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Gold Insights: This Is The Single Most Important Chart For Gold Investors Today

Jan. 24, 2017 7:19 AM ET3 comments
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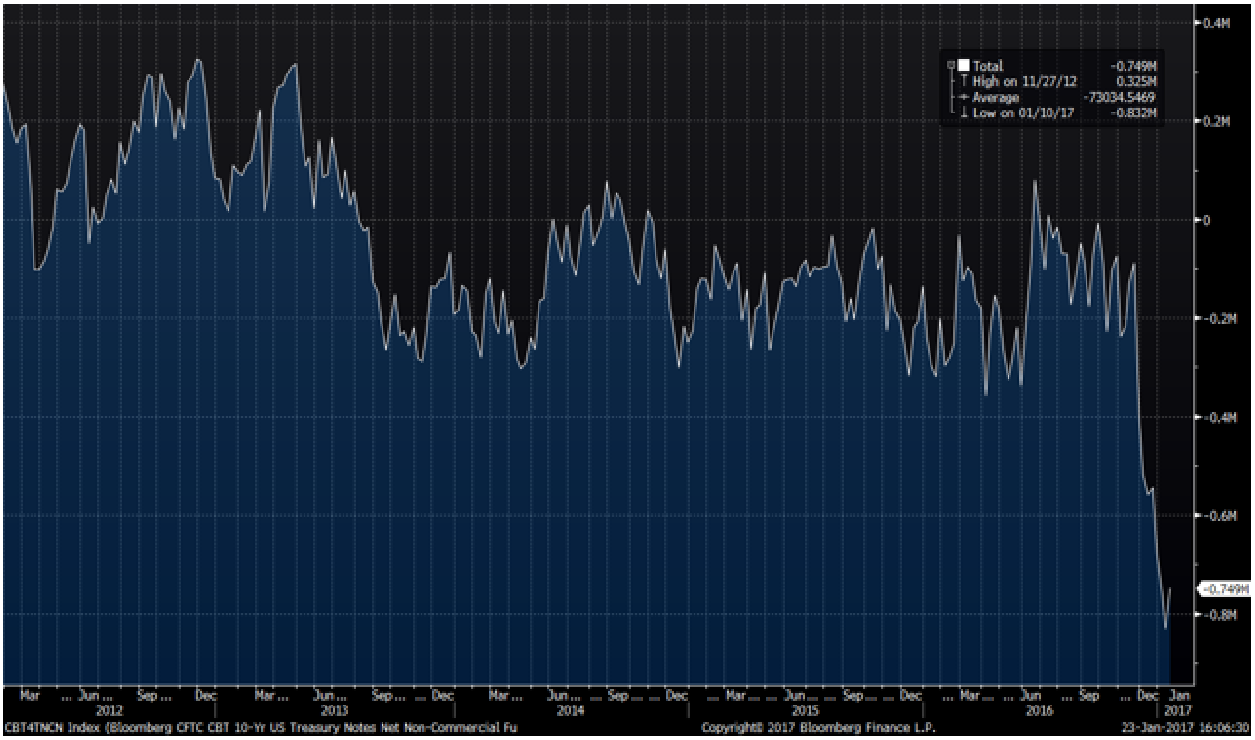
Summary

- The gold price is intricately linked to bonds and currency.
- There is currently a massive short on the 5 and 10 year US Treasuries.
- An unwind will have major consequences on gold.

Much gets said about gold (NYSEARCA:GLD) recently, but if I were to be brutally harsh, I would say that 99% of the material I have come across talks about gold in context with Trump, the U.S. dollar, the economy, the gold futures market, geopolitical uncertainty or a combination of the formerly stated points. Now this is not to say that this material isn't useful. If anything, I always glean an insight or two every time I read an article on gold.

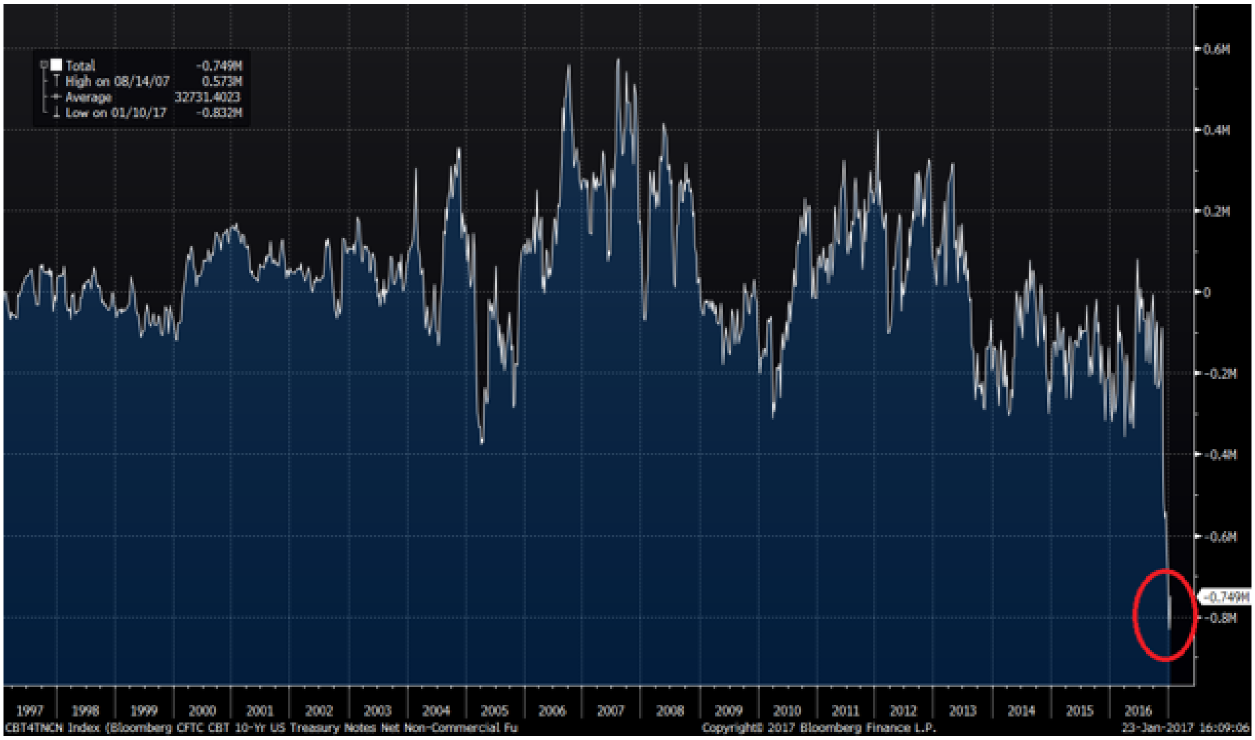
Now, I am lucky enough to have a fairly large audience who read my insights on a regular basis, who are probably used to having me harp on about the directionality of gold using gold futures positioning, rates and options. This article has something to do with rates, but it is not real rates only, which I have written about extensively here and here, but rather about longer dated Treasuries.

As without further ado, here is the chart you need to have a look at:



This chart illustrates the net positioning (longs minus shorts) of two of the most widely traded long-term Treasury futures. In this case, they are the 10 year Treasuries and the 5 year Treasuries. I have added up the net positioning in both the futures contracts to provide some scope.

This chart goes back five years and we see that the speculators, in this case hedge funds and CTAs are massively short Treasuries. So a natural question to ask is: How does it look on a longer time frame? To asnwer that question, I have this:



The traders haven't been THIS short Treasuries in 20+ years! This is your black swan folks - a four sigma event as pointed out by Deutsche Bank.

So how does this tie in with gold and why is this development the most important recent development in gold? The answer is multivariate and in the most concise of terms, this chart is important because mean reversion would dictate lower yields, which in turn should benefit gold tremendously.

Now, for the more detailed explanation for those who care:

The price of gold is driven by the U.S. dollar (intuitive correct) and real rates (nominal minus inflation). When nominal rates move quickly higher in the absence of inflation, gold gets sold. Why? Because gold is a store of value and if you earn more interest than what inflation takes away by keeping your money in a bank, gold becomes less attractive to hold. Vice versa, if inflation is high and your dollar, or pound, or rupee loses its value faster than the amount of risk free return you can earn, gold becomes a natural asset to own to prevent loss of your purchasing power. For this reason, countries such as India and China have had a long history with purchasing the yellow metal because these cultures are intimately aware of the ravages of inflation.

Over the past six months the US 10-year rates shot up from 1.4% to 2.6%. Inflation obviously hasn't moved as quickly. The resulting increase in real rates has been sharp and this has weighed heavily on gold. In that same time frame, the US dollar has continued to strengthen, also putting an anchor on gold prices.

Here is a look at how real rates are inversely correlated with gold. When real rates (rates adjusted for inflation) are moving higher, gold performs poorly and vice versa.

Now with this context, lets revisit the chart showing the massive short in Treasuries. As many of you have seen recently, following the election, the trade has been to "Buy America". So investors have bought US dollars and US equities. But curiously, one of the ancillary trades that has emerged is front running the expected stimulus package which would naturally be financed by bonds. For this reason, bond prices started moving higher - the reflation trade. This trade has become so big recently, that everyone believes in it. And the Treasuries as a result have become shorted as a result, I doubt that there remain many people who would still want to short the Treasuries here.

This has left with a rather one sided outcome, which is that yields have to decline. Interestingly, the 10 year yields have already started declining recently along with the US dollar as some of the steam comes out of the "Buy America" trade. Usually the dollar and yields move inversely, but this has been one giant correlated trade post elections. As the USD is sold, the 10 years get bought and as the 10 years get bought, the yields fall. As the yields fall, the shorts on the treasuries get squeezed and as the shorts in treasuries get squeezed, yields fall further. When yields decline, real rates decline (because inflation has remained relatively constant in the past two months). When real rates decline, gold goes higher. For this reason, the short interest in the treasuries is THE chart to watch if you are interested in determining the price action in gold going forward.

Disclosure: I/we have no positions in any stocks mentioned, but may initiate a long position in GDX CALLS over the next 72 hours.

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