Gold

10 February 2022

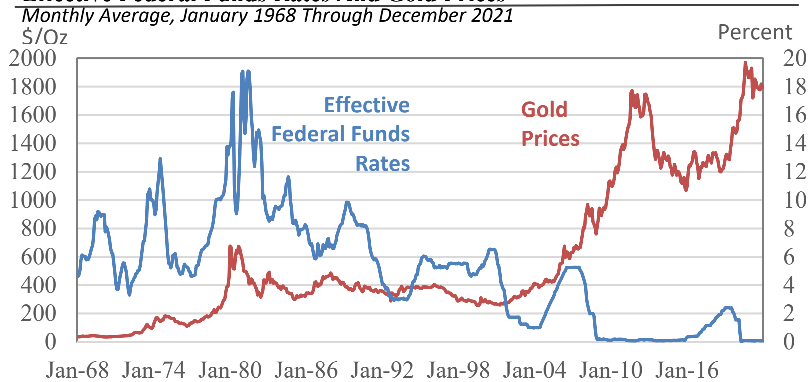
The Rising Fed Funds Rate Likely Effect on Gold

Much is being said, written, and thought about the likely effects on gold prices of the shift in Federal Reserve Board interest rate policies. The change in the Fed's policy stance, along with likely similar shifts in Europe, have contributed to heightened volatility in equities, debt, precious metals, and commodities markets.

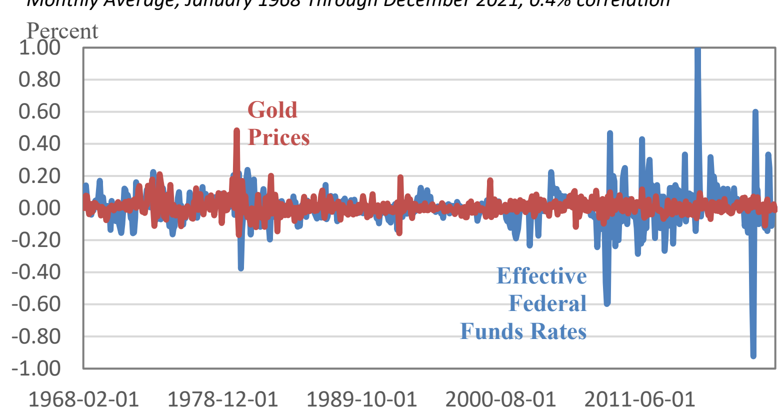
While it is unclear how exactly the new policies of shrinking the Fed's balance sheet by reducing bond purchases while also raising short-term interest rates will affect gold, some things are known.

Often, gold prices have tended to do well in periods of rising U.S. interest rates. This seems likely to do so again in the upcoming round of higher interest rates.

Effective Federal Funds Rates And Gold Prices
Monthly Average, January 1968 Through December 2021



Percentage Changes Effective Federal Funds Rates and Gold Prices
Monthly Average, January 1968 Through December 2021, 0.4% correlation



There are several reasons why rising interest rates tend to coincide with rising gold prices. For one thing, the first effect of a shift to raising interest rates often is weaker equity prices as valuation models indicate lower stock prices are needed to be competitive with higher rates. Some of the money coming out of stock markets is moved into gold and silver.

Additionally, interest rates are not raised on whims. Increasing interest rates signals that the Fed and Treasury are concerned about higher and rising inflation. Investors buy gold as an inflation hedge. They also buy gold to hedge against weaker economic growth and consequently weaker stock and bond markets due to the higher interest rates.

The initial gold price response to market anticipation about the Fed's pronouncements in the final week of

January was for gold prices to rise to $1,854.20. Prices then fell to $1,778.80 over the next three days, before recovering.

Some investors were concerned that higher interest rates could push gold and silver prices down. Then they realized that nominal rates will remain low and real rates will remain negative even if interest rates are raised twice as much as the Fed seems to plan to raise them. The prospective increase in short-term U.S. Treasury interest rates will be too little and at too low of levels to negatively affect gold and silver investment demand and prices.

Indeed, in 2021 the Fed expressed its expectation that U.S. Treasury interest rates may remain negative in real inflation-adjusted terms for perhaps the next decade. (Real rates on Treasury Bills have been negative for most of the time since 2008 already.)

The bottom line is that a new Fed interest rate regime, likely to be followed by similar moves by the European Central Bank shortly, creates uncertainty across financial markets. That leads to short term volatility, along the lines of what was experienced in the final week of January. Beyond that jolt, similar to when a sail boat tacks, the new Fed policies and anticipated increases in interest rates coupled with a reduction of Fed bond purchases all bode well for gold and gold investors.