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Gold at New Global Highs

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Europe is patient-zero, but the breakout in gold is a flight from currencies worldwide.

Gold at all-time highs is the realization of our long-standing "best idea" call, and it underscores our basic strategic conception of a world of "no exit." In that world, dangerous aftershocks of the credit crisis of 2008/9 continue to be felt, and the world's monetary and fiscal authorities will have no choice but to continue extraordinarily accommodative policies to protect a still-fragile banking system. Gold reflects the costs of that accommodation as the inevitable degradation of currencies in which gold is priced. Think of

Update to strategic view

GOLD: Flight from the euro is only the catalyst, not the root cause, of

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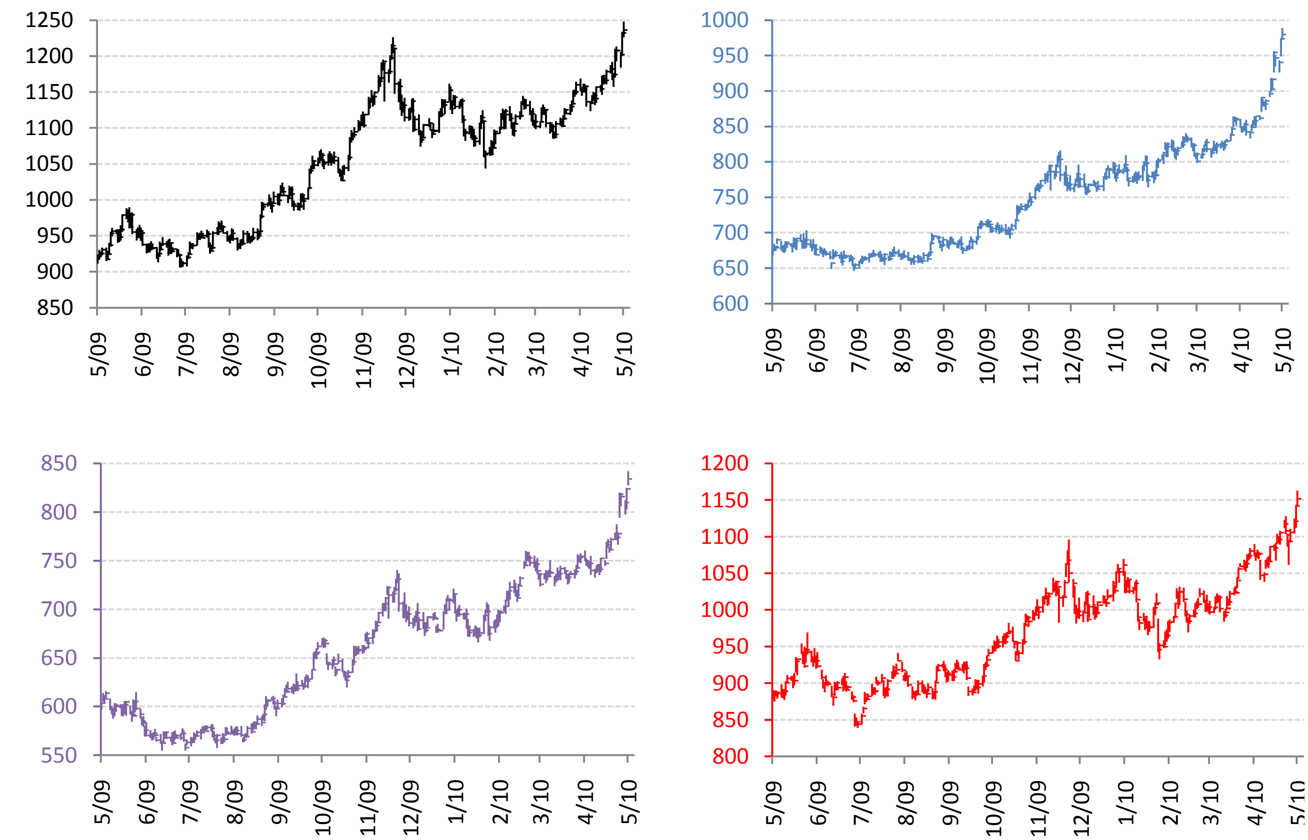
Gold priced in: — US dollar — Euro — GB Pound — Japan yen



Source: Reuters, TrendMacro calculations the price of gold as an exchange rate. When it strengthens against a particular currency, that's equivalent to saying that particular currency has weakened. What's especially notable about gold now is that gold has broken out to new highs in *all* major currencies, which is to say that they have *all* weakened (please see the chart on the previous page).

It's not just a euro thing. Gold's move to new highs was born in Europe's sovereign debt crisis, breaking out in euro terms in early February, well ahead of the breakout in any other major currency. This reflected the market's correct expectation that Europe would sacrifice the integrity and the purchasing power of the euro in order to save its largest banks from exposure to defaulting PIIGS sovereign debt (see "PIIGS, Panic and Jobs" February 5, 2010).

Press reports this week have explained gold's move entirely in the context of a flight to quality by Europeans. A story in yesterday's *Wall Street Journal* went so far as to present the admittedly "anecdotal evidence" of a gold coin dealer who said, "It's been exclusively European…I've seen no orders from America, no orders from Japan." But that leaves unanswered the question of why gold has broken out to new all-time highs in US dollars, and to post-1980 highs in Japanese yen (and also all-time highs in sterling).

One intuition that answers that question is to stipulate that the buying interest is indeed entirely European -- but then to ask why, in a flight to quality from the euro, a European would prefer to buy gold as opposed to dollars, yen, or sterling? If he had, the dollar, yen and sterling would have strengthened relative to the euro as much as the euro had weakened relative to gold, leaving the gold price unchanged in dollars, yen and sterling. If this seems too theoretical, think about it another more practical way. If the dollar, the yen and sterling were as good as gold, then when exclusively euro-based buyers pushed up the gold price in those other currencies, Americans, Japanese and British would have been sellers. But evidently, they were not.

Why not?

- First, because the crisis in Europe has alerted markets that the global credit crisis is not over. Remember, it's not just a question of a few little countries having trouble with their sovereign debt. The issue is that fact that the European banking system -- much of which, according to Fed sources, could not pass the "stress tests" administered last year to US banks -- is stuffed to the gunwales with PIIGS debt (see "Gold is the Strongest Currency" May 6, 2010).
- Second, the European crisis is evidence that fiscal and monetary authorities will do "whatever it takes" to prop up the threatened banking system, regardless of the long-term inflationary implications, and regardless of law. We cannot overemphasize the importance of the lawlessness of the European Central Bank's decision to engage in "quantitative easing" by buying distressed sovereign debt, despite Article 21.1 of Protocol No. 4, the statute

gold's new all-time highs. It reflects a flight from *all* major currencies, and will continue so long as monetary and fiscal authorities have "no exit" from extraordinary measures to absorb the ongoing shocks of the global credit crisis. We reiterate our longstanding price target of $1300, and are likely to revise it higher when it is attained.

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Key documents

Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB

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that supposedly limits the ECB's powers: "any other type of credit facility with the ECB…in favour of…central governments…shall be prohibited…" (see "Europe Gets *le TARP*" May 10, 2010).

- Third, with the ECB having broken the rules this way, it has permanently crippled the euro, which drew its credibility from the ECB's rules-based anti--inflation mandate. With the resulting euro weakness creating the illusion of dollar strength, the Fed is protected against dollar weakness acting as a constraint on its own inflationary behavior.
- Finally, the European crisis tells markets that there is no such thing as a local credit crisis anymore. *Everything everywhere* is systemic. Think you've got the problem licked at home? It will just spring up somewhere else, and wash back onto your shores. Presently, the risk of PIIGS debt bringing down Europe's banks is a threat to US banks, and so we see the Fed responding by printing more money to fund dollar swap-lines to the ECB and other central banks (again, see "Europe Gets *le TARP*"). So for the whole world, there is "no exit" from accommodation.

It's the fashion now to assume that the credit crisis of 2008/9 is entirely behind us -- *mission accomplished!* -- and we can now move on to a supposedly V-shaped recovery as though nothing had ever happened. We disagree. Credit crises are not like business cycles. They have unique lingering aftereffects that prolong risk and retard the maturing of recovery into expansion. The emergence of the crisis in Europe, and the massive global response to it, shows us that the mission is far from accomplished. And the flight from all major currencies to gold advises us that the ultimate accomplishment of the mission will not be without cost or consequence.

Bottom line

Flight from the euro is only the catalyst, not the root cause, of gold's new all-time highs. It reflects a flight from all major currencies, and will continue so long as monetary and fiscal authorities have "no exit" from extraordinary measures to absorb the ongoing shocks of the global credit crisis. We reiterate our longstanding price target of $1300, and are likely to revise it higher when it is attained.