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

MARKET CALLS

Gold is a Hold

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Donald Luskin

Not a buy, not a sell. The best bull case has weakened, but other upside factors are in play.

Now that we are forecasting for 2011 better than trend real growth and stocks 30% higher (see "Stock Outlook: Differences Make a Difference" November 10, 2010), then perforce we must forecast somewhat higher interest rates, and put our longstanding bull case for gold up for reexamination (see "Eyeing an Exit from 'No Exit'" November 18, 2010).

- The strong-form bull case for gold has hinged on the expectation for an endlessly weak economy requiring endless infusions of monetary liquidity and ultra-low interest rates -- which would only weakly reflate overall prices, while intensely inflating monetary commodities such as gold (see "Pushing On a Golden String" Friday, October 1, 2010).
- The Fed itself has expressed frustration that monetary policy alone has had to carry the burden of resuscitating growth (see recent statements to that effect by Bernanke, Yellen and Warsh), and has urged new pro-growth fiscal policies. Don't assume automatically that they are calling for more spending-driven "stimulus." Remember, when Ben Bernanke infamously talked about a "helicopter drop" of money he was actually talking about tax cuts.
- We don't see the tax compromise enacted last week as "fiscal stimulus" in any meaningful sense, or even an actual tax cut -- essentially everything in it is an extension of the status quo (see "Tax Cut Endgame" December 13, 2010). But the political re-alignment in favor of capital, capitalists and capitalism that it symbolizes is the logical equivalent of a pro-growth fiscal policy shift through the removal of private sector growth obstacles (see "To Get Rich is Glorious Again" December 7, 2010).
- Therefore we should now expect the Fed to need to do less than it would have otherwise. In other words, it will now take less monetary reflation to achieve the same growth outcomes.
- The arrival of QE2 cuts in the same direction. Yes, it is a reflationary monetization of debt (see "On the November FOMC" November 3, 2010). But now it's done, or at least known. Every reflationary step taken *already* is a step that won't have to be taken *in the future* -- and it's already impounded in the gold price.

Update to strategic view

GOLD: With growth improving, stocks rallying and rates rising, the strong-form bull case for gold is weakened. However, systemic risk in Europe and inflation risk in China are live factors that could drive gold higher. And if the Fed fails to tighten when growth visibly improves, then an inflation outbreak would be a real risk and gold's bull move would go into extra innings. While we wait to see how these complexities play out, we stick with our price target of $1500 -- only about 9% away, that makes gold a hold.

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- If we now expect less monetary reflation than we did several months ago, and if the bull case for gold hinges on reflation, then that case is now weakened.

Though the bull case is weakened, we are not adjusting our most recently upward-revised $1500 price target for gold (see "More Upside for Gold" June 10, 2010) -- even in light of the gold price having come so close to it at an all-time record high of $1430.95 less than two weeks ago. For one reason, we don't see an outright bear case taking the place of the bull case. More important, there are other factors, outside the bull case described above, that may very well still come into play.

While we might be able to glimpse in the distance an end to the Fed's reflationary efforts, other central banks may -- for good or for ill -- get considerably looser. Gold trades in a global marketplace, and gone are the days when we could look to its dollar price as an indicator only of dollar liquidity conditions. We now have to consider the backwash on dollar/gold of liquidity conditions everywhere in the world.

- The European Central Bank, in particular, is unconscionably tight in light of the crushing debt burdens afflicting peripheral nations, and the core nations that hold their debt (see "The Enemy of the Good" December 2, 2010). If it loosens again -- as it *should*, as it *must*, as it *will* if things worsen -- then gold would likely do what it did last May when the ECB first initiated its controversial program of sovereign bond purchases. Gold moved aggressively to new highs denominated in euro, as the euro weakened versus the dollar. But the move in euro/gold was greater than the move in euro/dollar, so gold denominated in dollars moved higher as well.
- China is experiencing considerable inflation, because it imports US monetary policy via its inflexible exchange rate. US policy is still arguably too tight here, but it's demonstrably too loose for China. China is constrained in how much it can raise interest rates, because the "financial repression" of artificially low rates is a policy tool that subsidizes low personal income and property tax rates, and supports the fragile housing market. And it seems reluctant to revalue the yuan any more than the minimum necessary to head off protectionist legislation in the US Congress. With no policy tools left but price controls, inflation is likely going to continue to accrete and accelerate. So with gold ownership by Chinese citizens liberalized, we would expect the yuan price of gold to rise, taking the dollar price along with it.

There are also bull cases for gold -- or at least bull scenarios -- that have nothing to do with other nations.

- First, we could simply be wrong about the US economy strengthening. If it weakens, or even if it doesn't strengthen, the Fed would surely keep reflating, and gold would keep rising.
- Second, we could be right about the US economy strengthening, but the Fed could nevertheless keep reflating.

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]

Recommended Reading

The Global Financial Crisis of 2007-08: Is it Unprecedented?
Michael D. Bordo and John S. Landon-Lane
NBER Working Paper No. 16589
December 2010

A Flaw in the Model...That Defines How the World Works
Volker Bieta, Hellmuth Milde and Nadine Weber
The World Bank, IDA Resource Mobilization
December 2010

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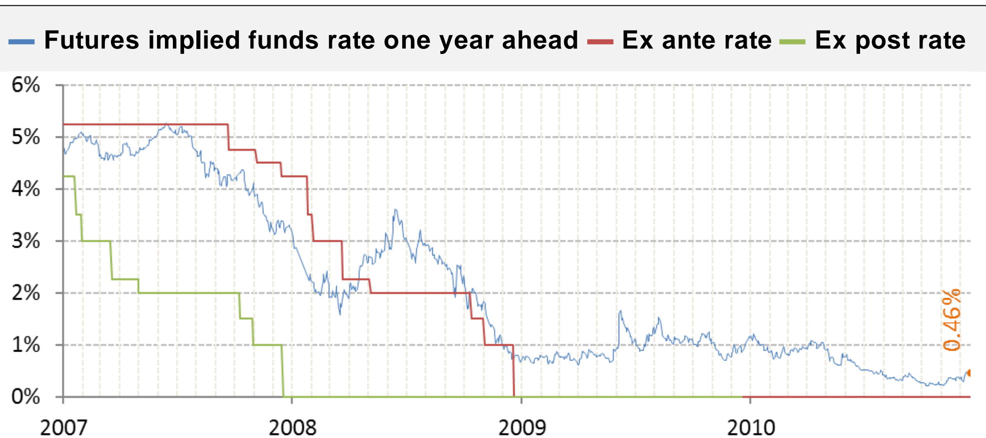
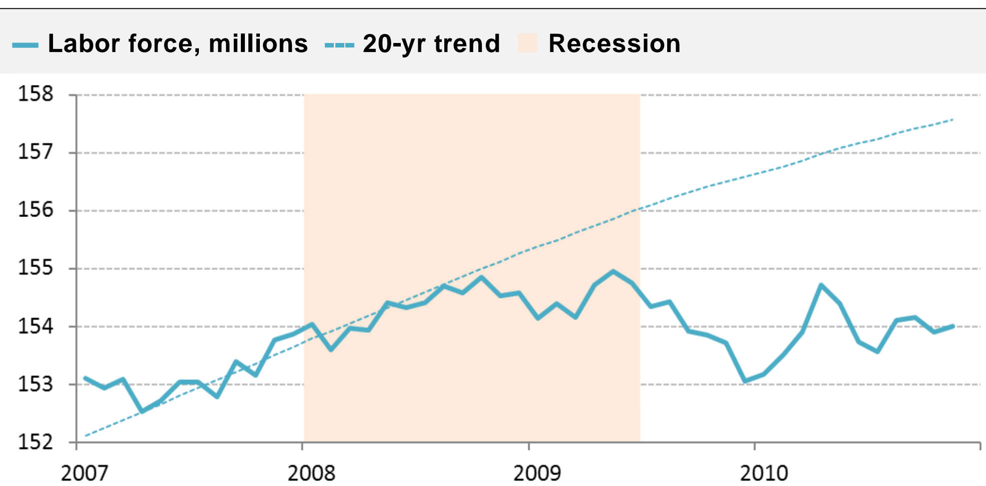
- Imagine the world one year in the future, if our forecasts come true. Real GDP growth will have been, say, 3.8%. The 10-year Treasury yield will be, say, 3.8%, too. Stocks will be 30% higher, touching all-time highs. What would the Fed do? Perhaps they'll look at those factors, conclude that self-sustaining growth has taken root, and begin to tighten policy -- either by selling Treasury bonds, or by hiking the funds rate. The latter is already being assigned an 80% probability by the fed funds futures markets -- although it must be noted that they have been very wrong in the hawkish direction for the last three years (please see the chart below).



Source: CME Group, Federal Reserve, TrendMacro calculations

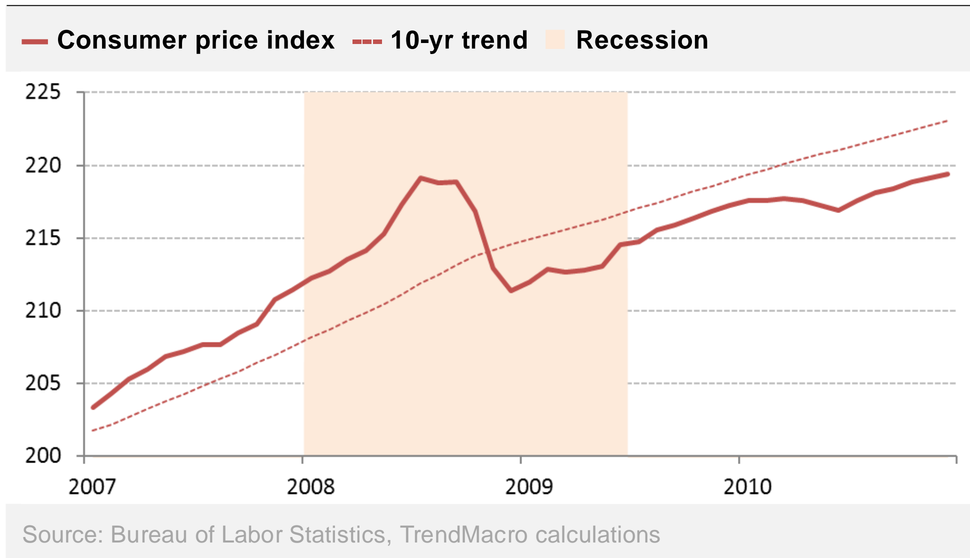
- But then again, even with the strengthening we're forecasting, it is unlikely that the unemployment rate will be much lower than it is today.
  - The labor force -- the denominator of the unemployment rate -- is now 3.6 million persons below trend. The more the economy improves, the more of those 3.6 million will return to the labor force looking for work, joined by another 80,000 persons each month from demographics (please see the chart below). With these new entrants to the labor force swelling the denominator, even if get, say, an average of 250,000 new jobs every month for the next year, if the labor force moves just halfway back up



Source: Bureau of Labor Statistics, TrendMacro calculations

to trend, the unemployment rate will have fallen only 10 bp.

- And how about inflation? We suppose anything is possible here, but it seems unlikely that inflation will increase enough by a year from now to ease the Fed's concern that it is insufficient.
    - But right now it is only with the most recent consumer price index data, for November, that the level of CPI finally slightly exceeded the all-time high set in July, 2008, ending two years and four months of technical deflation (please see the chart below). CPI would have to instantaneously jump 1.6% higher to catch up to trend. In the meantime, trend is growing at 1.9% per annum, while CPI itself is growing at only 1.5% per annum, falling further behind at this rate every month.



Source: Bureau of Labor Statistics, TrendMacro calculations

- Let's say a year from now the rate of inflation has gotten back to 2%, Ben Bernanke's approximate target. We'll still be well below trend. Will Bernanke *really* tighten policy with inflation at 2%? It's not like there isn't a precedent -- inflation had just risen 2% in August, 1937 when Fed chairman Marriner Eccles tightened, ushering in the "depression inside the depression."
- Let's say a year from now the unemployment rate is 9.7%, just 10 bp lower than it is today. Will Bernanke *really* tighten policy? The same precedent -- that's where unemployment was in 1936 when Eccles tightened.
- Bernanke knows those precedents very, very well. When it's his opportunity a year from now to do the same things Eccles did in 1936, sitting in his office in the grandiose Washington building named after Eccles, he's very likely to think twice.
- Even if the fed funds futures are correct, and the first 25 bp rate hike comes at the December, 2011 FOMC meeting, that's hardly an aggressive tightening. In fact, the way Treasury yields have been moving, the market may very well force Bernanke to that degree of tightening, or perhaps an overnight rate as high as 1%. And at least in terms of absolute nominal rates, at that point the Fed would hardly be restrictive -- especially if it had done nothing to liquidate

the assets it has acquired in the various credit easings and quantitative easings since late 2008.

- Even if we have been too pessimistic, and the unemployment rate is lower -- what's the best case, in the mid-8's? -- and the inflation rate is higher -- best case, 2.5%? -- we can still see the Fed being extremely reluctant to tighten. Unless there is incontrovertible evidence that growth is running away to the upside, the Bernanke Fed will likely do what the Greenspan Fed did in similar circumstances in 2003 and 2004 -- take out some "insurance" against a relapse into deflation and high unemployment. Greenspan justifies the "considerable period" or low policy rates, and the "measured" track of eventually tightening as exactly that -- "risk management."
- *That* is the juncture at which an inflationary outbreak becomes a substantive risk -- when suddenly velocity, the transmission mechanism that turns base money into money in circulation, comes back to life, yet the Fed doesn't tighten. *That* would be the second-best bull case for gold -- not an outright dollar debasement, but a good old-fashioned inflation.

So while the most robust bull case for gold has fallen in probability -- endless economic weakness triggering an uncontrolled reflation involving wholesale debasement of the dollar -- other less dramatic bull cases are still very much in play. We don't think gold at $1380 requires the strong-form bull case -- if that case fully played out, gold would be north of $2000 easily -- so we don't see much downside if one of the lesser bull cases ends up being what happens.

If growth picks up 2011, as we expect, and the Fed does little to change its policy course, as we expect, then gold should easily make $1500, as a do-nothing Fed in that case is effectively becoming easier and easier as the economy improves around it. If we reach that price target, and it seems to be playing out that way, then we'll likely establish a somewhat higher target. Likewise if any of the non-US factors recounted above come into play.

But for now, we'll stick with our target of $1500. That's only about 9% away, so it's difficult to get too excited about gold here until we get more telemetry about growth, the Fed's intentions, and various global factors.

Bottom line

With growth improving, stocks rallying and rates rising, the strong-form bull case for gold is weakened. However, systemic risk in Europe and inflation risk in China are live factors that could drive gold higher. And if the Fed fails to tighten when growth visibly improves, then an inflation outbreak would be a real risk and gold's bull move would go into extra innings. While we wait to see how these complexities play out, we stick with our price target of $1500 -- only about 9% away, that makes gold a hold.