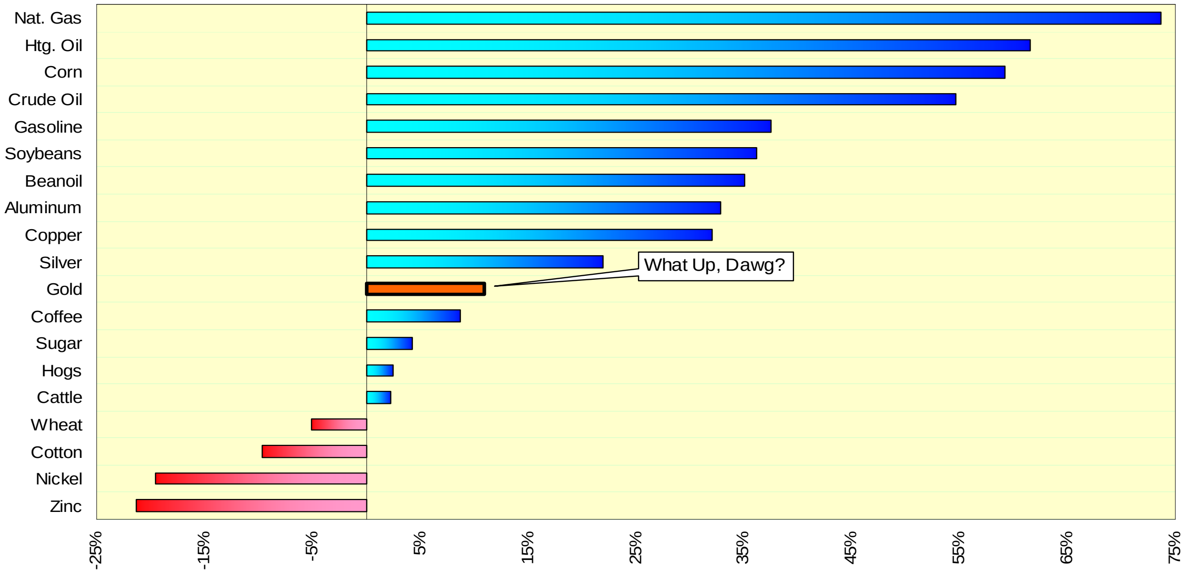
Gold Losing Its Constancy

Regardless of whether you consider yourself a gold bug or would just as soon see the yellow metal disappear from investors' collective radar screen, you should admit one thing, and that is gold is a constant. That and its pretty yellow shine have made it valuable since the dawn of time. You can print more paper and lower its purchasing power at will, but gold will remain.

This makes gold's performance in 2008 puzzling. Yes, it is up 11%, but that is dwarfed by the returns on other commodities. If we are in an inflationary environment, and this hardly seems controversial anymore, and if we are in a weak-dollar and a politically risky environment, and if traditional bullion buyers in India and the Persian Gulf have greater wealth than they did a year ago, then why hasn't gold put $1,000 in the rearview mirror? After all – and it will drive my gold bug friends nuts to hear this – who cares where the price of gold is? If the prices of energy, food or industrial materials increase, behavior must change. If the price of gold rises, it just means we can store more pieces of increasingly worthless paper per ounce.

Year-To-Date Returns For Dow Jones-AIG Components

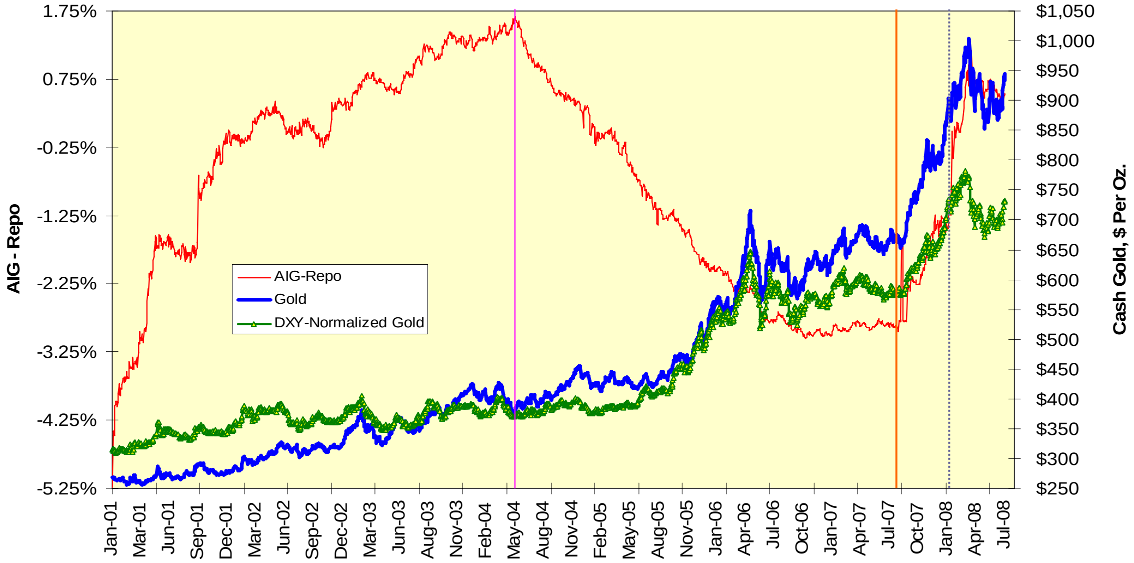


What Is It Hedging?

Many people assume gold simultaneously hedges both inflation and currency risks. They assume this so strongly they feel actual analysis of the data is superfluous. Let's revisit an indicator I introduced in May 2003, dubbed the annualized inflation gauge, or AIG, not to be confused with the woebegone insurer of the same name. This is the expected inflation as measured in the TIPS market converted to an annualized number. If we annualize repo rates and subtract them from the AIG, we get a net expected inflation number, which is the bedrock of my "handful of dirt" model. That states even a handful of dirt will rise in nominal price if expected inflation exceeds the interest rate cost of holding it.

The net inflation number peaked in May 2004, but gold zoomed higher into the July 2007 start of the credit crunch, both in dollar terms and adjusted for changes in the dollar index. Both bounds are marked on the chart. I commented often during this rally how gold was rising in contravention of its fundamentals, but that was only partially true; its big drive higher during that period was the newfound wealth in India and the Persian Gulf.

Gold Tracking Net Inflation, Not Dollar



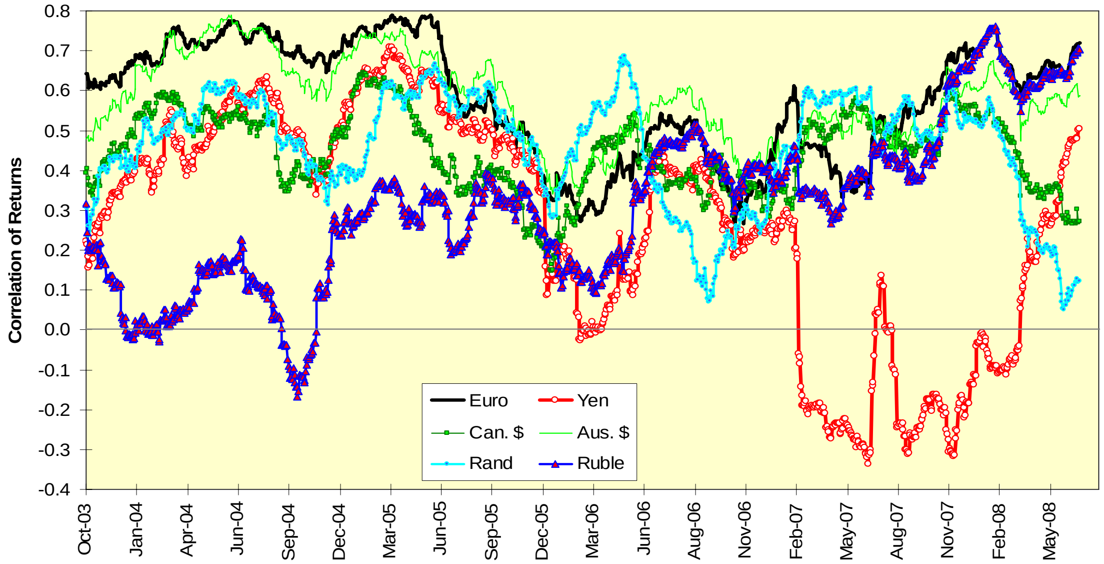
Once the Federal Reserve started cutting rates in August 2007 and signaled it cared not a whit about either the dollar or the course of inflation, gold shot higher into March 2008. Interestingly, the expected correlation between gold and the net inflation measure reappeared strongly. However, the link between this measure and gold adjusted for changes in the dollar index disappeared after the January 2008 panic, also marked on the chart. Gold is now acting as a hedge against expected inflation but not against the dollar.

A Market of Currencies

Just as it is a market of stocks and not a stock market – and as I noted in May 2004, it is a market of commodities and not a commodities market – we have to disaggregate currencies rather than speak of a singular measure for the dollar.

This can be highlighted in the case of gold by taking three-month rolling correlations of returns against six different currencies. In addition to the euro and the yen, we can look at the currencies of major gold producers such as the South African rand, Russian ruble and both the Canadian and Australian dollars.

Rolling Three-Month Correlations Of Returns: Gold Vs. Selected Currencies



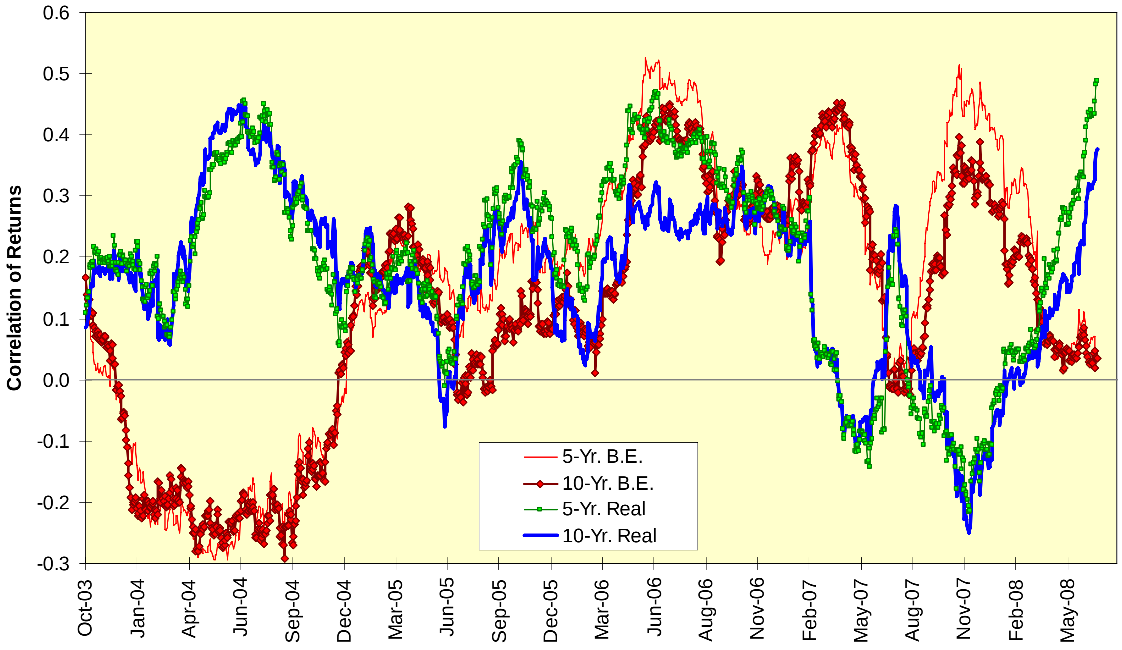
Gold has matched the course of both the euro and the ruble since last July, but the correlations against the Canadian dollar and South African rand have collapse. The yen, peripatetic as always, went from negative correlations to gold to an increasingly positive correlation. The Chinese yuan is not included in this analysis because it is too managed to be meaningful in this context.

The euro is 57.9% of the dollar index. The Canadian dollar and Japanese yen are 9.1% and 13.6%, respectively. A glance at the chart above tells you why you should not use the term "dollar" when you really mean the dollar-euro exchange rate.

Inflation And Interest Rates

Finally, let's look at gold in the context of some inflation and interest rate measures. We can nominal Treasury yields into "real" yields and expected inflation. If we convert both the real yield and the expected inflation components into constant maturity bonds and produce three-month rolling correlations of returns for them against gold, we see a rather striking pattern. Gold has become increasingly correlated to real interest rates and decreasingly correlated to expected inflation since the onset of the credit crunch. The expected inflation number is not net of short-term interest rates as was done above.

Rolling Three-Month Correlations Of Returns: Gold Vs. Selected Interest Rates



As real interest rates have fallen, one consequence of the Federal Reserve's monetary madness, gold has risen apace. This is exactly as we should expect. But note how time-dependent and unstable the patterns are over time. If gold is a constant, then these returns against expected inflation and real interest rates should be a set of near-horizontal lines. That they are not is further evidence of the damage done by ad hoc central bank policies around the world.

There is nothing the world needs more right now than some measure of consistent and transparent monetary policies; note the confusion after last Thursday's modest rate hike by the European Central Bank. We have no idea what either they or the Federal Reserve will do about inflation going forward. Gold is reflecting this confusion, and it is perhaps for this reason it has been less of a commodity haven so far in 2008 we had reason to expect.