

# Unlock the secrets of **trading gold**



## **AN INTRODUCTION TO TRADING GOLD**

A FOREX.com educational guide

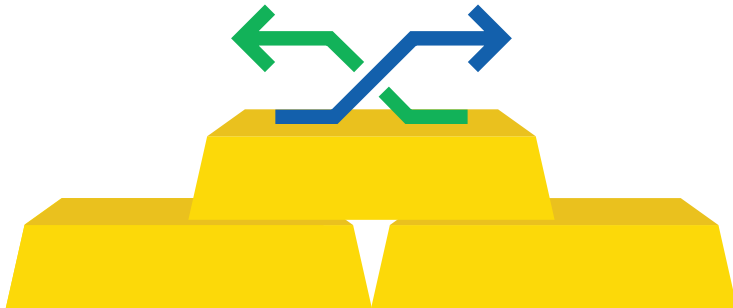
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## So everyone's talking about trading gold. What is it all about?

Human beings have long valued and treasured gold for its inherent luster and malleability. In fact, gold has been used in human commerce since the societies of the ancient Middle East over 2,500 years ago, making it the oldest form of money still recognized today. Gold's long track record as a store of value despite wars, natural disasters, and the rise and fall of great empires means that it is generally seen as the ultimate "safe-haven" asset.

“ The desire for gold is the most universal and deeply rooted commercial instinct of the human race ”

Gerald M. Loeb,  
Founding Partner of E.F. Hutton<sup>1</sup>

1. <http://www.nationalgoldgroup.com/history-of-gold-coins/>



Spot gold price in USD in oz



Source: World Gold Council

While gold has generally held its value for centuries, traders' interest has waxed and waned in recent years. From the early 1980s until the early 2000s, there was little interest in trading safe-haven gold amidst the strong, stable economic growth and high-flying stock markets. As a result, gold generally consolidated between \$300/oz and \$500/oz for twenty years, from 1982-2002.

Interest in gold grew slowly through the 2000s before exploding with the onset of the Great Financial Crisis in 2008. Gold prices rose in sympathy, hitting an all-time high above \$1900 in late 2011. In this guide, we will discuss the major forces that drive gold prices, along with some ideas for trading strategies and some of the most common methods for trading gold.



## Factors that influence gold's price

Gold is one of the most difficult financial assets to value. Gold is similar to a currency like the U.S. dollar or the euro because it is durable, portable, uniform across the world, and widely accepted; however, unlike these more commonly traded currencies, gold is not supported by an underlying economy of workers, companies, and infrastructure.

In other ways, gold is more similar to a commodity like oil or corn because it comes from the ground and has standardized physical characteristics. Unlike other commodities, though, the price of gold often fluctuates independently of its industrial supply and demand.

10%

**In fact, only about 10% of the world's gold is used in industry: primarily in electronics, due to its conductivity and anti-corrosive properties.**

90%

**The rest of the world's gold is either made into jewelry or held for investment purposes.**



Because of this dynamic, the emotions and behaviors of traders tend to drive major trends in the yellow metal. With gold more than any other asset, traders seem to be polarized between diehard “gold bugs” who believe that gold should be worth \$10,000 an ounce because central banks around the world are debasing their currencies and bearish traders who assert that gold is a “barbarous relic” of the past that should be worth closer to \$100. As the chart above shows, the gold bugs’ view developed into a bit of a mania back in the mid- and late-2000s, though the more recent drop suggests gold may be losing some of its previous luster.



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## GOLD AND U.S. INTEREST RATES

Historically, one of the most reliable determinants of gold’s price has been the level of real interest rates, or the interest rate less inflation. If you think about it, this relationship is straightforward.

When real interest rates are low, investment alternatives like cash and bonds tend to provide a low or negative return, pushing investors to seek alternative ways to protect the value of their wealth.

On the other hand, when real interest rates are high, strong returns are possible in cash and bonds and the appeal of holding a yellow metal with few industrial uses diminishes.

One easy way to see a proxy for real interest rates in the United States, the world’s largest economy, is to look at the yield on Treasury Inflation Protected Securities (TIPS).



## What is the correlation between gold and the U.S. Dollar?



One of the biggest points of contention for gold traders is on the true correlation between gold and the U.S. Dollar. Because gold is priced in U.S. Dollars, it would be logical to assume that the two assets are inversely correlated, meaning that the value of gold and the dollar move opposite to one another. In layman's terms, it takes fewer dollars to buy an ounce gold when the value of the dollar rises, and it takes more greenbacks to buy an ounce of gold when the value of those dollars is lower.



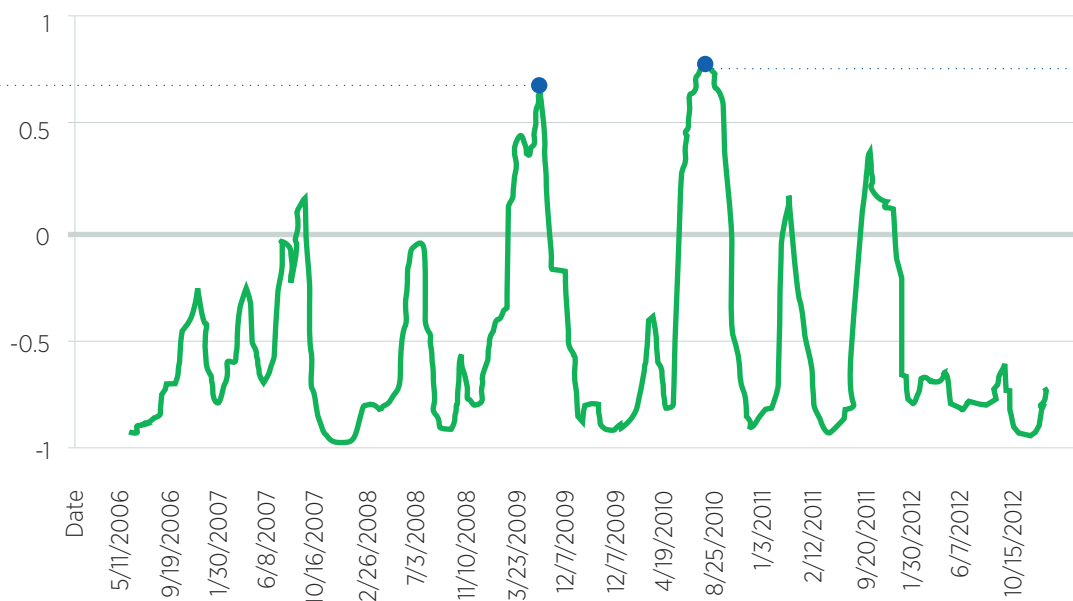
Unfortunately, this overly simplistic view of the correlation does not hold in all cases. The chart below shows the rolling 100-day correlation coefficient between gold and the U.S. Dollar. The correlation coefficient measures how closely together gold and U.S. dollar have moved over the last 100 days; a reading of 1.0 would show that they moved in perfect lockstep with one another, while a reading of -1.0 would show that their movements have been diametrically opposed.

As you can see, the correlation is negative the majority of the time, showing that the U.S. Dollar does tend to move opposite to gold.

- However, it has also shown a tendency to spike rapidly in periods of financial stress, such as in the depths of the Great Financial Crisis in early 2009 and the end of the first iteration of Quantitative Easing in mid-2010. This is because traders will buy both gold and the U.S. dollar as “safe-haven” assets in periods of uncertainty.

Traders who blithely traded on the assumption that gold and the dollar are inversely correlated would have encountered a couple periods of tough market conditions and likely losing trades over the past few years. Gold’s correlation with the U.S. dollar is one crucial piece of the puzzle, but as we noted above, there are many other factors that drive gold’s value.

100-Day Rolling Correlation Coefficient  
Between Gold and U.S. Dollar, 2006-2012



Source: Perth mint and Yahoo! Finance





## Gold trading strategies

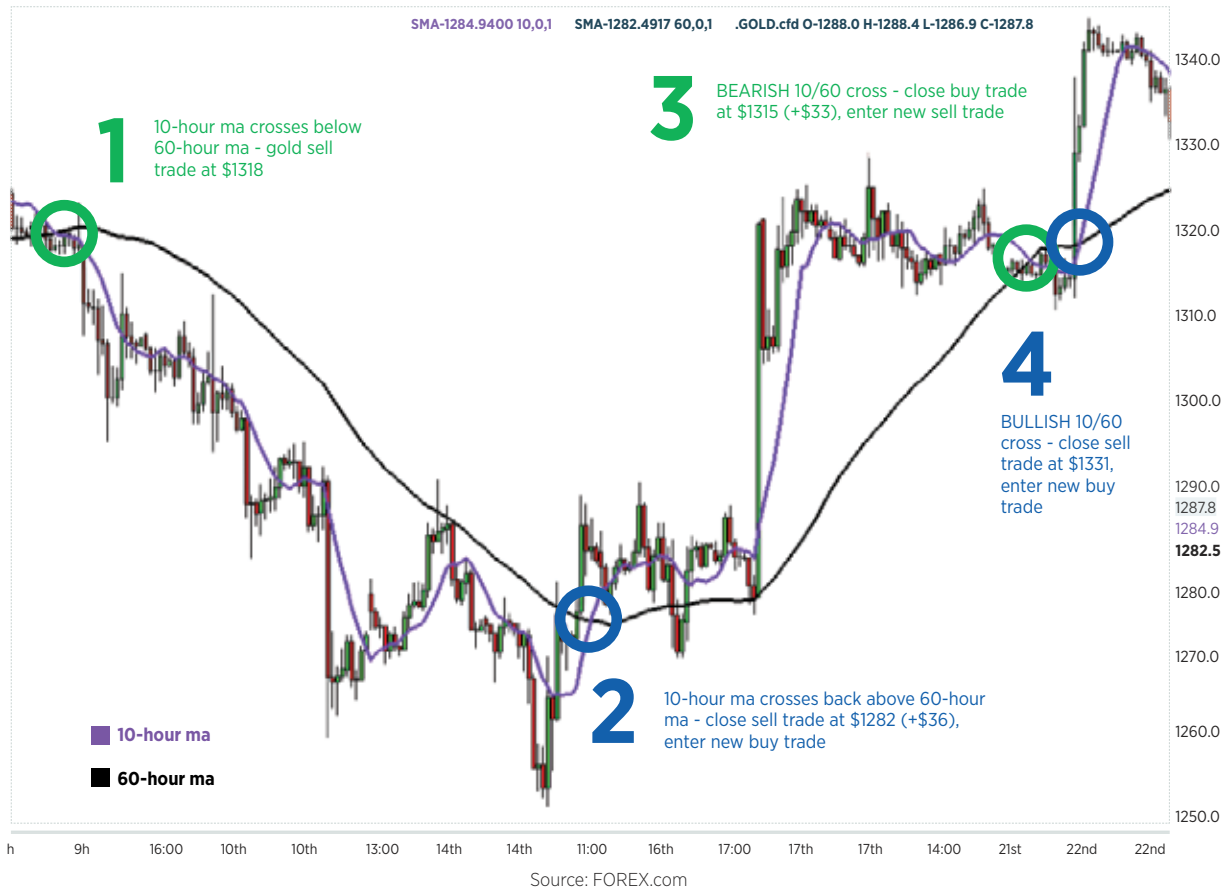
As with any trading instrument, there is no single “best” way to trade gold. Many traders from other markets have found that the technical trading strategies they employ on other instruments can easily be adapted to the gold market, especially given gold’s tendency to form durable trends. For example, many traders have found success adapting strategies based on trend lines, Fibonacci analysis and overbought/oversold oscillators like RSI and Stochastics.

### A SAMPLE SHORT-TERM STRATEGY: CATCH THE “MEAT” OF THE TREND WITH A MOVING AVERAGE CROSSOVER

For short-term traders, a classic way to try to profit from the frequent trends in gold is to use a moving average crossover strategy. In this strategy, a trader would look to buy gold if a shorter-term moving average crossed above a longer-term moving average and sell when the shorter-term moving average crosses below the longer-term average.

Traders differ in their opinions on the “best” timeframes for the two moving averages, but we’ve found that a 10/60 moving average crossover on the 1hr chart can be a strong combination for shorter-term traders. Historically, these settings have allowed traders to successfully trade the middle portion of a trend, though there is no guarantee of future performance. The chart shows how this strategy could be applied in the gold market:

## Gold 1hr chart



**1** At point #1, the shorter-term 10-hour moving average crosses below the longer-term 60-period average, suggesting that traders should enter a sell trade as a bearish trend may be forming. The moving averages do not cross again until point #2 a few days later, after gold has trended down to the upper \$1200s.

**2** At point #2, the initial sell trade is closed for a solid gain and a new buy trade is triggered as the trend shifts back to the topside.

**3** After a brief consolidation, gold rallies back into the lower \$1300s, and the trade is closed on the bearish moving average cross at point #3.

**4** Like any methodology though, this strategy will produce losing trades as well. In this case, the big spike near point #4 caused the sell trade from #3 to be stopped out for a loss. It's also important to note that the trade must be closed at the market price (near \$1330) when the cross occurred, not the \$1315 level where the two moving averages actually crossed.

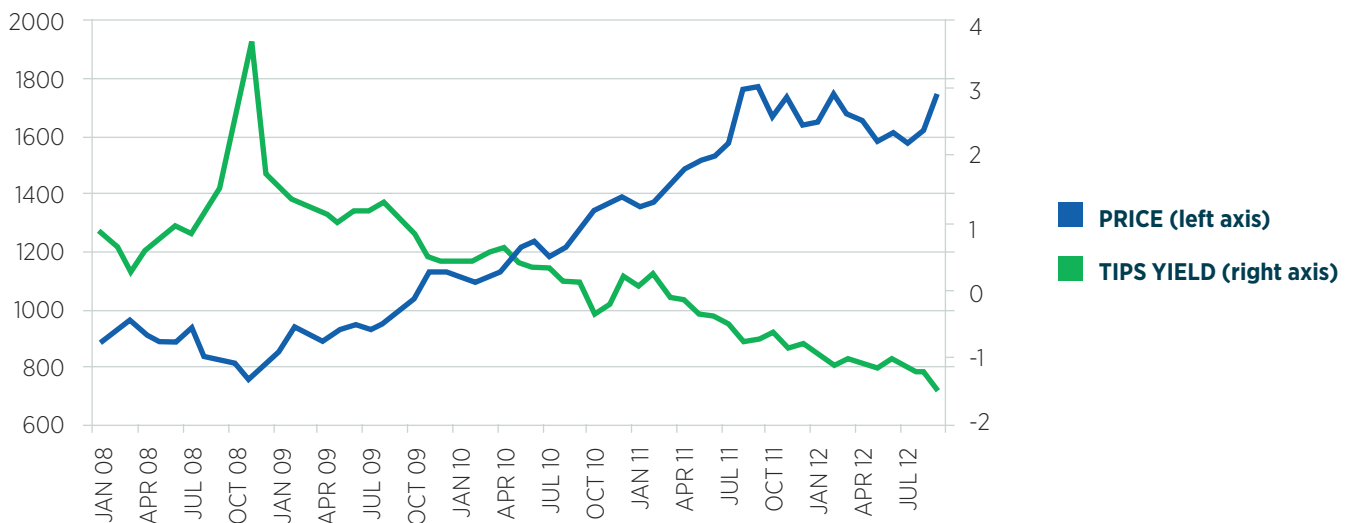
This simple trading strategy can help traders catch the middle portion of trends in more volatile trading environments like the one highlighted above, but using it when gold is merely consolidating in a range can lead to a series of consecutive losing trades. As a result, traders may want to consider supplementing this strategy with other indicators to improve its long-term profitability.



## **A SAMPLE LONG-TERM STRATEGY: WATCH THE LEVEL OF REAL INTEREST RATES**

Longer-term position traders and investors can focus more on the fundamentals driving gold's price, such as the level of real interest rates. The chart below shows the relationship between gold prices and the yield on TIPS, a proxy for real interest rates in the United States. The inverse correlation is obvious, but it looks like gold's rally accelerated as real yields dropped below 1% in early 2009. Not surprisingly, a longer-term look at the relationship would reveal that gold prices generally fell in the late 1990s, which were characterized by real yields above the 1% threshold.

Gold PRICE vs TIPS YIELD SINCE 2008



Source: Federal Reserve &amp; Perth Mint

Therefore, longer-term traders may want to consider buy opportunities if real yields are below 1%, a level which has historically been supportive of gold prices. Conversely, if real yields rise above 2%, investors may want to focus more on sell trades. Of course, this relationship between real yields and gold prices plays out over longer-term timeframes, so shorter-term gold traders can generally ignore the level of interest rates.

The ability to use a filter based on real interest rates is one of the unique features that traders can use to gain an edge when trading gold, but the trading strategies and opportunities in trading the world's oldest "currency" are truly limitless.



## Trading gold with FOREX.com

Some investors prefer to take physical possession of gold bullion to ensure that they can access it at will, but that strategy can be prohibitively expensive once additional costs to transport, store, protect, and trade the bullion are accounted for. Instead, some traders focus on trading the current “spot” price of gold, which is based on the price of the most active futures contracts on the COMEX (Commodities Exchange) in New York. Because these futures contracts are actively traded in a central location every single day, they provide the most accurate, up-to-date prices for gold.

FOREX.com’s spot trading is based directly on the actual price of gold, not an exchange-traded product like some other products. Gold offers diversification from other commonly traded markets. The inverse correlation with the U.S. dollar was covered at length above, and gold has historically moved independently of stock and bond market prices as well.

However, please be aware that there is no guarantee that it will be correlated in the future and past performance is not indicative of future results. Spot gold and silver trading is available 23 hours a day from 6pm ET Sunday through 5pm ET Friday. Trading is closed from 5pm to 6pm ET daily. Spot gold and silver trading also follow CME holiday closures.

- **Gold is traded on 1:1 margin, or 100% of the contract value.**
- **The minimum lot size for gold is 1 troy ounce.**
- **The symbol for spot gold is XAU/USD.**

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