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Gold, the Dollar, and the Fed

Monday, April 3, 2006

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Gold may be caught up in a commodity boom, but it's also saying the Fed is still accommodative.

Gold, the **commodity** with the long and reliable track record as singularly most sensitive to changes in **monetary purchasing power**, has apparently been singularly unimpressed by the latest **hawkish** soundings from **the Fed**. Since last Tuesday's **FOMC** meeting ended with policymakers countering widespread expectations that they were ready to signal that the end of the present **rate-hiking cycle** is in sight, the price of gold is up nearly $25 and -- at just below $590 -- is hitting 25-year highs.

At first blush, the gold price response would seem to suggest that, rather than getting closer to **monetary equilibrium**, Fed policy is actually becoming more **accommodative**, even after the **overnight rate target** has been lifted from 1% to 4.75% since mid-2004. Our analysis suggests, however, that this would be a misreading of the forces at work. Were the recent gold price behavior a sign of a **weakening** in the real **value of the currency**, we would expect to see some confirmation of that in the **foreign exchange markets**. Fact is, even as gold has risen overall by some 14% thus far this year, **the dollar** has essentially been stable against its **major currency counterparts** represented by the **G-6 trade-weighted index**. The price of gold, in other words, has risen proportionately by about the same amount in all the major industrial country currencies. While some of those currencies -- the **euro** and **Japanese yen**, for example -- are managed by **central banks** that are maintaining **easy** policy stances, it would be a stretch to suggest that all the major central banks are pursuing equally accommodative postures.

Gold, moreover, has hardly been alone. A broad spectrum of **industrial commodities** continue to rally across currencies with some -- notably **copper** -- reaching historic highs. In large measure, since monetary factors do not appear to be at work, these price moves have to be considered a reflection of robust **global economic growth**. Although gold is not normally a growth-sensitive commodity -- that is, its price has historically risen and fallen independent of **cyclical forces** -- it could be that trading in gold has gotten caught up in the **speculative** excitement of a commodity boom.

While we rebut the idea that the current gold rally reflects a progressively easier policy posture by the Fed, by the same token, had the Fed reached equilibrium, a significant response would almost certainly have been seen in gold and the dollar. Since mid-2003, when the Fed entered its **hyper-accommodative easing mode**, gold has risen by about 70% from around $350. With restoration of **monetary neutrality**, we would expect to witness the gold price rolling over and heading back toward $400 in a fairly decisive manner, along with a considerable dollar forex rally. So gold may currently be overstating the extent to which the Fed remains easy, but no doubt it is indicative of the fact that policy is still accommodative.

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Meanwhile, we also note that some are making the argument that the central bank's rate-hiking efforts have been self-defeating, actually perpetuating the Fed's **inflation-biased** stance. In earlier Fed policy cycles, my work examined the extent to which distortions caused by the central bank's deeply flawed **interest rate targeting mechanism** can give rise to unintended policy consequences. In the 1994 tightening exercise, I developed the **"treadmill"** analytical concept after observing that the Fed's **open market operations** were actually becoming more generous even as rates were rising due to the **banking system's** scramble for **reserves** to beat the anticipated rate hikes. As a result, growth of the Fed's **balance sheet** accelerated during the bulk of that cycle. But reserve market conditions in the current episode are quite a bit different. On a four-week moving average of 13-week annualized change, Fed balance sheet growth has contracted from a double-digit pace at the outset in mid-2004 to just about flat currently. There's no question that the Fed's rate hikes have worked to slow the growth of **liquidity**, but not enough yet to overcome the decline in **dollar demand**.

Bottom line: The gold price rally of the past week has represented the continuation of a trend seen in the last several months in which the gains have been seen against all major currencies. Rather than indicating a real weakening of money purchasing power, the gold price move appears to be taking place in concert with a broad commodity rally. If that's the case, it could be setting up a substantial downside correction when the Fed finally reaches equilibrium and dollar demand is enhanced along with confidence in the currency. TM