Fun Fact About Gold And Stocks

A long-ago colleague once turned to me and said about gold futures, "You can have one client long and another one short, and they're both unhappy." I might add in fairness this was said during the late 1980s, a period when gold prices were languishing in the high $300 per ounce range and still had well more than a decade to go before they broke out to the upside. There must be some belabor-the-obvious point from behavioral finance about the psychological frustrations of long-term trading ranges, but I will leave the explanations to someone else.

War On Deflation

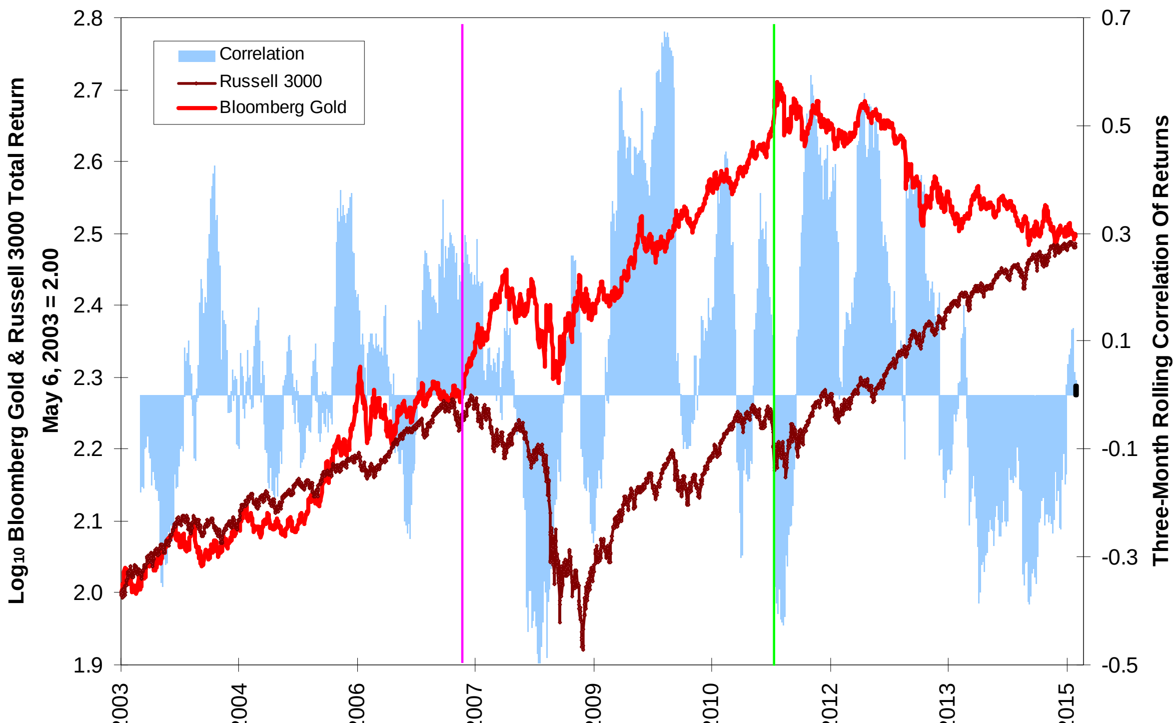
The Federal Reserve may or may not end its zero interest rate policy soon, but it and its sister central banks appear to be making hay with their war against the straw dog of deflation. Whether you should greet this deliberate assault on the purchasing power of your money with relief is entirely up to you.

Regardless, the FOMC declared war on deflation on May 6, 2003, the date when it moved to an unprecedented 1% target rate for federal funds. For those of you keeping score at home, this war was launched while we were fighting the global war on terrorism, wars in Iraq and Afghanistan, a long-term war on drugs and an even longer-term war on poverty. A cynic might note the ratio of fighting to winning was very high.

How would you as an investor have fared if you chose a continuous position in gold as measured by the Bloomberg (formerly Dow Jones-UBS, formerly Dow Jones-AIG) gold total return index versus a long position in U.S. equities as measured by the Russell 3000 index when this war on deflation began?

Let's map the two return series on a common logarithmic scale reindexed to May 2003 along with the rolling three-month correlation of returns between them. I superimposed two vertical lines on the chart, the August 17, 2007 date of the first intermeeting rate cut of what would become known as the financial crisis and the August 9, 2011 date when Operation Twist was launched.

Correlation Between Gold And U.S. Equities



Almost Full Circle

Please note how gold's returns outpaced stocks' returns after the Federal Reserve's drive toward zero began in August 2007; a more proper description would be gold's returns stayed on their previous path while stocks' returns headed south in a hurry. Once Operation Twist lowered long-term interest rates and increased the relative attractiveness of risky financial assets, the opposite phenomenon occurred. Stocks kept marching higher and gold turned lower despite global monetary ease.

Where does this leave us now? As you can see, the total return paths of gold and equities converged in March 2015. Gold's returns remain slightly higher than those of equities; the average annual rates of returns since May 2003 have been 9.484% for gold and 9.147% for the Russell 3000.

Restated, the two markets with their different risk and return profiles and their different camps of investors have provided near-equal returns. The only real difference has been their distributions of happiness and unhappiness over time.