Inflation, Deflation And Gold

There's an old saying in the newspaper business that dog-bites-man is not news, but man-bites-dog is. This observation still holds true even under today's faster and looser standards of journalism.

By this standard, the gold market today may be getting ready to give Fido a hefty chomp on the shins by rising in what is alleged to be a deflationary environment. Let's look at some key quantitative indicators of the gold market, including the inflationary expectations embedded in the bond market, the dollar and gold lease rates.

Two principles are important here. First, the price of any physical commodity will rise if the expected rate of inflation exceeds the costs of holding it. Second, the price of any physical commodity will rise in a given currency if that currency becomes worth less.

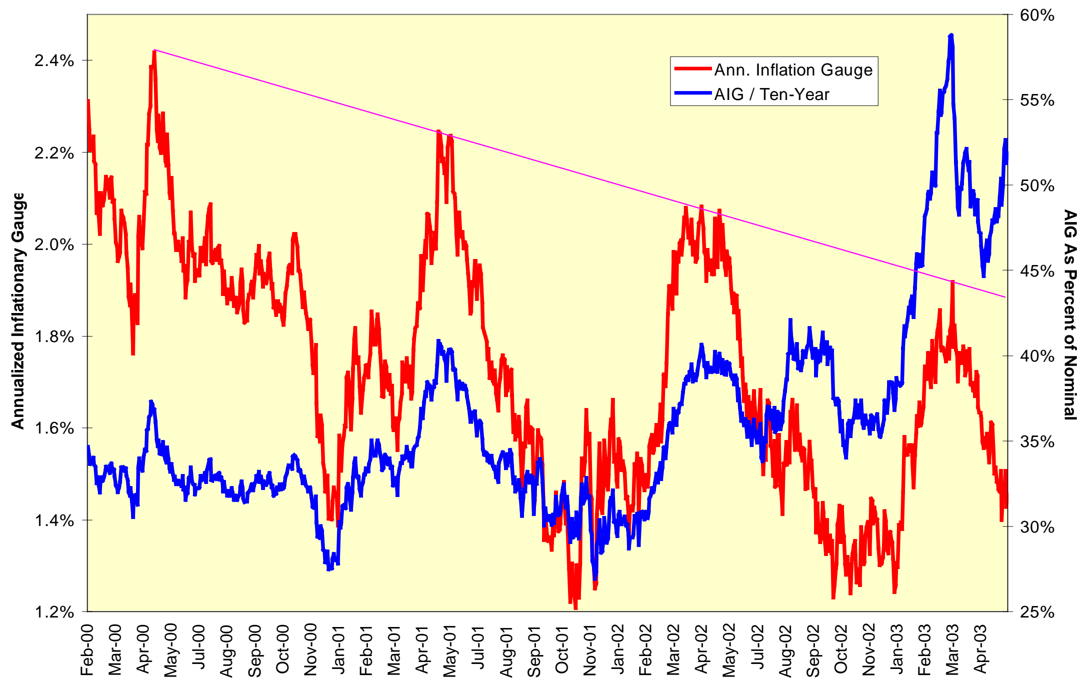
TIP-Toe Through The Minefield

If deflation is about to become a scourge upon the land, the Treasury note market appears relatively unfazed by the prospects thereof. We can compare the yield spread between two notes of near-equal maturity, the 6.50% note due February 15, 2010 and the inflation-protected 4.25% TIPS due January 15, 2010.

While the maturities are nearly equal, their risks are not: The 6.50% has a modified duration, or percentage price change for a given change in yield, of 5.52, while the 4.25% has a modified duration of only 2.86. You would need to purchase 10,000 TIPS to have a risk-adjusted position equivalent to 4,994 conventional notes.

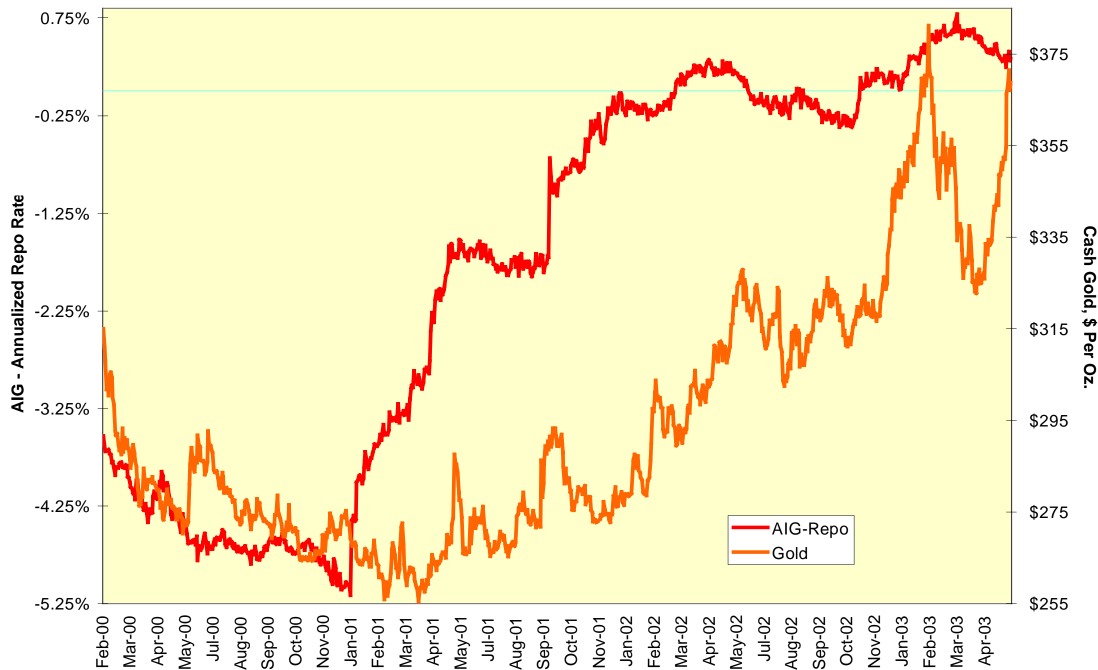
This is the opposite of the expected relationship for conventional bonds where the lower coupon bond would have the higher duration and is due to the mechanics of TIPS. The principal to be repaid on the TIPS is adjusted on a daily basis for changes in the urban consumer price index, which gives current holders an accelerated claim on cash flows. In addition, should we in fact be headed into a deflationary environment, the Treasury will make up the difference between $100 and the deflated price of the TIPS. In option terms, the TIPS investor has both a call option on inflation and a put option - a straddle - on deflation simultaneously.

Let's dub the yield spread between these two notes the annualized inflation gauge, or AIG, not to be confused with the insurer of the same name. The AIG has been making a series of lower highs since early 2000, which is consistent with disinflation. Its present reading of 1.46% annually until 2010 is neither deflationary nor lower than the readings below 1.25% seen in the fall of 2001 or between October 2002 and January 2003.



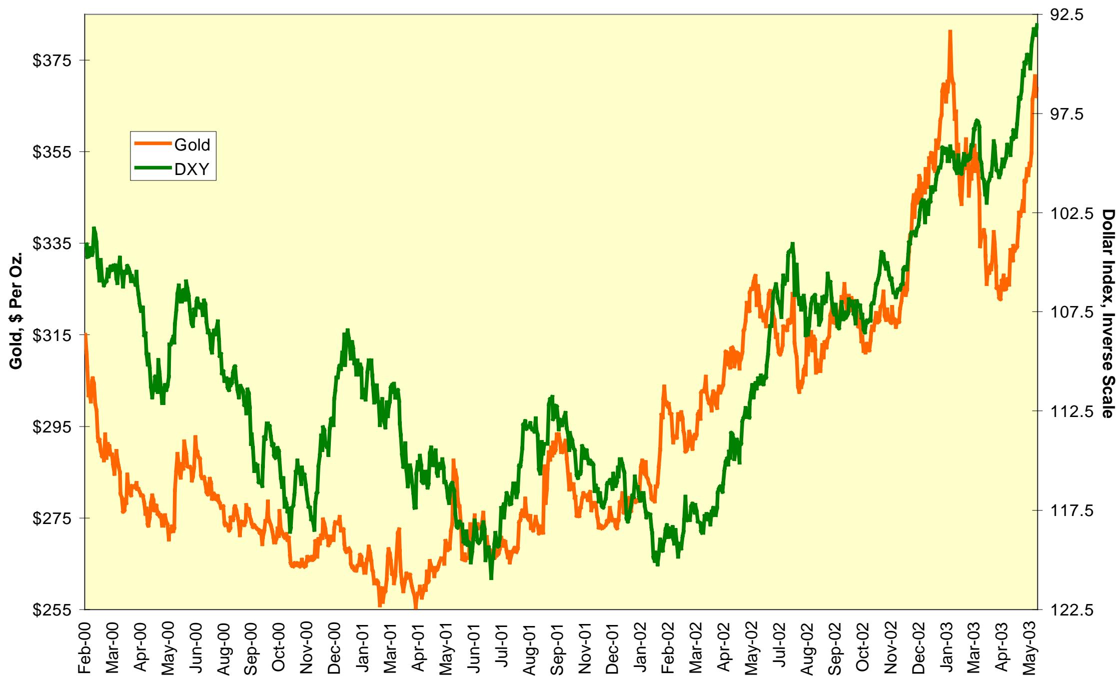
The AIG as a percentage of the conventional Treasury yield rose fairly rapidly going into the war with Iraq, fell once the shooting war stopped, and has proceeded to rise once more as the Federal Reserve has promised to fight deflation. The TIPS market appears to be find the Fed's promise to reflate if necessary credible.

Is expected inflation greater than the cost of holding gold? We can compare the AIG to the annualized repurchase rate. This measure had been negative throughout 2000 and then started to jump toward 0% once the Fed's rate cut campaign began in January 2001. The measure hovered near the 0% line until the start of 2003. It peaked near 0.80% just before the start of the war and has started to move back toward zero. Given the leading relationship of this measure to the price of gold itself, we would have to conclude that expected inflation exceeding holding costs would support future gold prices.



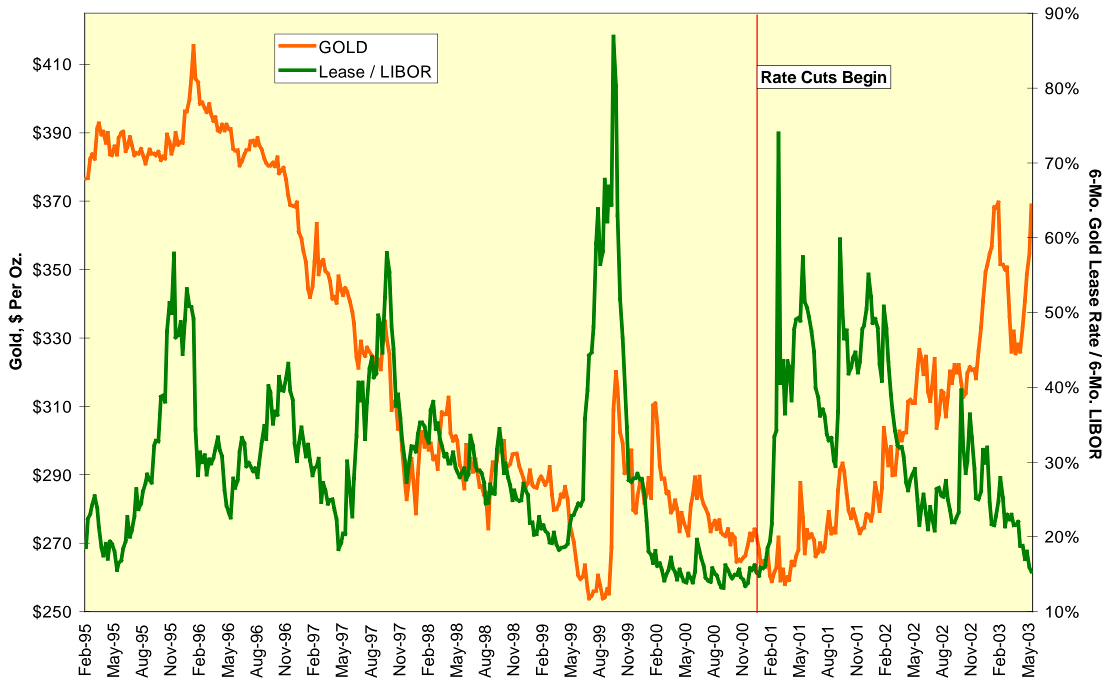
The Dollar Connection

The dollar's present weakness does not stem from any misstatements by Treasury Secretary Snow as much as by the Federal Reserve's aggressive rate-cutting policy, one the bond market finds credible. The inverse relationship between the dollar and the dollar price of gold is strong and historically demonstrable. We have to conclude that if monetary policy continues to be loose and this looseness is not matched by other central banks, the dollar will continue to weaken and take gold higher.



Give Lease A Chance

The demand to borrow gold can be measured by the lease rate, the difference between LIBOR and the gold swap rate. This measure works much like a short interest ratio in stocks: Heavy demand to borrow metal for short sales creates the potential for a future short squeeze. Jumps in the lease rate frequently preceded jumps, albeit short-lived ones, in the price of gold itself.



Lease rates expressed as a percentage of LIBOR have been tracking downward since the spring of 2001, the point at which stocks began to ignore the Fed's rate cutting campaign. Gold prices have continued to track higher, which suggests little speculative interest in selling gold at the recent higher prices. While some could construe this as a negative indicator, such behavior commonly is found at the start of long-term bull markets.

Never Certain

While all three measures appear to support the prospects of higher gold prices, there are no sure things. An aggressive round of rate cutting globally could support the dollar, and if this is accompanied by prolonged price weakness, gold could fall and fall hard. In addition, the bond and gold markets could be deceived by faith in the Federal Reserve much the way the stock market has been over the past three years.

But gold can acquire a security value in a deflationary period as returns on other assets become so small and as faith in governments becomes so shaken as to make gold an attractive alternative. Should this very negative environment emerge, gold could have the same option straddle value as do TIPS. Now there would be an interesting portfolio to bet against long-term price stability: Gold plus TIPS.