Classical Insights

Global Investment Analysis Based on the Classical Economic Model

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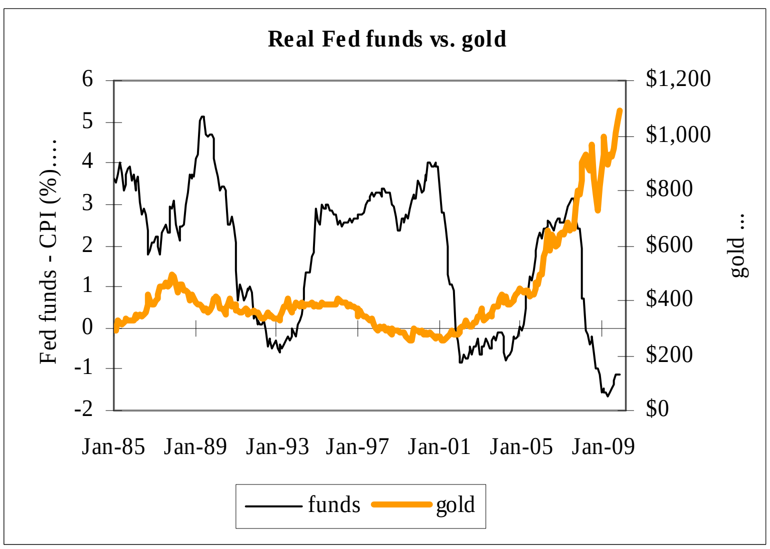
A very good economist I know recently outlined a scenario for gold falling below $500/oz. The chain of events would be as follows:

* Economy turns around;
* Investors start to price in rate hikes;
* Gold falls in anticipation of said rate hikes;
* Gold price potentially falls to $450/oz., since that is the price consistent with stable street prices.

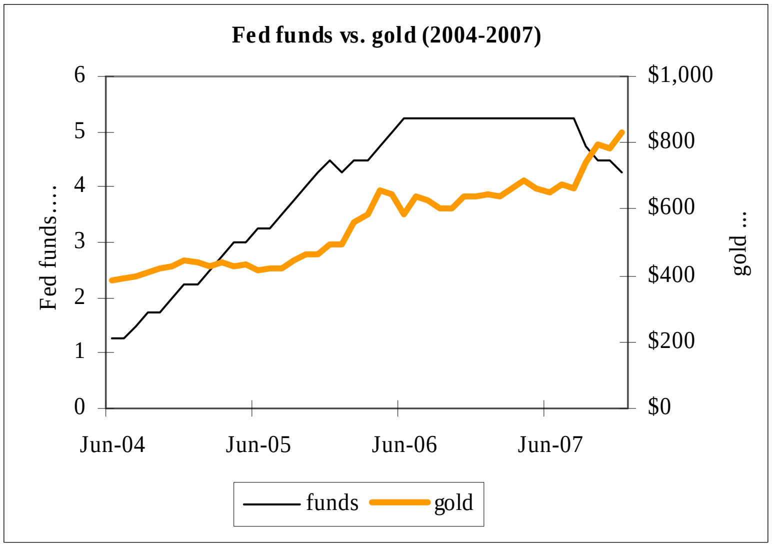
Importantly, the economist himself views this scenario as highly unlikely, on the grounds that the Fed is unlikely to hike rates enough to push gold that far down. But I wanted to explore his concepts anyway, *for this is THE bear case for gold*.

Points:

1) The first question to ask is, "Does gold really respond to *anticipated* rate hikes?" While the data aren't conclusive, from the chart below I'd say the answer leans more toward "no" than "yes." Generally speaking, the Fed has to actually do the deed to have any impact on gold. It can't just threaten to raise rates, it has to raise them.



2) A good example of this can be seen in the 2004-06 rate-hiking campaign. Over the course of two years, the Fed increased the funds rate from 1.0% to 5.25%. Gold kept right on rising until the funds rate got to 4.75%, at which point there was a brief and violent correction (of $185/oz.). Afterwards, gold continued working slowly higher, even as the funds rate was raised to 5.25%. Importantly, this chain of events occurred against a backdrop of 2.5-3% CPI, which means the real fed funds rate got to about 2.5% at its peak. Clearly, that figure wasn't high enough make gold fall in 2006-07. One could posit that the Fed would have needed about a 3% real funds rate (or a 5.75-6% nominal funds rate) to pull gold down at that time.



<u>3) Now, if 5.25% wasn't a high enough funds rate to corral the gold price in 2006, what funds rate would be needed to corral it today? Higher or lower?</u> You could argue lower, on the grounds that the core CPI rate is lower today (1.4% today vs. 2.5% in 2006). But I would argue that one would need a higher rate, on the grounds that pent-up CPI in the system is more pronounced today than it was in 2006. Moreover, by the time the funds rate realistically could be increased to the 5.25% range (say 12-18 months) core CPI is likely to be running at 2.5%, if not more. Since 5.25% was not enough to pull down gold the last time CPI was 2.5%, one would have to assume a higher rate would be needed this time, too. So you'd be talking about a SIX percent- funds rate (or more) today to corral gold – assuming core CPI is still only 2.5% by the time the funds rate got to 6%. And what if core CPI is actually 3.5% at that time? Would you not need a SEVEN percent funds rate to stop gold?

<u>4) This brings us to the next question: Could the economy handle a 6% funds rate?</u> The economy is clearly rebounding, but a huge driver for that rebound is the low funds rate itself. If you take that away, how much growth would there be? The outlook for fiscal policy today is much worse than three years ago. The top individual tax bracket is heading to a de facto 41% in 2011 once you factor in phase-out of deductions for high earners. Capgains and dividend taxes are heading higher in 2011 as well.

A good portion of this economic rebound is a result of the higher gold price (i.e. weaker dollar). It has boosted exports, boosted the nominal prices of commodities and boosted the attractiveness of emerging markets (which feeds back positively on the U.S.). If you take away higher gold, all those positives likely would reverse. Certainly there would be a wild crash in emerging markets as the dollar soared and EM currencies plunged (along with all commodity prices).

<u>5) Independent of whether the economy COULD handle a 6% funds rate, there is the additional question of whether a 6% funds rate would be even remotely feasible today.</u> Residential real estate prices much lower than three years ago and unemployment much higher. What would be the political fallout of the Fed sharply increasing the funds rates when unemployment is near 10%?

<u>6) For the bear case in gold to work, one key factor would be a meaningful drop in the unemployment rate.</u> Could unemployment start plummeting in early 2010? Maybe, I'm not sure. That's a key question. Could GDP charge higher? Here again, maybe (and on this point recent data have been quite good). If both were to happen, then the funds rate definitely could rise more than generally expected.

<u>7) All things considered, I would hang my hat on the fact that history suggests the funds rate needs to GET to a level sufficient to pull down the gold price before gold will actually fall.</u> History

suggests gold is unlikely to fall just based on hints, threats or insinuations by the Fed. If that holds true, we're looking at 500+ bps of rate hikes and at least 12-18 months of time before gold's rise is contained. And gold could just keep *rising* throughout that entire 12-18 month period.

<u>8) What are the risks to this scenario?</u> The top risk is that my premises are just plain wrong. I've never been *100%* convinced about what moves the gold price, though over time I have settled on the notion that gold is driven overwhelmingly by changes in the funds rate. However, just because the Fed had to hike 400 bps last time to begin to a grip on gold doesn't necessarily mean the same would apply this time. For one thing, gold is twice as high today as it was in 2005. As such, gold could fall by half and not affect street prices (which have not even begun to adjust $1,000 gold). Perhaps gold holders will be antsier this time around. The conventional wisdom among gold bugs is that the dollar is a doomed currency. What happens if/when the dollar and the U.S. economy turn out not to be doomed (which seems likely)? Many gold holders could become disillusioned and rush for the exits.

<u>9) On the other hand, we have the example of the 1970s, when gold rose about 900%, from $35/oz. to (ultimately) $350/oz. and the U.S. economy didn't collapse.</u> In fact, CPI only rose above the 10% mark a couple of times during that period (in 1975 and again in 1980-81). So, the U.S. economy has a precedent for a spectacular currency devaluation it manages to muddle through. This time around, gold has only climbed about 200% (from $350/oz. in the mid-'90s to $1,090/oz. today) and so far CPI hasn't even budged. Conceptually, then, *gold could double again from here and the economy still wouldn't be nearly as bad off as it was in the '70s.* Put differently, $2,000 gold must to be viewed as a live possibility.

<u>10) Bottom line: I'll be watching gold closely to see how it behaves as we get closer to the first rate hikes.</u> Everything I've written above is subject to alteration, re-thinking or rejection. This is an absolutely crucial issue for anyone with a commodity-heavy portfolio and I don't want to remain inflexibly stuck on any one line of reasoning.

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