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Odd times: Being long gold and USD at the same time is admittedly an odd position to take. Rarely have both assets generated positive quarterly returns simultaneously. However, due to a confluence of global economic and financial factors, this strange pair trade makes some sense.

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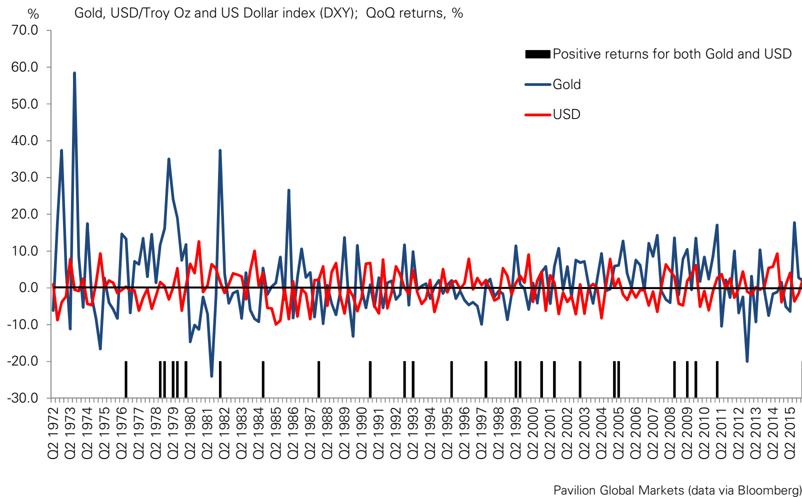
Original odd-couple: The dollar and Gold

We are aware that historically, it has been rare for both the dollar (DXY index) and Gold to generate positive returns simultaneously, but we think now is one of those times. We see a few scenarios developing in which both gold and the dollar strengthen, and can see many more in which at least one of them does well. It is difficult to see a situation in which both assets generate negative returns at the same time. To be clear, we don't think this long-paring should be the central focus of a portfolio, or that it isn't vulnerable to short-term volatility, just that down-side risks for both are limited.

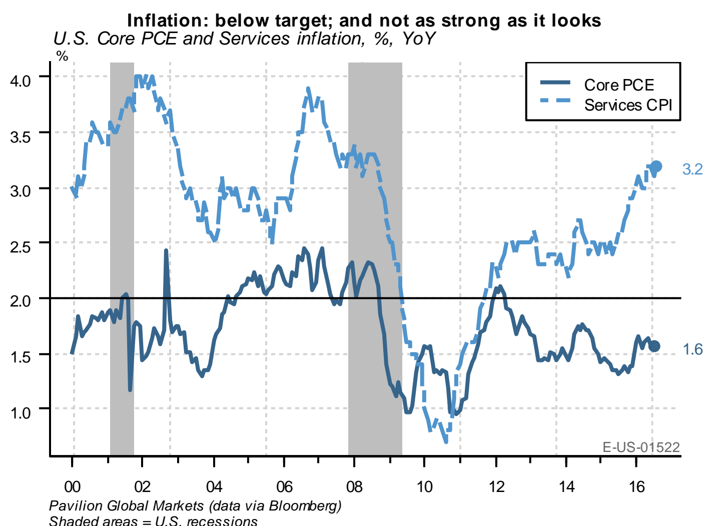
Since 1972, there have been just 26 instances (out of 176) where the DXY dollar index and gold have generated positive quarterly returns simultaneously. Each has been marked by a financial crisis, recession, stock market crash, or war. We are not brazen enough to predict any of these (although at least a few look likely). Instead, we think that global economic/financial conditions have aligned to create a very lopsided risk-reward outlook for the pair.

Odd bedfellows: Sometimes Gold and USD appreciate together

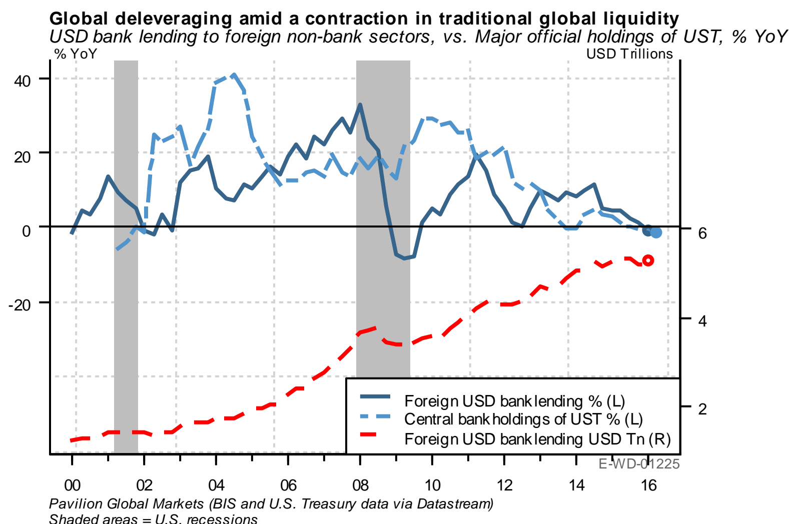


Pavilion Global Markets (data via Bloomberg)

One factor that should continue supporting USD is the dearth of entrenched inflationary pressure in the U.S. Core PCE—the Fed's preferred measure—is about 50bps below the Fed's two-percent target, and has been weakening since its peak in February. Services inflation, on the other hand, *appears* to be increasing. However, as we have mentioned (see: "*Dissecting the latest bond price moves",* Sept 13), this is being driven by health insurance, education, and housing costs—not an overheating economy.

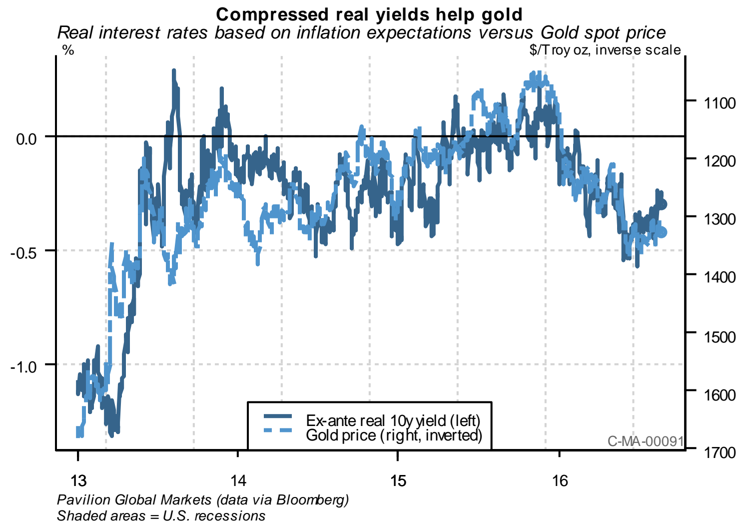


Another trend that supports the dollar is tighter global USD liquidity. Although EMs in particular, have been trying to reduce their USD-denominated debt since the taper tantrum of 2013, only recently have we seen a contraction in non-resident USD-denominated bank lending. Given the sheer size of total foreign USD-denominated bank loans outstanding—over USD 5 trillion—this structural process still has a long way to go, which implies strong demand for USD going forward. To facilitate this process, global central banks are selling their holdings of US Treasuries, and in doing so shrinking the pool of global USD-liquidity. Considering what other G10 central banks are doing, it is difficult to see USD/G10 crosses suffering, despite the dovishness of the Fed.

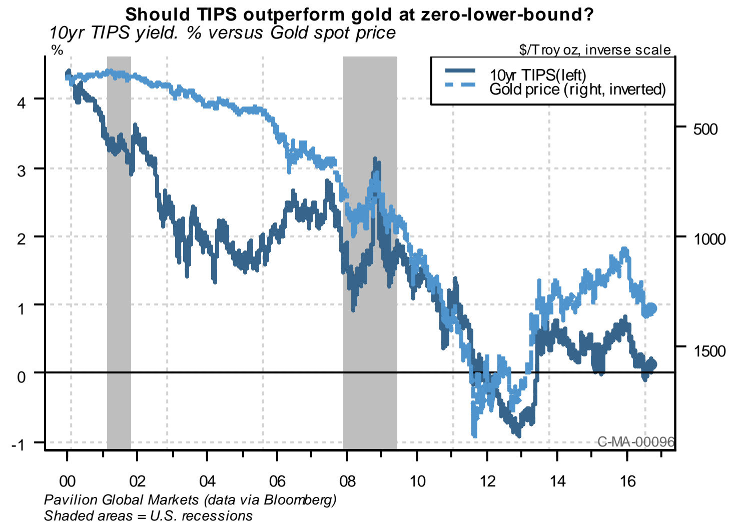


Like the dollar, gold too has supportive market dynamics. In this context we prefer the metal over the miners, as the latter are vulnerable to a wider set of factors. Negative interest rates not only bolster the case for gold as a store of value vis-à-vis bonds, they also reduce the opportunity cost of the metal. It is not surprising then, that the inverse relationship between gold and real interest rates has been very strong. Despite the latest tweaks from

the BOJ, there remains no end in sight for NIRP across much of the world, which should continue to support a bid for gold.



Negative interest rates are also closely related to another factor that supports gold prices: inflation. We are aware that historically, there is a very low correlation between gold and inflation (correlation coefficient is 0.2 on monthly returns since 2000). This has made sense; after all, why buy gold to hedge against inflation when you can buy yield generating TIPS instead? However, we question whether this logic makes sense as yields reach (and breach) the zero lower-bound. As nominal yields decline and drag TIPS yields down along with them, there is less incentive to hold the latter. In short, the impact of negative yields can be expected to dominate the impact of rising inflation on TIPS,



Bottom line: Being long gold *and* USD at the same time is admittedly an odd position to take. Rarely have both assets generated positive quarterly returns simultaneously. However, due to a confluence of global economic and financial factors, this strange pair trade makes some sense.

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