Gold And Negative Interest Rates

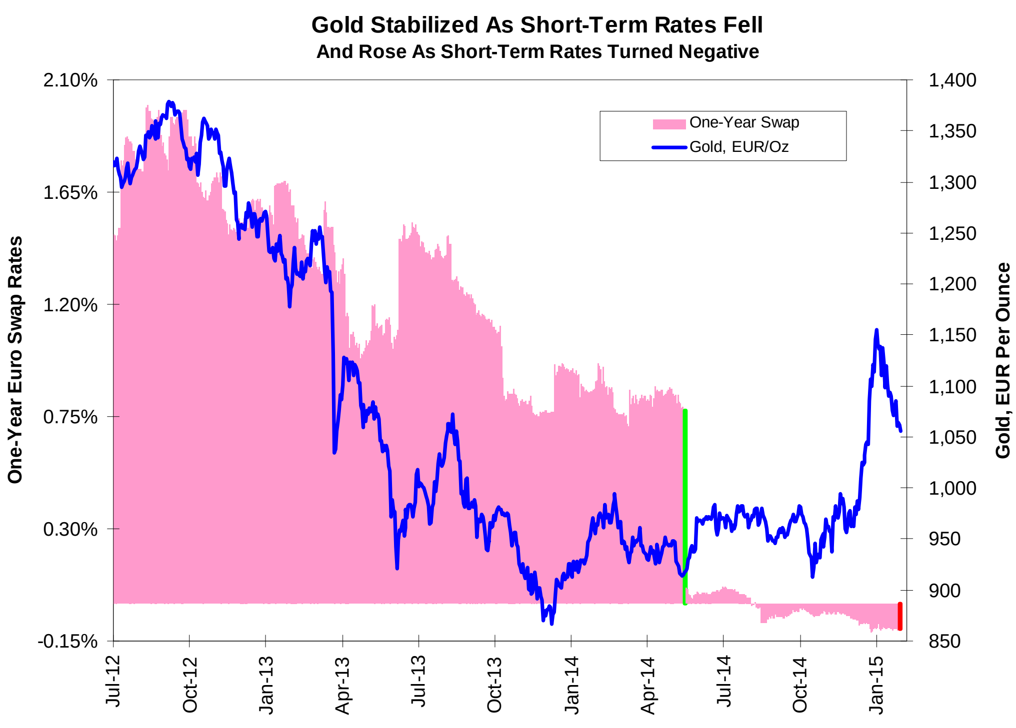
With apologies to *The Young Rascals*…

I was trading / Oh so bad / I asked my central banker just what I had
I said, "Mario Draghi / Mr. M.D! / Can you tell me / What's ailing me?"
He said, "Yeah, yeah, yeah, yeah, yeah / All you really need /
Is good money / Gimme that good, good money / Yes, indeed!"

You are supposed to learn from your mistakes. Why gold's many advocates have failed to learn the massive expansion of central bank balance sheets since the financial crisis and the drive to and through the zero bound in short-term interest rates have failed to drive the yellow metal higher in dollar terms since September 2011 will have to remain one of life's mysteries. Just as we are supposed to be able to disagree without being disagreeable, you are supposed to advocate hard money without having a hard head.

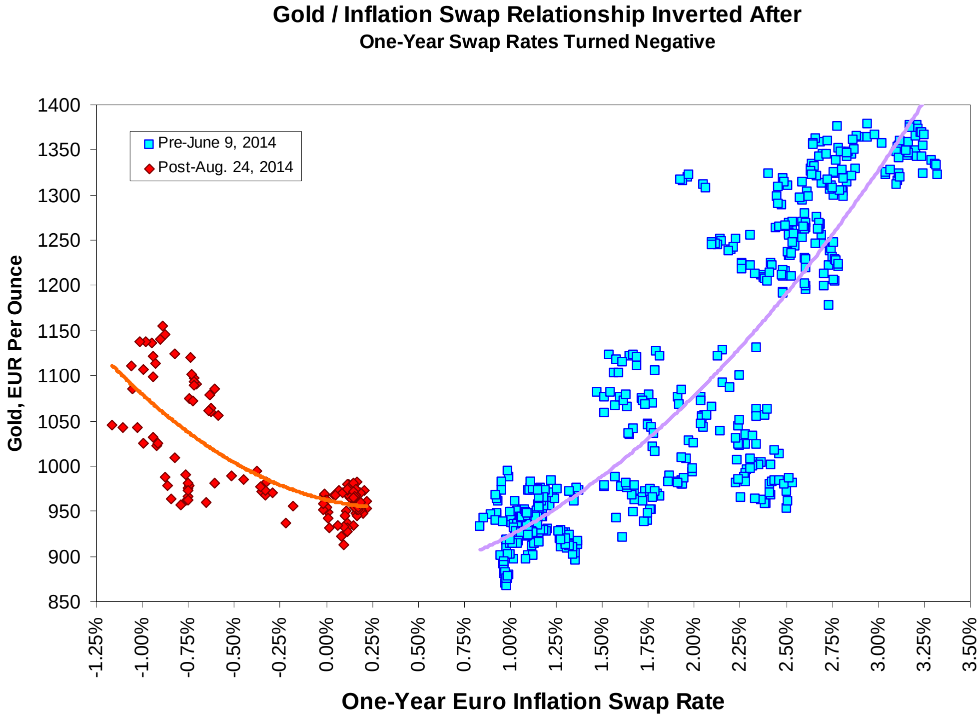
Negative Carrying Costs
Gold long has been regarded as a hedge against inflation; I have used net inflation expectations, or the excess of inflation breakevens over short-term interest rates as an explanatory variable for gold prices. However, the Eurozone's experience with negative short-term interest rates has indicated gold in EUR terms can rise in the face of declines in both reported and expected inflation. This has held true for periods when short-term Eurozone inflation swap rates were negative as well.

If we map one-year EUR swap rates from the July 2012 "whatever it takes" pronouncement by Mario Draghi onwards against gold, we see gold stabilized in June 2014 when one-year swap rates fell sharply, highlighted with a green column. Once these swap rates turned negative on August 25, 2014 in premature anticipation of direct quantitative easing by the European Central Bank, gold started to turn higher. Once one-year inflation swap rates bottomed at -1.063% on January 29, 2015, gold began a pullback from €1,110.75 to €1,056.29 on February 20, 2015.



If we map gold against one-year swap rates pre-June 9th and post-August 25, 2014, omitting the intervening segment for visual clarity, we see an inverted relationship between gold and both one-year swap and one-year inflation swap rates after short-term rates turned negative.

This is a very direct illustration of how negative interest rates affect asset pricing: The implied negative cost of carry for gold meant a forward purchase could gain at the negative interest rate less the physical costs of storage even as the metal provided no income stream and was being held in a negative expected inflation environment.



If we substitute one-year interest rate swap rates for one-year inflation swap rates, we see how negative interest rates have a mildly inverse effect on gold prices. We would have to push both one-year interest rate and inflation swap rates higher in the Eurozone to create a positive monetary impulse for gold priced in euro terms. As the European Central Bank is committed to keeping short-term rates as low as humanly possible, this is unlikely to happen until quantitative easing in the Eurozone ends in December 2016.