Trade Booster

10 June 2013

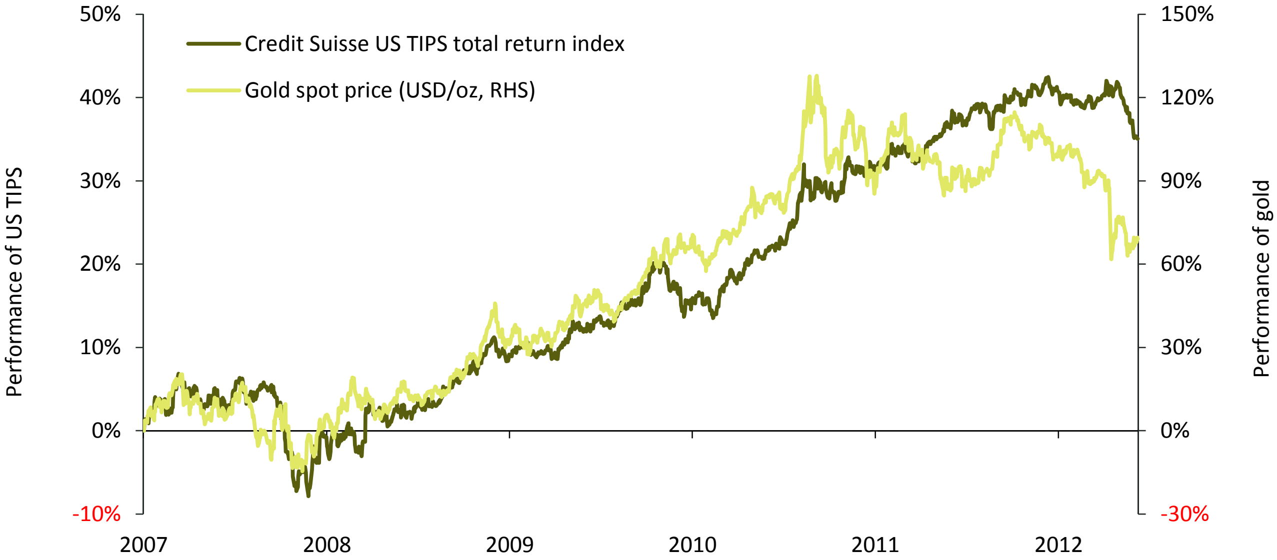
Disinflation in bearish bond markets. More sell signals for gold?

Summary

- **Disinflation in the US may reflect restored competitiveness of US jobs and longer-term structural advantages for the economy**
- **The downward price pressure building in US TIPS suggests benign inflation risks, undermining the case for gold**
- **Investors may consider buying Boost Gold 3x Short Daily ETP (3GOS)**

Are US TIPS pricing in more gloom for gold?

Performance rebased as at 01 Jan 2007, in USD



Source: Boost ETP Research, Bloomberg

Disinflation in the US may not signal economic weakness. Based on the current risk sentiment in financial markets, the low inflationary environment is being interpreted as positive for equities and negative for bonds. This outlook may mean further gloom lies ahead for safe haven asset classes, including gold. As a result, investors may consider a short leveraged gold position using the Boost Gold 3x Short Daily ETP (3GOS).

The extent by which inflation in the US and the Eurozone is undershooting its desired 2% target is growing. With the latest Y-o-Y CPI figures for May, showing growth of only 1.1% and 1.2% respectively, the deceleration of consumer prices is gaining momentum.

The disinflationary environment is having a significant impact on bond markets of late. US Treasury Inflation-Protected Securities (US TIPS), bonds that help investors protect themselves against (unexpected) inflation, have sold off sharply (see chart). The Credit Suisse US TIPS index has fallen by 4% YTD (to 6 June), a significant reversal given that the index returned 7% in 2012 and 13% in 2011. The last time such a similar correction occurred was during Q4

2010. Then, as now, US inflation was as low as 1.1%. A sell-off in inflation protected bonds also occurred in late 2008, when Brent crude oil prices collapsed from their 3 July peak of 146 USD/bbl to below 37 USD/bbl at 24 December.

What is different to the sell-off in US TIPS now however, is that deflation worries in the US have not been accompanied by economic weakness or slumping oil prices. In fact, US GDP grew 2.4% in Q1 2013, mainly on the back of buoyant consumer spending, even amidst ongoing public spending cuts and relatively high oil prices[1].

If suppressed wages have helped the US in reducing unemployment by creating a more competitive labour force, then the low rates of inflation may simply reflect this trend. Furthermore, this could imply that the US recovery continues to be structural rather than cyclical led: the internal devaluation in the labour market is creating the foundations for the US to further sustain the economic recovery.

Another indication for why the disinflationary environment may not undermine US growth is the poor performance of US government bonds of late. The rise in government bond yields have accompanied the falling returns of US TIPS. However, if investors were truly concerned about inflation lurking just around the corner, the returns of US TIPS would be rising and not falling. Instead, equity indices are rising, and in spite of benign inflation, bond prices are falling. Risk sentiment is anything but downbeat.

As we enter the summer season, equity markets may continue to lose some of their momentum. Yet, against the larger macro backdrop, the greatest downside risk may continue to be within safe haven asset classes, particularly gold.

[1] WTI crude oil has hovered around 95 USD/bbl since the start of this year.

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Three-thinking ETPs

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