What Really Drives Gold Prices

Introduction

Gold occupies a special place among precious metals. For much of recorded history it has played an important role as money or, more recently, as a relative standard for other currencies. In the latter part of the 19th century, many European countries as well as the United States instituted gold standards, pegging their currency to a fixed amount of the precious yellow metal. This system remained more or less in place until after World War II, when the Bretton Woods system pegged the US dollar to a fixed exchange rate of US$35 per troy ounce. In 1971, the U.S. suspended the convertibility of dollars to gold, transitioning to the system of fiat currency still in place presently.

Today, there are no remaining currencies pegged to gold (the Swiss Franc was the last currency to drop the gold peg, in 2000), but its legacy as a store of value still greatly influences the way it is used today. Unlike many other precious metals, gold's usage is dominated by investing applications: 40% of the new gold produced every year is used in investments, 50% is used in jewelry, and 10% finds its way into industrial applications (Source: Metals Focus, as of 12/31/15).

All of this is to say that, from an investing standpoint, gold does not behave very much like other metals. It is not very responsive to changes in supply or demand. Rather, gold's price movements are largely attributable to a number of global economic forces or "price drivers." The purpose of this article is to explore which ones and why, in order from most to least impactful. This article will also examine Negative Interest Rate Policy (NIRP), and take a cursory look at where gold might be headed for the remainder of 2016.

Driver 1: Changes in the trade-weighted US Dollar

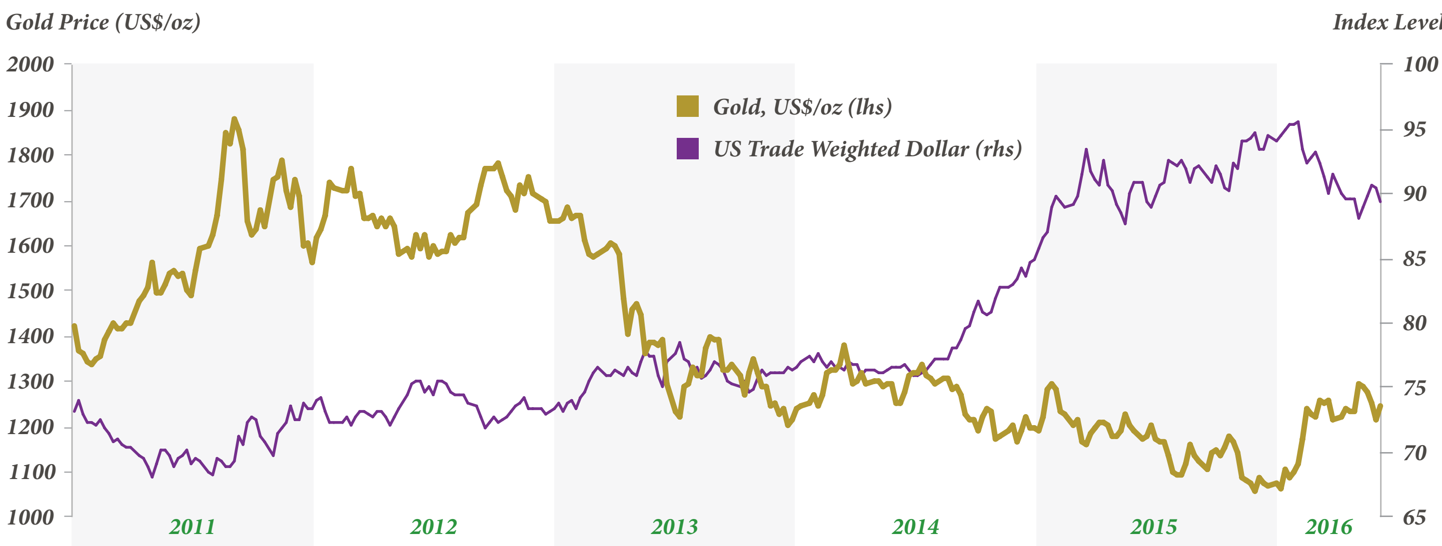
As the world's foremost reserve currency, dominating international trade and transactions, the strength of the U.S. dollar has a tremendous impact on financial markets worldwide, and by extension on the price of gold. We see this as the number one driver of gold prices.

The trade-weighted dollar is widely used to measure the purchasing power of the U.S. dollar, as well as the effects of its appreciation and depreciation against foreign currencies. The Trade Weighted Dollar Index, also known as the Broad Index, uses the currencies of 26 foreign countries, accounting for 90% of U.S. trade, to calculate the trade-weighted dollar. As the dollar rises in value, exports to other countries become more expensive while imports become cheaper.

If the U.S. dollar is being debased, for example by loose monetary policy, the price of gold tends to react inversely, that is, to rise. When the value of the U.S. dollar drops, many investors rush to gold as an alternative currency. Conversely, if the trade-weighted U.S. dollar rises in value, gold prices tend to fall.

Exhibit 1: Gold and the trade weighted dollar tend to exhibit an inverse relationship

Source: Bloomberg, ETF Securities. Data as of June 3, 2016. Chart from 12/31/2010 – 06/3/2016.



Driver 2: CPI Inflation

We see Consumer Price Index (CPI) inflation as the second-most important price driver of gold. CPI, or the Consumer Price Index, is a statistical estimate which uses a representative basket of goods to measure price changes over time, and is usually calculated on a monthly or quarterly basis. The representative basket is composed of a very wide variety of goods ranging from rent payments, to utilities, food, apparel, transportation, medical care, and much more. A rise in the Consumer Price Index represents rising prices of everyday goods and services, in other words an inflationary environment. Gold has historically been a hedge against rising prices, and therefore tends to respond positively to CPI inflation. On the other hand, in a deflationary environment with falling consumer prices, gold would also tend to decline in value.

Over the last ten years (12/31/05 – 12/31/15), the annual CPI inflation rate has averaged around 2%, though in any one year inflation may have been significantly lower or higher than that amount. For example, the annual inflation rate in 2005 was 2.5%, rising to 4.1% in 2007 before falling to 0.1% the following year. Indeed, CPI inflation rates are adjusted as the CPI index is recalculated on a monthly basis by the U.S. Bureau of Labor Statistics, and so can swing from month-to-month. News of abnormally high or low inflation rates would likely have an immediate effect on the price of gold.

Driver 3: Changes in nominal yields on 10-year U.S. Treasuries

In our view, the third most important driver of gold prices is derived from changes in nominal yields on 10-year U.S. Treasuries. Loose monetary policy (low or zero interest rates) tends to have a positive effect on gold prices, and this can also be reflected in longer rates on 10-year U.S. Treasury bonds. By combining inflation figures with nominal 10-year rates, it is possible to arrive at a real rate proxy, providing some indication of how gold might respond. In other words, a positive change in nominal yields on 10-year U.S. Treasuries would tend to be negative for gold prices. Gold prices would tend to respond positively to falling nominal yields.

Driver 4: Investor sentiment

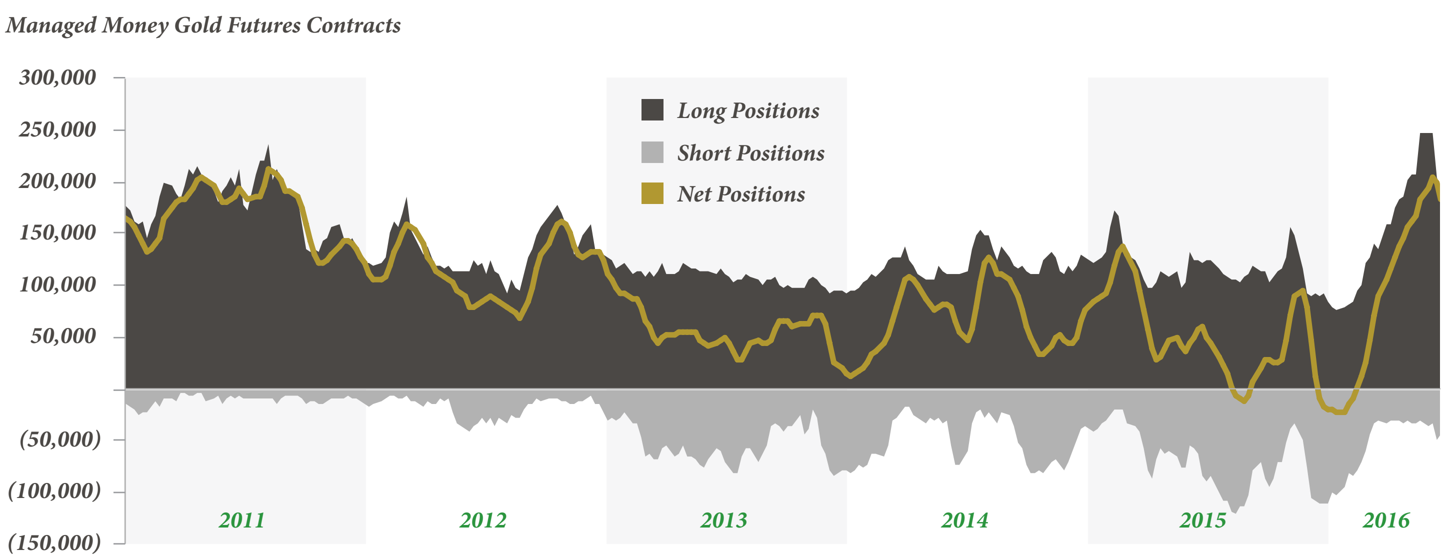
Investor sentiment is by its very nature a fickle and difficult-to-quantify variable, but it is undoubtedly important. In general, we view it as the fourth-most important price driver for gold, however judging by recent surges in net long speculative positioning in futures markets, it is one of the most important currently (as of May 31, 2016). Thanks to gold's status as a "safe haven" asset, disasters and other shocks to the financial system including wars, financial dislocations, anxieties regarding the political situation (e.g. the 2016 U.S. presidential election), and general instability may push gold prices higher.

Driver 5: Position in the economic cycle

Generally speaking, economic cycles are the natural ups-and-downs between times of expansion and contraction. Wherever we find ourselves in an economic cycle, whether it happens to be a growth period or a recession, may have some impact on gold prices. However, because the four preceding drivers also to some extent behave as functions of the overall economic cycle, we find this to be the least significant driver of gold prices overall.

Exhibit 2: Sentiment towards gold has reversed dramatically in 2016 as investor positioning has shifted from net short to net long

Source: Bloomberg, CFTC ETF Securities. Data as of May 31, 2016. Chart from 12/31/10 – 5/31/16.



Negative Interest Rate Policy (NIRP) and Gold

In their ongoing efforts to stimulate the world's economies, some central banks continue to loosen monetary policy. After finding Zero Interest Rate Policies (ZIRP) to be inadequate, certain central banks have moved on to what is known as Negative Interest Rate Policy (NIRP). Under NIRP, depositors must pay to keep money in the bank, in an effort to incentivize banks to lend more freely to businesses and individuals, and eventually increase aggregate demand.

These policies have augmented demand for gold and physical cash, pushing gold prices higher. For example, MunichRe, a German reinsurer, has parked 324 million Euros in physical gold out of a 231 billion Euro investment portfolio, while also adding tens of millions of Euros to its cash pile (Source: Reuters as of March 18, 2016). There have also been reports of increased demand for domestic safes in countries such as Japan (which have NIRP in place)—rather than park their money in the bank where they must pay to keep it. People are holding onto their cash and continuing not to spend it, an indication that NIRP may not be having its intended effect. It's also worth noting that while the United States nominally has normal, positive interest rates, they are still negative in real terms (when factoring in inflation)—money's value is actively being debased as it sits in a bank. In such environments, gold may look very attractive to investors.

Looking Forward

It is our belief that the Fed has made a critical policy error by not raising rates in response to inflationary pressures (especially in ex-energy and food prices) and a tight labor market. Although the need for higher interest rates is clearly visible, the Fed's dovish (low interest rate) rhetoric has convinced market participants that it won't be hiking interest rates again any time soon. Dollar weakness, high inflation, and relatively low interest rates help support gold prices. Even if and when the Fed decides to raise rates, if it does so half-heartedly rather than with bold strides, it's quite likely that real interest rates (net of inflation) will continue to be negative, which also tends to be supportive of gold prices.

Speculative positioning is currently very high, running at levels that were last seen at the peak of the Greek sovereign wealth crisis. If this situation persists, it's feasible that gold prices may rise above US$1300/oz. At some point in the future, market anxieties will dissipate and the Fed will have caught up to the economic climate, perhaps causing gold prices to decline, although there is little sign of this happening in 2016.

Conclusion

As far as metals go, gold is a very unusual one, and its price is much less responsive to the traditional forces of supply and demand than one might at first assume. The most powerful price driver for gold is the trade-weighted dollar, measured in terms of a basket of 26 foreign currencies. A falling dollar tends to have a positive effect on gold prices. CPI inflation is the second-most important price driver—in an inflationary environment, gold tends to rise. Third-most significant is changes in nominal yields on 10-year U.S. Treasuries, followed by investor sentiment, whose importance can vary greatly from one environment to the next, and lastly our position in the economic cycle.

Important Information

The ETFS Gold Trust is not an investment company registered under the Investment Company Act of 1940 or a commodity pool for purposes of the Commodity Exchange Act. Shares of the Gold Trust are not subject to the same regulatory requirements as mutual funds. These investments are not suitable for all investors. Trusts focusing on a single commodity generally experience greater volatility. There are special risks associated with short selling and margin investing.

Commodities and futures generally are volatile and are not suitable for all investors.

The value of the Shares relates directly to the value of the precious metal held by the Trust and fluctuations in the price could materially adversely affect investment in the Shares. Several factors may affect the price of precious metals, including:

- A change in economic conditions, such as a recession, can adversely affect the price of the precious metal held by the Trust. Some metals are used in a wide range of industrial applications, and an economic downturn could have a negative impact on its demand and, consequently, its price and the price of the Shares;
- Investors' expectations with respect to the rate of inflation;
- Currency exchange rates;
- Interest rates;
- Investment and trading activities of hedge funds and commodity funds; and
- Global or regional political, economic or financial events and situations. Should there be an increase in the level of hedge activity of the precious metal held by the trust or producing companies, it could cause a decline in world precious metal prices, adversely affecting the price of the Shares.

Also, should the speculative community take a negative view towards gold, it could cause a decline in world gold price, negatively impacting the price of the Shares.

There is risk that part or all of the Trusts' physical gold could be lost, damaged or stolen. Failure by the Custodian or Sub-Custodian to exercise due care in the safekeeping of gold held by the Trust could result in a loss to the Trust. The Trust will not insure its gold and shareholders cannot be assured that the custodian will maintain adequate insurance or any insurance with respect to the gold held by the custodian on behalf of the Trust. Consequently, a loss may be suffered with respect to the Trust's gold that is not covered by insurance.

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Investors buy and sell shares on a secondary market (i.e., not directly from trust). Only market makers or "authorized participants" may trade directly with the fund, typically in blocks of 50k to 100k shares.

The Fund's net asset value per share (NAV) is calculated by dividing the value of the Fund's total assets less total liabilities by the number of shares outstanding. Market Price returns are based on the bid/ask spread at 4 p.m. ET and do not represent the returns an investor would receive if shares were traded at other times.

Bretton Woods – the international monetary arrangement, agreed upon by the allied nations in 1944 in Bretton Woods, US, that created the International Monetary Fund (IMF) and World Bank and that set up a system of fixed exchange rates with the US dollar as the international reserve currency.

Long position - The buying of a security such as a stock, commodity or currency with the expectation the asset will rise in value.

Short position - The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value.

Net position - The value of the position subtracting the initial cost of setting up the position.

Swiss Franc – The CHF (Swiss Franc) is the currency abbreviation for the Swiss franc (CHF), the currency for Switzerland.

Negative Interest Rate Policy (NIRP) – A negative interest rate policy is an unconventional monetary policy tool in which nominal target interest rates are set below zero.

Zero Interest Rate Policies (ZIRP) – An important milestone in monetary policy because the central bank is no longer able to reduce nominal interest rates—it is at the zero lower bound.

Trade Weighted Dollar Index – also known as the Broad Index, is a measure of the value of the United States dollar relative to other world currencies.

U.S. Bureau of Labor Statistics – A unit of the United States Department of Labor. It is the principal fact-finding agency for the U.S. government in the broad field of labor economics and statistics and serves as a principal agency of the U.S. Federal Statistical System.

Consumer Price Index – An index of the variation in prices paid by typical consumers for retail goods and other items.

Fed – The Federal Reserve System (FRS) is the central bank of the United States. The Fed, as it is commonly known, regulates the U.S. monetary and financial system.

Shares in the Trust are not FDIC insured and may lose value and have no bank guarantee. This material must be accompanied or preceded by the prospectus. Carefully consider the Trust's investment objectives, risk factors, and fees and expenses before investing. Please view the prospectus at http://etfsecurities.com/etfsdocs/USProspectus.aspx or visit the ETF Securities website: www.etfsecurities.com.

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ETF Securities (U.S.) LLC
48 Wall Street
New York
NY 10005
United States

t +1 212 918 4954
f +1 212 918 4801
e infoUS@etfsecurities.com
w etfsecurities.com