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

MARKET CALLS

Gold Hits Our $1500 Price Target

Wednesday, April 20, 2011
Donald Luskin

We're still bullish on gold, but it's not the "conviction trade" it was at $771.

Yesterday gold traded at $1500, fulfilling the price target we set for it two and a half years ago, in December 2008, when it was at $771 (see "Why Isn't Gold at $1500?" December 10, 2008). Back then, almost none of our clients had any exposure to gold -- many didn't recognize it as an investible asset, and even to discuss it was to risk one's credibility as a serious investor. But in the darkest moments of the global credit crisis, with gold having fallen in the wake of the Lehman failure along with every other risk-asset, gold was a "conviction trade" for us. We bet that the crisis would be addressed by massive global reliquefication and reflation, and that gold would lead risk-assets higher. Now that the crisis is over and gold is at all-time highs, it can't continue to be the same kind of "conviction trade." In fact, while maintaining our price target, we demoted gold to a "hold" last December, seeing the need for continued reflation having down-shifted as the global economy has recovered (see "Gold is a Hold" December 20, 2010). All that said, there remains a bull case for gold, even if a less intense one than in 2008.

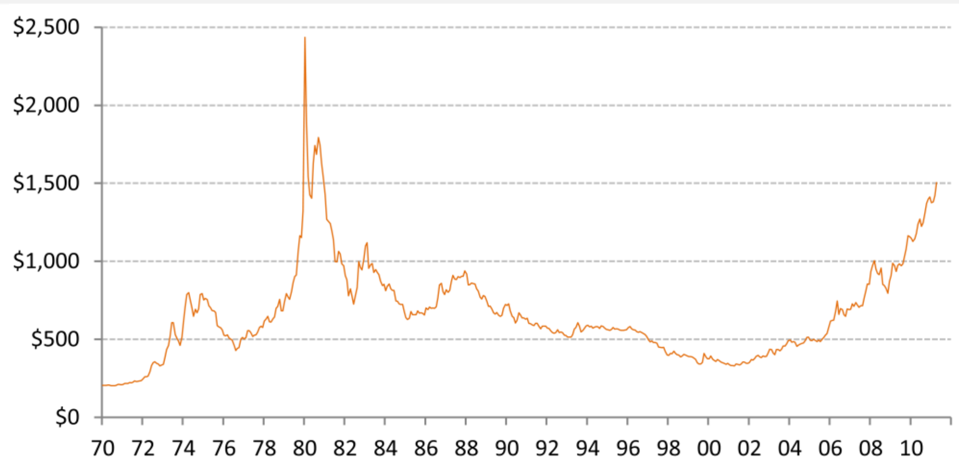
- Our trader's gut instinct makes us a little cautious on gold in the very near term. The pending Glencore IPO has raised plausible

Update to strategic view

GOLD: Gold has more than doubled to meet our $1500 price target set in late 2008. Short term, our trader's gut senses a slight speculative over-reach here. But while we don't intend to set a new price target, we remain strategically positive about gold -- so long as the consensus of the world's central banks is to keep reliquifying and reflating the post-crisis economy -- generally seeking inflation rather than fearing it.

[Strategy Dashboard home]

Gold in current dollars, deflated by CPI



Source: Reuters, BLS, TrendMacro calculations questions of whether we're at a crest in what has become a bit of a fad in commodities.

- But higher prices for gold are by no means implausible on the face of it. Gold is far below all-time highs in real terms (please see the chart on the previous page).
- Gold is not the contrarian trade it was two years ago, when most of our clients didn't even consider it an investible asset class. But gold is hardly in a speculative bubble. We know what *that* looks like. The gold price quadrupled in a single year in the run-up to its blow-off top in early 1980 (see "Gold's Most Immemorial Year" November 19, 2009).
- The world's central banks continue to reliquify and reflate the global economy, though not with the urgent intensity seen at the worst of the recent crisis. Global real interest rates remain negative (please see the chart below). Even if we've seen the bottom in real rates, they are still low, and will remain so for quite a while.

Global real interest rates: US, EU, JP, UK, CH, BR, IN
3-mo interbank rates minus 12-mo CPI, USD nominal GDP weighted

Source: Various national statistical agencies, TrendMacro calculations

- Europe is the only economic zone doing anything aggressive to quell inflation. Elsewhere else inflation-fighting steps are timid or non-existent. Even in Europe the interest rate hikes of two weeks ago are only aggressive against the backdrop of perilous debt overhangs. They are *too* aggressive in that context, and will only lead to further debt problems, which will ultimately lead to more policy accommodation and higher inflation (see "EUicide" April 7, 2011).
- At the Fed, while there are some dissenters, the thought leaders are producing research and making speeches to persuade markets that rising commodity prices do not signal higher inflation. The purpose is to justify the Fed's failure to tighten as headline inflation rises -- which serves the Fed's strategic view that there *still isn't enough inflation* in the US (see "The Fed is from Venus, The ECB is from Mars" March 9, 2011).

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

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

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

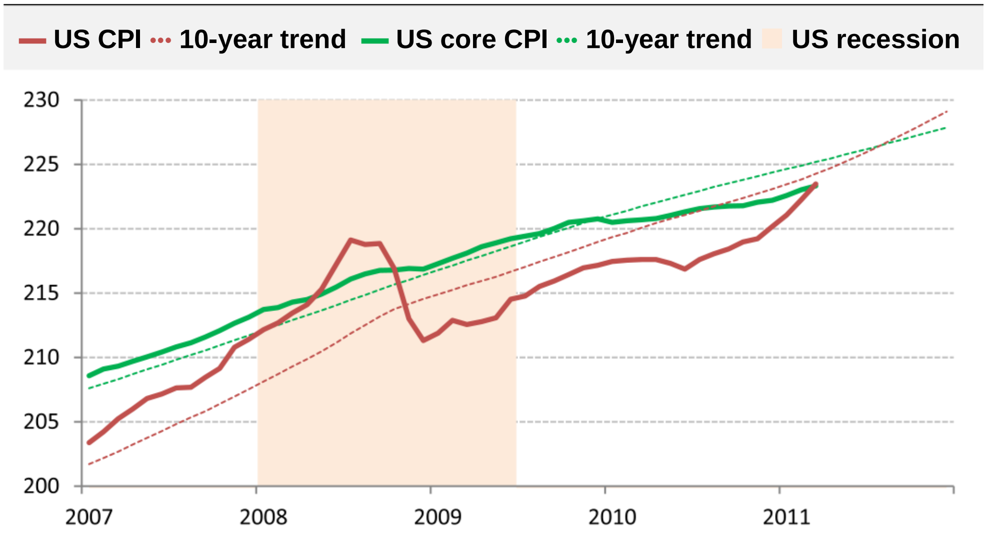
[About us]

Recommended Reading

What are the implications of rising commodity prices for inflation and monetary policy?
Charles L. Evans and Jonas D. M. Fisher
Chicago Fed Letter, May 2011

[Recommended Reading home]

- We sympathize with this view. Headline inflation would have to rise 3.4% over the coming 12 months just to catch up to its long-term trend, and core inflation would have to rise 2.5% (please see the chart below). Until the price level catches trend, the US economy remains functionally in a condition of mild deflation. From that starting point, somewhat higher inflation is a useful corrective.



Source: BLS, TrendMacro calculations

- The key word there is "somewhat." For the Fed, the trick will be to control inflation at trend *rates* when the prices reach their trend *level*. That's the kind of precision control central banks aren't very good at, and they typically compensate by deliberately erring on the side of inflation, just to avoid any risk of deflation. All year we've been talking about this outcome as "Plan B" for gold (see, for example, "Gold Acts Leaden" January 25, 2011).

So with all that, what's our new price target for gold? There isn't going to be one. We think it's going higher ultimately, but we're not picking a number.

- When we first set our $1500 price target for gold, we noted that price targets aren't our usual style. We think of prices as vectors, not as levels. We believe trends in motion stay in motion until something deflects them. So levels themselves are irrelevant, except as they sometimes implicate valuation or sentiment issues.
- We set the $1500 target in 2008 to get attention for an investment opportunity that otherwise "didn't get no respect." We don't need to do that now.
- The strategic backdrop is favorable for gold, for all the reasons we've explained. But while we think it's going higher, that same backdrop is favorable for other asset classes, too -- probably more so, in our view. For example, while we are positive on gold, we are *more* positive on US stocks.
- But gold has more than an upside. It is also a hedge. In linear space, the reflation that's good for gold is good for stocks (as it has

been over the last decade). But in non-linear space, gold and stocks could part ways. An out-of-control inflation that exceeds the Fed's wishes could be very good for gold and very bad for stocks at the same time. That's only an "if," and it's a long time off. But it's an embedded option in gold that bolsters the bull case.

Bottom line

Gold has more than doubled to meet our $1500 price target set in late 2008. Short term, our trader's gut senses a slight speculative over-reach here. But while we don't intend to set a new price target, we remain strategically positive about gold -- so long as the consensus of the world's central banks is to keep reliquifying and reflating the post-crisis economy -- generally seeking inflation rather than fearing it.