Cheap Oil Is Dragging Down the Price of Gold

By Debarati Roy - Dec 22, 2014

Gold, the ultimate inflation hedge, isn’t much use to investors these days.

Oil is in a bear-market freefall that began in June, spearheading the longest commodity slump in at least a generation. The collapse means that instead of the surge in consumer prices that gold buyers have been expecting for much of the past decade, the U.S. is “disinflating,” according to Bill Gross, who used to run the world’s biggest bond fund.

A gauge of inflation expectations that closely tracks gold is headed for the biggest annual drop since the recession in 2008. While bullion rebounded from a four-year low last month, Goldman Sachs Group Inc. and Societe Generale SA reiterated their bearish outlooks for prices. The metal’s appeal as an alternative asset is fading as the dollar and U.S. equities rally, and as the Federal Reserve moves closer to raising interest rates to keep the economy from overheating.

“Forget inflation -- all of the talk now is about deflation,” Peter Jankovskis, who helps oversee $1.9 billion as co-chiefofficial investment officer of Lisle, Illinois-based OakBrook Investments LLC., said Dec. 16. “Obviously, oil prices dropping are adding to deflationary pressures. We may see a rate rise next year, and we could see gold come under pressure as the dollar continues to move higher.”

Even though there’s been little to no inflation over the past six years, investors have been expecting an acceleration after the Fed cut interest rates to zero percent in 2008 to revive growth. Those expectations, tracked by the five-year Treasury break-even rate, helped fuel gold demand and prices, which surged to a record $1,923.70 an ounce in 2011.

Eroding Appeal

Now, inflation prospects are crumbling, undermining a key reason for owning the precious metal.

Crude-oil futures in New York have tumbled 44 percent this year, dropping below $54 a barrel last week, as global output surged. The five-year break-even rate is down 33 percent this year, the most since 2008. In November, the cost of living fell 0.3 percent, the most since December 2008, government data show, and economists surveyed by Bloomberg predict the annual gain in consumer prices will slow in 2015 to 1.5 percent from an estimated 1.7 percent this year.

Cheaper energy means there are no signs that inflation is approaching the Fed’s 2 percent target, Gross, who used to run the world’s largest bond fund at Pacific Investment Management Co. before
joining Janus Capital Group Inc. in September, said Dec. 12 in a Bloomberg Surveillance interview with Tom Keene.

**Shunning Gold**

Investor holdings in exchange-traded funds backed by gold last week were the lowest since 2009, and $7.68 billion has been wiped from the value of the funds in 2014, according to data compiled by Bloomberg. Open interest in New York futures and options dropped 5.3 percent this year, set for a second annual loss and the longest slump since 2005, U.S. government data show.

After rebounding 4.4 percent from a four-year low in early November, prices will average $1,175 next quarter, below the Dec. 22 close of $1,179.80, according to the median of 31 analysts tracked by Bloomberg. Goldman forecasts a drop to $1,050 by next December, while SocGen expects $950 in 2015’s fourth quarter.

Since touching a six-week high on Dec. 9, futures fell 4.9 percent to $1,178.20 on the Comex in New York today, heading for a second straight annual decline, down 2 percent. The Bloomberg Commodity Index dropped 15 percent this year, while the Bloomberg Dollar Spot Index climbed 11 percent. The Standard & Poor's 500 equity index is up 12 percent, after touching a record high Dec. 5.

**Rebound Bets**

Speculators haven’t given up on gold. Money managers remain bullish, increasing their net-long position to 103,738 futures and option contracts as of Dec. 16, more than doubling bets since early November, according to U.S. Commodity Futures Trading Commission data.

Signs that central banks in China, Europe and Japan will add to stimulus efforts have increased speculation that global inflation could rise, even as U.S. consumer costs stay stable. While dollar-denominated gold is down this year, bullion is up 12 percent priced in yen and 9.6 percent in euros.

“It’s confounding that inflation is not rampant on a worldwide basis, based on the amount of liquidity that has been pumped into the system,” Michael Mullaney, chief investment officer of Fiduciary Trust Co. in Boston, which oversees $11.5 billion, said Dec. 16. “We are not there yet, but once this starts to percolate, we will see headlines on inflationary pressures” that can support gold prices, he said.

**Rally Ends**

Gold climbed 70 percent from December 2008 to June 2011 as the U.S. central bank bought debt and held borrowing costs at a record low. Prices slumped 28 percent last year, the most in three decades, after some investors lost faith in the metal as a store of value.

The Fed’s benchmark interest rate will be 1.125 percent at the end of next year, quarterly estimates
from U.S. central bankers showed Dec. 17. Chair Janet Yellen said in a press conference that day that inflation will eventually reach the Fed’s target, allowing the central bank to raise borrowing costs.

Bullion’s link with inflation dates back more than 2,000 years, with the first use of coin currency in 550 B.C., according to the World Gold Council. While countries from the U.S. to the U.K. adopted a gold standard by the 19th century to limit inflation, no nation links currencies to the metal anymore. The Fed cut the dollar’s ties to gold four decades ago.

“Gold as an inflation hedge is unnecessary,” Atul Lele, who helps oversee $5.1 billion as the chief investment officer at Bahamas-based Deltec International Group, said Dec. 16. “We think inflation in the U.S. could rise, but nothing that should be a cause of worry.”

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