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Quick Takes

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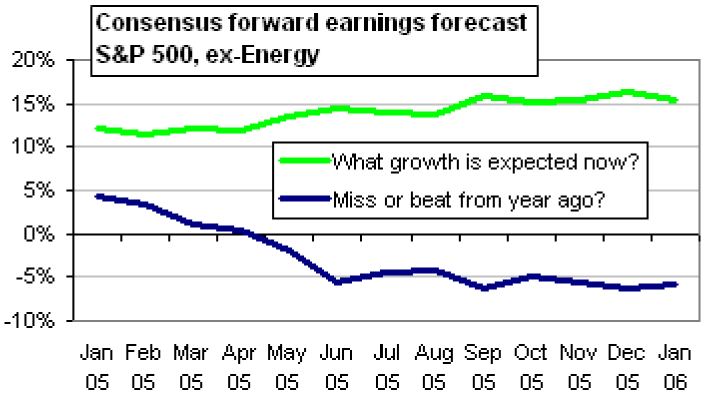
What's driving gold, corporate earnings slowdown, and tax cut extension progress.

GOLD OFF THE HIGHS It's gratifying to see the **gold** price falling sharply off its 25-year highs of last week, as **consensus expectations** for **continued Fed rate hikes** move closer to our longstanding out-of-consensus **higher-longer** forecasts. As the rate consensus gets even more **hawkish**, we expect to see gold continue to drop (along with **crude oil** and other **inflation-sensitive commodities**).

Setting aside the last couple of down days, gold has moved so sharply and relentlessly higher over the last year that a number of clients have asked us whether it may no longer be functioning as an accurate indicator of **inflation expectations**. One client shared with us a report suggesting that a substantial majority of **global gold demand** is now being driven by the rapidly growing **StreetTracks Gold Trust**, an **exchange traded fund** which backs its shares one-for-one with **physical bullion**. The report is wrong; in fact, the *entire cumulative value* of the Trust's holdings would be only about a third of demand in just a single quarter. Another client shared intelligence suggesting that a great deal of new demand was arising from private purchases in **Iran**. That's hard to substantiate or refute, but there's nothing inherently unbelievable about the idea that Iranians would seek to preserve their wealth in gold considering the dangerous nuclear course being taken by president **Mahmoud Ahmadinejad** (the **Teheran stock market** has lost about a third of its value since he was elected). Such forces can, indeed, affect relatively illiquid markets such as gold -- at least temporarily, until **equilibrium** reasserts itself. We give no credence whatsoever to the **conspiracy theory** currently making the rounds on the **Internet** concerning the **Iran Oil Bourse**, supposedly a world marketplace for crude oil based in Teheran with trading denominated in **euros**, intended as a part of a grand strategy to destroy **America** by dethroning **the US dollar** as the **world's reserve currency**.

While we by no means ignore the possibility that any number of factors can influence the gold price -- or any other market price, for that matter -- we continue to believe that the dominant component of any large gold price move is inevitably going to be inflationary expectations, informed in turn primarily by expectations of **Fed policy moves**. The move in gold from its bottom at the depths of **monetary deflation** in 2001 has been so substantial in magnitude and so perfectly event-coincident in the pattern of its timing that, even granting full play to other possible explanations, there is no doubt whatsoever that an important **inflation risk signal** has been and continues to be given.

EARNINGS SLOWDOWN? The latest **pessimistic meme** in the market is the idea that **corporate earnings** are slowing down. We simply don't see it in our macro forecast, and it's not showing up in the **cap-weighted consensus forward earnings** numbers. For the **S&P 500**, the consensus is for 15.7% earnings growth one year ahead. It can't be explained away by the **Energy sector**, either -- **ex-Energy**, the consensus is for 15.5% growth. The only arguably negative trend we see is that, over the last year, the trend of **earnings surprise** versus what had been expected a year earlier has drifted from **beat** to **miss** -- returning to approximately the long-term mean (about a 5% miss). At the same time, though, the forward consensus has moved in just the opposite direction, suggesting that any disappointments are being directly translated into heightened hopes for the future.



EXTENDING THE 2003 TAX CUTS
The announcement of the **White House's** 2007 budget has focused attention on increasing future **federal deficits**, and given an opportunity for opponents of extending the **2003 tax cuts on dividends and capital gains** another **news cycle** in which to make their case. For all that, our optimism is increasing that **Congress** will extend the tax cuts within the still ongoing framework of 2006 **reconciliation**. For one thing, evidence of the **economic growth** engendered by the tax cut continues to mount up. Yesterday's ***Monthly Budget Update*** from the **Congressional Budget Office** showed that the current trailing 12-month federal deficit is the lowest it's been since May, 2003 -- before the tax cuts were enacted. Certainly that's not due to **spending** being lower today than it was then. The difference is **revenues**, made possible by rapid economic growth in the presence of **lower tax rates** on **labor** and **capital**.

At this moment, according to sources close to the situation, there are enough votes in the **Senate** to approve extension once it becomes embodied in a bill passed out a streamlined **House/Senate conference committee** soon to be appointed by **leadership**. We are hearing that **"moderate" GOP Senators Mike DeWine** of **Ohio** and **Susan Collins** of **Maine** are now being counted in the **"aye"** column as is **Democratic Senator Ben Nelson** of **Nebraska**. Perhaps most critically, influential bellwether **John McCain** of **Arizona** seems to still be on the "aye" side, despite having originally voted against the tax cuts in 2003 and having recently made statements that are less than fully supportive (see "The McCain Mutiny" September 23, 2005). Tellingly, last week he succumbed to party pressure and changed his vote to **"no"** in a **"sense of the Senate" resolution** declaring the **AMT "patch"** to be a higher priority than extending the 2003 tax cuts.

BOTTOM LINE: Exactly as we said last week, **equity** and **fixed income markets** are still in the painful process of recognizing and digesting the reality that the Fed has further to go in its **policy normalization process**, and ultimately coming to accept that rates sufficient to quell inflation risk are a good thing (see "On the FOMC Meeting" February 1, 2006). In the meantime, we see political and tax policy uncertainties moving in a constructive direction. Deep **undervaluation relative to still-rising consensus earnings forecasts and still-low interest rates** puts a floor under any serious downside in stocks here, and the likely positive resolution of current risks would unlock substantive upside potential.