Of Gold Bugs And Lead-Heads

As we approach the anniversary of last December's earthquake and tsunami and look back at one of the dominant events of 2005, the large-scale destruction wreaked by Hurricane Katrina, consider how our long-ago ancestors would have interpreted these "disasters of Biblical proportions." They surely would have looked around to find the causes of what surely was divine retribution.

We still engage in this behavior, and probably always will. Currency movements are explained as part of a global morality play. We are lectured tediously how our twin deficits will produce interest rates so high that, in defiance of all known laws of supply and demand, no foreign investors will buy our bonds. And let's not get started on those never-ending stories of how residential real estate is going to be the death of us all. Sodom and Gomorrah will have gotten off easy compared to this impending bust.

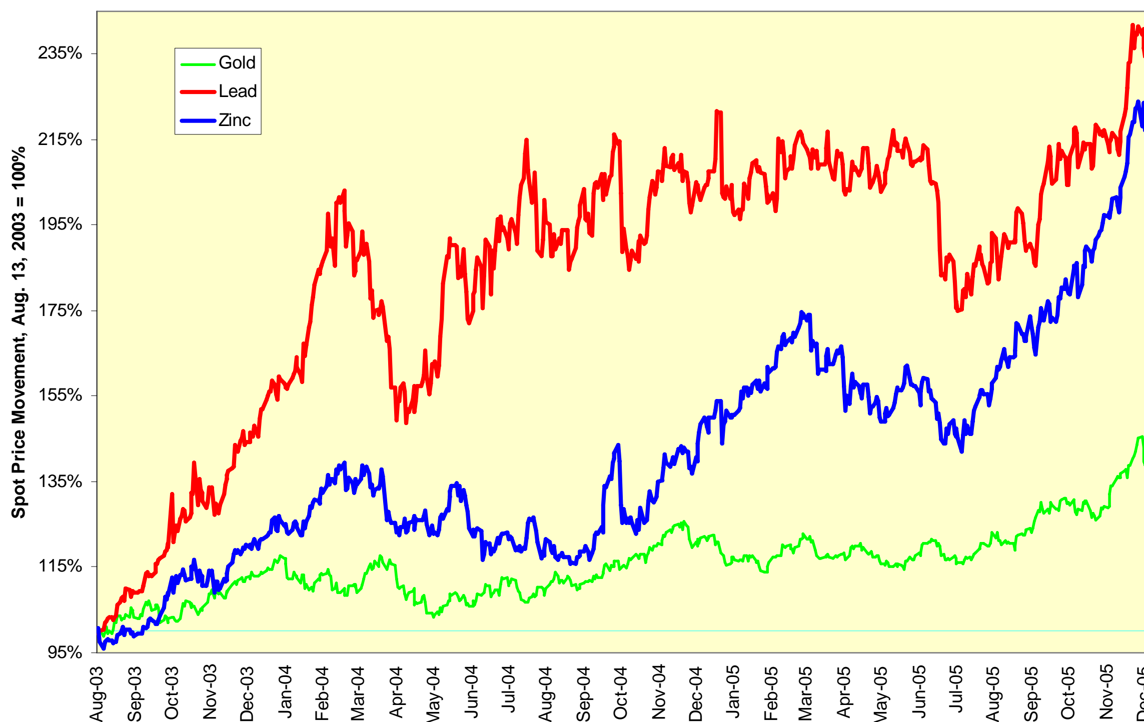
But nothing gets the juices flowing like a rally in gold, a subject last broached here in June in reference to its divergence from the dollar and then again in September in context of its non-relationship with crude oil. Even though the yellow metal hit an intermediate top last week, it is undeniably in a multi-year bull market and looks as if it will go higher after the various interlopers and tourists get scared out of their long positions.

So the question arises, in Biblical tones: What Does It All Mean?

In an answer surely unsatisfying to the gold bugs, it means the supply-demand balance for gold mandates a higher price. That's it. End of story, go home folks, there's nothing to look at. It does not mean impending war, pestilence, famine, hyperinflation, currency panics or a mandatory lifetime pass to Ashlee Simpson's concerts.

In the unkindest cut of all, gold's admirable performance in 2005 pales in comparison to those put in for base metals such as lead and zinc. It we go back to August 2003, the time when the yield curve peaked and began its long march toward inversion, gold has underperformed this pedestrian pair by a wide and growing margin.

Gold Can't Get The Lead Out

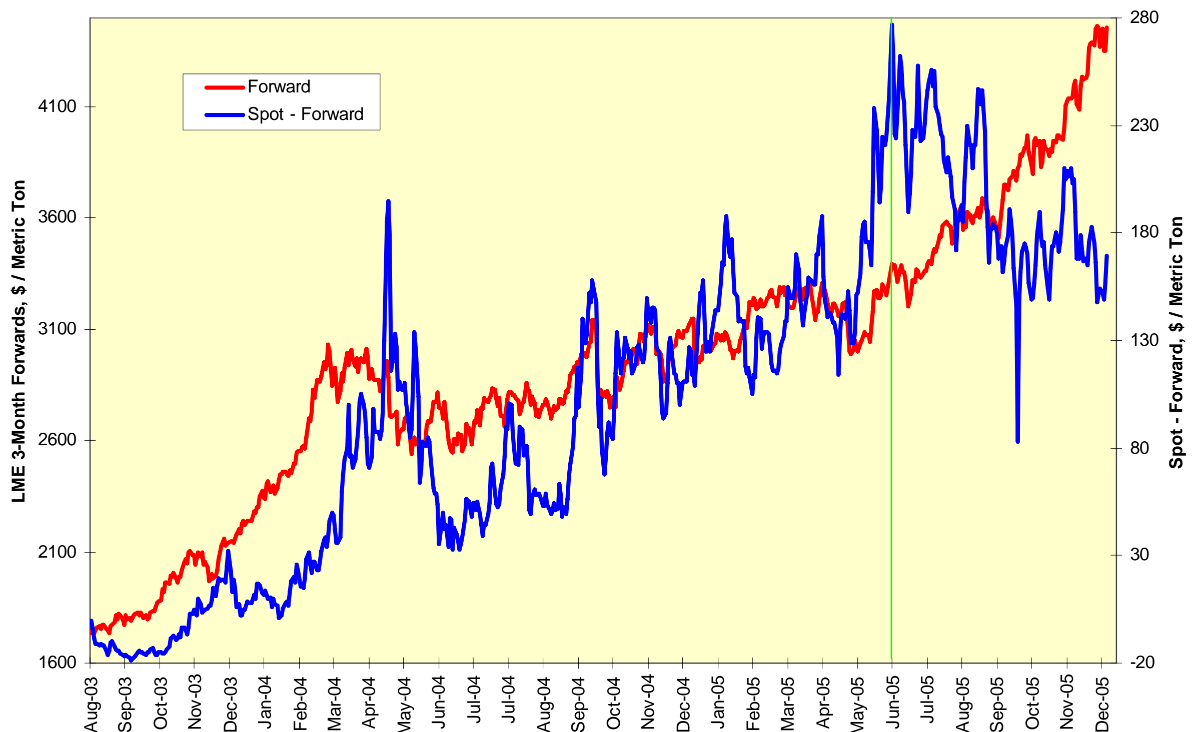


The lead-heads, a cult that follows the metal from smelter to smelter in garishly decorated VW buses, is grinning in knowing agreement. And they have the good grace not to bore everyone with arguments that zinc represents a permanent store of value, etc. Supply-demand imbalances will explain things just fine, thank you.

Base Metal Divergences Continue
Prior to China's emergence as the world's fastest-growing and probably marginal buyer of base metals, which include copper, nickel, aluminum and tin along with lead and zinc, these metals provided excellent coincident economic indicators. There was some hedge fund speculation every now and then, some Russian disruptions of the nickel market every now and then and a global aluminum cartel, but these were pretty much what-you-see-is-what-you-get affairs. Rising metals prices meant a strengthening economy and vice-versa for falling metals prices.

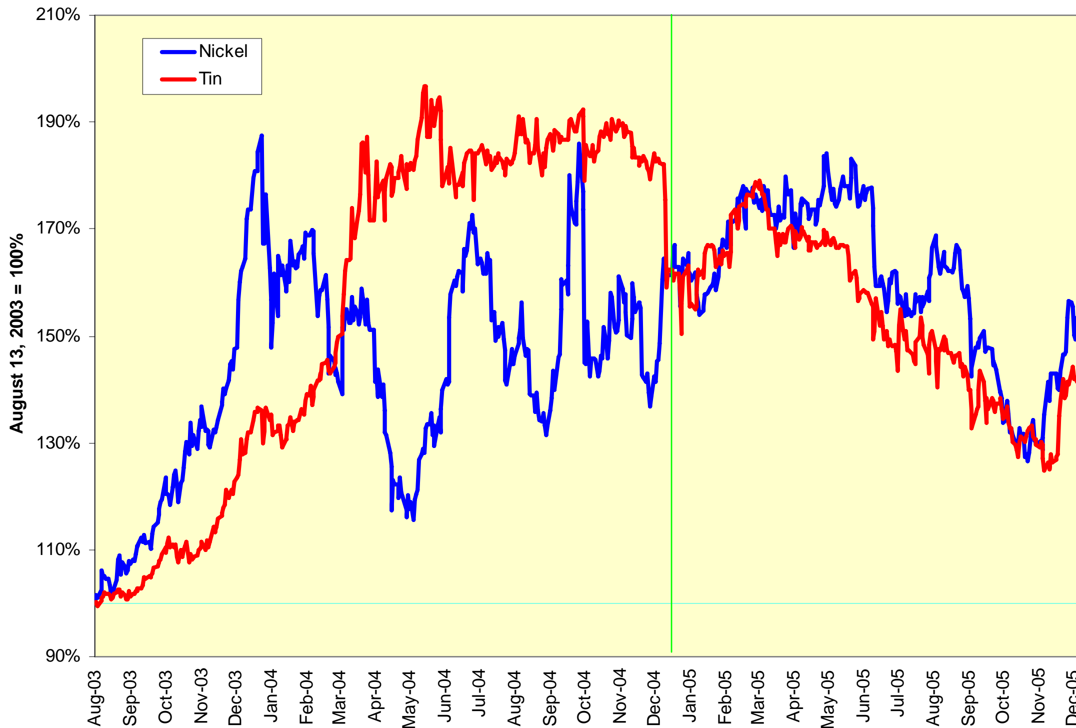
These metals are being swept up in the same long-only commodity index tide affecting just about all tangible exchange-traded commodities, and with the same predictable distortions. Just as the longstanding and theoretically justified relationship between rising crude oil prices and rising crude oil backwardation, or premium of front-month futures to back-month futures, gave way in 2005 to something quite the opposite, copper's forward curve is being distorted in its bull market, too.

Copper Backwardation Breaking At Higher Prices



It is important to note this divergence began in June 2005, well before the highly publicized large short position by a Chinese trader on the London Metals Exchange came to light.

But if it is manipulation and suspicious activities you want, let's put the legendary Inspector Clousseau to shame by taking a look at the most unusual convergence of trading pattern between two absolutely unrelated metals, nickel and tin. Nickel is used primarily in the manufacture of stainless steel and is produced in Russia, Canada, New Caledonia and Cuba, amongst other sources. Tin is used in plating steel and in bronze and is produced in Bolivia and Malaysia amongst other sources. They are not substitutes or joint products. Yet consider how closely their prices have moved during 2005.



They have risen, fallen and rebounded together. This is consistent with - but certainly not proof of - the hypothesis that activities of hedge funds are driving the prices of these two metals more than their actual supply-demand balances.

But what is really interesting is how none of these base metals has its traditional relationship to financial markets any more. If you want to measure credit demands, inflationary pressure or industrial capacity constraints by looking at these prices, you are going to be frustrated.

I rather suspect we can accept this reality for the base metals. We do not need to create myths and portents for their every movement. Why, then, do we devote so much attention to gold?