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# Stocks Test the Lows, Gold Tests the Highs

Monday, February 23, 2009

**Donald Luskin**

**Economic policy is in utter disarray -- all that's left is inflating our way out of this crisis.**

| Update to strategic view |
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| **US STOCKS:** It's encouraging that the S&P 500 didn't make new lows last week, given the chaotic political backdrop, and the drop in earnings since the November bottom. Some kind of rally attempt may be in the offing, but we still expect stocks to flail until the runaway train of "emergency" policy-making is arrested. **GOLD:** Challenging all-time highs, gold is signaling that the Fed's power to inflate us out of crisis remains, for better and for worse, a fixed point in the chaotic policy universe. A reaction after hitting the $1000 mark seems to be in the cards, but we expect the Fed to keep printing money, and for gold to make new highs. |
| [see Investment Strategy Dashboard] |

On Friday the S&P 500 tested the lows of last November when Senator Chris Dodd was reported as having said of bank nationalization, "I could see how it's possible." Then stocks rallied from the worst levels of the day when White House spokesman Robert Gibbs said, "this administration continues to strongly believe that a privately-held banking system is the correct way to go." Investors have been reduced to the state of primitive peoples who believe thunder is caused by the gods quarreling.

Indeed, at this point *it is* -- as we necessarily hang on every banality uttered by those who can exercise unlimited and arbitrary power, not knowing objectively whether the latest collapse in bank stocks is due to the risk that the gods will intervene badly, or to the risk that they won't intervene at all. We'll get more of a sense of that today, following the announcement this morning that the Treasury stands ready to support the banking system with investments in mandatory convertible preferred shares, and news overnight that Citigroup is in discussion with

**Q** …is it the President's responsibility to help create some confidence in the markets?

**A** Oh, absolutely. I don't think that -- I mean, I think the President would agree with that wholeheartedly. But again, I think… Well, again, I think the -- I think -- obviously I'm not on Wall Street, but I think it is not…

*White House spokesman Robert Gibbs*
*Press briefing, February 20, 2009*

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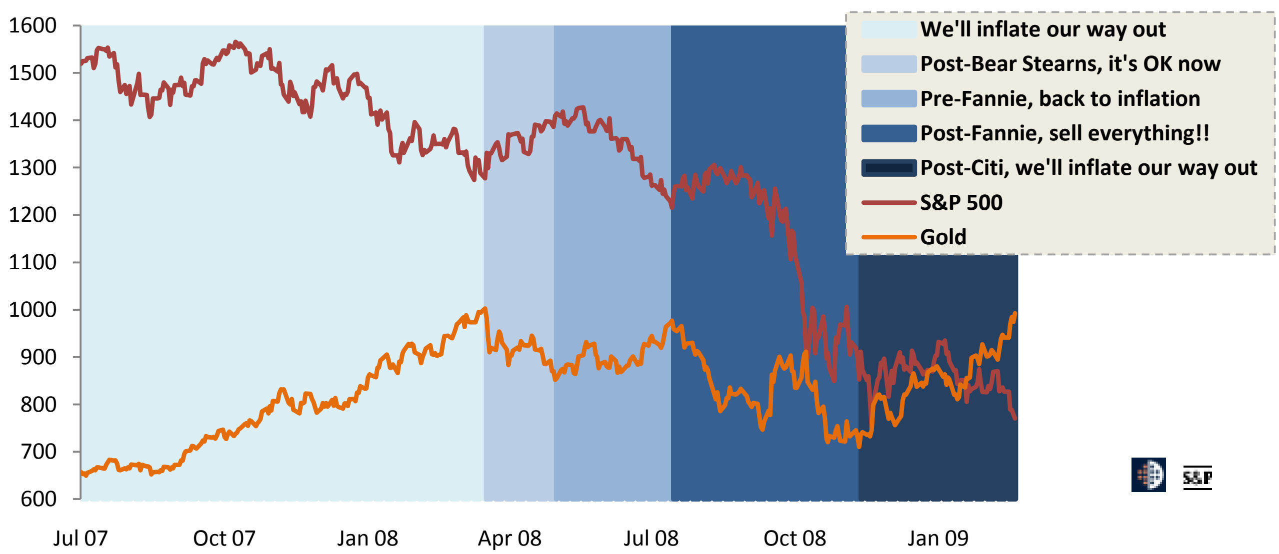
the Treasury about converting its and other investors' existing stakes to such shares (a move that, in our view, is mostly a gesture to accounting fetishism with little economic meaning, except that it would surely expand the scope of political control over the troubled bank). With the economic policy environment in such disarray, we expected stocks to break their incipient uptrend from the November lows (see "Two Strikes for Tim" February 11, 2009), and have expected them to keep flailing until the runaway train of policy-making in the name of "emergency" is arrested (see "On the New Bank Bonus Restrictions" February 15, 2009). In some sense it's a miracle -- and somewhat encouraging for some kind of rally attempt from here -- that the S&P 500 *didn't* make new bear market lows on Friday (the Dow Jones Industrials *did*), against the backdrop of a White House spokesman unable to clearly express the belief, when asked, that the president ought to inspire confidence in the markets (see the box on the previous page).

Meanwhile, gold -- our long-standing "best idea" investment -- traded above $1000 on Friday, challenging the all-time highs of last March (see, most recently, "Treasury Won't Bail Out the Fed" February 17, 2009). Just a month ago, gold and the S&P 500 were trading at about the same unit price (gold at $854, the S&P 500 at 840). From there, stocks have fallen 8% to near their bear market lows of last November, while gold has risen 16%, making it the world's only risk-asset to trade near all-time highs. Measured in euro or sterling terms, it has been at all-time highs for several weeks already (see "The Dollar: The Tallest Pygmy" February 5, 2009).

We think it's key to grasp the complex message that the gold price is sending, as the global economy works through the rigors of credit crisis and recession (see "What is Gold Trying to Tell Us?" February 3, 2009). At this point, we'd break the message into five distinct phases, portrayed in the chart below, characterized by the synchrony or dyssynchrony with which stocks and gold moved together.

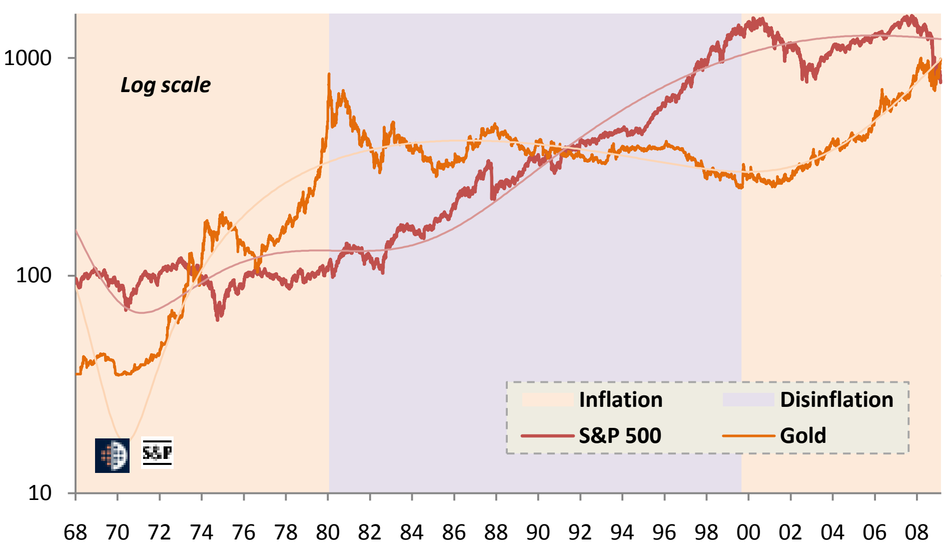



- **GOLD HIGHER, STOCKS LOWER: *WE'LL INFLATE OUR WAY OUT*** In the first phase, from the onset of the credit crisis in July 2007 to the Bear Stearns collapse in March 2008, gold moved higher as stocks moved lower. As the crisis deepened and stocks fell, the Fed relentlessly cut interest rates even though the economy showed few tangible signs of slowing, and steadily rising gold signaled that inflation would be the consequence.
- **GOLD LOWER, STOCKS HIGHER: *POST BEAR STEARNS, IT'S OK NOW*** With the Bear Stearns collapse, the Fed began to deploy new liquidity tools, some of which didn't require money-creation. Through early May, stocks rose on the hopes that the new tools

would be sufficient to arrest the credit crisis, and gold fell as the demand for inflationary rate-cuts was reduced (see "Three Quarter Profile In Courage" March 19, 2008).

- **GOLD HIGHER, STOCKS LOWER: *PRE-FANNIE, BACK TO INFLATION*** From early May to early July, it became increasingly evident that the credit crisis was deepening, and that the Fed would have to respond in a way that would likely be inflationary -- stocks fell and gold rose, climaxing with the Treasury's intervention in Fannie Mae and Freddie Mac (see "Fannie and Freddie Fan Inflation Fire" July 11, 2008).
- **GOLD LOWER, STOCKS LOWER: *POST-FANNIE, SELL EVERYTHING!!*** From there through late November, the credit crisis intensified, and stocks collapsed. The Fed responded by creating more new liquidity tools that tripled the size of its balance sheet. On the face of it, this would seem to be highly inflationary -- yet gold collapsed too, in part because of the panicked evacuation of speculative positions during a time of indiscriminate deleveraging -- and in part because regardless what the Fed appeared to be doing, the global economy was seized by intense deflationary forces (see "Deflation Takes Center Stage" November 19, 2008).
- **GOLD HIGHER, STOCKS FLAT: *POST-CITI, WE'LL INFLATE OUR WAY OUT*** In late November, the Citigroup collapse and the joint response by the Treasury and the Fed catalyzed a provisional bottom for stocks, which has been consolidating ever since. At the same time, the Fed's balance sheet has contracted slightly in as-reported terms, but the Fed has entered into commitments to continue to expand it -- and may well end up having to monetize government debt in order to keep a lid on interest rates in the face of record Treasury issuance. The pressure on the Fed to grow its balance sheet is all the more intense now, thanks to the policy disarray in which the Treasury and the Congress find themselves. So while stocks have consolidated, gold has moved back to near all-time highs -- as we predicted -- signaling that the Fed's generous liquidity posture will be more than enough to conquer the deflationary forces of the global recession, and that inflation is now the most likely outcome (see "Why Isn't Gold at $1500?" December 10, 2008).

With this narrative in mind, we don't subscribe to the theory that gold at $1000 is a safe-haven play in a world about to completely fall apart. Nowadays when investors want safety, even gold isn't safe enough -- only cash will do. We know what panic looks like -- in the panic that crested in late November, gold dropped 27%, about the same as the 29% drop in stocks over the same period. This latest phase from the November lows isn't about panic. From the November lows, gold is up 33% -- but the panic today is no greater than it was then, and arguably considerably less, as evidenced by the fact that stocks are higher by 2% even though S&P 500 consensus forward earnings are lower by 22%. So gold at $1000 isn't pricing panic -- it's pricing inflation.




Over the broad sweep of history, stocks and gold are generally dyssynchronous, which is to say that inflation is not a good thing. A glance at the chart above reminds us that the best twenty years for stocks in the last century -- from 1980 to 1999 -- coincided with a period of persistent disinflation (and a falling gold price). The decade *before* was a period of inflation (and a rising gold price), and poor overall performance for equities. The same can be said for the decade *after*, in which we now find ourselves in the ninth year. But remember, realistically, the choice now isn't between inflation and *disinflation*. It's more likely between inflation and *deflation*. And given that choice, we'd pick inflation every time. To be sure, combined with the anti-growth policy bias that is coalescing now in the name of "emergency," it's going to be tough sledding for corporate earnings, but at least stocks are cheap (see "At Least They're Cheap" November 20, 2008). So our tendency is to celebrate gold at $1000, not fear it. The alternative is deflation -- gold at $300 -- and probably not much in between. In *that* world, stocks can never be cheap enough.

| **Recommended reading** |
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| *How to Lift a Falling Economy*<br>Ricardo J. Caballero<br>*Washington Post,* February 22, 2009 |
| [Recommended Reading home] |

**BOTTOM LINE:** It's encouraging that the S&P 500 didn't make new lows last week, given the chaotic political backdrop, and the drop in earnings since the November bottom. Some kind of rally attempt may be in the offing, but we still expect stocks to flail until the runaway train of "emergency" policy-making is arrested. Challenging all-time highs, gold is signaling that the Fed's power to inflate us out of crisis remains, for better and for worse, a fixed point in the chaotic policy universe. A reaction after hitting the $1000 mark seems to be in the cards, but we expect the Fed to keep printing money, and for gold to make new highs.