Gold And The Dollar: A Real Relationship

"I have sworn, upon the altar of God, eternal hostility to all forms of tyranny over the minds of men"
– Thomas Jefferson

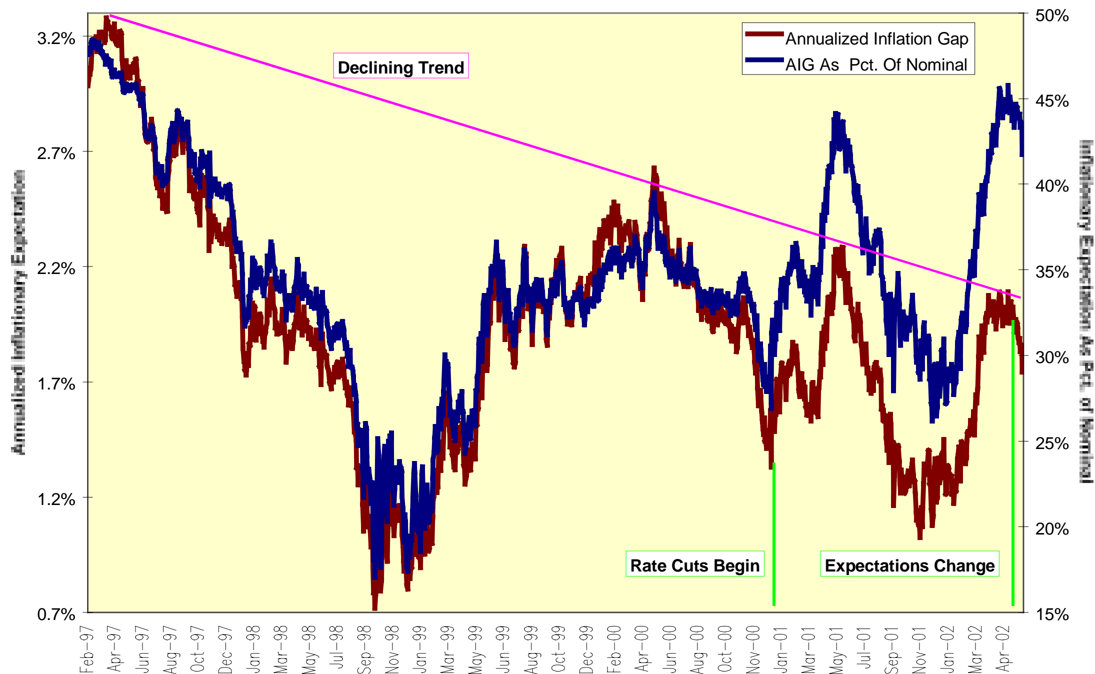
If you're going to be a nasty curmudgeon snarling at the world, go the whole way and borrow from a genuine Hall of Famer, one who didn't hit the steroids, Thomas Jefferson. I started to wonder if I had taken one too many Cranky pills myself after my last two articles on the statistically demonstrable non-relationship between the dollar and both stock and bond prices.

Then I received a phone call from a reporter at another financial Web site who wanted to talk about gold. Specifically, the scribe (can you inscribe in HTML?) wanted to know why had the price risen and whether it was too late to buy. The answers were not simple, but they were direct. The price of gold or any other physical asset can rise if the cost of holding it was less than the expected increase in inflation. In addition, the U.S. dollar price of gold can rise simply by an absolute depreciation in the value of the currency: If each greenback is worth less, it will take more of them to buy an equivalent amount of gold.

He was hoping I'd say something easy, like "India and Pakistan" so he could get off the phone.

TIP A Canoe and Gold Bugs, Too
While it's easy to assess the short-term interest rate of holding any asset – three-month repo rates are around 1.75% – longer-term inflationary expectations more often than not need to be inferred. We certainly have anecdotal evidence in the rising prices of real estate and other hard assets such as gold that inflationary expectations are on the rise, but can we quantify expectations on a consistent basis?

The yield spread between regular and inflation-indexed Treasury bonds (TIPS) can provide some clues. If we take two notes, the nominal 6.25% due Feb. 15, 2007 and the 3.375% TIPS due Jan. 15, 2007, and construct an annualized inflationary gap between the two issues, both as a spread and as a percentage of nominal yields, we see some interesting patterns emerge. As a side note, the spread is illustrated on a one-to-one basis with no attempt to adjust for the greater convexity and longer duration of the TIPS.

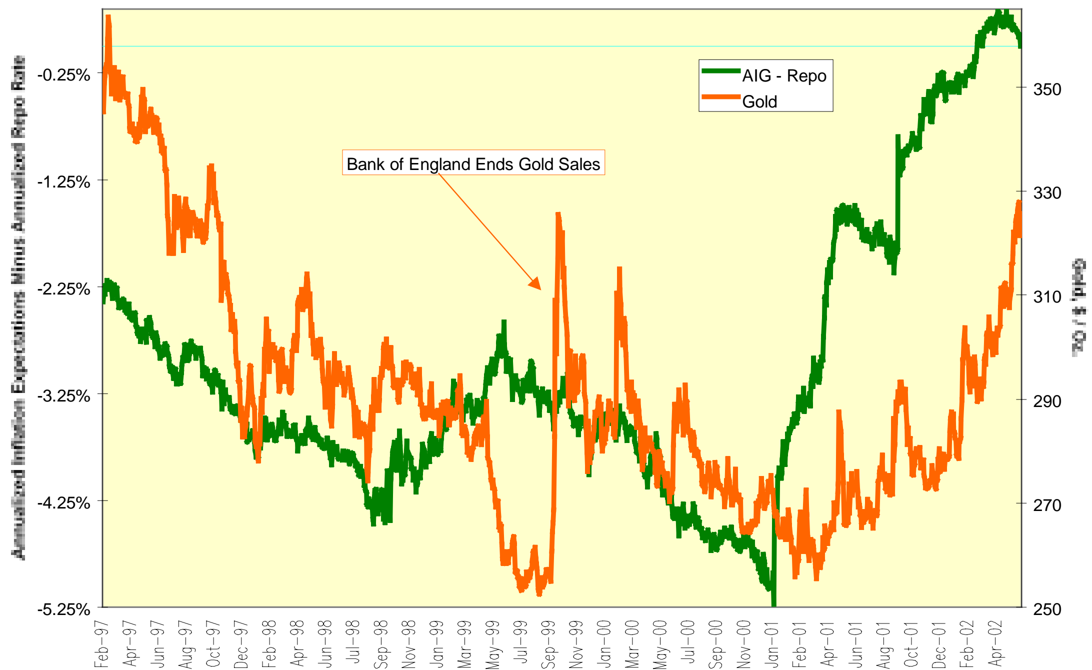


Much to my surprise, the absolute inflationary gap has stopped rising of late; a major turn occurred just before the Memorial Day weekend and the administration's decision to issue a daily terrorism threat. This timing coincided with renewed strong selling in stocks and the dollar and renewed buying in gold. How any of these market moves can be reconciled with an abrupt downturn in inflationary expectations is puzzling indeed. One explanation is a massive loss of confidence in American policy unrelated to the inflationary outlook. Another explanation is that the economy is about to head south in a hurry, but this does not seem supported by other data.

Despite the recent downturn in inflationary expectations, the broader trend in annualized inflationary expectations has been increasing as a percentage of nominal yields. This is without question a worrisome trend for all financial assets as rising inflation within a meandering economy and a blundering fiscal policy inexorably will lead to a 1970s-like stagflation. Inflation lowers the real returns on bonds and it raises the replacement cost of physical plant and equipment, thereby hurting stocks.

The Repo Man Cometh

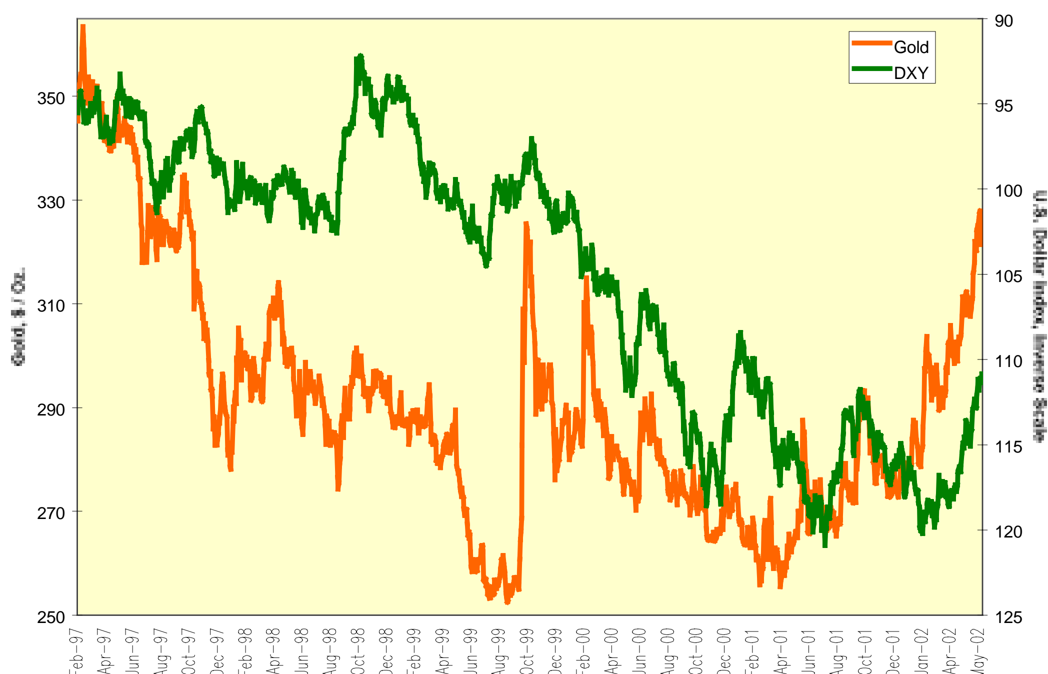
If we subtract the annualized repo rate from the annualized inflationary expectation embedded in the TIPS market, we should get a measure of the monetary "free ride" that an investor could get from simply holding gold. This measure confirms the extent to which the Fed was too tight during the critical May 1999 - December 2000 period. Once the Fed began easing and inflationary expectations shot higher, gold prices followed. The chart below indicates the monetary environment continues to favor higher gold prices.



The Dollar And Gold

If inflationary expectations lead gold prices, then gold prices seem to lead movements in the trade-weighted dollar index. The picture below is distorted somewhat by two events, the September 1999 snap rally in gold produced by the Bank of England's decision to end gold sales and by the extended weakness of the euro despite favorable interest rate differential for much of 2000 and 2001. We normally should expect exchange rates to move as quickly as gold; identical monetary factors and inflationary expectations drive the two markets.

Moving In Step



A Concluding Thought
Several of you have written to me expressing concern about a lower dollar producing capital outflows from the U.S. Relax. An absolute accounting identity is that the capital account surplus must equal the current account deficit; the U.S. has been in a monthly trade deficit since April 1976. If foreign investors cease financing the American deficit, they also cease financing their exports to the U.S.

A more likely outcome is the weaker dollar increasing net U.S. exports and reducing both our trade deficit and our capital surplus. This means that more of the fruits of our labors will be enjoyed elsewhere, a net drain on American wealth, but all part of a normal adjustment process in international trade and finance. The biggest threat to this adjustment process is not any particular level of the dollar, but various impediments to free trade, such as the administration's shameful steel and lumber tariffs and the indefensible farm subsidy bill.

So, is it too late to buy gold? Not at all, but it may be too late to buy gold quietly. The history of precious metals rallies is they get extremely volatile once the early stages are past and the easy money has been made.