Is The Stock Market A Driver Of Gold Prices?

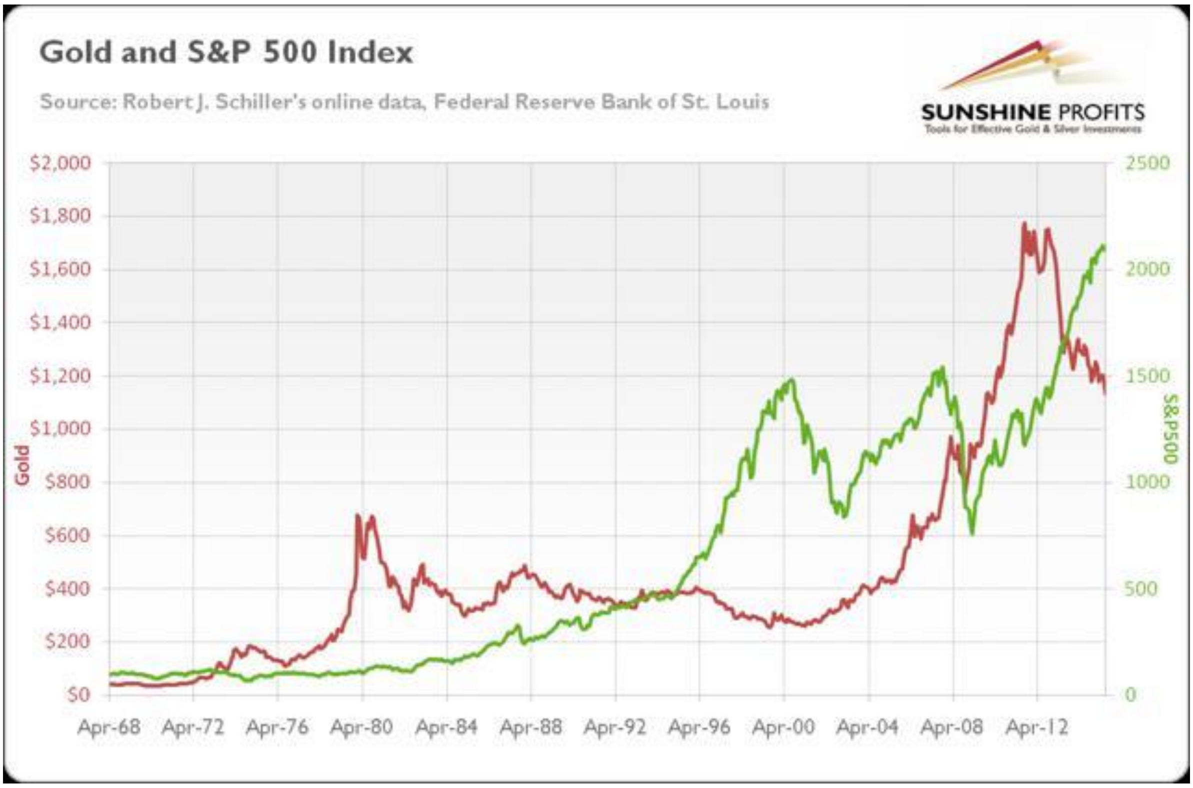
Sep. 26, 2015 by Arkadiusz Sieroń

Summary

- Why do we often see a negative correlation between the stocks and the shiny metal?
- Why were the shiny metal and equities rising generally in tandem in the 2000s?
- Is there a stable gold-stock relationship?

The relationship between stock valuations and the gold price is another widely discussed topic. The standard view is that these two markets are negatively linked: when the stocks go up, the yellow metal dives, and vice versa. There is empirical evidence that confirms this common opinion, at least partially. The chart below shows the gold price and S&P 500 Index. As you can see, from 1987 to 2000 there was negative correlation between these two markets. Then, the dot-com bubble started bursting in 2000, while the bull market in gold began not earlier than in 2001. The stocks and gold have also been moving in opposite directions since 2011; however the 2000s can be regarded generally as a period of co-movement. Therefore, this chart clearly indicates that the gold-stock relationship changed over time, depending on external conditions, especially the macroeconomic factors.

Chart 1: Gold price (red line, left scale) and S&P 500 Index (green line, right scale) from 1968 to 2015



Why do we often see a negative correlation between the stocks and the shiny metal? Well, **this is connected with risk aversion**. When traders go into defensive mode, they may prefer gold to relatively risky stocks. The saying goes that gold is a safe-haven, so it is naturally negatively correlated (or at least uncorrelated) to stocks during serious financial turmoil, like in 2008.

The second reason is that the opportunity costs and the resulting investment flows change over time. The risk appetite is the one factor affecting the relative attractiveness of stocks in comparison to gold, but not the only one. Others include the pace of economic growth, the real interest rates, the U.S. dollar exchange rate, the momentum in both markets and so on. Typically, when the economy experiences a slowdown with falling stock market returns, investors may shift their funds from stocks and invest them in the gold market until the economy rebounds.

This scenario is likely to happen when the real interest rates are low, which is often the case during periods of a weak economy (due to low demand of cautious consumers and businesses, the monetary loosening implemented by the central banks to revive the growth, or the high inflation). The best example may be the 1970s, when the economy was in stagnation, and the stock market remained flat. The expansionary monetary policy caused high inflation and weak U.S. dollar. All of these factors combined with low real interest rates (largely due to high inflation) made gold much more attractive than stocks.

Conversely, the next two decades were a period of stabilized economy and controlled inflation. The Volcker's interest rate hikes and reduced inflation led to higher real interest rates, which made gold less appealing. Additionally, the subsequent belief in economic prospects under the Clinton's New Economy (resulting partially from genuine wealth creation fuelled by technological progress, deregulation and globalization) combined with Greenspan's monetary easing fuelling the NYSE stock market bubble followed by the NASDAQ bubble.

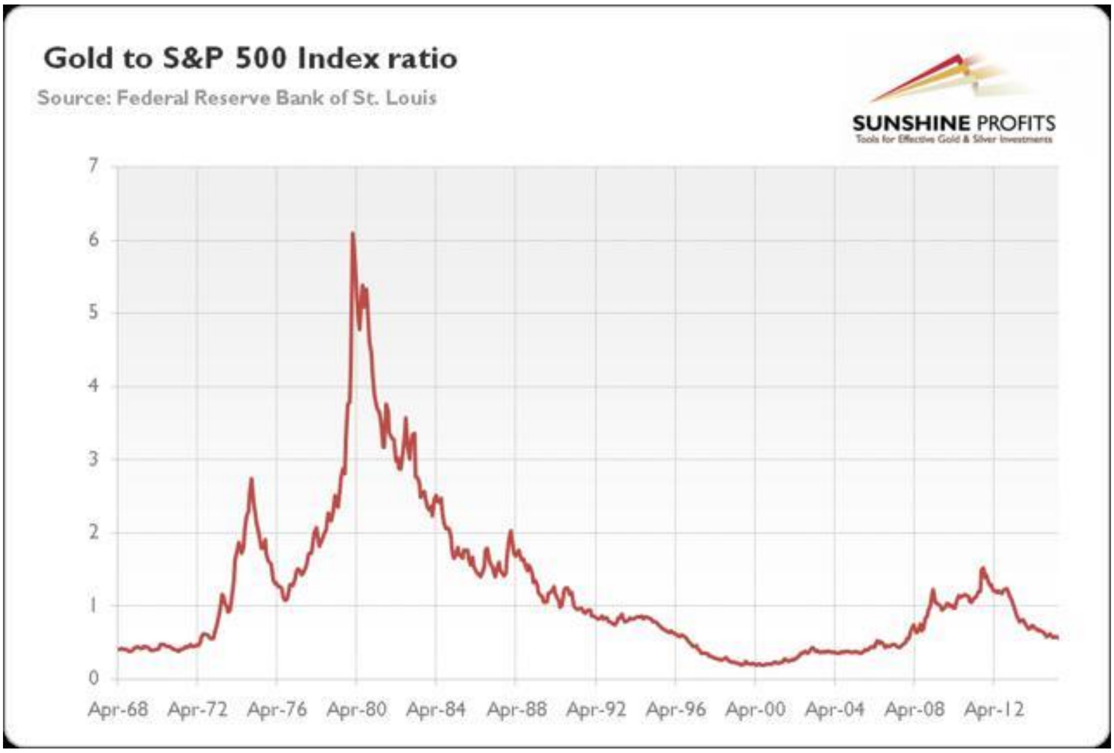
But why were the shiny metal and equities rising generally in tandem in the 2000s? Well, the financial deregulation implemented in the 1980s changed the nature of inflation. Since then, the new money enters asset markets - including the stock exchange - not the consumer good markets. Thus, the monetary pumping has been seen as causing an asset price rise, not the consumer price inflation. This is why stock prices have been generally rising since the 1970s and have been moving in tandem with gold in the 2000s. This phenomenon was at its highest level of visibility after the Lehman Brothers' bankruptcy. Since then, the stock market has been essentially on liquidity drip-feed provided generously by the Fed. The truth is that the boom in equities could not last long without the constant inflows of new money and credit.

<u>It should be clear now that, as in the case of [oil and gold](), there is no causal link between stocks and gold prices. Instead, they are determined by external macroeconomic factors. The only causal relationship between stocks and gold lies in flows of funds from equities to gold market in times of stock crashes. However, these shifts result from changes in investors' confidence in the fiat dollar-denominated financial system.</u>

<u>The ratio of gold to the S&P 500 is a good indicator of such confidence, since it isolates these two markets from the effects of monetary expansion</u>.

As the chart below shows, the ratio was rising in the 1970s, when the confidence in the U.S. dollar was low, reaching its peak in January 1980. Then, the ratio was declining due to renewed trust in the greenback until August 2000. It rose again until 2011, when the unprecedented central banks' actions after the outbreak of the Great Recession restored the faith in the global economy prospects and led to the end of the bull market in gold.

Chart 2: Gold to S&P 500 ratio (gold price divided by S&P 500 Index) from 1968 to 2015



The take-home message is that the stock market does not drive the gold market, although it may sometimes seem to do so. Although the stocks and the shiny metal frequently move in opposite directions, **there is no stable gold-stock relationship over time. The often observed negative correlation between stocks and the shiny metal results from changes in confidence in the fiat dollar-denominated system, which prompts investors to switch funds from stock market into gold and vice versa. It is just another confirmation that "correlation does not imply causation"**, as the observed divergence between performance of stocks and gold results from different responses to changes in the underlying confidence in the monetary system based on the U.S. dollar.

Total Returns by Asset Class Rankings

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	10-Years 2005-'14 Annualized	January-June 2015
REITs 30.4%	MSCI EmMkts 33.6%	REITs 34.0%	MSCI EmMkts 39.2%	Barclays Agg Bond 5.2%	MSCI EmMkts 78.0%	Gold 29.3%	Gold 9.6%	REITs 19.7%	Russell 2000 38.6%	REITs 27.2%	Gold 10.0%	MSCI EAFE 7.0%
MSCI EmMkts 25.5%	Gold 17.8%	MSCI EmMkts 32.1%	Gold 30.5%	Gold 4.9%	S&P 400 36.9%	REITs 27.6%	Barclays Agg Bond 7.8%	MSCI EmMkts 18.3%	S&P 400 33.2%	S&P 500 13.5%	S&P 400 9.6%	Russell 2000 4.8%
MSCI EAFE 20.5%	B'berg Commod 17.5%	MSCI EAFE 26.8%	MSCI EAFE 11.8%	Russell 2000 -33.6%	MSCI EAFE 31.7%	Russell 2000 26.6%	REITs 7.3%	S&P 400 17.7%	S&P 500 32.0%	S&P 400 9.7%	MSCI EmMkts 8.8%	S&P 400 4.2%
Russell 2000 18.1%	MSCI EAFE 14.0%	Gold 22.5%	B'berg Commod 11.1%	S&P 400 -35.9%	REITs 27.8%	S&P 400 26.4%	Mkt Neut HFs 4.5%	MSCI EAFE 17.7%	MSCI EAFE 23.1%	Barclays Agg Bond 6.0%	Russell 2000 7.7%	MSCI EmMkts 3.1%
S&P 400 16.3%	S&P 400 12.5%	Russell 2000 18.2%	Mkt Neut HFs 9.3%	S&P 500 -36.6%	Russell 2000 26.7%	MSCI EmMkts 18.9%	S&P 500 2.1%	Russell 2000 16.3%	Mkt Neut HFs 9.3%	Russell 2000 4.8%	S&P 500 7.6%	S&P 500 1.2%
S&P 500 10.7%	REITs 8.3%	S&P 500 15.6%	S&P 400 8.0%	B'berg Commod -36.6%	S&P 500 25.9%	B'berg Commod 16.7%	S&P 400 -1.7%	S&P 500 15.9%	REITs 2.3%	Mkt Neut HFs -1.2%	REITs 7.3%	Gold 0.5%
B'berg Commod 7.6%	Mkt Neut HFs 6.1%	Mkt Neut HFs 11.2%	Barclays Agg Bond 7.0%	REITs -37.8%	Gold 24.0%	S&P 500 14.8%	Russell 2000 -4.2%	Gold 6.6%	Barclays Agg Bond -2.0%	MSCI EmMkts -2.0%	MSCI EAFE 5.2%	Barclays Agg Bond -0.1%
Mkt Neut HFs 6.5%	S&P 500 4.8%	S&P 400 10.3%	S&P 500 5.6%	Mkt Neut HFs -40.3%	B'berg Commod 18.7%	MSCI EAFE 8.1%	MSCI EAFE -11.1%	Barclays Agg Bond 4.2%	MSCI EmMkts -2.3%	Gold -2.2%	Barclays Agg Bond 4.7%	B'berg Commod -1.6%
Gold 4.6%	Russell 2000 4.4%	Barclays Agg Bond 4.3%	Russell 2000 -1.5%	MSCI EAFE -41.8%	Barclays Agg Bond 5.9%	Barclays Agg Bond 6.5%	B'berg Commod -13.4%	Mkt Neut HFs 0.9%	B'berg Commod -9.6%	MSCI EAFE -4.0%	Mkt Neut HFs -1.0%	Mkt Neut HFs -1.9%
Barclays Agg Bond 4.3%	Barclays Agg Bond 2.4%	B'berg Commod -2.7%	REITs -17.8%	MSCI EmMkts -52.2%	Mkt Neut HFs 4.1%	Mkt Neut HFs -0.8%	MSCI EmMkts -17.8%	B'berg Commod -1.1%	Gold -28.3%	B'berg Commod -17.0%	B'berg Commod -3.3%	REITs -5.4%

Source: Oppenheimer Asset Management Research, Bloomberg's total returns calculator, Standard and Poor's, Credit Suisse, Barclays, MSCI, Bloomberg, and NAREIT. At press time, June, 2015 data for the Credit Suisse Hedge Fund Neutral Index was not yet available.
Return calculations exclude applicable costs including interest and commissions.