Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MACROCOSM

Gold at $300: Is This the Turn?

Wednesday, February 13, 2002

David Gitlitz

While airing nearly every conceivable rationale for the gold price jumping to the $300 per ounce plateau the past two weeks – from the **Enron** scandal to the Japanese banking crisis -- the financial establishment may well be overlooking the most convincing explanation of all. That should come as no surprise. For the economic and financial "mainstream," gold long ago attained the status of "barbarous relic" first proffered by **J.M. Keynes** some seven decades ago. The metal nonetheless continues to demonstrate its utility as a nonpareil gauge of monetary purchasing power, and it would be a mistake to disregard that signaling function in assessing its recent rise. The fact is, we see compelling – if still tentative -- indications that this move at least partly reflects a shift by the **Fed** to a marginally less scarce liquidity position. Should these early indications be confirmed and the gold move sustained, the mitigation of deflation risk that it would imply would also clear away the most threatening clouds hovering over the economic and financial landscape.

While we have always respected gold's role as a monetary indicator, we have ourselves been cautious about reading too much into this gold price gain. For example, we noted last week that the early action in this most recent pop above $280/oz. appeared to be tied to the scaling down of forward-sales programs under which gold producers have hedged their future production. Over any extended period the gold price is dominated by the balance of supply and demand in the global market for dollar liquidity. But the short covering and related trading activity triggered by such producer announcements can certainly have a short-run effect on the price. Yet, some of the tell-tale signs of a purely technical trading event have been absent recently. For one thing, unlike earlier unsustained surges, futures never went into "backwardation" relative to the spot price. As the most monetary of all commodities, gold futures are rarely in backwardation because the spread between the spot price and futures represents a pure time value premium – i.e., a real interest rate reflecting the preference for present vs. future dollar holdings. (The value of a future dollar is discounted relative to a current dollar, thus the gold futures price is higher relative to the current spot price.) Backwardation will occasionally occur, though, during a short-covering rally. It is almost always caused by the spot price being driven higher in a short squeeze, which is also a sign the price is likely to reverse course once the covering pressure is relieved. In the short-lived rally last month that saw gold momentarily touch the $290 level, we pointed to the presence of backwardation as an indication that the move higher was likely to be short-lived. It was. The fact that backwardation has not been seen in the most recent run to $300 is one indication that it is more than a technical, short-covering event.

At the same time, we also suggested last week that for the higher gold price to be sustained it would likely require some confirmation in the form of a marginally weaker dollar in foreign exchange markets. The accompanying chart plotting gold against the G-6 trade-weighted foreign exchange index over the past two years shows a generally consistent pattern of the dollar's forex value being led by gold. (The scale for the gold price on the chart has been reversed to show a general strengthening trend of the dollar against both gold and foreign exchange.) Note, though, that on several occasions sharp gold moves were reversed when they were not confirmed in the forex market. That is, when a rising gold price is reflected nearly

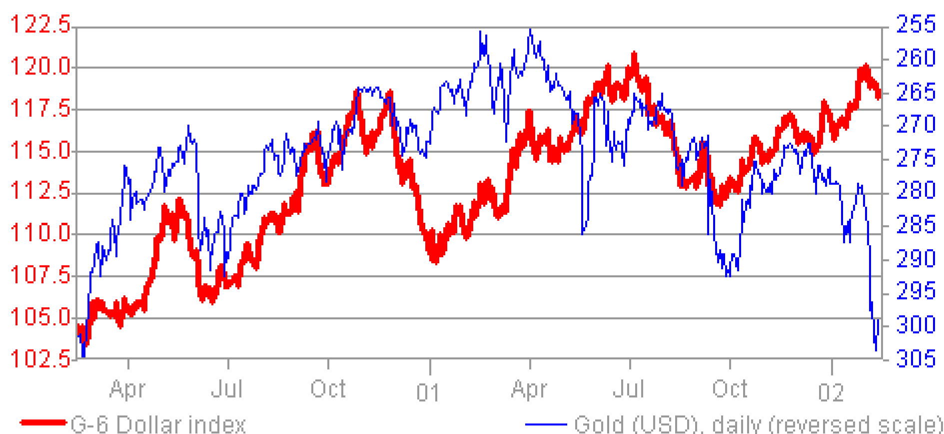
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

uniformly across currencies, it is likely an event keyed to short-term supply and demand conditions in the metal rather than a change in monetary conditions, and is thus unlikely to hold up.

G-6 Trade-Weighted Dollar Index versus Dollar/Gold



Obviously, the dollar's recent 7% weakening in gold terms currently appears as an outlier in this chart, as do the three previous trading events in the past year when gold briefly popped higher only to fall back to its earlier ranges. Over the past several sessions, however, there have at least been some preliminary signs of a softening greenback. Since the beginning of the month, the forex index has fallen from near15-year highs around 120 to just above 118, while the euro has rebounded from 0.86/$ to above 0.87/$. Not much, perhaps, but it could represent the early stages of an unwinding of deflationary pressures reflected in the dollar's foreign exchange value.

Most significantly, though, our attention is drawn to the Fed's open market stance, which continues to exhibit signs of a more robust pace of liquidity creation. Just prior to the most recent **FOMC** meeting late last month, we pointed out the prospect that the conclusion of the Fed's rate-cutting cycle could actually see an increase in liquidity injections (see "Now What?" January 28, 2002). As borrowing activity that had been delayed pending confirmation that rates have bottomed is brought on line, reserve demand would tend to rise, forcing the Fed to accommodate the demand to defend its 1.75% rate target. That appears to be happening. In the last two weeks, the Fed's liquidity injections have consistently exceeded the posted estimates. On one occasion last week, **Wrightson Associates**, a money-market analytical firm specializing in Fed operations, acknowledged that its projections of the Fed's "add job" needed to be revised upward, an unusual concession to a changing environment.

Recent data also shows the beginnings of a reversal in the months-long decline in commercial lending activity, with commercial and industrial loans up some $7 billion since the beginning of the year. The availability of profitable new lending opportunities in the banking system can be seen denoting a higher level of risk preference, and would be consistent within the system with a reduced demand for riskless money market instruments. Indeed, the latest data also shows that Money of Zero Maturity – the Fed's broadest definition of immediately available funds, whose growth the past year has been dominated by institutional money fund balances – growing at below-double-digit rates for the first time in 18 months. We will be awaiting further confirmation of these trends in the data, but the declining investment demand for money against increased reserve growth provides an early signal of relief from a deflationary dearth of liquidity. That also appears to be the message of the higher gold price, which if sustained would be one of the more bullish portents currently available. TM