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To Understand Gold You Have To Understand Interest Rates

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Last year I wrote a couple of articles highlighting how gold was behaving like a leveraged long bond. (Gold is behaving like a leveraged bond and Gold Continues To Behave Like A Leveraged Long Bond, Not An Inflation Hedge)

This theory is significant because it defies many of the conventional wisdoms that people use to support buying gold. If gold as an inflation hedge, just the opposite would be occurring. As inflation picks up, interest rates should go higher, bond prices should fall and gold prices should go higher. When gold is an inflation hedge, it should be inversely correlated with bonds/directly correlated with interest rates.

That however is not how gold has been behaving. Gold has been demonstrating direct correlation with bonds and inverse correlation with interest rates - the exact opposite of what would happen if gold was acting as an inflation hedge.,

That observation has not gone unnoticed, as Claude Erb, a former commodities portfolio manager for Trust Company of the West and co-author Campbell Harvey, a Duke University finance professor, highlight in a recent National Bureau of Economic Research Report entitled "The Golden Dilemma."

In the report they highlight that gold and the 10-year treasury yield have an R-Squared of 0.78.

> *In the case of the gold-interest rate correlation over the last decade, Erb told me in an interview, the r-squared is a very high 0.78. (Click here for a summary of his findings.)*
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> *Most correlations on Wall Street don't come anywhere close to being that high. Indeed, many of the drugs that get FDA approval have lower r-squareds between their use and positive medical outcomes.*

As pointed out, that is a very high R-Squared for these kinds of relationships. The author then used this simple single variable model to forecast the price of gold given various interest rates. He claims that a 3% yield on the 10-year Treasury would translate into a gold price of $1,196.70/oz, a 4% yield would result in a price of $841/oz for gold, a 5% yield would take gold down to $471/oz and that it would take a 1% yield to get gold back up to $1,900/oz.

> *If the 10-year Treasury yield rises to 5%, gold will fall to $471 an ounce... And if that yield rises to just 4%, from its current 2.8%, gold will still plunge - to $831... for gold to make it back to its all-time high above $1,900 an ounce is for the 10-Year Treasury yield to fall to 1%... At the beginning of 2013, of course, that yield stood at 1.76%, and gold bullion stood at nearly $1,700. He told me that the model at that time would have predicted bullion's price would be $1,196.70 when the 10-year yield hit the 3% point.*
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> *That point was reached on Dec. 26 of last year, and the London Gold Fixing price on that day stood at $1,196.50.*
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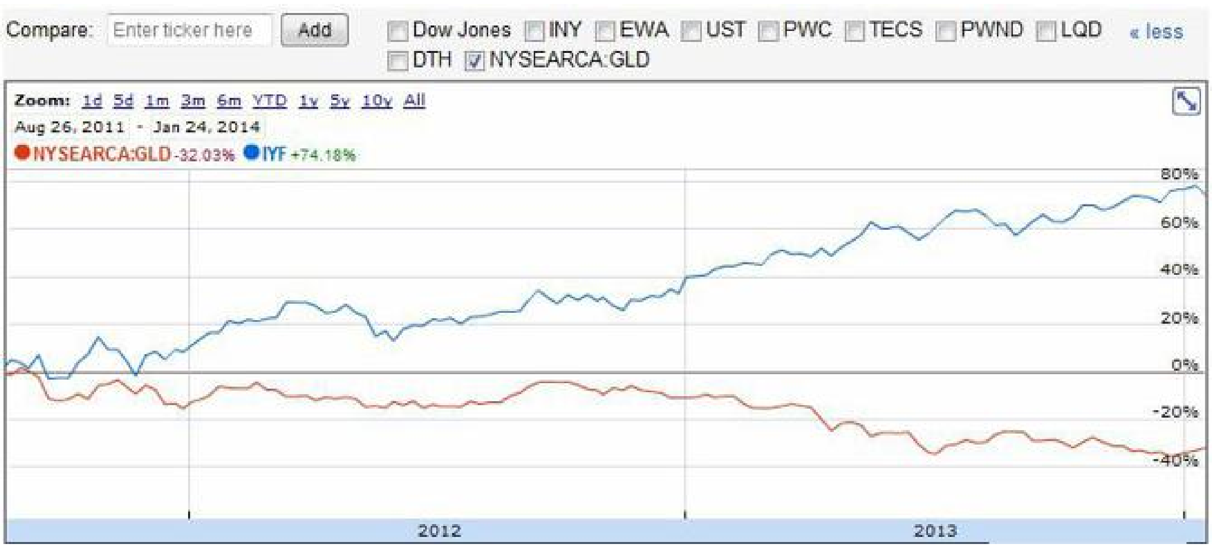
> *That counts as hitting the bulls eye.*

Why this is so important is because gold is acting in a counterintuitive manner. The classic relationship of gold to inflation has been flipped on its head. Unlike past times when gold performed well when inflation developed, it is likely that gold will do just the opposite this time, at least in the early to mid stages of this recovery. The reason gold has such a lofty value isn't because of inflation from printing all this "money out of thin air," it is because of fear of a financial collapse. Gold has a fear premium built into it, not an inflation premium.

Higher interest rates will signal economic recovery, a return to normalcy, a lowering of the risk of a financial collapse, higher inflation and lower gold prices. The key is that the fear premium has to be removed before an inflation premium gets built in. The cycle in gold therefore is likely lower gold prices in the near to intermediate future, then a period of consolidation as the economy picks up steam, but not so much as to threaten undesirable levels of inflation, and then a tightening labor market, the emergence of demand driven inflation and then higher gold prices as the inflation premium starts to build. That however may be a long way off given the tremendous excess capacity that exists in the labor market.

Believe it or not, when an economy is teetering on deflation, inflation is greatly desired by the markets. A return to mild, stable inflation will be welcomed by the markets with a sigh of relief, and gold should sell off with the lowering of fear and anxiety. Only when inflation gets to the point where it appears to be getting out of control will gold start to rally, but that is likely a long way off in the future. Sustainable high inflation almost always occurs with a very tight labor market, and we are a long way away from that happening.

Another way to demonstrate this theory is by plotting the financial sector against gold. As the fear of a financial collapse waned, financials headed higher and gold headed lower. The more confidence there is in the financial sector recovery, the higher the financial sector has gone and the lower gold has gone. Gold looks almost like the mirror image of the financial sector since mid-2011 when gold peaked.



(click to enlarge)

In conclusion, if gold investors want to understand where gold is headed, they should study where interest rates are headed. Gold currently has an inverse correlation with interest rates meaning that it isn't acting as an inflation hedge. As the economy picks up and inflation and interest rates head higher, gold should head lower. News of higher inflation won't be welcomed news for gold. Because we are at the very very very early stages of a recovery, and unemployment remaining stubbornly high, I wouldn't count on gold having a sustained rally for quite some time. That is unless the economic recovery stalls, and fear of deflation and a financial collapse returns to the markets.

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