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Gold: differences of opinion

Why does the gold price fall when war risk increases, and rise when tension relieves? And if oil goes up, why is that bad for gold? This is the opposite of what should happen.

Alasdair Macleod

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MacleodFinance has received several requests for an explanation of this phenomenon from investors worried that as the situation over Iran deteriorates, or bond yields or oil prices surge that gold prices will fall. These concerns are increased by some so-called experts, often chartists forecasting lower gold and silver prices.

US-centric pricing is a credible explanation for gold's performance, and this is how investment managers and hedge funds assess events when accounting for their profits and investment returns in dollars, euros, or yen.

Higher oil prices, in this case due to developments over the Persian Gulf are leading to higher inflation which in turn means higher interest rates. This is deemed to impose a cost penalty on being long of gold. Therefore, anticipation of these events makes the dollar attractive relative to gold. We have seen this relationship between oil and gold play out consistently over the Hormuz crisis and it explains why gold didn't rise as a safe-haven hedge when political risk increased with the bombing of Iran. Crucially, it assumes that there is minimal medium-term existential risk to the values of the dollar, euro, and yen.

The Asian view is very different. Asians ignore the interest rate argument adopted by Western paper markets because they see the risk to fiat currencies' purchasing power. In their view, all paper currencies will be worth less in future and should be sold for real money, those sales starting with the dollar.

In short, paper traders in New York and London are blind to the risk to the value of paper currencies. Their view is that the risk is to assets, such as bonds and by extension probably equities. This is why they sell them for cash in the currencies in which they account.

The difference in approach is why gold and silver migrate from West to East. As oil prices soar, open interest in Comex gold and silver contracts declines. And stands-for-delivery continue apace as demand from Asian central banks and funds with excess dollar balances reduce their currency exposure. We must also bear in mind that every futures contract has a short side, and the shorts are predominantly hedging against a fall in price or are market makers with uneven books. The market

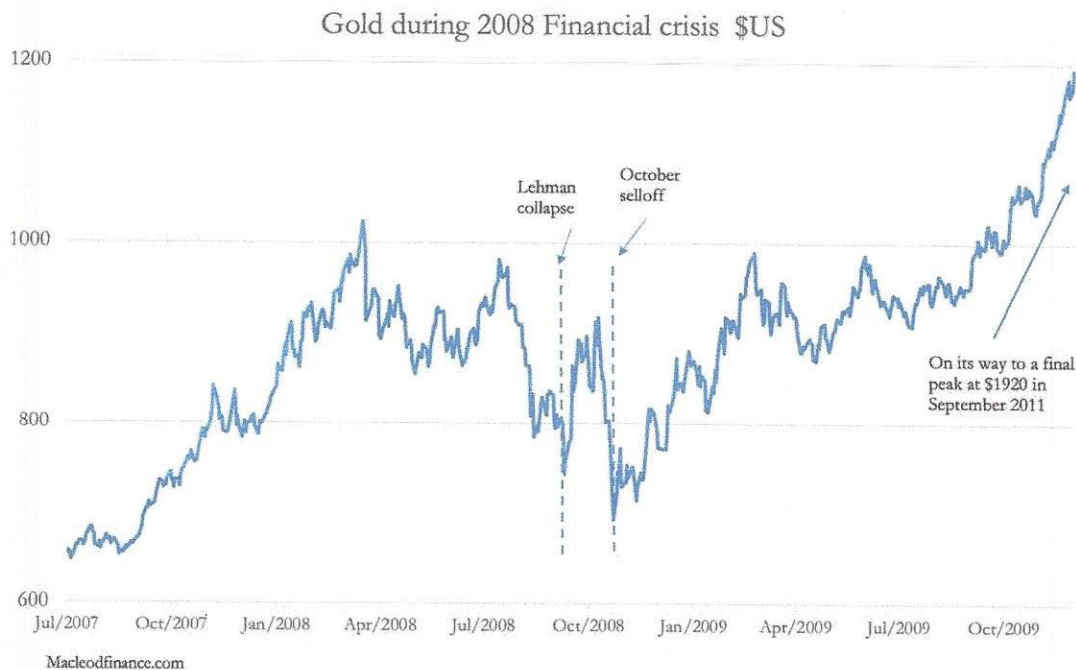
makers along with sundry bullion bank traders comprise the swaps category. Their collected vested interest is almost always to see lower prices, so they have the incentive to manipulate them downwards. They also take the default view that higher interest rates are bad for gold and silver because that is their vested interest and experience.

However, history exposes the error in this way of thinking. In 1971, gold was \$35, and the Fed's fund rate was less than 4%. Ten years passed and gold rose to \$850 and the Fed's fund rate rose to 19%. Not only that, but during the 1970s both these trends were upwards admittedly with considerable volatility.

At that time there was mounting concern about the loss of purchasing power for the dollar and other major currencies. This led to the dollar being sold for gold as the safe haven for foreigners with dollar balances. That echoes the position today, with foreigners reducing their holding of dollars at the margin.

Central banks for which dollars, euros, or yen are foreign currencies are rebalancing their holdings in them for physical gold without the counterparty risk of highly indebted governments. And many of them are even repatriating their bullion for ultimate control.

Today, it is becoming apparent to US-centric investors and market makers that CPI inflation is likely to return with a vengeance and bond yields are starting to rise. For them, this is bad for gold and explains some forecasts from technical and other analysts talking gold and silver down. We have seen this before, notably in 2008. When faced with the collapse of the US financial system, gold sold down from over \$900 to under \$700 in 14 trading sessions that October.



Should bond yields track higher and G7 nations led by the US have severe financing difficulties as a result, the conditions for a crisis will return. All investors in those jurisdictions are bound to rush to liquidate financial assets, just as they did with equities in 2008. It turned out that that sell off was a massive gold buying opportunity.

Doubtless, analysts looking only at price history see similarities today. And with pricing dominated by investment flows in the US, Europe, and Japan it would be foolish to ignore it. But in the run-up to the early-January 2008 peak at over \$1000 from under \$270 in 2002, central banks were net sellers reducing their total holdings from 32,879 tonnes at end-2001 to 30,094 tonnes in March 2008. Furthermore, gold's geopolitical importance was not an issue at that time. We can only conclude that should the opportunity to buy gold in a market crisis recur today, not only would it be a blink-and-you-missed-it opportunity, but the risk for market makers in London's spot market and on Comex would be that a severe liquidity squeeze would follow.

The practical course for investors is not to think in terms of price but protection: are you still trying to maximise your portfolio, or protect it? The chances of coming badly unstuck for traders playing a dip appear to be extremely high. The winners will be those who understand that the safest approach is simply to sell down currencies for gold as the Asians have been doing in the knowledge that fiat currencies are where the risk truly resides, not in gold.

Furthermore, there's always the possibility that the brief history of 2008's October dip will not repeat itself.

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[548 Market Street](#) PMB 72296, San Francisco, CA 94104