Stocks Have No Cross of Gold

"…you shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold." -- William Jennings Bryan

One of the reasons certain truths are held to be self-evident is no one likes to check whether they are evident in fact. In no are shoot-from-the-lip assertions as common as they are in gold. If we accept my longstanding premise gold is understood best as a religion and not as a market, everything falls into place.

Religions make assertions as a matter of faith; certain religions add the sanction of eternal damnation as a negative incentive. Gold's aficionados also make assertions as a matter of faith; their negative sanction is eternal annoyance: One day gold will enter a bull market to end all bull markets, and you will have to listen to me forever and ever and ever!

One of these assertions, which I promised to address in a Columnist Conversation posting last Friday, is gold is nothing less than the anti-financial asset. When paper fails, when trouble looms, when that Fan is turned on and begins blowing all manner of stuff in your general direction, gold will provide salvation.

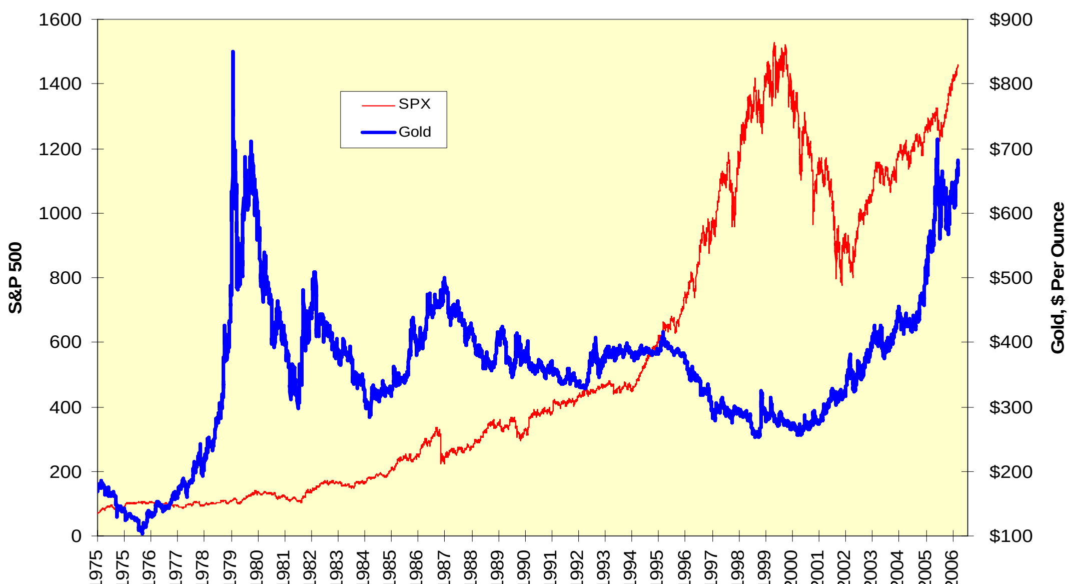
Gold also is pretty and shiny. Some people are quite taken with pretty and shiny things.

A Convenient Truth

Let's take a look at the comparative histories of gold and the S&P 500 since 1975; this starting date was chosen to coincide with the introduction of gold futures in the U.S. Lost in the collective memory is it was illegal for Americans to own gold except as art, jewelry or dental work between 1933 and 1974.

An ideal comparison would be to map the total return series of the S&P 500 against a backward-adjusted series of gold futures, a methodology that incorporates the costs of rolling contracts in gold's forward curve. The S&P total return series begins in 1988, however, and I wanted to make sure the comparison included gold's great bull market of the late 1970s and early 1980s. As much of the return on holding stocks derives from the reinvestment of dividends, and as ownership of gold entails suffering holding costs equivalent at minimum to the short-term interest rate cost of carry, the price-to-price chart below greatly understates the true advantage of holding paper over holding metal.

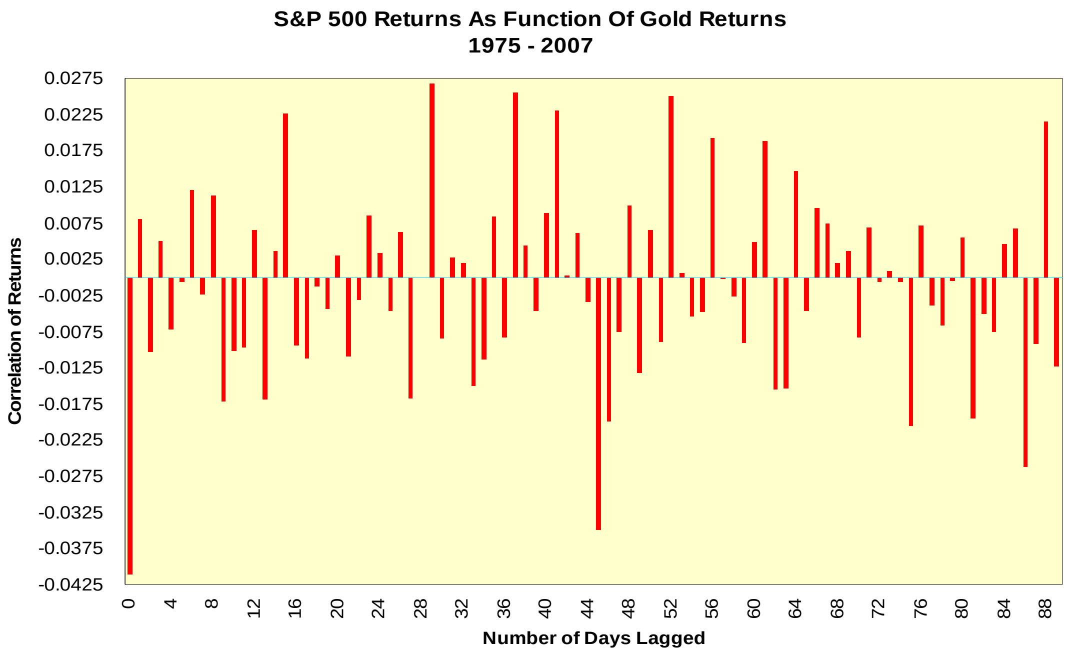
Gold And The S&P 500 Since 1975



What stands out in this chart? First, while the inflationary late 1970s were a terrific time to own gold, the stock market of that time simply stagnated in nominal terms; it did not return to medieval levels. Second, while gold collapsed in the early 1980s under the weight of Paul Volcker's tight credit policies, stocks struggled against these very same policies. Third, the 1985-1987 bull market in stocks was accompanied by a rise in gold prices. Fourth, the 1987 stock market crash preceded the start of gold's long decline in 2001, not a flight into gold. Fifth, while gold began its bull market in 2001 while stocks were in the midst of their worst bear market since the Great Depression, the rally in gold did not pick up speed until the equity bear market ended. Gold and stocks have been in parallel bull markets since early 2003.

Statistical Leads

The narrative provided above should be sufficient to convince all but the true believers gold is not the anti-equity, but experience dictates it is not. Let's haul out a correlation diagram of to assess whether the daily returns on gold are correlated negatively to stocks with a consistent pattern. If gold was either a refuge from stocks or whether rising gold prices did in fact lead to lower stock prices, we should see 1) consistently negative bars in the chart below, and 2) a modal pattern wherein we see a local minimum with successively less-negative correlations at greater and lesser lags.



We see nothing of the sort. The two markets' have a negative contemporaneous correlation, but then the pattern oscillates between positive and negative readings out to lead times of more than four months. The expected smooth modal, or humped, pattern is nowhere to be seen. In other words, the relationship between gold and stocks over more than 8,100 trading days is not one of causation or even of negative correlation. It is, for those yearning for an English language translation by now, random garbage.

Recent History

Alright, scoff the true believers, you hauled in 32 years of data to prove your point. How about confining it to recent history? OK, scoff I in riposte. Let's return to an analysis first introduced in [February 2005] on assessing the impact of factor prices on S&P industry groups, and add the twist introduced in [November 2006] on weighting these factors by the groups' representation in the index, we can construct a table of groups both helped and hurt by rising gold prices at a 90% confidence interval. The data sample here is restricted to the period from April 2004 forward; this interval was selected to coincide with the point when Federal Reserve rate increases from 1.00% became foreordained.

There are 44 industry groups representing 47.51% of the S&P 500 with a statistically significant negative relationship to gold. If we multiply these groups' weights by their relative performance betas to gold, we obtain a net weighted impact of -3.67%. In contrast, there are 21 industry groups accounting for 15.90% of the S&P with a statistically significant positive relationship to gold. However, they have strong positive relative performance betas, and their net weighted impact is 4.15%. On balance, therefore, the S&P 500 has had a 0.48% positive beta to gold since April 2004. The negative relationship surmised as an article of faith is a positive one as a matter of fact.

Gold Beta-Weighted Impact On S&P 500

	SPX Weight	GC Beta	Weighted Beta
Pharmaceuticals	6.21%	0.085	-0.53%
Industrial Conglomerates	3.78%	0.063	-0.24%
Integrated Telecommunications	2.94%	0.076	-0.22%
Hypercenters & Superstores	1.14%	0.178	-0.20%
Home Improvement Retailers	1.11%	0.171	-0.19%
Computer Hardware	3.23%	0.053	-0.17%
Household Products	2.17%	0.079	-0.17%
Systems Software	2.71%	0.058	-0.16%
Healthcare Equipment	1.66%	0.088	-0.15%
Biotech	1.33%	0.085	-0.11%
Drug Retailers	0.55%	0.194	-0.11%
Managed Health	1.38%	0.073	-0.10%
Soft Drinks	1.63%	0.062	-0.10%
Multiline Insurers	1.89%	0.052	-0.10%
Tobacco	1.53%	0.061	-0.09%
Regional Banks	1.81%	0.051	-0.09%
General Merchandise Retailers	0.52%	0.157	-0.08%
Property & Casualty Insurers	1.38%	0.059	-0.08%
Data Processing & Outsourcing	1.03%	0.075	-0.08%
Air Freight & Logistics	0.89%	0.079	-0.07%
Healthcare Distributors	0.47%	0.135	-0.06%
Thrifts & Mortgages	1.45%	0.043	-0.06%
Department Stores	0.74%	0.082	-0.06%
Broadcast & Cable TV	1.21%	0.046	-0.06%
Food Retailers	0.38%	0.134	-0.05%
Packaged Foods	0.91%	0.055	-0.05%
Healthcare Services	0.58%	0.062	-0.04%
Specialty Stores	0.30%	0.112	-0.03%
Publishing & Printing	0.41%	0.069	-0.03%
Automobile Manufacturers	0.27%	0.100	-0.03%
Food Distributors	0.16%	0.154	-0.02%
Apparel Retailers	0.26%	0.077	-0.02%
Leisure Products	0.14%	0.135	-0.02%
Motorcycle Manufacturers	0.14%	0.127	-0.02%
Casinos & Gaming	0.24%	0.070	-0.02%
Computers & Electronics Retailers	0.20%	0.080	-0.02%
Environmental Services	0.17%	0.065	-0.01%
Advertising	0.18%	0.058	-0.01%
Airlines	0.09%	0.110	-0.01%
Healthcare Facilities	0.10%	0.063	-0.01%
Diversified Commercial Services	0.08%	0.057	0.00%
Distributors	0.07%	0.058	0.00%
Commercial Printers	0.06%	0.055	0.00%
Healthcare Suppliers	0.02%	0.114	0.00%
Subtotal:	47.51%		-3.67%

	SPX Weight	GC Beta	Weighted Beta
Integrated Oil & Gas	6.17%	0.280	1.73%
Oil & Gas Equipment	1.32%	0.489	0.64%
Oil & Gas Exploration	0.92%	0.415	0.38%
Diversified Metals & Mining	0.29%	0.917	0.27%
Oil & Gas Drilling	0.41%	0.474	0.19%
Gold	0.16%	1.063	0.17%
Oil & Gas Refining	0.34%	0.444	0.15%
Steel	0.32%	0.459	0.15%
Investment Banking & Brokerage	2.67%	0.054	0.14%
Construction & Farm Machinery	0.79%	0.094	0.07%
Aluminum	0.23%	0.291	0.07%
Fertilizers & Agricultural Chemicals	0.23%	0.176	0.04%
Industrial Machinery	0.78%	0.033	0.03%
Agricultural Products	0.18%	0.142	0.03%
Specialized Finance	0.36%	0.052	0.02%
Industrial Gases	0.29%	0.061	0.02%
Forest Products	0.15%	0.112	0.02%
Construction Materials	0.09%	0.165	0.01%
Electrical Manufacturing Services	0.11%	0.113	0.01%
Construction & Engineering	0.06%	0.152	0.01%
Trading Companies	0.05%	0.090	0.00%
Subtotal:	15.90%		4.15%
Total:	**63.41%**		**0.48%**

Now, none of this is to say we cannot awaken one day to find financial assets in ruin and people fleeing into gold. In the years since this analysis began, the world has gone through many scary moments both in financial markets and with events. And still you made more money – a lot more money – in financial assets than in gold.