Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

TRENDMACRO LIVE!

On Today's Drop in Gold

Thursday, July 1, 2010

Donald Luskin

Good news for the euro is bad news for gold, at least in the near-term.

Yesterday we noted that gold had been "rock steady" (see "Betting Against a 'Double Dip'" June 30, 2010). Today, quite the contrary -- gold is off 3.4% as we write this, flirting with the $1200 level. It's off even more priced in euros, down 5.2%. And therein lies the probable explanation. A flurry of positive news for Europe's frail banking system, reflected in a surge in the euro exchange rate, seems to suggest that the euro won't have to undergo as much degradation in order to save the banks than was previously feared (see "Gold is the Strongest Currency" May 6, 2010). If that's the right interpretation, then it dials down one notch the importance of the ECB as an inflation vector. So for inflation-sensitive gold, that's a blow. From a trading perspective, another way to say the same thing is that the euro just became more competitive with gold as a currency.

Here's what has happened in Europe:

- Today Spain was able to auction €3.5 billion of 5-year bonds. It was hardly the strongest possible auction -- but it succeeded only a day after a ratings downgrade warning from Moody's.
- As we predicted yesterday (again, see "Betting Against a 'Double Dip'", the ECB seems to be have successfully managed the long-term refinancing operations (LTRO) associated with the expiration of €442 billion in 1-year loans to 1,100 member banks. Only a half of the outstanding loans were rolled into shorter-term loans, which would seem to indicate that European banks need liquidity less desperately than the market had feared. While the roll was successful, it remains to be seen how much liquidity will be needed and for how long. The half of the loans that were rolled were likely on behalf of the weakest banks. Or it may well be that as much liquidity is needed now as before, but various arbitrages attractive with 1-year loans are unattractive with the 3-month loans now on offer.
- The successful roll is a feather in the cap of the ECB, which urgently needed something to enhance its credibility after months of compromising its statutory principles to aid in bailing out Europe's lesser sovereign credits (see "Europe Gets *le TARP*" May 10, 2010). All the more so, because this success followed intense public pressure by Spanish politicians and bankers to renew the

Update to strategic view

GOLD: Gold took a big hit today on a surge of confidence in the euro, itself based on a surge of confidence in the fragile European banking system. If this rising confidence is maintained, it will reduce the pressure on the ECB to inflate Europe out of its banking difficulties -- and that takes some wind out of the sails of inflation-sensitive gold. But we doubt it will be this easy for Europe. And nothing in the news out of Europe really changes our call for an "expansionless recovery" around the world. We think the world's central banks will still have to maintain highly inflationary postures for years to come in order to combat ongoing deflation pressures. The longer that goes on, the higher gold will go. From all-time highs last week, gold was due for a correction anyway. We don't know how much lower it might carry gold in the short-term, but our call is to buy the dip.

[Strategy Dashboard home]

one-year loans. Standing up to such pressure is the first act of discipline that the ECB has dared in a long time.

- It took three painful rounds of voting, but German chancellor Angela Merkel succeeded in installing her coalition's candidate for federal president, Christian Wulff. A key flaw in the European Commission's rescue plan for the Euro Area's ailing economies is the continued willing participation of Germany, the region's strongest balance sheet (again, see "Europe Gets *le TARP*"). Wulff's election leaves Merkel bruised -- but shows she was able to muster sufficient support despite intense opposition to her role in what is seen as the bail-out of weaker nations.

Bottom line

Gold took a big hit today on a surge of confidence in the euro, itself based on a surge of confidence in the fragile European banking system. If this rising confidence is maintained, it will reduce the pressure on the ECB to inflate Europe out of its banking difficulties -- and that takes some wind out of the sails of inflation-sensitive gold. But we doubt it will be this easy for Europe. And nothing in the news out of Europe really changes our call for an "expansionless recovery" around the world. We think the world's central banks will still have to maintain highly inflationary postures for years to come in order to combat ongoing deflation pressures. The longer that goes on, the higher gold will go. From all-time highs last week, gold was due for a correction anyway. We don't know how much lower it might carry gold in the short-term, but our call is to buy the dip.

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

Correction

Yesterday in an analysis of the track record of the ECRI leading economic indicators we incorrectly referred to the index as based on year-over-year changes, when in fact it is based on quarter-over-quarter changes. The chart and the analysis were correct; only the description of the period was incorrect. We apologize for any confusion. You may download a corrected version of yesterday's report by clicking on this link.