Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MARKET CALLS

A Bounce for Gold

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David Gitlitz

With war-fear trades unwound and the Fed still committed to fighting deflation, gold has more upside than downside.

We are establishing a **Model Position long gold** at today's closing prices. The dollar price of gold has bounced more than $6 since hitting lows under $320 per ounce early yesterday on the final dumping of safe-haven long positions with the apparent collapse of organized **Iraqi** armed resistance. After coming so far, so fast in liquidating the war-uncertainty premium in the face of the extraordinary work of **US-led coalition** military forces, however, this bounce-back rally looks to have some further head room as the customary monetary factors again come to dominate the gold pricing process.

Remember, gold was still trading in a wide range topping out around $320 per ounce last fall until **the Fed's** commitment to finally pursue an anti-deflationary policy course was made abundantly clear in word and deed in the final weeks of the year. First, speeches by **Fed Governor Ben Bernanke** and **Chairman Alan Greenspan** declared the central bank would be unconstrained -- if necessary -- in providing the liquidity required to root out deflationary impulses. Soon enough, it became clear that the speech-making was being matched by action, as year-on-year growth of the Fed' balance sheet assets rose from a rate of less than 8% to nearly 10.5% in the space of a few weeks in December. With the increased liquidity easing the scarcity of dollars relative to demand, gold jumped from about $320 in early December to above $340 before the end of the year, *before* geopolitical risks came to have a growing influence on trading activity.

At this point, we see no indication that the Fed's stance has shifted in a material way. Expansion of the central bank's balance sheet has been maintained at a rate of more than 10% year-on-year. It's not inconceivable that some increased demand for dollars in the face of a steady Fed liquidity posture can explain part of the gold price slide these last several weeks. Within the banking system, however, there are few signs of growth in demand for dollar balances that would be consistent with this indication of renewed dollar strength.

The Fed, moreover, appears to be going to some lengths to provide assurances that it remains committed to an anti-deflation orientation. A story in today's *Wall Street Journal*, "Fed Weighs Alternative Ways To Create Economic Stimulus," describes central bank officials as pondering the steps that might be taken if the funds rate target -- now at 1.25% -- is pushed to a level so low that conventional rate-targeting mechanisms become inoperable. We have suggested those steps could involve a price-rule procedure that would have the Fed target a sensitive commodity price (such as gold) or a basket of commodities with its liquidity injections. As the *Journal* story suggests, the Fed "expects never to get to such a point" that it would be necessary to consider such alternatives. Publicizing the possibility that unconventional action could still be taken, however, underscores that top policy makers remain inclined toward a more, rather than less, generous liquidity posture, which is also probably a good indication that the upside potential in gold at these levels significantly outweighs any downside risk. TM

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

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924