A Gold Rally? This Time For Sure

"Always" and "never" are two words one should always remember never to use. Several years ago, a retail commodity broker inquired whether gold would ever reach $500 an ounce, or even higher, again. The answer was simple: "Ever" is a tough standard to deny, but until the expected rate of inflation exceeded the short-term interest rate cost of holding gold, the yellow metal would – and did – continue its decline.

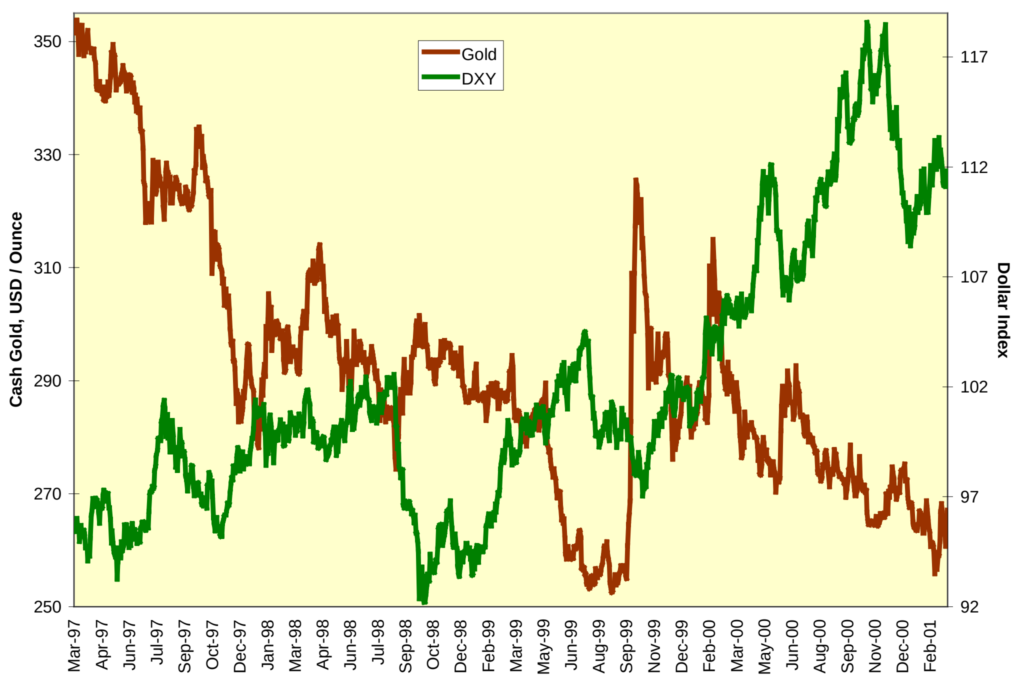
Had someone similar asked in March 2000 whether the NASDAQ would ever see 2,000 again, the answer would have been similarly open-ended and conditional. All traders study markets and form strong opinions. Only good traders know when to reverse these opinions instantly as necessity dictates. That time may be now for gold.

Reasonable Skepticism

Premature sightings of gold price revivals have been so common and so wrong for two decades that we're entitled to ask "says who?" To which the response must be "the currency market, the bond market, gold stocks, and the cash gold market, that's who." Let's take each of these in turn.

Since little gold actually is consumed, its dollar price is an excellent barometer of monetary creation and inflationary expectations. Too many dollars should lead to each one exerting a smaller claim on both non-dollar assets and on gold. We should see an inverse relationship between the trade-weighted dollar index (DXY), which is the price of non-dollar assets, and gold, and we do.

Gold And The USD: An Inverse Relationship

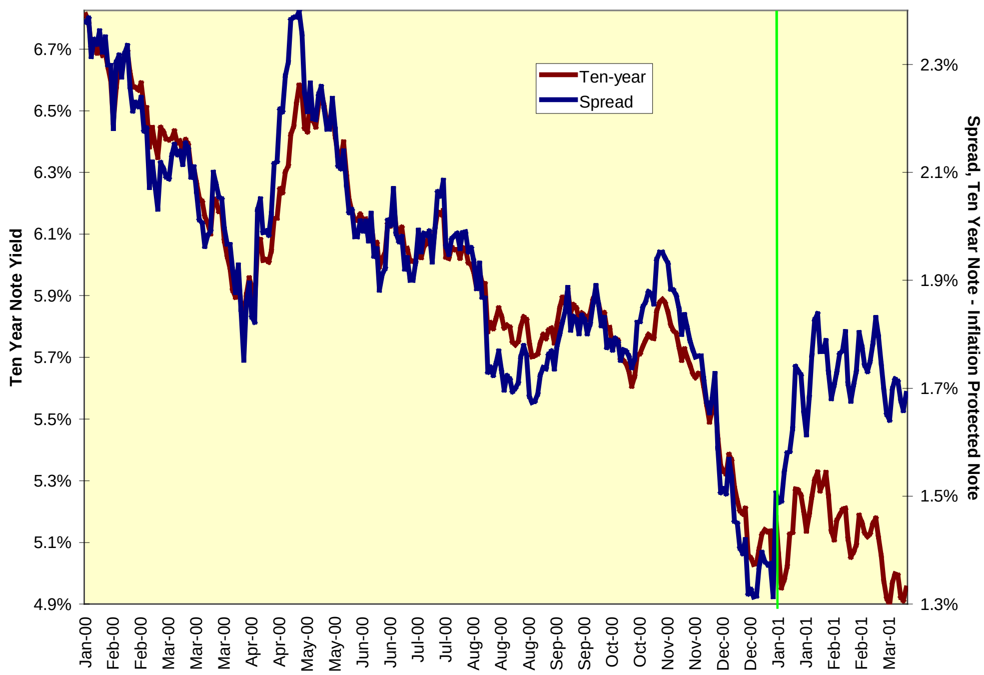


The Fed's recent and expected rate cuts have knocked the DXY down considerably since late 2000. This selloff is all the more remarkable when we consider the near-record low of the Canadian dollar and the flight from the Japanese yen; these two countries are our first and third largest trading partners, respectively. The DXY looks quite fragile on the charts, and has no real support until 102.35. The message here is clear: Too many dollars will lower their value and must raise the dollar price of gold.

The Bond Market's Perspective

The very same monetary largesse is increasing the bond market's fear of inflation, even as the economy slows. This can be seen in the yield spread between a generic ten-year note yield and the yield on the inflation-indexed 3.625% bond (TIP) due January 15, 2008. The spread exploded higher in January as the Fed cut the funds rate by 100 basis points. While nominal ten-year yields have continued to fall, the inflation premium built into the TIP has remained high. This widened spread is consistent with the rational expectations hypothesis that expected rate cuts should have no effect on employment and output, only on expected inflation.

Ten Year Notes: Yields And Inflationary Expectations

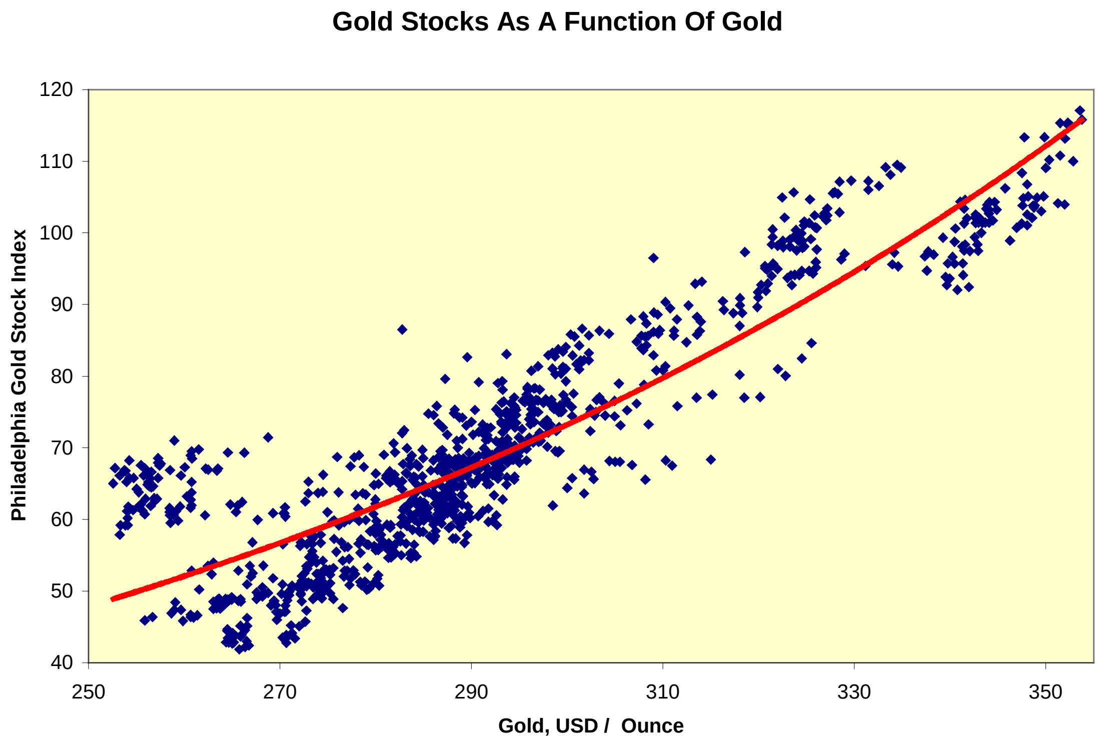


Gold In Them Thar Stocks

The Philadelphia Gold & Silver index (XAU) has been creeping higher, by 7%, since the start of the year. As is the case in any index, some members are more equal than others; Freeport McMoran is up 52%, and Homestake Mining is up 40%. Only Phelps Dodge, which is primarily a copper mining firm, has a negative return, 10.2% year-to-date, in the nine-member index. As for so many commodity-linked stocks, the XAU has an exponential relationship to the price of gold:

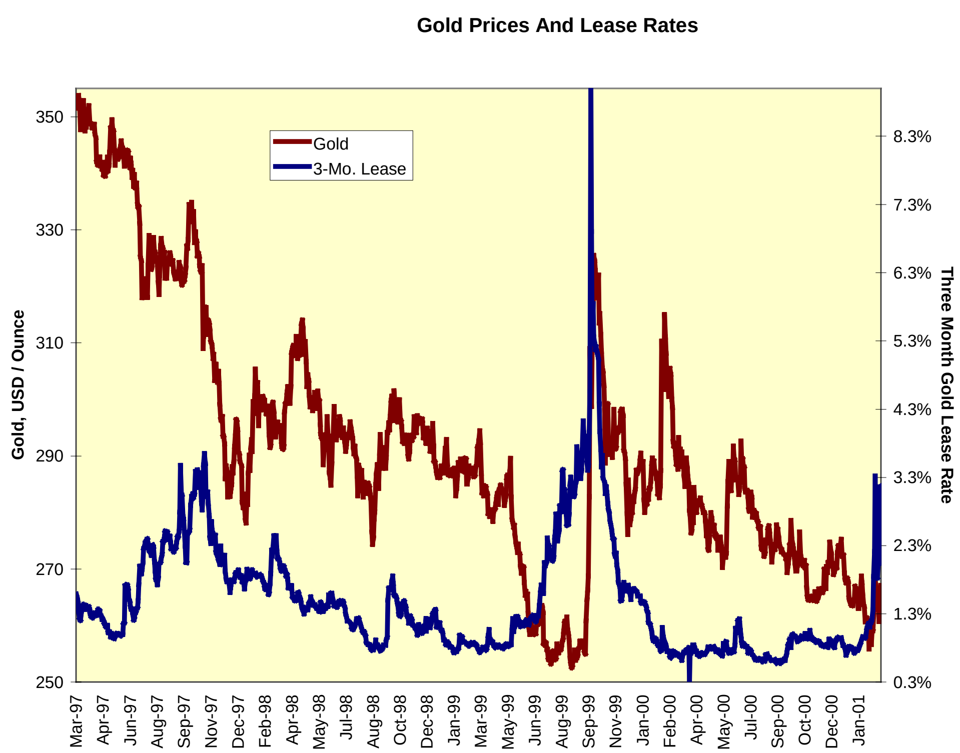
$$XAU = 5.68 * \exp(.0085 * gold), r^2 = .75$$

This relationship allows gold stock investors to acquire accelerating participation to gold price increases, while enjoying decreasing exposure to falling gold prices. It also creates an obvious hedge trade: Buy gold stocks and either sell gold futures forward or purchase put options on gold.



Signing The Lease

Of course, all of this would be irrelevant if we had no evidence of gold prices themselves rising to the occasion. Not to worry: The lease rate for three month gold, calculated by subtracting the gold swap rate from LIBOR, has been jumping. Lease rates only rise during times of short supply of gold for delivery, and we should be no more eager to sell gold forward in such an environment than we should be to sell a hot IPO (remember those?) short on its first hour of trading. In both cases, covering the short position can be a challenge.



Sometimes the lease rate proves to be a false indicator of an impending gold rally, as was the case in mid-1997. A minor gold rally was derailed by the onset of the Asian financial crisis, which ushered in a deflationary three-year period. At other times, such as mid-1999, the rising lease rate proved to be a great leading indicator of the short, sharp gold rally that occurred in late September of that year.

The present jump in lease rates may produce a gold rally of greater staying power for two of the reasons listed above, the injection of liquidity by the central banks and a cessation of gold sales by many of the European central banks. The latter had been aggressive gold sellers in order to window dress their national accounts prior to the introduction of the euro.

Well, there you have it, a lot of reasons why gold should rally, and no reasons why it should not. Sometimes a preponderance of fact and logic is a negative indicator in itself, but why fight the Fed?