What is Gold Telling Us?

Gold is notoriously hard to value. It's often thought of as indicator of incipient inflation, but its track record in that regard is empirically dubious.

It can be seen as a risk haven, but there are plenty of other havens that don't often move hand-in-hand with the shiny yellow metal. It pays no cash flows or dividend, so discounted valuation models are not useful.

In the post-Bretton Woods era, one of the few good indicators to explain gold movements has been the real interest rate. The logic is that as a store of value, the closest competitor to gold is the real return on safe assets. When the real interest rate falls, gold becomes relatively more attractive and should be expected to rally.

It would stand to reason, then, that the correlation between inflation-linked bonds and gold should be somewhat stable, and over the medium- to long-term it indeed is.

But today's chart presents an interesting observation. We regressed the level (in logs) of the gold price against the level of the 2-year, 5-year, and 10-year TIPS yields, as well as daily differences of those three bond yields. In this way we proxied the slope and change in the slope of the (real) US yield curve.

The fit is pretty good over the short term; as real yields fall, gold goes up. The decline in TIPS yields that began at the beginning of 2019 coincides with the rally in gold from about $1250 per oz. to $1350 through the end of May.

But the next leg up in XAU, to a level over $1400, doesn't fit the real yield data. This can
be seen in the divergence of the fitted values from the regression and the actual price series for XAU.

It can also be seen in the residuals from the regression, which drift well above zero during that period. This means since May, something other than real yields has been driving gold prices.

Certainly to some degree, gold’s haven properties have probably helped propelled prices, but we think the gap is mostly driven by recent talk about USD intervention. If the US were to undertake unilateral actions to weaken the dollar, the risk is that such an action would be the first shot in a currency war, with the potential to see the BOJ, SNB, and maybe even the ECB, to respond in a similar fashion.

When all the major currencies in the world are being sold and pushed to weaken, the winner of a currency war would be the barbarous relic.

**Gold Detached from Real UST Yields.**

![Gold price and model estimates](image)

*SOURCE: BNY Mellon Markets, Bloomberg, data through 23 July 2019. (NOTE: Estimate is derived via regressing the log-level of XAU against the yield on 2-, 5-, and 10-year TIPS and daily changes of those levels, plus a constant.)*

Please direct questions or comments to:

AerialView@BNYMellon.com

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