Pedal To The Metals

Gold and silver. The very names are synonymous with wealth, power, elegance, and an ability to attract divorce lawyers' attention in a property settlement. Historically, the precious metals have been associated with money and coinage, and since they cannot be debauched by reckless governments and always will be accepted by border guards, they have been considered safe havens in times of inflation and political turmoil.

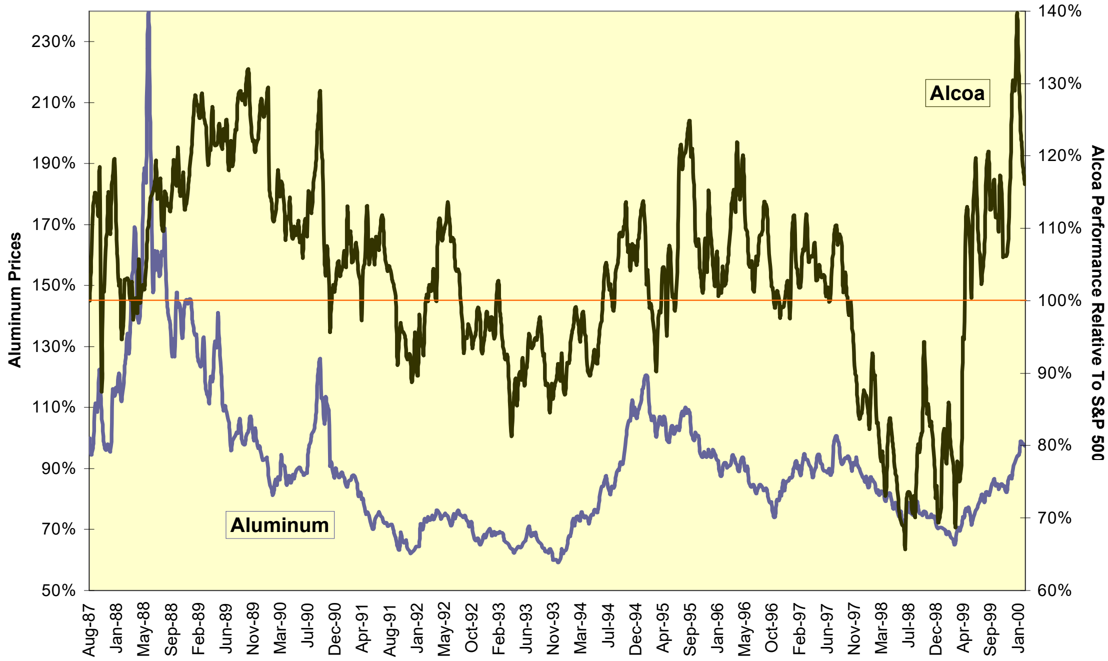
The last twenty years have not been kind to metals speculators. Not only has inflation been tamed from 1970s levels, but also we now have a wealth of other trading vehicles with which we can express our opinions. The sad and inexorable truth for any product not consumed -- and gold, for all the primordial lust associated with it, is one of the least intrinsically useful metals around -- is that its nominal price should rise only when the expected rate of inflation exceeds the expected cost of holding it. Why forego the 5.5% you can earn on a T-bill if expected inflation is not at least that high?

In our excitement over the New Economy, it is important to remember the Old Economy still swings a pretty big stick, and many of these sticks use base metals or precious metal catalysts in their manufacturing process. Gold may be produced simply to hoard, but nearly one-fifth of the goods produced in the world today depend on platinum or palladium catalysts. Steel may dull and prosaic, but we use an awful lot of it, and many basic and all stainless steels contain nickel.

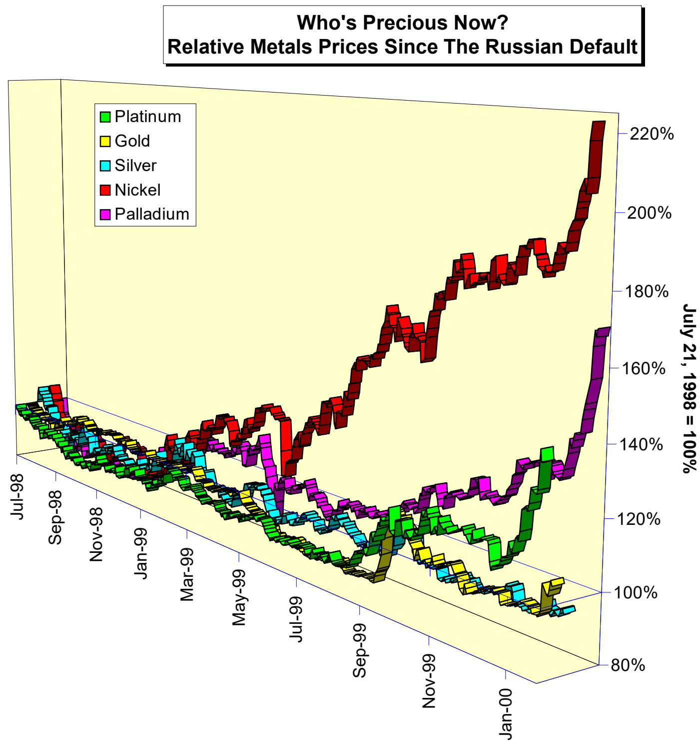
Just as we cannot talk of crude oil without discussing OPEC or coffee without Brazil, we cannot discuss metals without mentioning Russia. Along with South Africa, Canada, and Australia, Russia dominates the production of many precious and industrial metals.

Aluminum prices surged during the late 1980s, coincidentally the last time the yield curve inverted. After the fall of communism, the empire formerly known as Evil flooded the world with aluminum ingot in order to raise hard currency. This price collapse lasted to late 1993, and made Alcoa an underperforming stock. A later price collapse associated with the Asian/Russian crises of 1997-1998 hurt Alcoa as well, and it wasn't until an apparent bottom in aluminum in early 1999 that Alcoa took off and became the best-performing stock in the Dow Jones Industrial Average for year as a whole. The recent drop in Alcoa's relative performance in light of firmer aluminum prices may be signaling an emerging slowdown in industrial demand as higher interest rates start to bite.

Alcoa Performance And Aluminum Prices
August 1987 = 100%

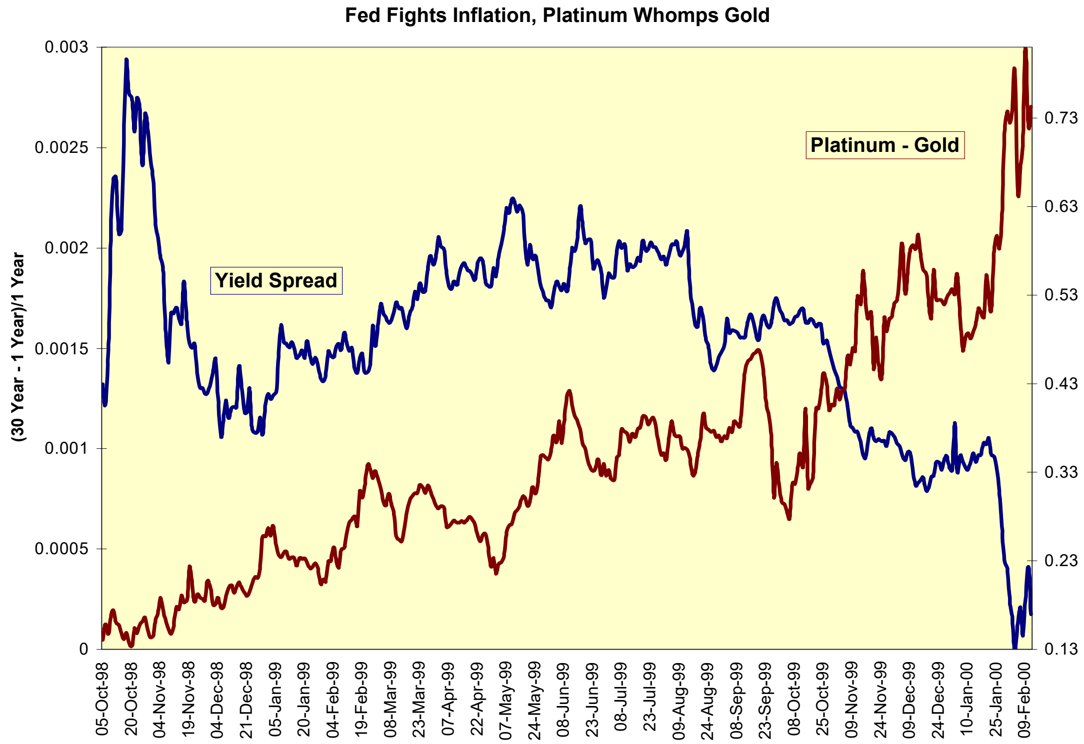


Every time gold hiccups, it makes the financial headlines, but the price is still nowhere. Nickel, on the other hand, has been trading like Nickel.com. As Russia's capital-strapped (gee, why won't anyone lend these guys money?) mining and transport sectors struggle to keep up with world demand, the price of platinum, palladium, and nickel has been soaring. Nickel is more than twice as valuable as it was just prior to the Russian default, and palladium is 70% higher.



Financial markets are continuously paranoid over inflation. The European central banks announced suspension of their gold selling in September 1999. Placer Dome recently announced it would stop selling gold forward. Warren Buffett still has, to the best of anyone's knowledge, the huge silver position he acquired in 1997 (Think this guy sits in Omaha and gets nagged? Waarrrenn! You should have bought palladium!). So how come the action is in the base metals?

The answer, quite simply, is strong economic growth and increasing inflationary pressures are two very different things. If inflationary expectations were in fact increasing, two observations on market spreads would be true. First, the spread between 30-year and one-year Treasury yields should be increasing, and increasing as a percentage of one-year yields. Second, the spread between platinum and gold should be stable or falling, and falling as a percentage of gold prices.



Neither is the case. The Treasury yield curve is in the process of inverting at higher one-year rates as the Fed tightens credit. And the platinum-gold spread is moving strongly in favor of platinum at a flat gold price as industrial demand surges. While we can credit all sorts of special factors to both of these spreads -- the supply uncertainties of long Treasury bond and Russian production and shipping disruptions -- we come back to one simple reality: Inflation is too much money chasing too few goods. The Treasury spread is telling us we are producing less money, and the platinum-gold spread is telling us we are producing more goods.

It won't happen tomorrow, or even next week or next month, but this confluence of factors is setting us up for a pretty good bond market once again. And if November 1994 is any indication, when the bond reversal comes, it will come quickly and powerfully. Hop on board, you'll love the ride.