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Gold is the Strongest Currency

Thursday, May 6, 2010

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Thanks to Greece it's at all-time highs in euros -- but why is it surging in dollar terms, too?

The more the European Union commits to saving Greece, the lower the euro falls. It's about the fear of contagion to other weak Euro area nations, but more fundamentally it's about the original sin at the heart of the whole euro currency experiment -- first having formed a rules-based monetary union without a political union, second having admitted Greece and other deficit-heavy countries in violation of the rules (see "Greek Farce" February 16, 2010), and third bailing out Greece in further violation of the rules (see "Greece Gets TARPed" April 12, 2010). A fiat currency is inherently a faith-based enterprise, and faith in the euro has depended mostly on rules, now all broken. But there was no choice for Europe in a world in which everyone and everything, everywhere, is too big to fail, and debt is not to be liquidated but instead moved from weak balance sheets to strong ones. The EU was faced with a Bến Tre scenario in which it had to destroy the euro in order to save it, and so it has.

This means that the US dollar has now won the lottery twice. First, it soared in the credit blackout of 2008 in a flight to liquidity and a mad scramble for trade settlement balances, despite the fact the US was patient-zero in setting off the blackout in the first place. Now, with the EU shredding the rules-based standard underpinning the euro and disqualifying it for decades as a credible alternative to the dollar as a global reserve and settlement currency, the dollar is most of the way back to its March 2009 peak. This shouldn't be mistaken for dollar strength. This is euro weakness.

This becomes crystal clear when both the dollar and the euro are viewed together in terms of a third currency as a common reference point -- the global non-fiat reality-based currency, gold. We see that gold, priced in euros, has made new all-time historic highs. It has *not* made new highs priced in US dollars, which tells us what we already knew, that the dollar has been stronger than the euro. But if the dollar were *really* strong, then gold priced in dollars wouldn't have moved at all during the PIGS crisis. Instead, since February, the dollar price of gold has moved up to within striking distance of all-time highs. This isn't supposed to happen. We're not supposed to see a strong dollar and strong gold at the same time. Yet we have. It means that the dollar has lost value, but just less than the euro has (please see the chart at the top of the following page).

Update to strategic view

US DOLLAR: The EU has destroyed the euro in order to save it. In the process, it has created the illusion of a strong US dollar, but in fact both currencies are extremely weak versus the objective standard of gold.

GOLD, OIL, COMMODITIES, US RESOURCE STOCKS: Gold is at all-time highs in euros, and challenging the highs in dollars. The EU's open-ended commitment to save Greece and other PIIGS take the risk of global deflation off the table, and enable the Fed to stay easier longer. In the last week of rising global risk aversion, gold has outperformed other inflation-sensitive assets, a reminder that gold is the pure play on inflation, while the others are joint plays on inflation and growth.

US BONDS: Over-supply is an unimportant factor in US Treasuries -- global financial conditions, and Fed policy linked to them, remain in the driver's seat. The 10-year was a great speculative buy at 4% recently -- now below 3.5% it's in shorting territory.

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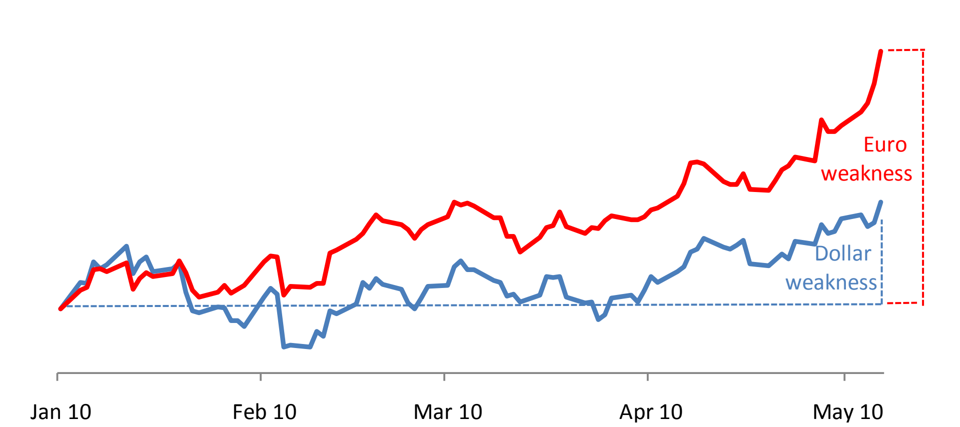
Gold in US dollars **Gold in euros**
Indexed to 1/1/2010, log scale

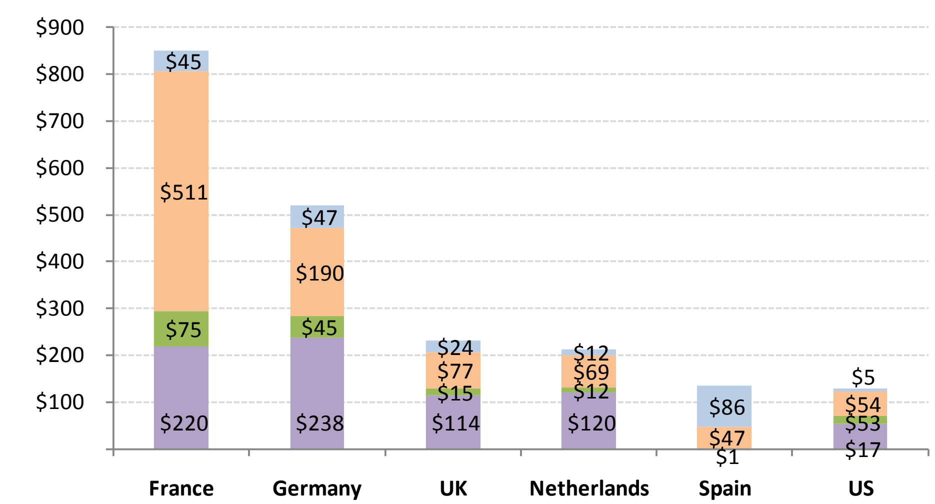


Source: Reuters, TrendMacro calculations

Initially, as the Greek crisis began to unfold in late January, gold fell in dollar terms. As we explained at the time, (see ["PIIGS, Panic and Jobs"] February 5, 2010), that was because of the risk that the EU would *not* intervene to save Greece from default, thus setting off a deflationary banking crisis like the one that brought gold below $700 in October 2008. We predicted then that gold would recover when the authorities made it clear that Greece would be saved, and deflation risk taken off the table -- and that's exactly what has happened. But why has it played out in the *dollar* price of gold, as well as the *euro* price?

First, the deflation that would have arisen from a Greek default would have been a global contagion. In that particular contagion, patient-zero would not have been the US banks, as in 2008, but rather the European banks (please see the chart below), whose exposure to sovereign debt of PIIGS

Bank exposure to sovereign debt **Portugal** **Italy** **Greece** **Spain**
USD billions, as of 12/31/2009



Source: Bank for International Settlements

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Recommended Reading

Is Greece different? Adjustment difficulties in southern Europe
Alcidi Cinzia and Daniel Gros
VoxEU
April 22, 2010

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Key documents

Treaty on European Union

Report On Greek Government Deficit And Debt Statistics Eurostat nations is potentially ruinous. But the risk aversion resulting from a European banking crisis would have triggered a surge in money demand world-wide -- and unless non-European central banks responded with a commensurate increase in money supply in their respective jurisdictions, the result would be deflation everywhere.

Second, remember that in late January, the conventional wisdom was that the Fed was poised to signal the end of its hyper-accommodative policy posture (see "Advice and Dissent" January 28, 2010). Thus it would be particularly ill-equipped to deal with any deflationary impulses imported from Europe. Since then, just as the European authorities have made it clear they will do whatever it takes to rescue Greece, the Fed has signaled nothing but continued extreme ease (see "On the April FOMC" April 28, 2010). We're not saying that the Fed's "extended period" of ease is a direct response to risks in Europe, although surely the Fed has taken those risks into account. As we've explained so many times, the Fed has plenty of entirely domestic reasons to stay easy. But if nothing else, the strength in the dollar versus the euro removes one important potential side-constraint that might have otherwise made it difficult for the Fed to maintain a funds rate of near-zero. It's a lot simpler for the Fed to stay easy when, thanks to the euro, the dollar appears strong, and Treasury yields are falling.

So the rally in gold priced in dollars can be understood in two complementary senses. First, it is a sigh of relief that the risk or a renewed bout of global deflation is off the table. Second, it is an expression of the long-term inflationary risks attendant to the Fed's seemingly permanent commitment to hyper-accommodative policy, a commitment enabled by the side effects of a weak euro operating upon the dollar and on Treasury yields.

We see all the dynamics playing out now as having a great deal of momentum. We think the EU will have to keep propping up Greece in various ways virtually permanently -- Greece has entered a death spiral in which its nominal GDP growth can't possibly cover its nominal debt service, so its debt as a percentage of output can only increase. This is only exacerbated by the austerity measures being imposed as a condition of rescue, which reek not so much of Bến Tre but of Great War reparations imposed punitively on Germany.

Then as now, the idea was to contain moral hazard. But if we have learned anything from the series of botched bank bail-outs in 2008 that failed to stem the banking crisis, it is that you can't punish and rescue at the same time (see "Death by Rescue" November 17, 2008). The US banking crisis was solved in February 2009 only when Tim Geithner's Financial Stability Program effectively extended a free safety net to all stakeholders, no questions asked (see "Geithner Gets a Do-Over" March 24, 2009). The European debt crisis seems to be retracing this learning curve, and is only about halfway through. On the face of it this is a recipe for continued euro weakness. But because these issues are inherently global in scope, it's a recipe for dollar weakness, too, at least as measured against an objective standard such as gold.

Bottom line

The EU has destroyed the euro in order to save it. In the process, it has created the illusion of a strong US dollar, but in fact both currencies are extremely weak versus the objective standard of gold. Gold is at all-time highs in euros, and challenging the highs in dollars. The EU's open-ended commitment to save Greece and other PIIGS take the risk of global deflation off the table, and enable the Fed to stay easier longer. In the last week of rising global risk aversion, we've seen gold outperform other inflation-sensitive assets, a reminder that gold is the pure play on inflation, while the others are joint plays on inflation and growth. Over-supply is an unimportant factor in US Treasuries -- global financial conditions, and Fed policy linked to them, remain in the driver's seat. The 10-year was a great speculative buy at 4% recently -- now below 3.5% it's in shorting territory.