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

MACROCOSM

Gold Acts Leaden

Tuesday, January 25, 2011

Donald Luskin

Why has gold dropped $100 when everyone's suddenly worried about inflation?

Gold has now corrected about $100 from its all-time highs last December. Many of the other inflation plays -- resource stocks, oil, emerging markets equities -- have sagged as well. At the same time, most non-energy and non-precious metals commodities indexes are making new highs. We take this as confirmation of the view we started taking in mid-November -- that upgraded growth prospects for 2011 take the strongest bull case off the table for gold and other inflation plays (see "Eyeing an Exit from 'No Exit'" November 18, 2010).

- It's not that we see the inflation plays, as many analysts do, as safe harbors against continuing systemic risk events -- hedges that become increasingly unnecessary as the global economy begins to grow again and those events become less likely. The reality is that in mid-2008, when the mother of all systemic risk events took place, these so-called safe harbors were among the worst-performing investments you could have made.
- Instead, we see it as a matter of the *institutional response* to systemic risk events. What markets didn't know in mid-2008 -- which they do know now -- is that such events will trigger enormous and unconventional responses from monetary authorities, seeking to head off the risk of deflation and to use inflation as a means of absorbing shocks and kick-starting growth. As growth improves and systemic risk recedes, the likelihood of such inflationary responses recedes as well.
- Critically, we simply have no way of knowing -- other than gut feel based on watching the co-evolution of markets and narratives -- exactly how much institutional response was impounded in the price of gold and other inflation plays. So it's difficult to estimate with any precision how much downside risk there is as the probability of those responses fades. Our intuition is that while the inflation plays were never priced for worst-case responses -- for example, our sense is that the price of gold last December at the highs was not based on an anticipation of QE4 -- but may have been based on something beyond QE2, which at this point we may not get. So the withdrawal of worst-case possibilities now needn't be catastrophic for gold or other inflation plays.

Update to strategic view

GOLD: Gold continues to fall as world growth prospects improve and systemic risk recedes, suggesting that monetary authorities will likely have to intervene less than previously thought. We don't see a catastrophic downside here, and we still think there is a reasonable chance that the Fed and other central banks will be so tardy in tightening as growth improves that they will effectively loosen, thus making an unintended intervention that could move gold back to the highs and somewhat beyond.

US RESOURCE STOCKS, OIL, COMMODITIES: The inflation plays have been weak along with gold. But most are dominantly growth-driven, and growth is improving. So even if one is bearish on gold here (which we are not), one would look for entry points in the current weakness.

[Strategy Dashboard home]

- We note that these questions must always be considered in a global context -- it's about more than just what the Fed does. The sag in inflation plays over the last two weeks has coincided with more evidence of monetary normalization in China -- with the yuan at new highs versus the dollar since the peg was reformed in mid-2010 -- and the relaxation of fears about sovereign defaults in Europe, which reduces the demand for the ECB to loosen.
- At the same time, there has emerged a new narrative about the risk of inflation. Most prominently, high food prices are causing disruptions in emerging economies, and whether or not that really has anything to do with inflation, the narrative is that it does. In the developed world, Europe and the UK reported attention-getting jumps in statistical inflation at year-end. One might expect that this would be good for the inflation plays, but again it's a matter of institutional response. Somewhat elevated inflation expectations are exactly what monetary authorities want, certainly the Fed -- so the more the inflation-risk narrative takes center-stage, the less the authorities have remaining to do.

So with all this in mind, why haven't we made gold -- and implicitly the rest of the inflation plays -- an outright sell (see "Gold is a Hold" December 20, 2010)? For the inflation plays other than gold -- such as oil and emerging markets -- it is because our expectations for improving growth bring new demand factors into play for these assets, substituting for ebbing inflation effects. For gold, it is because we are far from convinced that the monetary authorities -- especially the Fed -- will not still make inflationary mistakes, failing to respond appropriately to the improving growth picture.

- As growth improves, it becomes incumbent on the Fed to begin to withdraw its present accommodation. So the inflation risk going forward is likely to be not from the mistake of putting in place new accommodation -- e.g., QE3 or QE4 -- but instead the failure to downwardly fine-tune to accommodation already in place.
- We are not at all persuaded that the new voting composition of the FOMC -- bringing in two known hawks with histories of dissent, Dallas's Richard Fisher and Philadelphia's Charles Plosser -- will ameliorate this risk. We think that this is very much the Bernanke Fed, and whether or not one or both these men make dissents, Bernanke's view will carry the day -- and it's likely to be that a lingering high unemployment rate and still low statistical inflation requires an ongoing "insurance policy" against deflation, or at least against insufficient inflation.
- By the way, we are hearing chatter to the effect that neither Fisher nor Plosser will dissent in tomorrow's FOMC statement, wanting to put on a unified face in light of the criticism the Fed has undergone. We don't think it matters much one way or the other, but if we had to guess, it would be that one of them -- probably Plosser -- will indeed dissent. He's a very nice man, and if Bernanke asked him not to dissent, we have no doubt that he would comply. However, we know he is very opposed to QE -- and we know that Bernanke is very open to the expression of divergent views. In fact, we think it would serve Bernanke's purposes for Plosser to dissent -- it would

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

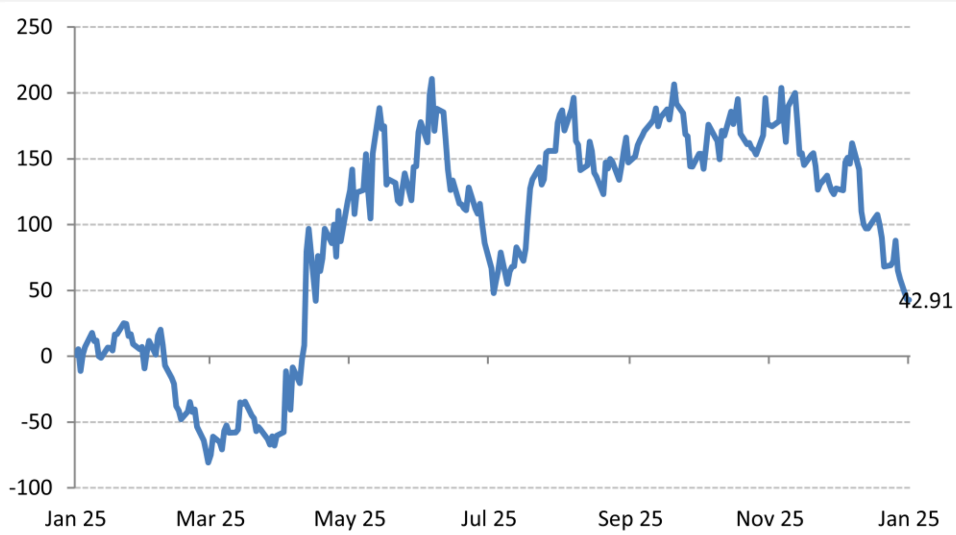
[About us]

help fortify the Fed's inflation-fighting *bona fides*, while at the same time it continues to pursue the current reflationary agenda. Remember, their game is to increase inflation expectations, but only to a point -- a dissent would be a way of cementing that point.

Stepping aside from thinking about gold and the inflation plays as investments, let's consider them as indicators. For much of the past three years we have always felt better when the gold price rose and worse when it fell -- because we've held that one of the key problems in the global economy was a lack of liquidity and an insufficiency of inflation during a time of ongoing debt liquidation, creating an ongoing risk of systemic credit failure (remember, inflation facilitates orderly debt liquidation, and deflation turns it into a contractionary spiral). So when gold rose, it told us that systemic risk was less -- and when gold fell, it warned us that systemic risk was greater.

- At the moment, we are inclined to think that the fall in the gold price is telling us something else entirely. Rather than indicating monetary conditions that would cause an increase in systemic risk, it is telling us that because systemic risk has fallen thanks to improved growth prospects, monetary conditions no longer have to be so easy. The lines of causation are reversing -- happily.
- A rough-and-ready confirming indicator of this is that stocks have moved to new recovery highs over the last month, while gold has fallen back (please see the chart below). During most of the last

Difference between gold and the S&P 500



Source: Reuters, TrendMacro calculations

three years of crisis, gold and stocks have moved pretty much in tandem. This new behavior suggests that stocks are now being driven by improving *real* -- or organic -- growth prospects, not just the *nominal* -- or monetary stimulus-driven -- ones that would have been implied if gold had made new highs at the same time stocks have.

Bottom line

Gold continues to fall as world growth prospects improve and systemic risk recedes, suggesting that monetary authorities will likely have to intervene less than previously thought. We don't see a catastrophic downside here, and we still think there is a reasonable chance that the Fed and other central banks will be so tardy in tightening as growth improves that they will effectively loosen, thus making an unintended intervention that could move gold back to the highs and somewhat beyond. The inflation plays have been weak along with gold. But most are dominantly growth-driven, and growth is improving. So even if one is bearish on gold here (which we are not), one would look for entry points in the current weakness.