Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

Cash for Gold!

Wednesday, January 11, 2012

Donald Luskin

Gold should rally as the market realizes the ECB has embarked on major QE.

The gold price started to drop sharply after December's European Central Bank policy meeting, when new president Mario Draghi threw cold water on the idea of buying more sovereign bonds in the Securities Market Programme (see "On the ECB Monetary Policy Decisions" December 8, 2011). The drop accelerated the following week after the December FOMC meeting, when the Fed's slightly more upbeat view on the economy seemed to rule out QE3 (see "On the December FOMC" December 13, 2011).

- The narrative for gold's large drop -- having just been at all-time highs above $1900 -- is that the liquidity spigot from the world's central banks is being turned off. We think this is not the case, so assuming the drop in gold is in fact a bet on that, then we stand by our view that gold is "an interesting speculative opportunity" (again, see "On the December FOMC").
- We agree that gold is the canary in the mineshaft of monetary liquidity conditions. In the distant past, gold was all about inflation. No longer. Now it's about liquidity. Liquidity is desperately needed by a world still struggling with deleveraging its banking system, especially in Europe. So a sharp drop in gold does alarm us.
- But as we have argued, and will explain in detail momentarily, liquidity is very much on the rise, especially in Europe.
- So while we have to take gold's seeming message seriously as a possibility, we nevertheless interpret its price action since early December as a technical phenomenon of some kind -- a classic shake-out amounting to *noise*, not signal.

It strikes us that the market doesn't appreciate that recent policy developments at the ECB represent the greatest liquidity spigot seen so far in the post-Lehman epoch. To be sure, they don't take the exact form that would typically be called "quantitative easing" -- for political and cultural reasons, that is *verboten* at the ECB (see "QE Nein" November 23, 2011). But they are in fact QE, and on a vast scale.

- At the December policy meeting, the ECB announced 3-year fixed-rate full-allotment longer-term financing operations (LTRO). This

Update to strategic view

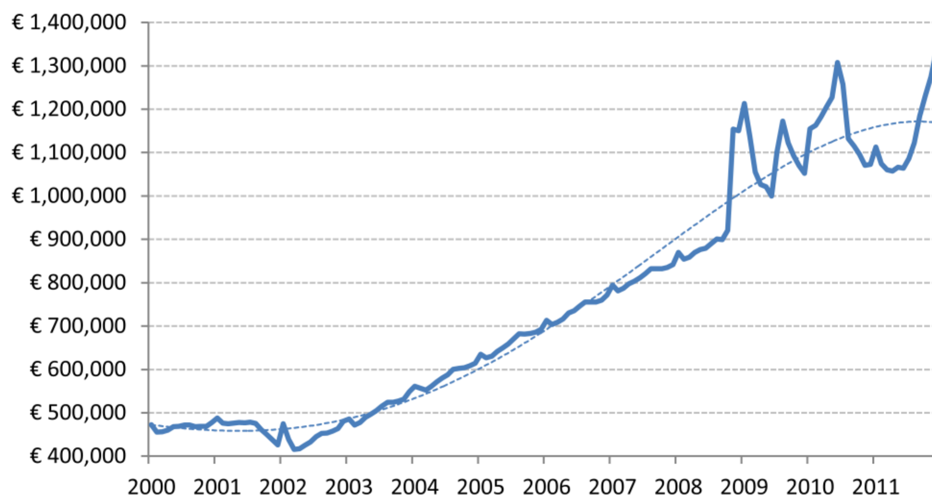
GOLD, EUROPEAN FINANCIAL STOCKS, ECB: Gold has fallen from all-time highs amidst a narrative that central bank liquidity is drying up. But the opposite is the case: the ECB's new 3-year LTRO program is in every way the equivalent of QE, performed on a vast and market-determined scale. With QE3 from the Fed still off the table, the ultra-bull case for gold can't be made. But the Fed will stay easy, and China appears to be easing now. So with the ECB as an underestimated source of liquidity, we see gold moving higher following last month's speculative shake-out -- and Europe's banks having turned the corner.

[Strategy Dashboard home]

Copyright 2012 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

means that European banks can get *literally an unlimited amount of financing from the ECB for eligible collateral*.

- At the first auction for 3-year LTRO in December the uptake exceeded the wildest expectations, pushing total ECB liquidity to a near record (see "Europe's Wall of Liquidity" December 21, 2011).
- *This is, for all practical purposes, QE.*
- No, the ECB is not printing money to buy sovereign bonds. But it is printing money. It is using it to buy the equivalent of 3-year secured floating rate notes issued by banks.
- The result is the same either way. The ECB prints money, the ECB buys securities, and the quantity of reserves rises. That's QE.
- Already, this new regime has pushed euro area base money to a new all-time high -- a very much needed move, as it has been dangerously below trend for more than a year (please see the chart below).



Source: ECB, TrendMacro calculations

- This is just the beginning. The ECB has radically loosened the standards for eligible collateral, *making it possible for banks to post unsecuritized individual credits*. This has resulted, in the last week of the year, in the vast expansion of officially recognized collateral instruments (see "Le Collateral" January 6, 2012).
- *This expansion sets up the next LTRO auction on February 28 to be another blowout, almost certain to vault ECB base money to another new all-time high.*

We think this is not well appreciated because, in the typical media narrative about Europe -- which is all about the politics of sovereign debt -- the ECB's failure to use the SMP to buy Italian and Spanish bonds is a big disappointment.

- It does leave the sovereign bond market without direct ECB support. But some 3-year LTRO money will no doubt end up buying sovereign bonds as banks set up nearly riskless carry trades. Yes,

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

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

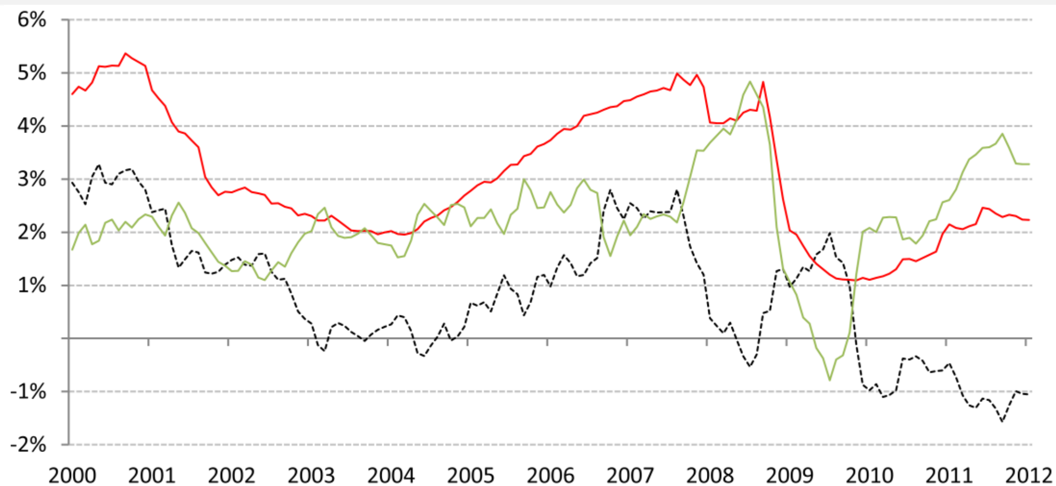
leaving this to risk-capital constrained banks is suboptimal if the goal is simply to provide support for sovereigns. But that's *not* the ECB's goal, apparently -- it is to provide QE without calling it such, and the 3-year LTRO program will do that very effectively.

- 3-year LTRO puts the market in charge of the amount of liquidity it wishes to have. No ECB committee has to decide how many Spanish or Italian bonds to buy. Banks decide how much liquidity they want -- trillions upon trillions potentially, *without limit* -- and the ECB will provide it.
- This rules out a Lehman-type funding crisis in euro area banks -- something that the SMP could have never assured (again, see "Europe's Wall of Liquidity"). With that -- and with Unicredit's agony last week ending the present cycle of Italian bank recapitalizations, and Santander's elegantly managed recap on Monday taking out the largest capital requirement in Spain -- Europe's banks have probably now seen the worst.
- Just a conventional QE crowds savers out of the government bond market and forces them do so something else with their money, 3-year LTRO crowds investors out of the bank funding market. Either way, there's lots of liquidity -- that is, *lots of money* -- out there looking for alternative uses. Typically in such situations the assets that respond best are *monetary* assets -- first and foremost gold.
- Another side note: the rise of 3-year LTRO as a form of QE explains the recent weakness in the euro -- and means it's a good thing. The ECB has been too tight for a long time, resulting in a too-strong euro. Now, as it loosens -- and loosens more than it would have had to if it had not mistakenly tightened last April -- the euro is experience a welcome weakness, as we predicted (see "EUicide" April 7, 2011).

To be sure, ECB policy isn't the only liquidity event influencing the gold price. But worldwide, we see a very liquidity-friendly environment.

- As inflation falls worldwide -- after a mid-year scare -- central banks that were tightening can stop, and ones that were considering tightening can defer doing so. Otherwise, falling inflation will automatically result in a rise in real rates (please see "Data Insights: Global Real Rates" January 10, 2012, and the chart on the following page).
- We don't expect the Fed to do QE3 -- we never have, except for the passive QE resulting from its currency swap operations (again, see "On the ECB Monetary Policy Decisions"). Without it, the ultra-bull case for gold can't be made. But the Fed is highly likely to maintain its present easy posture for a very long time -- even if the economy recovers (rendering that easy posture even easier). The economy has been visibly stabilizing for months -- yet the pattern of dissents at FOMC meetings have shifted from hawkish ones to dovish ones (see "On the November FOMC" November 2, 2011).
- China is easing. It has lowered reserve requirements, and bank lending has been on the rise for two months now. Rates haven't come down yet, but surely that's the next shoe to drop.

--- Global real rates — Global 3-mo interbank rates — Global CPI yoy
8 major economies, weight by nominal GDP at official USD FX rates



Source: Bloomberg, various statistical bureaus, TrendMacro calculations

All in all, we can't make the ultra-bull case that we would if the Fed were doing QE3. But we still stand by what we've called Plan B-plus: the ECB as the liquidity source at-the-margin (see "Plan B-Plus for Gold" July 14, 2011). We think it is presently an underestimated source, the dawning appreciation of which will sustain a move higher for gold.

Bottom line

Gold has fallen from all-time highs amidst a narrative that central bank liquidity is drying up. But the opposite is the case: the ECB's new 3-year LTRO program is in every way the equivalent of QE, performed on a vast and market-determined scale. With QE3 from the Fed still off the table, the ultra-bull case for gold can't be made. But the Fed will stay easy, and China appears to be easing now. So with the ECB as an underestimated source of liquidity, we see gold moving higher following last month's speculative shake-out -- and Europe's banks having turned the corner.