15 November 2021

Gold, Inflation, And Interest Rates

Gold prices rallied last week as U.S. producer and consumer inflation indices released for October where higher than expected. While inflation is not the end all be all for higher or lower gold prices, rising upward inflationary pressures help make the case for higher gold prices.

Monetary officials, market participants and commentators have suggested that recent higher inflation statistics are transitory, reflecting strong demand across the segments of goods and services coupled with lagging supplies and major distribution and labor shortfalls – those supply chain issues commonly discussed from a lack of truck drivers to service workers.

Part of the problem with much of the commentary is that Fed and Treasury officials purposefully have declined to define 'transitory,' leaving observers to make their own decisions about what that means. When the Fed first used this term in April 2021, observers thought that transitory inflation meant three months or so. Economists saw it as more likely that such transitory inflationary pressures would last into early 2022. By not specifying that, the Treasury and Fed have contributed to the impatience visible in public commentary and concerns.

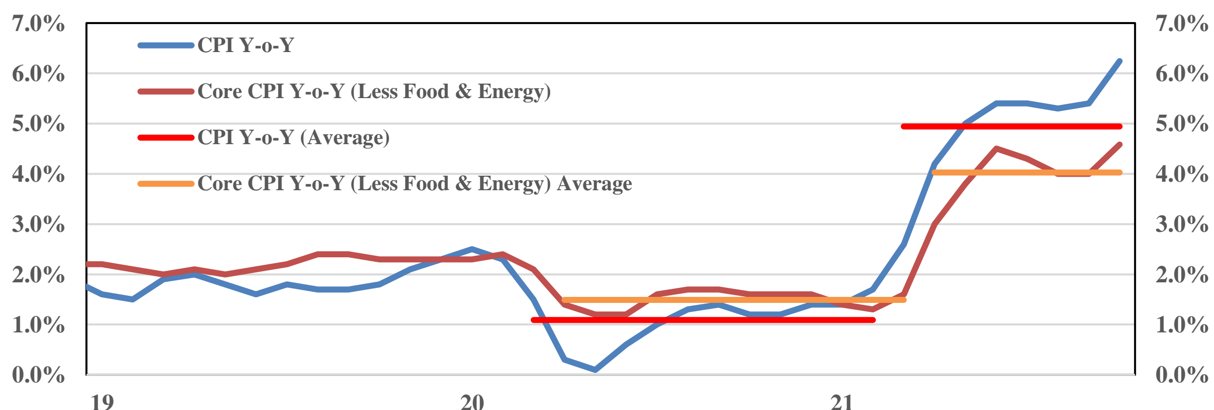
The chart below takes a closer look at inflation figures from 2019 through October of this year, the most recent data available on U.S. inflation.

This chart shows that from around March 2020 through February 2021 headline inflation averaged about 1.1%, while core inflation excluding the more volatile food and energy averaged 1.5%. This was well below the rates of inflation in 2019 (and earlier), as well as half the 2% that Fed officials had been targeting.

This low inflation also was seen as transitory, the result of the U.S. and global lockdowns aimed at controlling the Covid 19 pandemic.

This transitory low inflation lasted around 12 months. The more recent high inflation figures

U.S. Inflation - CPI Y-o-Y



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are well above 2% since March of this year have been ongoing for eight months.
These reflect several developments.

1. Much stronger demand for goods and services, including imported products, far greater than pre-pandemic levels.
2. Supplies lagging this surge in demand.
3. Major disruptions in overseas shipping of products, U.S. port processing times, and U.S. truck drivers.
4. Labor shortages due to several factors including the restrictions on allowing foreign workers into the United States and major re-evaluations of work-life balances by people after the economic lockdown.
5. Higher energy prices due to reasons ranging from slow recovery in supply from the pandemic to changes in the energy mix used to produce electricity to meet climate change goals.
6. Higher labor costs and shortages of child-care capacity to ease decisions about returning to work.

Just as the 2020 period of below-trend inflation was transitory, the current period of higher inflation should be expected to last for at least another four months, if not longer. The average CPI inflation rate since March has been 4.9% for headline inflation and 4.0% for core inflation.

From 2017 through February 2020 the average for headline inflation was 2.1%, right on the Fed's target. Core inflation meanwhile averaged 2.1% during the time, too.

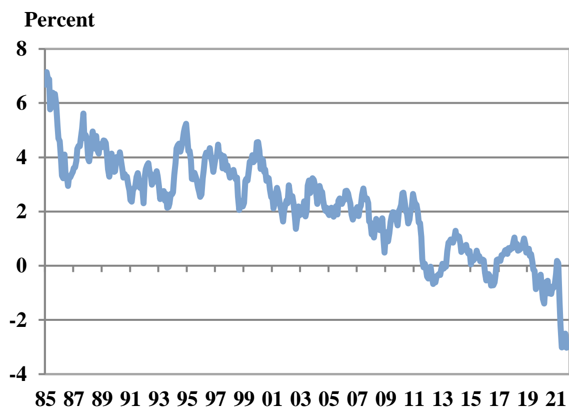
As Covid's economic fallout and the supply chain effects from the economic lockdown and ongoing politico-economic factors interrupting both international trade and domestic freight distribution work themselves through the markets, it is expected that inflation rates will trend back toward 2.0% - 2.5%. Such a reduction in inflation rates is expected by CPM to set in during the second and third quarters of 2022. Monetary officials also will try to adjust their policies more favorably, aiming toward 2%.

In the interim, the 'transitory' inflationary pressures are expected to support the near-term price for gold. The gold price support will come from investor assumptions that higher inflation is supportive of higher gold prices, a self-fulfilling assumption not supported by data. Historically, for gold prices to rise due to inflation, inflation has had to rise more strongly than we are seeing at present and stay elevated for longer. The 1970s is a good example of when gold responded positively to inflation. From 1970 through 2020 the correlation of changes in U.S. CPI and gold price was 9.0%. From 2008 through 2020 the relationship was -5.0%. None of this particularly supports the common assumption that gold prices rise along with inflation. It takes higher inflation rates to really push gold prices higher, however.

Interest Rates, Too

Drilling a bit deeper into inflation, one also must consider real interest rates. Real interest rates have dived more deeply into negative territory.

Real Interest Rates (10 Year Treasury - U.S. Inflation)



Real interest rates mostly have been consistently negative since the middle of 2019, using the 10-year Treasury minus headline inflation. Since June of this year negative real interest rates have pushed below -2.5%, most recently notching -

3.0% for October. In a real negative interest rate environment, investors favor gold and silver, which tend to be seen as currencies as well.

A continuation of negative real interest rates for the near future should be expected to help push gold higher. This may depend on how negative interest rates fall and how long negative interest rates last. Combined, the increase in inflation and deepening negative real interest rates both support higher gold prices.