The Twist Mattered For Gold

Every business has its occupational hazards, something that just must be accepted. I cannot speak for all other financial commentators, but I have commiserated with enough of my colleagues to know writing anything negative about gold invites criticism and writing anything negative about silver invites vicious insult.

Maybe this is why I have seen so many stories about gold on the order of "No one saw it coming." Really; horse or bull; it is your choice: I was talking about gold's trend exhaustion in April 2012 and the negative implications of declining interest in gold just a few weeks ago.

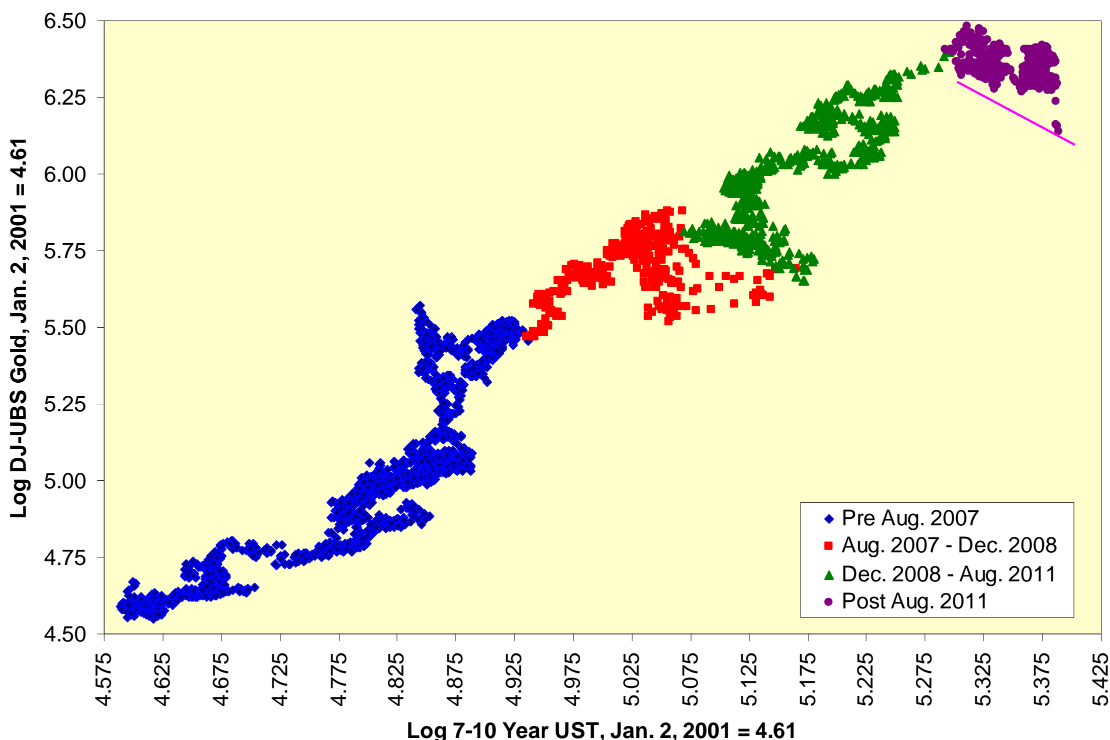
Twist And Peak

Gold peaked shortly after the Federal Reserve began driving long-term interest rates lower in Operation Twist, announced in August 2011. Previous market interventions had focused first on driving short-term interest rates toward 0% and then on expanding the Federal Reserve's balance sheet. Those actions, beginning with the January 2001 intermeeting rate cut by Alan Greenspan – remember him? – had the dual effect of propelling both gold and long-term Treasuries higher.

Let's map the total returns for the Dow Jones-UBS gold subindex against those for both 7-10 year Treasuries and high-yield corporate bonds across four different monetary regimes:

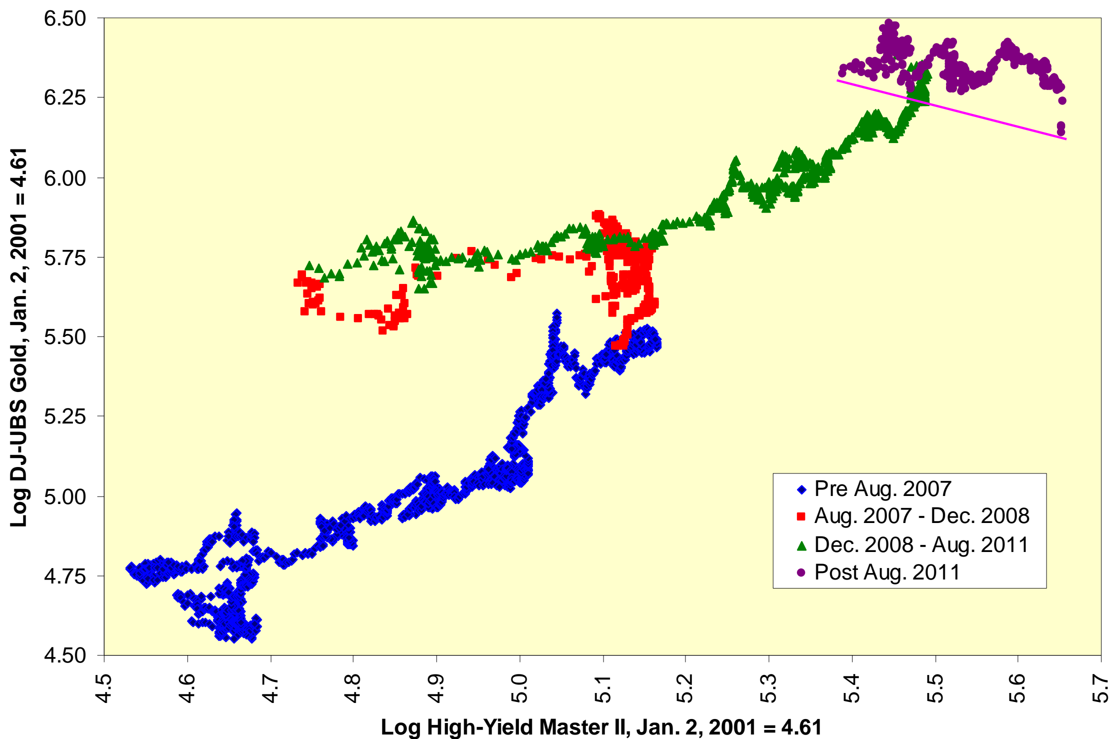
1. January 2001 to the August 17, 2007 intermeeting rate cut, the first such move in the financial crisis;
2. August 2007 to the adoption of 0% interest rates on December 16, 2008;
3. December 2008 to the August 10, 2011 Twist announcement; and
4. Post-August 2011

In the case of 7-10 year Treasuries, the relationship between the first and third periods is statistically identical; the financial crisis period understandably was different. However, all three of these periods had a positive relationship; the current one is different from the others with near-100% confidence.



The map is a little bit different for high-yield bonds as the financial crisis and recovery therefrom wreaked havoc upon these bonds' returns, but the negative relationship in the post-August 2011 Twist period remains the same.

Gold's Inverse Relationship To High-Yield In Twist Era



Negative Real Rates

Most of us believe negative real interest rates should support the price of any asset as you effectively are getting paid to hold it. That was true for short-term rates. Once long-term rates started to go negative, and the real rate on ten-year Treasuries is -0.568% as I write this, investors started to shift out the risk curve to markets such as stocks and high-yield bonds, restoring the expected hierarchy of risk and return in the process.

Those negative long-term real rates apply to all markets, gold included. However, as holding gold involves negative nominal cash flow while holding risky financial assets involves long-dated positive cash flow and in the case of stocks and several classes of bonds embedded call options on cash flow growth, financial assets became preferable. Risk-averse investors who recoiled at stocks and were not intrigued with the idea of paying $1,800 per ounce or so for a lump of shiny yellow metal were content to accept increasingly negative real interest rates.

Gold offered no upside to the risk-seeking and no shelter to the risk-averse in this post-Twist world. More than 18 months into its downtrend, the face-plant happened. We can debate the triggering events and ask why it happened on the days it did, but a better question is why it took so long to arrive given the market conditions noted.