Revisiting Gold And The Twist

Gold's continued move lower in 2013 invites an update of an April article discussing the relationship between the Dow Jones-UBS gold subindex and the total returns for both 7-10 year Treasuries and high-yield corporate bonds. The germ of this analysis was planted more than one year ago when I noticed a combination of factors surrounding the yellow metal. They were, in no particular order, it had declined regardless of inflation expectations as measured in the TIPS market, regardless of the dollar's strength or weakness, regardless of ETF holdings of gold and regardless of the stock market's trend. I give my regards to "regardless."

What did appear to be significant were what I dubbed "pseudo-real" short-term interest rates, the difference between one-year Treasuries and the trailing rate of reported inflation and the downward deviation of long-term interest rates produced by Operation Twist and its various QE supplements. Gold could rise if the short-term pseudo-rates fell, which was difficult to achieve when nominal rates were near 0% and reported inflation was declining. It also could rise if the yield curve steepened bearishly and made long-term financial assets such as stocks less attractive. As stocks have been in an uninterrupted bull market since the end of November 2011, that was a difficult hurdle for gold to overcome.

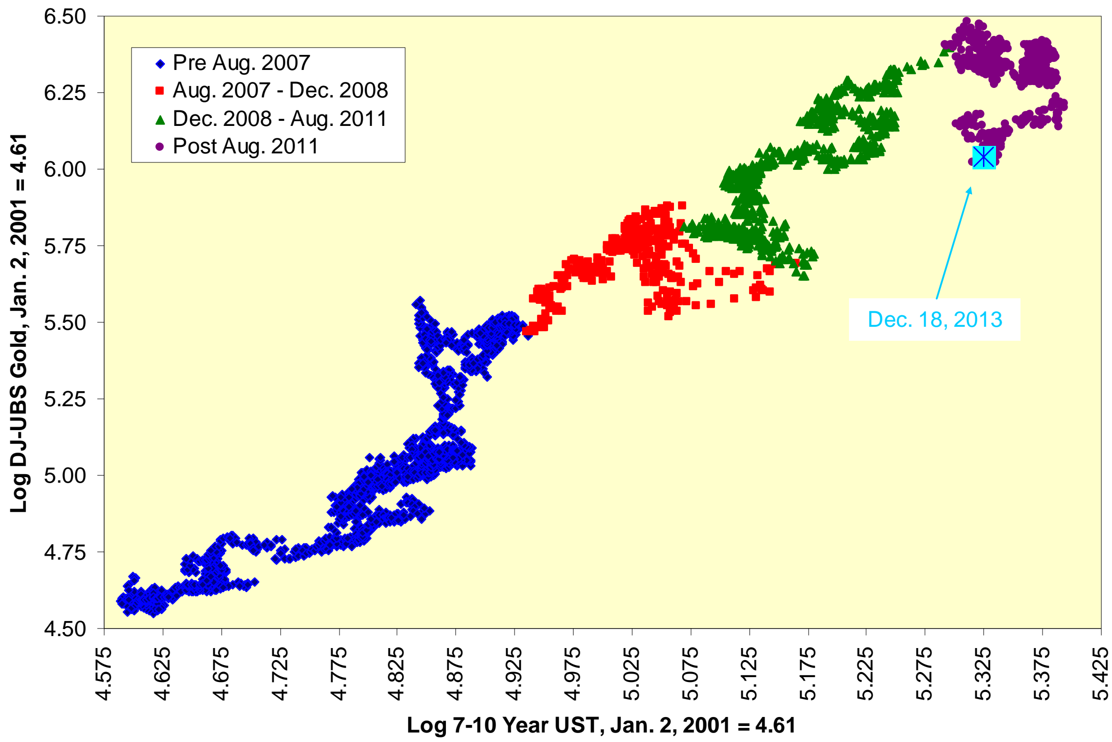
Twist And Peak
As before, let's map the total returns for the Dow Jones-UBS gold subindex against those for both 7-10 year Treasuries and high-yield corporate bonds across four different monetary regimes:

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

I noted in April:
"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."

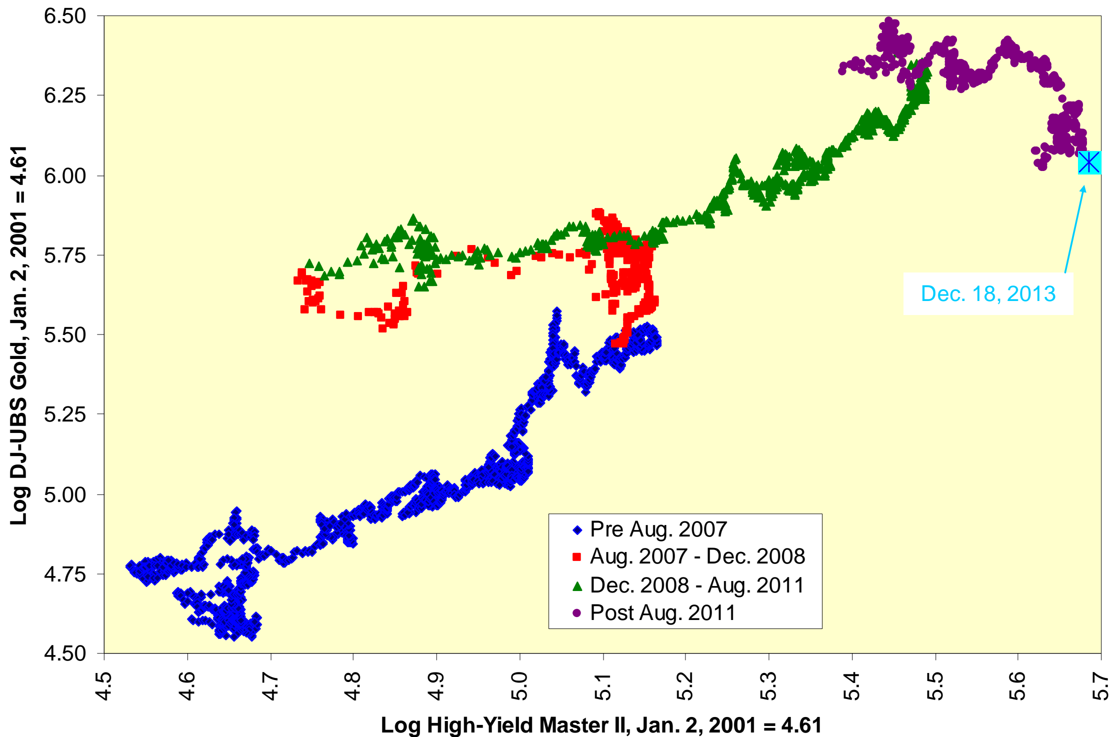
This has changed now as long-term interest rates have increased and are likely to remain under some modicum of upward pressure as the Federal Reserve will be printing only $75 billion per month as opposed to $85 billion per month. The restoration of a positive correlation is the good news for gold; the bad news is that correlation is positive by virtue of both gold and long-term bonds sporting negative returns.

Gold And 7-10 Year Treasuries



The map is different for high-yield bonds as could be expected given the risk-seeking effects of artificially low long-term interest rates. The negative relationship prevailing in the post-August 2011 Twist period remains intact.

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



Negative Real Rates
The real rate for ten-year Treasuries in April was -0.568%; it has increased to 0.755% at the time of this writing, and real Treasury rates are negative "only" out to the six-year horizon. If these real rates keep rising out of surging credit demand and a restrictive supply of funds, we would have to regard it as a negative for risky assets. If – and I say this as a statement and not as a forecast – stocks and other risky assets turned lower and demand for short-term instruments surged to the point where short-term rates became even more negative, then gold's bear market could end.

Restated, gold's best hope is for the rest of the world to roll up in a ball and die. I will leave it to others to decide whether true gold bugs would be pleased at this outcome. Otherwise, look for gold to continue moving lower.