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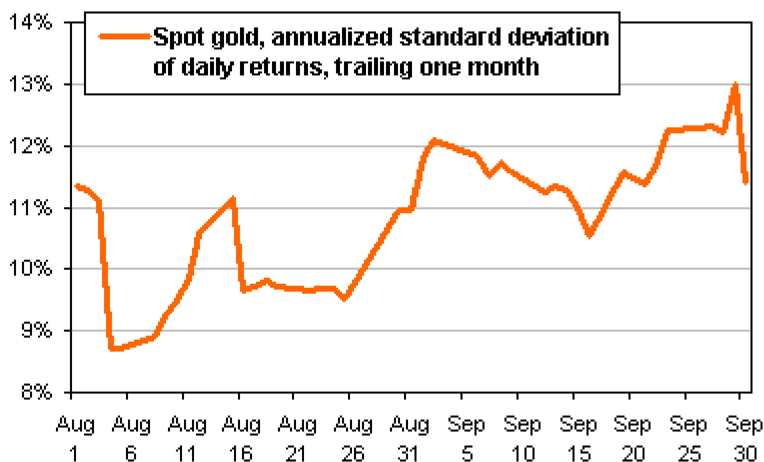
Fed rate hike expectations are above pre-Katrina levels -- so why is gold so high?

After taking nearly 50 bps off expectations for **out-month Fed action** in the immediate aftermath of **Hurricane Katrina** last month, **fixed income markets** have now more than corrected for their most recent spate of over-exuberance. For the first time, the **fed funds futures curve** is today pricing odds favoring ratification of a 4.5% **overnight rate target** at the January 31, 2006 **FOMC** session. On September 1, futures were priced for this **policy cycle** topping out at a rate no higher than 3.75%, a level which we concluded at the time was "unsustainable" (see "Katrina and the Fed" September 2, 2005).



The outlier in what we see as an otherwise constructive reshaping of market expectations has been the price of **gold**, which at $465 is still trading nearly $30 above pre-Katrina levels. In reading such market indicators, however, it's important to distinguish the **mean expectation** for future **inflation** embodied in the commodity's price from the **risks** attached to those expectations as reflected in **volatility** of the price. Should the price stabilize at these levels, it would indicate a non-negligible bump in the mean expectation. But as seen in just the last few weeks with the price widely fluctuating above and below the $470 line on a nearly daily basis, gold volatility has been substantial in this period. Such rising volatility suggests that the market has a considerable degree of uncertainty about the "right" price, which also suggests the price is vulnerable to a sharp "correction" of its recent run-up.

Of course, even discounting somewhat the significance of this latest gold price move leaves us far from sanguine about the inflation outlook. As we have detailed on several occasions, in a range above $420 virtually the entire year, gold has traded at increments above its long-term average (now around $330) which historically foreshadow significant inflation upticks. The longer the price stays at these elevated levels, the more extended the inflation episode is likely to be. The issue at hand is whether the Fed will pursue its **policy normalization** agenda to the extent required to staunch additional inflationary impulses coming into the system, and do so soon enough to prevent a moderate inflation uptick to 3 or 3.5% **core CPI** from becoming a destructive inflation breakout north of 5%.

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Our bet is that in his last months in his celebrated tenure, **Alan Greenspan** is intent on not leaving his successor with unfinished business. With three FOMC meetings remaining, that would put the funds rate at 4.5% on his last scheduled day in office, January 31. Gold will tell us definitively whether that will be enough to finish the job, but in our view that should put policy in a **near-equilibrium** posture. At some point, we'd expect to see gold respond by moving decisively toward -- and eventually below -- the $400 level. We see such downside vulnerability also applying to a range of **energy** and **industrial commodities** that have seen sharp price run-ups in no small part due to the same **weak-dollar** phenomenon manifested by gold.

While gold and other sensitive indicators will be the first to capture this shifting monetary stance, others -- **long-term Treasuries** being a prime example -- are only now beginning to catch on to the inflation reality that they have long dismissed. In the sell-off of the **10-year Treasury** since the yield bottomed just above 4% on the day following Katrina, nearly half the 36 bp jump in yield has been explained by a higher **inflation premium**, as seen in the **spread** between **nominal Treasuries** and their **CPI-indexed** counterparts rising to nearly 260 bps. Of course, that's still nearly 100 bps below the current 12-month **non-core CPI** growth rate, which is one measure of how much catching up **bonds** still have to do. At least, though, they've begun moving toward, rather than away, from a reality-based view.

Bottom Line: Market expectations for further Fed rate normalization action have come more than full circle since the post-Katrina blow-off, as the reality of the Fed's uncompleted mission steadily sinks in. While gold appears to be displaying skepticism about whether the Fed is prepared to follow through, we see considerable downside vulnerability in the gold price, and in other commodities prices, and expect the Fed to continue moving to restore monetary equilibrium. That will be of little aid, however, to long-term Treasuries, which remain badly mispriced for the approaching shift to a higher inflation environment. TM