Is Gold That Precious?

In early 1998, more than 18 years into gold's two-decade bear market, the question was posed whether the yellow metal would ever see $500 per ounce again. "Ever" is a very long period of time, and thus it was difficult to answer in the negative. The inquirer was reminded how a bond investor in 1981, a time of 16% interest rates, would wonder if bond yields would ever see the south side of 6% again, let alone the sub-4% levels they hit as recently as last year.

By late November 2005, gold was knocking on $500's door and being invited in for a cup of coffee. Was this move justified by common market indicators? And if it was justified given what we will see below, what does it imply for tomorrow's gold traders?

Gold's most perverse attribute is its low level of final consumption; some would even call it useless and no less than John Maynard Keynes referred to it as a "barbarous relic." Nearly all the gold ever mined is still visible above ground in vaults, artwork, jewelry and coins. Gold, unlike other metals, is fairly inert; it does not corrode. Its high value encourages the recycling of gold from its use in electronic components. And gold is rare; holders of bullion seldom have to be concerned with new supplies flooding the market.

More important, gold always had two powerful financial factors working on its behalf. The first, and most important, is the tendency of central banks and governments to repudiate their debts and lubricate social stresses through inflation. The second factor, certainly related to the first, is the abuse by the U.S. of the dollar's role as the world's reserve currency. More than once since the collapse of fixed exchange rates in the early 1970s has the U.S. engaged in a deliberate policy of dollar devaluation, usually in an ultimately failed attempt to narrow the American trade deficit.

All of these factors combine to make gold a static asset against which highly dynamic financial markets can be measured. Gold bugs take the matter one step further and view the metal as the ultimate report card on government policies. If gold prices are rising, they reason, inflation is rising or the dollar is falling, or both. And since gold is likely to outlast all human creations this side of the Pyramids, it will be a good asset to hold when something gold bugs call The Fan turns on and starts blowing all sorts of things at us.

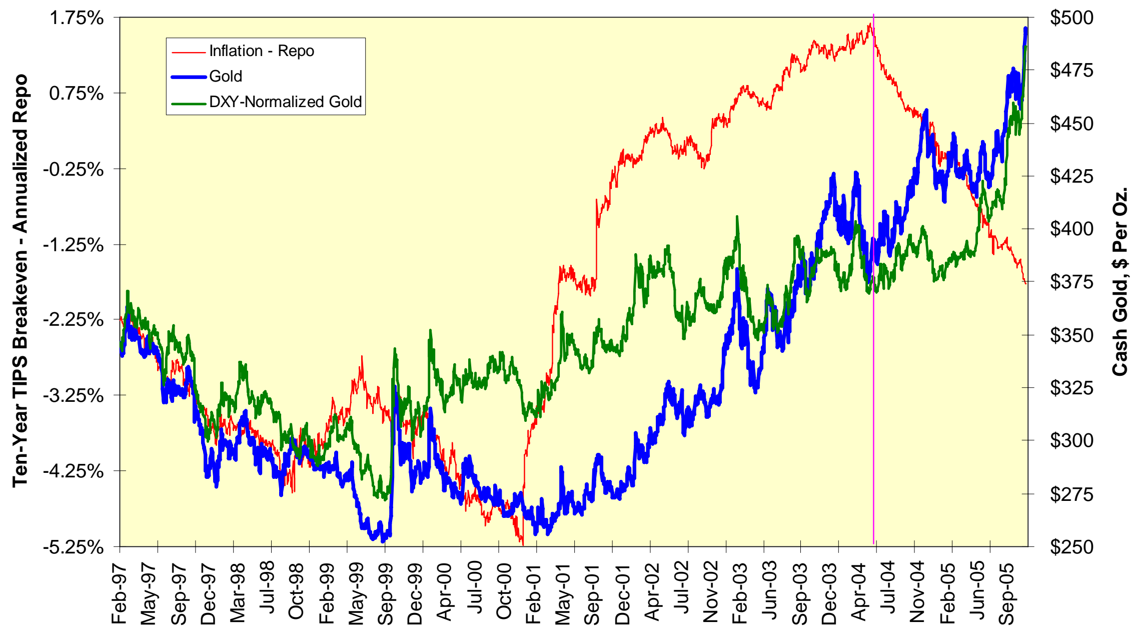
The Two Key Relationships

We can strip gold of all its mystical content and treat it simply as a commodity driven by two key relationships. First, gold's static absolute value should mean it will rise in price if the expected rate of inflation is greater than the expected short-term interest rate cost of holding it. If, for example, expected inflation is 5% per year, one dollar today should rise in price to $1.05 a year from now. If we tie money up in gold and do not earn, say, a 4% return on Treasury bills, it would still make sense to buy gold: The $1.05 price a year from now would exceed the equivalent $1.04 in Treasury bills. If, however, short-term interest rates rose to 6%, the case for gold gets much weaker. The return on paper now exceeds the return on gold.

Prior to the introduction of inflation-protected Treasury bonds (TIPS) in 1997, it was difficult to ascertain exactly what inflationary expectations were. This is no longer a problem; we can subtract the TIPS yield from the Treasury note yield of equivalent maturity. That breakeven rate is the market's assessment of what the Consumer Price Index is going to average over the period. As an aside, if you feel the CPI understates the inflation in your personal life, ask if you believe the TIPS' market assessment of this selfsame CPI. In late November 2005, it stood at 2.37%.

If we subtract the short-term interest rate, here the annualized 3-month repo rate, from the TIPS breakeven rate, we get a measure that should lead the price of gold by the mechanism described above. As we can see in Chart 1, this leading relationship worked quite well between 1997 and the time the Federal Reserve started raising interest rates in 2004, marked on the chart with a vertical line. The net of expected inflation less short-term interest rates shot higher in early 2001 and led the price of gold both in dollar terms and in prices adjusted by changes in the dollar index (DXY).

Chart 1: Gold Is Rising Faster Than Net Inflation



After the Federal Reserve started raising rates, the relationship changed and changed dramatically. The net inflation number started to fall steadily while gold broke to prices not seen since the aftermath of the 1987 stock market crash. This demands explanation.

The first and most logical answer that springs to mind is the TIPS market may understate actual inflation. TIPS are a complex instrument. Not only is their principal linked to the CPI and not to some more exotic and possibly higher measure of inflation, but this principal is subject to "phantom" taxation. The Treasury continuously adds the CPI accrual to the principal of the bond, which you will not see until either maturity or when you sell the bond, but it taxes you as if you received that adjustment as ordinary income. This makes the bond worth less and raises its yield accordingly. The higher TIPS yield then produces a lower breakeven rate of inflation.

Related to this issue are two call options embedded in the bond. The first is how the Bureau of Labor Statistics calculates the CPI and what their motivations are. We will skip the mechanics of CPI calculation for now, but the motivation issue demands comment. You do not have to be a conspiracy buff to realize many government payments ranging from Social Security to various labor contracts are indexed to the CPI. If you are in charge of calculating the CPI and you have an actual monetary interest in seeing a lower number – not to mention political interests – you have a conflict of interest. We have enough examples in recent years of corporate accounting chicanery to realize this could create problems. As James Madison noted and many of the female persuasion might agree, "Men are not angels."

The second call option is on tax rates. We do not know what tax rates will be over the next ten years, but it probably is not wise to bet on them being lower. A buyer of TIPS today has to be compensated for the risk of higher tax rates on the phantom income. This, too, pushes TIPS yields higher.

The second answer to the net inflation conundrum is one of mixed expectations. Yes, short-term interest rates were rising, but did traders expect them to rise faster than inflation? The Federal Reserve moved at its famous "measured pace," but gold buyers judged that pace too slow to squelch future inflation.

The Dollar And Gold

Related to the question of whether the Federal Reserve found itself behind the curve on inflation is the course of the dollar over this period. All else held equal, we should expect a combination of lower expected inflation and higher interest rates to support the dollar. And if each dollar is worth more, we should expect the dollar price of gold to be less.

In fact, this relationship, seemingly straightforward, works much less regularly than we might imagine. If we compare in Chart 2 the price of gold to the dollar index plotted inversely over the same 1997-2005 period used in

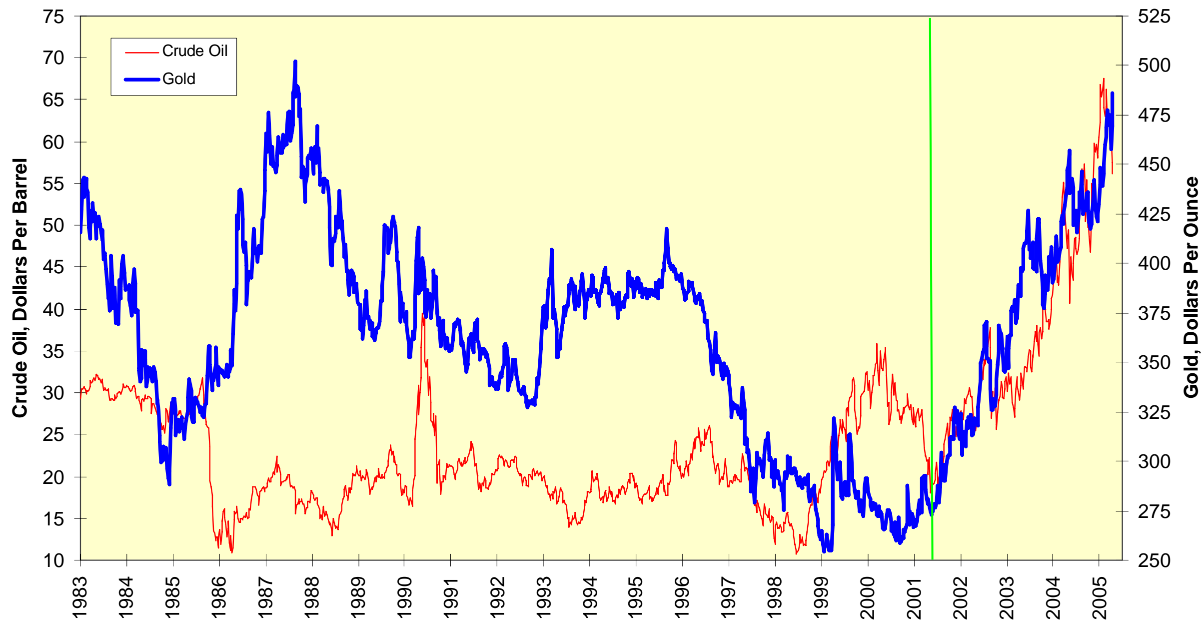
Chart 1, we see how the dollar and gold really only moved together during the 2001-2004 low-rate era. While the dollar firmed during 2005, the price of gold did anything but fall as expected. At the time of this writing, the DXY rose 13.84% while the cash price of gold *rose* an almost-equal 13.14%. So much for the argument of gold being a hedge against a weak dollar! The dollar's strength in 2005 gives us no reason to believe the Federal Reserve should have been more aggressive in raising rates; besides, we have no idea what other problems higher short-term rates might have caused.

Chart 2: The Gold-Dollar Relationship

Forget About Crude Oil

Let's take a few minutes to address one of the most common misconceptions in the world of commodities, the relationship – or more properly the complete lack of a relationship – between gold and crude oil. As we can see in Chart 3, the two commodities have been rising together since mid-2001. No argument there. But for a relationship to be valid and predictive, it must exist at all times and under all circumstances. The longer-term history going back to the advent of crude oil futures in 1983 – gold did not trade freely until the mid-1970s, and crude oil prices were administered by one cartel or another until the early 1980s, so longer-term comparisons are somewhat meaningless – shows many periods where the two markets are anything but related.

Chart 3: Oil-Gold Correlation Not Constant



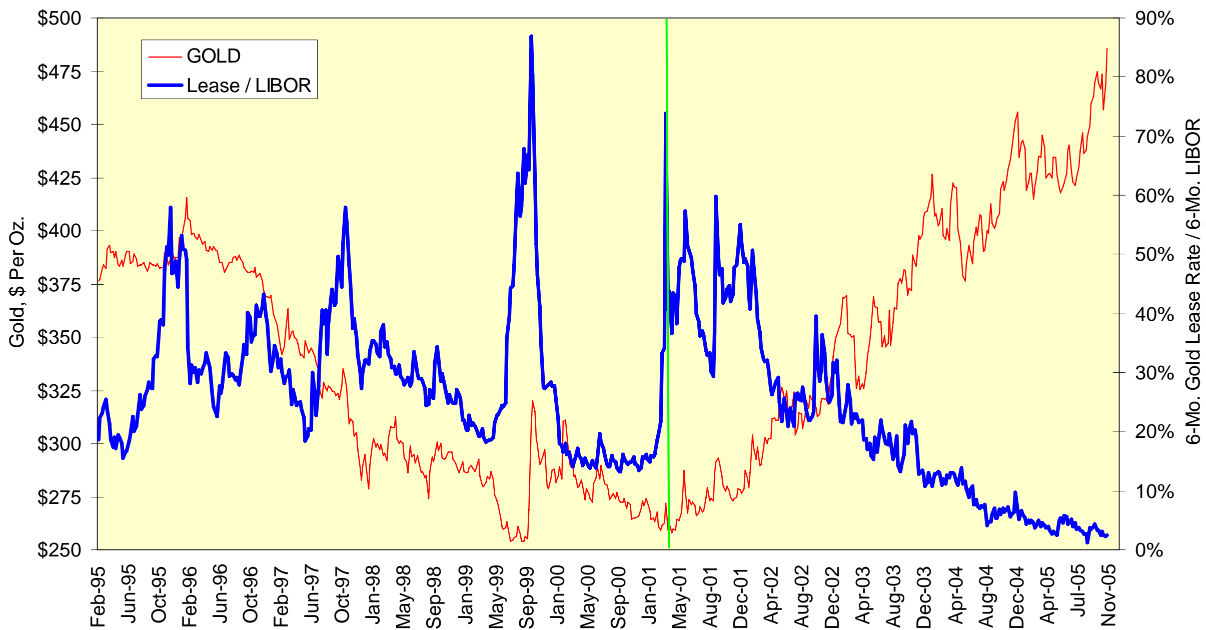
Attempts to explain the problem of non-correlation away only makes it worse. For example, let's take the mid-1980s period when crude oil collapsed and gold prices shot higher. Aha, you say, the reason is simple: As crude oil prices fell, the Federal Reserve felt it could lower interest rates and drive the dollar lower, and both of those helped push gold prices higher. And therein lies the rub; the financial factors of interest and exchange rates which affected gold in the 1980s and are not affecting it the same way today, had no effect on crude oil prices. If two markets are not driven by common factors, any common behavior observed between them is anecdotal and nothing more.

The Lease Market

What about good old-fashioned scarcity? Just as trust banks and stock loan departments make money by lending shares to short-sellers and arbitrageurs, central banks have made money by leasing their gold reserves to various traders. This leasing has spawned a cottage industry of conspiracy theorists who see nothing but sinister motives behind both the central banks and the ink-stained wretches who write about gold on occasion.

As short-sellers always discover sooner or later, someone comes along to squeeze them in a most indelicate manner. As Chart 4 depicts, several of the modest bear market rallies in gold during the 1990s were preceded by upturns in the lease rate; here the lease rate is divided by LIBOR to express it as a percentage of prevailing short-term interest rates. After the mid-2001 start of the gold rally, lease rates as a percentage of LIBOR fell as gold prices rose. Once again, we have a reversal of historic relationships that worked for gold.

Chart 4: Price And Lease Rates Moving Inversely



Closing The Ring

Let's review the bidding. Gold is rising in the face of lower net inflation, a stronger dollar and declining lease rates. This is sort of like the sky getting dark as the sun rises higher in the sky. Experienced traders know that when a market does not do what it is supposed to do, it is to be respected. A stock selling off on bad earnings is expected; when a stock rises on poor earnings, you had better find out why.

One by one, the reasons behind the gold rally peel away. We could ask industry sources about the physical supply/demand balance for the metal, and they will tell you that physical demand, particularly from India and the Middle East where gold is valued as a store of wealth, is rising faster than supply. This is all well and good, but these supply balances always have been in gold's favor. Have you ever seen any bearish balance sheet for gold, even during its 20-year bear market?

Moreover gold is a commodity. If newly-wealthy Indian households want to sell rupees for gold, great, but each rupee is now going to buy less metal. And miners are going to have every incentive to develop the lowest-grade and highest-cost ore bodies to eke out additional supply.

Can the growth of long-only commodity index funds explain part of the rally (see "*Long-Only Commodity Indexes Fall Short*," August 2005)? Yes, in part, and by the same mechanism and with the same consequences as noted for our hypothetical Indian buyers. If anyone keeps buying and holding any asset without regard to fundamentals, prices disconnect from reality. In stocks and in real estate, we call this a bubble. In gold, we look around us to find fault with government policies.

In the end, gold can go up in price for as long as people keep buying it. Like fine art or other collectibles, do not try to analyze the market for fundamentals or for related developments. Higher prices attract buyers in gold just as they did for tech stocks in 1999 – or for gold in 1979-1980. Neither market had a pretty ending.