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MACROCOSM

Gold: Is Enough Enough?

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The drop in the "inflation plays" is overdone in light of worsening inflation risks.

Update to strategic view

US RESOURCE STOCKS, GOLD, COMMODITIES, OIL: Oil deserved to get whacked after the speculative frenzy of recent months, but it has unreasonably dragged other "inflation plays" down with it. Underlying inflation trends are worsening, not improving -- and resource stocks are now among the best bargains in the stock market.

[see Investment Strategy Dashboard]

What is gold telling us as it nearly fell to $800 yesterday? When it first passed *above* $800 in early November 2007, it was unambiguously telling us that the Fed was fueling the fires of inflation with its panic-driven rate cuts designed to stem the crisis in the financial sector (see "Fed Liquidity Runneth Over" November 7, 2007). Now, nine months later, $800 is still $800, whether we approach it from above or below -- still a very elevated gold price, indicating that inflation pressures remain quite intense. And gold's well-established trend from its deflation-driven bottom in 2001 is still very much intact. But having been above $1,000 in mid-March at the depths of the Bear Stearns crisis, gold now at $800 must at least be telling us that inflation risks are not as great as they were then.

But that may not really be saying much, because inflation risks then were extraordinary. In mid-March, the fed funds futures curve was priced for expectations of a funds rate as low as 1.4%, with no significant rate hikes for as far as the eye could see (and the whisper number was a Japan-style zero-rate). From there, inflation risks have surely lessened. We correctly predicted then -- when gold was still trading above $1,000 -- that mid-March's rate expectations would be reversed as the Fed's

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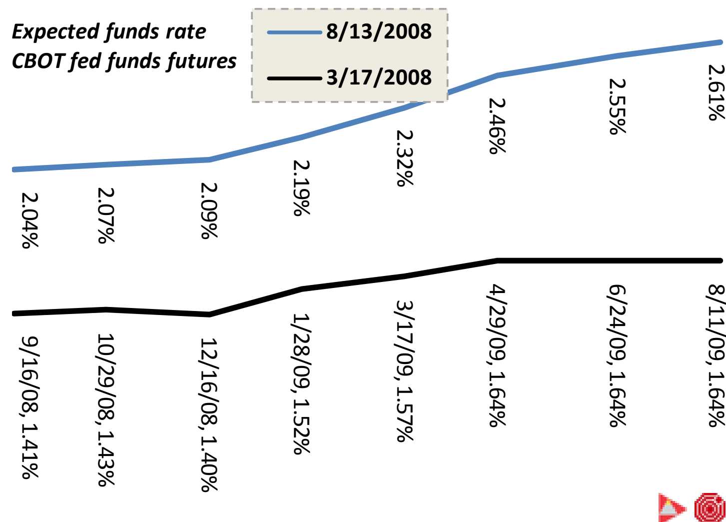
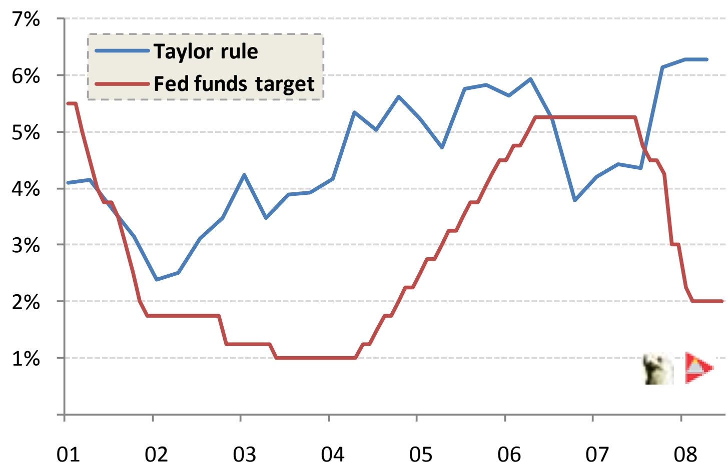


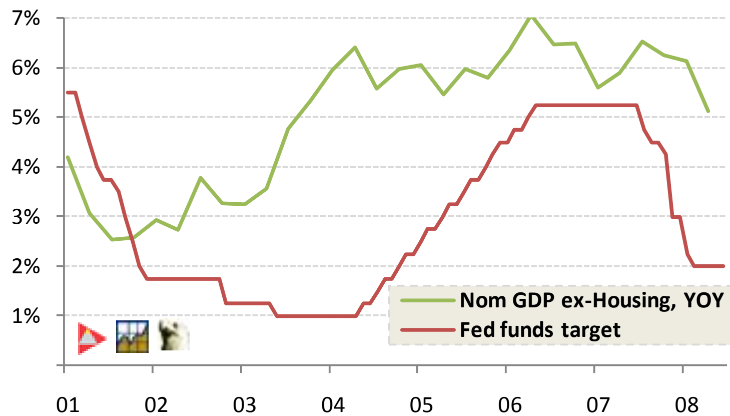
new liquidity tools began to substitute at the margin for rate-cutting (see "Three Quarter Profile In Courage" March 19, 2008). Today, the futures curve shows expectations for a very modest pace of hikes from today's 2% funds rate. So with the Fed expected to be less extraordinarily expansive today than it was then, it makes sense that the gold price would be lower today than it was then.

But less than extraordinary can still be a lot. So while our renewed alarm on inflation risk three weeks ago as rate hike expectations collapsed in the Fannie/Freddie crisis was poorly timed (see "Stocks are Cheap, But the Fed's Asleep" July 15, 2008), we think the move down over the last several weeks in gold, other commodities, resource stocks and in forex are overdone. They should not give comfort that inflation is likely to moderate very much, if at all. The dramatic drop in crude oil from its record high a month ago has only moved its price back to the then-record high of four months ago. That might be good for several basis points off headline inflation, but it won't make any difference at all to core. And while that might improve sentiment about inflation for a while, these market moves are likely to embolden to Fed to be even tardier in moving rates back up to normal non-inflationary levels. And that's where the rubber is going to meet the road -- because oil prices don't cause inflation, the Fed does. So if the drop in the oil price has triggered a stampede out of inflation plays in general (see "Dollar/Euro, Fed/ECB, Gold/Oil: Keeping It All Straight" August 11, 2008), then we think it's about time to take the other side of the trade.

Are we saying that gold is simply wrong to have dropped so much at the same time as inflation expectations should have worsened? In some sense it's impossible to say whether $800 -- or $700, or $1,000, or any given gold price -- is the "right" price to reflect any particular set of inflation expectations. But having closely watched over the last several years the dynamics of gold and other inflation-sensitive markets interacting with these expectations, our strong sense is that either gold has over-reacted here, or something else that we are treating as a fixed point in our analysis would have to be wrong.

Where might we be wrong? We think there ought to be no doubt that the Fed is super-easy at a 2% funds rate. It may seem unbelievable, but it's a fact that with GDP now growing only a little below trend, and with inflation elevated -- core PCE inflation has now exceeded the Fed's 2% benchmark *for 17 consecutive quarters!* -- a simple version of the Taylor Rule concludes that the funds rate should now be about 6%. A Wicksell-type analysis, comparing the funds rate to nominal GDP (with



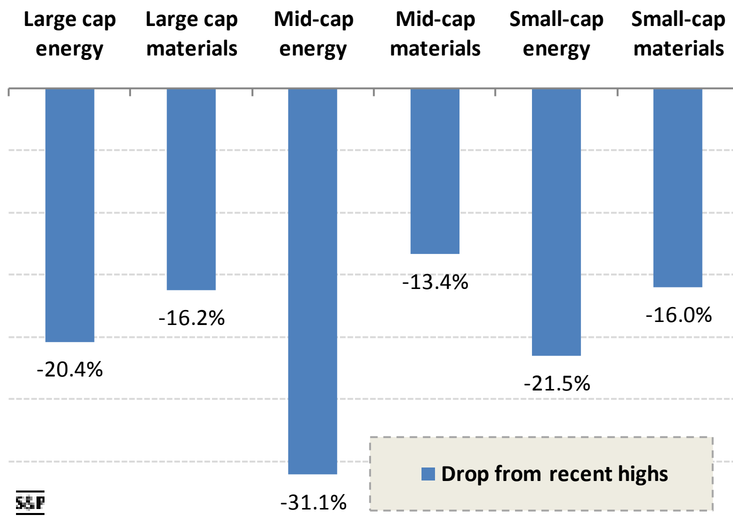


residential investment backed out, to remove the disproportionate influence of recent large declines in this small sector) gives a similar result -- about 5%. Either way, the funds rate is as much too low now as it was from 2003 to 2005, the years of excessive liquidity creation that laid the groundwork for the inflationary bull market in gold, oil, commodities and forex.

And we think there is little doubt that the Fed is going to stay super-easy for quite some time. Fed officials -- in individual private conversations with us, at least -- agree that rates are too low by any objective standard. But at this point, when it comes to making public and collective policy decisions, they have all been captured by a bureaucratic group-think that holds that making any move that might possibly stimulate further credit market turbulence is too great a risk, and that inflation is a fair price to pay to contain that risk (see "Fannie and Freddie Fan Inflation Fire" July 11, 2008). This was underscored yesterday by very dovish public statements by the Dallas Fed's Richard Fisher and the Minneapolis Fed's Gary Stern, both of whom had recently been very much in the hawkish camp among voting FOMC members. As recently as late June we were confident that the Fed would respond to improving growth, stabilizing credit markets and rising reported inflation by starting to move the funds rate higher as soon as the August FOMC meeting (see "Bonds Wish, Stocks Worry" June 26, 2008). But the July Fannie/Freddie crisis changed everything, causing the Fed to "miss the window" to hike rates without feeling they would risk the stability of credit markets -- and conditioning the Fed to expect that market fragility will now be, for all practical purposes, a permanent state of affairs. At this point, what could possibly convince them otherwise, other than the passage of a great deal of time?

One other possibility that might justify the sharp down-moves in inflation-sensitive markets over the last several weeks is that we are facing a slowdown in global growth. If that were the case, a drop in commodity prices would occur irrespective of inflation prospects. But why should we suddenly expect a global recession starting in mid-July? World stock markets in both developed and emerging economies have all been falling since late last year, and many commodity prices ran to all-time highs at the same time. And why would the prospect of a global slowdown be having such a bracing effect on the forex value of the US dollar? In our framework, the biggest risk to global growth would be a coordinated tightening by central banks in emerging economies seeking to reduce dollar-induced domestic inflation (see "What Did They Do To Deserve This?" August 5, 2008). But if that were happening on any significant scale, we'd expect to see the dollar weakening, when in fact it has been strengthening across the board as gold, oil and commodity prices have fallen.

The only other explanation we can think of is the "Olympic Effect." Perhaps the gold price has dropped in anticipation that Michael Phelps will be auctioning his surplus medals on eBay. But ruling that out, we have to end up thinking that gold -- along with the other inflation-sensitive markets, with the possible exception of oil, which had been in its own unique speculative orbit -- have moved too far to the downside. We've seen speculative purgings like this before, when some event trigger -- this time, the bursting of the oil bubble -- sets off an excessive and short-lived decline across the "inflation plays," despite continuing background inflationary pressures (see, for example, "The Frustrated Fed" September 28, 2006). Within the US equity market, the



energy and materials sectors have sold off so violently over the last three weeks that, in both cases, their equity risk premiums are wider than at any time during the entire bull market in "inflation plays" over the last five years. How quickly investors seem to have written off these sectors as dead. Ironic, considering the bottom-fishing that goes on endlessly in the hopelessly broken financial sector, where the equity risk premium has dropped to the narrowest level since the onset of the credit crisis a year ago.

BOTTOM LINE: Oil deserved to get whacked after the speculative frenzy of recent months, but it has unreasonably dragged other "inflation plays" down with it. Underlying inflation trends are worsening, not improving -- and resource stocks are now among the best bargains in the stock market.