Seeking Alpha

Gold Vs. Dollar: Facts And Myths

Oct. 31, 2017 11:48 AM ET14 comments
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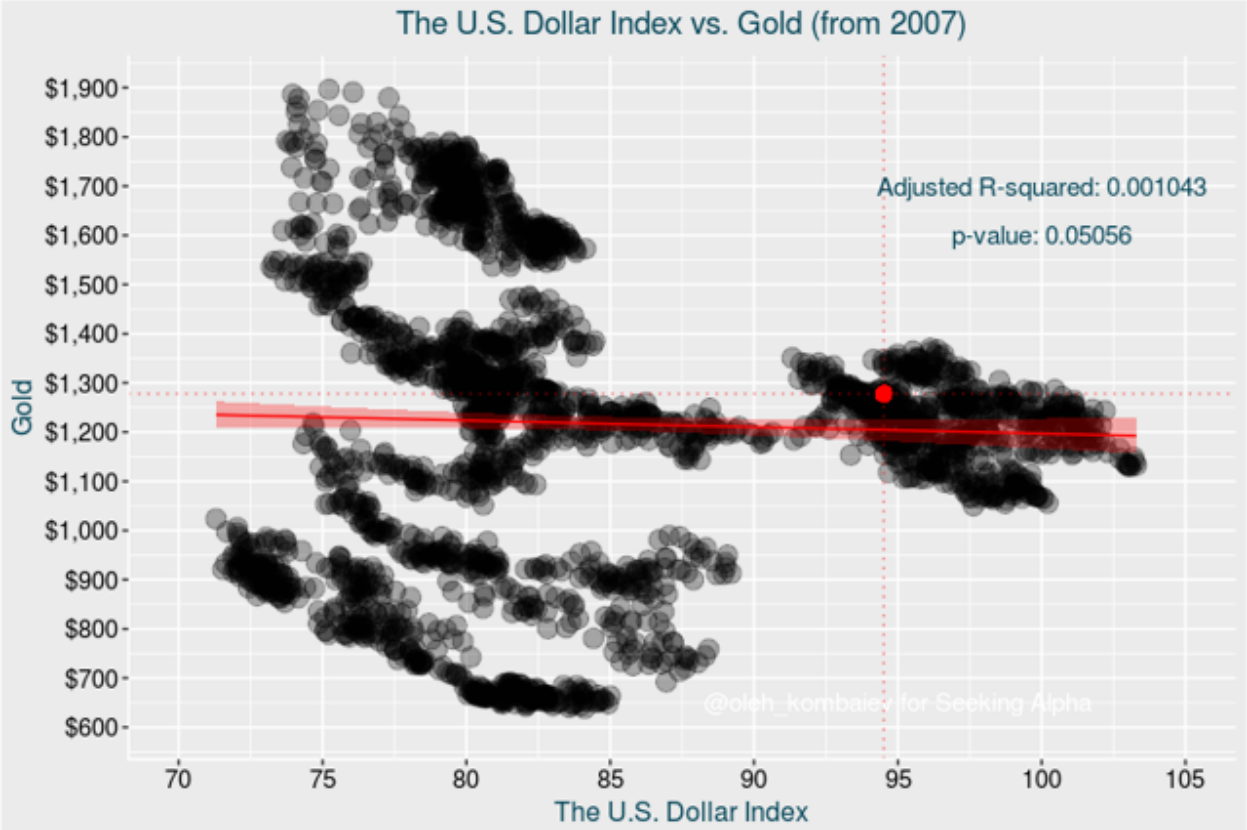
Summary

- The dollar rate by itself does not determine the gold price.
- However, the dynamics of the dollar is generally inversely related to the dynamics of the gold price.
- A number of factors allow you to expect the rise of the dollar in the coming quarter, which is a negative factor for the gold price.

Investment Thesis

In addition to the real interest rate, the dollar exchange rate dynamics in the international market is another factor putting pressure on the gold price and the SPDR Gold Trust ETF (NYSEARCA:GLD) (a fund that tracks the price of gold).

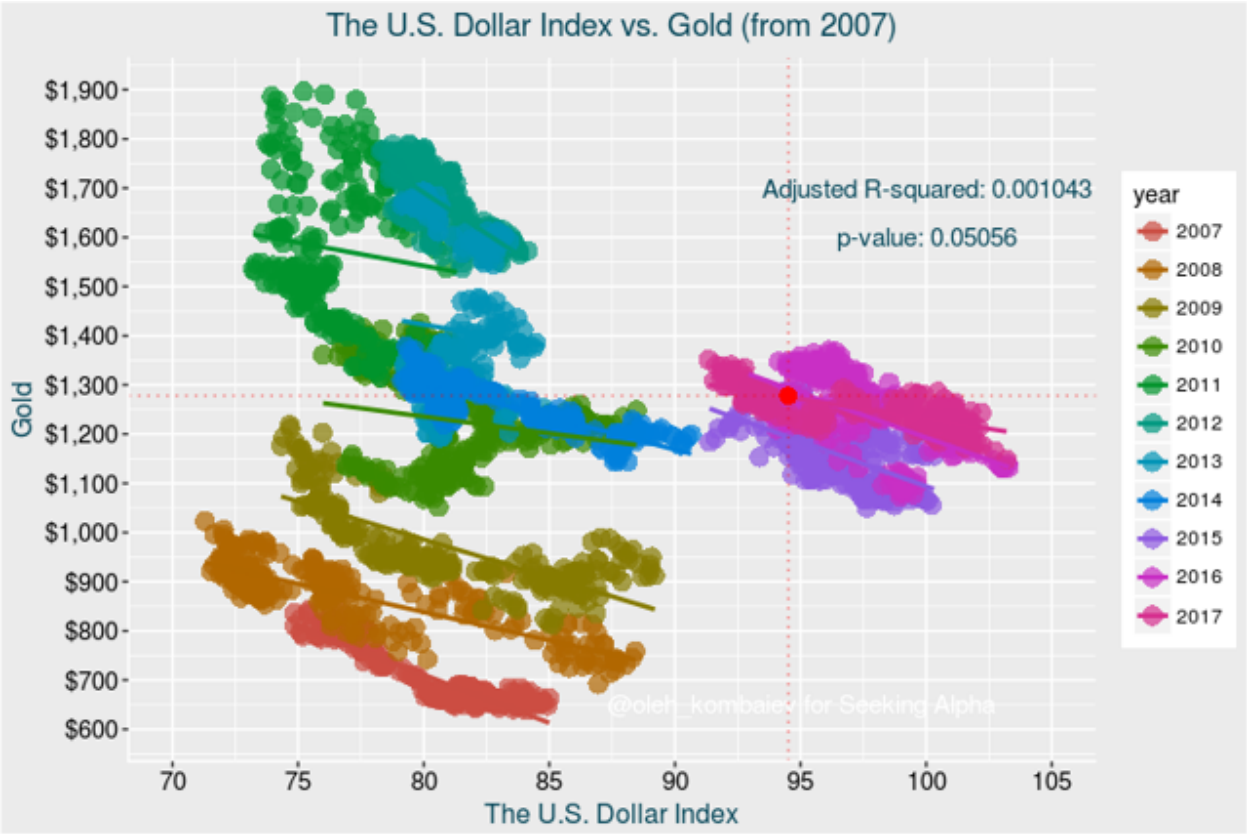
To begin, let's just take a look at the scatter plot of the daily values of the dollar index and gold prices over the last 10 years:



As you can see, there has been no resistant dependency between the dollar index and the gold price over this period.

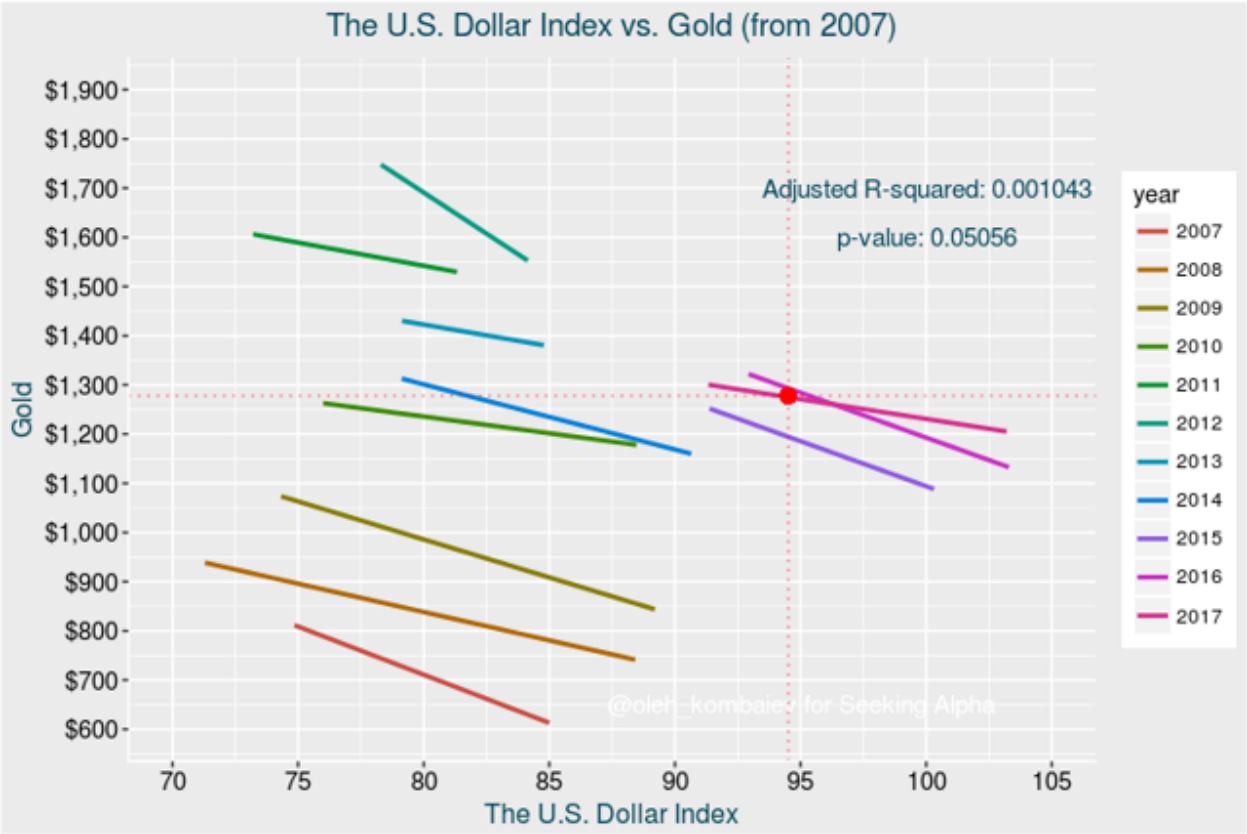
Let's dig dipper.

We'll now build the same graph, painting the dots in different colors according to the years they represent. Moreover, we'll build ten regression lines instead of one - one line for each year. Here's what happens:



It looks like a contemporary painting, doesn't it?

Therefore, for the sake of clarity, let's get rid of the points and leave only the regression lines:

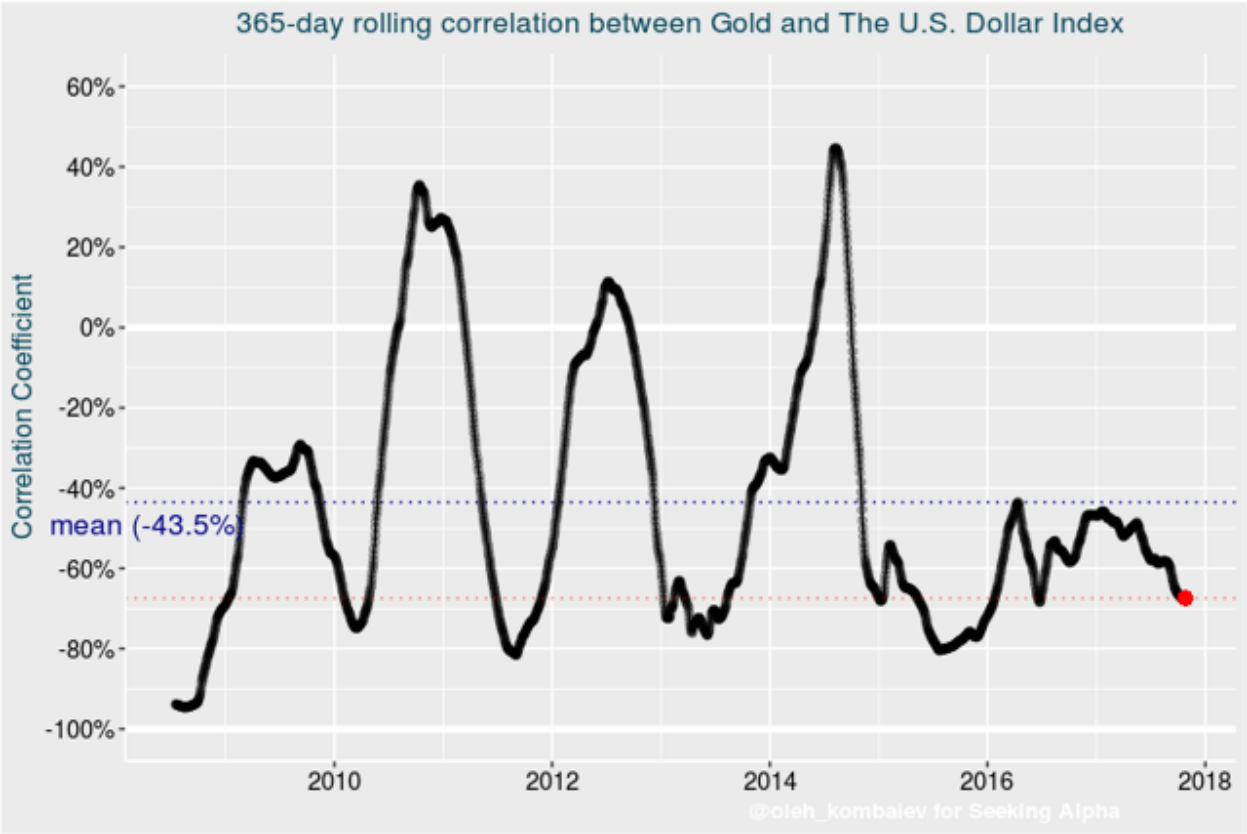


That looks promising! As you can see, an inverse relationship between the dollar index and the gold price was witnessed in each year over the last ten years. But at the same time, *there is no functional interdependence between the dollar rate and the gold price in the longer time intervals*. In other words, the dollar index by itself does not affect the gold price in the longer periods of time. When the dollar index equals 85, the gold price may be $1200, or, for example, $800. However, *there is an inverse interdependence between dynamics of the dollar and the dynamics of the gold price*: when the dollar goes up, it has a negative impact on the gold price and vice versa.

Moving on.

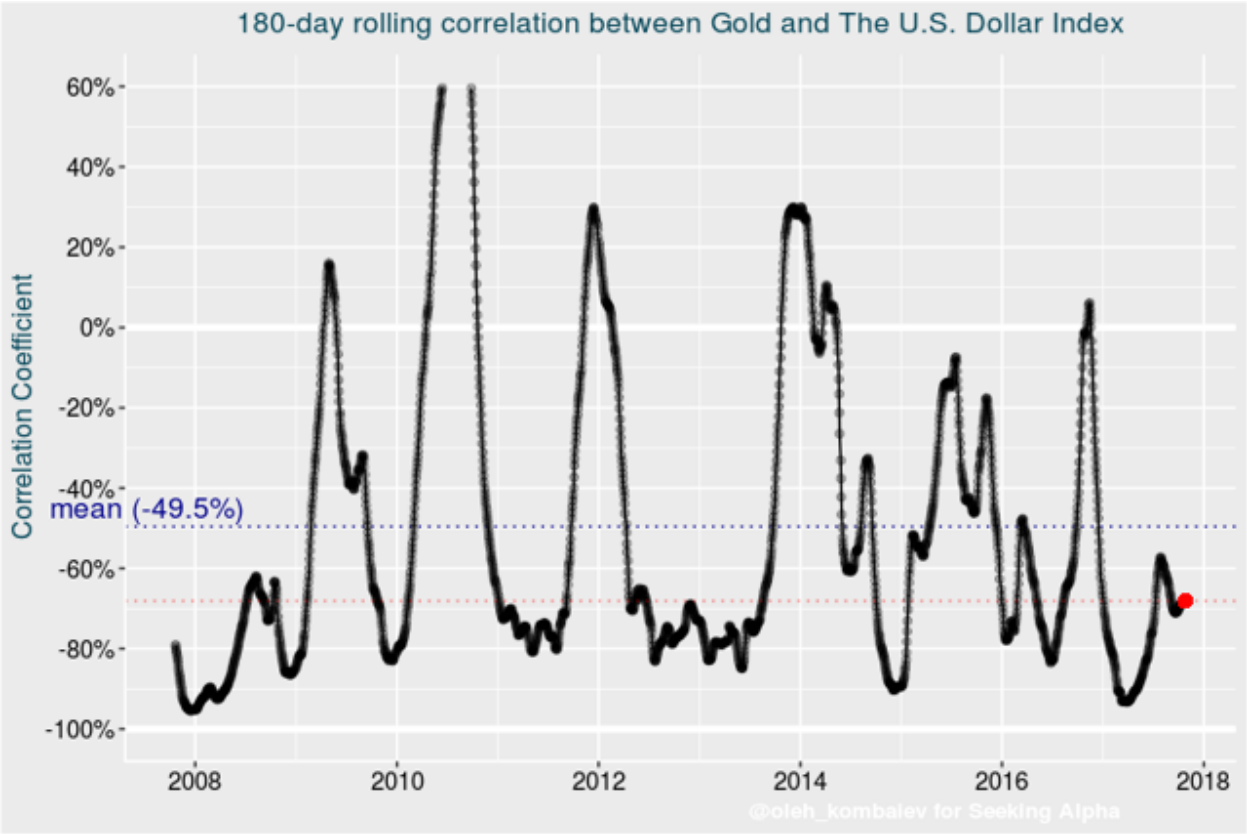
Now let's try to analyze where the cycles of periods of the greatest interdependence between the dollar index and the gold price begin and end. And most importantly, where we are now.

To do this, I've built a graph of the 365-day rolling correlation between gold and the U.S. dollar index - i.e. each point on the graph shows the correlation coefficient between the dollar index and the gold price over the previous 365 days.



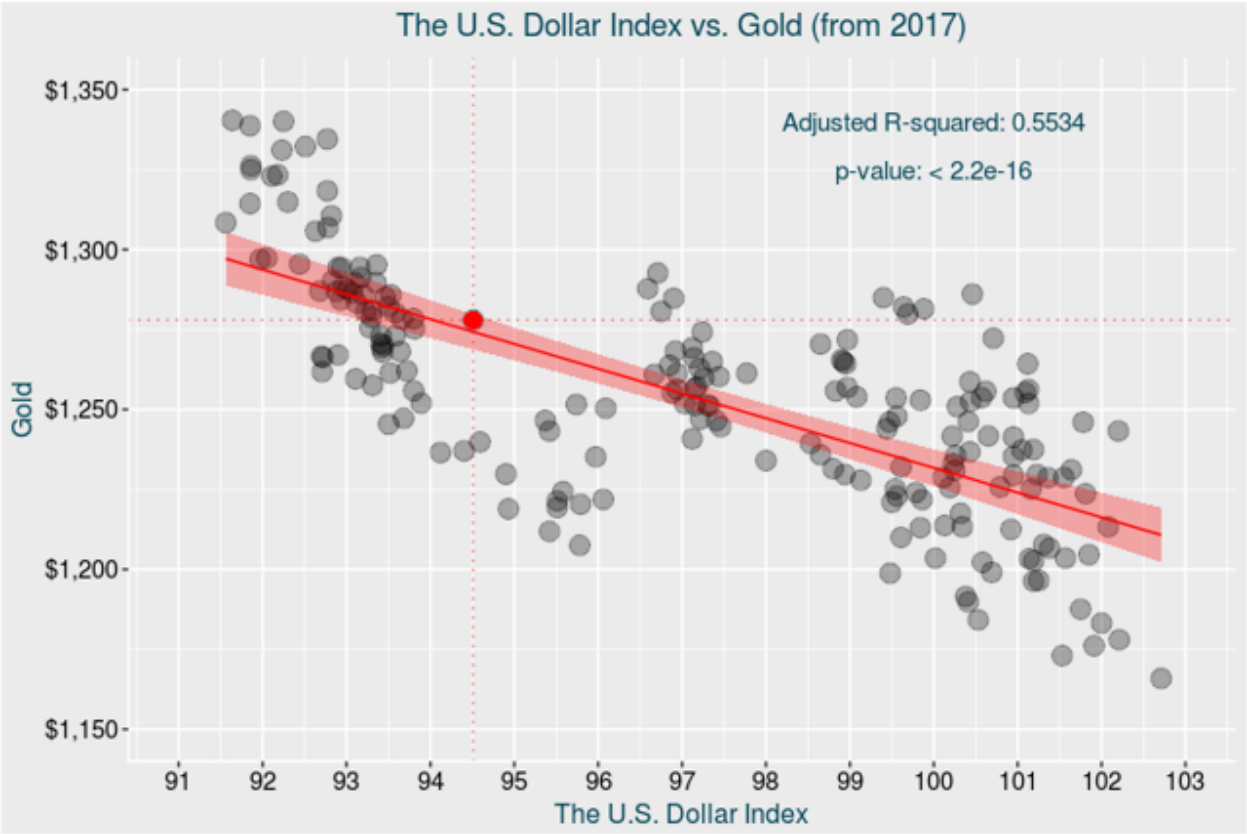
Now the picture is even more clarified: the current cycle of the relatively strong inverse correlation between the dollar and the gold price started in 2015, and, judging by the dynamics, it is continuing now.

For even greater detail, I've calculated the 180-day rolling correlation between gold and the U.S. dollar index.



As you can see, there was no correlation between gold and the dollar exchange rate at the end of 2017. However, the new cycle has started in the beginning of 2017, and it is still continuing.

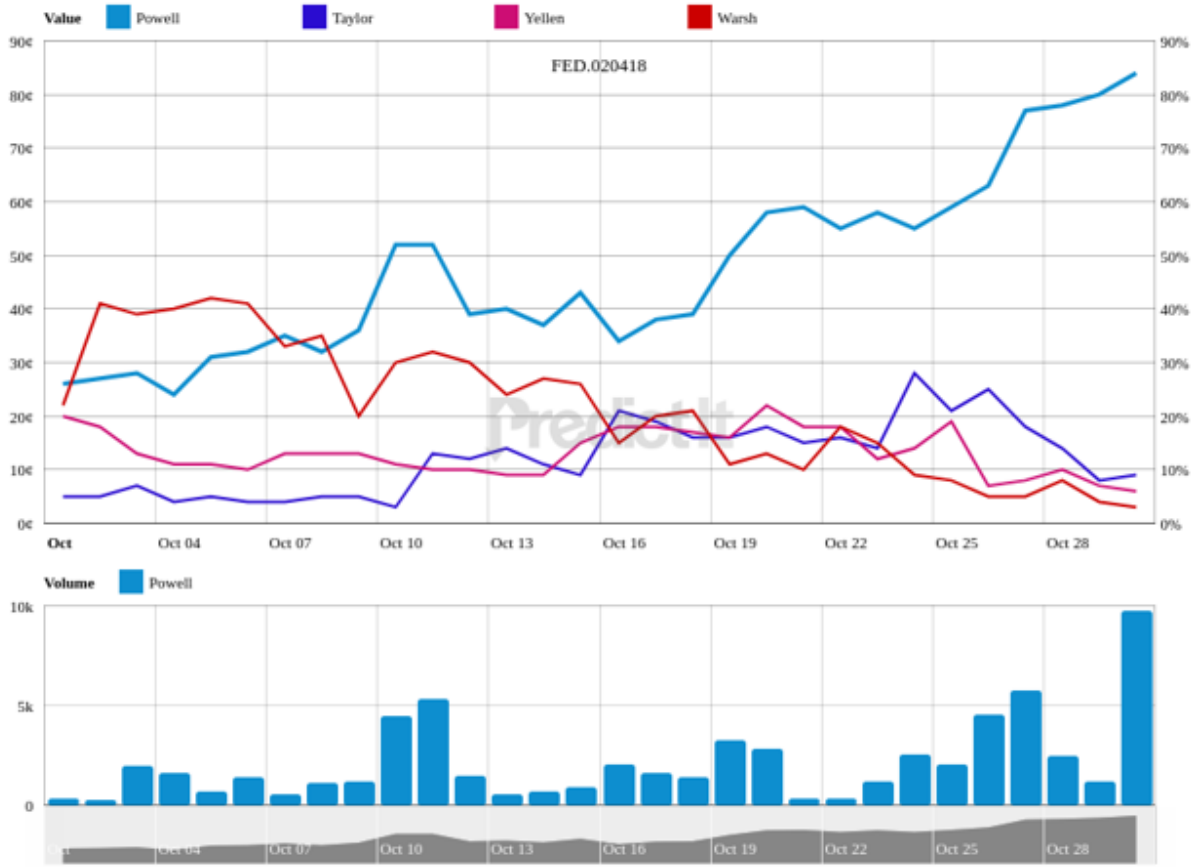
Now let's analyze the functional interdependence between the dollar index and the gold price since the beginning of 2017.



So, within the framework of the current cycle of relatively strong inverse relationship between the dollar and the gold price, we should recognize that the gold price is balanced. But the possible further growth of the dollar index will be a distinctly negative factor for the gold price.

So, we have seamlessly switched from gold to the prospects of the dollar. Here's what I think about this.

The December increase in the interest rate is already practically assured: the probability of this step is estimated at 98%. Now the market is focused on identifying who will chair the Fed after Janet Yellen. Judging by the bets placed on the binary exchange Predictit, Jerome Powell who has steadily supported the Fed's current approach to the monetary policy is the most likely candidate.



In addition, both direct and indirect indicators confirm the acceleration of the U.S. economy in Q3. The October data reveal an intense growth of business activity both in the U.S. service sector and industry.

United States Manufacturing PMI

United States Services PMI

The GDP is significantly above the forecasts:

The outcome of October ECB meeting where Mario Draghi announced the reduction of the monthly asset purchase from 60 billion to 30 billion euros complements the overall picture. The euro lost more than 2% in the international market on that day, which, in my opinion, more than clearly illustrates the attitude of investors to this situation. Of course, the fall of the euro automatically leads to the growth of its main rival - the dollar.

Putting It All Together

So, the likely further tightening of the monetary policy, as well as the U.S. economy acceleration in Q3 and the potential weakness of the euro are the dollar's growth drivers at least in the horizon of the nearest quarter. And this, as I've justified above in detail, puts pressure on the gold price.

All the above considered, my forecast remains the same - the gold prices will decrease to a level of $1,230 in the next two months.

Applying the foregoing to the dynamics of the SPDR Gold Trust ETF, I expect the fund price to drop to $116 and below in the next two months.

Disclosure: I/we have no positions in any stocks mentioned, but may initiate a short position in GOLD FUTURES over the next 72 hours.

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