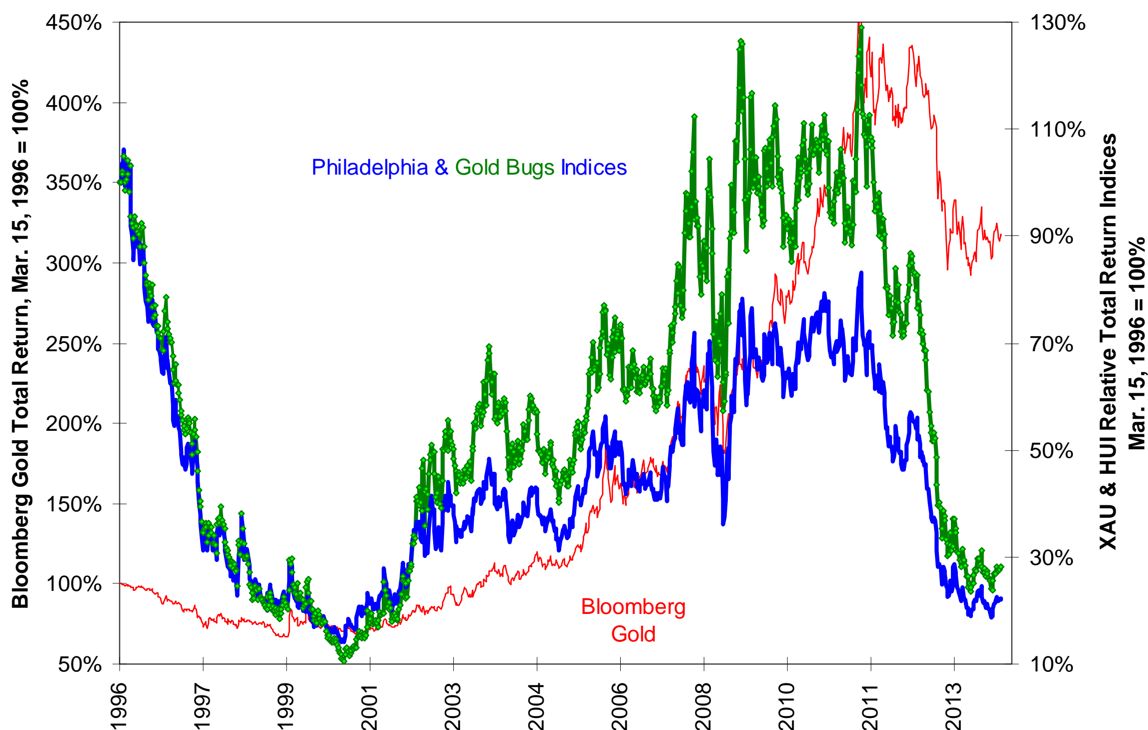
Gold Miners Retain Embedded Call Option On Gold

I discussed the effect of Operation Twist, now three years in the rearview mirror, on gold prices last week. To recap, gold's return have been correlated positively with 7-10 year Treasuries since January 2001, and gold's correlation with high-yield bonds' returns switched from negative to positive once QE tapering began in December 2013. The two driving variables for gold prices have been real short-term interest rates and the shape of the yield curve with negative real short-term rates being the primary bullish driver.

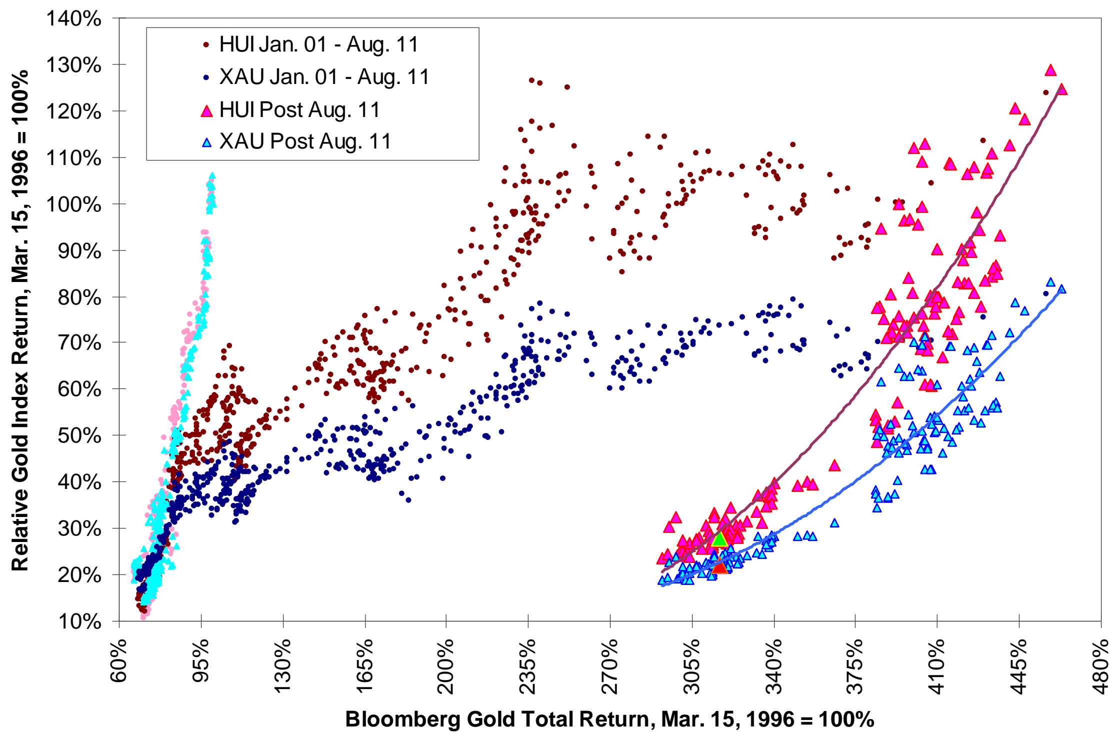
Data Mining Miners' Relative Performance

If we shift our focus from bullion to gold miners, what do we see? First, let's map the total return paths of the NYSE-Arca Gold Bugs and Philadelphia Gold & Silver indices relative to the S&P 500 and the equal-weighted S&P 500 indices, respectively, against the Bloomberg total return index for gold. The members of the Gold Bugs index do not hedge their production forward past five years while those in the Philadelphia index are free to do so.

The dominant feature in this chart is the dreadful collapse of the gold miners' relative performance between the start of the Twist and June 2014. Relative performance then started to stabilize about six months after the total return on gold futures. As an aside, gold miners used to be considered a leading indicator of gold bullion prices, but this latest episode has them lagging gold instead.



Gold miners' relative performance in the post-Twist era continues to describe an embedded call option on gold. If we map the relative performance of the two mining indices against the Bloomberg index, we see a quadratic trend curve. I marked the most recent data points used. Gold miners' relative performance should be a leveraged function of gold prices and not simply a linear one. This makes sense given the consolidation in the industry and the compression of operating margins following the two year-plus downturn in gold prices. Every tick higher in gold prices should flow through to the proverbial bottom line before mining costs start to rise in response.



The interesting point about this embedded call option relationship is how it implies fairly limited downside risk; a further downturn in gold prices should produce only limited damage to the miners who have survived the bear market already.

Before you run out and fill your pockets or mining pans or whatever else you fill on such occasions, please remember gold still depends on increasingly negative real short-term rates to go higher. There is a limit to how negative they can get before lenders simply stop paying borrowers for the privilege.