MiningJournal

Higher metal prices from US dollar fall

A potential decline in the US dollar provides price support for industrial metals and gold.

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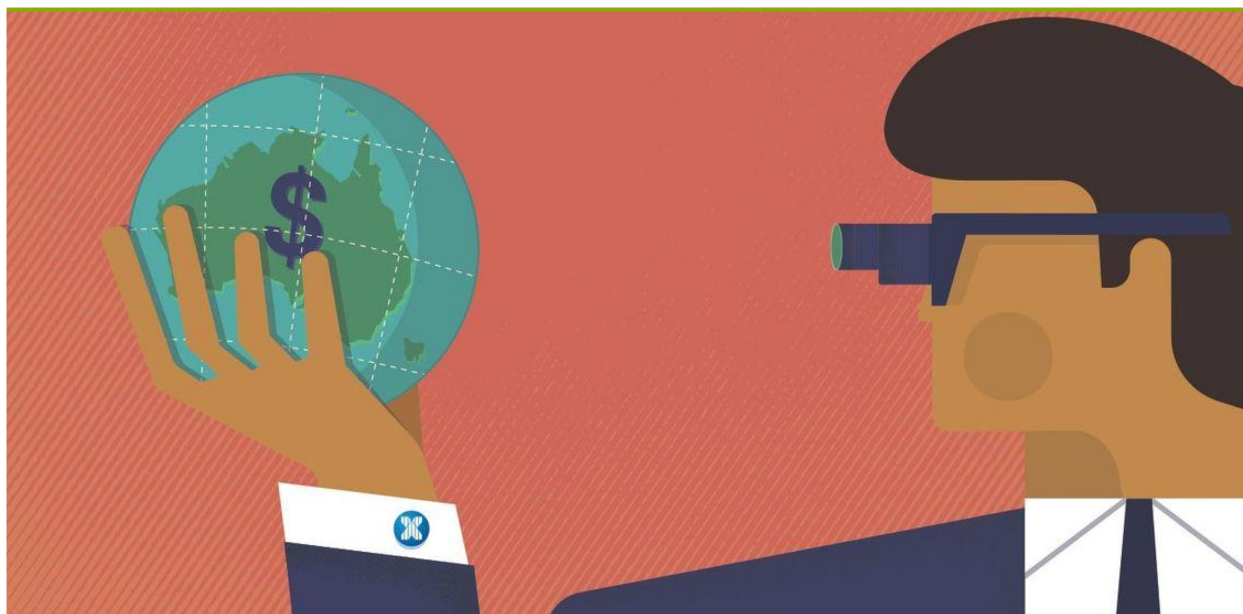

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The trade weighted index measuring the US dollar against the currencies of advanced countries has fallen by more than 7% since mid May, mostly since the beginning of July, after having been on a moderately strengthening path for the prior two years.

The unusually dramatic move lower has prompted thoughts of a continuing slide in the currency consistent with its historical trajectory.

The US dollar has been trending lower since being freed from government control in the early 1970s.

The moderate 0.9% annualised weakening trend is a consequence of the still dominant role of the US dollar in international commerce. Dollar supplies must grow faster than domestic economic conditions might otherwise dictate to accommodate growing global trade and investment flows.

Occasional periods of considerable strength have given way quickly to greater weakness to produce a series of declining peaks and lower troughs.

The strongest upside move occurred between October 1980 and March 1985. The currency appreciated 54% before giving up all those gains and more. Between May 1995 and March 2002, the exchange rate index posted a 37% rise which was also subsequently given up.

Between February 2011 and January 2016, the exchange rate appreciated 32%. Unlike in the two earlier periods of cyclical strength, the dollar has since more or less retained the gains leaving it vulnerable to a downward shift.

Over the past 50 years, a 1% monthly fall in the US dollar trade weighted index has come with an average rise of 3% in US dollar denominated daily traded nonferrous metal prices.

The magnitude of the metal price response has varied but the inverse correlation and uncannily precise timing has been consistently evident in major currency shifts.

Between 1980 and 1985, the 54 % appreciation in the exchange rate was accompanied by a 30% decline in metal prices.

> **"As gold prices have set a new record this month, US government 10 year bond yields have flirted with a historically unprecedented drop below 0.5%**

The currency slide of 39% over the subsequent three years coincided with a 67% rise in metal prices.

The 37% appreciation in the dollar between 1995 and 2002 came with a 24% decline in metal prices.

The 255% cyclical upswing in metal prices between 2002 and 2008 came with a 36% currency slump.

A 32% dollar rise during 2011-16 came with a 53% metal price decline.

Since 2016, an unusually moderate 6% currency decline has elicited a 35% metal price gain.

Even the least strong metal price response has been highly significant. On average, currency moves of 33% have accompanied metal price changes averaging 75%.

A dollar reversion to August 2011 levels would imply a 22% decline from the end of July and a substantial rise in industrial metal prices based on the historical experience.

Exchange rate movements, although important, play second fiddle to movements in physical market balances in determining industrial metal prices. Consequently, the 2002-08 price move, driven by Chinese industrial expansion, was seven times larger than the corresponding exchange rate fall.

Conversely, a metal price response to prospectively lower currency values in the coming year or two could prove weaker than average with so much excess manufacturing capacity in the aftermath of the coronavirus pandemic.

In contrast to the industrial metals, gold prices are more completely a product of financial market conditions which have moved radically in favour of higher precious metal prices.

Gold prices have benefitted from a double whammy of near term currency weakening and unprecedentedly low interest rates. As gold prices have set a new record this month, US government 10 year bond yields have flirted with a historically unprecedented drop below 0.5%.

Negative real yields on long term government bonds are consistent with record prices being paid for any long duration assets, even in the midst of the weakest economic growth in decades. A falling US dollar is further encouraging purchases of US dollar denominated assets.

Prevailing exchange rates and bond prices would be more than enough to validate a gold price in excess of US$2,000 an ounce, based on the historical links among this set of prices. Something in the range of US$2,600-2,800/oz would be more consistent with past outcomes.

Prices of financial assets are now extraordinarily sensitive to sentiment swings. Hundreds of dollars could be lopped from the gold price in the event of a concerted reversal in bond yields, for example.

Steps taken to counter the economic consequences of COVID-19 policy measures are adding to the size of the US government deficit, the size of the government debt and the bond selling task. Without central bank intervention, bond prices would be considerably lower and gold prices at risk of collapse.

That said, bond markets are signalling that low interest rates will persist for a very long time. Financial markets have never had such certainty. US Federal Reserve officials have said explicitly that they have

not even thought about thinking about when the next rate rise will occur. Gold investors now have time to consolidate price gains.

An eventual reversal in real bond yields will be a welcome sign of improving labour market conditions and narrowing output gaps. Gold prices are likely to suffer whenever that happens but not before the precious metal has had the chance to track much higher than today's levels.

Efforts to stifle the spread of the coronavirus are likely to add volatility to the currency as it resumes its historical trend lower. In the years ahead, excess US productive capacity and rising debt are likely to push the currency toward its longer term downward trajectory.

A US economic turnaround need not coincide with a sustainably stronger dollar. Greater optimism about the general economic outlook, of which the US is a part, will typically encourage investment flows into economies outside the USA.

Normality implies a weaker US currency with benefits flowing to gold and industrial metal prices.

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