Gold, Euros And Mattresses

It has been said many European businessmen keep three sets of books: One for themselves, one for their partner and one for the tax collector. Those in the United States who believe income taxes should be replaced with consumption taxes should see how much time and effort Europeans spend on gaming their value-added taxes.

These ancient and less-than-honorable practices were used to explain the euro's nearly continuous descent between its January 1999 introduction and its reversal in the spring of 2002. Dubbed by some the "mattress trade," it held that holders of francs, lira, pesetas, marks, guilders, etc., were swapping unreported cash holdings – cash in the mattress - in these legacy currencies for dollars. Once cash euros were introduced at the start of 2002, the trade would be reversed, selling dollars and buying the newly-printed euros.

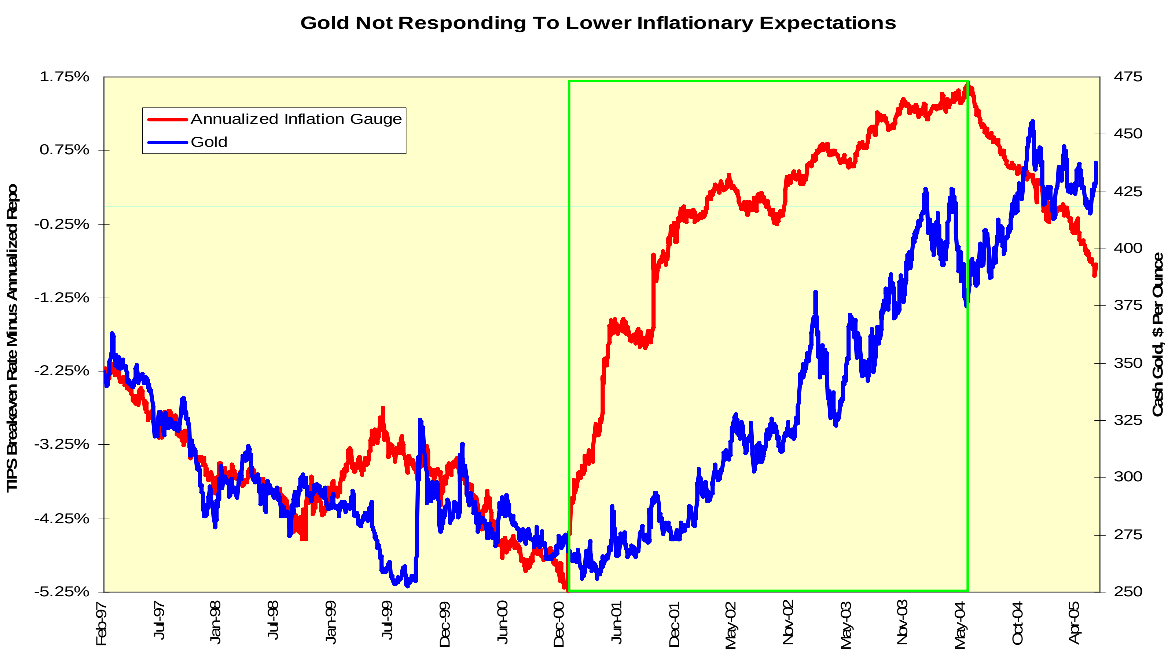
A mattress trade in reverse may be underway today, at least by those good burghers who have yet to buy a waterbed. While the euro is unlikely to disappear from the face of the earth, the last month has exposed some very nasty fault lines in Europe. The reverse mattress trade does not involve swapping euros for dollars, but rather for gold. This may explain one of the many conundrums stalking financial markets at present, why gold has disconnected from normal relationships and is moving higher at present.

A Bull Market, Regardless?

Let's update an analysis from last October on gold and its relationship to the euro and expand on a Columnist Conversation exchange from last week. Gold's fundamentals are surprisingly simple. We should expect it to rise in price under one of two conditions:

1. The expected rate of inflation is greater than the expected short-term interest rate cost of holding it. If these expectations are realized, the nominal price of gold will rise by an amount greater than the foregone interest income.
2. The currency in which the gold is priced weakens. If each dollar becomes worth less, it will take more of them to claim a given quantity of gold, and the nominal price will rise.

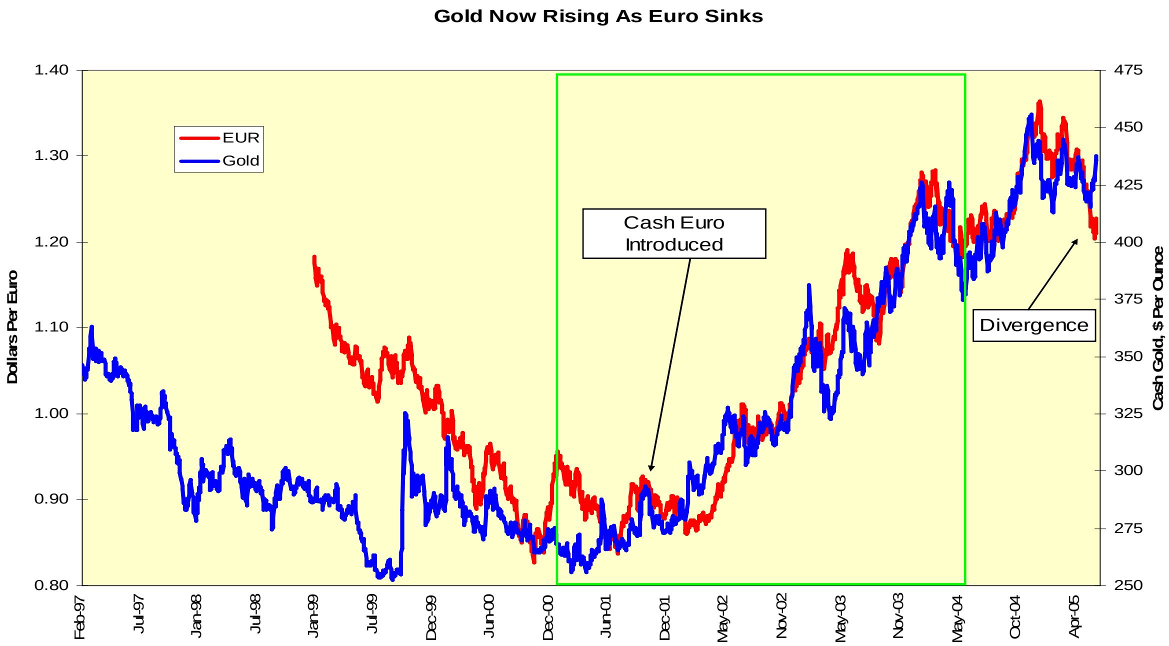
That is it; too many people start howling at the moon and engaging in various forms of religious mysticism when talking about gold. Neither fundamental is supportive at all of higher gold prices at present, yet gold prices are rising nevertheless. If we compare my annualized inflation gauge (AIG, no relation to the insurer), the spread between the rate of inflation implied by the TIPS market less the annualized three-month repo rate, to the price of gold, we see that this measure has been decidedly unfriendly to the gold market since the start of 2005.



The Federal Reserve's grand experiment in rate-cutting is highlighted on the chart. Prior to January 2001, the AIG and the price of gold matched each other into the start of 1999 and again after October 1999. The divergences in between were related to European central banks selling gold to meet the European Union entrance requirements; the big jump in gold prices in September 1999 was the Bank of England's surprise decision to end these gold sales.

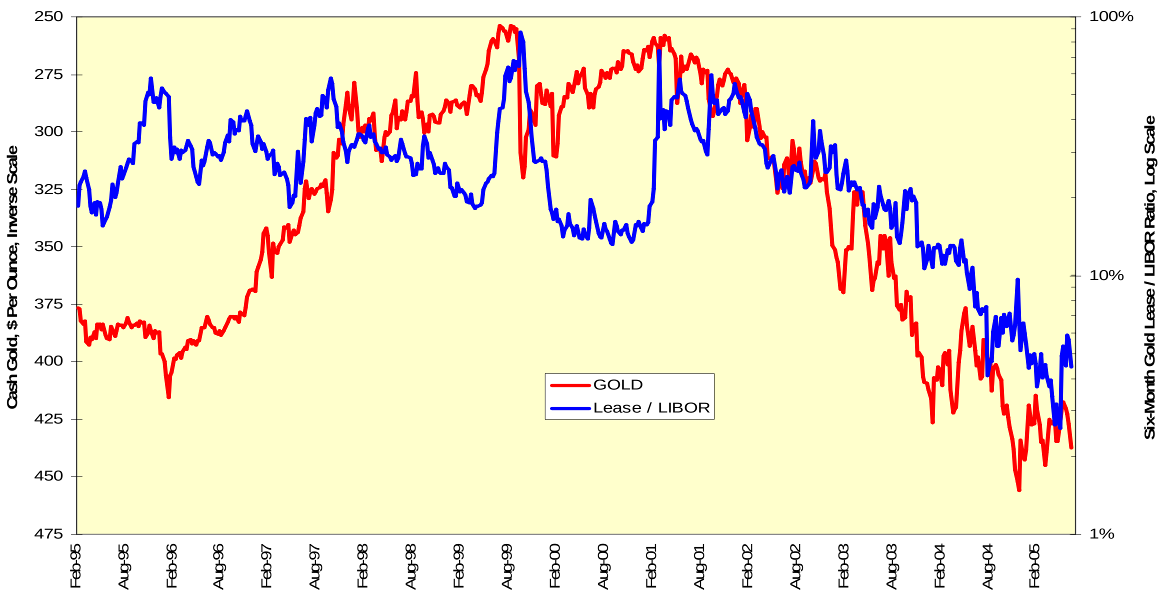
Once U.S. interest rates fell, the AIG rose rapidly and led the price of gold higher. No surprise here; this is exactly what should have happened. Once the Federal Reserve started to raise rates with considerable patience over a measured period or whatever it is they are doing now, the AIG started to fall and has yet to stop.

Gold prices rose on the force of a weaker dollar overwhelming the AIG. If we compare the dollar price of gold to the dollar price of a euro and highlight the same rate-cutting period, we see how the euro fell far more than did gold prior to 2001. Once the rate cuts began and in particular once cash euros were introduced, gold and the euro were joined at the hip. Until recent weeks: Gold has gained as the euro has fallen.



Can the divergence be explained by the favorite whipping boy of gold bugs when things do not go their way, central bank gold sales or leases? In some measure, yes: If we plot the ratio of the six-month gold lease rate as a percentage of six-month LIBOR against gold plotted on an inverse scale, we do see a recent uptick in lease rates. While this and other recent up-ticks, such as the one in November-December 2004 coincide with price increases for gold, we do have to keep in mind that the four-year bull market in gold has been accompanied by ever-declining lease rates. The gold bugs who cry "manipulation" from their black helicopters never let the facts get in the way of a good conspiracy theory, do they?

A Minor Uptick In Gold Lease Rates



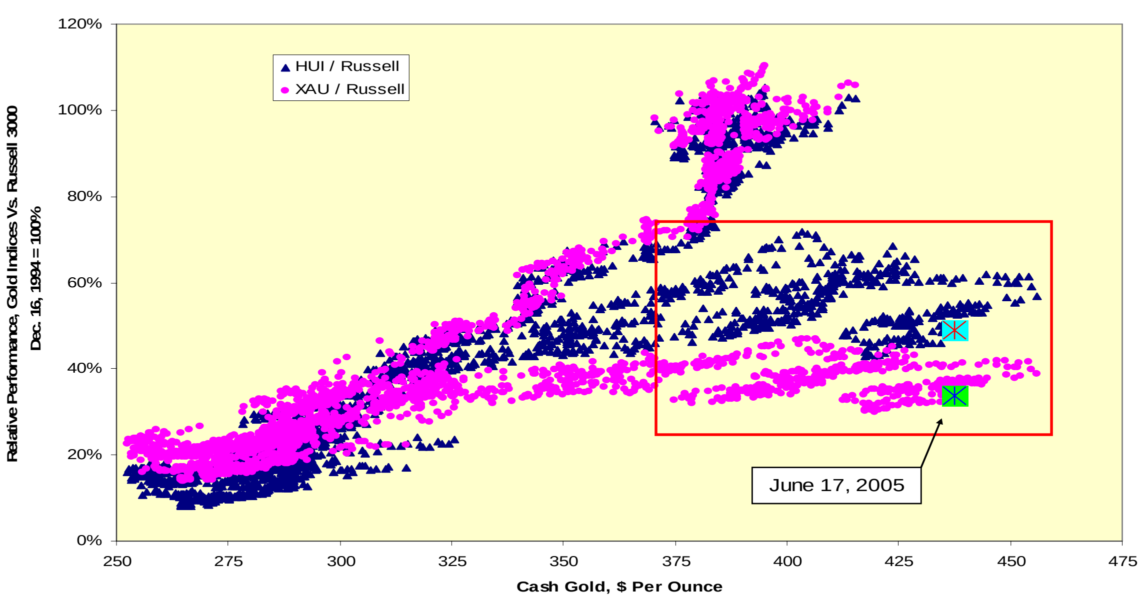
Review The Bidding

The euro has fallen from 1.2585 on May 27th to 1.2286 on June 17th, a decrease of 2.4%. The AIG has fallen from -0.65% to -0.80%; properly measured, this 15 basis point decline is a decrease of 22.7%. Gold lease rates as a percentage of LIBOR have declined 2.73%. And yet cash gold prices have increased 4.3%. The one event capable of explaining the divergence of bullion from its fundamentals is a willingness of euro holders to swap euros not for dollars – *sacre bleu!* – but for gold. Gold has been known to rise in such times of uncertainty, so how much of a stretch is this? Reverse the mattress, and in a fit of Gallic pique, tear off the tag under penalty of law.

Gold Stocks

Gold and gold stocks are two very different things. Let's conclude by demonstrating how these stocks have underperformed their alternative of simply buying and holding a broad measure of the U.S. market, the Russell 3000, during the recent rally. Two gold indices will be used, the Philadelphia Exchange's Gold & Silver index (XAU) and the AMEX' Gold Bugs index (HUI). The latter only includes stocks of firms who do not hedge their production forward past 18 months.

Gold Stocks Underperformed Bullion After Rate Hikes Began



The chart highlights the data points since May 2004, the start of the Federal Reserve's rate hike campaign and the last two data points of both relationships. As gold prices have risen, neither gold index has outperformed the Russell 3000. If you want to trade gold, trade gold. Gold stocks are not a substitute.