# I Am Sticking With Gold: A Critique Of 'The Golden Dilemma'

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## | includes: GLD, SPY, UUP

**Disclosure:** I am long GLD. **(More...)**

> …the main determinant of asset prices in recent years has been the level of long term real interest rates, which remain remarkably low, and are expected to remain remarkably low for some considerable period.
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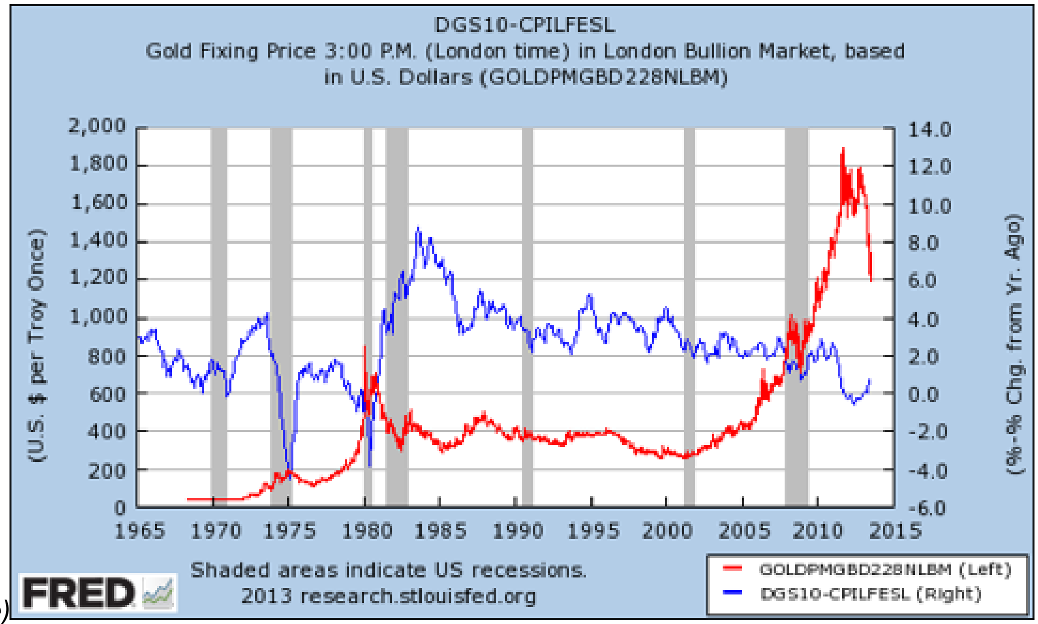
> When you've got such low long term real interest rates, asset prices, all asset prices, will inevitably be high. And on that basis, as the Committee explained, very clearly before the crisis, it's not surprising that if people feel that asset prices, particularly house prices, are likely to remain at this high level - it's not a question of expecting them to rise further, I think that's gone, clearly; but they're not expected to fall sharply…
>
> The reason for concern in the future is not the current configuration of interest rates and asset prices; it's that we know that at some point real interest rates have to get back to a healthier and more normal level. Positive real interest rates are crucial for the successful operation of a market economy. The real challenge is to navigate our way back to that level.
>
> Once real interest rates are back to that level then you would expect to see some consequences for asset prices, possibly falls in asset prices. And at that point it will be important that people have had time to deleverage and to get to a point where their degree of indebtedness is not such that they find themselves in deep financial trouble when asset prices fall. - Former Bank of England Governor Mervyn King during the Q&A section of his final Inflation Report, May 15, 2013.

When King uttered these words in his final Inflation Report as Governor of the Bank of England (BOE), there was no sudden surge in interest rates or sell-offs in financial markets as we saw when one week later Federal Reserve Chairman Ben Bernanke seemed to suggest that the Fed was getting ready to start the process of normalization. Yet, no one in the press conference questioned King's premise.

Assuming gold is an asset, its price seemingly violates this simple relationship. In the graph below, I juxtaposed data available from the St. Louis Federal Reserve: the price of gold, the consumer price index (excluding food and energy), and the 10-Year Treasury Constant Maturity Rate as a proxy for long-term interest rates. I constructed an approximation of real interest rates by simply subtracting the year-over-year change in the CPI from the 10-Year Treasury rate. The graph shows gold in red and the real interest rate in blue.




*(click to enlarge)*

**Gold's price has had an inconsistent relationship with real interest rates**

**Source: St. Louis Federal Reserve**

While it is possible to explain the rapid rise in gold since 2005/2006 as an anticipation of negative real rates, it only took a small reversal in real rates to generate a rapid collapse in gold's price. Inconsistent relationships like these form the crux of a larger conceptual dilemma that authors Claude B. Erb and Campbell R. Harvey (Duke University, National Bureau of Economic Research) attempt to tackle in a May 2013 paper called "The Golden Dilemma." This paper is a comprehensive examination of the various reasons offered to buy gold. The authors systematically undermine almost every reason. I found the paper interesting and compelling enough to offer up my own summary and critique of it. In particular, I take issue with the failure of the authors to address the biggest elephant in the room: unprecedented easing and accommodation in global monetary policies. To me, these actions truly define a "new era" in financial markets that justifies investments in gold. The Golden Dilemma is a very long paper, but I encourage my fellow gold bugs to give it a glance and a chance.