Why Isn't there a Gold Rush?

September 19, 2022

Inflation is surging to the highest level since the early Eighties. As a result, the Federal Reserve has implied that it will continue raising interest rates until inflation has dropped to around its historical 2% level. We expect another 75 basis point increase this week. These "tight money" policies of the Fed are beginning to have an effect. The housing industry is experiencing a downturn even though there is a shortage of homes. A year ago, the 30-year mortgage rate was at 2.86%; today it is 6.42%. A buyer must deal with a mortgage payment that is more than twice as much as twelve months ago.

The surge in inflation seems to have bypassed one investment that is designed to protect against inflation—gold. While inflation has soared, gold prices have gone in the opposite direction. At the end of 2021, the price of gold was $1,888 per ounce. As of this past Friday, the price of gold was $1,671, down 8.5%! What happened to all those TV ads by prominent actors encouraging individuals to buy gold instead of traditional bonds and stocks since gold "is the only real protection against inflation?" Interestingly, as inflation has surged there has been a decline in the price of gold that accelerated more recently. From August 15th to September 19th, the price of gold fell from $1,775 to $1,672 per ounce, an annualized decline of over 7%. One analyst explained this anomaly by saying that all the gold buyers saw more glitter in bitcoin and its cousins, shifting into these volatile cyber securities. To us that sounds like a reach because bitcoin prices have collapsed. The mystery is wrapped up in the aftermath of the pandemic crisis as well as the continuing war in Ukraine.

Fed policy has driven U.S. interest rates higher while the war in Ukraine and its impact on the world economy implies that a global recession is underway, at least according to the CEO of Fedex and other executives. As a result, there has been an unusual appreciation of the U.S dollar. The Euro has fallen below parity while the Japanese yen has plummeted more than 20% and the UK Pound has depreciated by 18% so far this year! Emerging Market currencies have fared even worse. Wealthy foreigners see the writing on the wall. They can invest in U.S. dollars where the current yield is higher than investments outside the U.S. while they get the double-play of an appreciating currency. As the outlook in Europe darkens (excuse the pun) as winter approaches, output in energy sensitive industries is likely to decline and undermine any progress on avoiding recession. The European Union (EU) seems to have gone off the deep end by proposing cuts in electricity use and applying windfall-profit levies on energy firms, which it said would raise 140 billion euros ($140 billion) for governments to help businesses and citizens with soaring energy bills. Such a transfer is likely to push energy prices even higher thus almost assuring more shrinkage in output.

Meanwhile, back here in the United States, prices seem to be settling down after that surge through June. If Fed policy gets the credit for curtailing inflation, then the U.S. dollar could continue an upward trend. Companies with broad international operations could be at risk as a strong dollar increases the price of exports that will lower the volume of exports while increasing imports. As that transition happens, the balance of trade will be reflected in a larger deficit leading to a lowering of gross domestic product (GDP). Companies that depend on imports will have an advantage because they will not be pressured to lower prices in an inflationary environment. On the other hand, companies that depend on exports will have a difficult time without lowering prices. Even with lower prices, a global recession will take a toll on the volume of those exports. So, Fed policy unilaterally focuses on higher domestic interest rates to curtail inflation while the international implications of such policy during an impending global recession is likely to have a greater impact than most people imagine.