Precious And Few

It's like trying to find gold in a silver mine
It's like trying to drink whisky from a bottle of wine
-- Elton John & Bernie Taupin

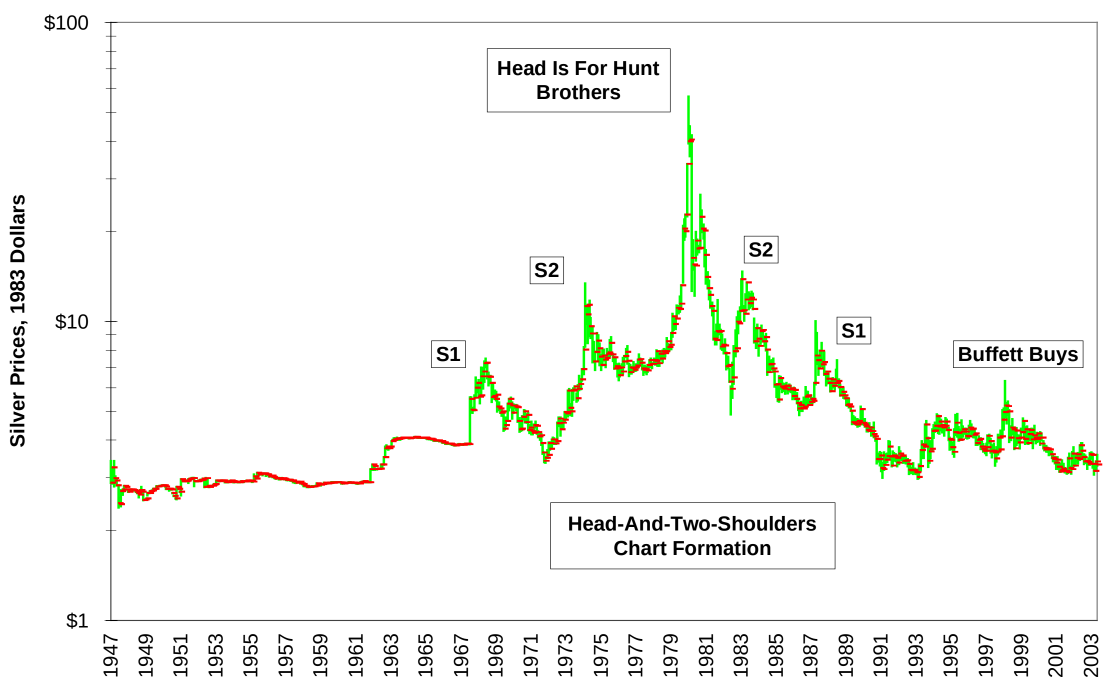
Certain metals are associated with each other indelibly in the popular imagination and in the spread margins offered on commodity exchanges. You are more likely to find silver in either a copper mine or in a lead and zinc mine than with gold, but that would make for a clunky set of lyrics, wouldn't it?

Platinum and palladium are linked as well, and while they don't roll off the tongue well enough for songwriters, they along with fellow platinum group members, osmium, iridium, ruthenium, and rhodium, are spectacularly useful. How odd is it that silicon, the base of modern technology, is as common as sand, while you could fit all of the platinum group metals ever mined into a modestly sized warehouse. But their ability to catalyze organic chemical reactions has led to them being involved, at some point in the process, in the production of one-fifth of the industrial goods produced.

But enough of the chemistry: We are traders interested in the price and in the information content of these markets. Just as we saw last month for the base metals, (see "Base Metal Werewolves In London," *Futures*, October 2003) these two pairs of metals are sensitive barometers of economic activity and financial pressure.

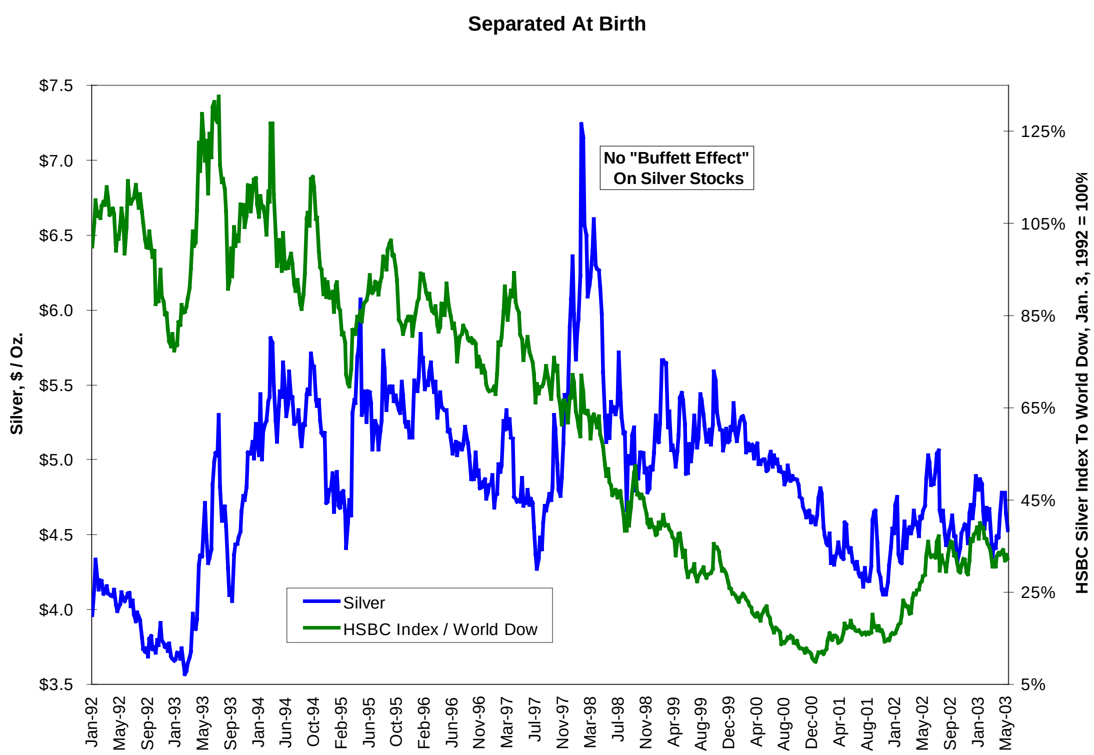
Silver's Streak
Silver always presents an interesting comparison to gold. Unlike its yellow cousin, it has significant industrial applications in electronics and photography. We all are aware of the significant inroad digital cameras have made into the photography business, but in the long-term picture of silver, it does not seem to matter. We can use the very long-term price histories available on the CRB Infotech CD-ROM to show that, deflated by the producer price index, silver is no higher than it was during the Kennedy administration. Its downturn began long before digital cameras hit the market, either, and its price pattern describes an odd variation of the head-and-shoulders formation beloved by chartists.

Silver's One Brief Shining Moment



One tongue-in-cheek response to this head-and-shoulders could be that silver will never rise in price again. Do not accept this bet, for we can never be sure when the next deep-pocketed silver buyer will emerge to leave his mark on the chart. The Hunt brothers during the double-digit inflation of the Carter administration formed the head on the chart, and Warren Buffett, of all people, caused a hiccup in late 1997. Just as all traders should take to heart the maxim it is better to be lucky than good, all of us should grasp the relative quantities of money and brains.

A more direct clue as to the relative strength of silver prices lies in the prices of silver mining stocks; like all stocks of commodity producers, these issues tend to move as a call option relative to the price of the underlying commodity (see "The Producers," *Futures*, June 2002). Very little silver is mined as such in the U.S. - nearly all silver is produced as a by-product of other ores - so we should look globally and use the HSBC global silver mining index relative to the Dow Jones world equity index.

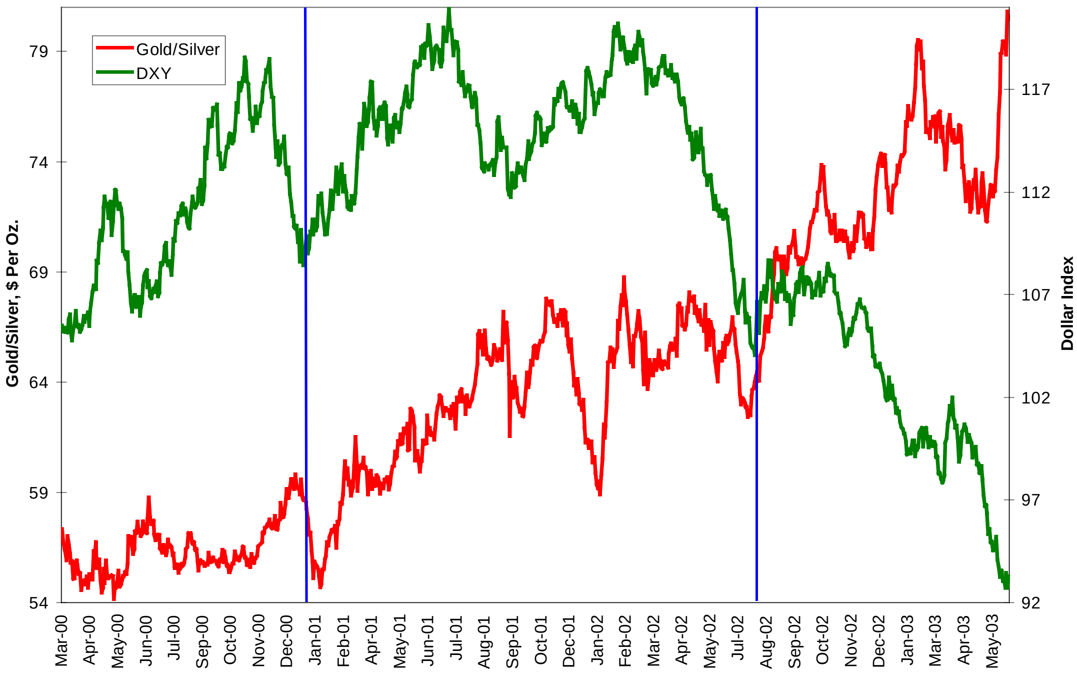


The relative performance of the HSBC index to the Dow Jones world index has tended to lead the price of silver by nine to twelve months since 1992. This indicator did not take the bait of silver prices being pushed higher by Buffett's 1997 purchase of 129.7 million ounces of silver. Interestingly, this indicator bottomed in early January 2001; that silver stocks rose more than the broad market was an early warning that the world's economic problems were not going to be solved a few 50 basis point cuts in overnight interest rates.

Metal Spreads

Gold, unfortunately, is as much of a religion as it is a market. A surefire way of telling we are in a bull market for gold is when talk of the gold/silver ratio emerges (GSR, see "Aren't You Precious" *Futures*, April 1998). You will hear about shekels and talents and the cost of Solomon's temple before you get a chance to exit the room. But the GSR does have its merits as an analytic tool.

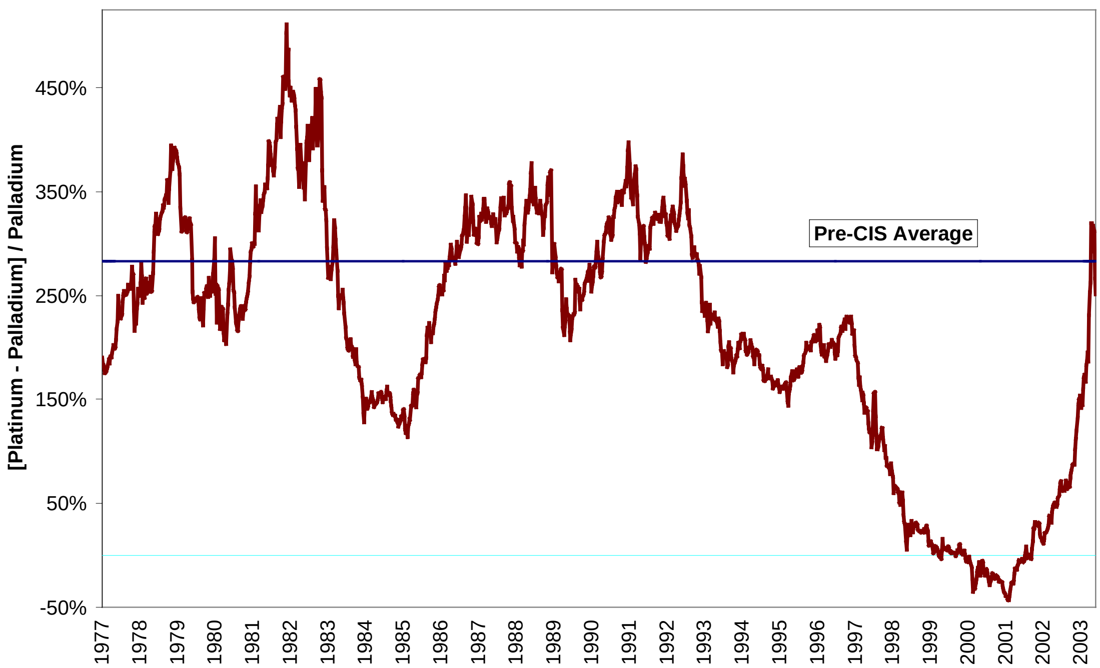
The Dollar And The Gold/Silver Ratio



Let's take a smaller snippet of history, that from the start of the bear market in equities in March 2000. Reported economic growth remained relatively strong throughout 2000, and the Federal Reserve steadfastly resisted loosening monetary policy. These factors kept the dollar firm and the GSR under pressure. Once the Fed started cutting rates in January 2001, the dollar remained firm on the expectation of relatively high returns on U.S. assets, but the GSR kept moving higher as gold rose on the back of the steeper yield curve and silver fell with a weakening economy. By the time stocks hit a multiple-year low in July 2002, the dollar was moving solidly lower and the GSR was moving solidly higher, demonstrating once more how intermarket relationships cannot be taken out of context (see "Trade A Sympathetic Market, Get Sympathy," *Futures*, February 2003).

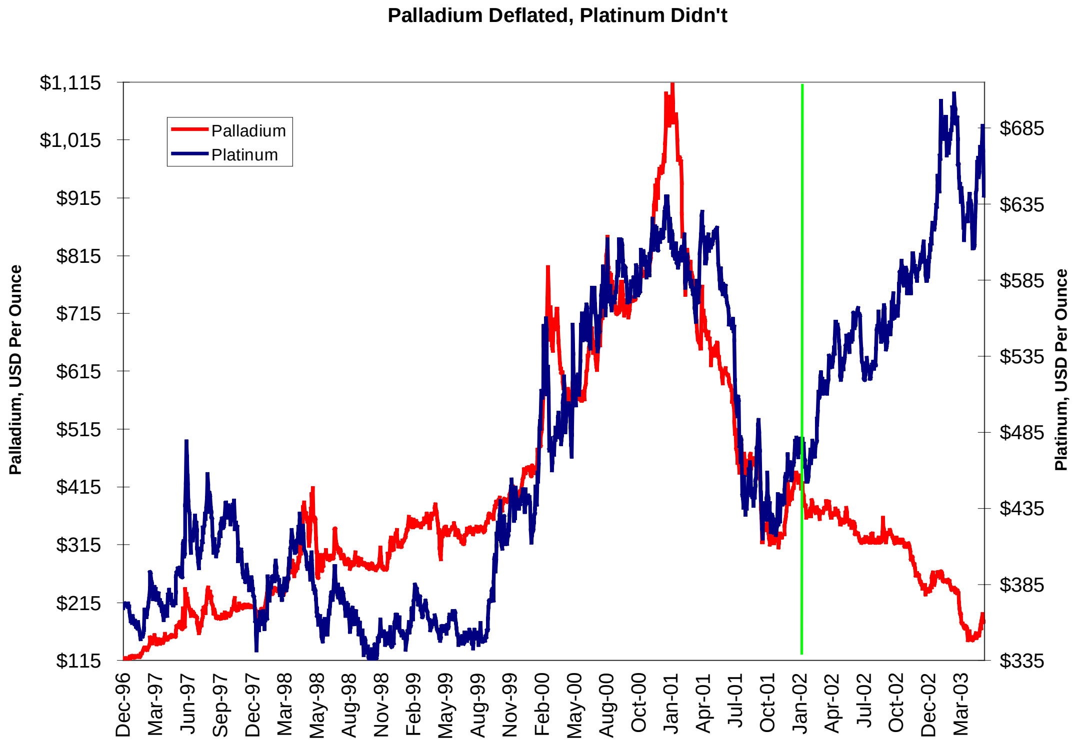
A similar divergence occurred in the relative prices of platinum and palladium. While these two metals are not exact substitutes, they have many of the same uses and quite frequently are produced together. The spread between them, expressed below as a percentage of palladium's price, predictably follows the characteristics of a related spread (see "Think Before You Spread," *Futures*, April 2001).

Return To Normal



The catalyst for the large price trend in favor of palladium was the downfall of the Soviet Union at the end of 1991 and its replacement by the Commonwealth of Independent States. The Evil Empire was a reliable supplier, while the CIS exporters knew market power when they saw it. Shipments of palladium became less reliable, and that placed severe pressure on the automobile industry, which had shifted from platinum to palladium in the manufacture of catalytic converters.

If you have ever felt that the market is watching to see when you buy in order to mark a top, know that you are in good company. Ford Motor feared further price increases and amassed a stockpile of palladium as the metal moved over $1,000 per ounce. They had to take a write-down in the neighborhood of $1 billion.



If we display the platinum/palladium spread over a shorter time frame as the two metals separately, we see just how much of a divergence occurred after February 2002. That such a previously stable relationship could breakdown this suddenly and completely should give pause to those who create value-at-risk models or who trade related spreads on a reversion-to-the-mean, or countertrend, basis.

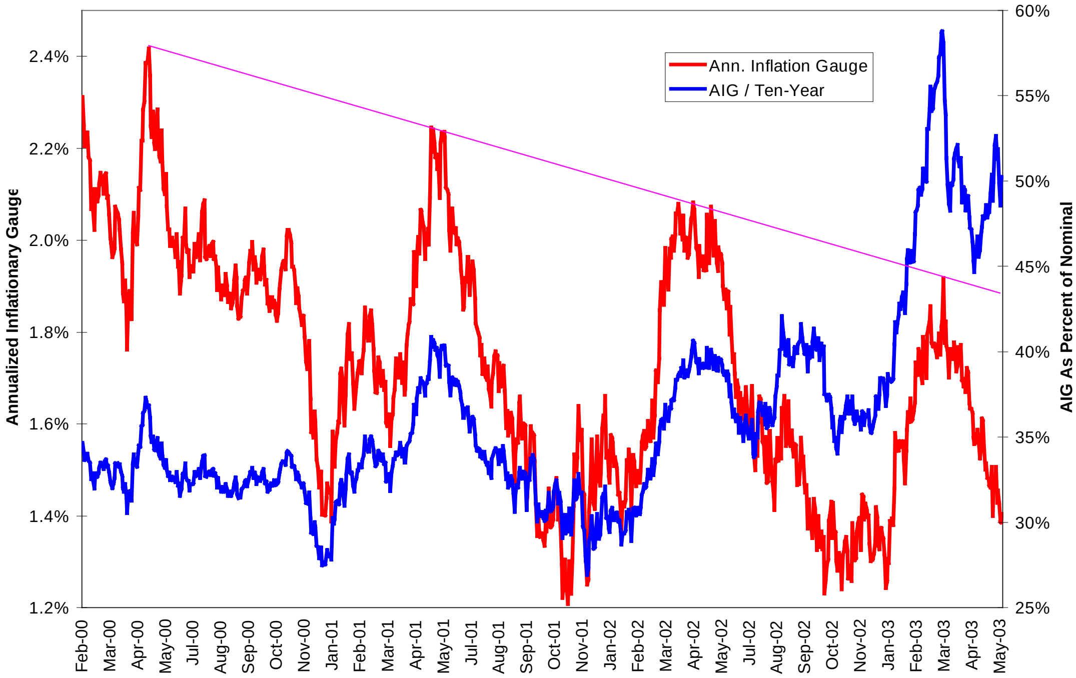
The Smart Money

Gold, as much as any market, qualifies as being "smart" for the simple reason that so little of it is actually consumed. Gold is not subject to the vagaries of seasonal production, demand surges or international cartels, the 1990s experience of European central banks selling reserves to meet the Maastricht Treaty requirements excepted. It is simply one speculator up against another in a contest of whose judgment is better.

Can this judgment be quantified? Gold, like any other physical commodity, should rise in price if expected inflation exceeds its expected holding costs. A longer-term measure of expected inflation can be derived from the yield spread between two notes of near-equal maturity, the 6.50% note due February 15, 2010 and the inflation-protected 4.25% TIPS due January 15, 2010.

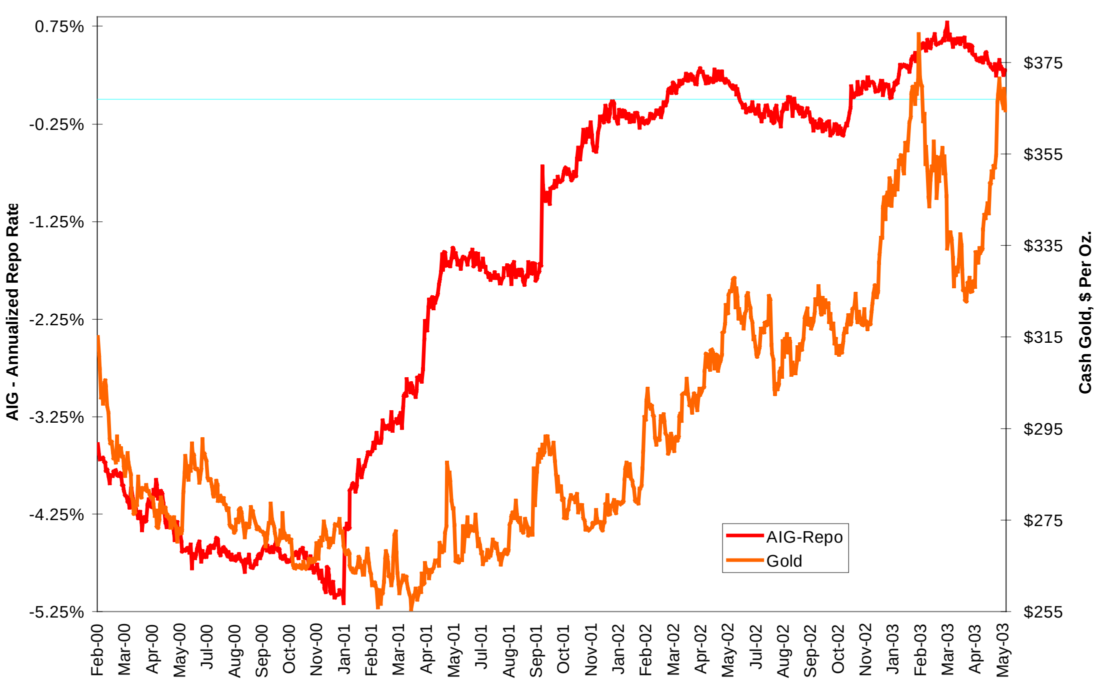
Let's dub the yield spread between these two notes the annualized inflation gauge, or AIG, not to be confused with the insurer of the same name. The AIG has been making a series of lower highs since early 2000, which is consistent with disinflation. Its reading of 1.40% annually until 2010 at the time of this writing is neither deflationary nor lower than the readings below 1.25% seen in the fall of 2001 or between October 2002 and January 2003.

Disinflation, Yes. Deflation, Not Yet



If we subtract the annualized short-term repo rate from the AIG, we obtain a measure of whether expected inflation exceeds expected holding costs or not.

Gold And Inflationary Expectations



Not only was the answer was a resounding "no" in 2000, the gap was moving in the opposite direction. It was not until the first of the interest rate cuts in January 2001 that expected inflation started to exceed holding costs. The gap did not become positive until we had 475 basis points of rate cuts in place by early 2002.

The gold market did not wait for the fact, it started to rise in anticipation thereof. Gold confirmed a double bottom in early April 2001 - on the very day when the equity market sold off in disappointment of a mere 50 basis point rate cut - and started to head higher. It did all we can ever ask a market to do, and that is to discount the future. That is worth its weight in gold.