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INTELLECTUAL AMMUNITION

Gold's Most Immemorial Year

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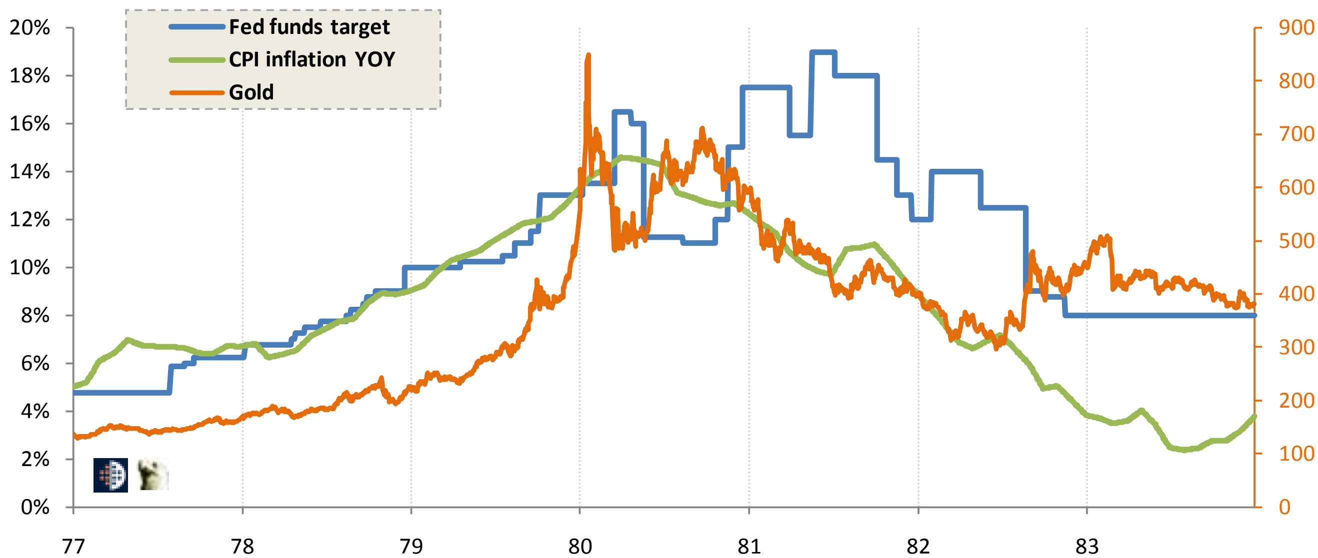
What 1979 can teach us about gold, inflation and the Fed.

Update to strategic view

GOLD: Without an overt shift in Fed policy, the gold price will continue to rise. As in 1979, a year in which gold almost quadrupled, such a shift will have to be dramatic in order to be effective.

[see Investment Strategy Dashboard]

We regard gold as the single best gauge of real dollar value and relative monetary scarcity. Over the centuries, the real value of gold has remained essentially constant. A rising gold price, if not reversed, is tantamount to an increase in the price level -- that is to say, *inflation* -- over some indeterminate period of time. The current run in gold -- with yesterday's new all-time record price exceeding$1150 -- is commonly viewed as a speculative bubble, and therefore implying little about future inflation. Gold can be seen as being in a "bubble" in the sense that its rise has roots common to the housing and credit bubbles earlier this decade: excessively easy monetary policy. Some of the $430 gold rally from a closing low made almost exactly one year ago reflects the recovery from the severe monetary deflation associated with the world-wide banking panic. But its move now to all-time highs means something more than just reflation. The fact that this has been a greater than 60% move does not argue for dismissing it as mere speculation. Quite the contrary: the



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larger the move, the greater the implied inflationary threat. To put this in context, let's look back to a time well within living memory when gold experienced a far greater move -- a 276% gain from the end of 1978 to the then-record peak at $850 in January 1980, almost a quadruple.

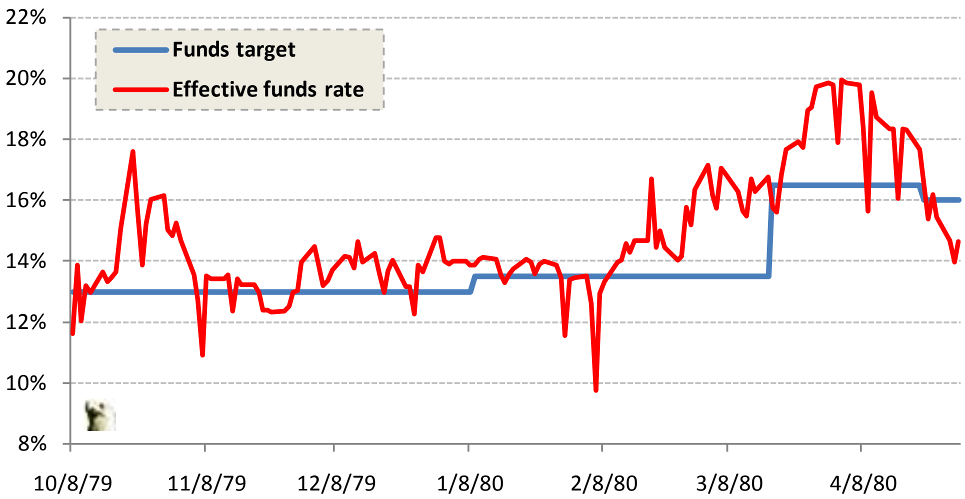
The 1979 inflation outbreak was the second double-digit inflation experience of the decade. CPI inflation had peaked at 12.2% in late 1974, up from 3.4% two years before. That outbreak had been foreshadowed by gold, following its "decontrol" in August 1971, moving to more than $100 in mid-1973 and $175 by early 1974. Following a Fed tightening cycle that got the funds rate target to 11% by mid-1974, CPI fell back to 5% by the end of 1976, with gold having dropped back to near $100 by mid-year. But the seeds for the next inflation breakout were being planted under the inept Fed chairmanship of Arthur Burns. Following the tightening cycle in 1974, Burns cut the funds rate to 4.75% by early 1976. By the third quarter, gold was setting off on a new rally that would ultimately bring it to extraordinary heights, along with the inflation rate.

Gold started 1979, its most immemorial year, at $226, with year-on-year CPI inflation at 9.25%. As it became clear that the Fed under then-chairman G. William Miller was unwilling to confront the problem -- the Fed had already raised rates by 375 bp in 1978, but now Miller's patron Jimmy Carter was facing re-election in 1980 -- gold rallied to $300 by the summer. With inflation running at almost 12% in August, Carter was finally prevailed upon to replace Miller with Paul Volcker. With his background as president of the New York Fed, and at the Treasury where he had been deeply involved in the 1971 decision to close the gold window in 1971, Volcker was considered far more credible.

While Volcker is now regarded as a heroic figure for finally slaying the hyper-inflation of the 1970s and early 1980s, he didn't start out that way. At his first FOMC meeting as chairman in August 1979, "Some doubt was expressed (by committee members) … that further restraint could have a significant effect on inflation." According to the minutes of the meeting, "In the face of clear evidence of weakening in economic activity, it was observed, the need to balance the objective of containing the recession with the goal of moderating inflation called for a steady policy for the time being." The Fed did raise the funds rate by 50 bp to 11% at this meeting, but with inflation racing ahead at a 3-month annualized rate of 14.3%, the Fed itself did not regard the move as restrictive.

The price of gold continued to rally to almost $400 over the next month after the Fed Board of Governors voted 4-to-3 in September to raise the discount rate to 10.5% from 10.0%. The split vote was widely seen as an indication of resistance to taking further action to restrain inflation. The FOMC raised the funds rate by 50 bp, too, another move widely regarded as a cosmetic attempt to merely keep pace with inflation, leaving policy still behind the curve. The impression that the Fed still lacked the resolve to tackle the deepening inflation problem motivated Volcker in early October to convene a special meeting of the FOMC. Afterwards, he announced that the Fed was changing its operating procedures so as to more directly target the provision of bank reserves in order to gain better control of the monetary aggregates, which were then growing at double-digit rates. The funds rate target would be maintained, but the effective funds rate would be permitted to float in a range as much as 400 bp above the target. Several days later, the target was raised by 150 bp to 13.0%, where it was held through the rest of the year.

Whatever the intent might have been, in practice the change in operating procedures made little difference over the next several months, and potentially exacerbated the sense of uncertainty about the Fed's resolve. The funds rate traded in a highly volatile fashion, but mostly in a range not much above the target (the average effective rate from the announcement of the policy change through year-end was 13.6%, versus 13.0% for the target). Gold snubbed Volcker's



supposedly more focused effort to get a handle on the rapid erosion of dollar purchasing power. Gold was at $414 at the beginning of October, and stood at over $600 by the first week of 1980.

As the new year opened, the next FOMC meeting was scheduled for January 9. Leading up to the meeting, press reports suggested that the Fed was likely to stand pat on the funds rate target, letting the changes under its October shift in operating procedures work through the system. In fact, the FOMC did raise the target, but by just 50 bp to 13.5%. Inflation at this point was running at 13.25% year-on-year, meaning the Fed was still targeting a negative real funds rate. Gold soared following the FOMC meeting, rendering an unmistakable vote of no confidence in the chairman. From $607 on the day of the meeting, gold followed nearly a straight line upward, rising 40.0% in eight trading sessions, including a one-day move of 11.3%, or $85, on January 20. The high-water mark on a closing basis was on January 21, at $850.

There may be no specific reason why gold topped at exactly that price on exactly that day. When expectations-driven markets become highly excited, there can be a great deal of noise overlaid on a great deal of signal. But gold's move was no doubt part of a broad complex of alerts that, circularly, ended up influencing the institutions about whose behavior its price embodied expectations in the first place. On the day gold set its then-record price, President Carter delivered a State of the Union message to Congress announcing that a widely expected tax cut would not be included in the White House's budget for the coming year, because it was seen as further stimulating inflation. As a matter of first principles, tax cuts don't cause inflation -- but when they are seen as contributing to deficits and are expected to be accommodated by a too-easy central bank, they can. Carter's reversal of these expectations, grounded in a heightened concern with inflation, may have been seen as Carter giving his blessing to Volcker to finally take a truly effective inflation-fighting posture.

Volcker did, but it wasn't immediately obvious. The funds rate target was left unchanged at 13.5% at the February FOMC meeting, 11 trading sessions later, by which time gold had fallen back to below $700. Gold seems to have anticipated that, starting shortly after the meeting, the effective funds rate began to trade consistently far higher than the target rate, indicating that the Fed was willing to effectively permit extremely tight monetary conditions (see the chart above). In response, by the time of the March meeting 6 weeks later, gold had already fallen back to an interim low at $481. At that meeting the funds target was hiked by 300 bp to 16.5%, finally getting well ahead of the inflation rate, then running at what proved to be the cycle peak of 14.6% year-on-year. The hike validated where the effective rate had already been for several weeks. Extreme tightness persisted as the effective funds rate traded as high as 20% in early April -- and gold traded in a narrow range around $500 through the end of May.

But with an election approaching and the economy still weak, Volcker went into an easing posture, cutting the funds rate 50 bp to 16.0% at the April FOMC meeting, and then slashing it by 4.75% to 11.25% at the May meeting. At that point inflation was only marginally down from its highs, still running at just below 14.5%. By June, gold resumed rallying, reaching $700 around the same time as the Fed easing cycle concluded in October.

As we know, Volcker eventually got a handle on the requirements of his job. Two weeks before the election of Ronald Reagan, he began tightening again, with the target funds rate at 17.5% by the end of the year. With Reagan's endorsement of his anti-inflation campaign, Volcker maintained the Fed's tightening posture into the summer of 1981, bringing the funds target to an all-time high of 19%, with the effective funds rate peaking at almost 22%. By this point, gold had fallen back to below $400 and continued to drift lower for the next year, eventually bottoming just above $300 in mid-1982. The back of the great inflation was decisively broken, with CPI running at about 2.5% year-on-year by mid-2003.

This episode validates for us the powerful ability of the gold market to anticipate and interpret monetary conditions, and therefore to embody inflation expectations. Yet critics of gold often complain that the $850 price in January, 1980 was "wrong" -- because it coincided with the peak of CPI inflation. This reflects a misconception of how markets embody expectations in a dynamic economy. The $850 gold peak was not a hard "forecast" of the likely inflation outcome, but rather a measure of the market's expectations based on its lack of confidence that the monetary authorities would have the resolve to undertake the action necessary to root out the strong inflation impulses in the system. Eventually, due in no small part to the market's alarm reflected in the gold price, that resolve was mustered, and once it was, gold fell to reflect a sharply less dire expectations environment.

How shall we relate this to the present situation, with gold making new all-time highs? A key difference between now and then was that the inflation reality at that time was already clear-cut enough to support an aggressive policy response. Yet it wasn't aggressive enough -- though in 1979, the year in which the gold price nearly quadrupled, the funds rate was hiked no less than five times. Currently, it's easy to observe inflation data and conclude that there's nothing to respond to. That, in fact, has been the Fed's rationale for promising to keep rates extremely low for an "extended period." But that, too, is not aggressive enough -- or so the gold market is telling us. We are convinced that gold price acceleration we have witnessed over the past year is a signal of the beginnings of a loss of confidence potentially as deep as that experienced in 1979.

BOTTOM LINE: Without an overt shift in Fed policy, the gold price will continue to rise. As in 1979, a year in which gold almost quadrupled, such a shift will have to be dramatic in order to be effective.