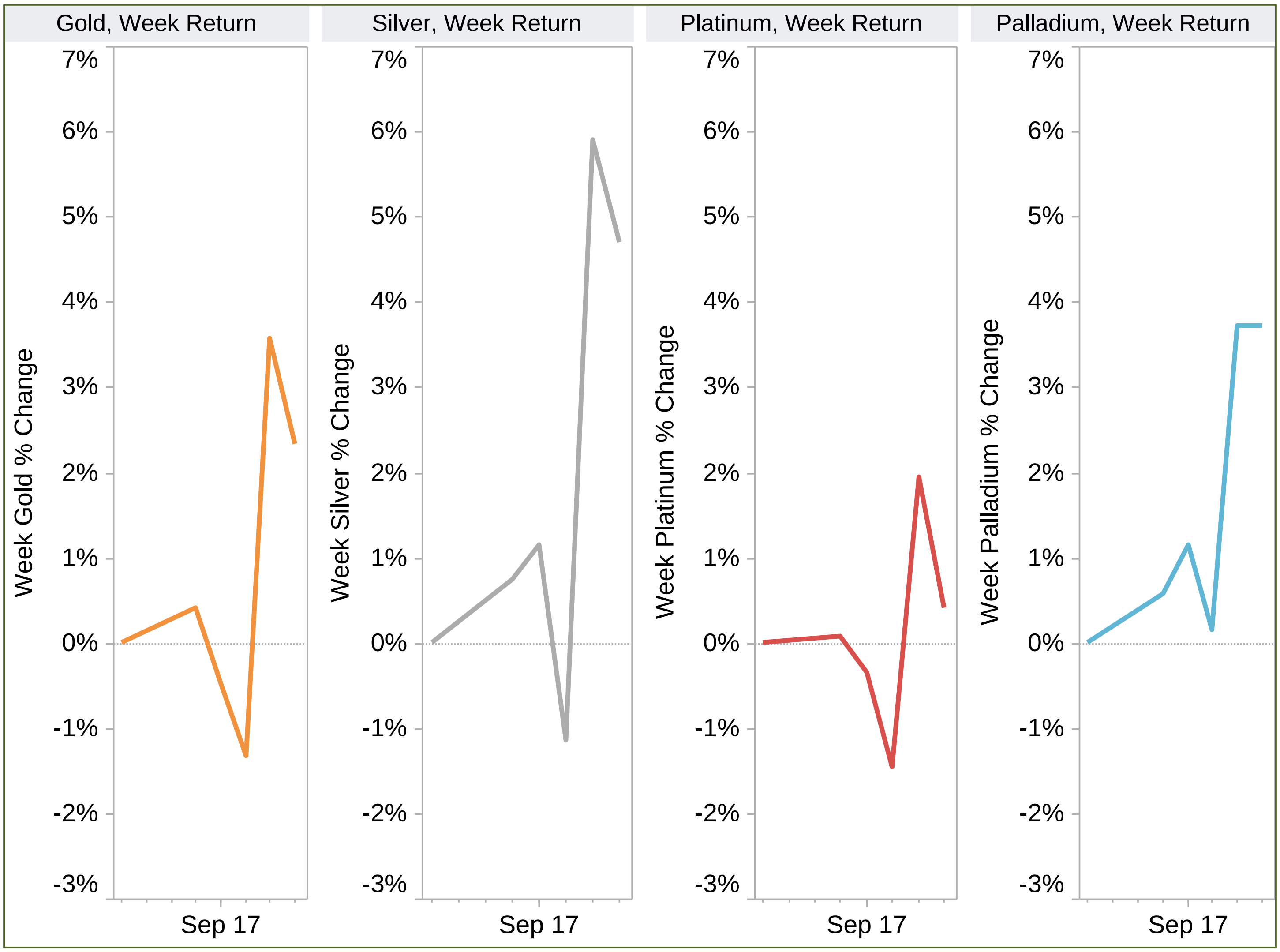
WHY GOLD AND PRECIOUS METALS LOVE CENTRAL BANKS

Sunday, September 22, 2013

On Wednesday of this past week, Federal Reserve Chairman Ben Bernanke announced that the U.S. central bank would not begin "tapering" of its $85 billion bond buying program. Stock markets responded with exuberance, pushing the S&P 500 and the Dow Jones Industrial Average each up over a percent for the day.

Precious metal investors loved the announcement as well, pushing gold up over 5% for the day, silver up over 7%, and platinum and palladium each up over 3%[1].



With precious metals investors giving such a strong response to the announcement of "no taper," one might ask – why?

Here's some background behind quantitative easing and explanations for the "no taper" response.

[1] All precious metal prices quoted here are London PM.

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QUANTITATIVE EASING

Quantitative easing (QE) generally refers to the practice of central bankers buying government bonds and other financial assets from commercial banks and other financial institutions by "printing money," where printing money generally refers to central bankers' ability to create money out of nothing (also known as *high-powered money*)[2].

The policy of QE first originated in Japan in March 2001, where the Central Bank of Japan (BOJ) was attempting to combat domestic deflation for the initial years of the 21st Century.

Since the early Japanese experiment, the practice of QE has taken hold among many central bankers, with the Federal Reserve currently on its fourth round of QE[3], the Bank of England and the European Central Bank each respectively on at least their third round of QE, and the BOJ approaching its 13th year of QE.

The practice of QE is hotly debated among economists and market observers.

Some professionals argue that the benefits of QE far outweigh any costs, largely because, as the argument goes, QE reduces the costs of borrowing for businesses and individuals. The reduced costs of borrowing provide businesses and individuals with more money to invest and create jobs.

On the other end of the debate are professionals who argue the risks of QE are far too high to justify central bankers' desire to manipulate interest rates. Essentially, although QE may reduce interest rates in the short-term, central bankers' meddling puts upward pressure on inflation, induces risk-taking that may be unwarranted, worsens government balance sheets, reduced interest income, and creates moral hazard problems, to name just a few.

WHY DID GOLD AND PRECIOUS METALS RESPOND SO STRONGLY TO "NO TAPERING"?

With this background in mind, why did precious metals investors love the decision not to taper?

The main answer is simple, although a number of other explanations have been given as well.

Gold, silver, platinum, and palladium provide a safe-haven against inflation. Because tapering, is, by definition, an attempt to induce more inflation, precious metals investors viewed the lack of concern for inflation as disconcerting and therefore moved quickly into these safe-haven assets.

WHEN WILL THE PRECIOUS METALS' LOVEFEST WITH CENTRAL BANKS END?

With quantitative easing likely to be around for a while, what does this mean for precious metals investors?

Well, just take a look at the following figure, which shows how gold and silver have performed relative to selected equity indices over the time period of quantitative easing (i.e. from 2001 to 2013). Overall gold and silver have

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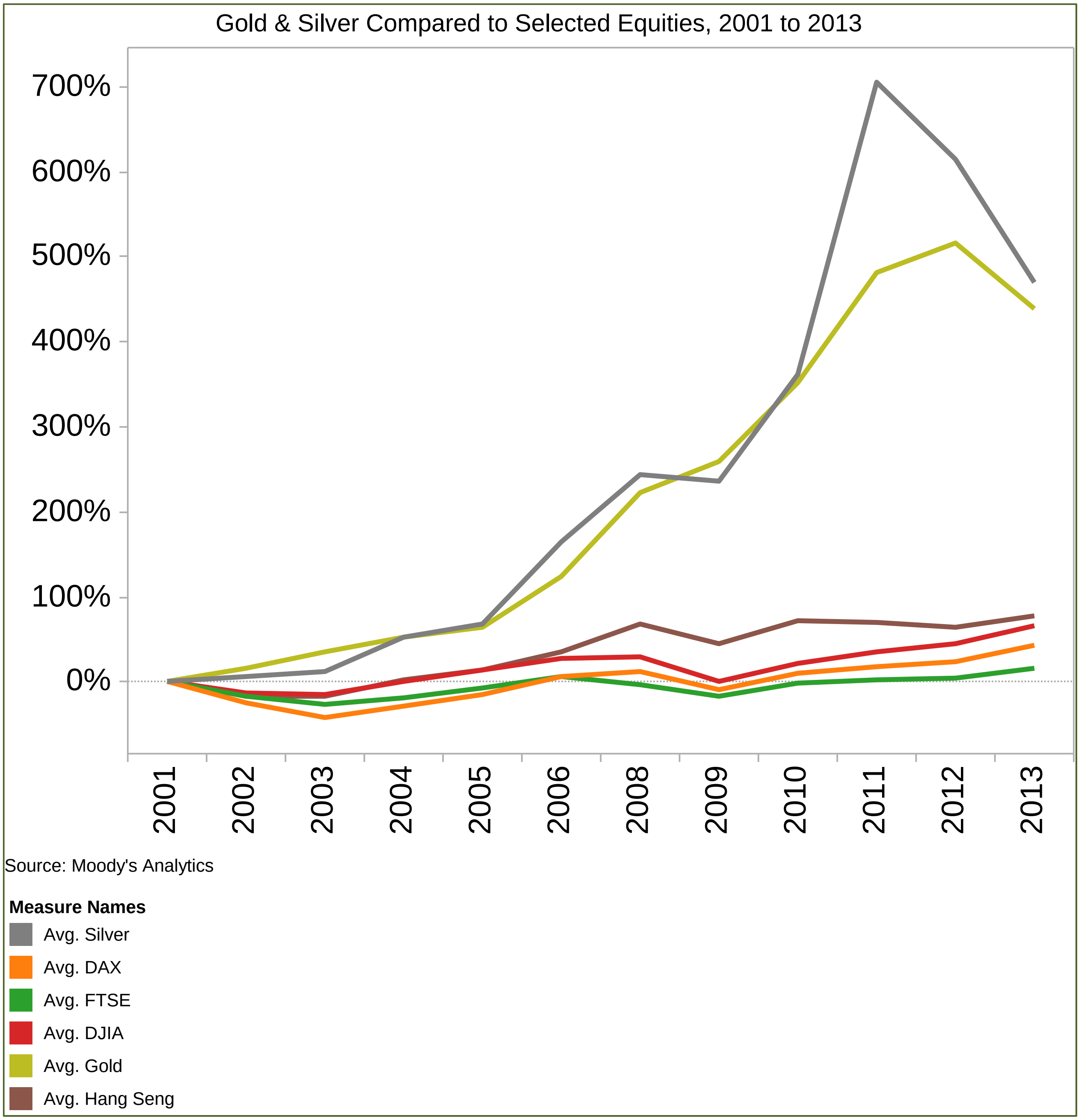
[2] The process is actually done through the use of computers, with the Federal Reserve simply crediting its account

[3] Some market observers have famously called the Federal Reserve's QE policy QE-Infinity, with the reasoning being that the Federal Reserve has given no indication of stopping. As a note, the issue is whether the Federal Reserve is on QE3 or QE4 depends on whether one counts Federal Reserve's recent December 2012 action to increase its purchases of agency-backed mortgage securities and Treasuries from $40 billion to $85 billion.

performed much better than equities over this time frame, with gold up 438% and silver up 639%. Comparatively, the best performing equity index over the same time frame is the Hang Seng, up 78%.



Overall, as long as central bankers continue to use quantitative easing, precious metals will likely continue their lovefest with central banks. If history is any guide, should central bankers be unable to disentangle their quantitative easing practices, precious metals are likely to outperform equities by a good amount over the long-term.