

Gold: As the USD Declines

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- We revisit the close relationship between the USD and gold, quantify the impact a change in the USD has on the gold price, and lay out the seasonal factors at play. We make the case that the gold price is high, due to the decline of the dollar, but not at bubble heights. In our view, as long as the USD bearishness persists, the gold price could stay elevated and lend AUD, CAD and ZAR extra support.

Golden opportunity or golden bubble?

Gold is stretching past \$450/oz, marking 16-year highs. At the same time, the gold price does not appear to be in a bubble in terms of its 25 years of price history. However, if anything, its 54% rise from the lows in the summer of 1999 now looks like a return to trend. (Exhibit 1).

Quo vadis?

The dollar's decline is keeping gold attractive as the natural beneficiary of USD bearish sentiment. This is due in part to the fact that gold is priced in USDs: a stronger dollar naturally buys more ounces of gold. The gold price is inversely correlated with the USD to a fairly high degree, on average 30% as the table on the next page suggests. Even so, on a rolling basis the correlation between the USD and the price of gold appears to be intensifying at the moment, heading toward 55%. (Exhibit 2)

To the extent that the USD is driving gold higher, gold is further strengthening certain currencies. Based on our correlations, the currencies most likely to appreciate relative

to the USD in line with a rise in gold prices are AUD, CAD, JPY, EUR and ZAR.

While a correlation with gold alone is not enough to recommend the commodity currencies, it is a feather in their caps. For example the price of gold has been positively and strongly (between 27% and 34%) correlated with AUD since the 1980s. Similarly ZAR shows a positive 12-17% correlation with gold (the negative number in the table is due to the way the currency is quoted). In tandem with the recently strong ZAR performance based on economic fundamentals, we see no reason to think ZAR cannot keep gaining.

Quantifying the impact of the USD decline on gold

We also quantified the impact of a change in exchange rates on gold. Specifically we estimated the relative change in gold prices for a given change in the exchange rate at the one-month and one-week frequencies. These uniformly suggest that the average monthly change in the Fed's major USD index is responsible for about a \$1 change in the price of gold. Of course with the USD currently in freefall, we would expect a much larger impact on gold. Causality tests confirmed that changes in the USD index can drive changes in the spot price of gold.

'Tis the season...for gold prices

In addition to gold rising on the momentum of the USD decline, there may be a small seasonal factor at play.

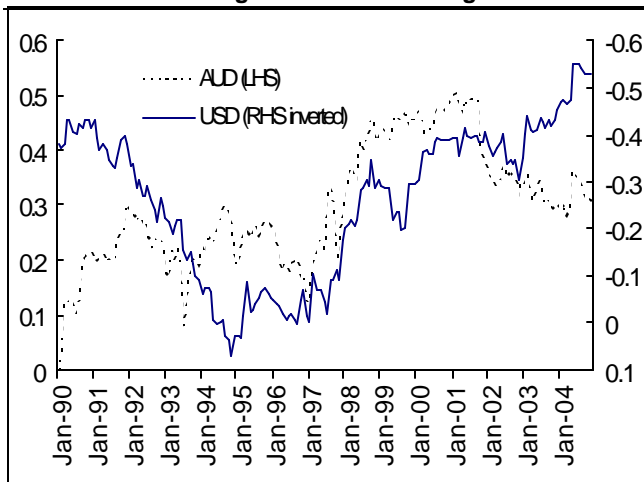
Exhibit 1

Gold price performance



Exhibit 2

The Gold-USD rolling correlation is rising



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Generally speaking most studies conclude that there is no dominant seasonal pattern to gold, at least from the demand side. However, we found that there has been a year-end rise in the price of gold over the past 25 years. Exhibit 3 plots this year's price of gold month-by-month against the average seasonal index factors. It suggests that, at the very least, we do not expect seasonal impediments to rise further.

Market factors decreasing supply and raising demand

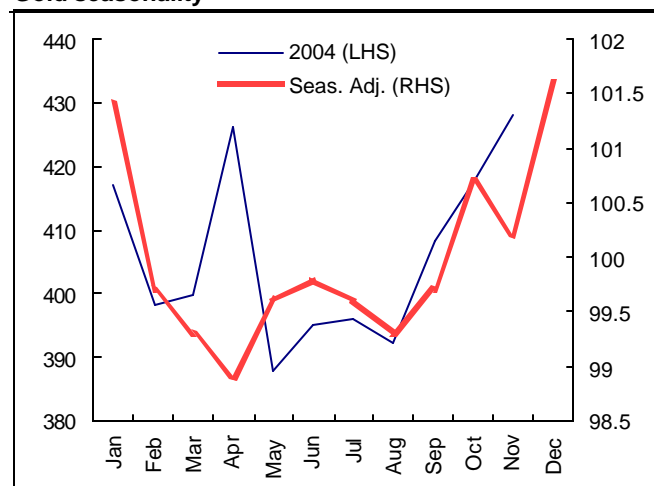
It's worth mentioning that the supply and demand characteristics also suggest that gold prices will continue to rise from current levels. The supply side is principally driven by mine production, and while this has been stable to falling over the past two years, central bank sales and the net hedging by producers has been more key to overall supply. The second Washington Agreement on Gold went

into effect this September, regulating European Central Banks' sales of gold to 500 tonnes per year over the next five years. These banks account for 40% of existing stocks of institutionally held gold and by selling stock they have increased supply in the market, though only at the margin. Net hedging by producers gained market attention in 2000 when they began reducing the amount sold forward, and so far this reduction in supply has outweighed the increase generated by central bank sales. Overall supply could be more constrained going forward.

The demand side is driven largely (80%) by demand for jewellery, particularly in Asia and the Middle East. Demand in these regions could increase further if geopolitical tensions remain high, petrodollars continue to flow in the Middle East, and Asian currencies appreciate relative to the USD as we expect they will.

Exhibit 3

Gold seasonality



Source: Morgan Stanley Research, EViews

Macro risks to a USD/GOLD rate

Imagine gold were a currency the way other monies are. What macro factors would influence the USD/gold rate? This rate is susceptible to a number of currency-related factors. For example, the risk of intervention by the Japanese MOF to support USD/JPY could stop the rising gold price in its tracks. Another risk to gold prices is the possibility of increased hedging again. Declining interest rates had brought down the contango in gold; now, the return to rising rates may well make selling forward more attractive and possibly generate interest in hedging, thus increasing supply. Yet, despite these potential macro risks to gold, the Bush administration's effective green light to a softer USD has given the gold price freedom to rise. As long as the USD keeps going, gold may too.

Exhibit 4

Gold price correlations with FX

	AUD/USD	AUD/TWI	USD/TWI	USD/ZAR	USD/CAD	CAD/TWI	CHF/TWI	USD/JPY	JPY/TWI	USD/RUB	EUR/USD	EUR/TWI
1980-2004 monthly	0.27	0.07	-0.35	-0.17	-0.13	0.15	0.19	-0.25	0.14	NA	0.29	0.21
1990-2004 monthly	0.34	-0.27	-0.28	-0.12	-0.21	0.15	0.10	-0.20	0.15	0.04	0.16	0.08
1990-2004 weekly	0.32	0.16	-0.31	-0.18	-0.18	0.12	0.13	-0.20	0.14	0.05	0.26	0.17

Source: Datastream; correlations based on monthly logarithmic returns

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