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MACROCOSM

What is Gold Trying to Tell Us?

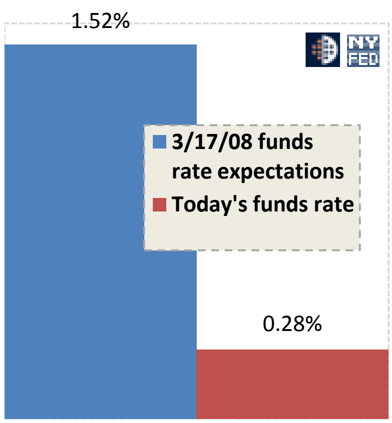
Tuesday, February 3, 2009

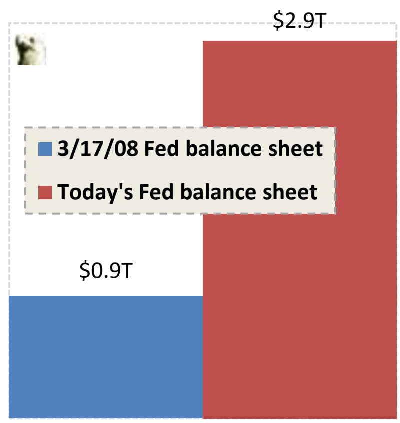
Donald Luskin

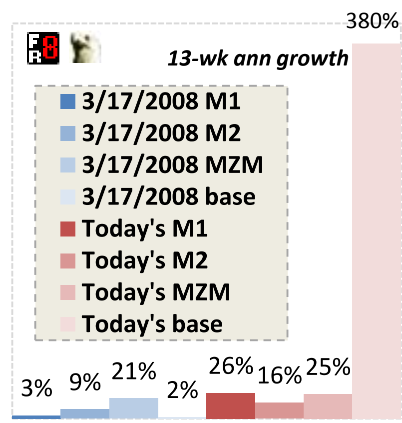
Mixed messages about deflation, inflation and the limits of fiscal stimulus.

THAT WE'RE IN A TERRIBLE DEFLATION Judging just by the unprecedented liquidity campaign being waged by the Fed, and the inflation expectations it ought to have engendered, you'd think gold would have soared to all-time highs (see "Why Isn't Gold at $1500?" December 10, 2008). Gold's actual all-time closing high of $1002 was on Monday, March 17, 2008, the first trading day following the weekend announcement of the Fed's $30 billion intervention in the collapse of Bear Stearns, when it seemed the Fed was destined to make a terrible inflationary error (see "Bernankruptcy" March 17, 2008). With the fed funds rate target at 3% then, futures markets were forecasting for today an unthinkably low rate of 1.5%. Now, at only 28 bp, the funds rate is far lower than March's panicky speculations. Since March, the Fed's balance sheet has more than tripled from $928 billion then to $2.86 trillion today. And growth rates in all the money aggregates have dramatically accelerated -- most notably the monetary base, growing at a 13-week annual rate of 2% then, and 380% now. Yet for all that, which at any other time would have surely meant an immediate and dramatic inflationary

Update to strategic view
GOLD: Gold sits precariously at a point of meta-stable equilibrium between powerful forces of inflation, deflation and "stimulus." We expect it will break out to the upside, as the world's central banks inflate their way out of the present credit crisis and recession. If it breaks to the downside, they will have failed, and further economic deterioration will be in store.
[see Investment Strategy Dashboard]







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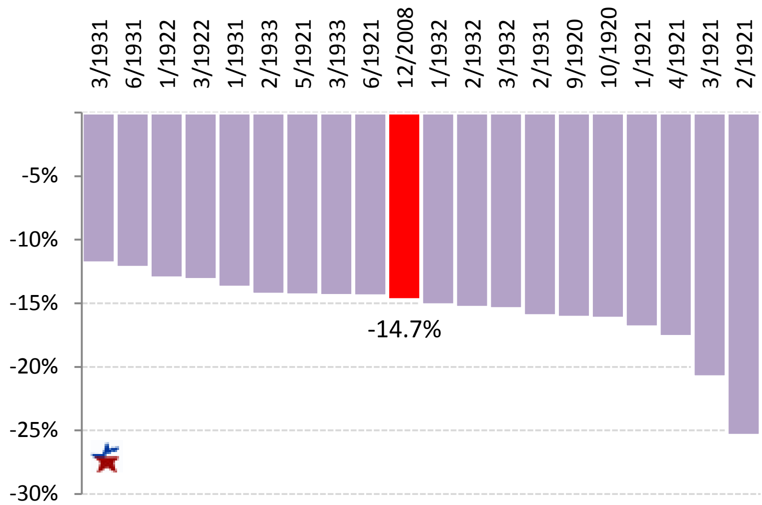
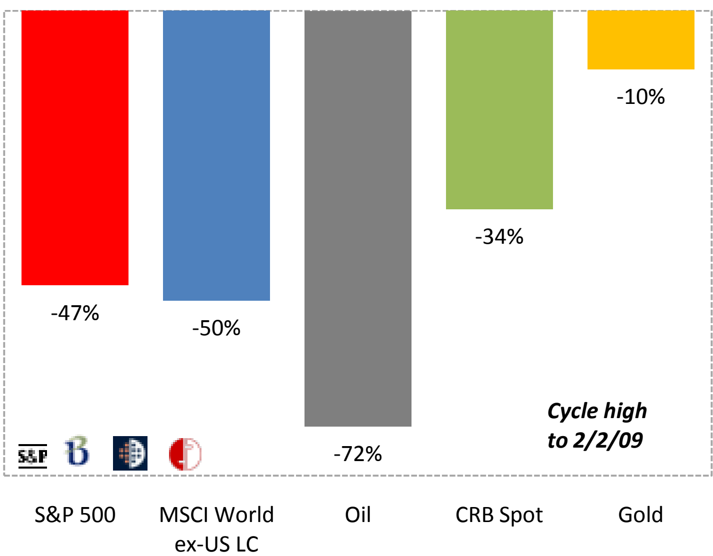
acceleration, gold -- the market's most inflation-sensitive barometer -- is *not* at all-time highs. At around $910, it's struggling to break out of the intermediate-term downtrend from its March, 2008 high. So it must be the case that, however great the Fed's present liquidity campaign, the global credit-market crisis and recession have unleashed demands for liquidity that are even greater. When the demand for liquidity exceeds the supply of it, *that's deflation*.

THAT WE'RE IN A TERRIBLE INFLATION When gold was at all-time highs in March 2008, the three-month annual CPI inflation rate was an uncomfortably high 6.8%. Three months later, in June, it had risen even higher -- to 10.3%, a rate not seen for 17 years. Now, just six months after that, we're experiencing an even more historic *deflationary* surge (see ["Deflation Takes Center Stage"]() November 19, 2008). As of December, the CPI has declined 14.7% on a three-month annual basis, the biggest drop since 1932 and the 11th biggest drop in the history of the data. Yet for all that, gold is off only 10% from all-time highs. Despite the deflationary backdrop, it has been by far the best performing risky asset throughout the present global credit crisis and recession (for example, by comparison, oil is off 72% from its cycle highs, the CRB Spot Index of commodities is off 34%, US stocks are off 47%, and non-US stocks are off 50%). What's unique about gold among risky assets is, again, that it's the market's most inflation-sensitive barometer. So with statistical deflation running currently at levels not seen since the depths of the Great Depression, for gold to be so close to all-time highs when all other risky assets have collapsed, it must be the case that markets are discounting a significant probability of future inflation.





THAT FISCAL RESCUE CAPACITY IS FINITE There are two intertwined pathways to the inflation threat to which gold appears to be sensitive. The most straightforward path is that, as the credit crisis gradually eases, the Fed will be tardy in withdrawing the liquidity supplied by its enormous balance sheet. Not wanting to take the chance of triggering another bout of credit market turbulence, the Fed will walk eyes open into a surge of inflation, judging it to be the lesser evil. The second path is that Congress will effectively force the Fed to begin monetizing government debt by purchasing Treasury bonds, in order to keep interest rates low. Over the last month, as the cost of the proposed "stimulus" bill approaches $1 trillion,

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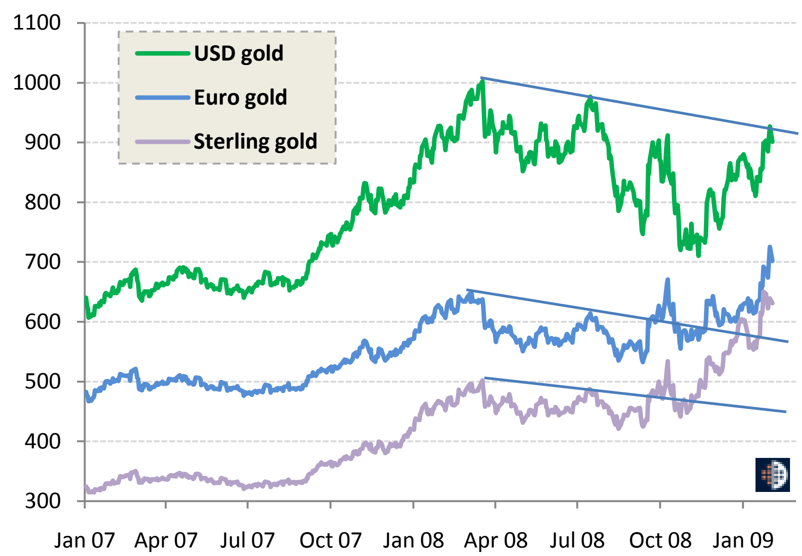
and the cost of a comprehensive solution to the banking crisis is quoted as high as $5 trillion (see "Unknown Unknowns" January 30, 2009), and the bond market anticipates a flood of new issuance to fund them, 10-year yields have risen from a December low of 2.08% to as high as 2.87% last week. With the funds rate stuck at the zero bound, at some point soon the Fed may have to intervene to cap long rates, by making good on its repeated statements that it would buy Treasury bonds directly in the open market (see "'Some Time' A Great Notion" December 17, 2008). At that point, in combination with its program to buy $600 billion of GSE direct mortgage obligations and pass-through securities, it would be nearly impossible for the Fed to keep the asset side of its balance sheet from growing considerably -- making it all the harder to unwind in a timely fashion when the demand for liquidity begins to ebb.



For other nations, the risk is greater and more immediate. In the United Kingdom, it may be the case that solving the banking crisis will take a greater percentage of national resources than in the US, quickly exhausting debt capacity. In the case of the Euro-zone, the only partially federal structure of macroeconomic management makes debt financing difficult for the individual nations that need it the most. So in both sterling and euro terms, last week gold moved to all-time highs. This could be a preview of what's in store for gold priced in dollars. In the end, there are limits to the ability of *any* nation to borrow. When those limits are touched, the only recourse is inflation. But remember, a sharp drop in the dollar gold price would be even more alarming than an upside break-out. As costly as inflation is, and as maddening as it may be to see it aggravated by wasteful "stimulus" programs that won't really stimulate, it's better than deflation. Down the deflationary road lies further asset depreciation and debt collapse. We don't want to go there.

BOTTOM LINE: Gold sits precariously at a point of meta-stable equilibrium between powerful forces of inflation, deflation, and "stimulus." We expect it will break out to the upside, as the world's central banks inflate their way out of the present credit crisis and recession. If it breaks to the downside, they will have failed, and further economic deterioration will be in store.