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MACROCOSM

Plan B-Plus for Gold

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Donald Luskin

Gold at new all-time highs is about the euro, not the Fed or the debt ceiling.

Gold has made new all-time highs in most major currencies, with a spectacular breakout on the chart when measured in euros (please see the charts below). With Moody's threatening to downgrade US Treasuries as the Fed hints of QE3, close on the heels of rumored ECB intervention in *buoni del Tesoro poliennali* -- Italian Treasury bonds -- we have to ask: *are we back to "Plan A" for gold?*

- By "Plan A" we mean a soaring run higher as investors evacuate

Update to strategic view

GOLD: Gold has made new highs, rising as the European sovereign debt crisis has reached out…

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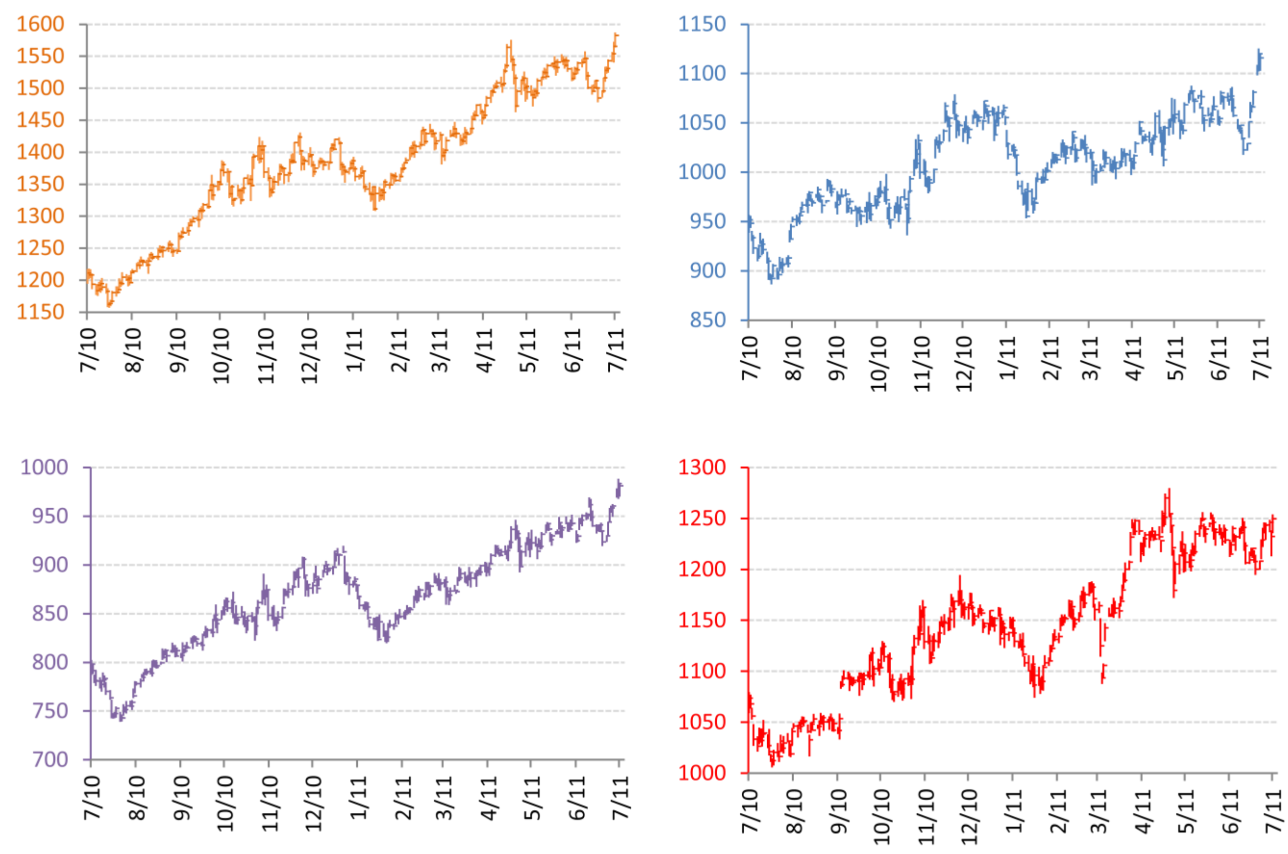
Gold priced in: — US dollar — Euro — GB Pound — Japan yen



Source: Reuters, TrendMacro calculations

paper currencies, fearing they are destined to be catastrophically debased to solve otherwise intractable growth and sovereign credit issues (see "Gold is the Strongest Currency" May 6, 2010).
- This was our vision for gold from the depths of the financial crisis, when gold traded as low as $680 after Lehman collapse. It was our strongest conviction idea, and it was a very successful one (see, among many, "Why Isn't Gold at $1500?" December 10, 2008).
- After gold hit our $1500 price target, we stayed positive on it (see "Gold Hits Our $1500 Price Target" April 20, 2011).
- But it's been a while since we were really enthusiastic. Expecting the world economy to finally emerge from the Great Recession, we started to talk about "Plan B" (see "Gold is a Hold" December 20, 2010). *That* is our more plain-vanilla vision of the Fed failing to adjust policy promptly as the economy gains strength, with today's eagerly sought *re*flation curdling into intractable *in*flation.

So is it time to revert to "Plan A"? Yes, no and maybe. For now, let's just say it's time for "Plan B-plus."

- We think the driver behind gold's run to new highs over the last two weeks has been Europe, as the ongoing debt crisis has reached out and tested Italy -- a major economy (see "The Sack of Rome" July 13, 2011). We expect Europe to be the biggest driver going forward.
- Yes, on the one hand the European Central Bank is unconscionably too tight (see "On Europe's July Rate Decisions" July 7, 2011). But the more pressure the ECB's monomaniacal rate-hiking exercise puts on struggling peripheral economies, the more it will ultimately be forced to solve the problems it has thus created with asset purchases -- such as those rumored in Italy on Monday (again, see "The Sack of Rome") -- and extraordinary liquidity assistance (ELA) as we expect is coming in Greece (see "Black Wednesday in Greece" June 16, 2011), and as was endorsed this morning in an IMF report on the Greek crisis.
- So while it would seem the euro exchange rate is being supported by the market's knee-jerk reaction to the ECB's rate hikes, we continue to believe that those very rate hikes are nearly certain to ultimately drive the euro's sharp decline (see "EUicide" April 7, 2011). We're somewhat baffled that it hasn't happened already.
- So holding all else equal in the world, we think the large increment to liquidity-creation that will have to emanate from Europe ought to drive gold higher.

While Europe is moving us closer to "Plan A," we're not convinced that the Fed will play into it very much.

- Much was made yesterday of Ben Bernanke's congressional testimony as being a hint of further quantitative easing to come. To be sure, Bernanke let it be known that the Fed stood ready to execute QE3 if necessary -- "if conditions warrant," in his words. But didn't we always know that? Bernanke expended 172 words to

Update to strategic view

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…and tested Italy, implying an inevitable liquidity-creation response from the ECB. At the same time, the US Fed has declared it stands ready to execute QE3 "if conditions warrant." We don't think conditions will warrant, but Europe will be an ongoing issue. That adds up to a better bull case for gold, but not the pound-the-table case that obtained when it was likely that the Fed would have to continue QE ad infinitum.

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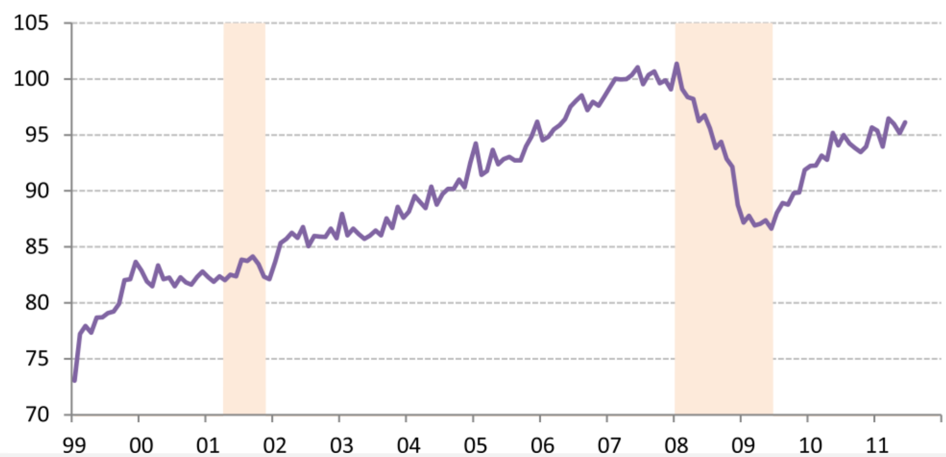
make that simple point -- and then went on for 312 words about how the Fed would tighten policy, "when conditions warrant," not "if."

- Today conditions do not warrant QE3. Even with the uptick in unemployment to 9.2% (see "On the June Jobs Report" July 8, 2011), the version of the Taylor Rule that Bernanke follows calls only for exactly the amount of quantitative easing already on the Fed's balance sheet (see "FOMC Preview: In Praise of Ben Bernanke" June 22, 2011).
- We don't expect future conditions to warrant QE3. We think the Fed's next move will be to tighten, not loosen (though we don't expect that any time soon).
- We continue to believe that the present economic slow-down is transient, and we expect marked improvement in the second half of the year as oil prices stabilize (or even drift lower) and Japan continues to plug itself back into the global supply chain (see "Footprints of the Black Swans" June 30, 2011).
- We note that one of our favorite lesser-known macro indicators turned in a very positive reading yesterday. The UCLA Ceridian Pulse Index, derived from real-time readings of truck diesel fuelings on US highways and highly correlated to industrial production, reported a 1% gain for June (please see the chart below).

UCLA Ceridian Pulse of Commerce Index **Recession**
Seasonally and days-in-the-month adjusted



Source: UCLA Anderson School

- To be clear, unless conditions deteriorate significantly from the Fed's point of view -- which means some combination of rising unemployment and falling inflation -- there won't be QE3. Without the Fed re-engaging as an agent of liquidity creation, we can't expect "Plan A" for gold.

The crisis surrounding the US Treasury debt ceiling isn't likely much a factor in what gold has been doing over the last two weeks -- except that it contributes generally to an atmosphere of risk aversion with respect to sovereign credits (including the ultimate sovereign credit, fiat money).

- The main relevance here is the possibility that a catastrophic bargaining failure would lead to economic weakness, raising unemployment and/or lowering inflation, and thus moving the Fed to action.
- What would such a failure look like? It could have four dimensions: (1) the GOP concedes to White House demands to raises taxes; (2) the breakdown leads to a technical default on US Treasury securities; (3) the breakdown leads to a shut-down of various non-Treasury payments and functions; and (4) the GOP concedes and raises the debt ceiling without earning important spending trade-offs.
- We see only the first three as being dangerous possibilities. Yet in taking the pulse of our clients, we sense the balance of concern is with the fourth issue. Many would regard raising the debt ceiling *at all* as a catastrophic failure, even if doing so won spending concessions. We disagree strongly. Self-evidently the bond market is putting the US under no pressure whatsoever to cap the debt ceiling. Indeed, the debt ceiling urgently *must* be raised, because failing to raise it -- without default -- could only mean a hard-stop in spending that would surely trigger severe economic weakness.
- Several weeks ago we had glimmers of hope that something useful might emerge from these negotiations (see "Chaos in Athens, Progress in Washington" June 20, 2011). At this point, all we expect is some kind of mutually face-saving disengagement.
- We will be watching the results not so much for their immediate economic substance -- which we expect to be trivial -- but for their long-term political implications. At the moment the GOP is poised to retain House control and take Senate control in 2012, which would contribute mightily to the valuable ongoing process of US political stabilization (see "The Pendulum Swings Back" November 2, 2010). But if the GOP is seen -- fairly or unfairly -- as responsible for an economy-damaging result here, all that could change.

Bottom line

Gold has made new highs, rising as the European sovereign debt crisis has reached out and tested Italy, implying an inevitable liquidity-creation response from the ECB. At the same time, the US Fed has declared it stands ready to execute QE3 "if conditions warrant." We don't think conditions will warrant, but Europe will be an ongoing issue. That adds up to a better bull case for gold, but not the pound-the-table case that obtained when it was likely that the Fed would have to continue QE *ad infinitum*.