Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

FED SHADOW

Gold's Wild Ride

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David Gitlitz

It's for sure now -- both gold and Greenspan are telling us unambiguously that the Fed "gets it" on deflation.

It has been one wild ride in the gold market, with the yellow metal swinging from below $340 per ounce Wednesday, to above $355 overnight in Asia Thursday, and now back skirting the $340 level after trading above $330 for the first time in five-and-a-half years just over a week ago. That kind of volatility is a measure of current uncertainty about what the "right" price is, a trading phenomenon which is not terribly unusual during a major phase-shift in the market environment. That shift is primarily a reflection of the **Fed**-engineered alleviation of deflation risk that we have identified over the past several weeks. In other words, the freeing of gold from the range-bound trading that only rarely broke above $320 over the last six months -- after spending virtually all of 2000 and 2001 below $300 -- can be seen largely as representing final confirmation that the Fed's deflationary siege is now over.

Alan Greenspan's speech last night to the **Economic Club of New York** gives an additional measure of confidence in that regard. Greenspan spent the bulk of the past six years in denial that his stewardship of the currency could possibly be implicated in the disturbances attributable to a deflating dollar that broke out across the globe in that interval, beginning with the Asian financial crises of 1997 and 1998. Now, it seems, he has subjected his assumptions to a long overdue reconsideration. "Recent experience understandably has stimulated policymakers to refocus on deflation and its consequences, decades after dismissing it as a possibility so remote that it no longer warranted serious attention," Greenspan said. While the US is "nowhere close to sliding into a pernicious deflation…a major objective of the recent heightened level of scrutiny is to ensure that any latent deflationary pressures are appropriately addressed well before they became a problem."

Obviously, those "latent" pressures were a problem long before Greenspan chose to acknowledge them. But his attention to the issue, however late, at least offers assurance that the reflation of the unit of account seen thus far can be sustained. Of course, as we have noted previously, in such periods it pays to remain on guard for indications that the Fed is again "fighting the last war," giving rise to risks that are equal and opposite to those it is belatedly confronting. After all, the deflationary wipeout was the result of the central bank's heightened inflation vigilance during a period of minimal actual risk to the currency's purchasing power.

Certainly, if such disastrous deflationary error can arise from the Fed's efforts to contain what it considered a dangerously overheated economic boom, there's nothing to say that an equally costly inflationary error cannot result from its preoccupation with deflationary risk in the present climate of economic sluggishness. The good news, though, is that there remains little if any indication that such risk is a factor in the current market environment. Long-term Treasury yields remaining near multi-generational lows, for one thing, are surely not auguring for inflation's return. Trading in the Treasury's inflation-indexed debt (TIPS) is also a useful tool for gauging the market's changing inflation expectations. If, for example, the recent gold price moves and Fed policy pronouncements were seen as a threat to the currency's purchasing power, we could

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 402 5074

expect to see indications of the market opting for the inflation insurance, widening the spread between nominal and TIPS yields. In fact, though, at about 1.64%, the 10-year TIPS spread is now at the lower end of the range it has been holding since mid-October, and about 10 basis points below the range it held in the several previous months. TM