Reverting to the Mean

By The Mogambo Guru

11/27/06 **The Daily Reckoning PRESENTS:** Somewhere along the line, the high price of gold fell to its theoretical value, and then overshot on the downside. And that's where we are now. And now the actual price is 300% below its theoretical value! The Mogambo explores…

REVERTING TO THE MEAN

Troy Schwensen, of The Global Speculator newsletter, has taken a look at the price of gold in Australian dollars versus inflation and interest rates during the 24 years from 1982 to 2006. "We can see that in this period where high interest rates eventually tamed core inflation, the actual price of gold fell below the theoretical value, as people regained confidence in the financial system and interest rates eventually declined. This consequently fueled unprecedented gains in financial assets."

It's the next part that gets our attention when he says, "We can see now in 2006 that a massive disconnect again exists between the actual and theoretical prices," and that the difference this time is that "Actual is just 33% of Theoretical".

So in trying to understand what is going on, it seems that somewhere along the line, the high price of gold fell to its theoretical value, and then overshot on the downside. And that's where we are now. And now the actual price is 300% below its theoretical value!

My sensitive Mogambo Investment Opportunity Sensors (MIOS) spring to alert, and an inner voice says, "Hmmm! This reverting to the mean thing seems intriguing to me for some reason! But why? Why? Why?"

Being a real stupid kind of guy, I missed the obvious conclusion that gold will again revert to the mean by going up in price until it reaches its theoretical value. Fortunately, there was a kindergarten class taking a field trip through Mogambo Galactic Headquarters (MGH), and Larry, one of the smart-aleck little kids, saw me laboring over this an said "Hey! Stupid Mogambo Idiot (SMI)! It means gold will rise 300% and then overshoot to the upside, dork!"

My intense gratitude at learning this valuable piece of information directly offset my supreme irritation at being addressed so rudely by a little five-year-old brat that I could have easily beaten up if I wanted to (so watch it punk). Successfully throttling my rage, I ended up letting him off by sticking a "kick me" sign on his back, but he saw me and started running.

I had a big grin on my face and was just starting to take off after him when Larry's teacher imploringly looked to Mr. Schwensen for help in controlling what appeared to be developing into another Unfortunate Mogambo Incident (UMI), who saved the day by putting it into a pithy nutshell when he went on to say, "Rising interest rates and high levels of debt are obviously not a good combination."

Immediately spurred to action by his words, I change course, and run out of the door to get more money (probably by begging from total strangers) as my "friends" are all tapped out (so they say, the liars!), and I use the money to buy more gold. But as I am leaving, I stop in my tracks when he says that I may be making a mistake by not begging for money with which to buy platinum instead!

"Hmmm!" I say to myself! "Tell me more!" So they do, and it seems that John Ross Crooks at Money and Markets wrote, "The automotive and jewelry industries account for roughly 80% of annual demand for the metal. These days, about half of the world's platinum goes into jewelry. Mines in South Africa and Russia account for 90% of the world's platinum. All told, about five million ounces of the metal get hauled out of the ground annually. In case you're wondering, that's nothing compared to annual gold and silver production of 82 million ounces and 547 million ounces, respectively."

I raise my hand, interrupting to ask, "Now, this is all very interesting, dude, but what is the point of it all to someone who is just interested in making a whole lot of money as fast as he possibly can so he can get out of this stupid town and away from these stupid people?"

Apparently he lives a very sheltered life, and I guess he has never seen a sociopath consumed by raw, naked greed before, but, obviously repulsed, he nonetheless graciously replies, "This year, stocks of platinum are expected to fall short of demand for the eighth year in a row", which assumes I know how the supply/demand dynamic works. And brother, do I ever!

As if to buttress my case for somehow accumulating a stake in crude oil, Dan Denning, editor of the Australian Daily Reckoning writes, "the IEA released its World Energy Outlook 2006."

While lengthy, at 596 pages, he says, "You don't have to read all 596 pages to understand the Outlook's basic proposition," which is terrific news for me because I sure as hell wasn't going to read no stinking 596 pages of anything that is not pornographic and with a lot of steamy pictures, too. He says the summary is simplicity itself: "Demand for energy is growing. Supply is not."

Now, if you are familiar with the graph of the supply and demand curves and how they equilibrate at some price, then the phrase "Demand for energy is growing. Supply is not" surely caused your budding Mogambo Larval Greed Gland (MLGG) to squish some "avarice hormone" into your bloodstream, and now you are fixated, like a hungry predator upon prey, on what happens to the price of oil when "Demand for energy is growing [and] supply is not."

And since we buy most of our oil from foreigners, paying a rising price for it is only a part of the problem. A falling dollar is, to use a Real-Life Mogambo Example (RLME), like me going into the convenience store and selecting a candy bar that costs one dollar, but then handing the clerk three quarters and just walking out with the candy.

Immediately, you know something is wrong when he starts yelling at me, and I deny the accusation vehemently, but I don't know whether it was the peanuts caught between my teeth, or the fact that I had chocolate smeared all over my face and hands, or the fact that I politely explained to him that paying him less money now, is exactly the same as paying him with more money that loses its buying power in the future, but he was surprisingly calm and cool. He even seemed to like it when I explained that we have brilliantly smoothed, real, inflation-adjusted prices across the portals of time! We're time travelers!

Then I politely and generously explained how this is exactly what we are doing to OPEC and everybody else who will stupidly accept dollars in exchange for something, be it candy bars or oil.

"Sooner or later that dollar is going to be worth 75 cents, you moron!" I explained. "Which I already paid you! So shut your stupid hole, you conceited, greedy jerk! Everybody's getting screwed over!"

That was when, for some unexplained reason, he decided to get all huffy with me, and started yelling "You stupid xenophobic paranoid nutcase thieving Mogambo pig!"

With my famous rapier-like wit, I replied "Touché, dude! But that does not change the facts of the case – namely that we are paying for oil with a depreciating money, and now I am merely doing the same thing to you with a candy bar, although one is a delicious and chewy confection of caramel, nuts and milk chocolate, while the other is a much better source of energy but tastes like crap! So, what do you want from me, stupid? You want me to drink oil? Is that what you want? Punk!"

Mr. Denning is horrified at this surprising and utterly bizarre chain of events, and he quickly tries to break it up by saying that the report is clearly succinct in that "we are on course for an expensive and dirty energy system that will go from crisis to crisis. It can mean more supply disruptions, meteorological disasters or both. This energy future is not only unsustainable, but it is doomed to failure."

And don't embarrass yourself by asking Mr. Denning or me for an example of the price of oil going down "in a crisis." Asking such a silly question is the sure sign of a rookie.

Until next week,

The Mogambo Guru
for The Daily Reckoning