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MACROCOSM

Going for the Gold

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The media's consternation over the dollar and gold is off the mark. These are the best indications yet that the Fed's deflationary siege is finally over.

Last month we warned that faulty interpretations of a largely positive softening in dollar purchasing power could become fodder for a "global financial press eager to seize any opportunity to fan the flames of a 'flight from the dollar'" (see "Dollar Daze" May 7, 2002). Yesterday's *Wall Street Journal* front-pager, "No Safe-Haven: Dollar Slide Reflects Wariness About US," can be labeled Exhibit A of that phenomenon. The piece is a digest of misinterpretations that finds alarming macroeconomic and financial portents in the decline of a dollar that, on a trade-weighted basis, has only declined to levels last seen in mid-to-late 2000, when the US economy was in the early stages of its slide from the late-1990s boom. The one-dimensional analysis which sees relative currency strength or weakness as a simple reflection of economic health invariably fails to account for such realities. The fact that the dollar's value peaked -- both against foreign exchange and in terms of its real domestic purchasing power indicated by gold -- as the US economy groaned through its first recession in a decade is simply not broached among keepers of conventional economic wisdom.

By the same token, then, the sudden discovery of gold among so-called mainstream Wall Street opinion leaders probably should come as no surprise. After ignoring the deflationary implications of its better-than $100 per ounce decline from late 1996 through last year, the financial cognoscenti now spies significant inflation risk in a rally that has taken gold above $325 for the first time in nearly five years. More than anything, though, the recent rise in the price of gold, like the decline of the dollar, appears to offer a handy crutch for the legions of pundits and analysts seeking rationalizations for the continued failure of the equity markets to confirm their bullish calls. A sure sign that the supposed risks posed by the rising gold price have entered the realm of accepted wisdom: gold was included in a Reuters report over the weekend as among the immediate obstacles to equity market recovery.

From our perspective, reversal of the market indicators which had until recently been signaling continued deflation risk is overwhelmingly good news. We don't entirely dismiss the potential for a dollar rout, stoked by panicked press and financial market commentary taking on a life of its own, and in the process abruptly swinging from deflationary to potentially inflationary territory. But after ascending in highly volatile fashion over the past month from below $310, spot gold show signs of settling into a range -- albeit an erratic one -- above $325, which would appear to substantially limit that risk. Indeed, the far greater concern is that the high volatility of gold trading at times during the past few weeks implied a degree of uncertainty in the market that could call into question the staying power of the move. One report last week noted similarities of this gold rally to the one in September and October 1999 that followed an announcement by European central banks limiting future gold sales and leasing activity. That rally, it should be noted, proved largely illusory, with gold steadily falling back to earlier ranges below $280 after peaking at $325, the deflationary influences of a too-scarce dollar remaining intact.

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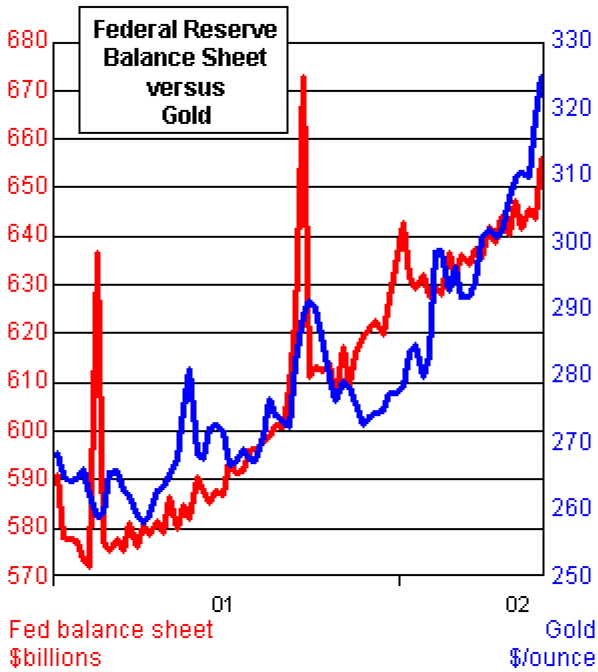
To be sure, given the manifest geopolitical risks now confronting the global economy, there is likely an element of safe-haven buying in this gold rally which casts some doubt on the sustainability of the full price gain. At some point over the next several weeks a moderate retrenchment -- to a range, say, around $320 -- would not be a major surprise. To the extent that the exogenous risk environment is attracting portfolio investment into gold at the dollar's expense, there are also indications that some reversal of the dollar's recent forex decline could be in store. It's not likely that expectations for sustained dollar depreciation against the euro, for example, would be met by outperformance of dollar *vs*. euro-denominated fixed-income assets. Yet, over the past seven trading sessions, the yield spread between 10-year US Treasuries and the German Bund has widened in favor of Treasuries by some 14 basis points.



For the most part, however, this gold/dollar move appears fundamentally based, with **the Fed's** maintenance of a 1.75% overnight target rate since late last year bringing about welcome relief from an excess scarcity of dollar liquidity. The Fed's more generous operating stance has been seen in a marked acceleration of its balance sheet expansion. After registering about 2.7% year-on-year in April 2001 -- around the same time gold troughed below $260 -- the rate of Fed balance sheet growth has been running above 10% since February. The accompanying chart, plotting the price of gold against the Fed's balance sheet assets (reserve bank credit, in the vernacular) since the beginning of last year portrays a distinct medium-term relationship between the two variables. While we wouldn't claim that such a close correlation would hold over longer periods of time, the chart suggests that the faster pace of Fed liquidity additions has had a direct impact correcting the deflation exposed by the five-year, better-than 30% decline in the price of gold.

As the Fed's deflationary error was the leading causal factor precipitating economic recession and an outright profits depression, so does this reversal inspire considerably greater confidence about this recovery. We detailed the degree to which excess demand for dollars produced a plunge in the turnover rate of money in the economy (velocity), resulting in a braking in growth of nominal GDP from which profits are derived. Reflation of the unit of account as seen in gold and the dollar, therefore, also implies a recovery in velocity, with a concomitant boost to nominal GDP, providing support for profit growth. That's not to say that nothing but blue skies await for markets and the economy. Obviously, a complex of factors -- from new terrorism threats to ongoing questions of basic corporate financial integrity -- continue to present daunting challenges. But as restoration of a non-deflationary unit of account enhances confidence sufficient to reduce risk premiums -- helping to rebuild market-wide risk preference -- the outlook grows increasingly promising. TM