

The Money Tide, Gold And Stocks

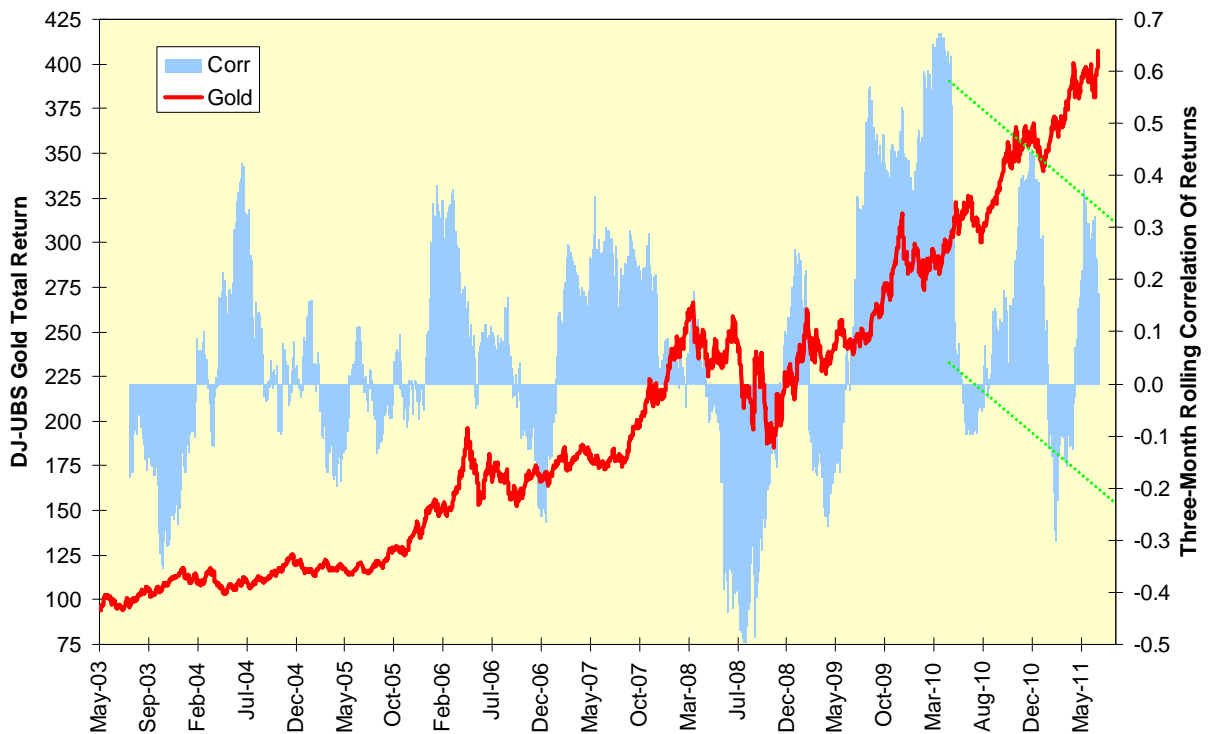
One of the characteristics of markets over the past decade and change has been how many divergent and unprecedented relationships we have seen. I believe this has been caused by the unprecedented efforts by governments and central banks to engage in short-term interest rate suppression and to support financial markets at the expense of the real economy, but that is simply a hypothesis, not a provable theory.

Just to engage in a small roll-call, we have seen negative TIPS breakevens, negative Treasury bill yields, negative ten-year swap spreads, bond yields falling while inflation is rising, stocks rising in tandem with crude oil prices and stocks rising in tandem with gold. I often marvel how, at the start of my career, bond traders regarded the rising federal deficits of the time as anathema; now one of the biggest dangers posed to the bond market is, or is said to be, an possible failure to expand a \$14.3 trillion federal debt ceiling.

These divergent relationships and upending of truths once held to be self-evident demand explanations. By 2006, many analysts were comfortable in saying stocks and gold could rise simultaneously as both were being propelled higher by excess liquidity. That was and very largely still is true. However, a divergence is taking place, one demanding of our attention.

Let's map the total return of the Dow Jones-UBS gold index against a rolling three-month correlation of returns against the Russell 3000. These correlations of returns peaked in the first quarter of 2010, near the end of QE1 and during a heady time for both gold and stocks.

A "Divergence" Underway Between Gold And U.S. Equities



What do we see here, highlighted by a set of superimposed green channel lines? A pattern of rising returns for gold is being met with a pattern of lower highs in the correlation between gold and stocks. I interpret this to mean the ongoing abuse of the dollar and other paper currencies still can suppress paper lower relative to gold, but we are in an era of diminishing returns for stocks as a function of currency debasement. Those who are salivating over the next round of money-printing should take note: The additional dose of money will make gold look good, but the effect on stocks will not be as great.