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Gold at All-Time Highs

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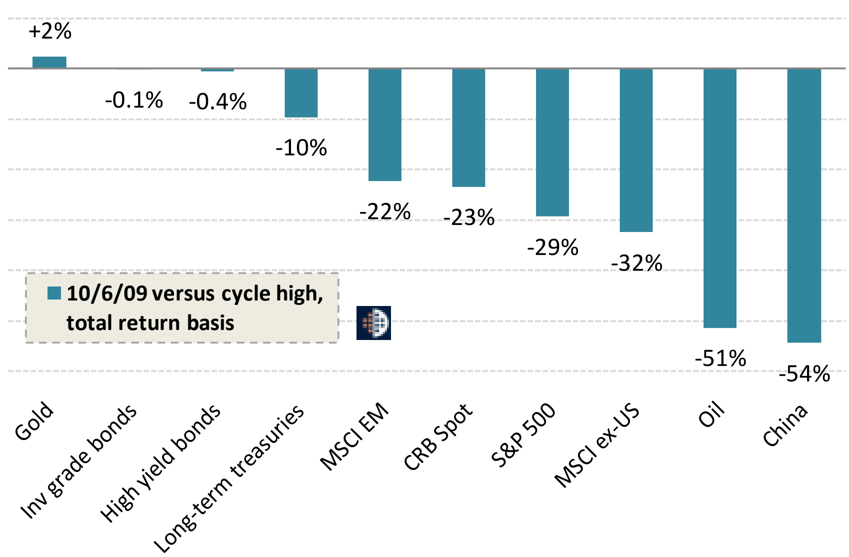
Donald Luskin

Believe it: the crisis of deflation has been turned into the problem of inflation.

Update to strategic view
GOLD, US RESOURCE STOCKS, COMMODITIES, OIL, US DOLLAR: Gold's new all-time highs reflect expectations that the crisis of deflation has been replaced by the problem of inflation, a victory for the Fed. The accommodative policies that accomplished this will stay in place for the foreseeable future, so we expect gold to work higher -- and take the rest of the "inflation plays" along with it.
[see Investment Strategy Dashboard]

Gold broke out yesterday to a new all-time intra-day high at 1043.45 and a new all-time closing high at 1040.85. The previous high-water mark at 1030.2 was made intra-day on March 17, 2008 -- "Bear Stearns Monday" -- when it seemed that the world was going to come to an end. It almost did, thanks to the chain of events that began that day. Now, ironically, gold has made new highs precisely because the world is *not* going to come to an end. This move embodies the expectation that Ben Bernanke's Fed has conquered the *crisis* of monetary deflation first unleashed by the Bear Stearns collapse, and thankfully replaced that crisis with a mere *problem* -- inflation.

Gold has been our "best idea" for a long time, because we have counted on both the Fed's resolve and the Fed's capability to engineer inflation (see, among many, "Why Isn't Gold at $1500?" December 10, 2008). For many months we have heard the criticism that this is a consensus view. We have never thought it was, but be that as it may, it has turned out to be right. In fact, on this day, gold is the only major asset class at all-time highs (see the chart at left).



Yet now we're hearing another criticism -- in fact,

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we have heard it so often lately we would go so far as to call *it* a consensus -- that whatever gold is telling us, it *can't* be about inflation, because inflation is deemed to now be structurally impossible. To over-simplify somewhat, the view is that the Fed can keep stimulating the economy virtually forever with near-zero interest rates and an enormous balance sheet -- without causing significant inflation -- thanks to a panoply of *deflationary* forces at work in the world in the aftermath of the credit crisis and recession. Among such forces most often cited are high unemployment, low capacity utilization, lack of pricing power, consumer retrenchment, financial deleveraging, slow real growth, falling import prices, and the lack of a transmission mechanism by virtue of broken credit channels.

Recommended reading

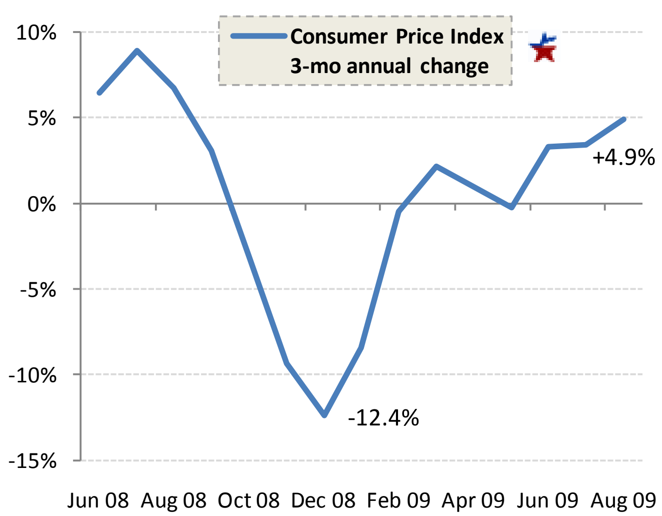
[Growing Up in a Recession: Beliefs and the Macroeconomy]
Paola Giuliano and Antonio Spilimbergo
Institute for the Study of Labor Working Papers Series
August, 2009

[Recommended Reading home]

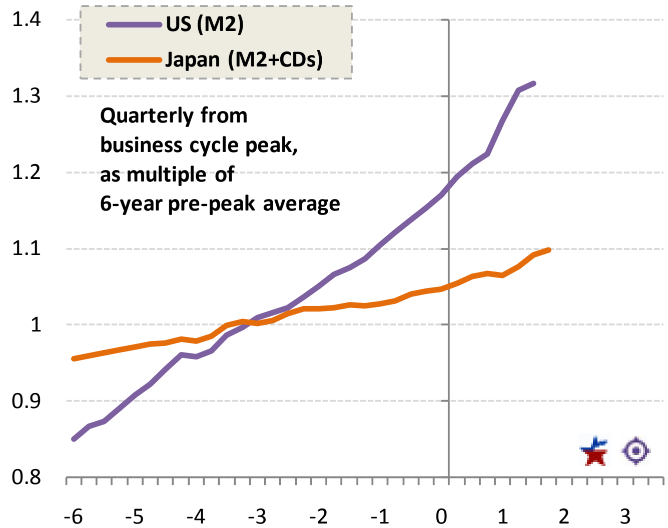
As potential causes of deflation, we think some of the items on this list are more salient than others. But for today's purposes we'll stipulate that are all deflationary -- yet nevertheless we'll argue that none of them, or *all of them together*, will in fact prevent a significant rise in inflation. For one thing -- setting reasons and rationales aside -- that is what the gold price is telling us. Movements in the gold price have been excellent predictors of changes in the rate of inflation. According to our research, since the dollar price of gold was deregulated in 1971,

- When the gold price is *up* year-over-year, the inflation rate *increases* 61% of the time over the coming year, by an average of 1.3%
- When the gold price is *down*, the inflation rate *decreases* 66% of the time, by an average of 1.6%
- When the gold price is *up more than 15%* year-over-year (as it is now), the inflation rate *increases* 64% of the time over the coming year, by an average of 2.2%
- When the gold price is *down more than 15%,* the inflation rate *decreases* 74% of the time, by an average of 2.3%

While this is only a technical argument, we are strongly inclined to respect it -- because it bears out the same conclusion we come to when we reason about inflation from first principles. We believe that *no matter what* deflationary forces the Fed faces, it can always print enough money to create inflation. Ben Bernanke agrees. As he said in 2002, "under a paper-money system, a determined government can always generate higher spending and hence positive inflation." This is what Milton Friedman meant when he said that "inflation is always and everywhere a monetary phenomenon." In other words, inflation can occur whenever the supply of money outstrips the demand for it -- and no matter how great the deflationary demand, a central bank has no natural limits on the inflationary amount it can supply.



This is no mere theory -- it is working here and now. On a 3-month annual basis, Consumer Price Index inflation is growing at a 4.9% rate. Just last December, it was falling at a 12.4% rate, a deflation of about the same magnitude seen in the depths of the Great Depression. Surely whatever list of deflationary forces may be in play today can be no worse than last year when the global banking system was collapsing -- yet even then, our determined government, or more specifically our determined central bank, reversed the deflation and turned it into inflation. So if there can be no inflation in today's deflationary world, then why is there inflation *right now*? All we're saying -- and all gold is telling us -- is that *it will continue*.



We are often asked why, if all this is so, does deflation persist in Japan? The answer is simply that the Bank of Japan has not been sufficiently determined -- for all it has done, it has not met the demand for money by printing more and more of it. We can see its failure of determination in an event-study of a type developed by Friedman in 2006, in the chart at left. Note the very obvious differences in the rates of money growth in the US and Japan over the present business cycle, especially the much greater post-peak acceleration in the US. Bernanke is well aware of the BOJ's failures, and indeed has lectured the Japanese government on what to do about it -- *to print money*, and if necessary to be downright irresponsible about it. In fact, we've been lecturing the BOJ ourselves as far back as 1995 (see "Where the Bank of Japan Errs" April 21, 1995).

So for us the example of Japan's *deflation* is an argument *in favor* of US *inflation*, because we know that it exemplifies for Bernanke exactly what must be avoided here at all costs. As a student of the Depression and a monetarist, Bernanke is first and foremost an anti-deflationist -- he will always choose the problem of inflation over the crisis of deflation, which his reading of history tells him caused the Great Depression. So when we hear the long list of items imparting deflationary pressures in today's economy, that just tells us the Fed will fight harder to create inflation. And it will win because, as Bernanke knows, all it takes is money -- and the Fed can never run out.

BOTTOM LINE: Gold's new all-time highs reflect expectations that the crisis of deflation has been replaced by the problem of inflation, a victory for the Fed. The accommodative policies that accomplished this will stay in place for the foreseeable future, so we expect gold to work higher -- and take the rest of the "inflation plays" along with it.