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What's Up With Gold?

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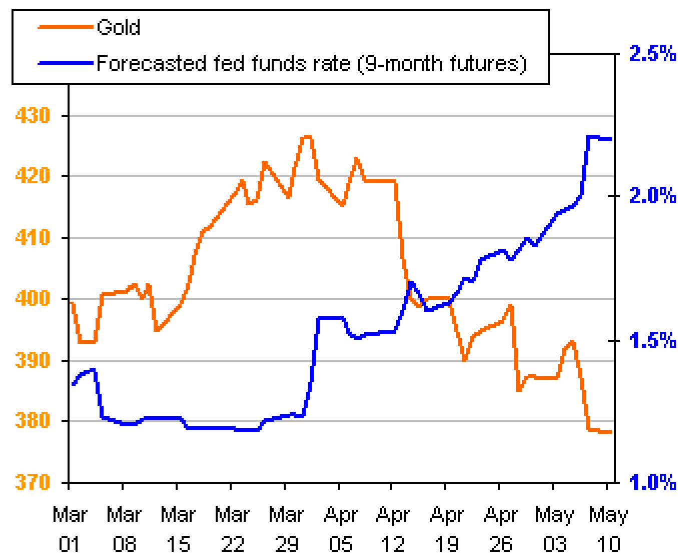
Does the drop in gold mean an end to inflationary risk? Not by a long shot.

The dollar price of gold has fallen from an intra-day high of $430 to below $380 since April 1, which to some is a sign that the incipient inflation reflected in gold's earlier rally to 14-year highs has been substantially quashed. We would caution against that interpretation, however, and still see upside risk in gold as the market sorts through the developing monetary policy environment.



April 1, of course, was the day before release of the breakthrough March jobs report, which shattered expectations that **the Fed** would remain on hold at least until November, and quite possibly into next year. That was followed by a string of data exceeding consensus expectations, importantly including a notable jump in reported inflation. Last Friday's report confirming a second consecutive month of robust payroll gains clinched the case -- at least as far as the consensus is concerned -- that the Fed has run out of excuses to avoid the necessary shift into normalization of its hyper-easy stance. It's now a near-certain bet in the futures markets that the first 25 basis point hike in the 1% funds rate will come at next month's **FOMC** meeting and that the overnight cost of funds will be 2% by the post-election meeting in November, with even odds that it will be 2.25% by year end.

Thus, the world has changed for a gold market that little more than five weeks ago saw few reasons to doubt that a complacent Fed would continue to slip further behind the inflation curve. While we view gold as the monetary indicator *par excellence*, during periods when such sharp shifts in expectations are being priced it's also important not to lose sight of the speculative nature of the market. As of April 1, with no end in sight to the Fed's excess liquidity posture, the speculative money was levering up and going long gold. To a considerable extent we're still in the backwash of that market being turned on its ear, with the urgent liquidation of highly levered long positions exacerbating the downdraft.

To be sure, the Fed's apparent awakening to the reality it faces renders a worst-case inflation scenario represented by $430 gold significantly less likely than it was on April 1. That doesn't mean, however, that all inflation worries will be over once the Fed finally moves into rate-raising mode. Not by a long shot. With its statement last week that "accommodation can be removed at a pace that is likely to be measured," the Fed meant to offer assurances that the policy

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tightening will be gradual and non-threatening. In fact, in an environment in which market-determined yields have jumped so far ahead of the Fed, the central bank essentially will be forced to continue easing even as it moves to lift rates.

The same forces working to push rates up across the bond curve, with yields free again to reflect real returns and higher inflation expectations as the 1% funds rate anchor is expected to be lifted, also are at work in the overnight funds market. Absent Fed intervention, the rate would be trading at a level consistent with the opportunity costs of the current market environment. Certainly, any such free-market rate would be multiples of the Fed's 1% target. There are signs that maintaining such an out-of-whack policy rate is compelling the Fed to inject significantly more liquidity to hold funds at target. In the past month, the Fed's balance sheet expansion, on a four-week moving average of a four-week annualized rate, has jumped from less than 1% to more than 12%.

While the intensity might vary, this dynamic is likely to persist in some form for as long as it takes the Fed to lift the funds rate to a market-neutral equilibrium level, probably in the range of 3.5 to 4.5%. This would suggest that gold and other real-time market prices most sensitive to the balance of liquidity supply and demand could yet see the effects of a renewed spell of dollar weakness in the weeks ahead. It also underscores that while the Fed will be described as "tightening" once it begins raising rates, its operating posture will be far removed from anything that could be considered "tight" for some time to come.

We don't rule out the possibility, however, that the Fed could still be compelled to carry out the coming rate-hiking exercise on a much more expedited schedule than is now anticipated. For one thing, it is striking the degree to which sentiment in just the past few weeks has swung from complete contentment with the Fed's sanguine inflation message to rising anxiety that the Fed has fallen dangerously behind the curve. Of course, we have been warning for several months that such a reckoning was inevitable. Now, in a familiar ritual, we await the signals from the monetary masters to ascertain whether they have absorbed the message. TM