Domestic Research
Polyconomics, Inc.

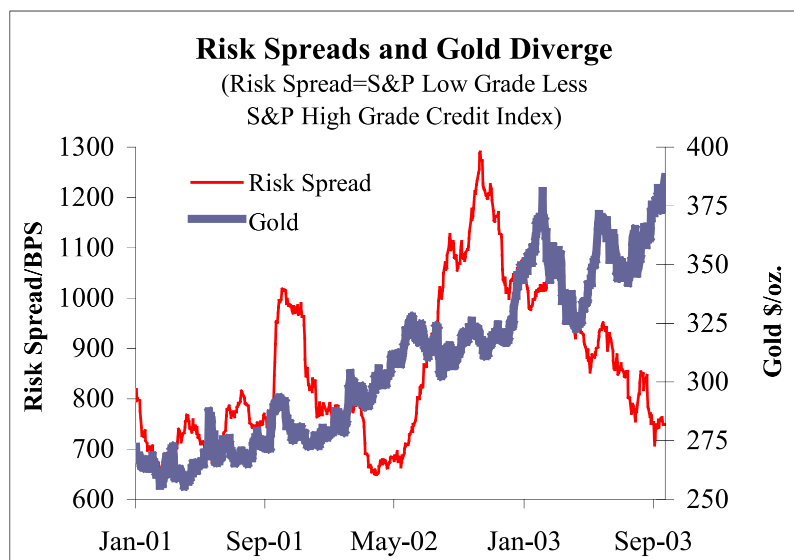
September 22, 2003

DOLLAR/GOLD, GETTING TO BE A PROBLEM

In jumping again today, the price of gold at $387/oz. would be at its highest closing level since September 1996. As a forward-looking inverse proxy for the value of the dollar, the price of gold is suggesting that deflation risk now has been replaced by the risk of mild inflation. Our operating hypothesis up until this point has been that it would be tolerable for the price of gold to show a bit of inflation risk, as a growing economy likely would put any excess dollar liquidity to use in the exchange economy -- once inventory building and capital spending rebounded in earnest. We no longer can be that optimistic.

From 2001 until October 2002, there was a fairly stable direct relationship between rising levels of systemic risk and the price of gold. For example, from January 2001 until October 2002, the NASDAQ swooned to 1114 from 2600. During the same period, the spread between S&P speculative grade credit index and its investment grade counterpart ballooned to 1300 bps from 800 bps. Thus, we could say with confidence that gold likely was rising for negative reasons, which essentially was confirmed by dour earnings reports and disappointing economic data.

From October 2002 until the present, risk spreads have tightened, speculative assets have rallied, and gold still has trucked higher. In fact, from its widest level in October 2002, the S&P low grade/high grade corporate debt index has tightened a whopping 552 bps. Over the same period, the NASDAQ has rallied to 1870 from 1114, a rise of 68%. Yet instead of falling back on this reduction in systemic risk, the price of gold has rallied to $387/oz. from $320/oz, with ups and downs in between. While the geopolitical situation remains abnormal, the behavior of the best risk indicators -- spreads, emerging market equities and currencies, and tech stocks in the U.S. -- strongly suggests some new factor is at work.



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There are several reasons that gold could be rising, which we dissect below:

1. **Although not reflected in the risk spreads or equity prices, the Fed may be generating currency risk by promising to fight deflation when deflation is over.** Fed Chairman Alan Greenspan first mused openly about deflation risk on April 30, 2003 before the House Committee on Financial Services. Fed Governor Ben Bernanke, a rising star at the FOMC, has mentioned several times that he believes the real risk going forward is the output gap and core CPI inflation actually falling further from an "already low level." The FOMC incorporated the view that the risk of declining inflation (deflation) outweighed the risk of a pickup in inflation in its May 6 policy statement and repeated it in June, August and September. The price of gold has risen to $387/oz. from $342/oz. during the intervening period. With the dollar no longer in deflationary territory against gold, commodities or currencies, the Fed's concern about deflation is based on flawed, backward-looking measures of inflation. This increases the risk of the Fed's deflationary error being replaced with an inflationary one.

2. **There is significant "pressure" on the funds rate, which could mean the Fed is now forced to add liquidity the real economy does not need or want.** The Fed is now growing its reserve base at a 10.3% year-over-year rate. From April to September, a period over which gold was up strongly, the Fed's reserve base expanded at a 16.8% compounded annual rate. With gold rising throughout this period, the Fed clearly was creating an excessive supply of liquidity relative to the *non-inflationary* demand for it. This stands in stark contrast to the deflationary period of 1997-early 2001 when reserves grew at less than 1% per year, commodities and broad monetary velocity crashed, the dollar rose, and a flummoxed Fed pushed the Treasury yield curve into inverted territory. Now, precisely the opposite set of variables are in play: Reserve growth is strong, gold/commodities are rallying, the dollar is falling against forex, and the Treasury yield curve is close to record steepness. It should be noted that under an interest-rate targeting system, the Fed sets the overnight target for loans and then becomes a passive actor, providing precisely the amount of liquidity necessary to keep overnight rates trading on target. Depending on the pressures exerted on the funds rate (which could be due to rising loan demand or to expectations of rate hikes) the Fed could be forced into accommodating an inflationary level of reserves growth.

3. **The Bush Administration's confused rhetoric on the Chinese yuan and its endorsement of floating exchange rates this weekend in Dubai likely has increased monetary risk.** We think the Administration's message on floating currencies in general and China's yuan link in particular is extremely flawed. Stable currencies are a *critical prerequisite to low tariffs and free trade* while floating currencies, which inflate and deflate, undermine trade and increase pressure to hike tariffs. The recent round of tariff negotiations in Cancun ended abruptly, largely because of a debate about farm subsidies that would not have been necessary with a price rule monetary policy. In addition, Democrats and some Republicans now are pushing a tariff bill that would impose a steep 27.5% tariff on Chinese goods unless China

revalues its yuan. If the U.S. government appears determined to weaken the dollar relative to Asian currencies, the market would have to assume the Treasury/Fed would succeed. This in itself would reduce the demand for dollar liquidity and push up gold.

4. **The Iraq situation clearly is not going as planned, which means above normal geopolitical risks remain.** Terrorist activity in Iraq and Israel is on the rise. At the same time, global tensions are running high as the Bush Administration squabbles with the UN concerning the emergence of an Iraqi government and stepped-up security forces. The breakdown of the "road map" to a Palestinian state further increases the chance of renewed Islamic terrorism directed at the U.S. economy. The administration's decision to commit $100 million to fit commercial airliners with anti-missile systems is a clear sign that the geopolitical situation is far from normal. This is a risk the dollar/gold market must discount.

5. **Additional news on the Washington Agreement governing central bank gold sales may be responsible for the recent jump in gold.** The $6 jump in gold Friday occurred when Reuters ran a story about central bankers discussing the renewal of a four-year-old accord limiting European central bank gold sales. We really do not think central bank gold sales have a lasting impact on the price of gold, as total central bank sales have been just a sliver of the total, above ground supply of gold. Over short periods of time, however, such announcements can spark short-covering rallies that impact the thinly traded bullion market.

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We are debating all these possibilities of gold's rise without real enthusiasm for any of them. The expansion of the economy that is clearly underway should be steadily increasing the demand for dollar liquidity and at some point should be overwhelming any of the forces still creating excess liquidity supply. The combination of policies coming out of Washington on fiscal, monetary and geopolitical issues certainly is a mixed bag of positives and negatives. The rising gold price itself becomes a greater negative at these levels because it means more inflation. Incomes are protected against inflationary bracket creep, but capital gains are not, which means the equity market will have to discount a real capgains tax higher than the nominal rate.

This is exactly the kind of worry that does not now occur to the administration's economic team, which is so eager to aid the manufacturing sector to bolster the President's re-election chances. In 1971, when President Nixon worried about his re-election, he got similar advice from his economic team, which was the central rationale for floating the dollar so it could depreciate against the Japanese yen and make U.S. exports cheaper. With the dollar already floating, the Bush team follows a parallel line of reasoning in its insistence that the Asian currencies *appreciate* relative to the dollar, which means China must float. The net effect will be to delay the U.S. expansion to a degree, an expansion that would bring with it the jobs the President's political advisors believe they must have come next spring, summer and fall. In

this case, the President would be served best by having his counterparts in Asia ignore him. Of course, as the dollar/gold price rises, so does the yuan/gold price. At some point, perhaps sooner rather than later, China will realize it is in its interest to appreciate its currency, to avoid an inflation that would bring with it another set of problems at home. In the first instance, the rural population benefits from a rise in commodity prices, but the urban population suffers, as wages no longer buy as much from the countryside.

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