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MACROCOSM

Gold and Commodities: Breaking Bad

Monday, April 15, 2013

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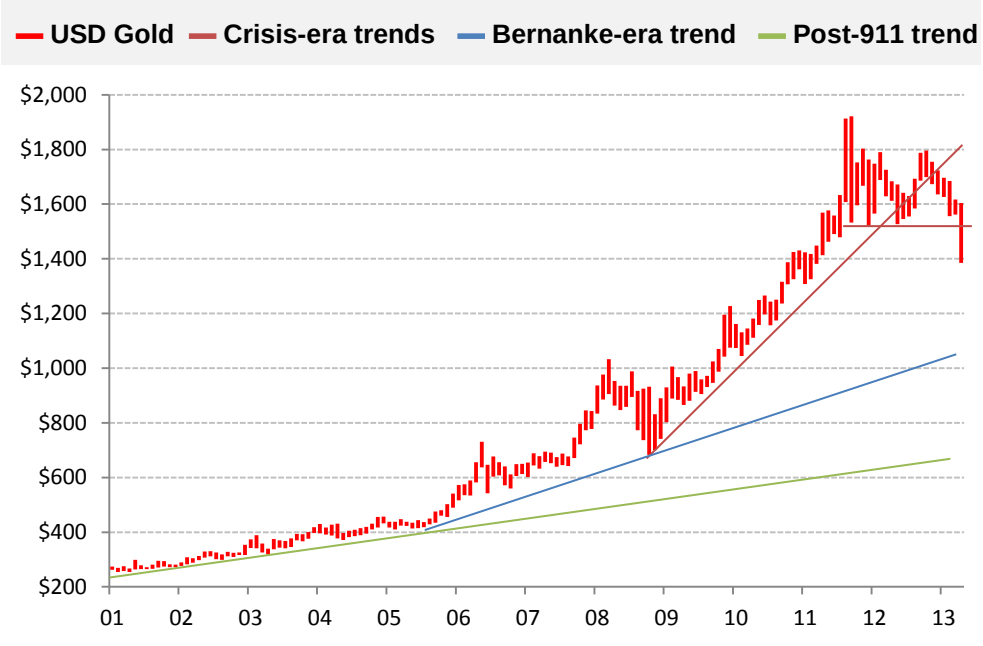
QE3 has failed. Gold points to deflation, commodities point to continued anemic growth.

Gold has broken down well below the $1525 level, where it had found support in a series of tests beginning in September 2011, right after the run to all-time highs above $1900 (please see the chart below). This follows the May 2012 break in gold's great bull move from the onset of the global financial crisis in 2008 -- a break only temporarily reversed following the announcement of the Fed's unlimited QE3.

- What we are seeing, in fact, is a breakdown in commodities generally. Gold's breakdown raises critical questions about the Fed's ability to prevent deflation -- the broader commodities breakdown raises questions about its ability to stimulate growth.
- While these breakdowns are attention-getting, they are only part of a larger and ongoing pattern. Gold and commodities topped in 2011 after an almost decade-long run (see "The bin Laden Commodities Crash" May 6, 2011).
- There is good news and bad news in this larger pattern. In this report, we'll try to put it all in an historical context that can help



Source: Bloomberg, TrendMacro calculations

Update to strategic view

GOLD, OIL, COMMODITIES, US MACRO, ASIA MACRO, US FED: Gold has broken down severely, consistent with official measures pointing to a return to deflation and the fundamental failure of QE3. We now can't rule out a hint from the Fed that QE3 will be extended or enlarged, which could quickly reverse much of gold's drop. At the same time, commodities overall have broken down, confirming disappointing macro statistics pointing to continued slow growth. The commodities rally that began in the aftermath of the terrorist attacks of 2001, when China's sudden accession to the WTO launched a decade of unprecedented development, is over. The death of Osama bin Laden marked the top, taking out the geopolitical risk premium from commodities, especially oil. Separately, the end of China's decade-long hypergrowth run takes competitive demand from commodities. Perhaps lower commodities prices can stimulate growth at some point, but for now we're looking a drop in demand and the slower global growth that goes with it.

inform present strategy.

We will begin with the implications for *inflation*, where gold has the most to say of any commodity.

Coming as US stocks make new all-time highs, it is tempting to see the inflation message in the present gold breakdown as an upbeat one. We might conclude that the Fed's and other central banks' ambitious easing programs are adequate to the task of liquefying the global economy and restarting sustainable growth. There will be no need for an endless series of *further* programs that would result in massive currency debasement, higher inflation and far higher commodities prices. Instead, the next move will be an orderly exit from the existing programs. We ourselves have said all year that the Fed would taper its Large-Scale Asset Purchases (LSAPs) sooner than the market would expect (see "2013 Outlook: Doves Ruled Out at the Fed" January 25, 2013).

- Part of the conventional media narrative now on gold is to stick it to the "gold bugs" who feared inflation too much, and had what now seem to be far too optimistic price targets.
- In that regard, let us come clean. We have never been one of the catastrophists who expected $10,000 gold. We became directionally bullish on gold right at the bottom more than a decade ago -- and more than four years ago set what was then a very aggressive $1500 price target (see "Why Isn't Gold at $1500?" December 10, 2008). It was an important "conviction trade" for us then, but after our target was hit, we gave up our strong conviction (see "Gold Hits Our $1500 Price Target" April 20, 2011). Since then we have been on-again and off-again on gold, but generally more optimistic than not while it has gyrated in the now-broken trading range above $1525 (see, most recently and most wrongly, "Positioning for the Fiscal Cliff" October 3, 2012).

Gold may indeed be correcting now from absurdist fears about future inflation. Yet its dramatic present breakdown comes at the same time as statistical inflation is falling everywhere in the developed world. It is underscoring what should be obvious -- that we are on the verge of deflation again, for the third time in five years

- Looking at it this way, stocks at all-time highs could be wrong. The breakdown in gold does not indicate that central banks have already done enough -- rather that they have done too little, and lack the will to do more without a precipitating crisis or threat. Gold is thus anticipating a deflationary liquidity squeeze, just as it did when it experienced a decline even greater than the present one in the aftermath of the Lehman Brothers failure in 2008.
- In the US, core personal consumptions expenditures inflation has fallen to 1.26% year-on-year (please see the chart on the following page).
- The Fed's communications now are slanted toward targeting unemployment (see "On the September FOMC" September 13,

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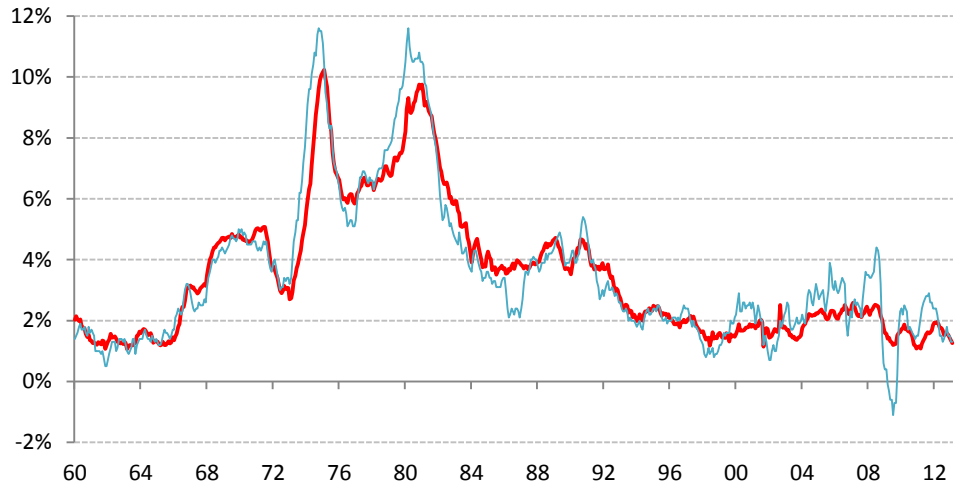
Personal consumption expenditures inflation YOY — **Headline** — **Core**



Source: BEA, TrendMacro calculations

2012), but at 1.26% core PCE inflation it ought to be worried just as much about slipping into deflation. Indeed, today's core inflation is only a handful of basis points higher than it was in 2009 and again 2010, a level sufficiently alarming to have served as the Fed's rationale for QE1 (see "Ben Boldly Goes" March 19, 2009) and QE2 (see "On the November FOMC" November 3, 2010).

- In the euro area, core inflation has fallen almost to the same level, at 1.28%. Yet the ECB isn't overtly worrying about deflation, either. And unlike the Fed, it's not actively engaged to support employment.
- The Bank of Japan is the only major central bank overtly worrying about deflation and seeking inflation (see "On Kuroda and Iwata at the BOJ" February 25, 2013). It is no coincidence that gold is stronger in yen terms than in any other major currency -- indeed,

JPY gold In thousands

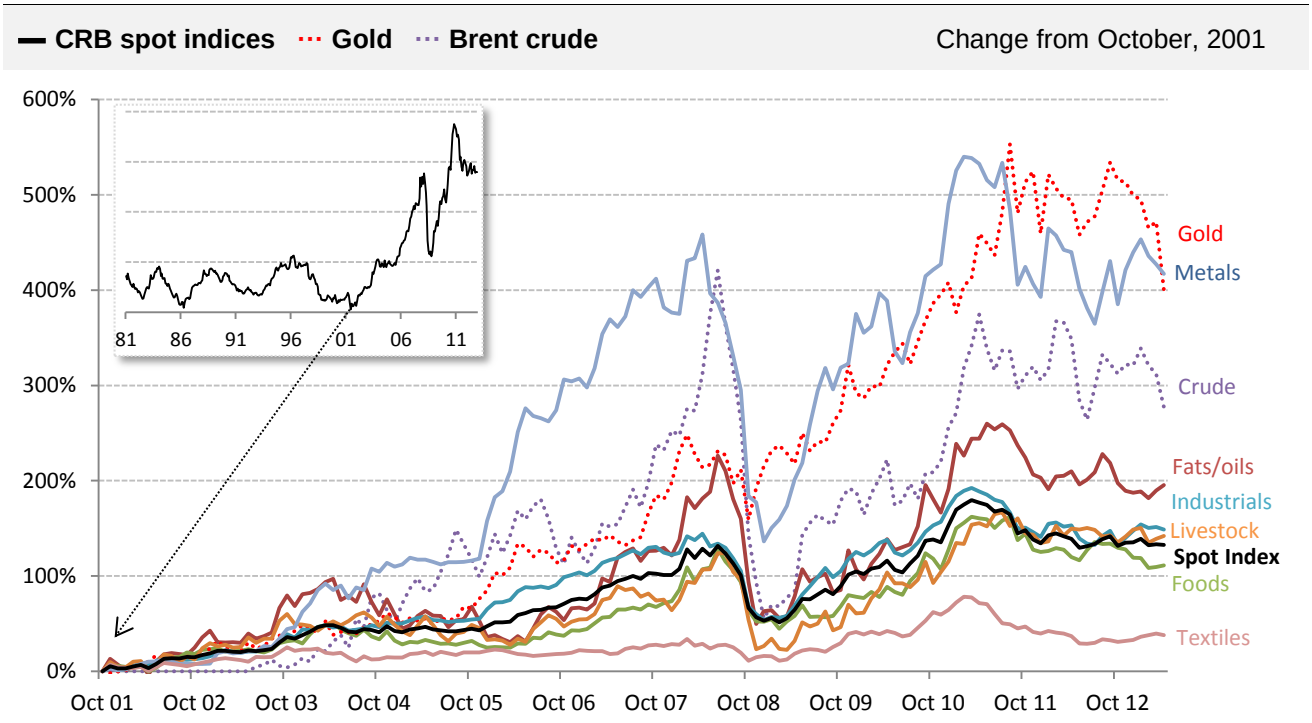
Source: Bloomberg, TrendMacro calculations

gold is close to all-time highs from the Japanese perspective (please see the chart on the previous page).

- We are not arguing that the gold price is an exact proxy for expected inflation -- an hypothesis we embraced many years ago, when the strong correlation between gold and the future price level seemed to bear it out. That correlation has not held up for the better part of two decades now. Nevertheless, we strongly believe that in some admittedly imprecise way, *changes* in the gold price do reflect *changes* in inflation expectations.
- So it worries us that even though the Fed is executing unlimited quantitative easing, the drop in the USD gold price is consistent with the drop in official inflation. We have to ask: is the deflationary undertow of the Not So Great Expansion following the Great Recession so strong that even QE3 can't turn it back?
- So contrary to our sense that the Fed would end QE3 sooner than expected, now we can't rule out that the breakdown in gold -- highlighting the emergence of a deflation threat -- could shift the Fed to prolong it. A mere hint to that effect from Ben Bernanke or Janet Yellen would produce a dramatic reversal higher for gold.

This brings us to the question of *growth*. We ask: *if the breakdown in gold is telling us that unlimited QE can't even stanch deflation, isn't the breakdown in commodities generally telling that it can't stimulate growth, either?*

Let's begin at the beginning. The entire secular rally in gold has coincided with a rally in all commodities, which was born at the bottom of October 2001 (please see the chart below).



Source: CRB, Bloomberg, TrendMacro calculations

- Over the life of the commodities rally, gold has acted pretty much like just another metal, closely tracking the CRB Spot Metals Index. This index includes no monetary metals at all -- only the industrial metals tin and zinc, and scrap copper, lead and steel.
- For that matter, *all* the industrial commodities and crude oil have generally followed the same pattern as gold, with betas lower by varying degrees.

The starting point of this great secular commodities rally was October 2001, right after the September 11, 2001 terrorist attacks on New York and Washington DC.

- What's the connection to 9-11? There are, in fact, two.
- First, 9-11 itself and the subsequent US "war on terror" built a geopolitical risk premium into the prices of all strategic global commodities, most obviously oil. Surely the heightened possibility of risk events led to prudential inventory accumulations that had the effect of accelerating demand and raising prices.
- Second, and almost unrecognized, is the fact that 9-11 catalyzed the sudden integration of China into the global economy. In the days following the attacks, the US intensely accelerated bilateral negotiations with China, resulting six days afterward in an announcement that led, three months later, to China's accession to the World Trade Organization. Ever since, with a new Public Enemy Number One and the need for a potential superpower adversary to be an ally, the US political establishment has suppressed populist anger against China and supported its rapid growth.
- Since 9-11, over a little more than a decade. China has needed commodities sufficient to build the equivalent of two Japans (China has added 132 million new urban jobs, more than twice the number of persons employed overall today in Japan).

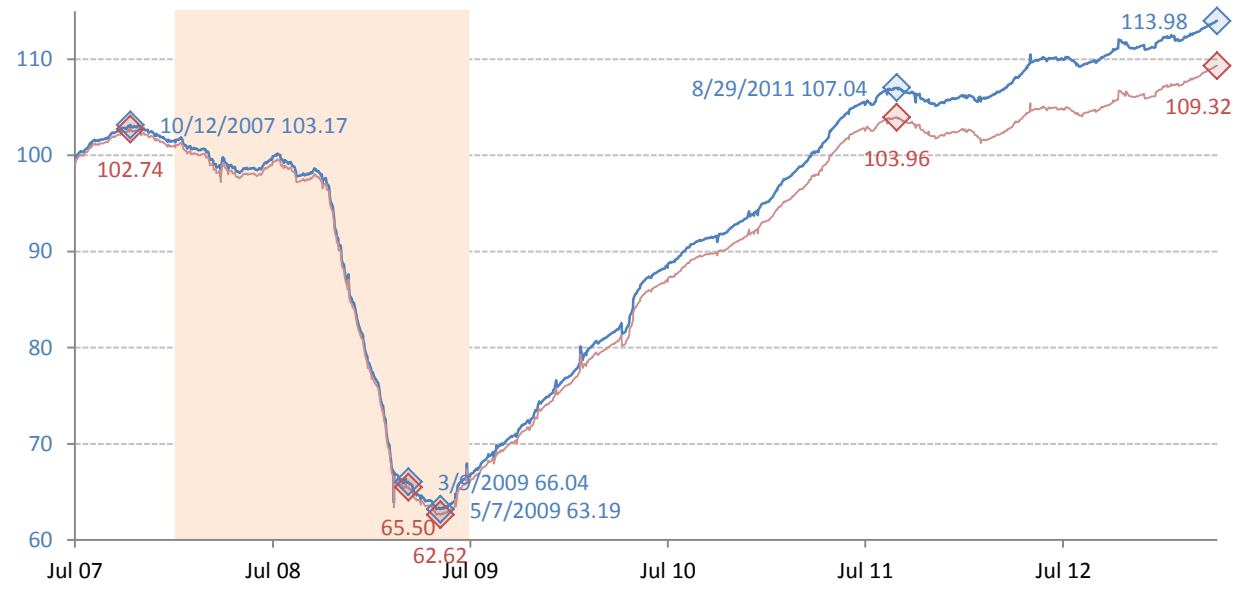
The top of the commodities rally came in 2011, with all commodities topping at various unique points in the same year.

- It's a tidy historical bookend. The war on terror and the commodities rally began together in 2001. And they ended together in 2011 with the death of Osama bin Laden on May 2.
- At that time we immediately identified the threat to the nearly ten year old commodities rally (again see "The bin Laden Commodities Crash").
- Neither Brent crude, the CRB Spot Index, nor the CRB Industrial Commodities Index has ever traded above its respective level of May 2, 2011, the day of bin Laden's death.
- Other CRB indices did trade slightly higher, but topped at various points in June or August. Gold was the last man standing -- topping at $1921.15 on September 6, missing the tenth anniversary of the 9-11 attacks by five days.
- Having less expensive commodities thanks to a lessening of geopolitical risk is a good thing. It is a tailwind to global growth,

which has usefully offset the many headwinds we face in the Not So Great Expansion. Now it fits neatly into a theme that we think is dominant in 2013 -- the reduction of systemic risk in the world economy.

- But the end of the commodities rally in 2011 hasn't, in fact, been sufficient to accelerate global growth. Indeed, the pace of global recovery from the Great Recession appreciably slowed in 2011.
- We have noted many times that S&P 500 forward earnings growth deflected to a new slower pace in 2011, one that has not improved at all this year (please see the chart below).

Forward earnings per share — **S&P 500** — **Snapple (S&P 500 no Apple)** **Recession**



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

- China's growth began to visibly decelerate in 2011, too, after the temporary effects of its 2009 stimulus program ran off. China continues to slow, as evidenced just today in disappointing data on GDP growth, fixed investment, industrial production and retail sales. China's historic burst of development, born in the ashes of 9-11, now seems to be over. In the words of Mansfield Mills, one of our mentors from decades ago who is now scarcely remembered at all by investors: *all superior growth is temporary.*
- China doesn't seem to be doing anything about it, either. China now has the highest real interest rates of any large economy (please see "Data Insights: Global Real Rates" April 15, 2013).
- As the commodities demander on the margin, a slower growing China is a mixed blessing. And for now, let's assume away a chaotic hard landing scenario -- which could have unpredictable systemic consequences transmitted through China's dodgy banking system.
- A slower China takes the pressure off of commodities prices, and that's good for consumers everywhere. But on net it's been

unquestionably good for global growth for China to have created two Japans in just ten years, and that's just not happening now.

- The problem is that for a decade the *growth and the commodities demand went hand in hand*. High commodity prices were good, because they betokened fast growth. We suppose lower commodity prices could themselves stimulate growth -- think of a world with a crude oil price of zero. But in the real world, growth will simply restore higher commodity prices, which will in turn constrain the growth that was dependent on lower prices. For now, it's just a reality that falling commodities prices betoken falling demand, which means we are looking at slower growth than stocks at all-time highs would seem to be counting on.

Now that China isn't creating two new Japans anymore, just who will? QE3?

- Self-evidently, QE3 has not succeeded in keeping monetary deflation in check.
- Apparently QE3 has been sufficient, through Ben Bernanke's much-vaunted "portfolio balance channel," to move stock prices to new all-time highs (see "Is the Fed Moving the Stock Market?" March 11, 2013). But other than some wealth effects, what really is the point of that?
- For all the optimism generated by stocks at new highs, by our reckoning QE3 has so far done nothing to inflect real growth to a faster rate (see "New Highs, Same Old Cloudy Skies" April 1, 2013). Even unemployment, right in the crosshairs of the Fed's so-called "Evans Rule," is only coming down at the same snail's pace as *before* QE3, and even that is being accomplished only by the labor force participation rate falling to new cycle lows, the lowest level since 1979 (see "On the March Jobs Report" April 5, 2013).

We are facing the immediate unambiguous threat of falling back into deflation. Gold is telling us that. And we are facing continued slow growth -- not a new recession, but more of the Not So Great Expansion. Commodities in general are telling us *that*. In future reports we will discuss the Fed's possible response. For now we will say only that our sense that QE3 will end sooner than expected must be moderated in light of gold having highlighted the deflation threat.

Bottom line

Gold has broken down severely, consistent with official measures pointing to a return to deflation and the fundamental failure of QE3. We now can't rule out a hint from the Fed that QE3 will be extended or enlarged, which could quickly reverse much of gold's drop. At the same time, commodities overall have broken down, confirming disappointing macro statistics pointing to continued slow growth. The commodities rally that began in the aftermath of the terrorist attacks of 2001, when China's sudden accession to the WTO launched a decade of unprecedented development, is over. The death of Osama bin Laden marked the top, taking out the geopolitical

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