All That Glitters Isn't Gold

The unbearable summertime heat in Chicago this past week did not deter your loyal correspondent from taking a stroll in the park past assorted mad dogs, Englishmen, and laid-off chip designers from Motorola and network engineers from Lucent and Tellabs.

When a bright yellow bus full of day-campers singing "the cow kicked Nelly in the belly in the barn, didn't do her no good, didn't do her no harm" drove by, the proverbial light bulb over the head appeared. Was this a Sign From Above telling me to pay attention to gold? At best, the bus-colored metal hasn't helped or hurt very many portfolios lately, but with the violent crosscurrents emerging in global financial markets of late, how long can this last?

For a while longer, it appears. But, that doesn't mean that inquiring minds can't come up with decent gold trades, as we shall see below.

The notion of gold, which reached $800 an ounce two decades ago, rallying to $275 an ounce on its good days would have seemed preposterous in 1980. Of course, we could say the same thing for the once-mighty Nikkei now struggling below 12,000, or the once-mighty Nasdaq now struggling below 2,000. But, as the bumper stickers say, stuff happens.

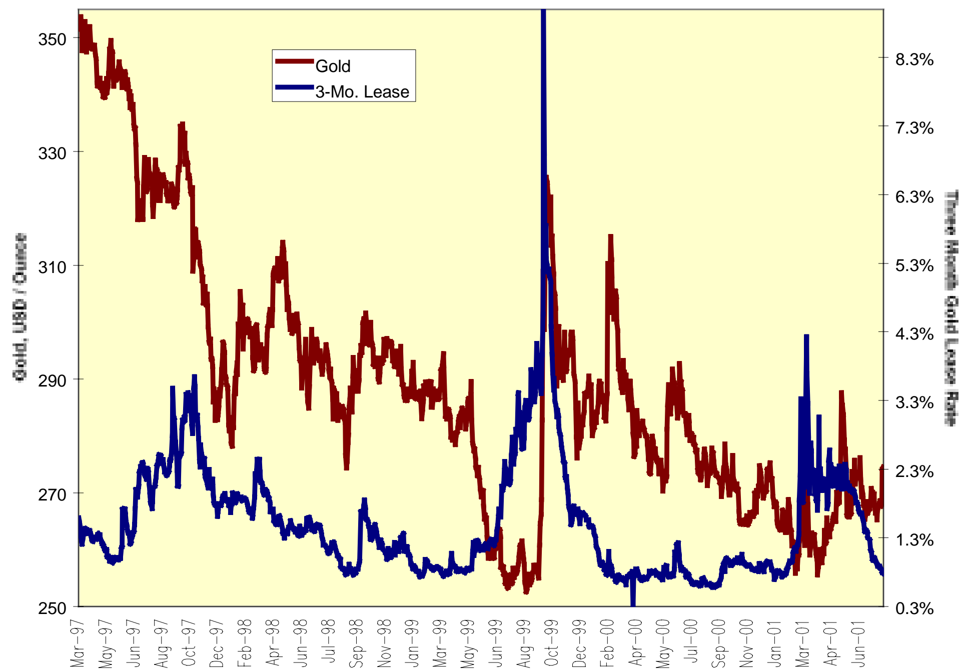
As far crosscurrents, gold will be hurt by falling measures of inflation, such as last Friday's .9% drop in producer prices. On the positive side, the ongoing central bank attempts to reflate the global economy should boost inflationary expectations, and the apparent crack in the dollar's strength should raise the dollar price of gold. Finally, we're witnessing what's shaping up to be the most misguided set of economic policies since the respective heydays of Richard Nixon and Jimmy Carter. Still, gold's going to do what it does best, and that's just sit there.

When In Doubt, Stay Out

The price of gold should rally only when the expected rate of inflation exceeds short-term interest rates, the cost of holding the metal. This hasn't been the case of late. If we take the spread between standard ten-year Treasuries and inflation-indexed bonds discussed here two weeks ago, (see "Economics Through the Looking Glass," Aug. 2, 2001) the present reading of inflationary expectations is 1.72%. Three-month Treasury bills are yielding 3.41%, a gap of 1.69%.

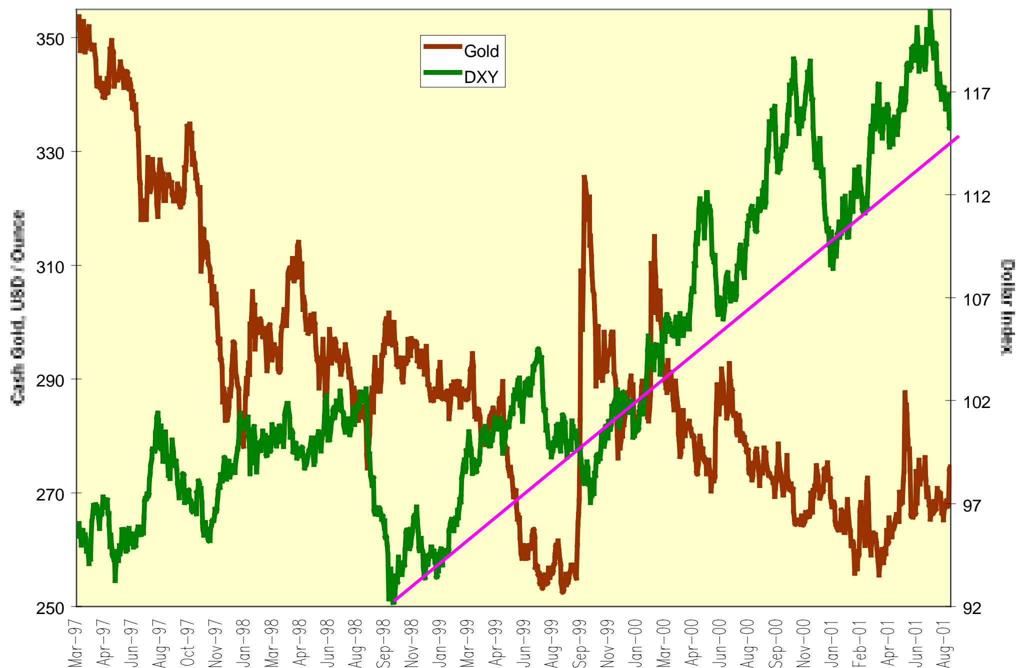
This means a dollar-denominated holder of gold is either willing to pay a penalty of 1.69% for the privilege of converting cash into metal, or this same holder perceives an impending change toward scarcity in gold's supply/demand balance. At the risk of infuriating gold bugs in the readership, let's dismiss the latter possibility out of hand. Nothing in the gold lease rate market, which is the difference between gold swap rates and short-term interest rates, suggests any impending surge in demand for gold. In fact, present lease rates indicate a real lack of interest in the metal.

Gold Prices And Lease Rates



The first point, a willingness to pay a penalty for owning gold, is more important. We do not live in a dollar-only world, and any holder of dollars who fears a loss in their exchange value greater than the 1.69% penalty may be willing to buy hold as a hedge. The dollar, measured here by the trade-weighted dollar index, (DXY) and gold long have had an inverse relationship. The DXY at present is approaching a major trendline of support going back to the Russian default crisis of 1998.

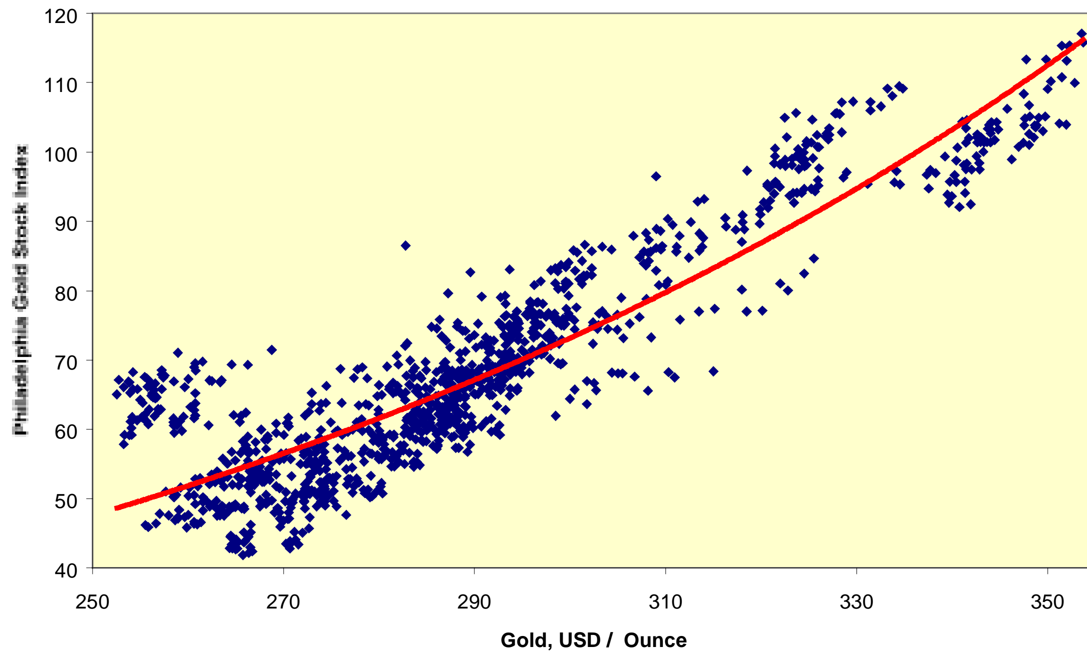
Rumors of the dollar's demise over the past two years have been exaggerated greatly, and the question of which currency would benefit from any dollar weakness is an open one. Has the European Central Bank or the Bank of Japan done anything recently to suggest they are ready to assume the mantle of world monetary leadership? The lack of confidence in others' economic management likely will place a floor under the greenback for the foreseeable future.



Gold Stocks

Nothing in the three indicators above, inflationary expectations, lease rates, or the dollar's exchange value, suggests the time is right to enter the gold market. If gold bullion is a waste of time, do gold mining stocks offer a better alternative? The nine-member Philadelphia Stock Exchange Gold & Silver index (XAU) has risen 4% so far in 2001, and has outperformed the S&P 500 by 24.9% since August 2000. One member of this index, Homestake Mining, is being acquired by Barrick Gold, a consolidation-style merger that suggests the cheapest place to mine gold is on Wall Street, not in them thar hills.

Gold stocks and gold bullion have a well-defined relationship: The stocks lead bullion higher and rise faster in price. While we can quantify this simply, XAU = 5.54 * exp (.0086 * gold), $r^2 = .77$, which means we can explain 77% of the variance in the XAU by the price of gold, we can illustrate it much more vividly.



If the bright red trendline looks like the profit profile of a call option, it should. If the price of gold falls, the damage to the XAU is gradual. If the price of gold rises, the gains on the XAU accelerate. An obvious hedge trade is suggested: Buy gold stocks and either sell gold futures forward or buy put options on gold.

A little bit more complex than finding the next hot tech stock, to be sure, but it may do you some good and won't do you much harm.