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A Haven From What?

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Don't worry about Ahmadinejad. Worry about Bernanke.

Update to strategic view
INFLATION PLAYS (US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR): The rally in inflation-sensitive assets (and the decline in the US dollar) has been falsely characterized as a "safe haven play" in light of the Iran-UK crisis. In fact it has been a response to inflation risk arising from the Fed's vacillation on rate policy. They will continue to rally (and the dollar to fall) until the Fed abandons its unnecessary "flexibility" to respond to exaggerated risks to growth.
[see Investment Strategy Dashboard]

The recent rally in the price of gold, we were told, was a safe-haven play attributable to the geopolitical tensions set off by Iran's seizure of 15 British sailors in disputed waters off the Iran-Iraq coast last month. Indeed, when Iran's president Mahmoud Ahmadinejad announced yesterday he was releasing the British captives, the price of gold dropped sharply. That is, until it rebounded and finished the day holding a gain of some $10 at above $670, with a further upmove today bringing the price to nearly $675, higher than it was at any time during the Iran-UK imbroglio.

We trace this latest gold price pop not to the onset of the British hostage crisis on March 23 but to an event a couple days earlier that had a more fundamental effect on the monetary metal. That was on March 21, the date of the latest FOMC meeting, when the Fed issued its policy statement removing reference to the potential for "additional firming," while noting "mixed" indicators on the economy. Although we refuted the instant interpretation that the shift in Fed language opened the door to a near-term rate cut, the statement certainly didn't advance the date when policymakers would return to the still unfinished task of restoring monetary equilibrium (see "On Second Thought…" March 23, 2007). Fed chairman Ben Bernanke further clarified the Fed's stance in congressional testimony last week, suggesting that while the central bank sees inflation as the primary risk in the current environment, it adopted the nuance of its latest statement to provide greater "flexibility" (see "Both Sides Now" March 28, 2007). Such flexibility, he indicated, could potentially have the Fed respond to what it perceives as somewhat greater downside economic risks.

The implication reflected in gold and the other market price indicators seems clear enough: with the Fed still in a surplus liquidity posture, such formulations can only further delay withdrawal of the surplus, allowing the inflationary impulses to become even more deeply embedded. In addition to gold steadily marching higher from its levels below $660 prior to the FOMC release, movements across the range of sensitive market prices have been consistent with this interpretation (see "Flex Time" March 30, 2007). The dollar's trade-weighted foreign exchange

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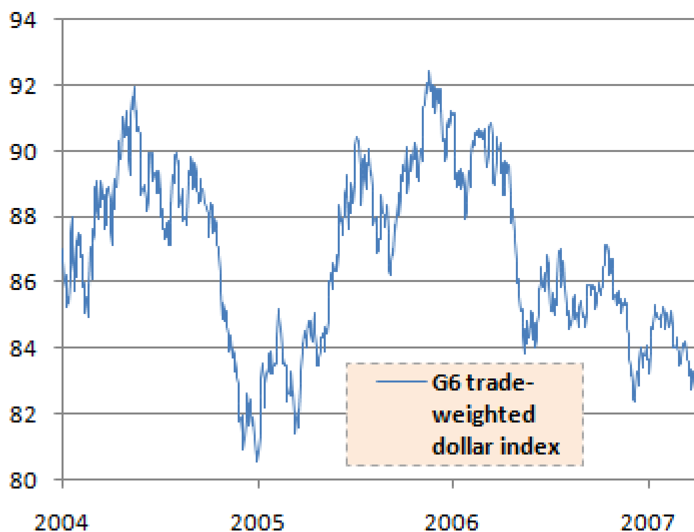

BACK TO THE LEVELS OF MAXIMUM DOUBT ABOUT BERNANKE'S INFLATION-FIGHTING BONA FIDES

value is near two-year lows, and not far above its weakest levels in late 2004 when the Fed's commitment to rooting out the inflationary liquidity excess was in significant doubt. Crude oil prices barely budged in response to the Iranian announcement and, at about $64, are more than $7 higher than their pre-FOMC levels. The CRB-Spot commodity index, meanwhile, is near all-time highs and it appears that even the Treasury yield curve has caught a whiff of inflation reality after months of steadfast denial. The 2/10 Treasury curve, having been inverted since last August, finally reversed the inversion on the day of the FOMC release and is now showing a positive spread of about 5 basis points. Inflation expectations reflected in the spread between nominal Treasuries and CPI-indexed bonds have widened only modestly since the meeting, from 241 bps to about 246 bps, but that's still some 20 bps off its lows early in the year.

This Fed flirtation with an inflationary breakout seems rooted in a bout of anxiety about the economic outlook that is likely to prove unfounded. Admittedly, there are a few soft spots in the current economic setting. But aside from the housing correction, indications are that these are likely to prove to be transitory events rather than prolonged downturns. Capital expenditures, for example, have declined in each of the past two quarters, and new orders for core capital goods -- a forward-looking proxy for business fixed investment -- are running negative on a year-on-year basis for the first time in more than three years. But to considerable extent, this appears due to an inventory correction that seems largely to have been worked off, as there are signs emerging of a rebound in the works. Unfilled orders, up about 17% year-on-year, are running at the highest levels since the late '90s investment boom. At the same time, the robust appetite for risk that's still apparent in a number of market sectors runs counter to the kind of dampening of expected returns that would be expected to accompany a serious capital investment slowdown.

Probably the best refutation of the notion that this economy is on the precipice of a significant slump can be found in the labor market, which shows no signs of slackening. Weekly initial jobless claims, one of the best forward-looking indicators of employment trends, ticked up slightly in the most recent data reported today. But on a four-week moving average basis, weekly claims of about 315,000 are on a par with the best levels of the late-90s expansion -- at least prior to its ascent into bubble status in 1999. This is the hallmark of a tight labor market, marked by consistent job growth, declining unemployment, and healthy wage gains. It's not the stuff of economic downturns.

BOTTOM LINE: Recent trends in gold and the other market price indicators suggest that geopolitical risk has had an insignificant impact relative to the policy risks of an accommodative Fed that seems intent on seeking excuses to remain accommodative. While we don’t doubt that at some point the Fed will be compelled to emerge from pause mode and return to the business at hand, its ill-advised ambivalence could prove to be costly in terms of the inflation it ends up sanctioning.