Forget the U.S. Dollar: The Bullish Case for Gold

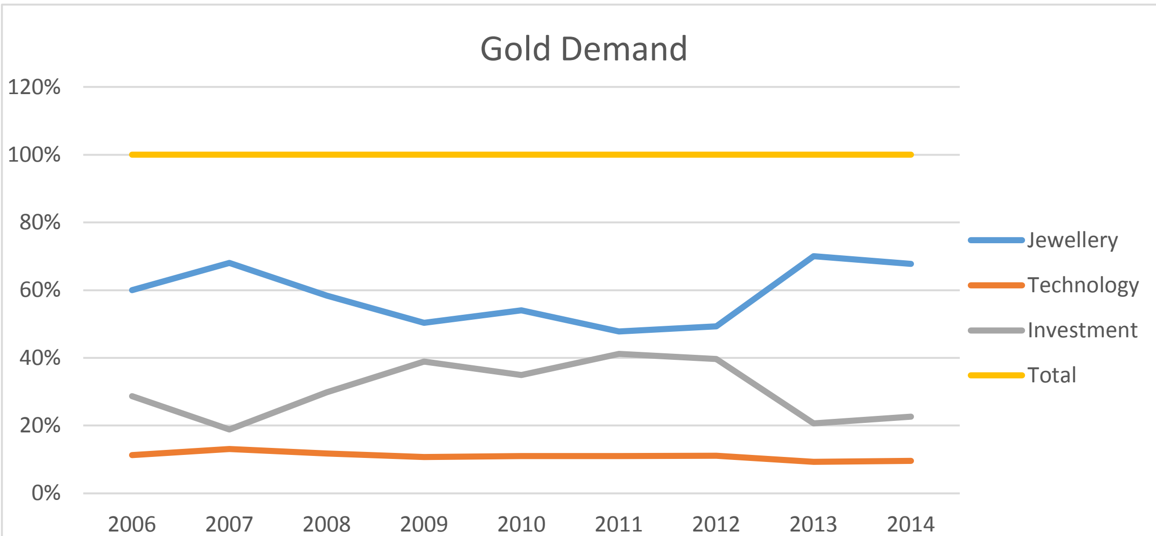
Yogi Berra, a baseball legend, once famously said, “A nickel isn’t worth a dime anymore” and to apply this statement now he would be right. Indeed since the 1980s the dollar has, with a few exceptions, steadily lost value. Reasons for this fall range from trade, economic recessions, central bank policies, etc. However, in the last year we have seen a dollar resurgence not witnessed since the early 2000s. While the dollar fell, almost simultaneously the FED began to unwind QE3, while Japanese and European Central Banks either initiated or ramped up similar programs. This combined effect, along with U.S. economic growth, has created a bullish dollar trend. The expectations for a rate hike in September may perpetuate this trend well into the future.

Why does this bullish dollar trend affect gold? Gold and the dollar are naturally negatively correlated. Gold is priced in USD and as the dollar rises it becomes more expensive for those outside of the U.S.to purchase the metal, thereby driving down demand and causing the price to fall (please refer to the below chart). In the last 15 years the negative correlation between the dollar and gold has been -0.42. This negative correlation has been a significant headwind for gold in the last year, exacerbating the decline in price that was already in place prior to the dollar rally. In contrast to this argument and because long-term the dollar has been down trending, the recent spike may simply be another short term anomaly. After which the dollar may revert back to its previous steady decline.

Security	USD Index	Gold Spot
US Dollar Index	1	-0.423
Gold Spot	-0.423	1

*Source: Bloomberg

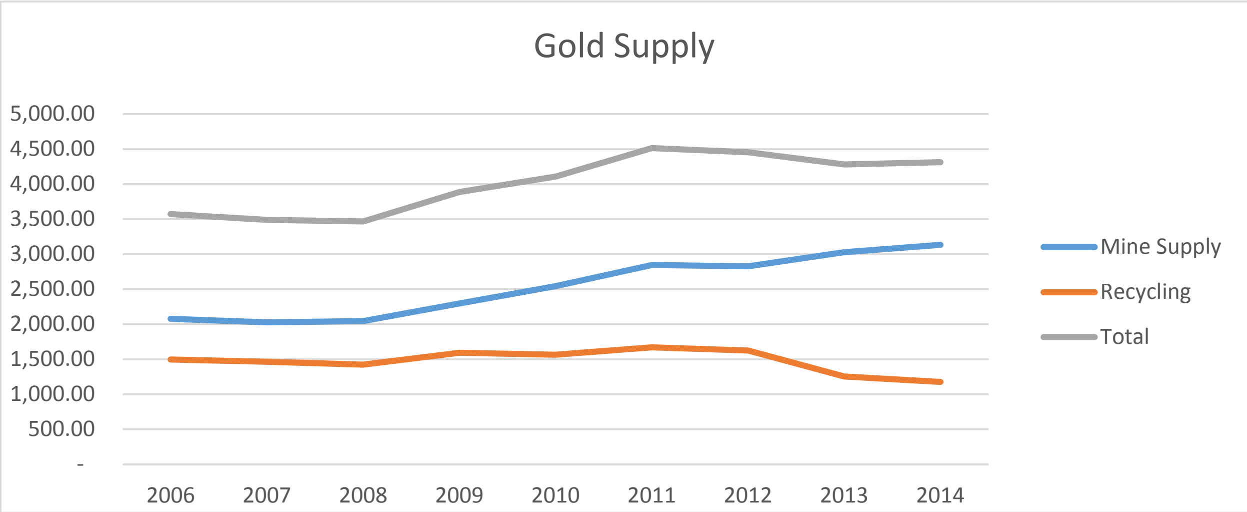
Now let’s look at the fundamentals of the gold market. The below chart shows the percentage of demand that comes from each of three sub-sectors in the gold market, technology, investment, and jewelry. As depicted, the gold price climbed between 2006-2009 in terms of “investment” demand, an increase from just over 20% to over 40% or a doubling for the category. In the last two years “investment” demand has returned to its previously held levels. This means two separate things. First, the rise and fall in gold demand as an Investment was counter balanced by the fall and then rise of gold in the form of jewelry. With jewelry back at over 60% of the gold market demand, the market metrics change drastically. When investments makes up a larger part of demand, the higher the price of gold the more demand there is as investors are expecting to make money. On the flip side, investors will pull out of the asset class as the price falls, exacerbating the situation. This is exactly what happened to GLD, a predominant ETF and gold investment vehicle, which lost 68.2% of its assets, falling from $75.6 bn to $23.7 bn.



*Source: World Gold Council data; Chart from Lynx Investment Advisory

Today the majority of the assets have been pulled from the investment category, leaving a higher percentage of gold assets in jewelry demand, which typically carries significantly different demand dynamics. As the price of gold falls jewelry demand tends to increase as it becomes cheaper for the average consumer. This means the recent shift in demand has become more consumer driven as opposed to demand from the investment community, possibly putting a floor on gold prices. The farther the price of gold falls, theoretically, the higher the consumer demand for jewelry will rise.

On the supply side things have begun to reverse as well. In the below chart you can see how supply has increased from roughly 3,500 tons in 2006 to a peak of 4,500 tons in 2011. However, production has begun to fall slightly and we expect it to continue to do so. Gold miners are slashing capital expenditures across the board in order to improve margins as the price of gold continues to fall. An estimate by Wood Mackenzie, an international commodity consulting firm, states that most of the recent projects for gold miners were based on $1200 gold prices. The fall in price to $1100 renders roughly 40% of these projects uneconomic. As labor costs continue to rise and “easy” gold is mined from those projects initiated over the last 5 years, it’s expected that gold production should level off and possibly decrease back toward 3,500 tons a year.



Another aspect of gold demand which is being overlooked may be China. China's huge decline in its stock market has been well publicized and debated in the financial press recently. Investors in China have seen their real estate bubble cool, debt has become harder to attain, interest rates have been slashed, and now their stock market is under pressure. Gold may be the next logical place for Chinese investors to flock to simply because other areas of the market have already gone through their bubble and bust period in the last decade, as well as this week's news on the yuan. Literally overnight the price of gold has increased for Chinese investors. Since, as previously discussed, gold is priced in USD the devaluation of the yuan by the Chinese central bank has increased the value of gold for anyone in China who holds it. Investors who may be looking for an alternative investment to the stock market may turn to bullion as they watch their government deliberately devalue their currency in an attempt to boost exports.

A bit of history, gold is engrained in the Chinese culture and has been for thousands of years. In 23 AD, the Chinese Emperor Wang Mang accumulated one of the largest stockpiles of gold in history at roughly 5 million ounces. Gold is considered a sign of wealth in China, more so than in western European civilizations. This cultural respect and demand for bullion plays a role in why China is one of the largest consumers of gold in the world today.

As you look back over this article you'll see a lot of moving parts, gold's correlation to the dollar, the underlying fundamental shift in gold demand, geopolitical factors in the form of QE and market specific dynamics across the globe. However, if you look at the main factors affecting gold many are bullish. Between the higher allocation to jewelry as a source of demand, the prospects of increased demand from China, the reduction in the volatile area of "investment", and the flattening and potentially falling supply dynamics, it is possible the price for gold bullion is nearing its floor and may be poised for a rebound in the near future.