WHEATON PRECIOUS METALS

The Macro-Metal News

Rising Dollar May Not Be A Problem for Gold

April 30, 2020

METAL

Gold is undisturbed by the US dollar's rise, but should investors be?

- Traditionally the US dollar and gold are inversely correlated to each other. Hence the dollar's recent, sharp rally is a concerning development for the gold investor.
- Also concerned with the dollar's behavior is the Federal Reserve, which expanded its swap operations to nine additional central banks in an attempt to improve global liquidity conditions by making dollars more widely available at subsidized rates.
- But such operations – previously carried out in 2007-09 and 2010-12 – have had no discernable impact on the dollar's value, implying no relief.
- Nevertheless, the gold investor need not be wary as there are exceptions to the traditional, opposing relationship. During periods of intense financial, economic and/or political disorder both rise in concert.

The gold investor looks wearily at the United States (US) dollar's recent strength. The currency[a] has appreciated rapidly from 115, at the start of January, to 123 by late-April. The relationship between the dollar and gold[b] prices has traditionally been inversely related. For example, the median rolling 30-day correlation coefficient between the two has been a negative 0.55 since April 2010. That means that 50 percent of the time for every 1 percent appreciation in the dollar, gold would depreciate 0.55 percent. That relationship is not much different for longer time periods. Since 1973, the median rolling 12-month correlation coefficient between the two was a negative 0.69.

The last time the dollar appreciated markedly, between July 2014 and February 2016, was also during a global economic slowdown and outright economic chaos across emerging markets. And though the disorder that caused the global slowdown was not conquered there was, at least, an 'armistice' that allowed the regions of the world to grow smartly again. During this period of "globally synchronized growth", as it was popularly referred to by the financial press, from February 2016 through January 2018, the dollar depreciated by 3.9 percent.

That may not sound like much, and indeed it is not if the standard against which the move is being compared to is zero. But zero is not the appropriate reference because the dollar was not treading water. Indeed, for just under five years prior, from May 2011 through January 2016, it had been appreciating at a compounded annual growth rate (CAGR) of 6.5 percent. So, in rate of change terms, the dollar actually depreciated more than 10 percent off-trend during the reflation. That is quite a material amount for a currency.

Gold investors remember those seven years well. During the dollar's run higher, from May 2011 through January 2016, gold prices fell at a CAGR of 6.5 percent. Then, for the two years that the dollar lost altitude, gold prices appreciated at a CAGR of 9.8 percent.

What has been sending the dollar higher? Can it be stopped? And if not, should gold holders be weighting the possibility of gold pulling back?

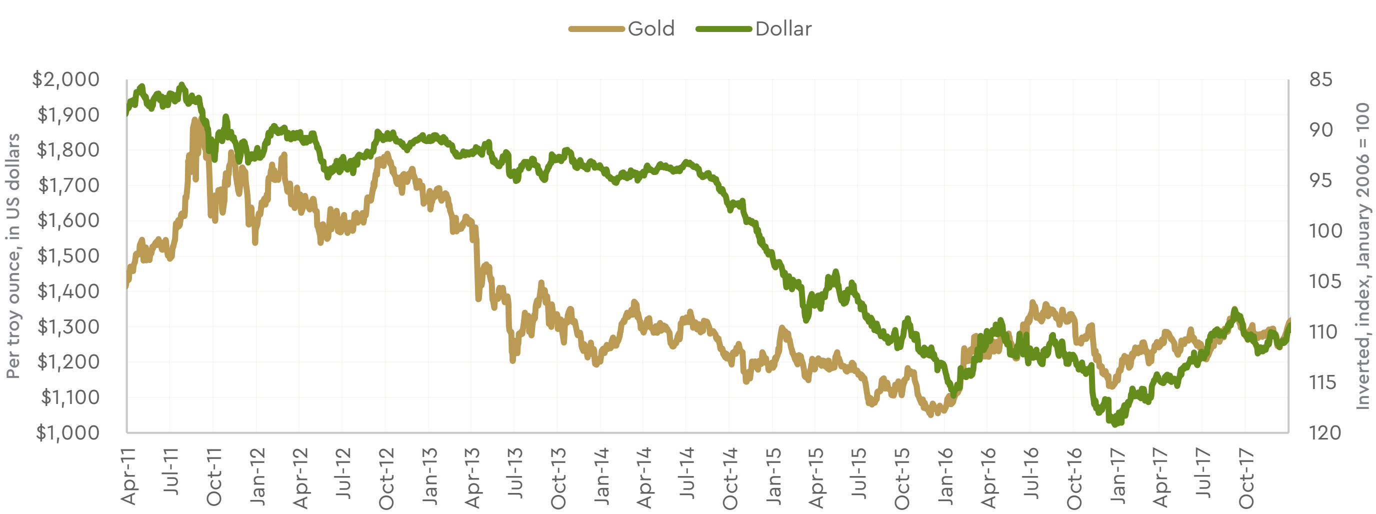
SAYŌNARA, SAYS TOKYO

Starting in late January 2018 the dollar began to rise for at least two reasons. Firstly, and most importantly, the acceleration in the creation of credit by the world's major money centers began to wane. As the international economy operates on a credit-based system, the expansion, stagnation or contraction of balance sheets by private, financial institutions has a direct impact on modern money supply. Much like the flame slowly starved of oxygen, the international economy's expansion is extinguished by the unavailability of credit.

Tokyo, an all-important global money

THE TRADITIONAL RELATIONSHIP HELD FROM 2011 THROUGH 2017

(LONDON 10:30AM GOLD PRICE FIX VERSUS TRADE-WEIGHTED BROAD GOODS & SERVICES US DOLLAR, DAILY)



[a] The dollar referenced in this report is a value as measured by the broad, trade-weighted goods and services index. In descending order of weight, the 26 countries are: the 19-country Eurozone, China, Mexico, Canada, Japan, the United Kingdom, South Korea, India, Switzerland, Brazil, Taiwan, Singapore, Hong Kong, Australia, Vietnam, Malaysia, Thailand, Israel, the Philippines, Indonesia, Chile, Colombia, Russia, Sweden, Argentina and Saudi Arabia.

[b] Gold prices referenced in this report are as measured by the 10:30 AM London time price fixing of the London Bullion Market Association.

center, in late-2017 began to, for the first time since 2008, withdraw from funding global expansion. This was highly unusual as there were any number of monetary, financial, economic and political reasons the world tempted Tokyo to retreat during the decade. Indeed the money centers of Europe, the Caribbean and the US had done precisely that in those intervening years. But not Japan, at least not until the October 2017.

Your blogger will speculate that the reason behind this fundamental sea-change was China's 19th Party Congress where President Xi Jinping announced – in so many words – that breakneck economic expansion was over.[a] Suddenly the world's undisputed growth miracle with an entire century-worth of runway – as per mainstream geopolitical pundits favoring "the Chinese century" – announced that the takeoff was being aborted. Naturally the heavily invested, well-connected Japanese banks had good reason to start reversing their balance sheet expansion. The consequences were global.

AMERICA DRAINS $1 TRILLION

Near-simultaneously as events were unfolding in East Asia the US began to drain the world of dollars. In late-2017 the Congress passed, and President Donald Trump signed, legislation known as the Tax Cut and Jobs Act of 2017. Within the Greek column-sized reams of pages was a section devoted to reducing the rate of taxation on US business earnings earned overseas; the intent was to encourage these dollars to come home. American businesses had been reticent for decades to return overseas profits because of the unusually large – relative to international norms – tax rate (i.e. 35%) charged by the US.

This idea had been acted upon before, during the Bush Administration in 2005. Then, instead of being assaulted with a tax rate that would make the Sheriff of Nottingham blush, businesses were offered a one-time holiday at about 5%. That year between $299 and $362 billion was brought back onshore.[b]

From 2006 and through 2017, the two bookend years of the repatriation tax changes, American companies returned, on average, $36 billion per quarter. But during the eight quarters of 2018-19 companies brought back $142 billion per quarter. This has been the equivalent of 104% of overseas profit whereas in the preceding 11 years repatriation had only been 35% of profit, on average. In total, US corporations drained the world of $1.1 trillion, about $0.8 trillion above the going pace.

PRESENT DAY

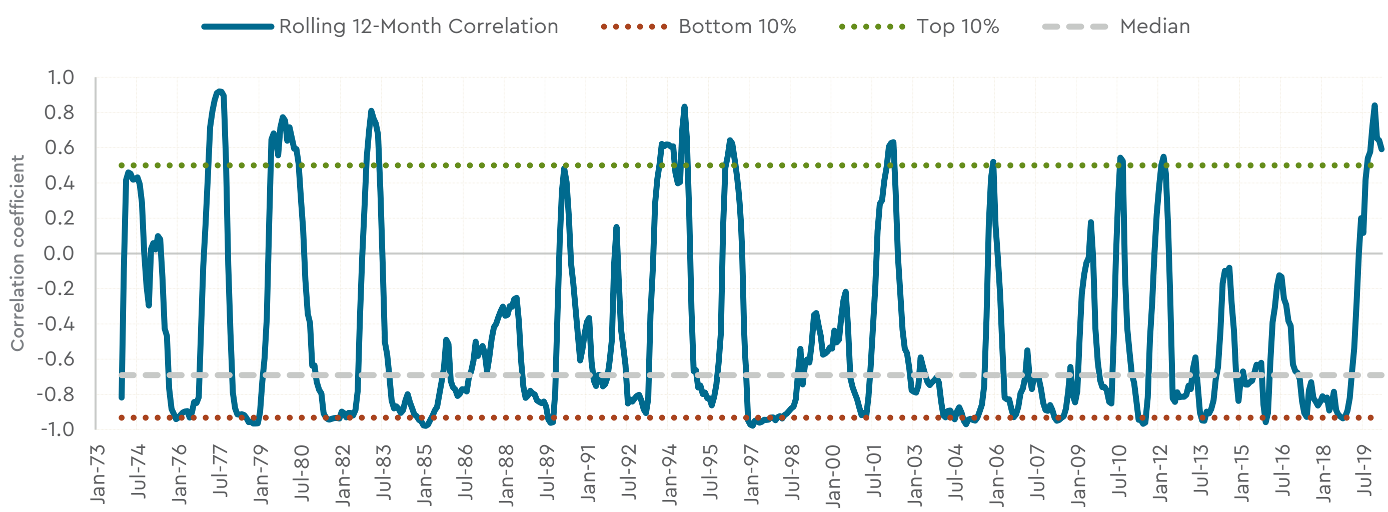
As Tokyo banks and American businesses sapped the world of either credit or cash the fourth monetary disorder[c] of the past dozen years began. At first it was only visible in currency markets. But soon industrial commodities, like copper and oil, turned down. By the four quarter of the year the real economy began to experience shocks. It marked the start of the dollar's appreciation.

From February 2018 through December 2019 the dollar appreciated at a CAGR of 4.0 percent, about an 8 percent swing off the preceding two-year trend.[d] Most of the damage occurred in 2018, with 2019 offering a deceleration in the rally as market participants weighed the probabilities of the burgeoning monetary squeeze against the central bank response to it.

The market was leaning away from central banks, and towards monetary disorder at the start of 2020, when the dual impacts of the virus and government-mandated shutdowns shoved the dollar higher by 7.4 percent in a matter of weeks.

For gold investors this was unwelcome news. And yet we have not seen the classic relationship reassert itself. Indeed we have seen the opposite; gold and the dollar have risen in tandem as both the 30-day and 12-

FOR HALF A CENTURY THE MEDIAN CORRELATION BETWEEN THE DOLLAR AND GOLD WAS -0.69
(CORRELATION, LONDON 10:30AM GOLD PRICE VERSUS TRADE-WEIGHTED BROAD GOODS US DOLLAR, MONTHLY AVERAGE)



[a] From the October 18, 2017 "Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era" speech delivered at the 19th National Congress of the Communist Party of China: "China's economy has been transitioning from a phase of rapid growth to a stage of high-quality development."

[b] The US Commerce Department's Bureau of Economic Analysis says $299 billion but the Internal Revenue Service said $362 in 2016.

[c] Respectively, the 2007-09 banking crisis, the 2011-12 European sovereign debt crisis and the 2014-16 emerging markets currency crises.

[d] Did the 2005 tax holiday and overseas earning repatriation have any impact on the dollar's value? Yes it did and the magnitude was similar to what was observed in 2018-19. From March 2002 through December 2004 the dollar *depreciated* at a CAGR of 6.3 percent. For all of 2005, the year of the repatriation holiday, it *gained* 3.3 percent. Then from January 2006 through to July 2008 the dollar again *depreciated* at that same -6.3 percent rate. Approximately a 9 percent swing.

month measures have recorded *strong positive* correlation rarely seen.

FED'S PRETTY, EMPTY DOLLAR SWAPS

Why might this be the case? Especially when the central banking world is doing everything in its power to lower the value of the dollar?

The Federal Reserve recently expanded its long-time US dollar swap program with the express purpose of reducing funding stresses globally. It sounds impressive but a brief review of the program's history shows it little, if any, relationship to the dollar's value.

Initially used during the 2007-09 kerfuffle, the Fed makes available to certain central banks[a] dollars in exchange for little more than the hedged currency of the counterparty. The foreign central banks then apportion those dollar credits locally in some subsidized, non-market manner because, after all, those local businesses and financial institutions requiring dollars could go out into the market to acquire them – if they could. Had these swaps been effective they would have reduced the value of the dollar because of the large surplus made available at below market prices.

The program was expanded piecemeal throughout 2007-08[b] with no de-escalation in the banking crisis. The swap line total began to peak in November and December 2008, but the crisis did not climax until March 2009 when, not-coincidentally, the dollar peaked.

The Federal Reserve wound up the program in February 2010 as a success, having passed the greatest financial crisis in four generations. The program was reopened that May; the opening moves of the second act of the disorder had begun.

During the European sovereign debt crisis the swaps were run up to $100 billion at the end of December 2011, peaked in February and yet the chaos and uncertainty regarding the euro and the Mediterranean debts continued for another seven months. It was not until late July when European Central Bank president Mario Draghi said he would, "do whatever it takes," to preserve the euro did the crisis begin to abate (again, not coincidentally that was when the dollar peaked).

Presently the swaps have been apportioned to 32 countries (13 countries and the 19-member eurozone) and have reached a very impressive sounding $432 billion. How has the dollar reacted? It has appreciated in value. (Readers of this blog will know that the central banking authorities are not in control of the money supply of reserve currencies, the dollar most prominently. Instead, the commercial banking network is 'in charge'.)

DOLLAR UP, GOLD UP?

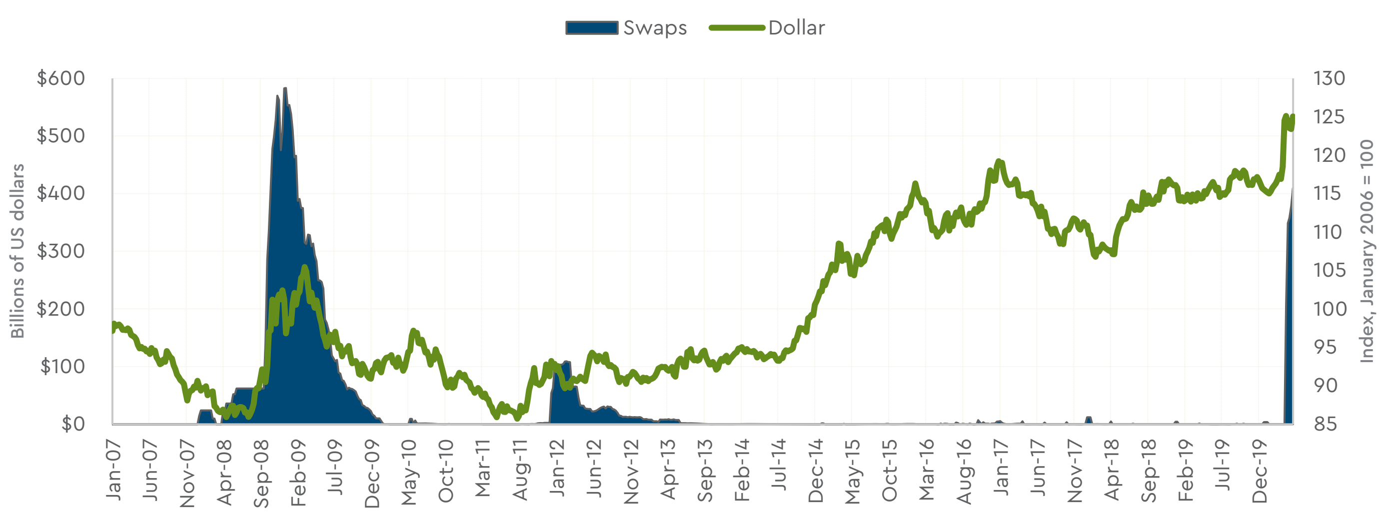
Is this bad news then for the gold investor? Does he or she find themselves in the uncomfortable position of relying on the hapless efforts of the monetary technocracy to lower the dollar's value? No. Despite the long-term inverse correlation between the two assets the relationship is neither preordained nor constant. There are periods when both will rise in value. These periods are generally ones of monetary, financial, economic, political and or social upheaval.

The present economic slowdown is having both immediate and long-term effects on the financial system. The most pressing of which is the revelation to many speculators that what they thought they had was not an asset but someone else's liability; not money, but credit. As speculators move down the narrowing funnel, from financial products to real economic goods, they are moving towards safe haven assets that are relatively less volatile and widely accepted. Assets like German government bunds, US Treasury securities, the US dollar and gold.

Though the dollar remains elevated, and though recent central banking experience suggests no help from that quarter, these are not normal times. They are not times when gold investors would expect to see the negative correlation hold. It is no surprise to see the two assets positively correlated and it will not be a surprise if they both continue to appreciate broadly.

THE DOLLAR HAS IGNORED THE FEDERAL RESERVE'S BID TO IMPROVE LIQUIDITY CONDITIONS

(FED CENTRAL BANK LIQUIDITY OPERATIONS VS. TRADE-WEIGHTED BROAD GOODS & SERVICES US DOLLAR, WEDNESDAY LEVEL)



[a] European Central Bank, Bank of England, Bank of Canada, Bank of Japan, Swiss National Bank, Reserve Bank of Australia, Danmarks Nationalbank, Norges Bank, Monetary Authority of Singapore, Banco Central Do Brasil, Bank of Korea, Banco de Mexico, Reserve Bank of New Zealand and Sveriges Riksbank.

[b] The swaps were extended in three phases while the crisis escalated throughout. First on December 12, 2007 (European Central Bank, Swiss National Bank). Then again on September 18, 2008 (Bank of Japan, Bank of England, Bank of Canada) and September 24, 2008 (Reserve Bank of Australia, Sveriges Riksbank, Norges Bank, Danmarks Nationalbank). Lastly, on October 28, 2008 (Reserve Bank of New Zealand) and October 29, 2008 (Banco Central do Brasil, Banco de México, Bank of Korea, Monetary Authority of Singapore).

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