TrendMacrolytics

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Gold: Back to Square One

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With spot gold pounding another $4.50 lower today to close below $275 per ounce, the yellow metal has now given up all but $3 of the $20/oz. gains that it held in the first several weeks of the post-Attack period. There now seems little doubt that, as we suggested at the time, the gold price pop was indicative of a classic safe-haven premium rather than a real dollar softening, and thus had little if any monetary significance. That conclusion was buttressed by gold rising nearly uniformly against most major currencies, suggesting that the price shift was less a matter of a marginally more ample supply of dollars than it was of a surge – albeit a fleeting one – in panic-driven demand for gold. Despite a total of 400 basis points in "easing" to date, the Fed's rate-targeting mechanisms still have not brought relief from a deflationary shortfall of dollar supply relative to demand. The lingering residue of a too-tight Fed will likely act as a damper restraining equities from entering a sustainable rally mode in the short run.

In large measure, the gold reversal is the mirror image of the equity market recovery, with the broad stock indexes all now essentially restored to their pre-Attack levels. The gold price boost was symptomatic of the extreme risk abhorrence which bludgeoned the major equities indexes with double-digit percentage losses in the first week of post-Attack trading. And just as the "end of the world" premium in stocks has gradually been absorbed since then, so too is gold now returning to its earlier levels.

Up to a point, then, the gold price reversal can be seen as carrying positive implications, at least to the extent that it indicates the panic-level collapse of the market's risk appetite has been overcome. That, however, is not likely to prove a sufficient foundation for lasting gains going forward. As confirmation that monetary policy remains too tight, the gold price retreat indicates a sustained rally across the spectrum of risk-based financial assets so decimated by the Fed's deflationary policy error also is likely not yet in sight. Earlier, we suggested that the Fed's most recent rate cut to 2.5% might have put the overnight rate at a discount relative to a market-wide rate of return sufficient finally to induce the requisite liquidity creation ("Looking Up," October 4, 2001). We don't rule out the possibility that that could still be the case. But the Fed's flawed operating procedures can only produce significant additions to liquidity in response to increased reserve demand. Given the inefficiencies of a regime governed by such exogenous forces, chances of any discrete Fed action positively affecting liquidity availability within a relevant time frame remain subject to considerable uncertainty.

Having said that, it's probably also worth pointing out that a relatively small shift in the Fed's stance could at this point have a major impact. To significant extent, the Fed's deflation of the past several years appears to be priced in. The price of gold on a three-year-moving-average basis now stands at about $277/oz., and at $295/oz. on a five-year moving average. Given average contract lengths and maturity of debt outstanding, it's a good bet that effective price stability would probably be found somewhere in this range. We intend to explore this matter further in the days and weeks ahead. For now, it's sufficient to note that while the remaining error in the Fed's posture might not be that large, it has not yet been fully absorbed, and there is yet more pain to be endured from an overly tight Fed.

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