TrendMacrolytics

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Different This Time?

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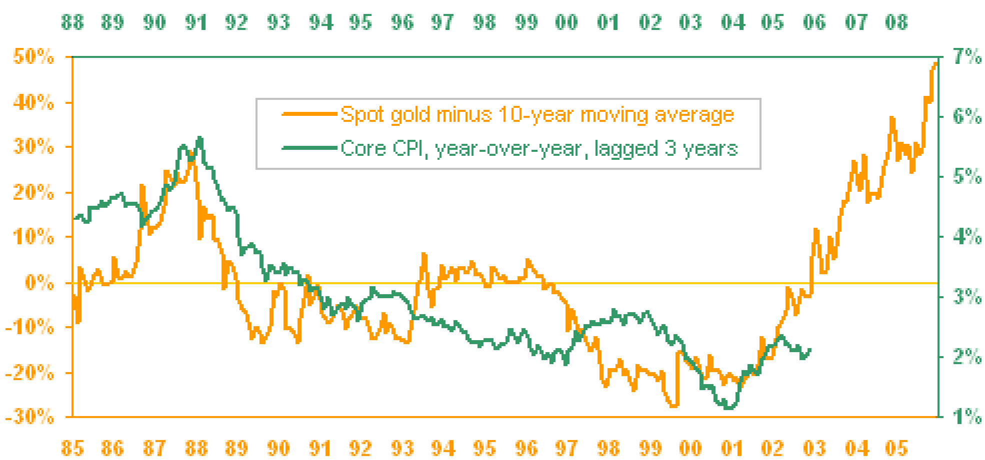
Nope. Indeed, gold may be signaling the first synchronized global inflation event in over two decades.

In the 34 years since **President Nixon** closed the **gold window** and severed the **US dollar's** last links to a gold anchor, a run-up in the price of the precious metal on a scale such as that seen in the last two and a half years has presaged a substantial acceleration in **core inflation** on every occasion. That fact should be kept firmly in mind in the face of an outpouring of analysis and commentary finding any number of causes for the gold rally except the one that almost certainly explains it: a sustained **excess supply of monetary liquidity** relative to **demand**, foreshadowing significant upward pressure on the **price level**.

The most recent previous extended gold price rally -- when the price climbed from below $350 in early 1986 to $500 by late 1987 -- came nearly 20 years ago, so perhaps memories have faded. But that bout of eroding **real dollar value** set off the last meaningful upshift in core inflation, with year-on-year **core CPI** rising from about 3.5% in early 1987 to more than 5.5% over the next four years. That interlude was followed by more than a decade of virtually uninterrupted **disinflation**, which has given rise to a general sense that inflation has permanently been banished.



In fact, core CPI is already running at nearly double the rates around 1% year-on-year recorded two years ago. But at little more than 2% it is still at levels that arouse scant notice or concern. In certain quarters, including among some **supply-siders** who should know better, the current benign levels of core inflation are cited as evidence that **price pressures** remain non-existent. The official inflation indexes, however, are among the most deeply lagging, backward-looking data aggregates in the statistical universe. To embrace current statistical readings from the price indexes in the face of gold soaring by more than 40% since mid-2003 is to ignore the clear lessons of economic history. That history is supported by our analysis showing that gold has retained its character as the most sensitive, forward-looking indicator of price-level changes (see the chart above).

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One of the key contentions of those arguing "it's different this time" is that even as gold has soared**, long-term bond yields** have failed to break out. The **10-year Treasury** yield is still below 4.5%, and the break-even **TIPS spread** is less than 2.5%. Surely, the argument goes, a realistic inflation threat would be tanking bonds, sending yields sharply higher. Not necessarily. The notion that bonds have served a reliable forecasting function has been regularly refuted by actual financial history. Bonds got it wrong in the mid-1970s, with yields being held down by a complacent **Fed** as gold shot higher and the dollar got hammered. Real yields were negative for extended periods during that time.

In the late 1990s, it was the opposite story. A rapidly descending gold price indicated price impulses were shifting from inflation to **deflation**, but a **Fed** typically **behind the curve** went into **tightening mode** to rein in what it fallaciously saw as an **overheating economy**. Bond yields followed the Fed and rose by more than 200 basis points from late 1998 through 1999. Once again, gold was right and bonds were wrong. Then, when the Fed belatedly recognized the deflation threat in 2002 and 2003 -- by which time gold was clearly indicating that the threat had passed -- bonds rallied to a yield as low as 3.1%, in keeping with the Fed's pledge to maintain its **hyper-accommodative stance** for a **"considerable period."** In these examples, it's clear that the factor with the greatest influence on bonds has been the level of the **real fed funds rate target**. In the current context, that suggests that yields are being kept in check by a Fed that, by historical standards, continues to maintain a low real funds rate target. As the funds rate rises, bond yields are likely to follow.

Another misleading indicator being cited as refuting the gold signal is the **foreign exchange** value of the dollar, particularly against the **euro** and the **yen**. It's true that gold and the dollar often move in tandem -- a dollar losing value in gold terms will also be weakening relative to its foreign currency counterparts, and *vice versa*. But it's important to recognize that forex rates are primarily a reflection of the *relative* policy stances of the various **central banks** of issue. In the recent episode that saw the dollar's forex value rising even as it was weakening against gold, yen and euro gold prices were rising even faster. In other words, the dollar only looked "strong" relative to currencies that were even weaker. It could be that this concurrent move higher in gold among the three major currencies indicates some loss of confidence in the **"paper standard"** that has been managed by the major central banks over the past two decades or so, with gold taking on a role as the **"fourth currency."** If so, it could well be foreshadowing the first **synchronized inflationary event** in the **major industrial economies** in some 25 years. It should come as no particular comfort, however, that among a group of very weak currencies, the dollar recently has been the least weak.

Bottom Line: The response of various market prices to this morning's **core PCE** -- another release showing a subdued rate of current statistical inflation -- underscores some of the concerns outlined in this report. As bonds rallied and yields fell in accord with out-month **interest rate futures** trimming expectations for forthcoming Fed **rate hikes**, gold rallied by some $10, putting its price back above $500. That snapshot serves to buttress our contention that were the Fed to accept the current statistical data as definitive evidence of totally benign inflation risks, the consequence would ultimately be even higher inflation. Although we know that Fed officials pay only the slightest attention to gold anymore, our analysis is that their preferred macroeconomic models -- flawed though they certainly are -- will compel hikes moving the fed funds rate to at least 5% by mid-year, which is beyond the expectations currently priced in the futures markets, which show the funds rate topping out below 4.75%.

Correction: In our previous report ("Bernanke's Conundrum" December 20, 2005) we incorrectly referred to the 10-*day* moving average price of gold, when what we meant was the 10-*year* moving average price. We regret any confusion that arose from our error. TM