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Re: Bloomberg gold article

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Bloomberg's Joe Weisenthal was kind enough to quote us in his attached article about gold prices. We wanted to elaborate on the discussion we had with him, as a few key points didn't quite make the cut for the final piece.

Correlation between gold and real yields

The correlation between gold and real yields is typically strong, but can be unstable and time-varying. One of the reasons we believed in March and April that the link would be stronger than usual is because of the Fed's strategic policy review, which de-emphasized the Phillips Curve, and set up for a more credible scenario of the Fed being willing to accommodate an "overshoot" of inflation beyond its 2% target, in order to play "catch-up" with past inflation target misses, rather than attempt to preempt inflation by focusing on labor market outcomes as a leading signal for inflation.

Gold reflecting policy *success* instead of policy *failure*

Like the article mentioned, we viewed gold as more of a barometer of policy *success* than policy *failure*, because if the US rates market discounts ZIRP for the foreseeable future, then real yields will be predominately a function of inflation breakevens, which themselves will be a function of two factors: 1) inflation expectations, and 2) TIPS market liquidity. Congress's CARES Act fiscal stimulus (along with various fiscal packages around the world, most notably China's, Germany's, and Japan's) helped to reflate inflation expectations, especially on the back of China's credit expansion, which supported production and in turn, the price of commodities inputs to that production. The Fed's liquidity injections helped to re-liquify various rates and credit markets, including the TIPS market, which helped breakevens converge back higher to indicators like forward inflation swap rates. As such, as the fiscal/monetary policy mixes succeeded in replacing income and backstopping credit markets, without bond yields rising or short-circuiting that recovery, the policy *success* supported gold prices.

This narrative shift is also supported by the fact that the Russell 2000 (an index of small- and mid-sized US companies, which tend to be more "economically sensitive" than the mega-cap tech stocks that are large index weights in the S&P 500) strongly correlated with the S&P 500 vs gold ratio for the last decade, and suddenly reversed its correlation since COVID. Below is a chart from Joe Weisenthal showing that correlation dynamic, and a great summary of "what changed" by macro trader Jon Turek:

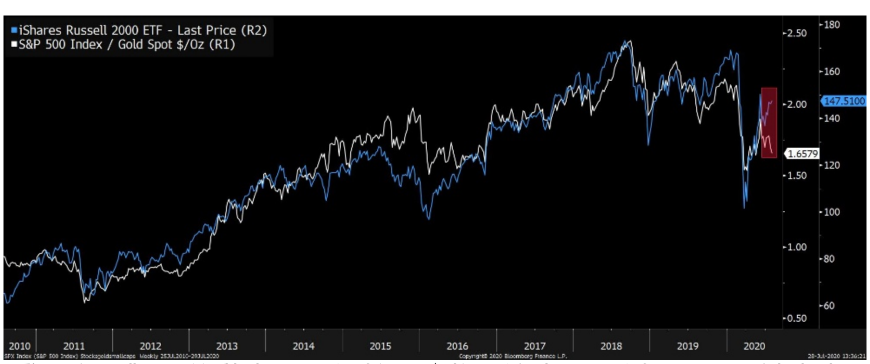

Figure 1. Russell 2000 ETF (blue line, R2 axis) vs S&P 500/gold ratio (white line, R1 axis). Source: Joe Weisenthal, Bloomberg.

Figure 2. *Jon Turek's explanation for the correlation shift above. Source: https://twitter.com/jturek18.*

Financial "alchemy" and portfolio insurance substitutes

One point we've made in prior notes that seems to be gaining traction in financial commentary circles is that gold may be increasingly interesting to portfolio managers for portfolio insurance substitutes for government bonds, as yields are near zero across the curves and across developed markets. Government bonds offer interesting portfolio insurance qualities in certain macro regimes, like the disinflationary one of the past few decades, because they will see capital appreciation during risk-off episodes in risk assets, because of increased expectations of central bank cuts and because of a rush to safe havens. However, the capital gains appreciation potential across DM government bond markets is much lower now because of the effective lower bounds in interest rates emerging, and although there's still some yield in the US long-end for example, portfolio managers are likely thinking about a world where using Treasuries to support gross risk units and leverage, is nearing its end-game.

In this environment, gold may become an interesting substitute in the eyes of portfolio constructionists, especially in strategies like risk parity, 60/40, and volatility-targeting. In our view, we have likely seen the early stages of this attempt at "financial alchemy" via flows into gold ETFs. Although we do think this dynamic materializes, we also believe that this type of "financial alchemy" is ultimately doomed to fail, because gold is unlikely to provide the right type of cross-asset correlations to risk assets, particularly in the post-COVID and -Fed strategy review macro regimes. It's possible that the desire for finding portfolio insurance substitutes leads managers into concentration in similar effectively "short volatility" positions, similar to past situations like when the shortage of safe assets stemming from Clinton fiscal surpluses led to another attempt at "financial alchemy" by utilizing "quasi-safe assets" like AAA-rated MBS for the same collateral/leverage purposes as US Treasuries, which ultimately led to the housing bubble and crash.

Our current views on precious metals

Although we have been bullish and long precious metals since late March/early April, the move in real yields and the US Dollar over the past two months has been very sharp in magnitude and direction, has increasingly become correlated to a variety of other cross-asset trends and narratives, and has reached an excessive stage of enthusiastic sentiment. As such, we have been sizing down our gold longs, as we approached our $1950/oz target (from March/April), and are stalking tactical short opportunities for a reversal. We do believe the longer-term trend is likely to remain intact, but it is no longer the risk/reward opportunity it was a few months ago, in our eyes, and we have been shifting our portfolio construction accordingly. We expect to be sizing back into the long side into a consolidation/digestion/reversal of the move in real yields, US Dollar, and precious metals from the past couple months.

Thanks as always for your support and feel free to reach out with questions!