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Gold at $490

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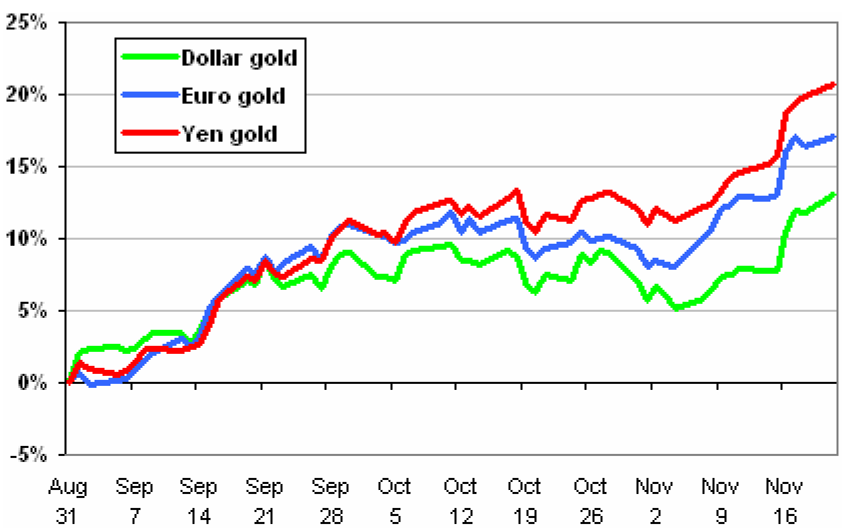
Fears that a new Fed chair will let inflation break out here are overdone.

The rapid escalation of the **gold** price to 18-year highs above $490, up some $25 since early last week, stands as a stark reminder that any talk of **the Fed** nearing the terminus of its **policy normalization program** remains premature. Indeed, this latest bout of weakness in **real dollar purchasing power** comes as a variety of factors -- lower **oil prices**, the **flat yield curve** and subdued **inflation** data, among them -- have combined to foster increased speculation that the Fed might be close to concluding **this rate-hiking cycle**. All this comes as **Ben Bernanke's** installation as Fed chairman approaches in early February, adding another risk factor to the mix.

The lessons of economic history, especially since the **US** left the last vestiges of a **gold standard** in the early 1970s, clearly instruct us that such gold price moves should not be taken lightly. The **monetary chaos** seen in gold soaring from $35 to more than $150 between 1971 and early 1974 ushered in the inflationary era of the '70s. The last time gold rallied to these levels in 1987 presaged an inflation breakout, with **core CPI** jumping from 4% to more than 5.5%. For those contented that current **core inflation rates** around 2% are proof positive that **price pressures** remain nonexistent, it should be borne in mind that in that earlier episode, core inflation didn't peak until early 1991. That was some three years after the gold price top, and about four and a half years after gold began rising from a range around $325 to $350 in mid-1986.

Even as gold traded in a range between $400 and $425 for the bulk of the past two years, we advised that at such increments above long-term averages around $330, it was clearly foreshadowing the inflationary consequences of a Fed that stayed too **easy** for too long. As it is, core inflation at current levels around 2% year-on-year is already running at rates about double that of two years ago. At that time, Fed officials were still convinced that the low level of core inflation was signaling **deflation** risk, and were committed to maintaining policy in its **hyper-accommodative** mode for a **"considerable period."** Our model, with gold as a key analytical component, showed that the Fed had largely



overcome its earlier deflation error by mid-2002, when gold had recovered to around $325 after trading below $260 a little over a year earlier.

Gold is hardly alone in signaling the price pressures occasioned by the accumulated **liquidity excesses** of a long-running **easy-money policy stance** and speculation that such a stance could remain in place for some time to come. The **Dow Jones-AIG Commodity Spot Index** is up some 20% since last May, and the **CRB Metals** and **Raw Industrials** indexes are near all-time highs. None of these commodity groupings includes oil. One outlier among the **market-price indicators** has been **the dollar's** apparent strength against **major foreign currencies**, with the **G-6 Trade-weighted Dollar Index** up about 7% since early September. The most that can be said for the dollar, however, is that over the past several months it has been the least weak among a very weak group of currencies. While the dollar has lost a little more than 10% of its value in gold terms since early September, **the euro** is down about 17% and **the yen** nearly 20% against gold over the same period (as shown in the chart on the previous page).

As noted, much of this recent weakness in dollar/gold has been inspired by speculation that the Fed will be compelled to cut short its rate-normalization campaign before policy reaches **equilibrium**. In the past week, the implied yield **on June 2006 Eurodollar futures** had taken about 13 basis points off what had been an odds-on bet for a 4.75% **fed funds rate** in place by mid-year. Further out, futures are actually pricing some chance for **rate cuts** before the end of next year. Today, release of the **minutes** of the most recent **FOMC meeting** gave added impetus to the unwinding of such speculation, with the June Eurodollar futures rallying nearly another 10 basis points. From our perspective, the record of the November 1 meeting raises more questions than it answers. But broaching the possibility of a near-term change in language of the post-meeting policy statement -- potentially no longer describing rates as **"accommodative"** -- points to some possibility of at least a near-term pause in this rate cycle. In fact, the minutes can be seen as reflecting reality: the rate target is rising to a level that simply can no longer be reasonably considered accommodative. But don't expect anything too definitive in any new language. We doubt that the panel is going to want to foreclose any options available to Bernanke when he takes the helm following the January 31 meeting.

Our read is that in Bernanke's first months as Fed chairman, the former **Princeton** professor will be most concerned with establishing his inflation-fighting credentials, and reassuring markets by demonstrating institutional continuity with today's regime of **"measured" rate hikes**. We have no reason to believe that sensitive market indicators such as gold are key components of his policy framework. But in the current context it's likely that the **output-gap model** -- to which Bernanke and virtually the entire Fed bureaucracy adheres -- will prescribe further action in response to the economy's diminishing reserves of **"slack."**

Bottom Line: At above $490, the price of gold is conveying the inflation risk implied by the possibility of the Fed calling a too-early end to its rate normalization campaign. Should gold stabilize at or above these levels, it would indeed signal a much more extensive inflation breakout than we have been anticipating. Our bet, however, is that speculation on the Fed looking for an early out, most likely compounded by the anticipated arrival of Ben Bernanke early next year, has been overdone. We continue to expect **Alan Greenspan** to leave office on January 31 having put the funds rate at 4.5%, and see Bernanke as more likely than not to push through rate hikes at two of his first three meetings, leaving the rate target at 5% by mid year. TM