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MACROCOSM

Why Isn't Gold at $1500?

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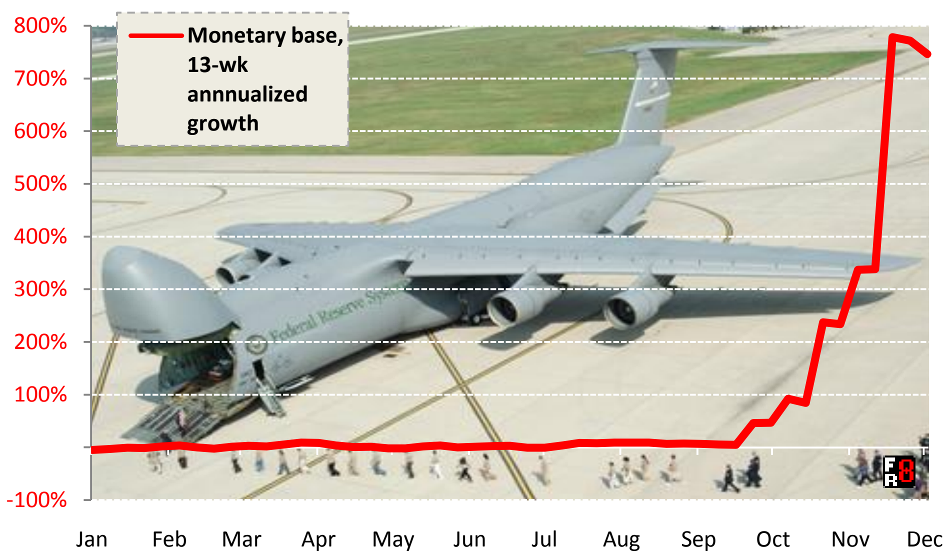
The Fed's managing an unstable balance of titanic inflationary forces against the risk of deflation.

Update to strategic view
US MACRO, GOLD: We don't think gold is signaling deflation, though it is off 23% from cycle highs. Having performed better than any other risk asset, it's more likely signaling the long-term probability of inflation. The Fed's massive ongoing program of money-creation is fighting deflationary impulses in this recession, but it's going to be very tricky to reduce it when the economy and the markets stabilize. That's when deflation fears will give way to inflation fears, and gold could easily run to new highs.
[see Investment Strategy Dashboard]

"Helicopter Ben" has become "C5 Ben" (the C5 Galaxy is the US military's largest cargo plane, capable of lifting as much payload at 10 cargo helicopters). The Fed's balance sheet now stands at record proportions, equal to about 20% of the aggregate balance sheet of the entire US commercial banking system. The sum of "factors supplying reserve funds" has more than doubled over the last three months, now topping $2 trillion. Some of that growth has been offset by "factors absorbing reserve funds," but by no means all. The monetary base -- after showing virtually no growth at all for almost three years -- began to surge in September, and is now growing at a 746% rate on a 13-week annual basis. And rapid money growth is likely to continue. From here, based on the announced plans of the Fed and the Treasury, absorbing factors can be expected to fall, while supplying factors can be expected to rise.



The Fed announced two

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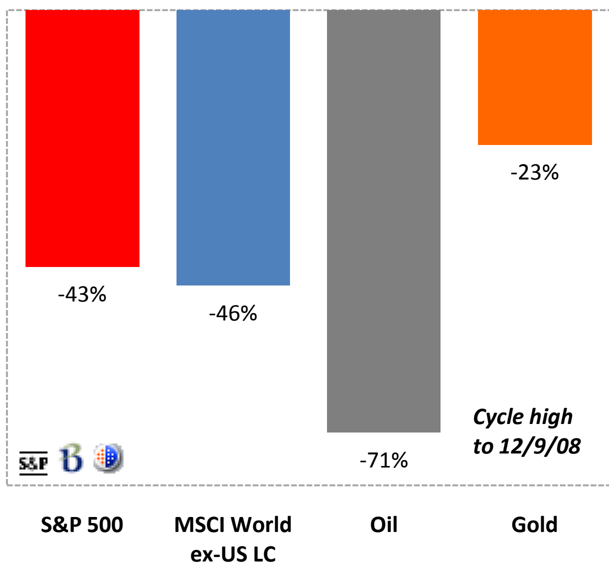
weeks ago that it will buy $600 billion of direct mortgage obligations and mortgage pass-through securities, and it disclosed last week that this will be funded by "supplying reserves" -- that is, the Fed will print the money. At the same time, the Supplementary Financing Program, a deposit with the Fed by the Treasury to help finance the emergency liquidity measures put in place in September, has been discontinued -- the Treasury announced last month that no new SFP bills will be issued as the existing ones mature. So from a high of $559 billion a month ago, that deposit has already fallen to $434 billion today, and will fall to zero by the end of January. While remarks by Ben Bernanke in a speech last week were widely interpreted to signal the Fed's intention to start purchasing Treasury securities, no one commented that the rolling off of the SFP is already exactly that. Ever dollar remitted to the Treasury by the Fed to fund a maturing SFP bill is, operationally, the equivalent of the Fed's buying bills from the Treasury. Put these factors together -- $600 billion of mortgages, plus $434 billion of SPF roll-off -- and we get $1,034 trillion of debt monetization, and that comes on top of the enormous balance sheet the Fed is already running right now.

With money-creation like that going on, why is everybody worrying about deflation (see "Deflation Takes Center Stage" November 19, 2008)? Deflation is strongly reflected in the Treasury curve, with notes being auctioned at a zero yield, the 10-year yield at its lowest level since 1955, and the five-year TIPS spread negative (see "Feeding Frenzy in Treasuries" December 2, 2008). Fed or no Fed, the Treasury market is focusing on some very serious deflationary threats operating in the combined recession and financial panic we're in. We think these threats are quite real, though we don't subscribe to the conventional interpretation that deflation in a recession is caused by producers selling goods at fire-sale prices, into the face of collapsing aggregate demand. The causality is the other way around. The same risk aversion that causes the recession in the first place increases the demand for prudential cash balances, and when that demand is inadequately satisfied by the central bank's supplying of additional monetary liquidity, assets and goods are dumped to raise cash. That's doubly so in *this* recession, which was triggered by a credit crisis in which cash balances were also urgently demanded to meet short-term funding requirements.



All that will lead to statistical deflation for several quarters -- it's already shown up in the last three months of increasingly negative CPI growth. But if we were looking at the serious probability of prolonged deflation, we wouldn't be seeing the price of gold -- the commodity that is the most sensitive to changes in inflation/deflation prospects -- at $775, down only 23% from its cycle highs, and still far above its 10-year moving average at about $450. Like all other risky assets, gold has been liquidated indiscriminately in this year's spasm of de-leveraging and de-risking. But compare it to the S&P 500 off 43%, the MSCI World Ex-USA Index off 46% and oil off 71%. If gold were warning of deflation, it would have made the round trip back to $325, where it was in early 2003 -- which is just the kind of round trip the S&P 500 and oil have made. In that sense, gold's being off *only* 23% is, if anything, an inflation warning signal.

Then again, if gold wanted to give a really serious inflation warning signal, it would be at $1500. In fact, to us, it's actually a bit of a wonderment that it's not. After all, gold's all-time high just above $1000 came in mid-March, when the Bear Stearns collapse led markets to expect that the Fed would risk higher inflation by becoming highly accommodative to soothe panicky markets (see "Bernankruptcy" March 17, 2008). Now, the Fed is vastly more accommodative than anyone would have dared to imagine in March, yet the predominant worry is deflation, not inflation, and gold is off 23%.

That's because for all the apparent inflationary enormity of the Fed's balance sheet, we have to remember that all that newly printed money is balanced against enormous deflationary forces. Today's gold price of about $775 represents that balance. While above the 10-year moving average of $450, it implies some underlying long-term inflationary forces at work. But it roughly splits the difference between the $1500 price that would imply a wildly inflationary Fed, and the $325 price that would imply a Fed that had failed to create an effective firebreak against deflation. But like the balance of a tightrope walker, the Fed's balance between inflation and deflation is not stable. Some event or some miscalculation will cause the tightrope walker to lose his balance and fall -- it's just a question of which side he'll fall on: inflation or deflation. For Bernanke, the riskiest period will be when the financial markets begin to heal and the economy begins to stabilize -- and he'll have to somehow decommission the Fed's towering balance sheet without destabilizing everything all over again. It would be a miracle if he can manage it. So in some sense, while usually the best forecast of an asset's future price is its price today, in the case of gold now $775 is the single more unlikely future price. A year from now it will either be at $325 or $1500, depending on which way the Fed falls off the tightrope. Given that Bernanke is a student of the Great Depression, and that he knows that monetary deflation was one of its key causes, if he feels he is about to fall off the tightrope he will surely attempt to land on the side of inflation. So we're betting on $1500.

BOTTOM LINE: We don't think gold is signaling deflation, though it is off 23% from cycle highs. Having performed better than any other risk asset, it's more likely signaling the long-term probability of inflation. The Fed's massive ongoing program of money-creation is fighting deflationary impulses in this recession, but it's going to be very tricky to reduce it when the economy and the markets stabilize. That's when deflation fears will give way to inflation fears, and gold could easily run to new highs.