As US recovery gathers momentum, gold likely to lose sheen

Stronger dollar, higher interest rates and treasury yields may drag the metal towards $1,100-1,050/ounce

PRITI GUPTA

Expectations that the United States is gearing towards the start of a monetary tightening cycle, following almost six long years of near-zero interest rates, have begun to have negative repercussions on gold. Since December 2008, the benchmark Federal funds rate in the US has held in the range of 0-0.25 per cent. Meanwhile, the Fed has expanded the size of its balance sheet by a whopping 450 per cent during this period. The intention of such an ultra-accommodative stance was to lift the US economy from its worst recession since the Great Depression of 1929.

Positive signs

In the past several months, the US economy has shown strong signs of progress. Most of the data sets coming out from the US have been encouraging. On the labour side, jobs per month so far this year have averaged 215,000, the strongest since 1999. Meanwhile, the jobless rate has declined to a six-year low of 6.1 per cent in August 2014. Besides the labour market, other sectors such as housing, manufacturing and services have shown a marked improvement in the past several months. All these suggest that the recovery has mostly been broad-based. Our base scenario is that the US economy will continue to strengthen in the months ahead.

During the 2007-08 housing crisis, the weakening of the US economy prompted the Fed to aggressively ease its monetary stance. This led to a sharp depreciation in the dollar and fall in treasury yields, offering a perfect environment for gold to rally. However, the role seems to be now reversing. The US economic recovery has caused the Fed to gradually scale back its stimulus (*aka* tapering). The fund infusions will stop next month.

Furthermore, strengthening economic conditions have raised expectations of policy normalisation, i.e., a calibrated increase in the monetary-policy rate and withdrawal of the monetary infusion during the phase of quantitative easing. These factors have been major reasons for the recent strengthening of the dollar and have put upward pressure on US yields, a combination that has caused gold to slip south in the past few weeks.

Mighty dollar

In the past, gold has trended in the opposite direction to the dollar and to US yields. A strengthening dollar puts downward pressure on inflation, which in turn diminishes the appetite to hold gold as a hedge against rising prices. At the same time, rising US yields boost appetite for interest-bearing assets, which in turn increase the opportunity cost of holding gold.

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As such, a combination of higher interest rates, a stronger dollar and higher treasury yields would be negative for gold and could resume the metal's downslide, possibly dragging it towards $1,100-1,050 an ounce in the next few months.

Over the next few weeks, we will closely monitor data sets from the US. If, as we expect, they continue to point at strengthening economic conditions, the Fed would most likely signal a shift in its monetary stance and prepare the financial markets to gear up for a series of rate hikes in 2015. Such expectations, we believe, would be the key factor that would exert downward pressure in gold in the months ahead.

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