A Theory About the Gold Rout and Implications for Risk Assets under QE

The sudden weakness in gold is intriguing given the acceleration in global QE most recently by the Bank of Japan. Gold has always been thought as a hedge against inflation and deflation. In fact most gold bugs would have one believe it can cure physical ailments. It is established wisdom, however, that gold is a hedge against the debasement of fiat currency. Now this thesis at least sounds plausible and I can accept it. But why then, in the midst of rotational, global, wholesale currency debasement, is gold weak?

Perhaps we are missing a particular nuance. Perhaps we need to modify our thesis and restate it as: gold is a hedge against ineffective quantitative easing and the debasement of currency. The subtlety here is that gold is a good hedge against QE assuming QE doesn't work. If, however, QE begins to work, that QE does more than inflate away debt, that QE does more than monetize sovereign debt, that QE in fact manages to stir 'animal spirits' and induce a self sustaining cycle of growth, then perhaps gold becomes much less valuable as a hedge.

This thesis would imply that the market as a whole is beginning to embrace the reality of a more durable economic recovery, led by the US, the UK, and bits of Europe. Surprisingly, the weakness now seems to originate from the emerging markets where central banks have begun to cut rates despite inflation rates that while not raging, are not entirely trivial. The developed markets, ravaged by poor sovereign balance sheets appear to be pulling themselves up by their bootstraps. If the thesis about gold is to be supported, we need to see more consolidation of the meagre growth that we have seen in the US and even better, a resurgence of growth after the summer. And further weakness in gold.