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Commentary

Market Opinions and Topics of Interest

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Revisiting Gold

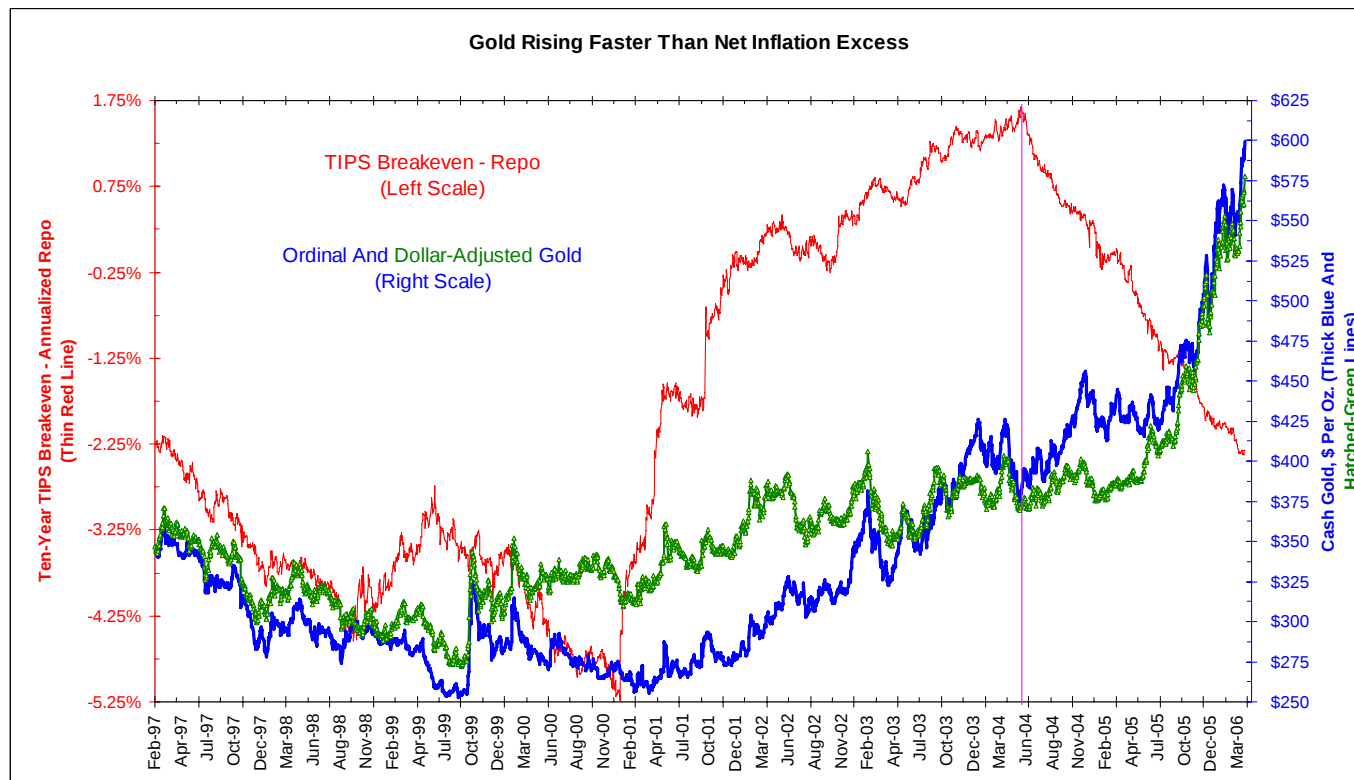
We entitled a September 2005 [Commentary](#), "Is Gold Wrong?" After reviewing a number of indicators not at all bullish for the yellow metal, we concluded:

Sometimes markets go higher for no reason other than they are going higher, and this may be the case with gold.... It will be a good sale eventually, but not now.

The above was considered insufficiently bullish in certain quarters and as the diplomats would say, a "frank and useful exchange of views" ensued.

Now that gold has broken over \$600 per ounce, up from its \$465 or so price just seven months ago, let's revisit some of the indicators used then and see if a more – or less – bullish case can be made.

First, let's stipulate the nominal price of any physical asset will rise if expected inflation over a period exceeds the expected costs of holding the asset over that same period. If we compare the expected rate of inflation embedded in the TIPS market less the annualized three-month repo rate (thin red line) to the ordinal dollar price of gold (thick blue line) and to the dollar index (DXY)-adjusted price of gold (hatched green line), **we see how two of the main reasons often given for holding gold, inflation protection and dollar-devaluation protection have become less compelling even as the price has risen.** This discrepancy has been continuous since the Federal Reserve began its rate-hike campaign in 2004 (vertical magenta line).

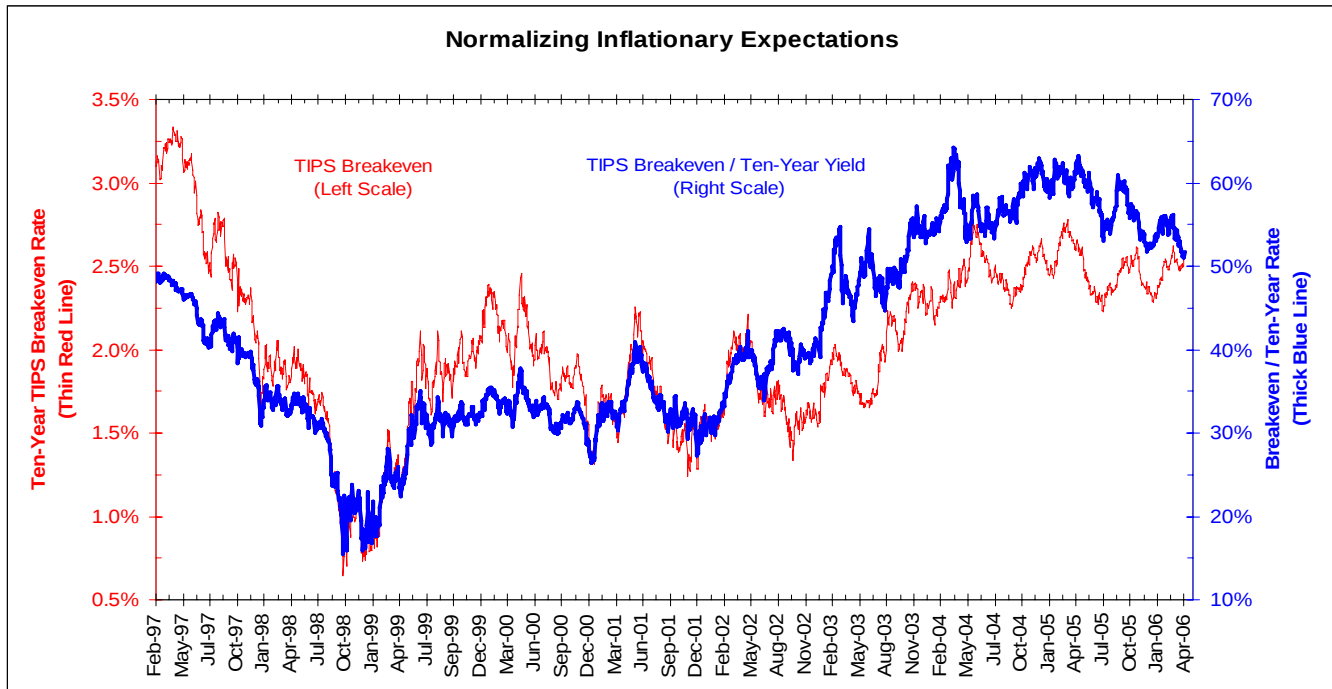


Comments On Components

Let's take a look at two of these components, the 10-year TIPS breakeven rate of inflation and the dollar index in turn.

The ten-year TIPS breakeven rate of inflation (thin red line) has been trapped within a trading range for the past year. As we noted in a recent [Special Report](#) on inflation, the TIPS market is an imperfect descriptor of a measure "nobody" believes, the Consumer Price Index, yet its general assessments

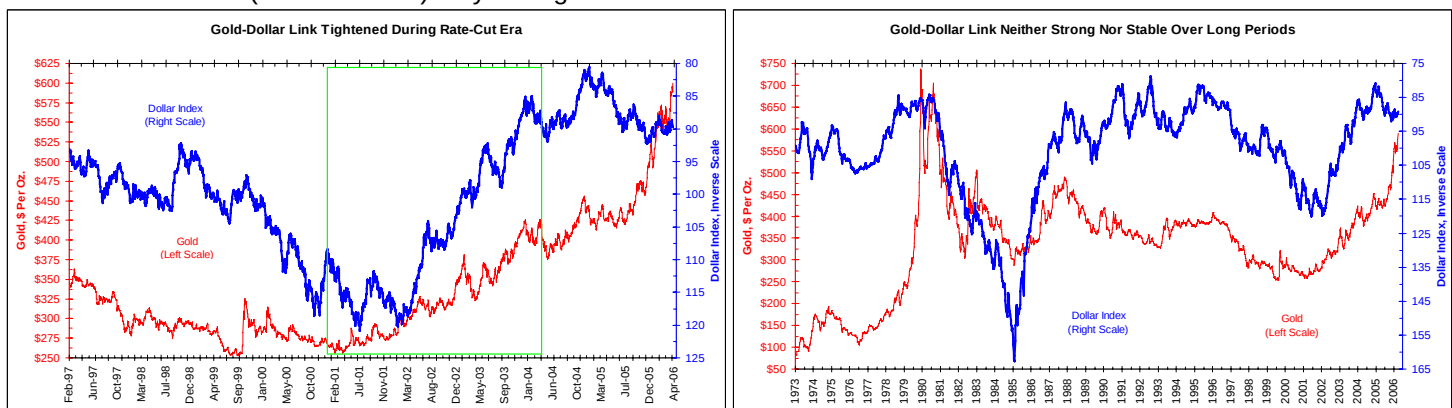
for real interest rates and trends in other financial markets are to be respected. As nominal ten-year note yields have risen over the past year, the ratio of ten-year TIPS breakeven rates of inflation to ten-year note yields (thick blue line) has declined. Implicit in this observation is the real rate of interest has increased; a conclusion consistent with strong economic growth. **A higher real rate of interest should be deleterious to an inert asset such as gold.**



The connection between gold and the DXY is far less direct and weaker than we would surmise before examining the data. Let's compare the two markets over the life-of-TIPS window above (left-hand chart) and over the entirety of the floating exchange-rate era (right-hand chart).

Over the TIPS era, gold (thin red line) provided dollar insurance (thick blue line) only during the rate-

cutting period of 2001-2004 (green rectangle). Over the long history, gold and the dollar exhibited a strong correlation only during Paul Volcker's harsh tightening of the early 1980s and during the aforementioned 2001-2004 period. **It appears fair to say the gold-dollar inverse relationship becomes prominent only during periods of extreme monetary policy.**



Le Petit Bull

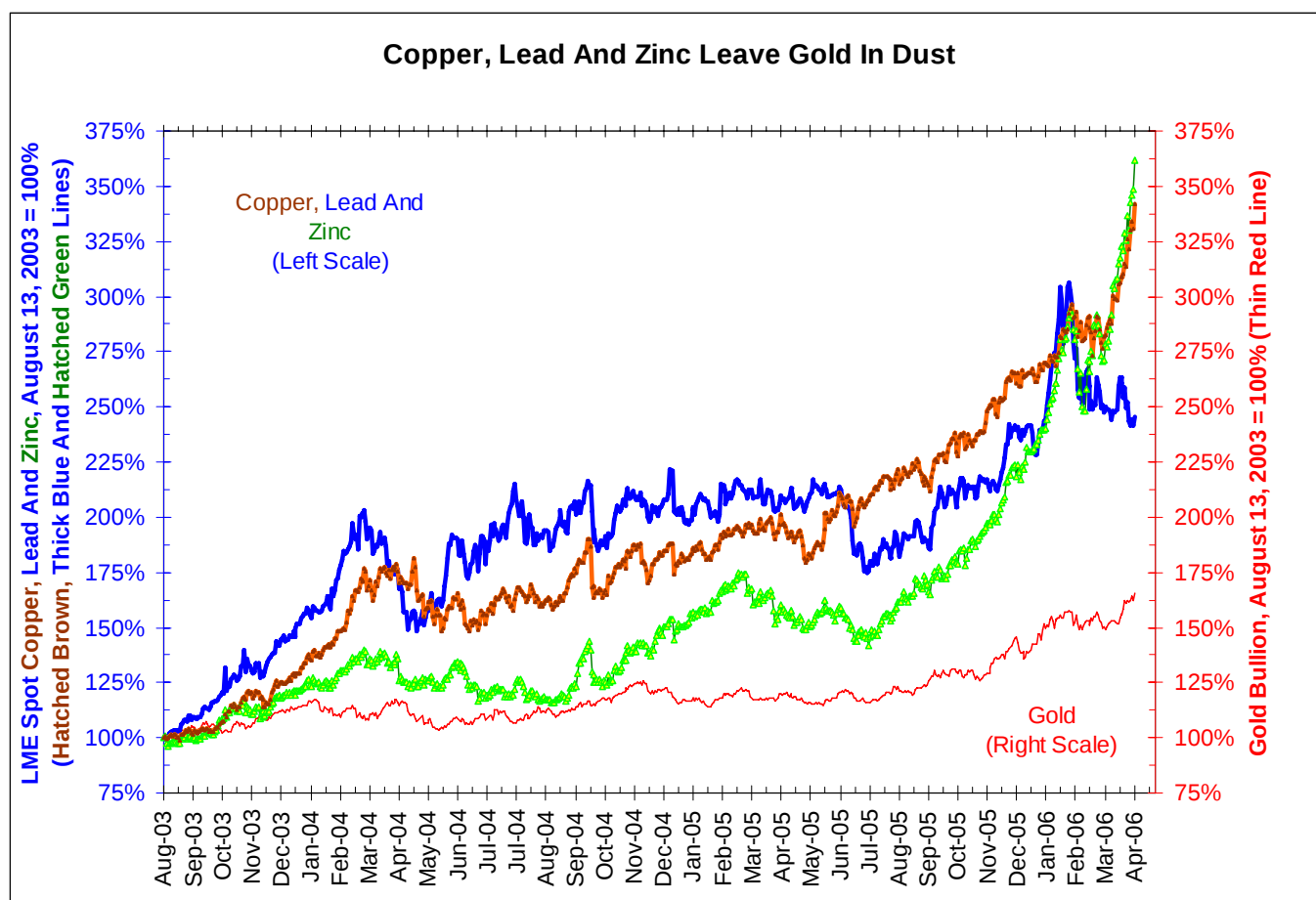
For all of gold's gains in the face of the impediments noted above, we should remind ourselves it is but one bull market among many, and not even the first among non-equals at that.

Gold's many adherents classify it as "a smart market," and admonish us to pay attention to what it is saying. As an aside, the author has done high-frequency data studies of intermarket systems and finds no evidence any where, any time or any place of any "smart market." To suggest one group of investors and traders has been endowed with superhuman powers of foresight is a statement demanding evidence to accompany assertion. Why

such demigods have not enslaved the remainder of humanity by now in an abuse of their powers must be evidence of their benevolence. We are grateful.

So if the gold market is in fact rising in the face of declining net inflation and is rising in all currencies, what is it "telling us?"

Let's compare the percentage price increase of gold bullion (thin red line) against those of copper (mottled brown line), lead (thick blue line) and zinc (hatched green line) since the beginning of the yield curve's flattening in August 2003. **Gold has gained 65% over that period. The respective spot price increases for lead, copper and zinc are 146%, 242% and 262%.** What is zinc telling us?



Conclusion

One of the best pieces of trading advice is, "When they pass around the cookies, take a few." Gold is in a bull market as other commodities are in a bull market. It matters not whether supply/demand imbalances, long-only commodity index funds, the world's hedge funds or just wild-eyed speculators are pushing prices higher; understanding has no effect on your account balance.

Given that, we must renew our previous conclusion gold will one day be a good sell, but not yet. Its very lack of utility means it can rise in price without choking off final demand, and its status as a superior good means investors will continue to feel good about paying more. Gold's rarity precludes an aggressive supply response.

The path of least resistance remains higher. Take the trade and leave it at that.

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