However, due to the physical limitations of mining for gold, the supply of gold in the world remains relatively stable (with the addition of the small amounts that are mined every year). This means that demand has a much larger impact on gold prices than supply does. When gold consumption increases, so does the price; the only thing that will drive prices down in a significant way is a decrease in demand.

Supply

Only about 2,500 metric tons of gold get produced each year, compared to an estimated 165,000 metric tons in the entire world's gold supply. To visualize this, imagine all of the gold in the world filling up three-and-a-half Olympic-sized swimming pools, and this year's production forming a cube that is only about 16 square feet.

Even though new production might seem modest compared to the total supply, production costs can influence the cost of all gold in the world. When production costs rise, miners sell gold for more money to preserve their profits, and those higher costs also get reflected when it comes time to sell coins if they were minted from gold that was originally mined yesterday or thousands of years ago.

China is the largest producer of gold in the world, accounting for about 15% of total gold production. Asia, as a whole, produces about 22% of newly mined gold, Central and South America produce around 17%, and North America supplies around 15%. Africa and the CIS (Commonwealth of Independent States) contribute 20% and 14%, respectively, to gold production.

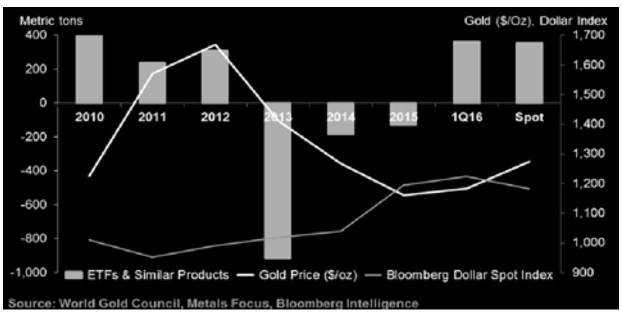
Demand

Safe-haven Demand: Gold is typically considered a safe haven when currency markets are volatile. United States Treasury Bills are also considered a safe haven even in a tumultuous economic climate because they are backed by the full faith and credit of the U.S. government. Increasing gold prices are a traditional indicator of a recession or a downturn in an economy. People run to the safety of gold when they think the value of other investments may go down in the future.

People flock to gold when the current paper money system experiences uncertainty. Some investors prefer the physical and tangible security of holding gold when central banks are going through deficits as a protection of wealth. In turn, an increased demand drives up the value of gold even more

Investment Demand: Gold ETF demand inflows Jan to April rose 24% from the end of 2015 as the gold price gained 20% and the Bloomberg Dollar Spot Index fell 4%. This suggests the 34% gold-price decline from the $1921 (2011 peak) is luring back longer-term investors seeking a safe haven.

Gold ETF Demand and Gold Price



Physical Demand from Consuming Nations: India and China are the world's two largest consumers of gold, and together they make up about 50% of gold's global demand. Gold is treated more as a commodity in these two countries, and its demand is relatively inelastic. Even gold's near 9% surge in price since the beginning of 2016 hasn't curbed its appeal. Instead, buying seems to have picked up.

Jewelry and Industry: Gold is not just valuable as a hedge fund and a safe haven investment; gold is also used in jewelry and industry. Over half of gold demand is from jewelry, and China, India, and the United States are three countries with the biggest demands. In some parts of India, gold is still regarded as a type of currency, a display of wealth, an important gift, and a hedge against bad times. This demand drives the price of gold in India up. Gold, both the color and the precious metal, is a symbol of opulence in China, and a booming Chinese economy means that more people have money to spend on China gold.

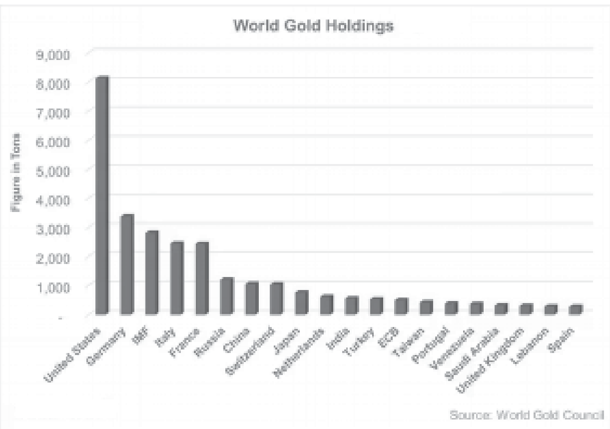
Besides jewelry, another twelve percent of gold demand is generated from industrial applications. Manufacturers use gold in all sorts of electronic devices, from computers to GPS systems, and medical devices like heart stints

Practical Applications: Gold isn't just an object of beauty and monetary value; it has many practical applications as well. We use gold in electronics, computers, dentistry, medicine and much more. When the demand for gold in any of these industries fluctuates, it's going to impact the price of gold.

Central Bank Buying

Central banks, like the U.S. Federal Reserve, hold both gold and paper currency in reserve. In fact, the United States and several European countries hold the bulk of their reserves in gold, and they have been buying more gold for these reserves recently. Other countries that hold gold include France, Germany, Italy, Greece, and Portugal. When these central banks start to buy gold in greater quantities than they sell, it drives gold prices up. This is because the supply of currency increases and available gold becomes more scarce.

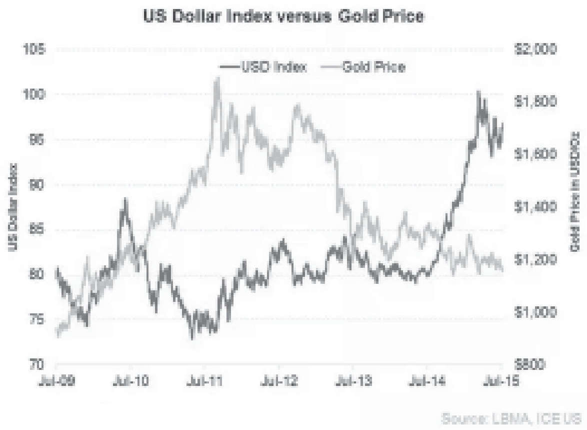
Over the past few years, a dramatic change has taken place in the precious metals market. The world's central banks have shifted from being net sellers of gold to net purchasers of significant quantities of gold. Since 2011, central banks and other institutions have been unwavering in their accumulation of gold. The countries that wish to diversify risks away from troublesome currencies may opt for gold as a backup.



Currencies

Gold is used as a standard of *value* for currencies all over the world. The price of gold gets stated as a currency value, often in U.S. dollars, and the price of gold can fluctuate with market conditions

Dollar Index: The U.S. dollar is still the world's dominant reserve currency, making it one of the main currencies that different countries hold for international trades.



There is an intrinsic correlation between gold prices and the US dollar. When the demand for the US dollar falls, banks, as well as investors around the world, invest more in gold. Gold and the US dollar are both used as a hedge against uncertainties and are favorites for central banks worldwide

Euro: The main reason for the high correlation has been the shared perception of gold and the Euro as alternative investments to US$. During this period the major currencies, including gold, have tended to react in concert to economic news from the USA. Gold, with neither an underlying economy, nor price-sensitive supply and demand issues, is the purest of the "currencies" and its fortunes have been a mirror image of the dollar's. Similarly, the Euro has been seen by many as the natural first choice alternative currency to US$, and has benefited from recent US$ weakness caused primarily by the USA's dual deficits growing to record levels.

Japanese Yen: There are several other currencies that also have this safe haven status, two of which include the Japanese Yen and the Swiss Franc. The Japanese Yen and Swiss Franc are viewed as safe havens because of their strong net international surplus. Japan is the world's largest creditor, last year having a surplus of over 3 trillion dollars. Switzerland ranks as 5th but is the only other currency out of the top 5 creditors that is not pegged or not convertible. There is also the issue of low interest rates in both these countries. Since interest rates across the term structure in Japan and Switzerland are close to zero, this leaves little room for further interest rate cuts. Since interest rates cannot be cut, in times of stress these currencies are less likely to weaken than others where interest rates can be cut in an attempt to lower the currency. Therefore both the yen and the Swiss Franc are treated as safe havens.

The correlation between the USD/JPY and Gold was negative, with the 7 year correlation standing at -0.86, 5 year -0.87, 2 year -0.89 and 1 year -0.86. This extremely strong correlation shows that gold is in fact viewed as a safe haven currency as opposed to a commodity, which it is often sited as. As a reminder, gold being negatively correlated with USD/JPY implies it is positively correlated with JPY/USD; so we can say that gold behaves in a similar way to the Yen

Swiss Franc: The Swiss Franc is also viewed as a safe haven currency. Like Japan, Switzerland has a surplus of international investment and has low interest rates across its term structure. This has made the Swiss Franc a core safe haven currency. For this reason Gold was very closely correlated with the USD/CHF. The correlation for 7 years was -0.91, 5 years -0.87, 2 years -0.82 and 1 year -0.35. Below is the 7-year and 5-year charted correlation between the USD/CHF and Gold.

Macro-Economics

Interest Rates: Interest rates are not the only variable that affects the future performance of various asset classes. Other variables include the true inflation rate, the real interest rate (nominal interest rate – inflation rate), the value of the dollar and whether its value is expected to increase or decrease and how the dollar fluctuates in comparison to other currencies, and market expectations regarding these factors, and other variables

Due to very low interest rates, many investors look for other investments where they can be a better rate of return. Low interest rates mean the "cost to carry" investments is low thereby increasing demand by some investors such as hedge funds. As interest rates rise, demand for gold is expected to fall which should mean decreasing gold prices.

Gold does not pay interest like treasury bonds or savings accounts, but current gold prices often reflect increases and declines in interest rates. As interest rates increase, gold prices may soften as people sell gold to free up funds for other investment opportunities. As interest rates decrease, the gold price may increase again because there is a lower opportunity cost to holding gold when compared to other investments. Low interest rates equate with greater attraction to gold. One of today's most important factors in the determination of the price of gold is the Fed's potential interest rate hike.

Inflation: A common reason cited for holding gold is as a hedge against inflation and currency devaluation. Currency values fluctuate, but gold values, in terms of what an ounce of gold can buy, might stay more stable in the long term. Because gold holds value outside of politics—it is valued the world over—gold is attractive as a low-risk, solid investment in the midst of floundering currencies. Investors may feel encouraged to buy gold when they believe the value of their paper money will decline.

Gold has served as a store of value for generations now. It is said to be a hedge against inflation, meaning that when prices rise, investors can park their money in gold. However, at times, the price of gold and the inflation rate show a direct relationship with each other and the hedge does not hold. How well gold can protect investors against inflation remains unclear.

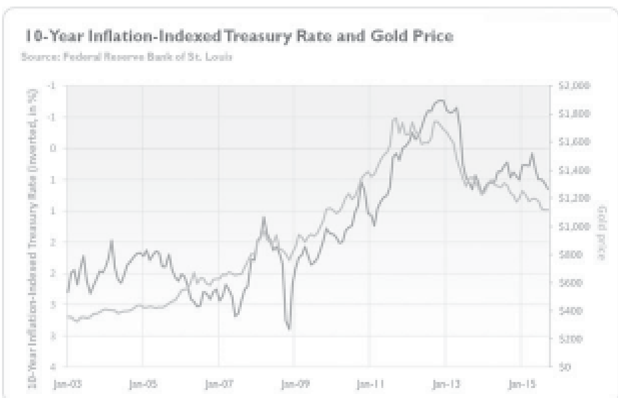
The chart above compares gold prices with the inflation rate. To describe inflation in the US economy, we can use the yield spread or the break-even spread. This measures the difference between the ten-year US government bond yield and TIPS (Treasury inflation-protected securities). The principal invested in TIPS is adjusted in line with the CPI (consumer price index). The yield spread, therefore, seems to be a good proxy for the US inflation measure. Over the past 45 years, gold prices and the US CPI show an average 12-month correlation of precisely zero

Outlook of other asset class

Equities: When the economy falters, it tends to send people into panic mode. When people are in panic mode, they like to invest in things that are proven and tangible in order to hold on to some semblance of security. This is why people flock to gold investment when the rest of the market is struggling; gold has held its value throughout the centuries, and remains an enduring and universally recognized symbol of currency and wealth. The proven worth of gold provides comfort to anxious investors. Because of the increased demand for gold during tough economic times, the price gets driven up, meaning that gold helps to buoy investment portfolios when the rest of the Equity market is struggling.

Bonds: The negative relationship between gold and interest rates imply positive correlations with bond prices, since the price of bonds is negatively related to the yields they offer.

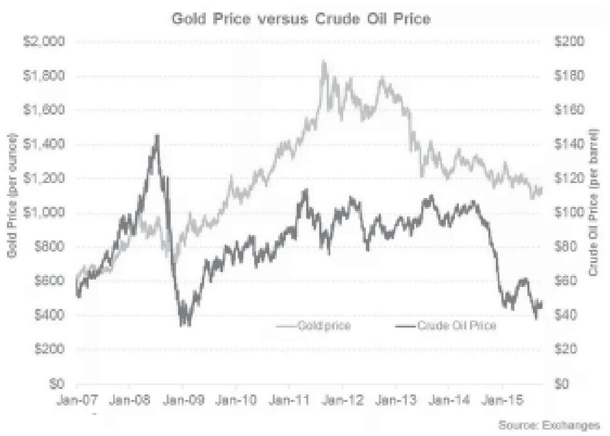
Gold is a substitute for Treasuries, especially when yields are near zero. In such an environment, investors may simply prefer to buy gold rather than bonds (that practically pays zero). Yeah, the precious metals do not yield any income at all, but at least they are not made of paper and U.S. government cannot issue them. Hence, there may be a positive relationship between gold and bonds due to the opportunity costs and capital flow from bonds to gold, when prices of bonds become too high (yields become too low). There may be also capital flows in the opposite direction (from gold to bonds) when bond yields increase (bond prices decrease) and provide a better alternative than gold. This is especially true in the case of U.S. Treasuries. They are considered as a safe-haven - but one which pays a yield. In other words, "fear trade" may increase demand for both gold and bonds. The latter are generally anti-cyclical, while gold is noncyclical, but both asset classes may sometimes move in tandem responding to changes in the stock market, as a non-confidence vote in the U.S. economy (this is why people invested in gold and bonds during the last financial crisis). Moreover, the Fed typically increases the money supply by purchasing government bonds and pushing their prices higher. If such purchases are considered as a signal that the U.S. economy is weak (e.g. as in the case of first quantitative easing), the price of gold may rise simultaneously with bond prices.



Investors should remember that what really matters for gold are real interest rates, not nominal yields. The chart below shows a significant positive correlation between the price of 10-year inflation-indexed Treasury and the price of gold, or negative relationship with real interest rates (10-year inflation indexed Treasury rate is a proxy of U.S. long-term real interest rate). The rates in the chart are in reverse order to show the trend in bond prices (which are inversely related to yields).

Crude Oil: The price of Crude oil plays a crucial role in the determination of the price of gold and gold-backed ETFs. Like gold, the price of crude oil is determined in the US dollar. When the US dollar rises, dollar-denominated assets usually drop in price, as investors of other currencies find dollar-denominated assets more expensive. Because gold and crude oil are dollar-denominated assets, they are strongly linked.

Another important link between gold and oil is inflation. As crude oil prices rise, inflation also rises. Gold is known to be a good hedge against inflation. The value of gold only increases when inflation rises. Over 60% of the time, gold and crude oil have a direct relationship. The above chart shows historical prices for both dollar-denominated assets.



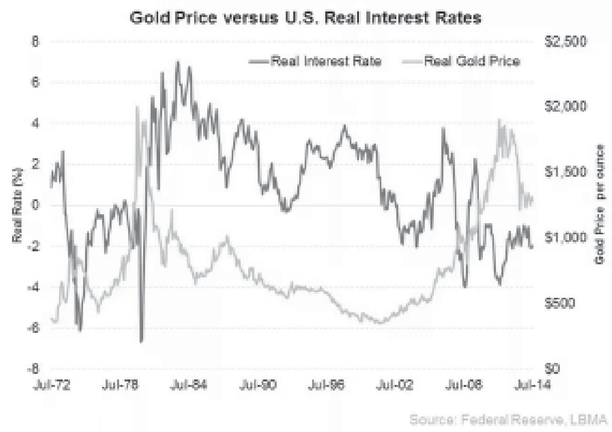
Gold and crude oil are further related in that a rise in the price of oil dampens economic growth due to its excessive industrial use. Dampened economic growth adversely affects most industries. This can lead to a fall in equity markets, which boosts the demand for alternative assets such as gold. Gold's magnetic force is in play here. The recessionary phase would be good for precious metal lovers by pushing gold prices higher.

Monetary Policy of Central Banks

Monetary easing is meant to spur a nations economy into growth mode by making capital readily available. However, monetary easing can also become a catalyst for inflation. When a nation floods its system with easy credit (via low interest rates) or floods the market with currency, it is hoping that the economy will expand.

A larger money supply pushes interest rates down, which could encourage investors to buy gold because of the lower opportunity cost. When overdone, this tactic this can trigger inflation, another signal of a rising price of gold.

With policy rates close to zero in the aftermath of the Great Financial Crisis, several central banks around the world have introduced unconventional policies to provide additional monetary stimulus. One example is the decision by five central banks – DanmarksNationalbank (DN), the European Central Bank (ECB), SverigesRiksbank, the Swiss National Bank (SNB) and most recently the Bank of Japan (BoJ) – to move their policy rates below zero, traditionally seen as the lower bound for nominal interest rates. The motivations behind the decisions differed somewhat across jurisdictions, leading to differences in policy implementation. Such monetary loosening with lowered interest rates gives a boost to haven investments such as gold, which are non-interest-bearing and provide no cash flows, just as zeroed down interest rates.



On the other hand, we have the Federal Reserve, which has optimistic plans for the comparatively stable US economy. The Fed had fixed on a gradual pace of raising interest rates in 2016 and on Monetary tightening cycle. The pace would have given way to four hikes during the year. However, the global turmoil adversely affected market sentiment in the United States, which may have left the Fed reevaluating its plan.

Crisis/Geopolitical tensions

Because gold prices tend to rise when people lack confidence in governments or financial markets, it often gets called a *crisis commodity*. World events often have an impact on the price of gold because gold is viewed as a source of safety amid economic or geopolitical tumult. For example, the price of gold spiked right after the Russians moved into the Ukraine as people became uncertain about geopolitical stability in the region. In other cases, military action may actually increase reassurance with geopolitical situations. For example, the gold price softened at the beginning of Gulf War I. The bottom line is that political chaos equates to more interest in gold as a safe haven.

As gold prices reached higher numbers during the 2008 stock market unrest, they have also done so during rising global tensions. Gold famously peaked in 1980 to $850 when the Soviet Union invaded Afghanistan. The wartime scenario usually pushes gold the most, and silver usually follows. On August 2, 1990, as Iraq invaded Kuwait, investors saw gold spike, and when the initial bombardment happened in Iraq in 1991, prices spiked again. The beginning of the Iraq War saw gold rise considerably. However, as war subsides, precious metal prices have been sinking.

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