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Fears of impending interest-rate hike tarnish gold

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Not so long ago, gold rose to new highs. Recently, it has suffered the most challenging losses since 1999. Rate hikes do not bode well for the gold in the near term, but what about in the medium-term?

AFTER climbing to US$1,206 per ounce in June, gold has suffered seven weeks of losses, the longest fall since 1999. After mid-July, gold prices plunged under US$1,090 as sellers in China appeared to offload the precious metal. That's also when China's announced gold reserves — though showing remarkable growth — proved significantly lower than market expectations.

As the Greek debt crisis seemed to stabilize, a calm returned to China's A-share market and Fed Chair Janet Yellen delivered a seemingly upbeat assessment of the US economy, the glitter of gold no longer appeared attractive. Yellen's preference for "sooner-but-slower" rate hikes indicated that the Fed was moving toward normalization.

As US non-farm payrolls climbed 215,000 last month and unemployment rate stayed at a 7-year low of 5.3 percent, gold rose close to US$1,100. That, however, was predicated on the assumption that the Fed would defer the interest rate hike beyond September. In the past two weeks, prices have been between US$1,080 and US$1,100. However, the impending rate hike is likely to strengthen the prospects of the dollar, which would put gold under further pressure.

The drivers of gold prices

Most observers have explained gold's plunge with a set of drivers. The problem is, at closer inspection, each proves elusive.

First of all, the continued recovery of the US economy is strengthening the dollar and expectations of an impending rate hike, which is seen as paving the way for gold's further decline. Yet, even as the US dollar index rose by over 12 percent in 2014, the dollar-denominated gold price was flat.

In fall 2014 and spring 2015, gold was driven by the broad commodity sell-off, especially the drastic plunge of oil prices which was fueled by the stronger dollar, along with concerns over China's slowdown. Yet, the reality is that gold has low correlations with commodities and other asset classes.

There is also the view that China's gold demand has been slowing. In relative terms, demand has eased after the 2013 highs, but the growth trend prevails. Since 2009 the People's Bank of China has increased its gold reserves by 57 percent and the first quarter of 2015 was one of the best on record.

If Chinese GDP per capita continues to double within the decade, consumer demand is likely to hold, and the PBC will increase its gold reserves, if only for diversification and to reduce dollar reliance. If Indian growth will prevail, it is likely to support similar trends.

Gold's diverging short- and medium-term trajectories

The idea that a stronger dollar is negative for gold became conventional wisdom in the 1980s and 1990s. In those decades, mine production was still growing strongly, central banks were selling gold and the West drove global growth prospects.

That's not the case today. Mine production is expected to dwindle in the coming years. Central banks are no longer net sellers, but net buyers. Gold demand is fueled by Asian demand, particularly by China and India which account for more than 40 percent of total demand and over 50 percent of private demand.

Also, the monopoly role of the US dollar that has driven markets since 1945. As the renminbi takes its place among major reserve currencies, the world's dollar-dependency will ease. Indeed, the short-term case for gold looks bumpy because US rate hikes are likely to tax the glitter of the precious metal.

Nevertheless, the medium- and especially long-term case look different because the new drivers of gold demand, particularly in Asia, could prove relatively solid through the 2020s.

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