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The relationship between gold and interest rates

This week's downside breakout in the T-Bond futures market and the associated rise in the T-Bond yield has prompted us to re-visit the relationship between gold and interest rates. In the process of doing so we'll address the question: are rising interest rates bullish or bearish for gold?

We'll begin by noting what happened to nominal interest rates during the long-term gold bull markets of the past 100 years. Interest rates generally trended downward during the gold bull market of the 1930s, upward during the gold bull market of the 1960s and 1970s, and downward during the first 10 years of the current bull market. Therefore, history's message is that the trend in the nominal interest rate does NOT determine gold's long-term price trend.

History tells us that gold bull markets can unfold in parallel with rising or falling nominal interest rates, but this shouldn't be interpreted as meaning that interest rates don't affect whether gold is in a bullish or bearish trend. The long-term trend in the nominal interest rate is not critical; but what is of great importance, as far as the gold market is concerned, is the REAL interest rate. Specifically, low/falling real interest rates are bullish for gold and high/rising real interest rates are bearish. For example, when gold was making huge gains during the 1970s in parallel with high/rising nominal interest rates, real interest rates were generally low. This is because gains in inflation expectations were matching, or exceeding, gains in nominal interest rates (the real interest rate is the nominal interest rate minus the EXPECTED rate of currency depreciation). Also, the first decade in gold's current bull market occurred in parallel with generally low real interest rates.

Very low real interest rates are artifacts of central banks. In the US, for example, the Fed's actions ensured that the real short-term interest rate on "risk free" (meaning: no direct default risk) debt spent a lot of time in negative territory over the past ten years. It was a similar story in the US during the 1970s. Also, despite a few "baby steps" towards tighter monetary policy, real interest rates in China are presently well below zero thanks to the People's Bank of China having simultaneously pegged nominal interest rates at low levels and rapidly increased the money supply. In other words, "very low real interest rates" means "excessively loose monetary policy". Excessively loose monetary policy will likely be with us for a quite a while.

Something else that affects gold's price trend is the DIFFERENCE between long-term and short-term interest rates (the yield-spread, or yield curve), with a rising yield-spread ('steepening' yield curve) being bullish for gold and a falling yield-spread (flattening yield curve) being bearish. It works this way because a rising trend in long-term interest rates relative to short-term interest rates generally indicates either falling market liquidity (associated with increasing risk aversion and a flight to safety) or rising inflation expectations, both of which are bullish for gold.

As is the case with the real interest rate, under the current monetary system the yield-spread tends to be a symptom of what central banks are doing. If money were sound and

free of central bank manipulation then the yield-spread would spend most of its time near zero (the yield curve would be almost horizontal) and would experience only minor fluctuations, but thanks to the attempts by central banks to 'stabilise' the markets the yield-spread experiences huge swings. Today's large US yield-spread, for example, is due to the Fed exerting irresistible downward pressure at the short end of the curve while the discounting by the market of currency depreciation risk causes interest rates at the long end to be 'sticky'.

Last but not least, gold is influenced by the economy-wide trend in credit spreads (the differences between interest rates on high-quality and low-quality debt securities). Gold, a traditional haven in times of trouble, tends to do relatively well when credit spreads are widening and relatively poorly when credit spreads are contracting.

In summary, gold benefits from low real interest rates, an increasing yield-spread (a steepening yield curve), and widening credit spreads, each of which can occur when nominal interest rates are rising or falling.

If the three main interest-rate drivers (the real interest rate, the yield-spread and credit spreads) are gold-bullish then there's a high probability that gold will be in a strong upward trend in terms of all currencies and most commodities. By the same token, if the three main interest-rate drivers are gold-bearish then there's a high probability that gold will be in a strong downward trend in both nominal and real terms. However, it's not uncommon for the interest-rate conditions to be mixed. The past three years is a good example of a mixed interest-rate backdrop for gold in that during this period the real interest rate and the yield-spread were generally gold-bullish, whereas the credit-spread situation was generally gold-bearish. The result was that gold fared well in terms of US dollars, but traded sideways relative to industrial metals.

The interest rate backdrop hasn't become any less bullish for gold as a result of this week's downside breakout in the T-Bond and the associated rise in long-term interest rates, but the sharp decline in the gold price was almost certainly related to what was happening in the bond market. It seems that some speculators have exited long positions or initiated short positions in gold based on the belief that a substantial upward trend in the REAL interest rate has just begun. This belief is unfounded, because sustaining the illusions that the US economy is recovering and that the US government can make good on its debt requires that the real interest rate be kept in negative territory.

A higher real interest rate would actually help the US economy by precipitating a proper cleansing process involving the liquidation of all bad investments and insolvent corporations. However, anyone who has been paying attention over the past few years would realize that monetary policymakers in the US, as well as in Japan, Europe and the UK, are committed to doing whatever it takes to avoid such a process. The goal is to make the economic situation as painless as possible in the short run, regardless of the negative longer-term consequences.

This goal isn't going to change anytime soon, which means that a negative real interest rate is here to stay and that this week's drop in the gold price is just another blip in the long-term bull market.