Gold Should Lose Its Midas Touch

The money supply is either stagnant or declining, depending on how you measure it, in spite of a 1% fed funds rate here in the U.S. and aggressive interventions on behalf of the dollar by other central banks. The year-over-year growth of M2 is down to 4.5%, just above the 4.3% growth of GDP. So, I thought I should check my own money supply to see how things were holding up.

The quantity is doing fine, I am pleased to report, but I am interested in quality as well. So, I pulled a $1 bill out of my wallet and checked the design on the back carefully to see whether those redesign maniacs at the Treasury, the same ones who keep enlarging Andrew Jackson's head, had messed with the Great Seal on the back. No: Underneath the unfinished pyramid with the disembodied Eye of Providence is the Latin motto, *novus ordo seclorum*, meaning "A new order of the ages." By the way, the history of the Great Seal is an amazing one; you can read about it here.

Whither Gold?

The timing of this inquiry was propitious, no doubt, for the nature of the FOMC's policy pronouncement last Wednesday rightfully may be construed as the first step of a secular change in monetary policy. It was a warning to the carry traders and others who have been feasting on cheap credit to get their affairs in order if they care anything at all about their next of kin.

Gold, interestingly enough, anticipated this change by nearly two weeks. Cash gold hit its intraday high on January 6, shortly after Fed Governor Bernanke's New Year's weekend speech interpreted by many as a promise to continue pumping out money regardless of the consequences, and has been in retreat since January 12th. The euro hit its high against the dollar on the same day; the linked movements are hardly coincidental.

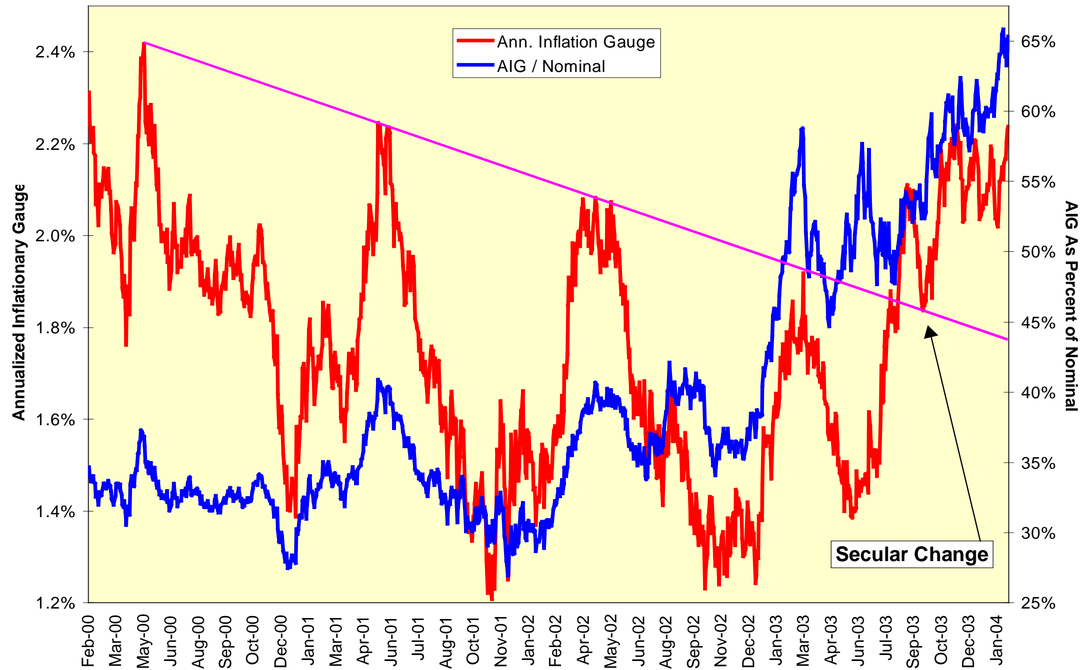
Gold is an exquisite barometer of monetary policy. Its movements depend on both the exchange value of the dollar as well as on the relationship between short-term interest rates and expected inflation. Let's revisit an analysis of the gold market from last May, when talk of deflation was upon the land, to see where the gold market may be heading now.

Now, as then, I will begin by taking an annualized yield spread between two Treasury notes with similar maturities, a 4.25% TIPS due January 15, 2010, and a 6.5% note due February 15, 2010. As is always the case with TIPS, please be mindful of their two embedded long options, one on the higher all-urban consumer price index, and one on deflation itself: Should deflation materialize, the principal of the TIPS at maturity will not be adjusted downwards.

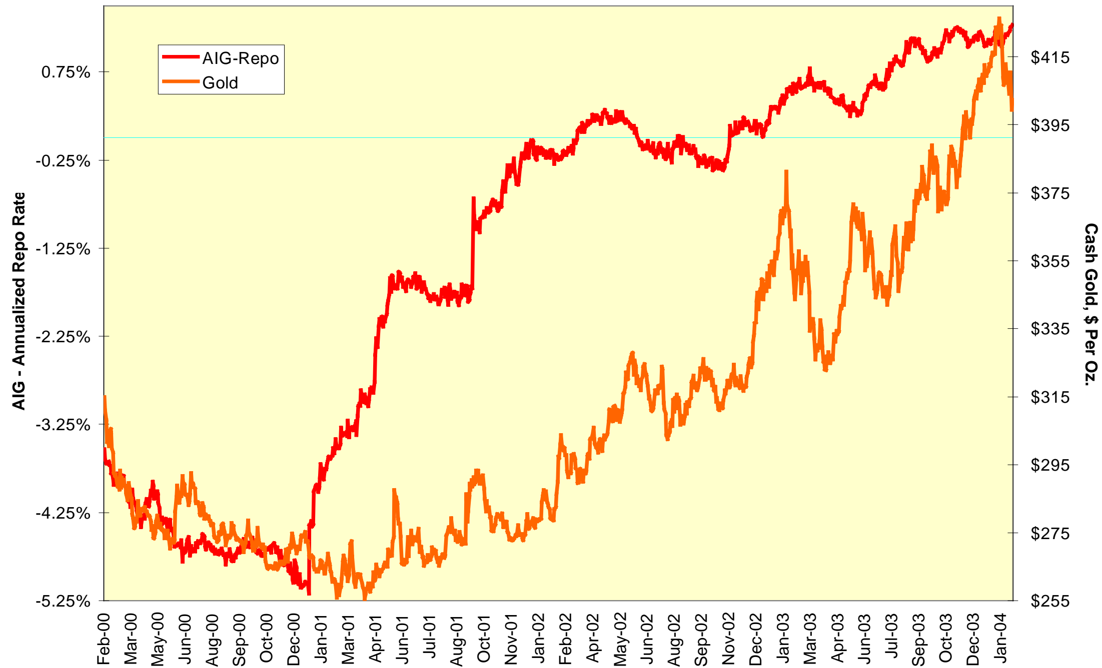
In addition, while the maturities of these two notes are nearly equal, their risks are not. The TIPS has a modified duration, or percentage-price change for a given change in yield of 2.65, while the regular note has a modified duration of 4.95. You would need to trade 10,000 TIPS to have the same risk as 5,354 normal notes.

The annualized inflation gauge derived from this spread, which I dubbed the AIG, had been making a series of lower high from May 2000, the date of the Fed's last and most ill-considered rate hike of the 1999-2000 cycle, to July 2003. It then broke higher out of this downtrend, retested it in late September 2003, and then began moving higher. Moreover, the AIG as a percentage of the 6.25% note's yield has continued the climb it began in late 2001. On the surface, this looks to be nothing more than a continuation of gold's strong fundamentals.

A *Novus Ordo Seclorum*?

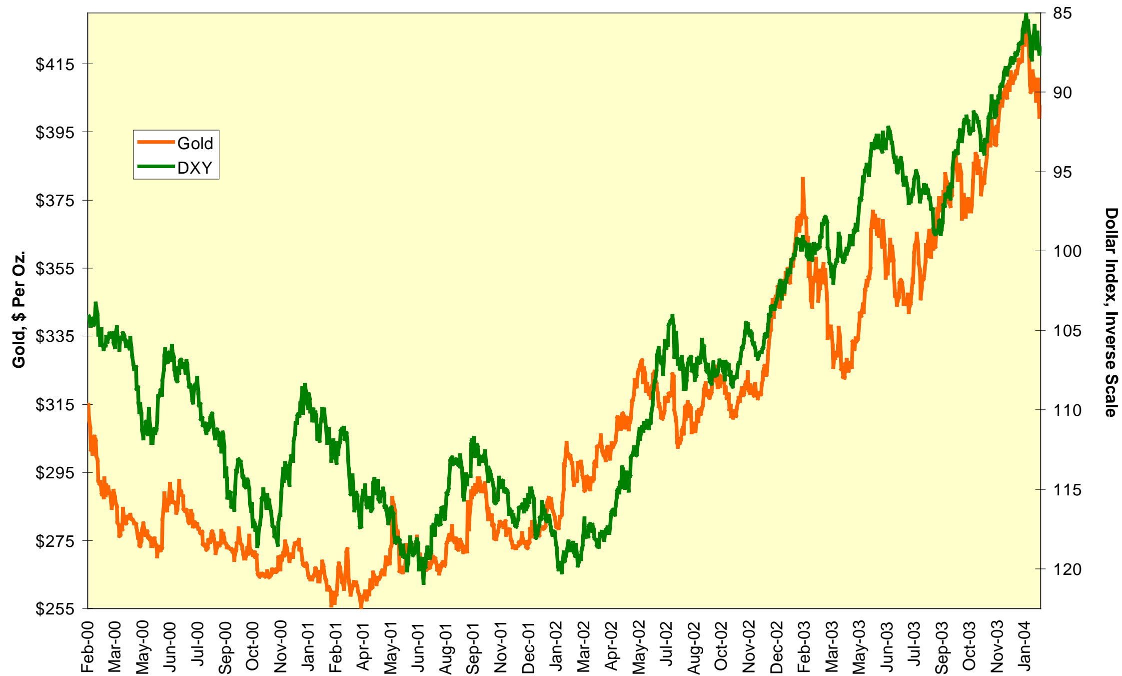


However, gold trades not off of inflation alone, but off of the spread between expected inflation and the short-term cost of carry, which will be represented by the annualized three-month repurchase rate. Here the picture starts to look different. Even though the spread between the AIG and the annualized repo is 1.28%, the highest in the history between these two notes, the rate of growth clearly has stalled. Any increase in short-term rates will contract the spread sharply and place downward pressure on gold.



Bucking The Trend Of The Buck

Some correlations are spurious, while others walk up to you and introduce themselves with a flourish. The latter is the case for the dollar and gold; more dollars lowers the value of each one in relation to both gold, an absolute standard, and to a basket of foreign currencies, a relative standard.



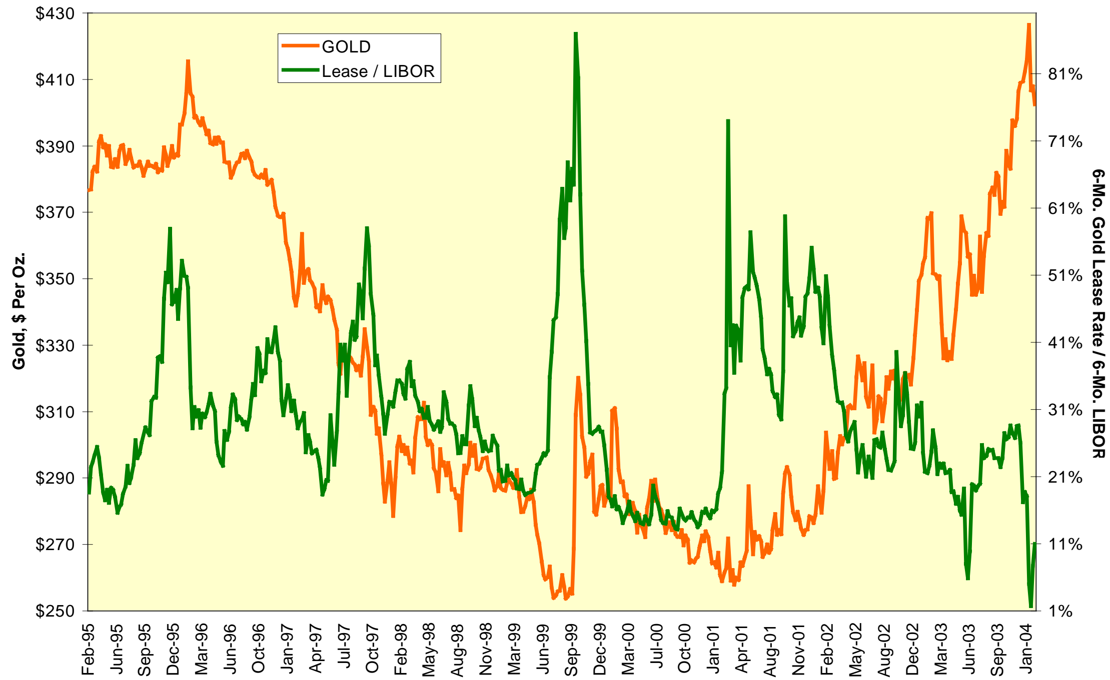
If the Fed starts to tighten credit and foreign central banks end their manic interventions on the dollar's behalf, it will not take a great deal of imagination to see a reversal of both trends. This will be true unless - and this is a very important unless - expected inflation rises at a faster pace than short-term interest rates do.

A New Lease On Life

Just as stocks have their negative indicators such as the VIX, put/call ratios, short interest and advisor sentiment, the gold market has the lease rate. This is the difference between LIBOR and the gold swap rate; heavy demand to borrow the metal for short sales creates a future demand to cover those shorts. Jumps in the lease rate often precede jumps in the price of gold itself.

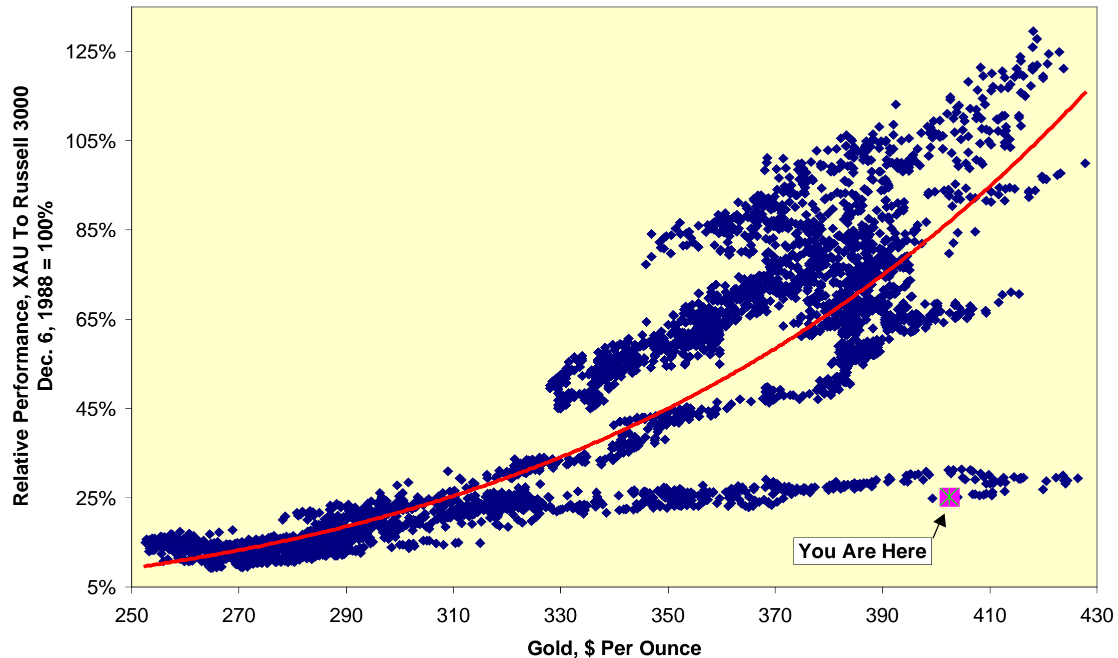
Gold lease rates plummeted into early January, and even though they have since rebounded slightly, they remain at multi-year lows. Sellers basically have backed away from the market, a condition associated commonly with a capitulation top.

Gold For Lease. Cheap.



Gold Stocks

The stocks of commodity producers relative to the market as a whole often trace the path of a call option on the underlying commodity. We expect them to rise earlier and faster than the commodity itself, and then fall more slowly when the commodity price itself falls as the producers close down higher-cost facilities. This was the case for gold stocks for years.



The recent rally in gold has provided an exception to this expectation, however. The Philadelphia Gold & Silver index' performance relative to the broad Russell 3000 has failed to match the move higher on bullion prices. These stocks have been major underperformers during the biggest gold rally in more than two decades, which confirms once again that if you want to trade commodities, trade commodities, and not commodity-linked equities.

Oh, that phrase *annuit coeptis* on the Great Seal translates to "God has favored our efforts." I doubt that will buy you much time with your compliance department or risk managers, so if you are planning on going short gold, use a buy stop.