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MACROCOSM

Gold's Rollercoaster

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Gold at $1900 was an overshoot -- this correction says no QE3 for now, but ample liquidity.

We have been relying on the rising gold price as one of several indicators telling us that the incipient global financial panic will remain contained, and that the volatile drop in stocks is nothing but a correction (see, most recently "On the August FOMC" August 9, 2011). This stands in stark contrast to the conventional wisdom that the rising gold price is, itself, a symptom of panic -- an "end of the world trade," the ultimate flight from financial assets of all kinds. *So what are we to make of the dramatic drop in the gold price over the last three days?*

- Believing that the European Central Bank would be forced against its will to abandon its misguided tightening posture and flood the Euro area with new liquidty -- to stave off a speculative attack on Italy and Spain -- we anticipated the last month's surge in gold (see "Plan B-Plus for Gold" July 14, 2011).
- While Europe's strategic problems are far from over, the ECB's new liquidity posture has been demonstrably successful as a tactical matter (see "Two-Tier Europe is Born" August 17, 2011).
- *Thus the rise in the gold price has been a good thing. Yes, it was fundamentally driven by the existence of a critical problem. But the fact that gold rose -- that it didn't fall, as it did in 2008 post-Lehman -- indicated that the problem would be addressed.*
- Now here's where it becomes much more art than science. Our intuition is that the gold price overshot the level rationally associated with the ECB's new posture. It carried higher -- even above $1900 -- on the belief that the Fed will be forced to execute QE3, and that it will be signalled tomorrow by Ben Bernanke at Jackson Hole.
- But despite the media chatter that the recovery in stocks over the last couple days has been based on just those beliefs, gold has fallen -- and fallen hard. We think gold is taking on board the view we talked about Monday (see "Being Ben Bernanke" August 9, 2011) -- that based on the data before the Fed right now, there's no reason for it to do QE3, and thus no reason for Bernanke to signal that it will. The stronger than expected macro data out this week has played into that view, with nothing confirming the cliff-dive reported last week in the Philly Fed survey.

Update to strategic view

GOLD, US MACRO: Gold above $1900 overshot an appropriate reflection of the ECB's more accommodative liquidity posture. It was discounting a FED liquidity response that is unlikely to occur, unless macro data deteriorates further from here. If that happens we don't doubt the Fed will respond, and then it will be "Plan A for gold" -- $2000 and beyond. For now we're still on "Plan B-Plus," in which the present correction probably doesn't have that much further to run, and where we would continue to rate gold a hold. If gold falls further than that -- and if stocks fall at the same time -- then all bets are off: that would mean another global liquidity crunch.

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- *Thus the fall in the gold price has been a good thing. Yes, it indicates that QE3 is not coming. But that's good -- the reason it's not coming is that it's not necessary: in other words, the widespread fear that we're in for another 2008 was overdone.*
- We're not trying to have it both ways. Like any other indicator, gold must be taken in context. In this case, the *rising* gold price (while stocks *fell*) indicated trouble ahead, but trouble that would addressed by new liquidity. Now the *falling* gold price (while stocks *rise*), indicates that the trouble ahead is less than feared, and so the liquidity needed will be less than anticipated.

Bottom line

Gold above $1900 overshot an appropriate reflection of the ECB's more accommodative liquidity posture. It was discounting a FED liquidity response that is unlikely to occur, unless macro data deteriorates further from here. If that happens we don't doubt the Fed will respond, and then it will be "Plan A for gold" -- $2000 and beyond. For now we're still on "Plan B-Plus," in which the present correction probably doesn't have that much further to run, and where we would continue to rate gold a hold. If gold falls further than that -- and if stocks fall at the same time -- then all bets are off: that would mean another global liquidity crunch.