Gold Failed

An e-mail from a *RealMoney* reader a few weeks ago asked in part, "Anyway, are you for or against gold? It is not clear." I responded, "One cannot be for or against gold. Sometimes I'm bullish, sometimes I'm bearish. That's why it's 'not clear.'"

As gold is as much of a religion as it is a market, this answer might infuriate some. After all, imagine the stunned silence in any religious gathering if you said, "Well, let me run the numbers before I decide whether I really believe this week. I did a month ago, so you never know. I still could be with you, brother."

But gold is a market and nothing more. And if I may allow myself one dig before proceeding, it is not smarter market than any other despite its proponents' claims in that direction. For if it was, the very smart traders who comprise that market would have acquired all of the world's wealth by now and enslaved the rest of us chumps. As Willie Nelson sang in another context:

> *All the Federales say, they could've had him any day*
> *They only let him slip away, out of kindness I suppose*

Gold's Warnings

First, you are invited to refer back to a column from early July on how gold had lost its constancy with respect to inflation and currency risks. This was a hint gold was in trouble; when a market's behavior vis-à-vis its known fundamentals changes, its price is about to disconnect and move sharply. Sometimes, as in the case of the many bubbles we have seen in our collective lifetimes, the price can disconnect by going to unsustainable valuations.

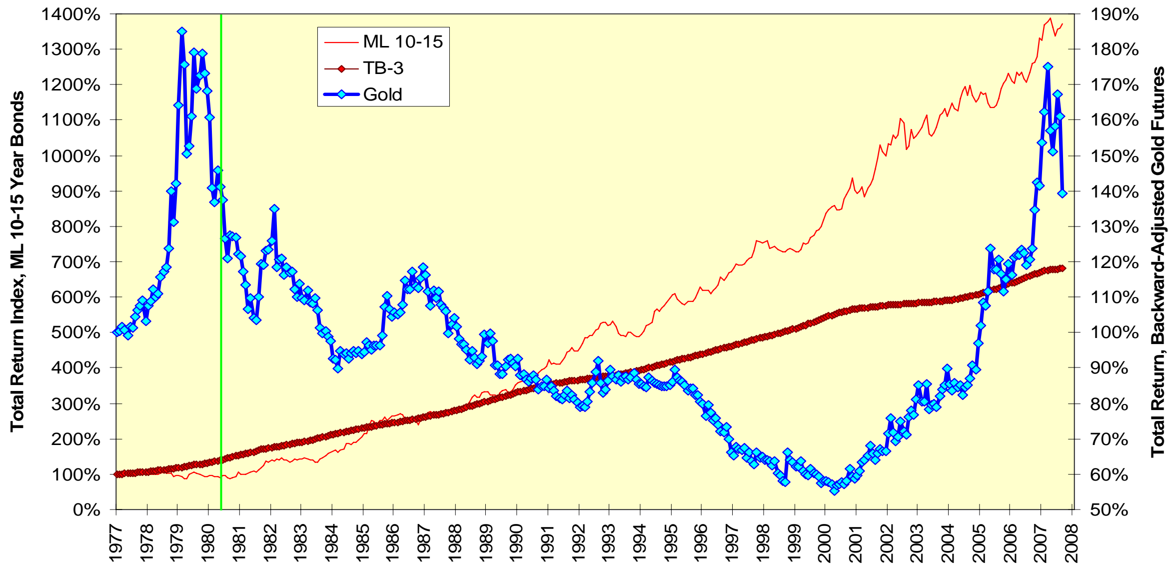
Other times, it can disconnect and signal us the fundamentals are about to change. This was the case with gold. It was signaling the problems of runaway inflation and dollar weakness were about to change. It also signaled something far more sinister, and that relates to the role of the federal government, our *federales*, in the economy. That column was written just over a week before the de facto nationalization of Fannie Mae and Freddie Mac. As more and more of our financial system becomes beholden to the federal government as a source of funds, credit, shareholder protection and management entrenchment, it is going to have to play by the *federales*' rules.

One of those rules could be a repeat of the 1933-1974 experience banning U.S. citizens from holding gold in monetary form (the best predictor of something happening is whether it has happened previously). That would make gold's price fall to whatever level someone decided. Would that level be higher or lower? Put me down for lower.

Many Unhappy Returns

Now let's get to the meat of the matter, and that is whether gold is a good investment. As all investments must be judged in reference to the risk-free rate, let's compare the long-term total return of gold as measured by backward-adjusted futures to the total returns of both three-month Treasury bills and 10-15 year Treasury bonds as reported by Merrill Lynch. Backward-adjusted futures incorporate both the interest rate and physical costs of carry for a commodity.

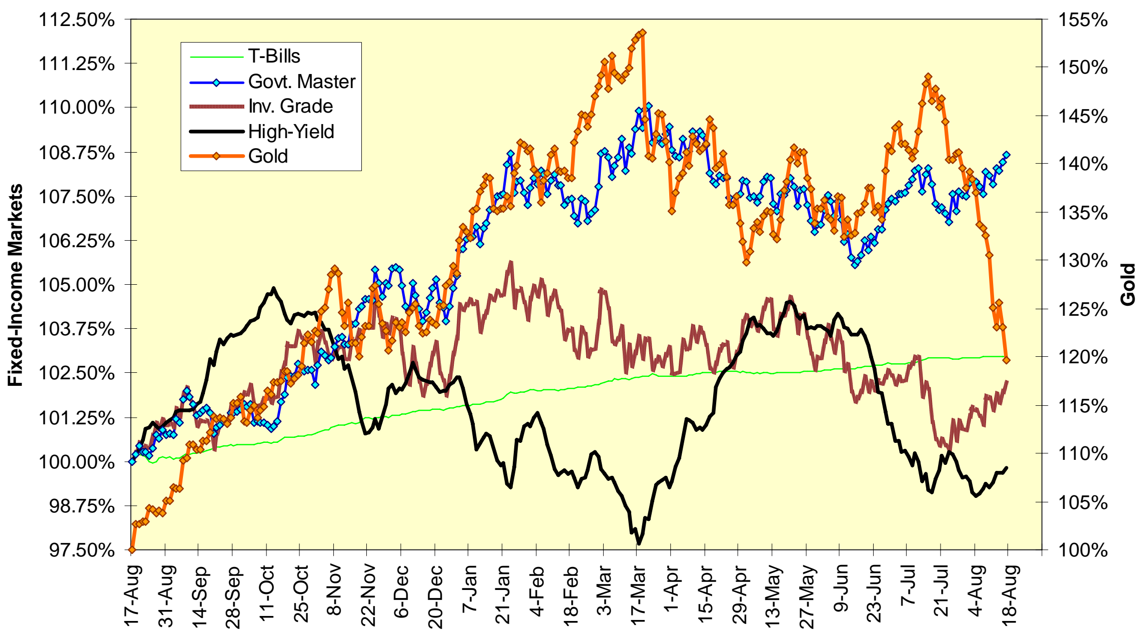
Comparative Total Returns: Bonds, Bills And Gold



The comparative performance going back to December 1977 is so lopsided we have to display it using two scales; gold on the right. The last time the total return on gold exceeded that of three-month T-bills was April 1981, marked with a green line. How can this be so? The answer is compound interest: While bonds and bills compound, gold faces discounting, or inverse compounding. The money tied up in gold futures includes an interest rate carry, and its cumulative effect over time is an enormous hurdle to overcome.

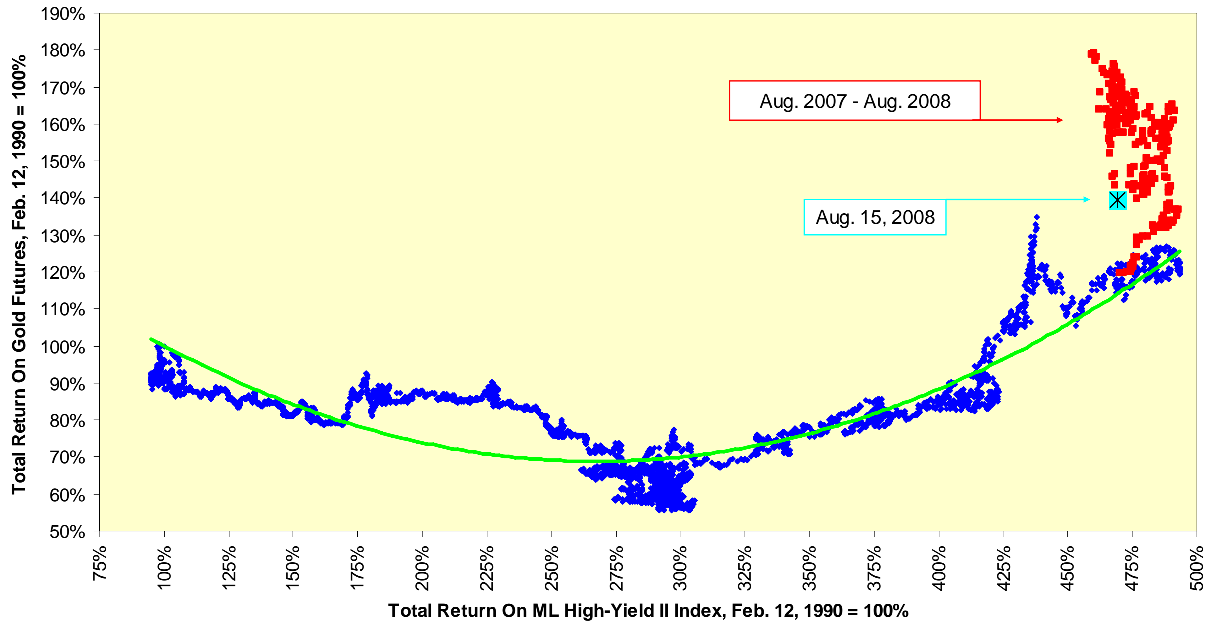
What if we shorten the timeframe up considerably, say to August 17, 2007, the date when the Federal Reserve cut rates before the opening? Let's widen the comparison out to include high-yield and investment-grade corporate bonds as well as three-month Treasury bills and an index of government bonds of all maturities. Once again, we have to use two scales, with the short-term total return on gold dwarfing that of the fixed-income instruments.

Comparative Returns Since August 17, 2007



While gold's dive over the past month is the dominant feature on the chart above, please note how it was preceded by the dive in high-yield bonds' total return. Is there some sort of long-term relationship between high-yield bonds, which are a barometer of risk-acceptance, and gold?

We can take the data back to February 1990. Prior to August 17, 2007, marked in blue, the general relationship was defined by the price of gold itself; the green trend curve declined as gold declined and rose as gold rose. After the credit crunch started to bite a year ago, marked in red, the relationship changed. Gold shot higher as high-yield stalled. Gold's current retreat is still within that trading range for high-yield bonds.



This summarizes gold's dilemma: It had everything – and I do mean everything – going for it. You had higher inflation, dollar debasement, huge flows into commodity-related instruments and terrible returns elsewhere, and it finally collapsed under its own weight. If the credit crunch is going to be with us for a while, and I am afraid it will be, global economies will contract, wealth levels will recede and the fuel for a future gold rally will disappear.

That is not being for gold or against gold. That is saying it is a poor long-term investment in a risk-averse world.