Gold by Montresor

Can a computer forecast the price?

A South African mining industry-sponsored project suggests an intrinsically unworkable equation.

The International Gold Corporation, which describes itself as "the marketing arm of the South African mining industry," has published a study purporting to analyze the components of changes in the gold price during the short period of free-market gold movements. Mr. Eugene Sherman, the group's economist, summarized the results in a pamphlet entitled, "Gold: A Pricing Model," written in cooperation with the Hudson Institute.

Like all such exercises in regression analysis, Mr. Sherman's computer calculated the logarithmic change in a number of variables, including American and world liquidity, Eurodollar interest rates, real Gross National Product, the dollar exchange rate, and political tension, according to a "quantitative index" prepared by the Hudson Institute staff.

The computer then found a half-dozen or so ways of adding up the change in these variables to produce a graph that looks remarkably like the graph of gold price changes during the past 10 years.

Of course, "the relationships developed appear to be dynamic," Mr. Sherman says, "which is to say that they may not have the same validity in the future as they have demonstrated in the past."

Since the paper was written for the benefit of American portfolio managers, whom the International Gold Corporation wishes to buy gold, it may be excused as an exercise in computerized rationalization for the benefit of gentlemen who do not mind losing spectacular amounts of money for their clients, so long as they can demonstrate that they acted with prudence.

Its conclusions, to the extent they bear validity, are not surprising: "Price movements tend to be dominated by inflation and inflationary expectations . . . commercial demand for gold is highly sensitive to both the real price of gold and real total incomes among industrialized countries . . . interest rates and political tensions cause identifiable movements in the gold price."

The fact that the computer people composed an equation (so much inflation fear plus so much political tension plus so much spare income, etc.) which "explains 87 percent of monthly price variation" in the past does not, as Mr. Sherman states candidly, have much to do with the future.

Nonetheless he ventures a set of scenarios for the gold price during the next several years, ranging from $485 with low liquidity growth and low political tension to $618 with high liquidity growth and high political tension by the end of 1982.

To the extent that the effort is interesting, if admittedly limited, one crucial assumption which underlies the study, and takes up much of the pamphlet's text, is utterly false: that the gold markets are "efficient." That means that the market supposedly comprises many participants who "very quickly translate into market price all available information." No one but an American portfolio manager, the laughingstock of the financial world, would believe this. The gold markets are rigged, by Mr. Sherman's employers, among others.

There is no present justification, for example, for a $400 or so gold price, except that every price rally has been squashed by a syndicate composed of the major gold accumulators, e.g. Union Bank of Switzerland, Banca Commerciale Italiana, and Banco Ambrosiano, as I earlier reported in this space. *EIR*'s estimate of the rate of growth of world liquidity is 35 percent per annum for 1981, almost twice what Eugene Sherman has plugged into his scenarios; under his liquidity weighting system this would produce a spectacular price increase.

The fact that much of the world is going bankrupt by stages compels both individuals and governments to sell gold. Certainly there is a relationship between the sudden spate of Soviet gold sales, which brought the first six months' sales to between 60 and 80 metric tons (equal to all of 1980's), and the financial crises in Poland.

What is interesting to watch is how underlying economic reality tends to assert itself against efforts to rig the market. Mathematicians would call this a "system with two conflicting optimizing criteria," and pronounce it unsusceptible of treatment by any computer-based analytical methods. However, the human mind, as all great music attests, is capable of making sense out of such striving, and remains an analytical tool superior to Mr. Sherman's computer.