May 2023

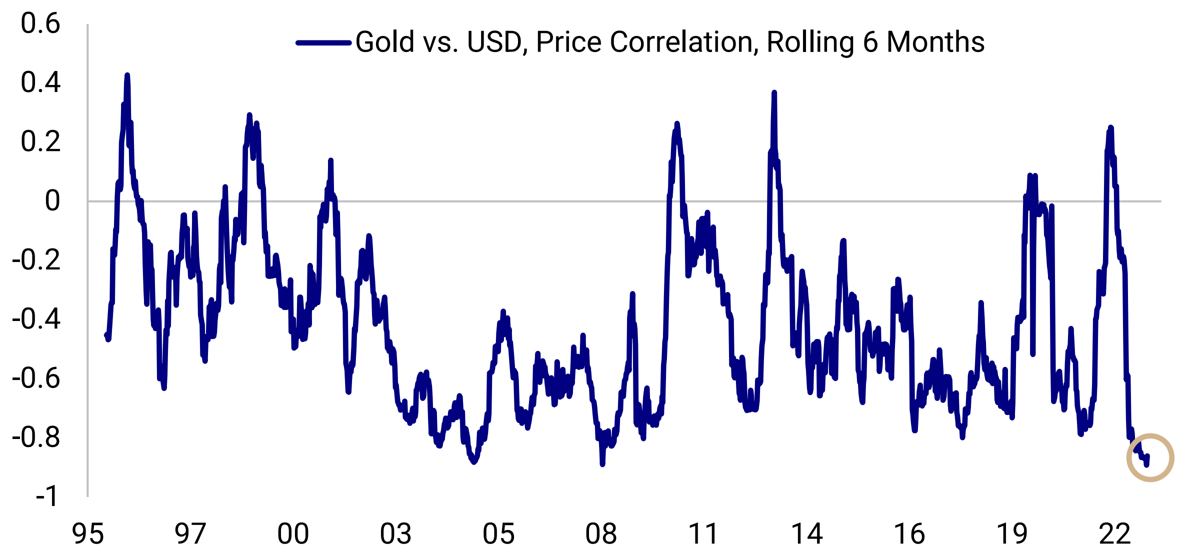
An EM Revolt Against the Dollar

Unusual signs of strength in gold prices are signaling weakness for the dollar, a long term plus for emerging markets, where historically one third of returns have been attributable to currency movements.

1. A historic gap between dollar and gold movements

The first sign came as the Silicon Valley Bank crisis got rolling. The dollar and gold--both traditionally seen as safe havens--started moving in opposite directions. The dollar drifted down as gold surged and the gap between them (the negative correlation in chart 1 below) reached a record high.

Chart 1. Price Correlation of Gold versus the dollar
(Rolling 6 Months)

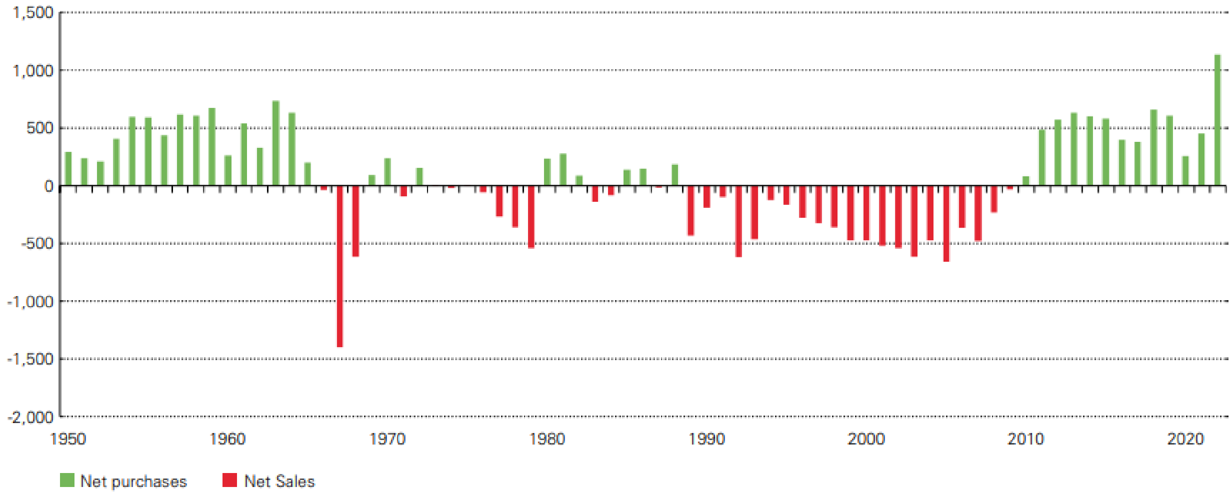


Source: Haver Analytics, IMF

2. Central banks are the biggest buyers

The overwhelming consensus among commentators was that this weak patch was no real threat, certainly not to the dollar's reserve currency status--because there is "no alternative". Perhaps, but the new demand for gold is in fact driven by central banks diversifying away from the dollar; central banks are buying more tons of gold each month than at any point since records began in 1950 (chart 2 below) and now account for a record 33 percent of global demand.

Chart 2. Net Central Bank Buying and Selling of Gold Since 1950
(Tons)

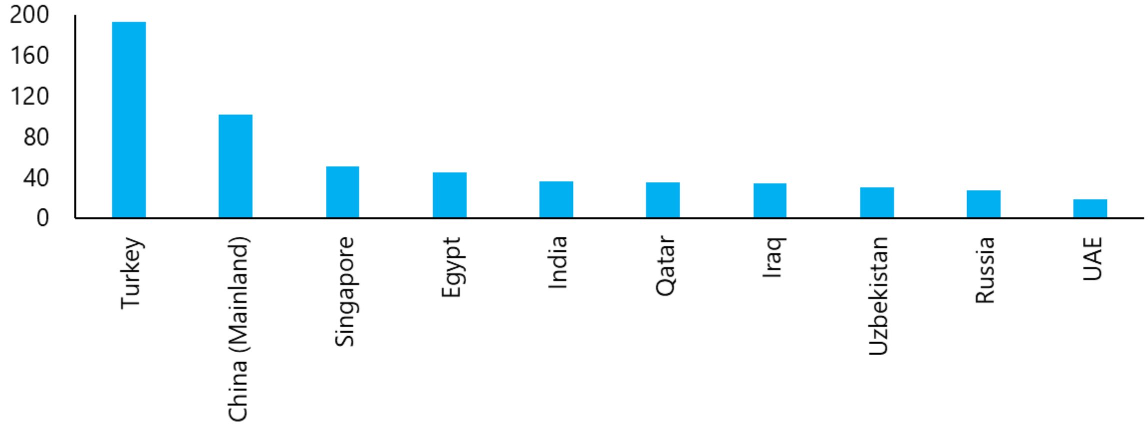


Source: Metals Focus, Refinitiv GFMS, World Gold Council, World Gold Demand Trends 2022

3. Emerging markets lead the flight

In fact gold, one of the oldest and most traditional of safe havens, has become a vehicle of central bank revolt against the dollar. Among the biggest central bank buyers, nine of the top 10 are in the developing world, including Russia, India and China. (Chart 3 below) Surely it is no accident that those three are in talks with Brazil and South Africa about creating a new currency to challenge the dollar. Their immediate goal: to trade with one another directly, in their own coin. The longer term goal, at least in China, is to replace the dollar as the reserve currency.

Chart 3. The Top 10 Central Bank Gold Buyers since end 2021
(Tons)

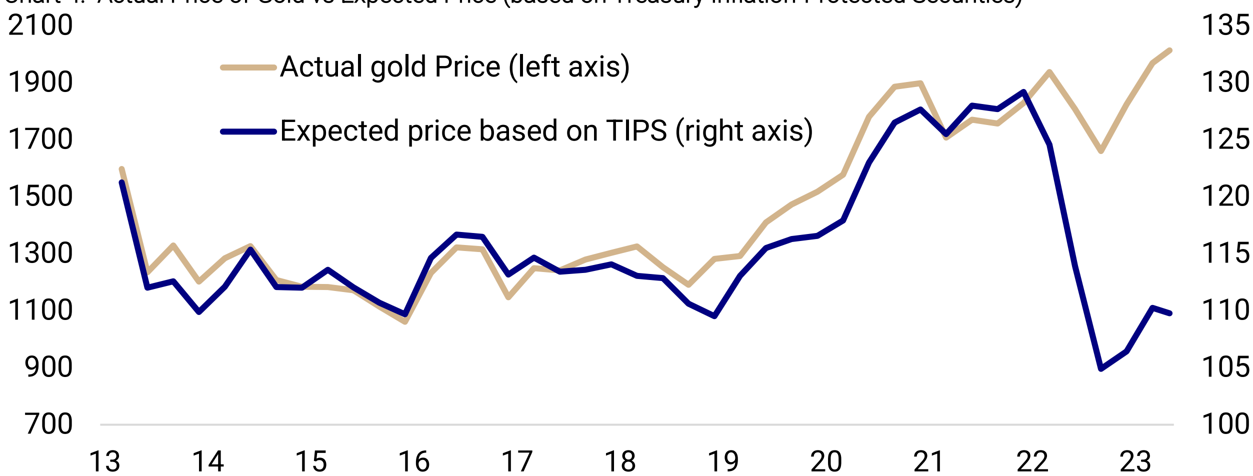


Source: IMF International Financial Statistics; ECB, Weekly Financial Statement, national sources, World Gold Council, Breakout Capital Calculations. Data updated as of April 2023

4. It's not about inflation

The central bank flight from the dollar has created highly unusual movements in the gold price. Its rise is not driven by retail or institutional investors seeking refuge from the return of inflation, since the price of gold is now above $2000 – almost double what models based on inflation adjusted interest rates would suggest (Chart 4).

Chart 4. Actual Price of Gold vs Expected Price (based on Treasury Inflation-Protected Securities)

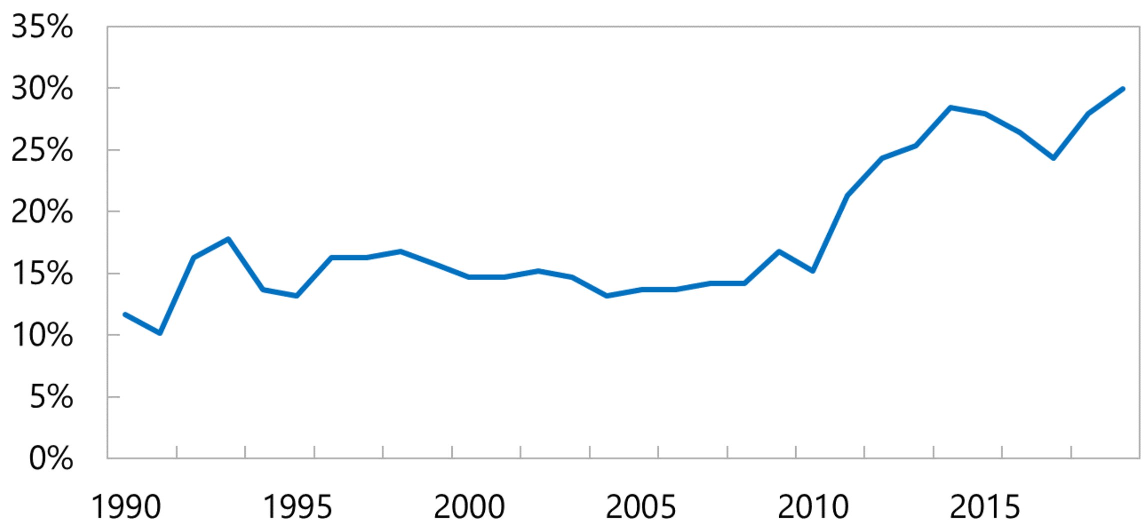


Source: Bloomberg, Breakout Capital Calculations. TIPS Prices represented by iShares TIPS Bond ETF. As of May 11, 2023.

5. The weaponized dollar

Something other than inflation is driving this shift to gold, and emerging world central bankers are the likely answer. Why now? One reason is long burning dissatisfaction with dollar dominance, another is that the United States and its allies have increasingly weaponized the dollar, in the form of financial sanctions. Today the US, UK, Japan and the EU hold 30 percent of all countries under sanctions, up from 10 percent in the early 90s. Until recently most targets were small, but the new sanctions against Russia over the war in Ukraine showed other big emerging markets that no nation is immune.

Chart 5. Countries Targeted by "Big Four" Financial Sanctions, 1990-2019
(Percent of total countries)



Source: Global Sanctions Database by Felbermayr et al. (2020, 2021), "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies" by Serkan Arslanalp, Barry J. Eichengreen and Chima Simpson-Bell

The conventional wisdom is encouraging complacency in the US. Assuming there is "no alternative" takes the wind out of efforts to address the forces undermining the dollar, including the US twin deficit—now second highest in the developed world after the UK. The US ignores these risks at its own peril, but to the potential benefit of EM investors, who gain as the dollar weakens.

Breakout Briefings

Our Worldview in Charts

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