A Rand(y) Walk Down Wall Street

Rorschach tests and other psychological parlor games can be a lot of fun if not taken too seriously. Those who must see meaningful patterns in every ink blotch and set of squiggles are condemned to spend their lives as technical analysts scorned by polite company everywhere (yes, I'm a technician; no irate e-mails, please).

As my French friends would say, if I have any left after the present spat *du jour*, "*c'est la vie*." Or, as my fellow free market economists would sneer, "there is no phrase in French for *laissez faire*."

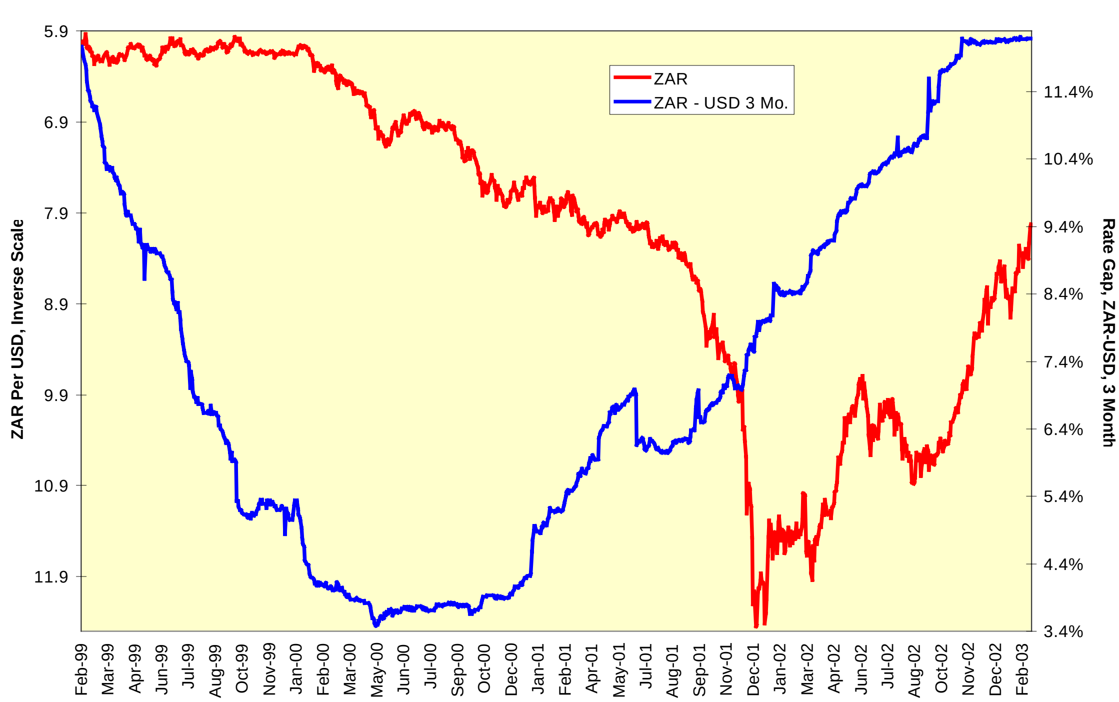
Back to the parlor game of word association: If I said "South Africa," sooner or later someone would blurt out "gold." And why not: The South African economy, both pre- and post-apartheid, has been based on the extraction of high-value commodities such as gold, diamonds and platinum. Gold is in its most pronounced and sustainable bull market since the Carter administration, and the South African rand (ZAR) has been the strongest performing currency against the U.S. dollar so far in 2003, up 6.74%. The Chicago Mercantile Exchange has a futures contract on the ZAR; it is very thinly traded, however, with an open interest of only 5,920 contracts.

By the way, the second-best performing currency of 2003 is the Mauritius rupee (MUR), up 6.64%. The French call this former Dutch, Portuguese and English island colony, named after the Dutch prince Maurice of Nassau and former home of the former dodo bird, Ile de Maurice. Wooo-Wooooo! (Actual lyrics spelling from the 1973 Steve Miller classic "The Joker." As a bonus, you may click here for the definition of "pompitous of love").

The ZAR Won't Rise Too Far

Despite the obvious allure of gold, the ZAR has rallied the old-fashioned way: It simply yields a lot more than do comparable U.S. dollar deposits. The ZAR's late 2001 crash against the greenback did not begin to reverse until the interest rate gap between the Johannesburg interbank agreement rate (JIBAR) and LIBOR began to expand in early 2002. The present rally has taken the ZAR back to its pre-crash level, and as any self-respecting technician will tell you, a market must clear its pre-crash level on the way back up to qualify as a genuine reversal.

The ZAR And Its Ministers

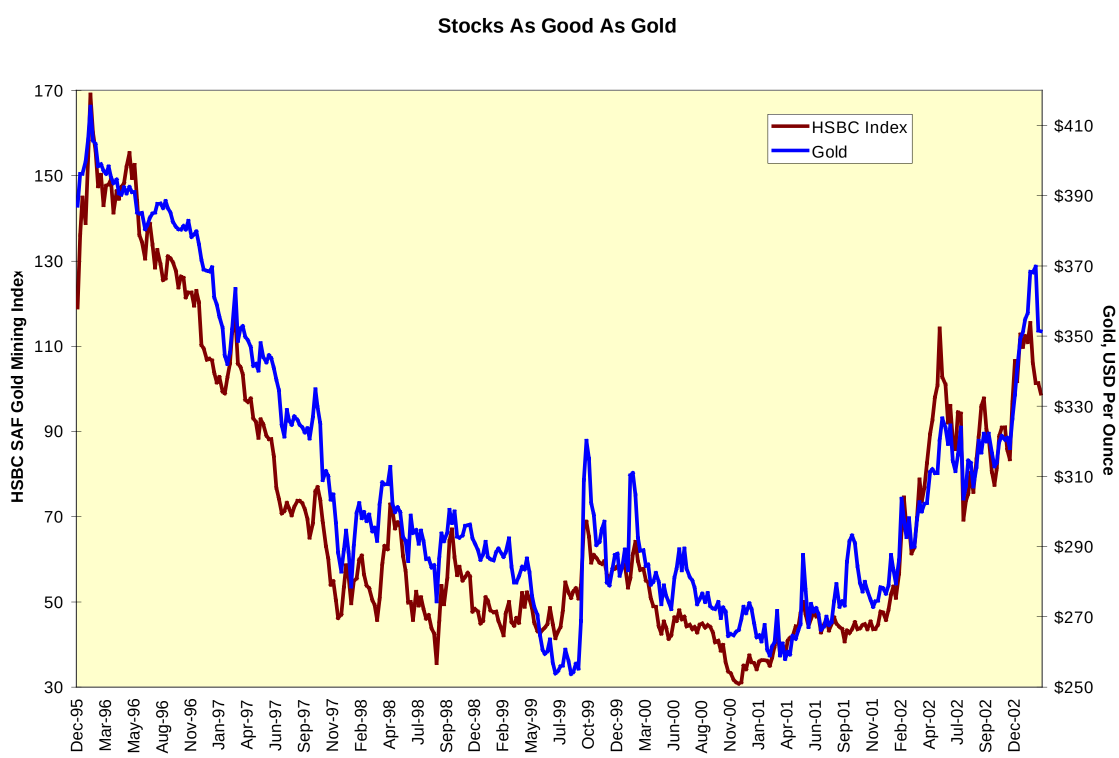


More important in terms of currency trading and stability, a high rate gap such as the ZAR-USD gap at present, especially one where the USD rate is as low as it is today, reflects the market's expectations of a weaker ZAR in the absence of high rates. High South African interest rates both raise the risk of American investors holding South African assets and dampen the return on those assets themselves.

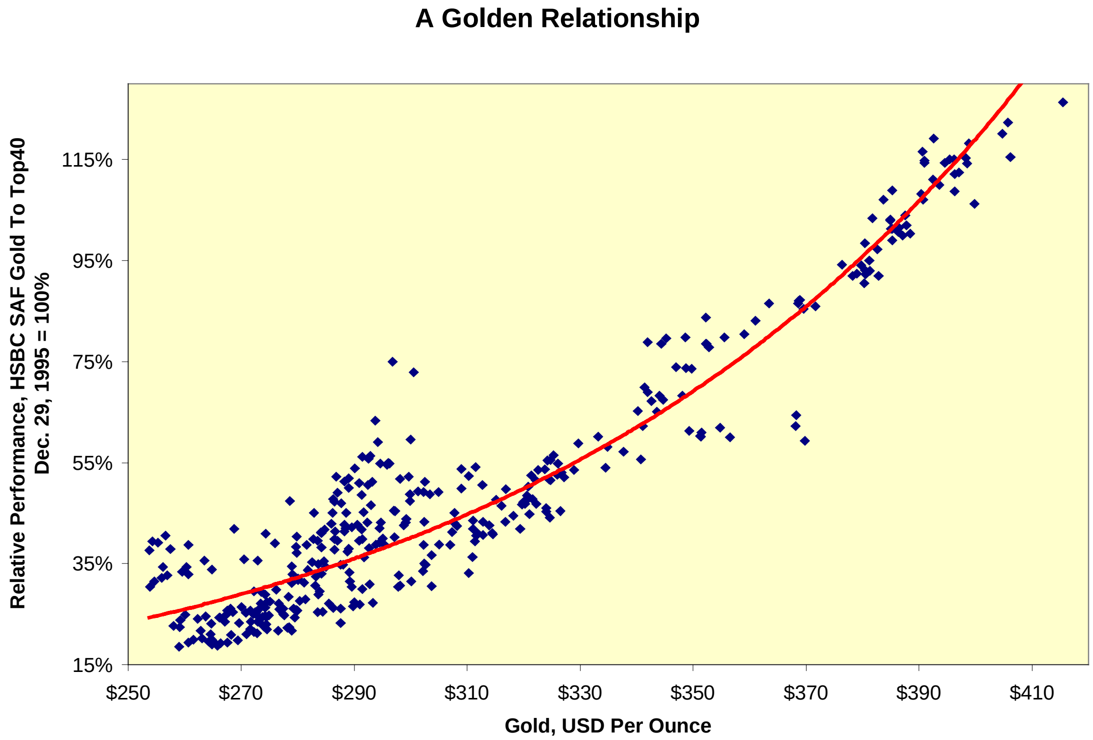
Strong Currency, Weak Stocks

Returns on South African stocks have been lagging despite the obvious boost from gold prices; those who associate a strong currency with strong equities should take note. The Financial Times/Johannesburg Top40 Tradeable Index, which has 41members, (don't ask) is down close to 9.1% so far in 2003 in ZAR terms. Gold miners Gold Fields, Ltd. and Harmony Gold are down 12.5% and 16.15%, respectively. SABMiller, which bought Miller Brewing from Altria Group, has turned its golden-hued outpourings into a 17.95% loss so far in 2003. But it's not all bad: Rainbow Chicken is up more than 19% on the year.

The absolute value of the Hong Kong & Shanghai index of South African gold miners describes a simple passthrough relationship between bullion prices and mining stocks. An American investor looking to play gold prices would have no apparent advantage in investing in South African mining stocks over just buying bullion or gold futures. In recent weeks, the HSBC index has headed south along with a minor retracement in bullion prices and with a strong ZAR.



However, the relationship need not be as brute force and inelegant as just trying to ride a price trend. Mining stocks always move in an accelerated fashion to the upside as a function of metal prices. The relative performance of the HSBC index to the currency-adjusted Top40 as a function of gold prices describes a call option on gold prices.



While the mechanics of trading commodity linkages to relative index movements may best be left to the hedge fund crowd, the implications of the quick move down by the HSBC index are unmistakable. Either the ZAR or gold or both have seen the end of their rallies for the time being. If South African gold stock investors sensed otherwise, the HSBC index would remain buoyant in anticipation of further gains.

I should hasten to emphasize the phrase "for the time being" in regards to the gold rally; I am still bullish on the metal longer term out of fear that central banks' reflation efforts might succeed too well. For those who wish to trade gold, I recommend simply trading the futures and not messing with the stocks. Gold stocks are not gold stocks: Over the past five years, the HSBC index of South African gold miners has outperformed the HSBC index of Australian miners by 58%. Picking different gold miners in different countries with different currencies and political systems is likely to be as rewarding as trying to pick the next hot mutual fund.