

MACROCOSM

Good as Gold

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Stocks were spooked by deflation fears today, but signals from gold and the dollar say "don't worry."

The initial knee-jerk analysis this morning held that US stocks were getting off to a weak start due to the falling dollar and the rising price of gold, which in early trading was stretching its recent gains to new five-and-a-half year highs above \$335 per ounce. But that doesn't explain why stocks continued to fall as gold came off its highs and the dollar steadied. Rather than being spooked by the long-sSpeculated dollar rout, it's more likely Wall Street was bearing the brunt of this morning's report of an unexpected 0.4% decline in the November PPI. Deflation, not the barely-visible specter of incipient inflation, remains the relevant risk factor at the margin.

Our analysis suggests that deflation risk has mitigated significantly over the past few months, contributing materially to the market's rally off the October lows. But the striking risk premium that continues to be available in non-tech sectors of the market also indicates that this remains an exceptionally cautious environment. And with a down month for producer prices -- now up 0.9% year-on-year, after declining at a rate of better-than 1.75% year-over-year as recently as September -- concern about the outlook for sustained profit growth certainly is not irrational.

That said, it's important to note that the PPI -- along with all the other official statistical inflation measures -- is a lagging, backward-looking index, while foreign exchange rates, commodity prices and, especially, gold are forward-looking auction market prices. Chances are the lingering deflation influences captured in the latest producer price report will be overcome in due course by the welcome reflationary impulses reflected in the 15-20% depreciation of the dollar's real purchasing power against the market price indicators this year.

From the perspective of the market's capacity to absorb risk, those positives also figure to be reinforced by recent, long overdue signals from **the Fed** that it is cognizant of deflation risk and is prepared to adopt unconventional measures, if required, to subdue the threat (see ["Monetary Progress, Fiscal Stasis"](#) November 25, 2002). That assurance provides some measure of confidence that the reflation of the unit of account will be sustained. Perhaps the early salutary effect of that can be seen most clearly in once forgotten locales such as the junk bond market. Even in the face of the equity market's faltering over the past two weeks, junk spreads have remained within a 10-15 basis point range of their recent lows, after rallying by more than 200 basis points from the record highs of early October.

We see a complex of factors as likely responsible for the latest reflationary push that has seen gold rally from below \$320 in the last two weeks. For one thing, seasonal factors should not be ignored. During the holiday season, the Fed routinely provides additional liquidity to the financial system to support the public's increased demand for liquid balances. There are hints, though, that the Fed could be overestimating those needs, providing an increment of excess liquidity relative to demand. On a five-day-moving-average basis, for example, the closing fed funds rate is now running at about 1.2%, five basis points below the 1.25% target. Some deviation

from the target is not unusual, but the five-day moving average has been below 1.25% since December 3, which *is* unusual.

It's also at least arguable that the dollar's recent moves can be viewed as being at the intersection of changing monetary and fiscal policy expectations. With its disappointing appointments to critical economic policy positions at the **Treasury Department** and the **White House** this week, the incoherence of the **Bush administration's** economic perspective has once again been exposed. The naming of a Treasury Secretary and White House economic counsel whose views to this point place them in the camp of budget-balancing obsessives certainly doesn't inspire great confidence that a pro-growth tax policy agenda will be aggressively pursued in the new **Congress**. The personnel changes are likely to result -- at best -- in a tax package that does less for growth-enhancing incentives than it otherwise could have. And they could well ultimately mean the opportunity for pro-growth policy change will end up being completely squandered. In the final analysis, in other words, the new economic team is likely to bring less robust expansion than what might otherwise have been expected. That also could mean greater reliance on the Fed remaining easy longer, speculation that could well explain at least part of the dollar's softening in the past week. **TM**