What is driving gold prices to all-time record highs?

From the Field
November 2024

Key Insights

- Since late 2022, the long-term inverse relationship that has existed between gold prices and real interest rates has decoupled.
- This reflects the growing influence of global fiscal policies and currency debasement, a sharp rise in central bank buying, as well as an environment of heightened geopolitical risks.
- From an investment perspective, we believe it is prudent to consider some exposure to gold as well as a diversified set of other commodities, through commodities-related equities.

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Gold has been prized as a store of value for thousands of years. In fact, up until the U.S. abandoned the gold standard in 1971, major fiat currencies (aka “paper money”) were backed by defined amounts of gold and were exchangeable into gold at any time. Although we are no longer on a gold standard, gold continues to be viewed as a stable currency because it is naturally scarce. It cannot be willed into existence the way that fiat currencies can be easily manufactured by central banks. When governments get into a financial bind, it is far too easy to debase their currencies by manufacturing more of it. When taken to an extreme, this leads to hyperinflation.

The Weimar Republic—during the inter-war period in Germany—is perhaps the most famous historical example of this, but there are more recent examples in frontier markets such as Argentina and Zimbabwe. And it is because of this possibility of having one’s savings “wiped out” by profligate governments that gold continues to maintain its popularity as a stable store of value.

Gold versus real interest rates

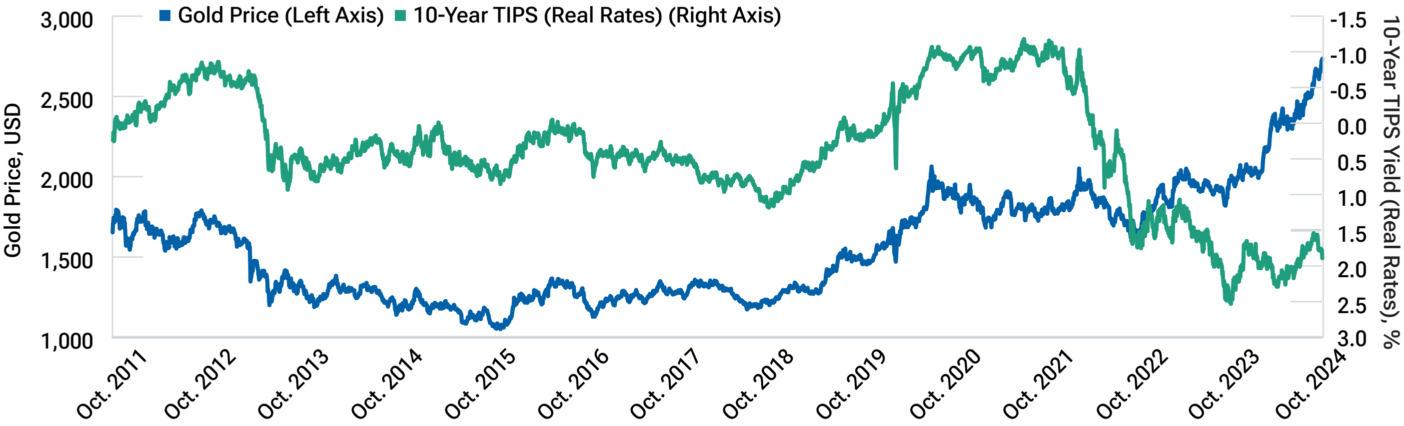
For decades, there has been a generally stable inverse relationship between the U.S. dollar (USD) gold price and real interest rates (nominal rates less inflation).

“...gold continues to be viewed as a stable currency because it is naturally scarce.

This makes sense given that gold has no yield. If real interest rates are high, there is an incentive to hold USD given its ability to generate real income. Conversely, as real interest rates fall or even go negative, the incentive to hold USD declines and the gold price rises.

Gold versus TIPS yield inverted (real rates)

(Fig. 1) The traditional inverse relationship has recently decoupled



As of October 24, 2024.
Past performance is not a reliable indicator of future performance.
TIPS = 10-Year U.S. Treasury inflation protected securities.
Source: Bloomberg Finance L.P. Analysis by T. Rowe Price.

However, as seen in Figure 1, this relationship noticeably decoupled starting in late 2022. In this article, we explore the potential reasons for this decoupling and the implications for investors.

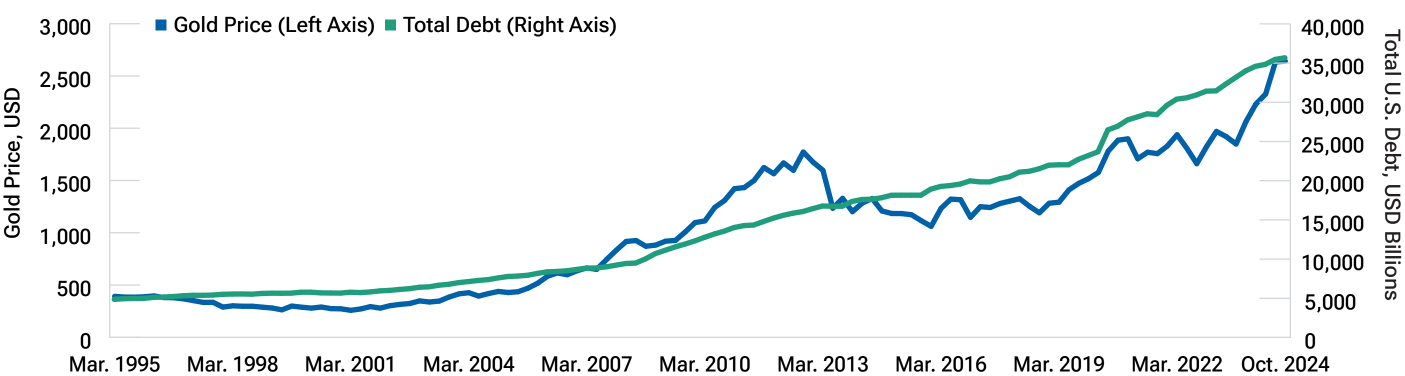
Growing fiscal deficits

One potential explanation is that gold is impacted not just by monetary policy, which determines interest rates, but also by fiscal policy. When the U.S. government runs large budget deficits and increases the national debt at an accelerated rate, it is essentially debasing the currency. Increased liquidity from loose fiscal policy more than offsets monetary tightness. As depicted in Figure 2, this scenario leads to a higher gold price.

To be clear, this is not just a U.S. phenomenon. Nearly ALL currencies are debasing by increasing supply at a rapid rate. This is why we have seen gold decouple from the relationship between

Gold versus total U.S. debt

(Fig. 2) Increasing national debt essentially debases the currency



As of October 7, 2024.
Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P. Analysis by T. Rowe Price.

Money supply versus impact on currency

(Fig. 3) Rapidly increasing money supply is a global phenomenon

Country	M2 1999[1] (B Local Crncy)	M2 Most Recent Available	M2 Today vs. 1999	Cumulative Debasement	Annual Rate of Currency Debasement
Japan	682,600	1,255,200	184%	45.6%	3.0%
France	688	2,985,366	434%	77.0%	6.1%
United States	**4,638**	**21,175**	**457%**	**78.1%**	**6.3%**
Canada	476	2,579	542%	81.5%	7.1%
South Korea	682,329	4,057,905	595%	83.2%	7.5%
South Africa	447	4,343	972%	89.7%	9.6%
Saudi Arabia	242	2,593	1,072%	90.7%	10.0%
Indonesia	844,053	8,973,697	1,063%	90.6%	10.9%
Brazil	275	6,364	2,316%	95.7%	13.5%
China	11,990	305,046	2,544%	96.1%	14.0%
Russia	715	106,243	14,867%	99.3%	22.4%
Argentina	48	52,115	108,858%	99.9%	37.9%

100%–800% increase in money supply
900%–15,000% increase in money supply
100,000%+ increase in money supply

As of October 25, 2024.
[1] Indonesia data since 2001, Argentina data since 2002, Japan data since 2003.
Money supply in local currency terms.
Source: Bloomberg Finance L.P. Analysis by T. Rowe Price.

the USD and other major currencies. It is not about USD versus euro or yen. Instead, nearly ALL fiat currencies are debasing versus gold. As seen in Figure 3, money supply (as measured by M2) has increased in many countries at a much faster rate than in the U.S.

Central bank buying

Another driver of gold price strength has been a strong increase in central bank buying. This buying is likely driven by several foreign countries' desire to decrease their dependency on the USD as the world's reserve currency. As seen in Figure 4, implied central bank buying increased significantly in 2022. It is unlikely to be a coincidence that 2022 was also the year that the West froze hundreds of billions of dollars of Russian currency reserves held in foreign banks as a response to Russia's invasion of Ukraine. Other countries, including China, quickly realized that they had best secure their own reserves to try and avoid the risk of running afoul of the U.S. and its allies in the future. Buying gold was one way to do that.

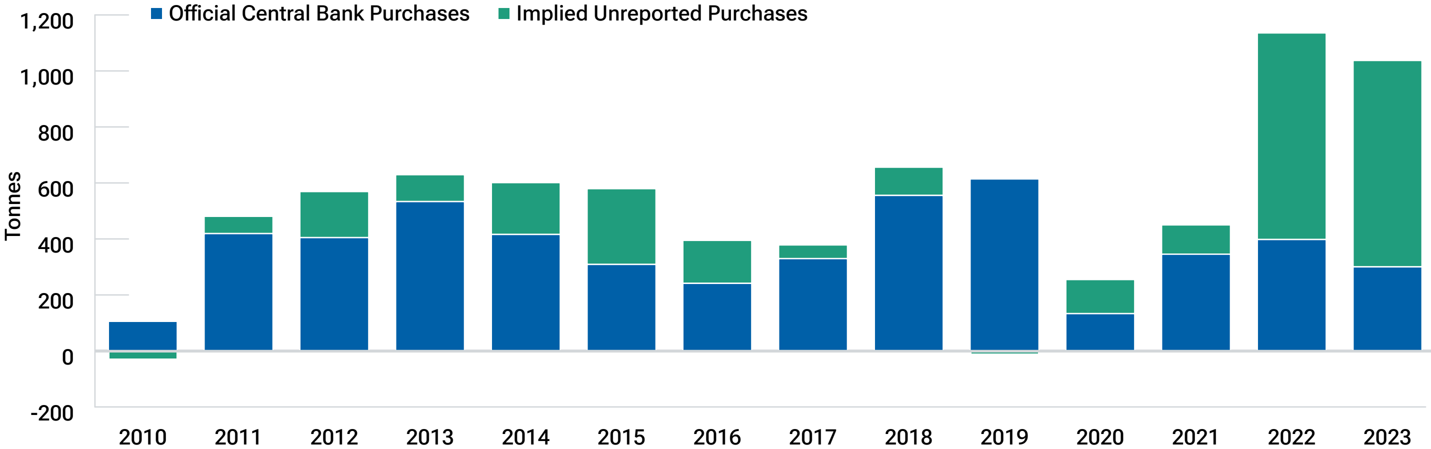
Importantly, the gold market is nowhere near the size necessary to completely replace foreign currency reserves. According to the World Gold Council, all the gold mined in human history is worth about USD 12 trillion. While that sounds like a big number, it is only a small fraction of the hundreds of trillions of dollars of financial assets in the world. That means that central banks would need to continue adding to their gold reserves slowly and methodically for a long period of time if they hope to make gold a more meaningful part of their reserve portfolio.

Investment implications

The trends discussed above seem unlikely to abate anytime soon. The U.S. government will likely continue to run large fiscal deficits. The Tea Party

Central bank net gold additions

(Fig. 4) Gold buying has increased sharply in recent years



As of December 31, 2023.
Source: BMO Harris. Analysis by T. Rowe Price.

wing of the U.S. Republican Party has diminished in significance, and now neither major party seems to stand for fiscal conservatism. Neither party seems interested in addressing the looming entitlement crisis in the U.S. (the deficit between what programs, such as Social Security and Medicare, will require in comparison to how much funding is available), which has the potential to increase debt and deficits further.

Geopolitical risks only seem to be growing. Wars rage in the Middle East and Ukraine. Conflicts between China and its neighbors are a looming threat. The coalition of countries hostile to the West will continue to look for ways to decrease dependency on the USD as a reserve currency and medium for international exchange.

For these reasons, we believe it is important to consider some exposure to gold as well as a diversified set of other commodities through commodities-related equities. As a pure financial asset, gold tends to move first as it reacts most immediately to the debasement of fiat currencies. But, over time, debasement is inflationary and should be reflected in rising prices of industrial commodities as well. With the U.S. Federal Reserve seemingly at the beginning of a rate-cutting cycle, commodities now have the potential to benefit from the dual expansionary tailwinds of both fiscal and monetary policy.

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