Will Gold Get Bold?

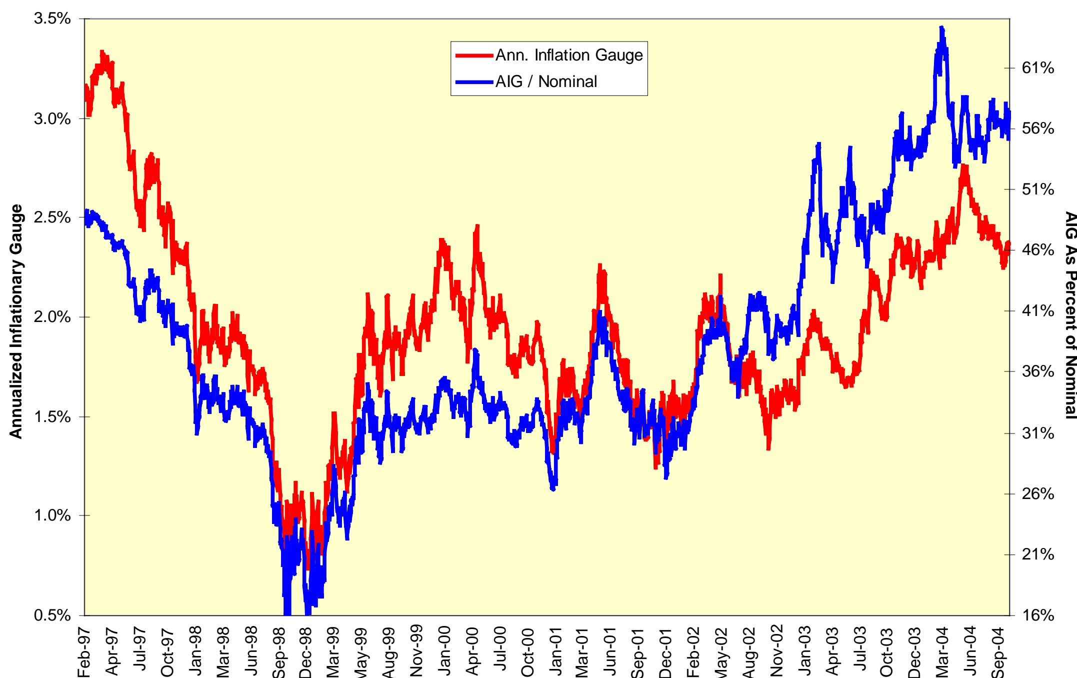
Market analysis requires a combination of detective work, an understanding of numerous economic and financial rules and relationships, and perhaps most importantly, the ability to throw everything aside when all of your past training and experience fails. Take, for example, the relationship between bonds and crude oil prices over the past three months: On many days both markets rose together on the notion that higher oil prices would slow the economy sufficiently to keep a lid on interest rates.

Even for one who has argued for more than two decades that this was the proper relationship, the irony of seeing the old shibboleth turned on its head was a little disconcerting. Even when I believed the market had the relationship wrong, I chose to go with the stampede in the interests of self-preservation. Besides, who would hear all my tut-tutting over the hoofbeats, anyway?

Where Does Gold Belong?

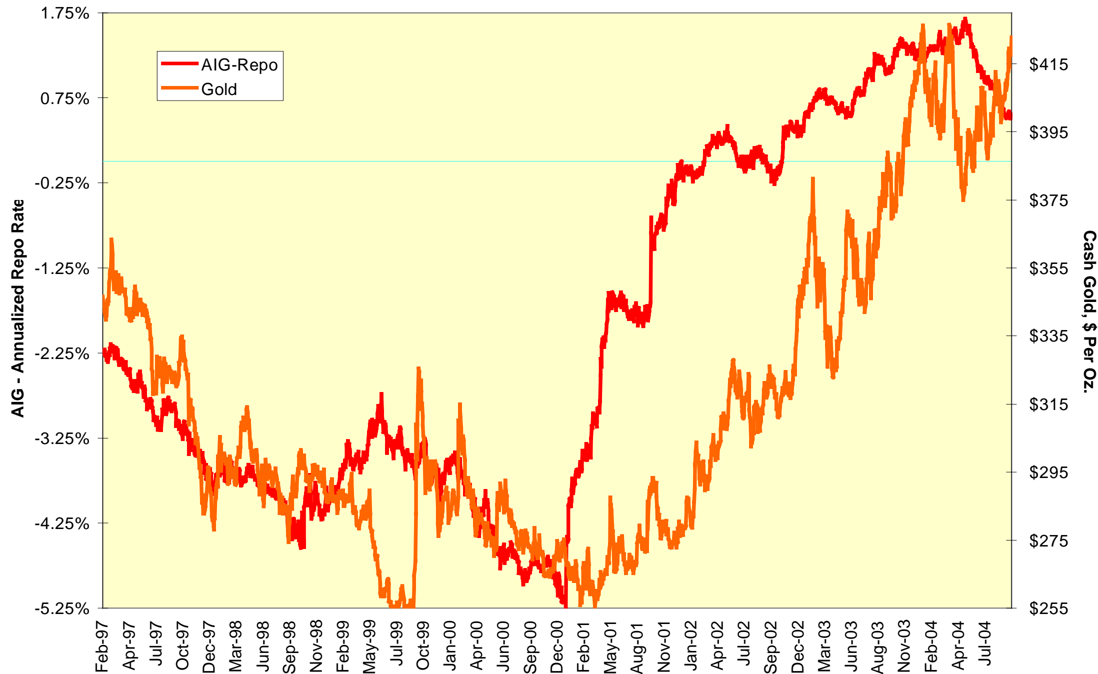
Gold has over the years entered and left analysis a schizophrenic. On one hand, it should be one of the simplest and most rational markets going: Its currency-adjusted price should be the product of the difference between expected inflation and the expected short-term interest rate cost of carry and nothing more. On the other hand, it is a market imbued with mysticism; Keynes called it "a barbarous relic" and it is a favorite of those who believe the creation of paper money has been the root of all evil. I recognize gold's various symbolic values and let it go at that. Let's turn our attention to something we can measure, a set of indicators listed here in February.

The first is the annualized inflation gauge, which I abbreviate AIG despite its confusion with the insurer of the same name. I have simplified the calculation of this measure to the difference between a constant maturity ten-year note and a constant maturity ten-year TIPS; this also allows for an earlier start, February 1997, to the series' history.



The AIG, both in its nominal measure and expressed as a percentage of the ten-year note's yield, is a little higher than it was in late January. Both expressions have retreated from recent highs, but neither measure indicates that inflationary pressures are disappearing. On the surface, we have to regard the AIG by itself as supportive of higher gold prices.

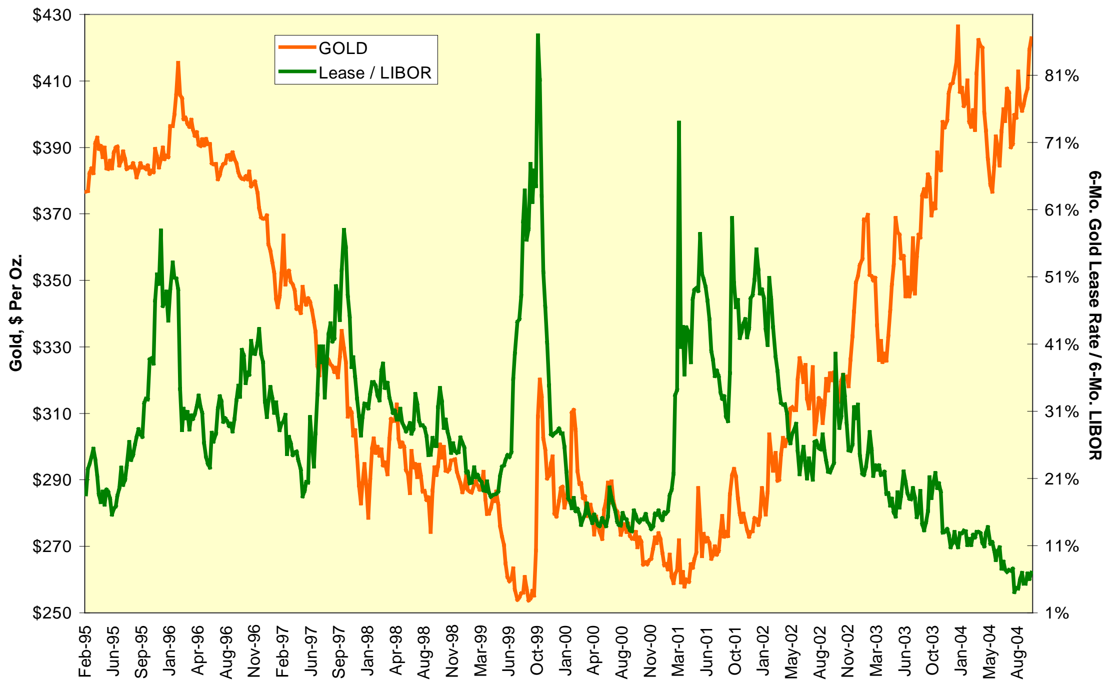
But that is the sound of one hand clapping. No matter how high the AIG goes, it will not be positive for gold unless it exceeds the short-term interest rate cost of carry. The spread between the AIG and the three-month repo rate peaked in late May, and while still positive, is back at its January 2003 level. The Federal Reserve has communicated its rate-raising intentions well, and unless the economy weakens to the point where the market no longer believes higher rates are in order, this declining spread is not all that encouraging for higher gold prices.



Signing A Lease

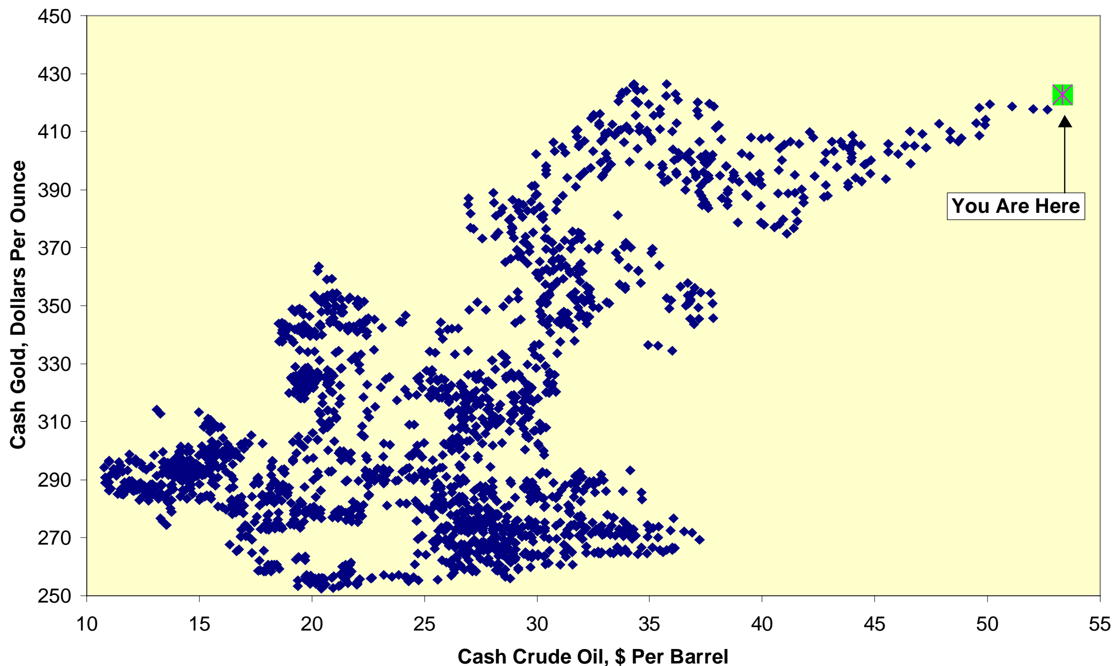
The actual supply/demand balance for gold is always difficult to ascertain; suffice to say many of the organizations that publish data are not disinterested. One datum that is market-based is the gold lease rate, the difference between LIBOR and the gold swap rate. When demand to borrow the metal is high, price spikes frequently follow. The ratio of the lease rate to LIBOR has been declining steadily for almost three years, a situation that bespeaks to both little interest in shorting the metal and a low level of future demand to buy it back in a short-covering trade.

Some gold bugs suggest the low lease rate is evidence that central banks are dumping gold bullion into the swap market in an attempt to cap gold's price. I prefer the simpler explanation. On balance, the low and declining lease rate should be a damper on gold's price, but gold has rallied for three years in defiance thereof. Let's call this one neutral.



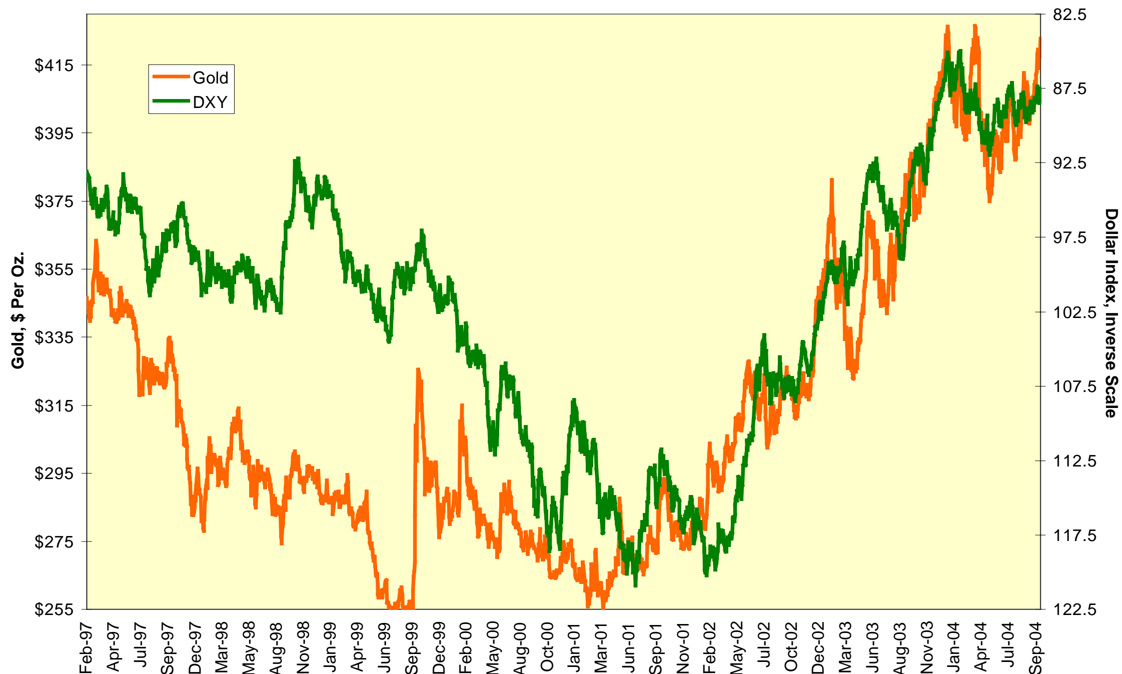
Gold And Oil

Let's take a brief detour into the relationship between gold and crude oil, or, as noted last May, a non-relationship despite the efforts of various twits to create one. Crude oil has been setting price records on a daily basis of late, while gold barely has budged. In fact, gold is no higher in price today than when crude oil was 30% lower in price than it is today. Bottom line: If you looking for a clue as to gold's future, look elsewhere.



More Bang With The Buck

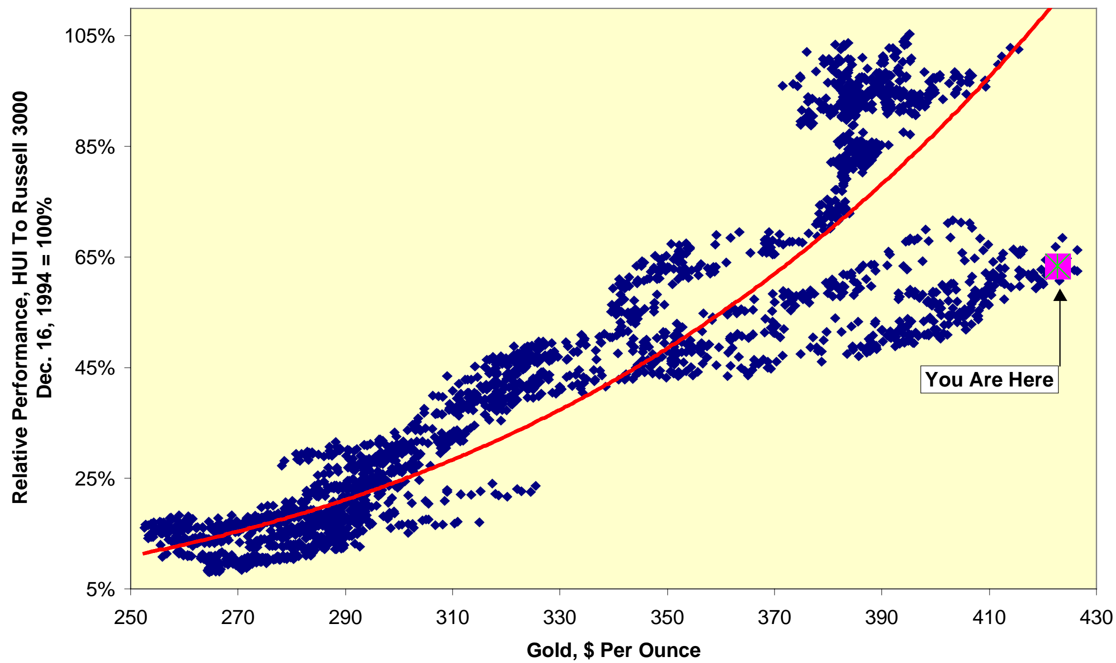
The place you should look is the dollar. When all is said and done, which won't be anytime soon, gold has been a proxy for the dollar, and vice-versa, for the past three years. The dollar's value, as discussed a few weeks ago and previously, is a function of relative inflationary expectations between the U.S. and the rest of the world. If the market senses the Federal Reserve will back away from rate hikes, the dollar will weaken and gold will rise in nominal dollar terms.



Of course, the opposite will hold true as well. Rate cuts elsewhere or more rapid rate hikes in the U.S. will strengthen the dollar and dampen gold. While a number of factors favor a weaker dollar, we must be cognizant that Asian central banks may repeat their performance of last winter and support the dollar in order to keep their own currencies from moving higher. Barring that scenario, which we will have to revisit at another time, I regard the dollar as the decisive factor that could lead to higher gold prices.

A Note On Stocks

A final note is addressed to those who like to play commodities via commodity-linked equities. I pointed out last time how the XAU, the Philadelphia Gold & Silver index, had underperformed the increase in bullion prices. Several readers asked me to look at the AMEX' Gold Bugs index, which includes only those firms who have not sold their production forward past two and one-half years. Fair enough; please find the comparison below.



The story remains the same one we have seen time and again: If you want to play the commodity, play the commodity. Or, in the case of gold, if you do not want to play the commodity, play the dollar instead by either trading the currency, using a non-dollar bank account such as offered by everbank.com, or diversified foreign bond funds.

In any case, cast off the mindset that growth causes inflation, which should support gold. The fashion in this market will be weak economic news will stifle the Federal Reserve, which will weaken the dollar and support gold.