15 February 2022

Gold, Inflation, And Interest Rates

Aside from the potential for an imminent Russian invasion of Ukraine, financial markets including gold and silver have been focusing heavily on the rise in inflation over the past 12 months and the probable increases in interest rates starting in March.

Much is misunderstood about the relationships between precious metals and interest rates and inflation.

The general views are that:

- Inflation is 'good' for gold prices, that gold prices tend to rise along with inflation, and
- Interest rate increases are bad for gold prices, and that gold prices tend to decline as interest rates rise.

Both beliefs are wrong.

Inflation and Gold

Regarding inflation, it is true that gold prices have tended to rise in past periods of high inflation, defined quantitatively in the past as inflation rates greater than 7% or so in the United States.

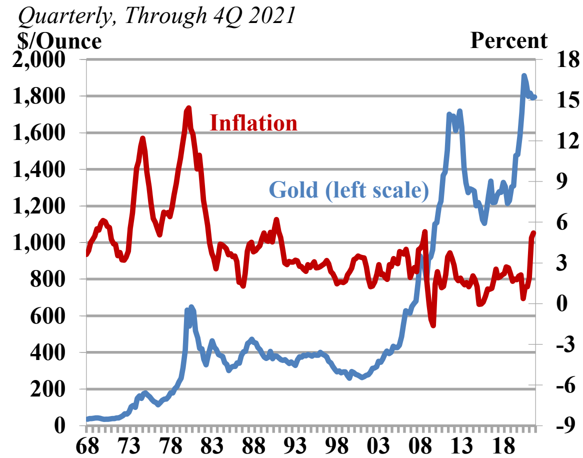
Overall, however, the quantifiable relationship between inflation and higher prices is weak. Statistically since gold prices were freed to float in 1968 the correlation between monthly inflation rates and real, inflation-adjusted gold price changes has been 9%. In other words, gold prices do not rise and fall closely in union with consumer price inflation.

More importantly, since 2008, when much of the monetary and financial mechanics globally underwent fundamental changes, the relationship between inflation and gold prices has been a -5%. Since 2000, the relationship has been 1%.

The first chart here shows that gold prices since 2000 have risen from around $270 per ounce to more than $2,000, and today stand around $1,850. During this time, until 2021, U.S. inflation has been exceptionally low, very stable, and declining over most of the past four decades.

Gold and U.S. Inflation

Quarterly, Through 4Q 2021



The conclusion is obvious, even if investors do not wish to recognize the reality: **gold prices have risen sharply over the past two decades in an absence of inflation**. Other factors have driven gold prices higher. Inflation has not driven gold prices higher in the past two decades.

Regardless of this reality, the market consensus is that higher inflation will push gold prices higher for some time to come. CPM has reservations about buying into this thesis. First, CPM is not at all certain that inflation will be a problem even six months from now. Even if it is, gold prices have risen for most of the past two decades in an absence of inflation. Our view is that gold prices will continue to rise, and rise sharply at some point in the next five years, even if inflation dissipates over the course of 2022. Other economic and political issues will keep investors interested in gold, whether inflation is one of them.

Our view on inflation is predicated on a lot of materials. Just looking at the two charts at the end of this report, excerpted from the Bureau of Labor Statistics January Consumer Price Index report released 3 February, illustrates some of the factors that lead CPM to expect that inflation statistics will show markedly lower levels of price increases by the middle of this year.

First, note that U.S. CPI, both headline and core, were extremely low, around 1.3% in January 2021, just a year ago. This was at the end of 10 months of global economic and social lockdown, when demand for goods and services had plunged. As vaccines became available and the U.S. and global economies began opening, in February and March, but then through the next six months, inflation rose. There was a sharp increase in demand for goods and services, taking demand for many items beyond their pre-pandemic levels. At the same time there were a number of bottlenecks that limited supply. This fueled the inflation rate increases from March through October last year.

The month-to-month inflation rate gives a better reading of current inflationary pressures, compared to the year-over-year. Both suggest that as 2022 progresses reported inflation rates may decline sharply. **This does not mean prices will fall, but that they may not rise as sharply as they did in 2021.**

Simple arithmetic will aid this. The year-to-year inflation rates in 2021 were measuring price levels in the recovery and expansion of 2021 compared to the price levels during the 2020 lockdown. As 2022 progresses, these year-over-year calculations will be measuring 2022 prices compared to the heated 2021 figures. Simple arithmetic suggests much lower rates – unless currently unforeseen events worsen the economic horizon over the course of this year.

The month-to-month figures show the declines in current, monthly price increases in July – September 2021 and again in December 2021 and this past January.

The conclusion is that inflation is a problem now, but it may seem far less of an issue by the middle of this year, especially if other economic and political developments are growing more difficult.

Additionally, the current inflation needs to be put into context. “The highest inflation rates since the early 1980s” suggests inflation as bad as we had in the 1970s into 1982 or so. **Inflation was persistently above 7% for more than a decade from the early 1970s until around 1982, spiking to 12% in 1974 and 14.4% in 1980. Inflation is a problem at present, but it is far different from a decade-long period of hyperinflation** that had its roots in a host of developments, including deregulation of prices and industries that had been under government price directions and controls for decades, and a poor set of fiscal and monetary policies.

Interest Rates and Gold

Just as it is not true that higher inflation necessarily leads to higher gold prices, it is also true that higher interest rates do not necessarily lead to lower gold prices.

CPM wrote about this in the 2 February “**The Rising Fed Funds Rate Likely Effect on Gold”**

. In fact, in many past periods of rising interest rates, gold prices have risen sharply during periods of rising interest rates. It happened in 1974 and again in 1980. Gold rose around 75% from 2004 to 2007, as interest rates rose. It happened again as gold prices rose from 2015 through 2019, first as investors and markets anticipated higher interest rates and then as the Fed did raise rates for a brief time.

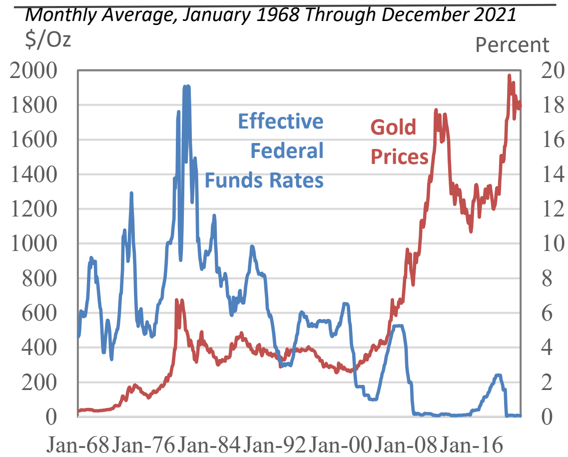
The keys to whether rising interest rates are positive or negative for gold prices rest in (a) why interest rates are rising, (b) how the market reads or perceives the rise in interest rates, (c) how high interest rates are, (d) the speed at which interest rates rise, and other factors.

If investors see the Fed raising interest rates to fight inflation, they must make a bet as to whether the Fed or inflation win. In those periods of rising gold prices in line with rising interest rates, the markets have bet against the Fed. Also, interest rates were higher, sometimes much higher (like 21% in 1980), than they are now.

As with inflation, the statistical correlation drives home the fact that rising interest rates do not preclude rising gold prices. From 1970 through 2020 the quantified correlation between changes in Treasury bonds and Treasury Bills and changes in gold prices have averaged out to zero. This makes gold an excellent portfolio diversifier, uncorrelated negatively or positively with bonds and bills.

Effective Federal Funds Rates And Gold Prices

Monthly Average, January 1968 Through December 2021



What This Means for Gold

As mentioned above, we expect gold prices to rise in the intermediate and long term from present prices. We predicate that view on a detailed analysis of a complex set of factors.

Our view is that inflation presently is at or past its worst and will dissipate over the course of 2022. That does not mean that we think gold prices will not rise, just that the upward pressures on gold prices will come from a host of factors other than inflation.

Similarly, our expectation is that interest rates will rise, but that this will present only a minor headwind to rising gold prices.

Even with sharper increases in interest rates than presently publicly envisioned by the Fed and other mainstream economists, nominal interest rates are expected to remain historically low, too low to be so attractive as to lure investors away from gold. We also agree with the Fed that real, inflation-adjusted short-term Treasury rates are likely to remain negative for another decade.

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Jan. 2021 - Jan. 2022

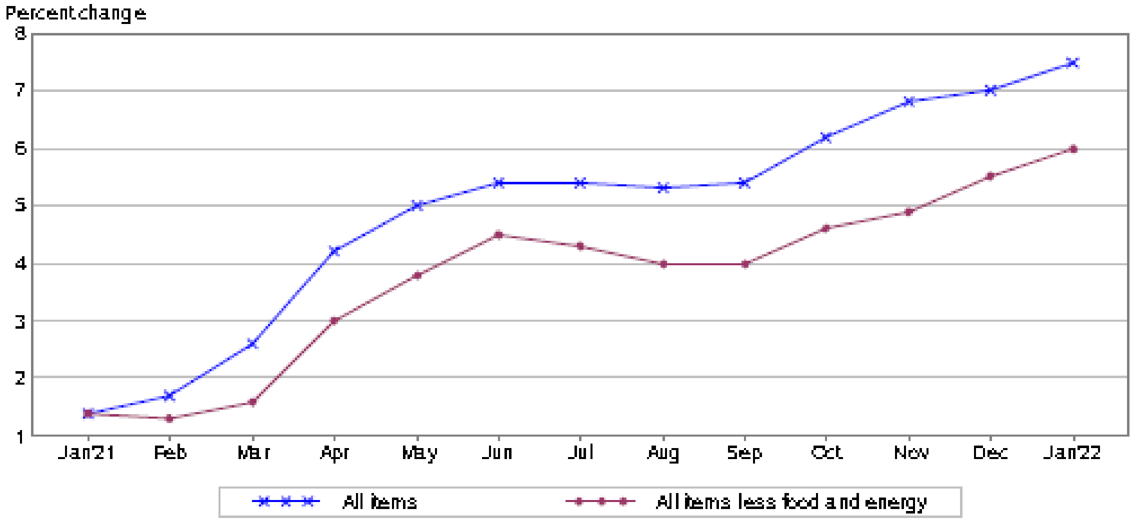


Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, Jan. 2021 - Jan. 2022