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Gold's New Line in the Sand

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Inflation-sensitive markets won't let themselves be talked down for long.

Update to strategic view
US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: Inflation-sensitive assets have corrected somewhat since the Fed started worrying more openly about inflation risks in early November. But continued pressure from credit markets will keep the Fed in an excess liquidity posture for the indefinite future, so we expect the inflation-driven trends of the summer -- higher commodity prices and a lower dollar -- to remain in place.
[see Investment Strategy Dashboard]

Gold has made a sharp correction from its high just above 831. It's probably enough to think of it as a reversal of speculative excess, especially as it seems to be associated day-to-day with the reported unwinding of yen carry trades and other indicia of the market's risk aversion. But it's significant that the correction began moments after Ben Bernanke's November 8 appearance before the Congressional Joint Economic Committee. In his prepared testimony he showed a deeper level of awareness and concern about inflation risks than he had at any time since the Fed began easing in August in response to the crisis in credit markets (see "The Dollar Will Have to Wait" November 8, 2007). For months Fed officials had publicly dismissed as short-term aberrations the manifest evidence of rising inflation pressures in response to their liberal injections of liquidity into turbulent credit markets (see "It's Not Just a River in Egypt" September 28, 2007). But Bernanke's JEC testimony was fairly candid about the possibility that higher commodity and energy prices and a weaker dollar had "the potential to boost inflation in the longer run" if "inflation expectations become unmoored." The identical language was utilized the following week in a speech by Fed governor Randall Kroszner.

Inflation expectations are the issue -- not the "pass-through effects" of higher commodity prices and a weaker dollar, as numerous Fed speakers had used to rationalize inflation-denial throughout the current easing episode. In fact, axiomatically, *there can be no such thing as a pass-through effect* -- in which a price shock in a single element of the consumption basket affects the price of the basket overall -- unless the central bank accommodates the shock by changing the quantity of money. Absent such a change, a shock in one element must be offset by price changes in the other direction elsewhere in the consumption basket. As proof, consider oil -- a commodity widely assumed to necessarily have strong pass-through effects on the overall price level. After all, energy is 8.7% of the Consumer Price Index, and motor fuel alone is 4.3%. Yet there is virtually no consistent evidence of pass-through effects in oil.

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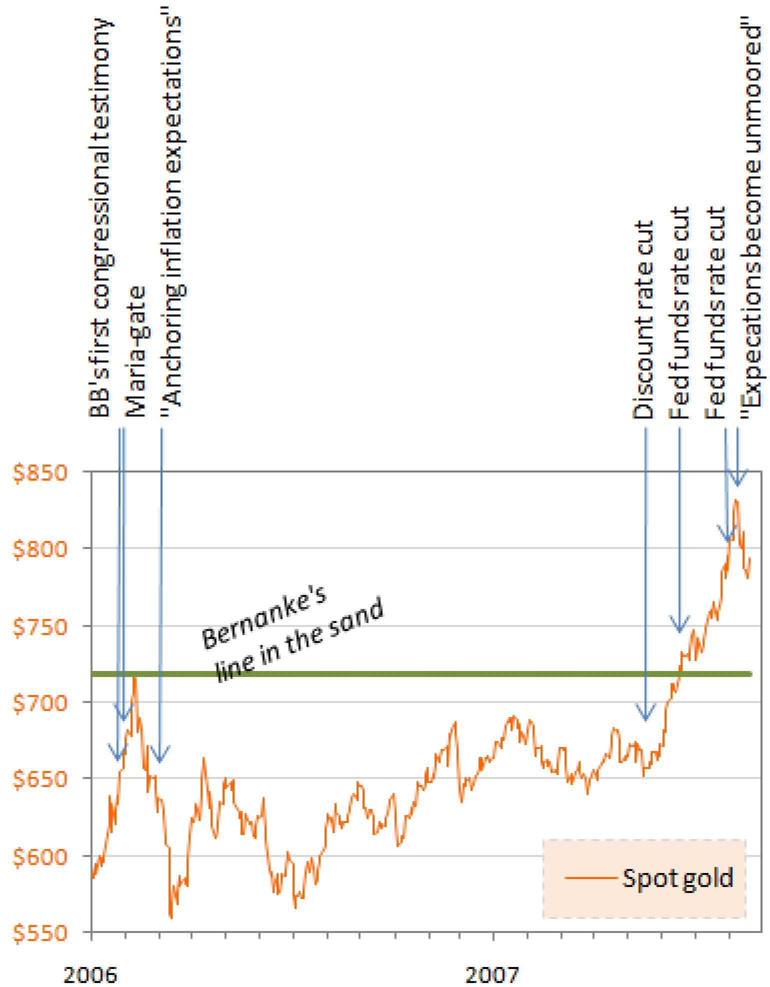
- Over the last 25 years (thus excluding the hyper-inflation years of the 1970s), whenever the oil price rose by more than 10% over two years, the rate of CPI inflation rose over the following two years only about 40% of the time (on average for such periods, the rate of inflation actually fell by 0.4%). When the oil price fell, the rate of CPI inflation fell only about 50% of the time (on average, the rate of inflation was unchanged).

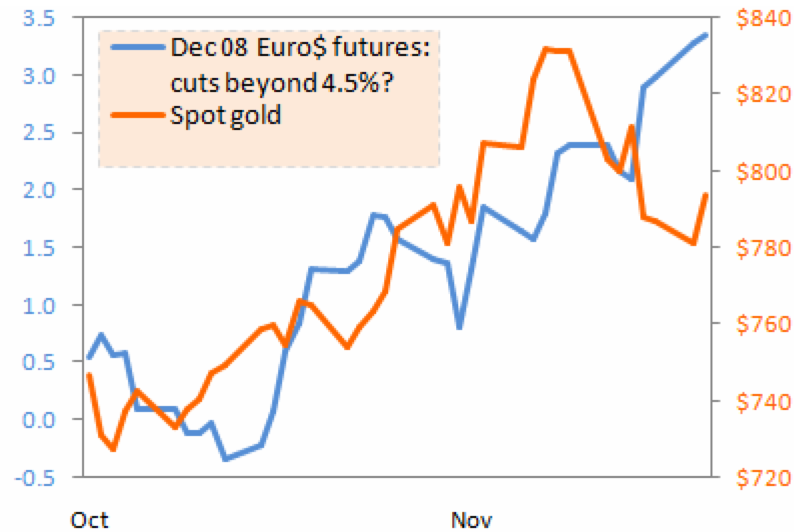
Now consider gold.

- Over the last 25 years, whenever the gold price rose by more than 10% over two years, the rate of CPI inflation rose over the following two years about 85% of the time (on average for such periods, the rate of inflation rose 0.8%). When the gold price fell, the rate of CPI inflation fell about 70% of the time (on average, the rate of inflation fell 0.8%).

This strong relation between changes in the gold price and future changes in the inflation rate cannot possibly be due to pass-through effects, since gold is a very small part of the consumption basket (the entire category of watches and jewelry represents less than one third of one percent). It must be that the gold price is picking up changes in inflation expectations that turn out, more often than not, to be fulfilled. So when Ben Bernanke openly worries about inflation expectations becoming "unmoored," that is tantamount to worrying about the gold price, even if Bernanke doesn't explicitly consider it. So it shouldn't be surprising to see the gold price correct somewhat once the Fed implicitly acknowledges the inflation threat that it represents -- such acknowledgment is potentially a first step toward tighter policy.



But in the present situation, with credit markets still in tumult and posing as yet unknown risks to employment, investment and spending, the Fed's tougher talk about inflation is likely no more than just talk. We've seen it all before. The "unmoored" language Bernanke is using echoes -- right down to its nautical imagery -- the language of his [June 5, 2006 speech] when he was still new in his position as Fed chair. He had just suffered the embarrassment of Maria Bartiromo reporting he told her that "markets misunderstood me," triggering gold and other market-based indicators of inflation risk to rise to alarming levels. He committed then to "anchoring the public's long-term inflation expectations," and that statement alone seemed for a while to achieve a great deal of the desired "anchoring." We have referred to that statement as Bernanke's "line in the sand," a threat to do whatever may be necessary to contain the gold price at its Maria-gate high of 718 (see ["Walk the Hawk"] November 30, 2006). When two months later the Fed paused -- or, as it has since turned out, ended -- its rate hiking at 5.25%, it began a year of talking hawkish while acting dovish. Until the credit crisis this summer, that was enough. Then the Fed had to act *very* dovish, and for a while stop talking hawkish. After the August cut in the discount rate, and even before the first fed funds rate cut in September, the gold price blew through the "line in the sand," and the Fed could do nothing whatsoever to stop it (see "From Line in the Sand, to Sand in the Face" October 30, 2007).



Now it seems that the Fed has drawn a new "line in the sand" at $831 gold, more than $100 above the old line in the sand at $718. But we think that line is very unlikely to hold as long as the last one did. Yes, the Fed is at pains to maintain a "neutral" bias, and to fret about inflation expectations, so that markets won't take it for granted that further cuts in the funds rate are inevitable. The minutes of the October 31 FOMC meeting released today even characterized the rate cut then as a "close call" in the minds of many members. But the downgraded forecasts for both growth and inflation released with the minutes suggest that the Fed is not really as "neutral" as it lets on -- it's worried about growth, and its benign inflation forecasts give it the scope to act on those worries. Absent some contravening miracle, at least one more cut at the December 11 FOMC meeting seems inevitable, unless the Fed will dare for the first time in history to violate the deeply-held easing expectations in futures markets, which are saying at least one cut is virtually a sure thing. Even if there are no further cuts after December, simply holding the funds rate at 4.25% for a long period is likely to keep the fed in a strong excess liquidity posture. The inflation expectations the Fed professes to worry about are likely to get more "unmoored."

BOTTOM LINE: Inflation-sensitive assets have corrected somewhat since the Fed started worrying more openly about inflation risks in early November. But continued pressure from credit markets will keep the Fed in an excess liquidity posture for the indefinite future, so we expect the inflation-driven trends of the summer -- higher commodity prices and a lower dollar -- to remain in place.

BONUS ROUND FOR BERNANKE TRIVIA BUFFS From the question-and-answer session following Ben Bernanke's speech of August 31, 2006:

> MODERATOR: Thank you Dr. Bernanke. As I mentioned a few minutes ago, we do have a few minutes. So, I am going to ask him if he would respond to some questions. And we could do this the old-fashioned way, where I ask the questions and you provide the answer or, this jeopardy kind of thing. Almost, considering that these questions have been hermetically sealed in a mayonnaise jar and kept in the turban that Johnny Carson used in his Carnack routine, you could provide me the answer first and then I could read the questions.
>
> BERNANKE: All right, four percent.
>
> MODERATOR: I really didn't think you would do that.