Aren't You Precious

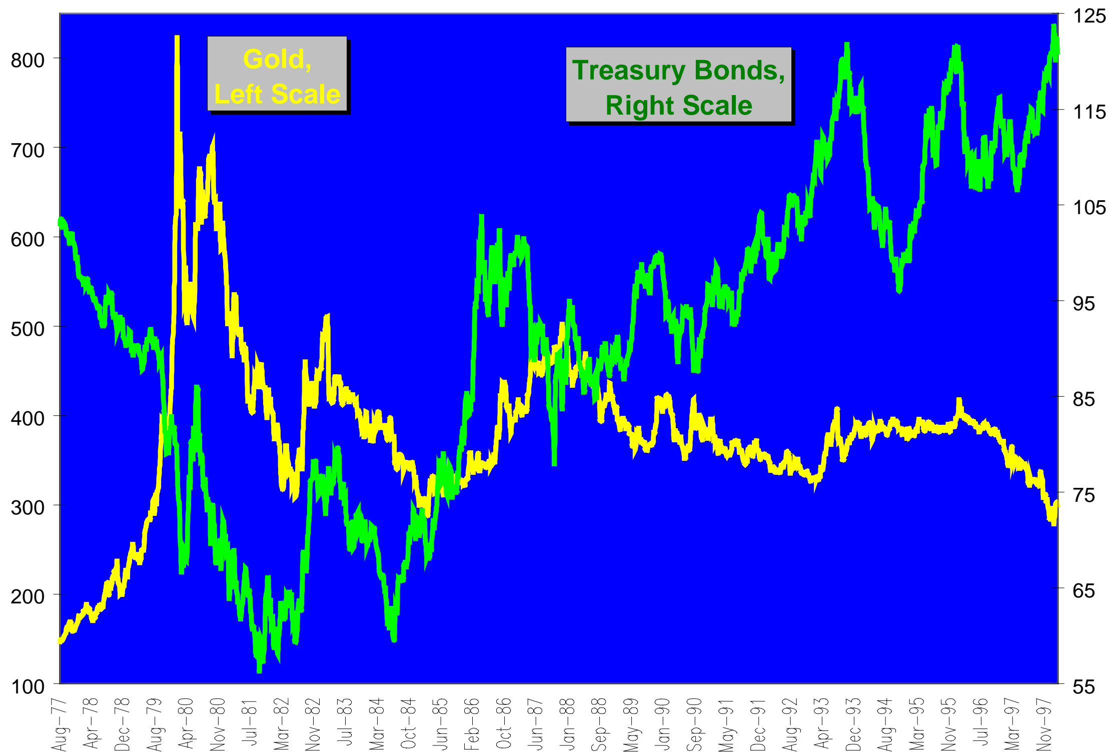
Phrases like "world's oldest…" immediately alert the reader to interesting material ahead. Such as "the oldest word in continuous use in English is 'gold'." No other commodity has exercised such a grip on the human mind, always and forever.

Once consigned to the status of a "barbarous relic" in the world monetary system by no less than John Maynard Keynes, gold soared in both price and prominence during the inflationary 1970s. In fact, it was the de-linking of gold and the dollar and the destruction of the Bretton Woods fixed-exchange rate system during the 1968-1973 period that helped create inflation; central banks had no idea of how to manage the money supply, and rather than admit their ignorance, they kept on expanding the supply of world liquidity.

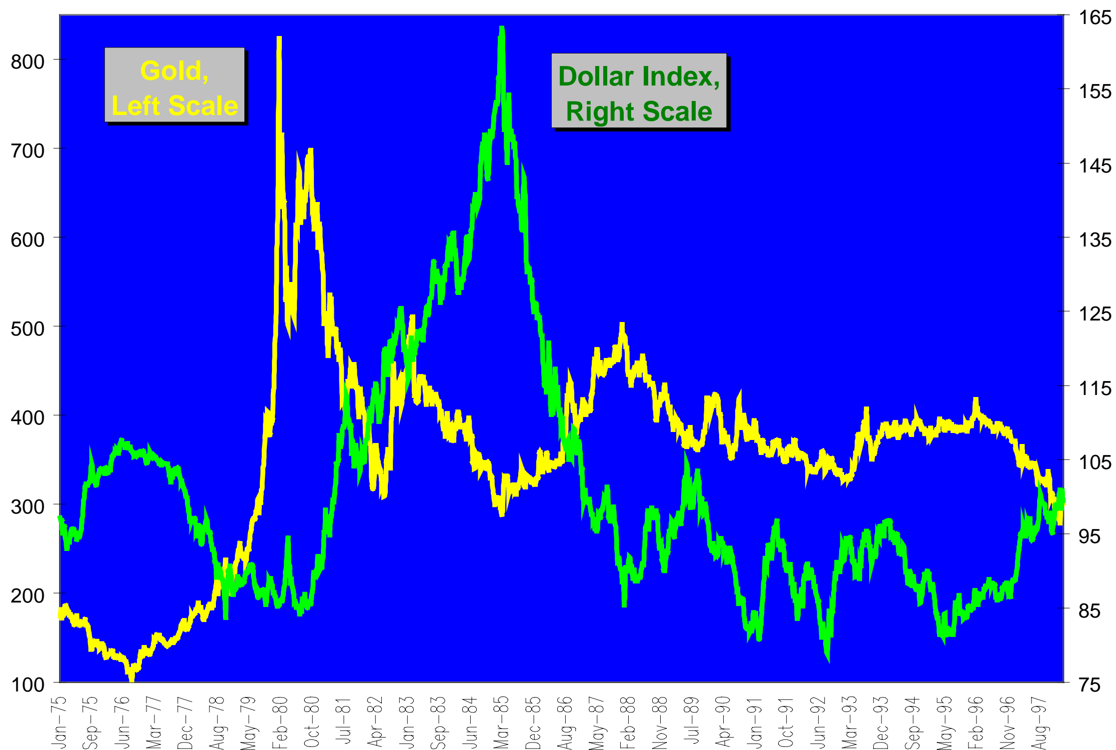
By the mid-1970s, gold acquired a near-religious significance among those appalled by this grotesque economic mismanagement. Anyone who thought that inflation would continue rising, or that the dollar would continue falling, or that malaise would remain the political war-cry du jour could express his opinion by buying gold. It seemed like a good idea at the time, even though the chart below is enough to bring tears to Krugerrand owners everywhere.

The logic behind owning gold, or any other physical commodity, is simple, and it has nothing to do with the specious notion of a natural return on commodities (see "A Positive Roll Model," *Futures*, September 1997). So long as the expected rate of inflation exceeds the cost of holding gold, which is short-term interest rates plus relatively modest storage costs, the owner can realize a nominal profit before inflation and taxes. It also assumes that the purchasing power of the currency relative to other currencies remains stable, that alternative investment opportunities are not offering attractive returns, and supply and demand remain in relative balance.

All of these assumptions have collapsed since 1980. First, the determined efforts of the last two Federal Reserve chairmen, Paul Volcker and Alan Greenspan, to wring inflation out of the economy have been successful to the point where serious discussion over deflation, an insufficient rate of monetary growth relative to aggregate demand, is part of the financial landscape. The strongly inverse relationship between gold and Treasury Bond prices – and the leading nature of gold prices to interest rates – is seen in the chart below. Moreover, the fundamental relationship is unequivocal: Long-term interest rates can decline only when inflationary expectations decline, and these expectations easily can decline below the short-term interest rate cost of holding gold.



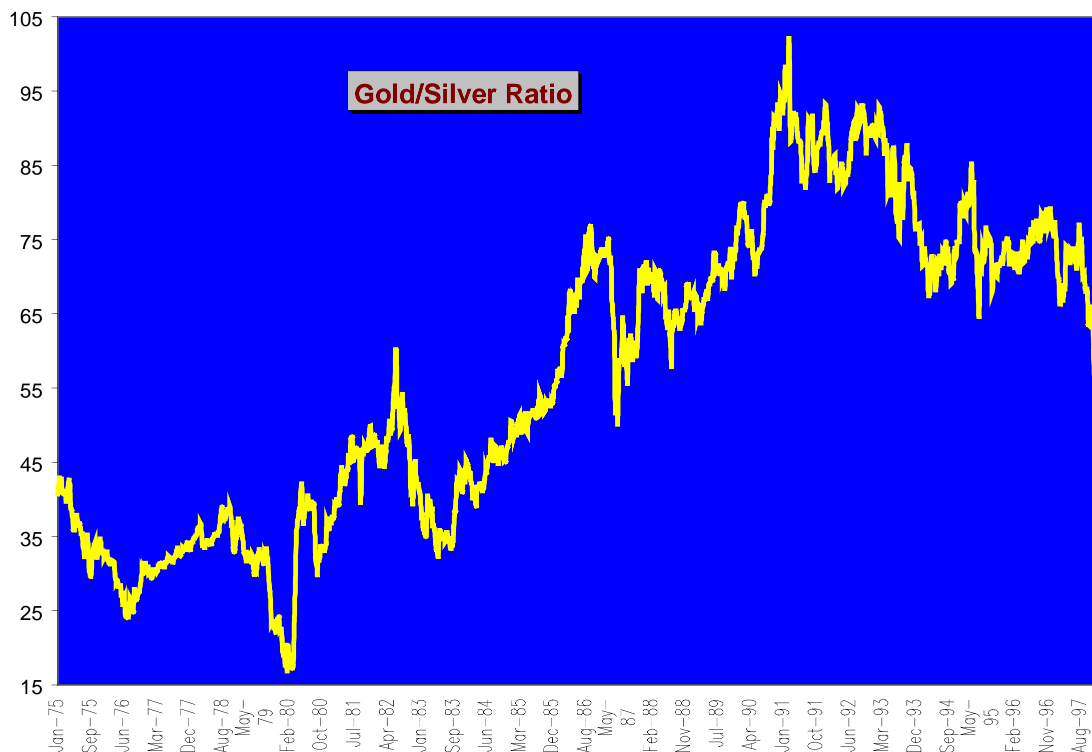
The relationship between the dollar and gold is more complex, as seen in the graph below. The combination of high interest rates and a strongly stimulative fiscal policy in Ronald Reagan's first term led to both a reduction in inflation and a soaring dollar. Gold stopped declining long before the dollar stopped climbing as a balance between supply and demand was achieved. The reversal of the tight money / lax fiscal policies in 1985 and 1986 (the 1985 Plaza Accords, the 1986 Tax Act) led to a sharp break in the dollar, but only a minor secondary rally in gold during 1987. By that time, monetary creation was no longer inflationary: the extra dollars fueled the explosive stock market rally of September 1985 - August 1987. The combination of a contractionary fiscal policy and a restrictive monetary in the 1990s led to a stable dollar and stable gold combination. Only recently has the dollar-gold relationship resumed a strongly inverse relationship; along with the deflationary events in Asia, this constitutes the clearest evidence yet that the world needs a greater infusion of dollar liquidity.



Third, alternative investments have been more attractive, to say the least: The U.S. stock market stayed in a trading range between 1966 and 1982 in nominal terms, while the 1982-1998 period has witnessed the greatest bull market in history. Fourth, and most important over the past year, traders have been reminded that the greatest potential supply of new gold is the reserves held by world central banks. Go ahead and buy gold – The Australian central bank will be more than happy to sell it to you, and they can sell a lot more than you can buy.

Buffetting The Market

A confession to readers: This article originally was going to be something of an obituary on gold, and nothing more. But by last winter, something strange was going on in the allegedly precious metals. Gold was declining for all of the reasons listed above, but silver was rallying rather briskly. One of the relics of the 1970s gold rally, when any crank more normally suited to street-corner preaching who happened to be long gold was accorded "Expert" status, is the gold-silver ratio, shown below. Why gold and silver should have a defined relationship never was made clear (although the preachers did cite some Biblical references to the gold-silver ratio denominated in shekels and talents!). The two metals are not joint products, are mined in totally different processes, and have vastly different end-use markets. You might as well be trading the Oats/Notes spread (see "A Modest Proposal," *Futures*, January 1997, and "Hedgers Don't Wear Chains," *Futures*, January 1998). There is no evidence of a normal ratio in the chart below, either. But the diverging paths of the two metals both demanded and defied ready explanation.



Now silver, like pork bellies, is one of those things the futures industry has always had to apologize for. The infamous Hunt brothers attempt to corner the market in 1980 and a trading fiasco in April 1987 that necessitated closures of the COMEX always threatened to put the metal on the other side of respectability. When a group of traders filed suit against Phibro in December of 1997 regarding manipulation of the silver market, it seemed like *deja vu* all over again.

Who knew that the center of the world silver market was not in New York, or London, or Hong Kong? No, it was in Omaha, and the man behind the purchase of 129.7 million ounces of silver was none other than the highly-respected Warren Buffett. Say what? Buffett also announced that he had no plans to either buy more or to sell what he already had, and since the man has no history whatsoever of being a disruptive force in any market, we have to take him at his word.

Go Ahead, Trade It Anyway

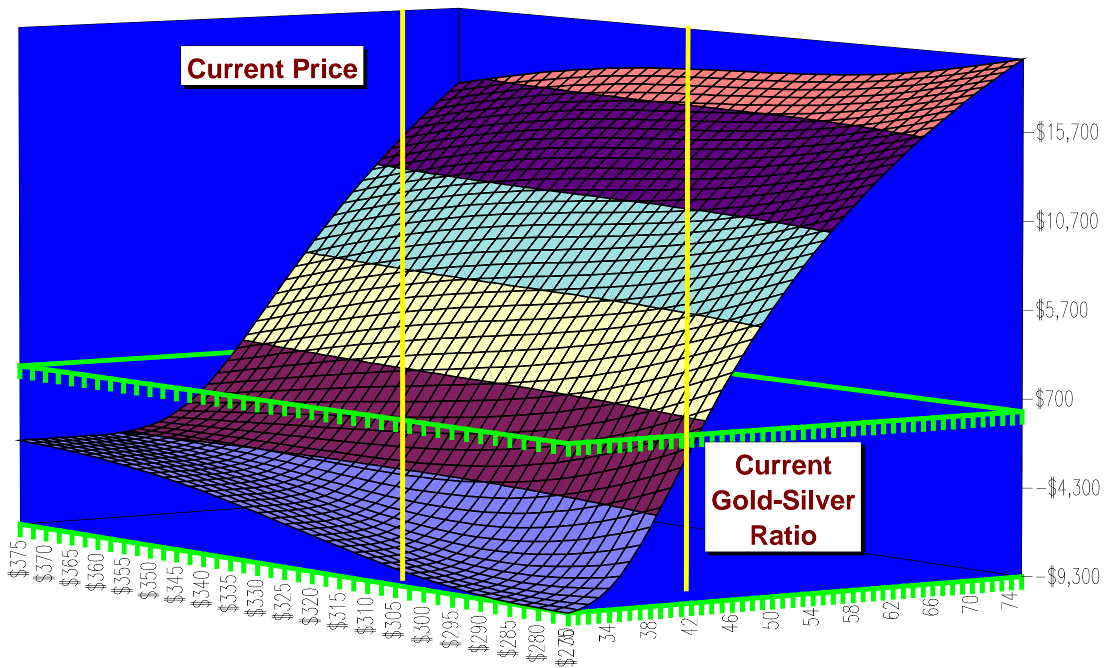
Warren Buffett has made his fortune by buying things that are undervalued, and avoiding those things which are overvalued. The temptation to place gold in the former category and silver in the latter will be irresistible to many, despite the warnings above. Is there a safe way to trade this spread using the Dynamic Option Selection System (DOSS, see “Using Options The Spec Way,” *Futures*, July 1994)?

Using data from the close of business on February 9, 1998, DOSS generated the following long gold / short silver trade for the equivalent of 100 futures on each side:

> **[gold] Buy 210 June $300 puts at $9.00 and sell 210 June $350 puts at $47.10**
> **[silver] Buy 145 May $7.75 calls at $0.243 and sell 145 May futures**

The return map of this trade across the dimensions of the June gold price and the gold-silver ratio, with two weeks remaining on the silver options, is shown below. The trade is highly leveraged across on the gold-silver ratio, but is not particularly dependent upon gold prices increasing. The

trade's profit range actually increases as gold prices decrease since the bull put spread on gold starts to approach its intrinsic value.



What role can we expect from gold in the future? It is unlikely that gold will ever return to the center of the world monetary system, nor should we wish it to: The previous gold standard eras were marked by prolonged periods of deflation since the money supply was hostage to physical supplies of gold. But it is equally unlikely that gold will ever be "just another commodity." As an amusing magazine advertisement for a bourbon whisky notes, "You always come back to the basics."