Metals Spreads: Two Pairs To Bet On

When I say I love you, say you better
You better, you better, you bet

-- *Pete Townsend, Who guitarist and Internet enthusiast*

For those of you feeling flush or willing to draw to the inside straight, or if you simply are appalled by the National Football League's foray into sanctimonious hypocrisy in rejecting Super Bowl advertisements for Las Vegas, it's time we talk statistical relationships. Like it or not, modern finance is grounded in probability and statistics, (try pricing insurance or options or optimizing a portfolio without these tools). These techniques were in turn developed by men such as Daniel Bernoulli, John Napier and Blaise Pascal for the benefit of gambling-addicted princes, the option-laden executive vice presidents of their day.

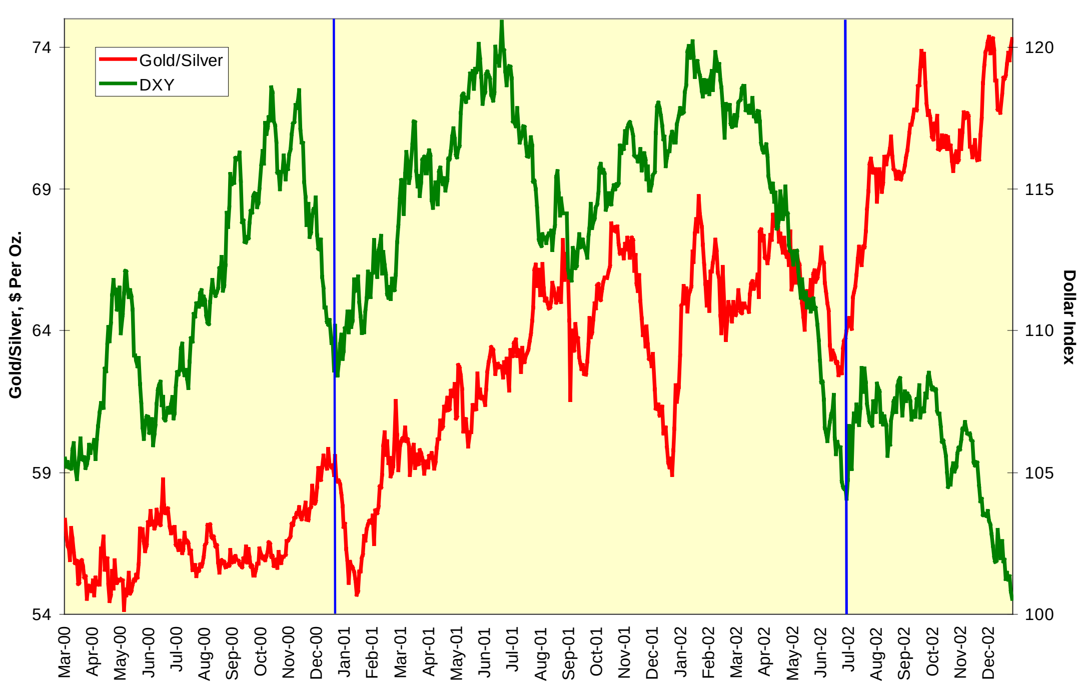
As the prospectus says, past performance does not predict future results, but what else are you going to use? Every study of mutual fund investing tells us we should not chase the hot sectors or hot managers; does this mean we should invest with managers who have demonstrated a proven inability to perform well recently? The plain and simple fact is that if the future does not look like the past, most of us are in trouble. Our minds are wired to recognize patterns and extrapolate trends, and this we do slavishly.

Metals Divergences

When some tried and true relationships in the world of commodity spreads break down, trading becomes difficult. Let's take two pairs of metals linked together in traders' minds if not in reality, gold and silver and platinum and palladium. In recent months, both of these metal pairs have been trading as if they don't know each other.

The relationship between gold and silver, one which I have contended is actually a non-relationship as the two metals have different production economics and are used in different final markets, is measured commonly as the ratio of gold to silver (GSR). As an aside, if you want to be bored to tears, sidle up to a gold bug at a cocktail party and ask him about the GSR. You'll hear a discourse about this number going back to Biblical days so tedious that you'll want to escape and listen to someone's story about his gall bladder surgery.

The Dollar And The Gold/Silver Ratio



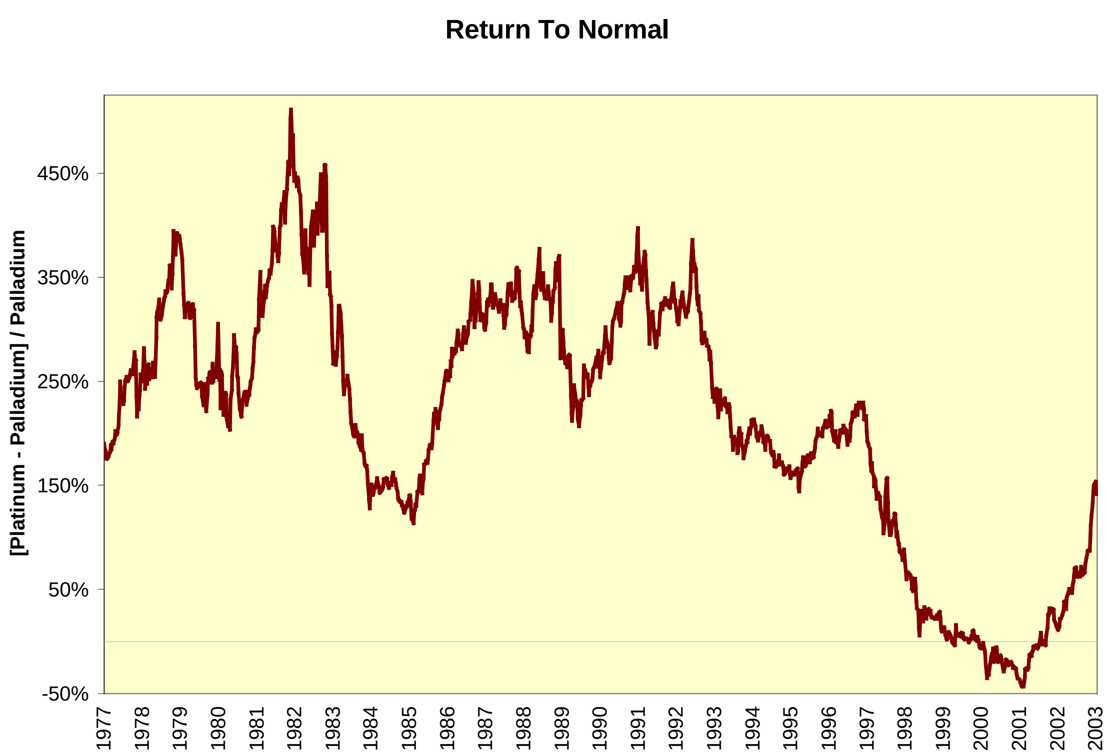
The GSR has been trending higher since the Fed began its rate-cutting campaign in January 2001. Between this date and the stock market's late-July 2002 low, the GSR and the trade-weighted dollar index (DXY) roughly paralleled each other, a brief exception in late 2001 notwithstanding. This parallel course was somewhat counterintuitive; we should expect gold to weaken as the dollar firms and the more economically sensitive silver to do the opposite. Yet the GSR rose in early 2001 as the dollar firmed and failed to rally in early 2002 as the dollar fell.

The expected relationship resumed after July 2002 as the market sensed the Fed was starting to take the threat of deflation seriously. The dollar is falling under the weight of low interest rates, and gold is rallying on the combination of these same low rates and the prospects of higher inflation once the economy starts to recover. Silver, an industrial metal, is languishing along with the base industrial metals.

So, here's the suggested trade: Once an economic recovery begins (it will, someday, I think) the Fed will start raising interest rates in a frantic attempt to forestall inflation. The dollar will rally, and gold will fall. At that point, sell gold and buy silver.

Platinum And Palladium

These two metals have far more of a substitution relationship than do gold and silver; they both are used as catalysts in the petrochemical industry and in automobile catalytic converters. While it is often found in the same ore bodies as platinum, palladium's marginal unit in global trade increasingly has been from Norilsk and other Russian nickel deposits. Disruptions to Russian exports in the late 1990s combined with a turn by automobile manufacturers to the then-cheaper palladium to drive palladium prices over $1,000 an ounce.



In addition, the ongoing Japanese recession lowered their demand for platinum. The final factor disrupting this market was an ill conceived and poorly executed stockpiling of palladium by Ford. The automaker stockpiled palladium - more than $1 billion worth - at the all-time high prices in 2000 and 2001. As a result, the spread between platinum and palladium, which always had been strongly in favor of platinum, turned negative in the 1999-2001 period.

The recent rebound in platinum prices relative to palladium simply reflects substitution economics. As Ford and others work down their palladium stockpiles and as platinum became relatively cheaper, it was natural to use platinum. Catalysts, as you may recall from high school chemistry, have the useful attribute of not being consumed in reactions and petrochemical manufacturers in particular find it economic to regenerate their catalyst trays as often as they can.

What should we do from a trading approach? The spreads between substitutes tend to move toward extremes; this is necessary for users to justify retooling their processes to use one commodity instead of the other. This suggests that the trade of being long platinum and short palladium is likely to persist.