Gold, The Twist And The Taper

I concluded at the end of 2013 gold might be able to break out of its bear market if the yield curve steepened bearishly and both stocks and high-yield bonds retreated. That scenario certainly unfolded during the now hard-to-recall January downturn and into February. However, as the yield curve started to flatten during the first Ukrainian-related situation of the year and as both stocks and high-yield-bonds resumed their advances into the end of July, gold stalled. It essentially has traded at mid-February levels since the start of April.

Let’s examine the relationship between the Bloomberg gold subindex and the total returns for both 7-10 year Treasuries and high-yield corporate bonds. The germ of this analysis began back in 2012 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. Restated, the factors often cited as causal for gold were not really causal at all; something else had to be brought into the equation.

Those factors 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. Gold could rise if short-term pseudo-rates fell or if the yield curve steepened bearishly and made long-term financial assets such as stocks and high-yield bonds less attractive.

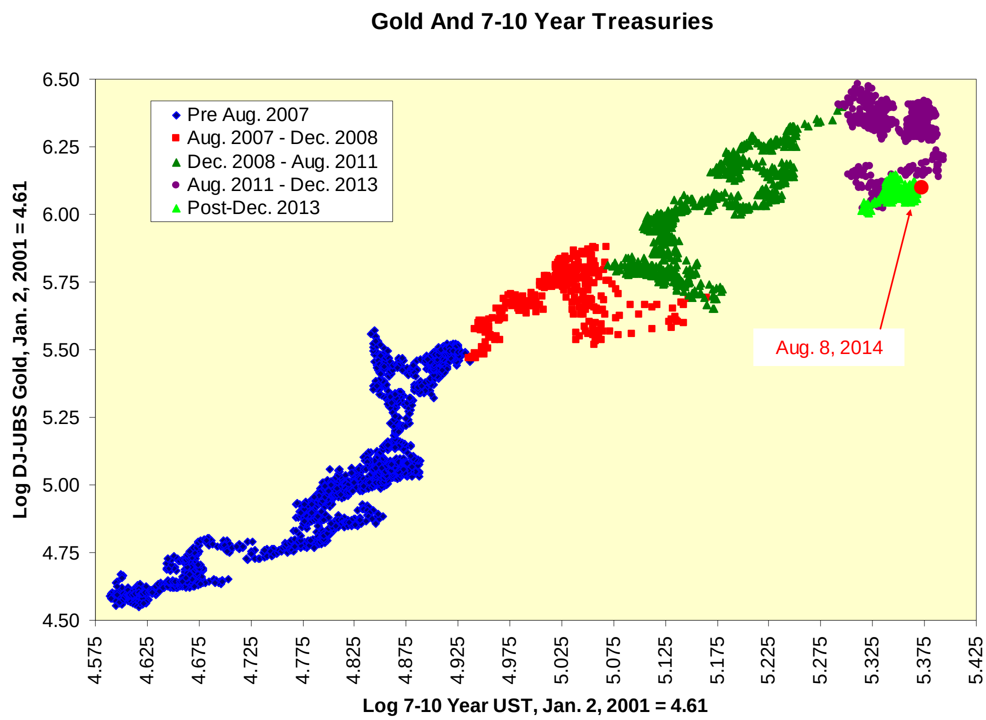
Twist And Peak

Let’s map the total returns for the Bloomberg gold subindex against those for both 7-10 year Treasuries and high-yield corporate bonds across five different monetary regimes:

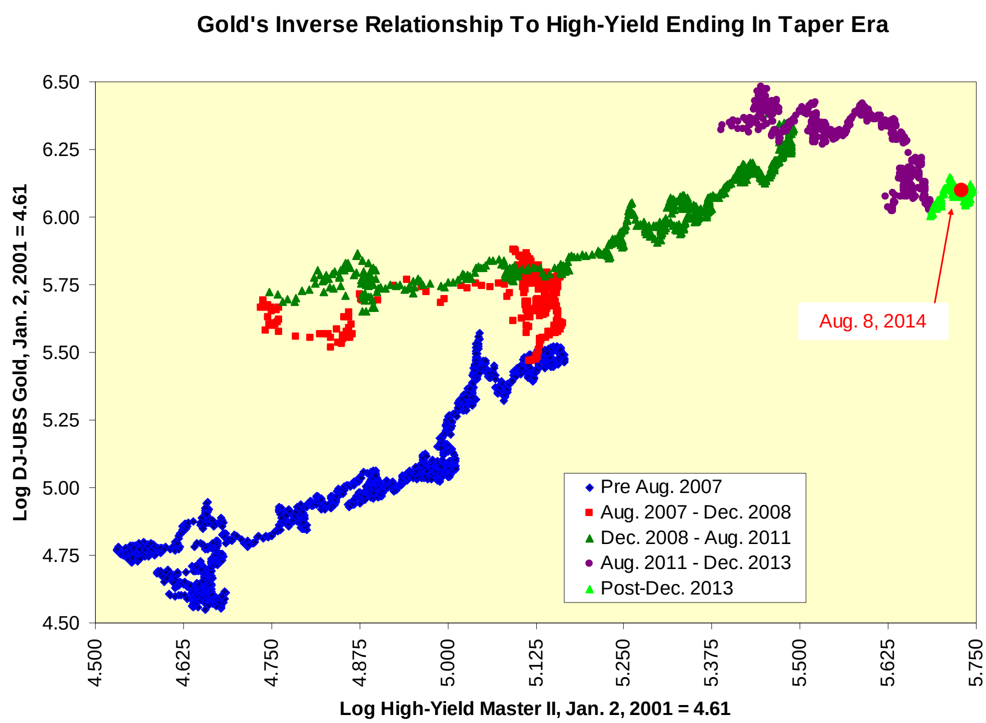
1. January 2001 to the August 17, 2007 intermeeting rate cut, the first such move in the financial crisis;
2. August 2007 to the adoption of 0% interest rates on December 16, 2008;
3. December 2008 to the August 10, 2011 Twist announcement;
4. The August 2011 Twist through the beginning of QE tapering in December 2013; and
5. The post-December 2013 tapering era

The relationship between gold’s returns and those for 7-10 year Treasuries has remained within a near-constant channel from January 2001 onwards with only short-term deviations unrelated to the prevailing monetary scheme. The relationship has become increasingly positive during the tapering era as pseudo-real short-term interest rates have remained strongly negative in support of gold and as global haven bids such as those seen last week with the second Ukrainian crisis and the ongoing problems in Iraq, Gaza and elsewhere have supported long-term Treasuries.

As an aside for readers old enough to remember, I do wonder how these dual and coinciding bull markets would have been regarded in the 1970s and 1980s when gold was regarded as an inflation hedge and tended to rise when long-term Treasuries fell.



The relationship between gold and high-yield bonds has changed during the tapering era. The strongly negative relationship prevailing during the post-August 2011 Twist period has reversed to a positive one. Statistically, a strongly negative beta of -1.059 turned into a positive beta of 0.861. The credit-spread compression that aided high-yield bonds since December 2013 has not diverted interest away from gold as it had during the Twist era.



Where are we today? My conclusion is the same as it was in December 2013 after the Bloomberg gold subindex lost 28.65% on the year: As long as pseudo-real short-term interest rates remain negative, both gold and risky financial assets can advance simultaneously. That combination still seems like the path of least resistance even though enthusiasm for both stocks and high-yield bonds has diminished with increasing geopolitical risk and assorted feints about tapering turning into higher short-term interest rates sometime in 2015.