TrendMacro

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MARKET CALLS

More Upside for Gold

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The future for gold, and what an all-time high gold price is saying about the future.

Gold made a new all-time intra-day high on Tuesday at $1251.20. As the panic in equities has abated, gold has pulled back a touch (please see the chart below). As a result, several clients have asked us to update our long-standing $1300 price target. Under what conditions could gold attain the target or exceed it? And under what conditions would it fail, and the bull market in gold end? Apparently Ben Bernanke is curious about gold now, too. Responding to a question from a congressman yesterday, Bernanke admitted "I don't fully understand the movements in the gold price."

Update to strategic view

GOLD: We raise our 12-month price target for gold to $1500, predicated on "no exit" for the Fed -- policy staying ultra-easy in the face of an "expansionless recovery."

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Gold — Polynomial trend — Various technical levels ▲ FOMC meetings
Source: Reuters, TrendMacro calculations

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About our $1300 price target

As a matter of policy we don't set price targets, but we made an exception for gold. Normally TrendMacro's approach is to avoid such static metrics, and to focus instead on economic forces in dynamic motion. In our model, a trend in motion in a particular direction is expected to stay in motion in that direction, until some force arises to deflect it, at any price and at any time. For gold, we set an ambitious but feasible price target to indicate our deep conviction about an asset that is often misunderstood or ignored -- indeed, it is often ridiculed.

Though we'd been very positive on gold for quite some time, our formal price target was first set at $1500 in December 2008 when gold was trading at $771 (see "Why Isn't Gold at $1500?" December 10, 2008). This was just before the FOMC lowered the funds rate to zero, and it became clear that the Fed was willing to take extraordinary measures to create more than enough liquidity to definitively reverse the monetary deflation triggered by an historic surge in money-demand after the collapse of Lehman Brothers. The connection to gold is simply that gold is first and foremost sensitive to the excess or scarcity of monetary liquidity, and to consequent long-term inflationary implications. We lowered our gold price target to $1300 in June 2009, when it had advanced to $920. We thought the worst-case inflation risk had been taken off the table then, because the Fed suddenly stopped overtly speaking about the threat of *deflation*. No longer having to fight deflation with inflation, we could reasonably predict that no new extraordinary liquidity facilities would be created (see "Can Inflation Plays Do Without Deflation?" June 25, 2009).

But while not expecting the Fed to do a lot *more* to ease, we expected that the Fed would *not* do *less*. That's just how it has turned out. Over the last year the Fed's balance sheet has grown by a little less than 10%, from $2.2 trillion to $2.4 billion. And the funds rate is still zero. With our Fed expectations met, it follows that our expectations for gold have been approximately been met, too.

Time to adjust the target

But what next? Versus what we would have guessed *a year ago* about what our expectations would be *today*, we are surprised to find ourselves believing deeply that the Fed has as little prospect of tightening now as it did then. For gold, the critical takeaway from that belief is that simply by *not tightening*, the Fed is implicitly getting increasingly easy. It is habituating the markets and the economy to easy money and subsidized credit, and building in distortions that will ultimately lead to intractable inflation. This is essentially the critique of Kansas City Fed president Thomas Hoenig in his serial dissenting votes at FOMC meetings (see "Advice and Dissent" January 28, 2010). Bernanke and those who vote with him don't particularly disagree with Hoenig's reasoning -- they just have a different objective function. They are willing, indeed eager, to court inflation risks and create market distortions -- pretty much whatever it takes

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US STOCKS: The fact that gold has moved to new all-time highs as stocks have corrected implies that continued ultra-easy policy will be there to put a floor under any growth disappointment. The correction is just a correction, a buyable dip.

US RESOURCE STOCKS, GOLD, OIL, COMMODITIES: Gold is the only pure play on "no exit" for the Fed -- other inflation-sensitive assets are also sensitive to cyclical risk, and so have been hurt badly in the present growth disappointment. But as the correction plays out, with "no exit" for the Fed, the "inflation plays" will be double winners, benefitting from both cyclical recovery and compounded inflation risk.

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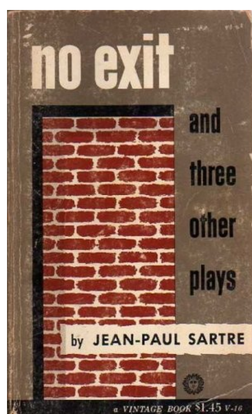
[About us]

-- to get credit flowing and to shock the economy out of its current stagnant state, what we call an "expansionless recovery."



- This means that gold is highly likely to reach our $1300 price target, *and more*, provided that the Fed simply stands pat. We believe that the Fed will stand pat for a very long time, for the mother of "extended periods." A Fed exit strategy? Hardly. It's "no exit"-- with the Fed playing one of the eternally trapped characters in the existentialist play of the same name.
- In fact, if there's going to be any move from the Fed at all it will be to ease even more. Look what happened when sovereign debt risk in Europe heated up last month -- the Fed instantly re-opened the dollar swap-lines for the ECB and other foreign central banks that it been shut down just months before (see "Europe Gets *le TARP*" May 10, 2010).
- Job One now for the Fed is to get the unemployment rate down, in an "expansionless recovery" taking place in an election year. The only reason unemployment downticked a little with the May employment report was that the economy is so weak that the labor force contracted, even after its record contraction over the previous year (see "On the May Jobs Report" June 4, 2010). This is no-win for the Fed. The only way the unemployment rate will come down at all anytime soon is if the economy weakens so much that the labor force contracts even more. If the economy manages the kind of anemic growth it experienced over the last six months, the unemployment rate will rise because the labor force will expand more rapidly than the jobs market can absorb it.
- What if there's a "super-V" recovery? We really wouldn't suggest wasting a lot of time planning for *that* contingency right now. It's simply not in the numbers. If it were there, we'd be seeing it by now (see "So Much for the 'V'" May 21, 2010)
- The Fed faces no side-constraints that would keep it from staying easy, or getting even easier. Reported inflation isn't an issue. Today it's *lower* than it was when the Fed was still talking about deflation more than a year ago -- core PCE inflation is now 1.15%, versus 1.61% then. For that matter, it's lower than it was at its lowest in 2002 and 2003, when the Greenspan Fed became so worried about deflation that Bernanke gave a notorious speech about "helicopter drops of money" -- then it was 1.37%.
- Inflation expectations aren't an issue, at least not from Bernanke's perspective. When he said yesterday "I don't fully understand the movements in the gold price," what he meant was that he will ignore the inflation expectations embodied in rising gold, and instead follow those in TIPS spreads, which have recently narrowed. We'll leave for another day why gold and TIPS are telling two different inflation stories -- for now, suffice it to say that Fed policy is being influenced by TIPS, not gold.

- A conventional analysis of gold as an inflation hedge would treat these conditions as headwinds. But we interpret the lack of officially reported and expected inflation as tailwinds, because it permits -- indeed, it *inspires* -- the Fed to do whatever it takes to reflate.
- Treasury yields aren't an issue. There was a little scare when the 10-year touched 4% in the wake of a couple less than stellar auctions. But we were right in calling the top in yields then (see "Obamacare: Do Markets Care?" March 26, 2010), believing that the Fed's resolute promise of an "extended period" of a zero funds rate would continue to anchor the curve, rather than risk unhinging it. In fact, the seemingly insatiable demand for default free instruments is anchoring the funds rate at this point. Could the Fed raise rates now even if it wanted to?
- The dollar isn't an issue -- anything but. There's no risk that the Fed will have to tighten to defend the dollar, not with the euro having permanently blown itself up as the dollar's nearest competitor for the world's reserve and trade settlement currency (again, see "Europe Gets *le TARP*").
- We see the world's other major central banks in similar situations -- if anything, in more extreme situations. The ECB urgently must ease to protect Europe's over-leveraged banks from the risks of their excessive PIIGS exposures. And the Bank of Japan urgently must ease to reverse Japan's crippling deflation. While the dollar price of gold is ultimately determined by what the Fed does, when all the major central banks' policies are pointing in the same ultra-easy direction, then it's all tailwinds for gold.
- Finally, as a technical factor, we are impressed that gold has performed so well despite the headwinds from the International Monetary Fund's highly publicized sales from its own hoard (see "On IMF Gold Sales" April 2, 2009).

- **So while it's not really our style to do price targets, we'll put our gold target back up to $1500, with the expectation that we'll get there within the next 12 months.**

We feel this is actually a conservative adjustment -- it's just 20% above the current price. Why aren't we being more bold? In our heart of hearts, we actually are -- if you will, our whisper number is higher. But we officially hang back because, while the fact that gold is a pariah asset gives us contrarian confidence, we recognize at the same time that every step higher is unusually challenging. The bull market in gold must climb a wall of ridicule. That takes time, and time entails risk -- the risk that the world will change, and require a change in our views.

What would make us change our view?

Since our thesis for a higher gold price is based on "no exit" for the Fed and the other central banks of the world, that thesis would fall apart if the Fed suddenly changed course and tightened before the economy became strong enough to take it. Unless there were a quantum leap upward in economic performance and credit market confidence -- which we

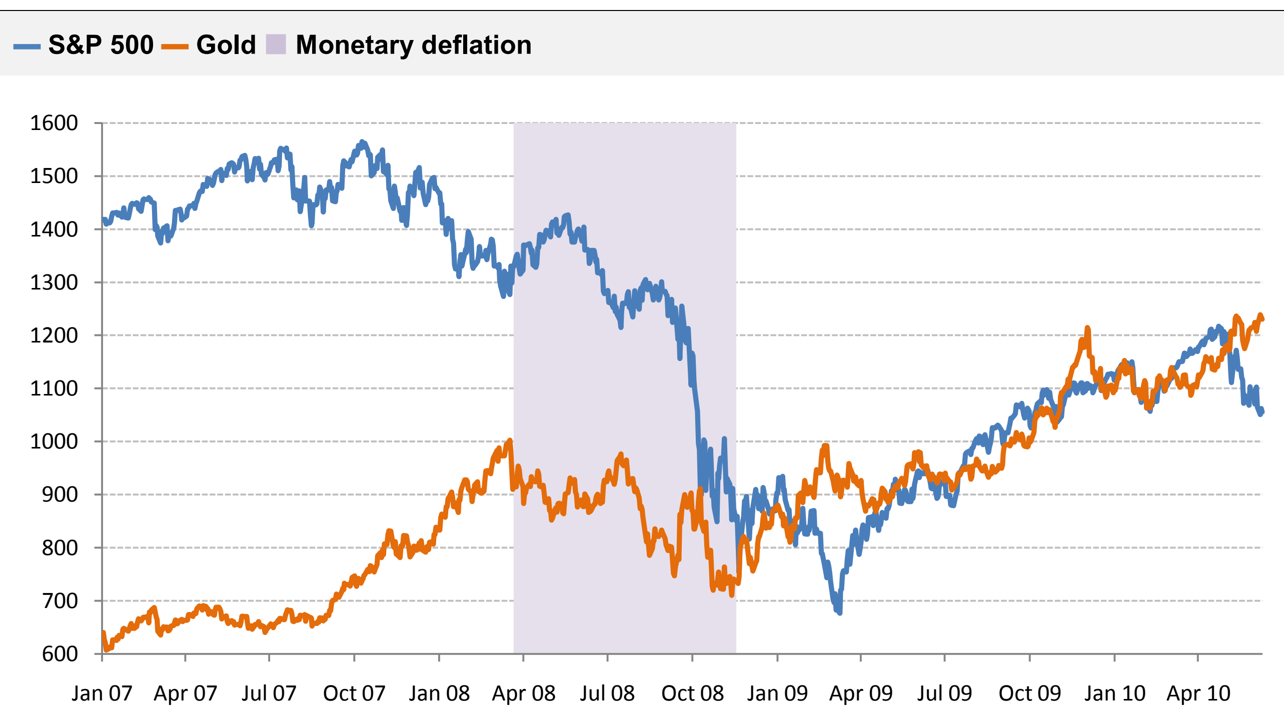
absolutely do not expect -- any tightening would surely throw the world back into the kind of steep deflation we experienced in the second half of 2008. Gold would fall just as it did then. It's really just that simple.

What is the gold price telling us now?

It's paradoxical. On the one hand, we think the rising gold price reflects continued ultra-easy monetary policy, driven by continued economic stagnancy. On the other hand, the fact that this stagnancy is being countered by ultra-easy policy means that it is highly unlikely that it will develop into a double-dip recession, or another near-depression such as we experienced in 2008-2009. Gold at all-time highs has been central in our belief that the current correction in stocks is just a correction, and that instead this will prove to be a buyable dip (see "The Panic Abates -- But Now What?" May 27, 2010).

Consider the intertwining histories of stocks and gold throughout the credit convulsion of 2007-2009 (please see the chart below). By the time the sub-prime mortgage collapse had claimed Bear Stearns as its first victim, gold had moved from $600 to $1000 in just 15 months, in anticipation of the easing the Fed would have to do to help the banking system and the economy survive. After Bear's failure, even though it had provoked the Fed's first extraordinary intervention in the form of the purchase of a $30 billion sub-prime portfolio at the behest of JPMorgan, the gold price began to decline (the shaded area of the chart).

With benefit of hindsight, we can now see that gold anticipated that the Fed would not be easy enough, soon enough, to prevent further failures, or



Source: Reuters

to accommodate the surge in money demand that those failures would trigger. With the Fed too tight, the string of bank failures combined with a savage monetary deflation -- at the worst of it reaching the same levels seen in the Great Depression. From mid-November 2008, the gold price bottomed and headed higher, anticipating the Fed would be ultra-easy enough to reverse the deflation and support the regeneration of the banking system. Even as stocks made their last big leg down in February and March 2009 after Obama's inauguration, the rising gold price signaled that the worst was over -- and indeed it was. Gold and stocks have risen together ever since, and for the same reason: ultra-easy policy has been floating both boats.

As global stock markets have corrected since the April top, if the gold price had been falling rather than moving up to new highs at the same time, we'd be terrified -- of a double-dip, or worse. That would have signaled that the Fed, and the other central banks of the world, were repeating the critical mistake that the Fed made in 1937 -- to tighten too soon, before economic recovery after a severe credit crisis had matured into a true expansion.

How about the "inflation plays"?

While gold has been strong, the "inflation plays" -- resource stocks, oil and commodities -- have performed horribly in the downturn since the April top. This has been a bitter disappointment to investors who keyed their inflation expectations to the rising gold price, but implemented those expectations in inflation-sensitive assets other than gold. Bernanke noted the divergence yesterday when he said, "Other commodity prices have fallen recently quite severely, including oil prices and food prices. So gold is out there doing something different from the rest of the commodity group."

The explanation is that gold isn't a "commodity." You don't eat it or put it in your gas tank. It's an alternative to money, and a very attractive one at a time like now when fiat money is being devalued to stimulate and support debt markets. For commodities, in the present episode of growth disappointment, rising inflation expectations in gold have been strongly overwhelmed by cyclical factors. Put another way, if the present correction in stocks was inevitable, then however much we may favor the "inflation plays" over time, in a correction they were bound to be hurt. But if we are right that the rising gold price implies that the present downturn is only a correction, then once it is played out, the "inflation plays" should come roaring back with a vengeance. They'll be at the forefront of cyclical recovery when investors understand that there's no double-dip in store, just a continuation of our "expansionless recovery." At the same time, "no exit" for the Fed means that inflation pressures will compound -- which is why we expect gold to attain $1500. For the cyclically sensitive "inflation plays," it's a double win.

Bottom line

We raise our 12-month price target for gold to $1500, predicated on "no exit" for the Fed -- policy staying ultra-easy in the face of an

"expansionless recovery." The fact that gold has moved to new all-time highs as stocks have corrected implies that continued ultra-easy policy will be there to put a floor under any growth disappointment. The correction is just a correction, a buyable dip. Gold is the only pure play on "no exit" for the Fed -- other inflation-sensitive assets are also sensitive to cyclical risk, and so have been hurt badly in the present growth disappointment. But as the correction plays out, with "no exit" for the Fed, the "inflation plays" will be double winners, benefitting from both cyclical recovery and compounded inflation risk.