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MACROCOSM

Gold $1000, Here We Come

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Donald Luskin

It's just a matter of time, with the Fed utterly oblivious to inflation risk.

Our "inflation plays" continue to surge (see "The Other Winners in the Credit Crisis" February 19, 2008). Gold and crude oil made new all-time highs yesterday. The dollar made new all-time lows against the euro. The latest official measures of inflation have the Consumer Price Index up 4.4% year-over-year, and 6.8% for three months annualized; the Producer Price Index is up 7.7% year-over-year, and 13.5% for three months. The monetary authorities are appropriately concerned, telling markets yesterday that expectations for rate cuts cannot be fulfilled while inflation is running so hot. Specifically, a central bank official said, "the current dominant market consensus on interest rate expectations clearly underestimates the inflation risks. These expectations do not drive the monetary policy view of a central bank which is committed to price stability."

Oops! That statement wasn't made by an official of *our* central bank. It was made by Axel Weber, a member of the Governing Council of the European Central Bank. Yesterday the chairman of *our* central bank acquiesced in the market's expectations for further rate cuts -- inflation be damned! -- saying, "The FOMC will…act in a timely manner as needed to support growth and to provide adequate insurance against downside risks." For *our* central bank, expectations *do* drive monetary policy (see "Jump! How High? Cut! How Low?" January 31, 2008) because *our* central bank is *not* committed to price stability -- at least not when there's a credit crisis to deal with (see "'No Quandary Here'?" February 21, 2008).

Update to strategic view

US RESOURCE STOCKS, COMMODITIES, GOLD, OIL: With the "inflation plays" at new all-time highs, and talk of inflation rampant in the marketplace, it might be time for a short term correction. But more likely, heightened awareness of inflation as a theme will be the catalyst for the next leg higher. The fundamental driver of the inflation theme -- the Fed obsessed with risks to growth and ignoring inflation risks -- remains entirely intact.
US DOLLAR: Our hopes that the dollar exchange rate would stabilize with the ECB taking a looser stance have evaporated, with recent statements renewing the ECB's commitment to inflation-fighting, while our own central bank sinks deeper into inflation denial.

[see Investment Strategy Dashboard]

We've been aggressively advocating the "inflation plays" for a long time (see, among many others, "Inflection Point Deflected" July 11, 2006). We strongly reiterated our advocacy when it became clear that the Fed's response the credit crisis would be to adopt an excessively easy posture (see "Thoughts After a Very Rough Week" July 30, 2007). Now, with talk of inflation (and "stagflation") rampant in the marketplace, with many physical

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commodities at all-time highs, and with energy and basic materials the two best-performing sectors in both US and global markets, it's a fair question to wonder whether the inflation theme is getting exhausted. Perhaps -- at least as a trading matter, it would be no particular surprise to see a correction here. But more likely this is one of those times when the dawning of general awareness about a theme -- a theme that had previously been the subject of dominant skepticism, and has not yet been fully adopted by the conventional wisdom -- will be the catalyst for a significant move higher. We stand by our call for "gold $1000" (see "A Dearth of a Thousand Cuts" September 18, 2007), and all that it implies for the inflation theme.

Certainly the fundamental driver of the inflation theme -- the Fed seemingly obsessed with downside risks to growth, and willing to throw inflation risks to the wind -- is entirely intact. A speech on Tuesday by Fed governor Frederic Mishkin (a former academic colleague of Ben Bernanke -- and a member, with Bernanke and Donald Kohn, of the "gang of three" that dominates monetary policy), reveals the reckless intellectual framework ruling the Fed's approach to inflation. For Mishkin, inflation is entirely the by-product of economic growth; the Fed's only role is to manage inflation expectations. Yet he admits that in the long run the Phillips Curve (essentially, the relation between growth and inflation) is "vertical" -- which is a fancy way of saying it doesn't exist.

At the same time, Mishkin posits with no explanation, as though none were necessary, that it is a "fact" that the Phillips Curve *does* exist in the short run. He uses this "fact" to argue that the Fed can safely pursue an "expansionary policy" in response to a "negative shock to aggregate demand." Because of "increased slack in the economy," the expansionary policy poses no inflation risk, and will indeed "keep inflation from falling." If this all sounds eerily familiar, it should -- it is the formulation, and in fact most of the very same words, that Ben Bernanke often in speeches used to justify the Greenspan Fed's "considerable period" of extremely low interest rates from 2002 to 2004. These are the policies that first set in motion the inflation dynamics we are now experiencing, and gave rise to the widespread credit abuses that led to the current housing collapse and credit crisis. For Mishkin, these unintended consequences of previous policy errors would seem to be nothing but a "negative shock to aggregate demand" calling for yet more "expansionary policy." As one wit once put it, "Irony is hypocrisy with style."

Mishkin cautions that the Fed's ability to pursue an expansionary policy without increasing inflation is enabled by inflation expectations being well anchored, when the market knows "the central bank is firmly committed, through its actions and statements…to keeping inflation low and stable." Mishkin does not say a word about how inflation expectations should be measured, so he does not have to address the question of whether today's all-time highs for commodities and all-time lows for the dollar reflect the possibility that the Fed has not been taking the right "actions" or making the right "statements." The closest he comes is to dismiss the importance of consumer goods with "flexible prices" such as food and energy, saying that a central bank should only target inflation in goods with "sticky prices." So while he acknowledges the importance of expectations, he waves away as unimportant -- as mere "supply shocks" -- price changes in goods most likely to reflect those expectations, instead focusing on the goods least capable of reflecting them.

When the central bank doesn't understand what inflation is (it is everywhere and always a monetary phenomenon) and can't see that inflation expectations are completely unhinged (commodities prices are at all-time highs, and the dollar is at all-time lows), then it's a virtual certainty that inflation will keep rising -- and that the "inflation plays" in markets will keep rising right along with it.

BOTTOM LINE: With the "inflation plays" at new all-time highs, and talk of inflation rampant in the marketplace, it might be time for a short term correction. But more likely, heightened awareness of inflation as a theme will be the catalyst for the next leg higher. The fundamental driver of the inflation theme -- the Fed obsessed with risks to growth and ignoring inflation risks -- remains entirely intact. Our hopes that the dollar exchange rate would stabilize with the ECB taking a looser stance have evaporated, with recent statements renewing the ECB's commitment to inflation-fighting while our own central bank sinks deeper into inflation denial.