Gold's Tale Of Two Cities

"It was the best of times, it was the worst of times." – Charles Dickens

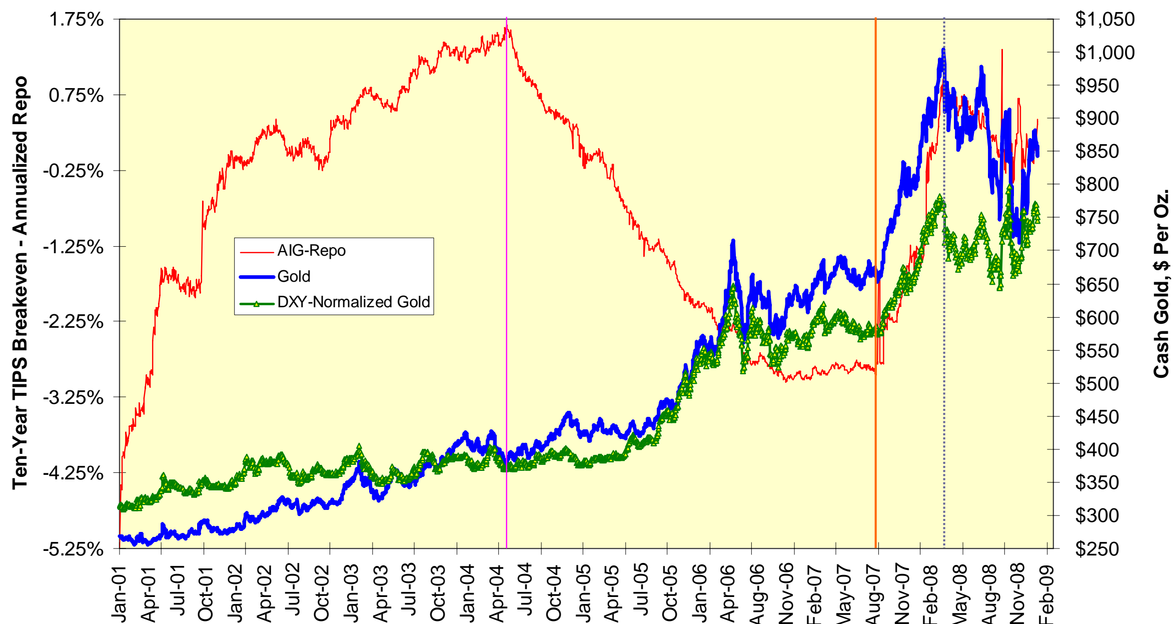
Charles Dickens did not begin his twelfth novel in deliberate reference to gold, but from the standpoint of an observer over the last ten months, he very well might have. The deliberate and concerted effort by the world's central banks to follow the Bank of Japan and the Federal Reserve down the road of zero interest rates cum quantitative easing does raise questions about the ultimate value of fiat money, does it not?

As both a detour and a plug for future columns, all this monetary stimulus has done to date is disintermediate capital markets and end the dollar carry trade. If everyone's short-term interest rates are going to zero, there is no need to borrow cheap yen or dollars or Swiss francs and swap them into another currency; you can borrow in your own currency for nothing and incur no currency risk. This will start to suppress currency volatility soon, but that is another topic for another day.

However, as noted last August, gold has failed to provide a refuge. Its 12-month return using the Dow Jones-AIG rolling contracts has been -6.5%, better than just about all stock and risky bond indices, to be sure, but hardly the returns dreamed about for years by gold bugs. One of the principal reasons for this deficient performance has been declining inflation expectations. Gold or any other static asset should rise in nominal price if expected inflation exceeds the cost of carry, short-term interest rates in this instance.

Gold's Primary Fundamental

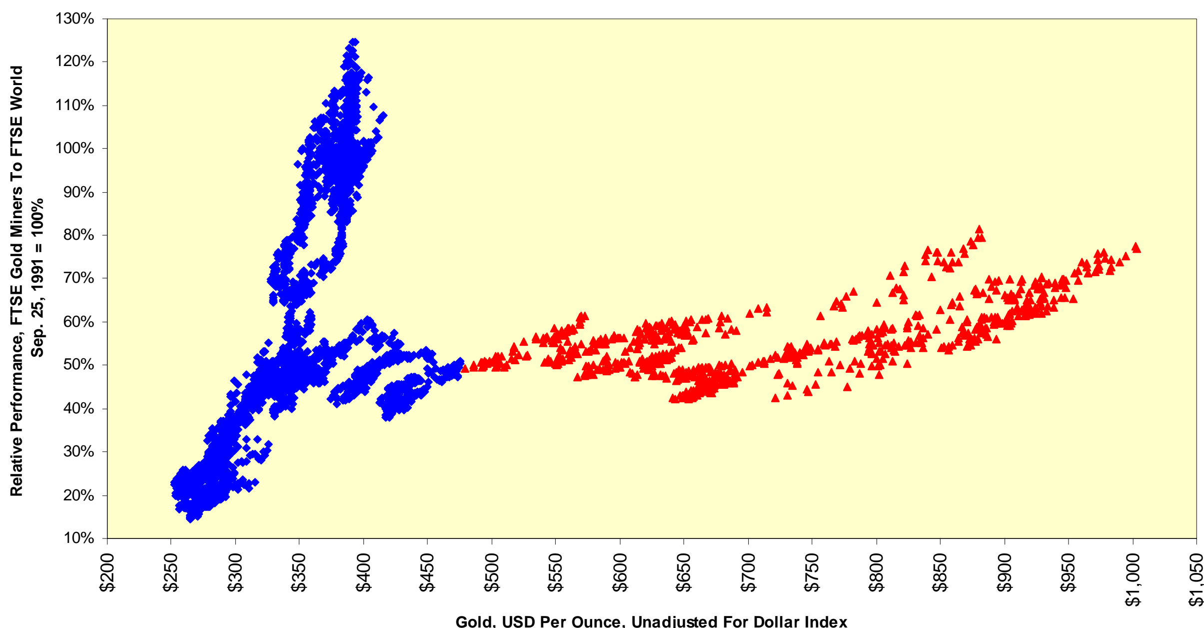
Let's return to this measure, first introduced here in May 2003. This net expected inflation measure began to decline in May 2004, marked with a magenta line, but gold rose as the new wealth of India and the United Arab Emirates was converted into gold. It shot higher at the end of August 2007, marked with an orange line, as the Federal Reserve began its credit easing policies, and it peaked in March 2008, marked with a dotted line, during the Bear Stearns rescue. It has been trending irregularly lower ever since, and as a result the price of gold has been hitting a series of lower lows and lower highs. In dollar index-adjusted terms, gold has been flat since February 2008.



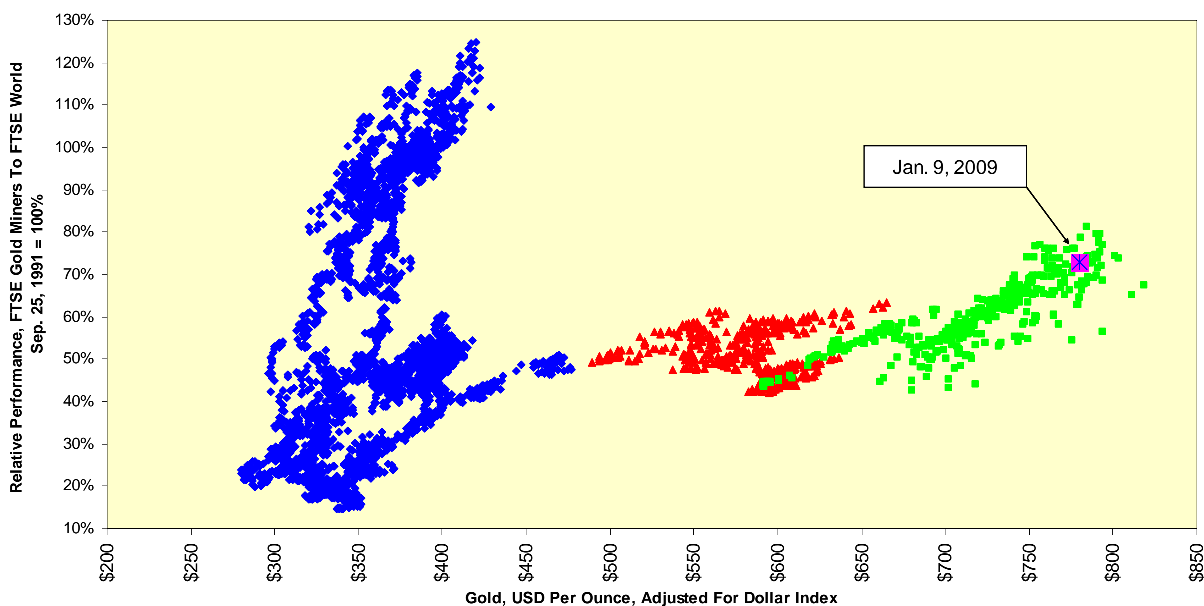
Global Gold Miners

As promised in a Columnist Conversation posting, I intended to take a look at gold mining stocks. In an approach similar to a December column on silver, I will take a global index of gold miners and its relative performance to a general global equity index. Parallel indices are available from FTSE going back to September 1991.

If we map the relative performance of the gold miners to stocks in general against the price of gold, a stark division emerges in mid-November 2005, marked in red. This is the same time division seen in silver. Prior to November 2005, marked in blue, the relative performance of gold miners was an extremely strong multiple of gold prices. After November 2005, the effect is weak. Anyone who bought gold bullion on November 16, 2005 at $479.30 per ounce has close to a 70% total return using the Dow Jones methodology; the return on the mining index is just over one-sixth of that.



The results do look better in dollar index-adjusted terms. Here we split the data one more time, this time with the August 17, 2007 emergency rate cut; the data points are marked in green. But considering the travails of the dollar during the August 2007 – April 2008 period and the drive of short-term interest rates to zero, this sort of tepid performance is not what gold bugs dreamed about for years.



The reason, one given in this space many times before and surely many times again, is commodity-linked equities and commodities are not the same thing. The gold miners faced rising operating expenses, especially for energy and

power and for labor. The commodity, much of which had been mined years earlier and was sitting in vaults around the world, had no such encumbrances. The moral of the story is if you want to be long gold, be long gold. Do not buy mining stocks unless you are in the early phases of the next bull cycle in gold (Hint: You are not).

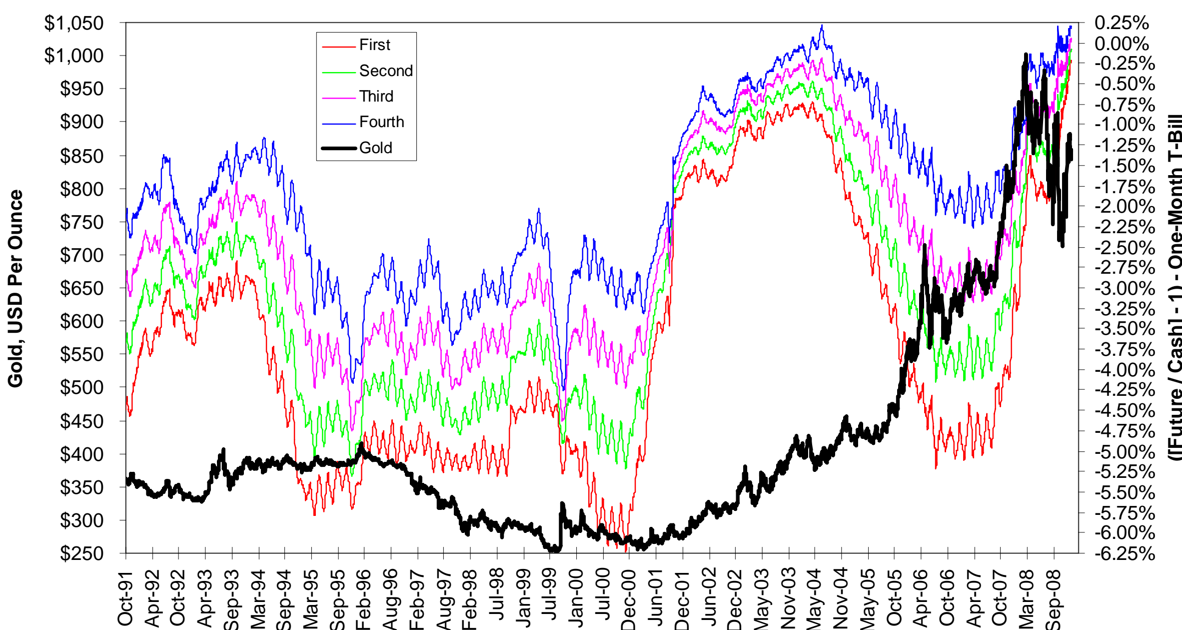
The Forward Curve

Let's conclude with a question I have received from many in recent months, and that is why gold coins and other forms of bullion are trading over the futures. Whenever gold bugs see something like this, they reach up and pull one of their many conspiracy theories off the shelf.

As a refresher, gold futures always should trade at a premium to gold; their fair value is the short-term interest rate cost of carry less some relatively minor physical storage costs. This means if we take the percentage premium of gold futures to bullion and subtract short-term interest rates therefrom, we should get a number near zero.

Instead, if we do this for the first four continuous futures contracts, here smoothed with a 21-day moving average, we see the number frequently is negative, with the first-month contract having the most negative premium of all. The higher the short-term interest rate, the more likely the premium is to be negative.

Futures Moving Back To Net Carry Over Cash



The premium is back at positive levels for the third- and fourth-month contracts. The negative numbers seen in recent months when futures were trading below coins and collectibles were an artifact of the futures contract being priced not from immediate short-term interest rates but rather from the much lower rates available in the forward rate agreement market. When short-term interest rates rise again, a statement and not a forecast, the situation should reverse and the futures market should be priced off the lower spot rate and not the higher cost that will prevail then in the FRA market. There; no conspiracy involving the artificial manipulation of gold futures by unseen powers who apparently had nothing better to do in the midst of the worst financial crisis since the 1930s was necessary.

It may yet turn out to be the best of times for gold. Until then, a line from Dickens' *Oliver Twist* may be appropriate for all of us: "Please sir, can I have some more?"