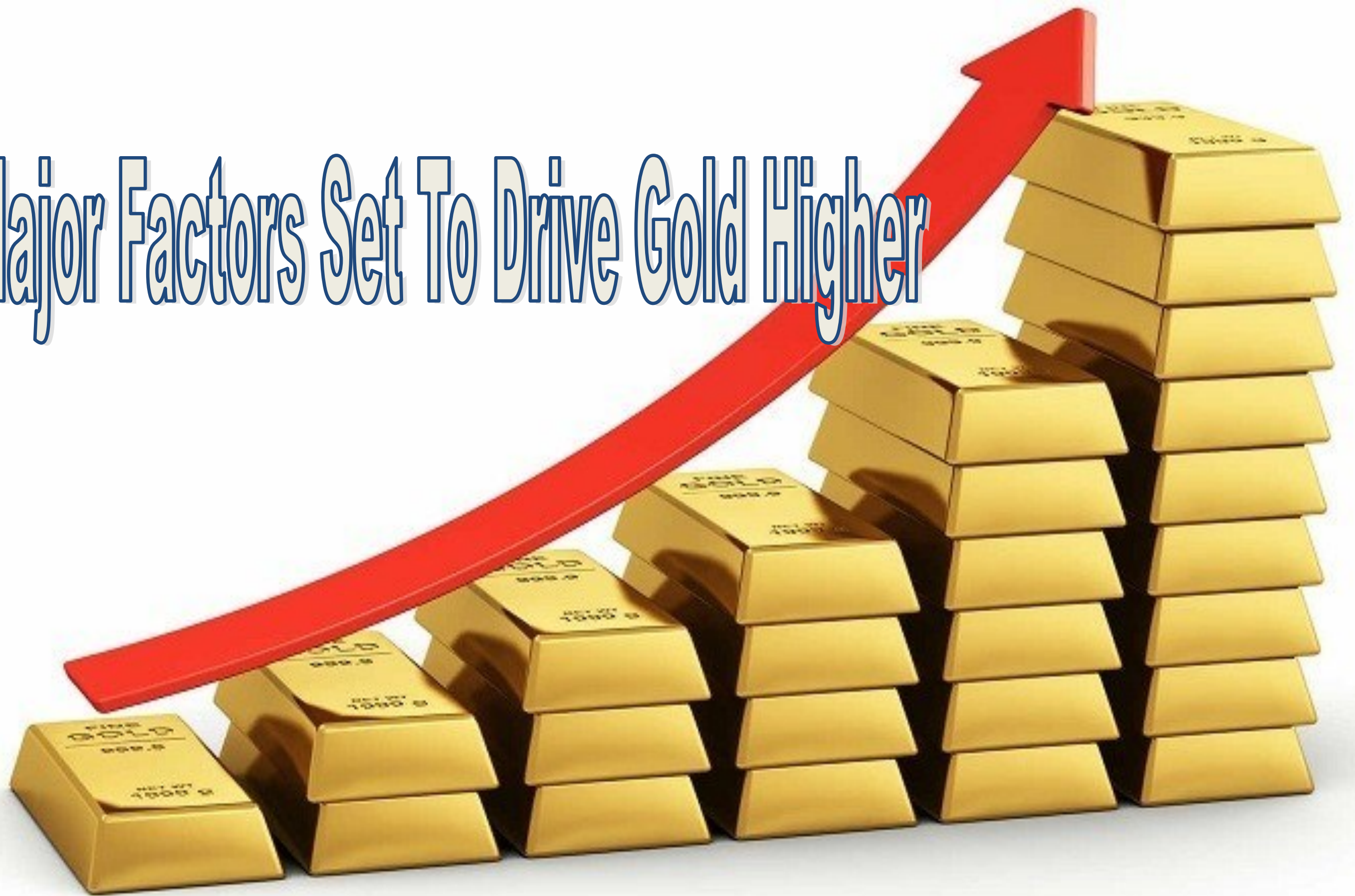
Major Factors Set To Drive Gold Higher



We've passed 100 days since Donald Trump's election to office and markets have reacted in several ways that seem contradictory. Base metals and the dollar index rose strongly based on inflationary expectations, whilst gold and oil initially fell based on deflationary expectations. In my view, the systemic risks that existed prior to the presidential election haven't disappeared and there are various factors supporting gold.

Gold Set for an Inflationary Boost

Inflation is traditionally gold's best friend, and these days, after over eight years of accommodative central bank policy in the wake of the 2008 global financial crisis, inflation could be coming back in earnest for the first time in almost four decades in the world's major economies.

Inflation can be an insidious beast that can eat away at the value of money. A little inflation can be a good thing for an economy as it is a sign of growth. However, inflation can get out of hand, and that is why central banks around the world pay particular attention to the inflation rate. Since the Fed began hiking interest rates in December 2015, the central bank set a target rate of 2% for inflation.

The Fed recently changed its statement about the target 2% inflation rate from "*moving towards*" to "*will reach,*" and it is likely that inflation is already higher than the Fed's target. There are many ways to measure inflation - and raw material prices are just one of the methods.

However, US commentators point out that when looking at the prices of healthcare, educational costs and even a grocery cart full of food for a family, it has become clear that prices are rising for average Americans. Job growth has been positive over recent months, but wage growth has trailed.

The Fed's perception of inflation is rooted in data and calculations, but for most people, things are getting more expensive - and their dollar is being stretched compared to its purchasing power over past years.

The Fed's 2% inflation target is therefore a mirage, as the cost of living has been moving higher at a faster pace than the Fed seems to believe in its analysis.

Years of ‘Easy Money’

The global financial crisis of 2008 and housing crisis in the United States that same year caused the central banks of the world to stimulate economies using historically low interest rates and programs of quantitative easing. The tools at the central banks' disposal stopped the U.S. and many other nations from plunging into a depression or experiencing a prolonged period of deflation and economic stagnation.

Zero interest rates in the U.S. and in negative territory in Europe were meant to encourage borrowing and spending, whilst inhibiting saving in order to jump-start economic growth. However, the flood of money at the hands of central banks has increased the prospects for inflationary pressures, as more currency chases finite goods. At the same time, population around the world continued to grow during the difficult economic period - and more people were chasing finite staples.

Interest rates remain at historically low levels today, with the Fed Funds rate at only 1% and European and Japanese rates at negative 40 basis points. QE has ended in the U.S., but it continues to the tune of 80 billion euros each month in Europe at least until the end of 2017. Almost nine years since the beginning of the global financial woes, the central banks continue to flood the monetary system with liquidity and the ultimate price is bound to be building inflationary pressures.

Lack of Faith in Currencies

Governments have been printing money and making it available at historically low rates for years, which in turn has led to a decline of faith in fiat currencies. The dollar, euro, yen, and other foreign exchange instruments are valuable only because they have the backing of governments, and people have confidence when it comes to the credibility of the countries that print the notes.

Gold traded between $300 and $400 per ounce during most of the period from 1982 through 2004. In 2008, it rose to an all-time nominal high of $1,033.90, and in 2011, it peaked at $1920.70. Today gold is around the $1,255 level, which is a signal that currencies are worth a lot less today than they were in past decades.

Commodities Signal Inflationary Prices

Raw material prices tend to be some of the best signals when it comes to monitoring economic conditions and inflationary pressures on the economy. During late 2015 and early 2016, the U.S. and global economy faced the risk of deflation - as raw material prices traded to multiyear lows. The prices of many of the primary industrial commodities like crude oil, copper and other base metals, iron ore, coal and many others reached bottoms and have since exploded higher. Many commodities have doubled in value since the lows.

The 2% Fed target inflation rate could be a mirage as these commodities are signaling that the value of money has declined precipitously compared to raw material prices.

Gold is the Ultimate Barometer

The price of the yellow metal has moved higher, along with many other raw material prices since late 2015. Gold has increased in value from $1,046 in December 2015 to its current price at $1,223, an increase of 17%. Gold has also signaled that there is inflation in the global economic system, as it has rallied in all the main reserve currencies over recent years. The current critical resistance level for gold is at the 2016 highs of $1,377.50 per ounce.

As the ultimate barometer of inflationary pressures, gold could take off to the upside and shock investors and traders into finally believing that inflation is a lot higher than the central bankers are leading us all to believe. Inflation is gold's best friend, and the precious metal is telling us that it is rearing its ugly head and could get out of control in the months ahead. There is a bill that will come due for all of the cheap and easy money policies of central banks.

The financial crisis required an aggressive approach from the monetary authorities, but the low rates and QE may have been in place too long and now we should prepare for an expensive bill that is likely to continue to eat away at the value of our money. Gold will be the best hedge when the world finally wakes up and realizes that 2% inflation is in the rear-view mirror.

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