Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Gold Above $1000: What Took So Long?

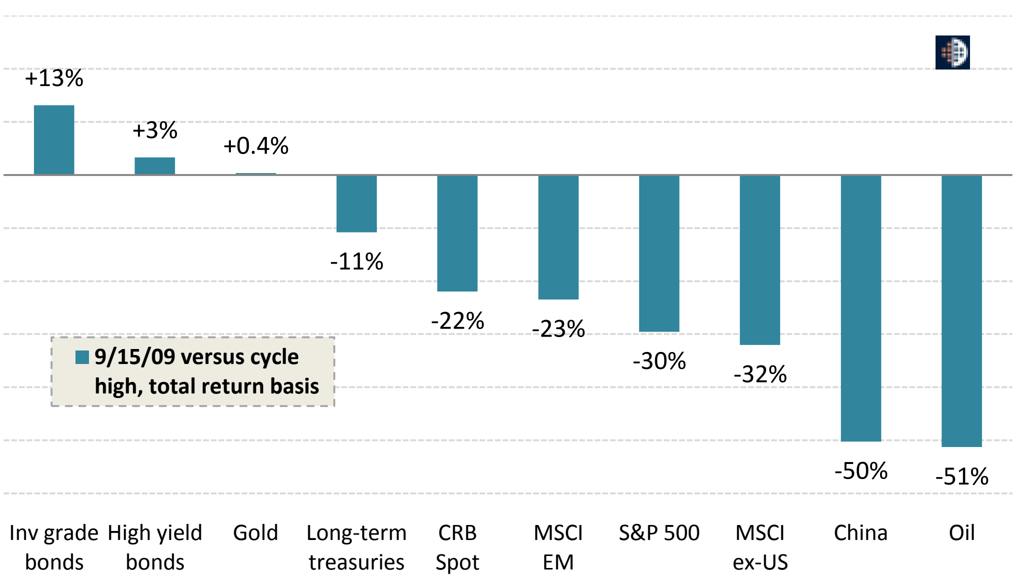
Wednesday, September 16, 2009

Donald Luskin

The Fed had to fix its bond boo-boo first, but now it's free to inflate -- and it will.

Update to strategic view
GOLD: Gold's new all-time high close above $1000 doesn't in and of itself imply an immediate run higher -- there's nothing magical about round numbers. But as the deepening inflation expectations gold is signaling get deeper still, and as it becomes understood that the bond market has given the Fed its blessing to stay stuck on easy virtually forever, we expect gold will climb significantly.
[see Investment Strategy Dashboard]

As of this writing early in the morning, gold has come within $9 of its all-time intraday high at 1030.80 on March 17, 2008. Friday it moved to a new all-time *closing* high at 1004.85, and bested that yesterday at 1005.90. Gold and the credit complex are now the only asset classes at all-time highs on a total return basis -- even long-term Treasuries can't make that claim (see the chart below). We are gratified that our two "best idea" themes -- gold and high yield bonds -- have come through so well. It is ironic, considering that we have just come through what has been ostensibly a deflationary credit collapse. What we are seeing now is the beginning of the fruition of our long-standing inflation call. It is driving inflation-sensitive gold directly, and driving the credit complex indirectly by reducing real debt burdens and effectively making borrowers more creditworthy.

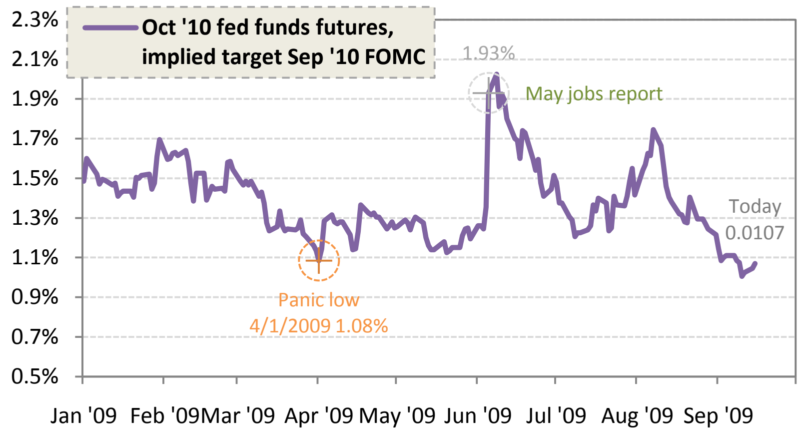


Focusing primarily on gold in this report, we have to ask what took so long? With the Fed's hyper-easy policy posture in response to the banking crisis

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625



and recession, it ought to be a lay-up that there would be a strong likelihood of significant future inflation, and that gold would reflect that by moving to new highs (see "Why Isn't Gold at $1500?" December 10, 2008). It has now finally made the move just as year-ahead expectations for the funds rate have dropped to new all-time *lows* (see the chart at left). Which only begs another question, which is the one we were asked last week by a former very senior Fed official, one of the architects of today's easy policy posture: *why has it taken the markets so long to believe that the Fed is going to stay extremely easy for an extremely long time?* The answer requires a complicated narrative, so bear with us, please.

Gold first traded above $1000, and made all-time intraday highs at $1030.80, on the day that Bear Stearns collapsed (see "Bernankruptcy" March 17, 2008). It was not clear then that the economy was in recession, only a slowdown -- so markets assumed that support from the Fed aimed at stemming a broad financial crisis would necessarily be inflationary. Those expectations were reversed the very next day, when the Fed surprised the market by cutting the funds rate target by only 0.75%, rather than the 1.12% that had been expected. We interpreted this surprise as the Fed's signal that it intended to intervene with its balance sheet -- which would be self-sterilizing so long as assets acquisitions were offset with asset sales -- rather that rate cuts, wherever possible. So we immediately said, correctly, that gold would retreat from its new highs as inflation fears were reversed (see "Three Quarter Profile In Courage" March 19, 2008).

From there the Fed got considerably easier -- the funds rate continued to be cut, and the Fed's balance sheet underwent an enormous expansion. But this wasn't immediately inflationary, because it only served to offset the explosion in money demand arising from the global banking crisis that began in September. In fact, this extraordinary easing wasn't enough, immediately, to prevent a siege of extreme monetary deflation (see "Deflation Takes Center Stage" November 19, 2008). At the worst, the Consumer Price Index was falling at a 3-month annual rate of 12.4% -- and gold fell as low as $680.80 on an intra-day basis. But we could see the Fed beginning to bulk up its balance sheet to supply the extraordinary demand for money, and made the call that gold would recover (see "On the Global Rate Cuts" October 8, 2008). It *has* recovered -- and as most other asset classes made lower lows early this year, gold never even came close to doing so. But gold has struggled to make new highs because, before inflation expectations could be restored *deflation* expectations had first to be rooted out.

As of this morning's data, CPI inflation is now running at a positive 3-month annual rate of 4.9%. But on the way to achieving that, the Fed made a big mistake -- by undertaking its $300 billion

Recommended reading

"Why did Paul Krugman get it so wrong?"
John H. Cochrane
University of Chicago website, September 10 2009.

"The story from the inside"
David Blanchflower
New Statesman, September 10, 2009

"Misdiagnosing the crisis: The real problem was not real, it was nominal"
Scott Sumner
VoexEU, September 10, 2009

"The crisis and citizens' trust in central banks"
Daniel Gros and Felix Roth
VoxEU, September 10, 2009

[Recommended Reading home]

Treasury bond buy program, announced at the March 2009 FOMC meeting, alongside other unconventional initiatives designed to ease policy with the funds rate at the zero bound (see "Ben Boldly Goes" March 19, 2009). As we have reported, according to very senior Fed sources, FOMC members now unanimously agree this was a serious error (see "The Fed's Bond Boo-Boo" July 24, 2009), because it raised the specter of outright debt monetization (see "They Laughed When I Sat Down to Monetize" June 4, 2009). With Bernanke still up for reappointment, it was seen as political acquiesce in an explosion of government debt, enabling a vicious cycle in which the government would run up *even more* debt than otherwise, knowing that a captive Fed was there to buy it (see "No, Mr. Bond, I Expect You to Die" May 22, 2009). That's why the program backfired, causing long term yields not to fall as intended, but rather to rise in a panicky back-up that took the 10-year yield briefly above 4% (see "Fed Still On The T-Bond Sidelines" August 24, 2009).

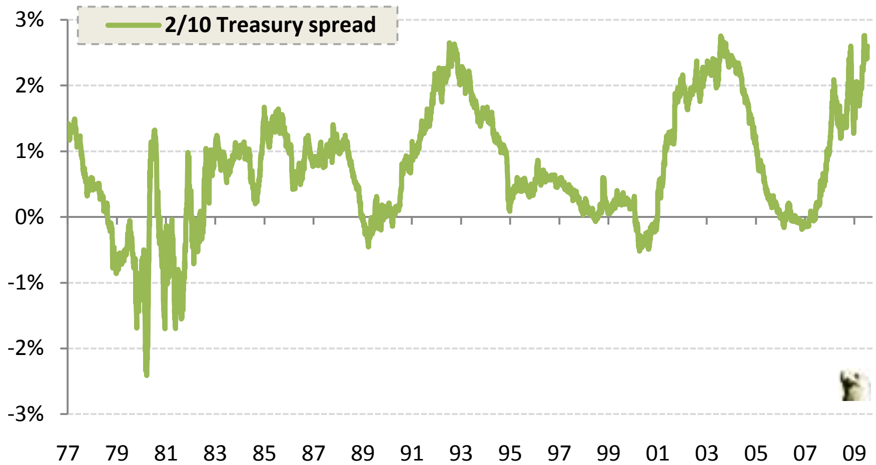
Now the buy program is officially dead and buried (see "On the August FOMC" August 12, 2009). *And* Bernanke has nevertheless been reappointed -- a powerful signal that the Fed will be allowed to continue as an independent agency, not a partner with the Treasury in a *folie à deux* of rampant debt creation. Yields have fallen following the program's termination, as they had been intended to fall following the program's inception. It would seem that bonds are saying, "all is forgiven" -- which is to say that the Fed now has the market's permission to be as dovish as it wishes. While the buy program was operative as an ongoing embarrassment, the Fed was obliged to make repeated hawkish reassurances that it would aggressively "exit" its huge balance sheet in time to prevent an inflation outbreak (see "Charm Offensive" April 6, 2009). But now the hawkish reassurances have stopped -- Fed officials have returned to warning of the risk that inflation could be *too low* -- that is, that the risk is on the side of *deflation* -- exemplified in the extreme by a nearly outlandishly dovish speech Monday by San Francisco Fed president Janet Yellen, the only regional governor with a serious voice on the FOMC. And that brings us all the way back to gold at $1000, after a long and winding road from that same level in March 2008.

And incidentally…

Another factor in play is a report this morning that the Treasury will dramatically reduce the Supplemental Financing Program, through which it issues cash management bills and deposits the proceeds at the Fed -- to drain liquidity and help sterilize the inflationary effects of the Fed's large asset acquisition programs. Similar reports circulated in November 2008 when the SFP fell from a peak of $560 billion, as its place on the Fed's balance sheet was taken up by excess reserves (see "Treasury Won't Bail Out the Fed" February 17, 2009). Since then the SFP has stabilized at $200 billion. If that were reduced to as little as $15 billion, as reported this morning, we have no idea what the Fed would to do to replace it as a balance sheet liability, or failing that, what assets it would sell. The inflation concern is that it will be replaced by currency in circulation -- that is, by simply printing money.

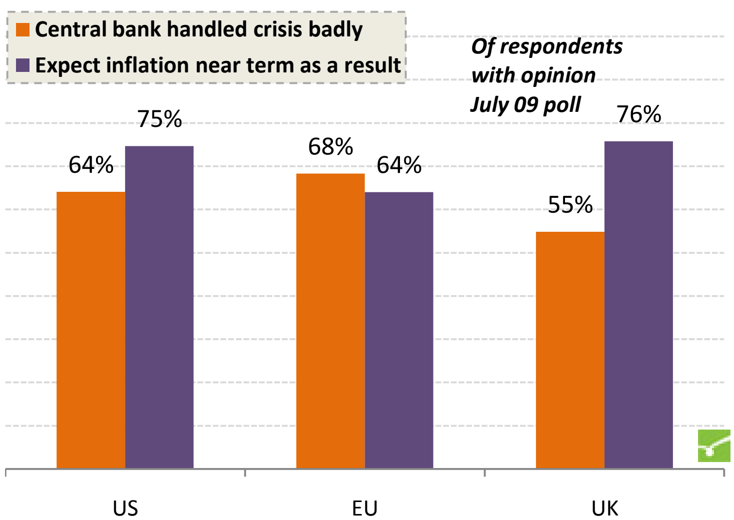
[Recommended Reading home]

But how, even with the specter of debt monetization off the table, can bonds be so seemingly unconcerned about inflation, when gold is making new highs (and the dollar is falling nearly in lock-step)? With every tick lower in year-forward funds rate expectations, the 10-year yield ticks lower too, inflation be damned. But this is not really so paradoxical. All else equal, the short end is the determining anchor point for the whole curve -- when the short end is low, *and especially when the Fed signals it will stay low for a long time*, the long end should be low, too. This was the logic of the Fed's assurances in 2003 that the funds rate would remain low for a "considerable period," and in 2004 that it would be raised only at "a pace that is likely to be measured." Such assurances set up incentives to do "carry trades" -- to borrow short and buy long.



And it helps that the bond market is looking at a very sluggish economic recovery (see "Muted Celebration" September 3, 2009). But that's not to say that falling long-term yields imply utter indifference to inflation risk. Quite the contrary -- the carry trade only works when the Fed holds down the short end sufficiently to create an attractive inflation premium in the term structure. This is exactly as described in Bernanke's notorious 2002 speech in which he also talked about "helicopter drops of money." Such a premium is definitely there -- the 2/10 spread, now at 251 bp, is near all-time highs (see "Thrown A Curve" June 1, 2009).

All that said, intuitively gold above $1000 is an inflation alarm sounding with an intensity not fully shared by the bond market. By our reckoning of the historical data, gold is a vastly more efficient inflation-predictor than the bond market. The Fed doesn't agree, though it can't be happy to see gold at new highs, nor the dollar falling back toward pre-crisis lows. But either way, the Fed is likely to allow -- indeed, to actively seek -- a certain resurgence of inflation as long as the bond market permits it. Because having restored its credibility with the markets with the discontinuation of its Treasury bond buy program, it now must restore its credibility with the world at large -- and the only way to do that is to engineer a satisfactory economic recovery.



On that score, the Fed has its work cut out for it. According to a recent Harris poll (see the chart at left), central banks around the world are generally regarded as having not acted appropriately in response to the banking crisis and recession. At the same time, inflation is expected in the near term as a result of the central banks' actions. With the public already braced to pay a price in inflation, from the central banks' standpoint there's now little to be lost when that inflation actually materializes -- and everything to lose if, when it does, there's no recovery.

BOTTOM LINE: Gold's new all-time high close above $1000 doesn't in and of itself imply an immediate run higher -- there's nothing magical about round numbers. But as the deepening inflation expectations gold is signaling get deeper still, and as it becomes understood that the bond market has given the Fed its blessing to stay stuck on easy virtually forever, we expect gold will climb significantly.