

October 14, 2003

NEW DYNAMICS IN THE GOLD AND CURRENCY MARKETS

There are several reasons why the Polyconomics analytical model has been able to stand the test of time while many others have fallen by the wayside in forecasting market movements. The most important is our use of the dollar/gold exchange rate as a primary signal of market direction in stocks and bonds. Other models frequently become confused because they are unable to distinguish between “inflation,” “deflation,” “reflation,” and “disinflation,” not having our intellectual anchor: the concept of an *optimal* value of a currency relative to gold in any national unit of account. Because the total above ground supply of gold is so massive relative to its annual flow, the price of gold is the ultimate signal of the dollar’s value. This is why the price of gold tends to lead all other commodities priced in dollars.

Our performance steadily has improved over the years as new insights have come to us with new experiences with data flowing from the changing world. Our chief economist, Michael Darda, has been working through new refinements on how to treat the gold variable, increasing its power as a forecasting tool. It will follow my quick review of the approach we have used to date.

The optimal price of gold simply is a specific value of the dollar required to optimize the interests of debtors and creditors. From a starting point determined by past experience in the debt market, a rise in the price of gold (decline in the value of the dollar) indicates “inflation” and a fall in the price of gold (rise in the value of the dollar) from that optimal level indicates a “deflation.” Because there are lags associated with universe of prices following an inflation or a deflation from a starting point, there could be reversals of *some prices* in that universe if the direction of the dollar relative to gold reverses before the lags of the first impulse have been completed.

If the dollar begins to rise after it has depreciated, the process can be termed “disinflation,” a process that continues until the dollar/gold price once again reaches the point where it *should be*, which is the dollar’s optimal value. If the dollar continues to rise relative to gold from that point, it is no longer accurate to call the process “disinflation,” because a rise in value from the optimum level is “deflation.” Similarly, when the dollar declines against gold from a deflationary position and begins movement back to the optimum, it will be *reflating*. A new inflationary impulse begins when the dollar's value slips below the optimum level. All this while, prices of all other goods and services are still leading and lagging, with a general equilibrium restored only when the dollar/gold price is stabilized at the optimal level and remains in place for some period of time.

The dollar at \$350/oz. relative to gold has been our preference because that seemed to be what the markets were the happiest with from 1985 to 1997. As a refresher, the dollar rose in value from \$415/oz. in early 1996 to \$350/oz. in early 1997 before leaping all the way to

\$255/oz. in 2001, a clear “deflation.” The stock market implosion that began in 2000 and the recession that followed it were the direct result of a dollar that had risen too much in value -- deflation. With the dollar having fallen to \$375/oz. against gold, deflationary forces have been completely neutralized. What follows is Michael Darda’s discussion of the new dynamics that have entered our analysis of the gold market and a fresh way to use gold to forecast the trajectory of statistical inflation and interest rates. [JW]

.....

During the last three decades of floating money, expectations of pro-growth policy changes almost invariably pushed the dollar up against gold while the perception of rising risks to commerce had the opposite effect. This uniform relationship has not held up since October 2002 when systemic risk began to recede from its zenith. In May 2003, top-notch supply-side tax cuts were signed into law, further increasing the outlook for risk-taking and growth. Normally, we would expect these positive expectations to increase the demand for dollar liquidity, which would foster a rise in the dollar’s value against gold and foreign exchange.

Instead of a steadily rising dollar (falling gold price), gold has rallied and the dollar has dropped. This is the first time in the history of floating money of which we are aware when the value of the dollar has fallen against gold and foreign exchange into the teeth of a major pro-growth tax cut and a massive rally in speculative-grade investment vehicles. To wit: during the past year, the dollar has declined by about 15% relative to gold and G6 currencies. This has occurred despite a blistering 73% rally in the NASDAQ from its October 2002 bottom and an equally impressive 43% contraction in junk bond spreads.

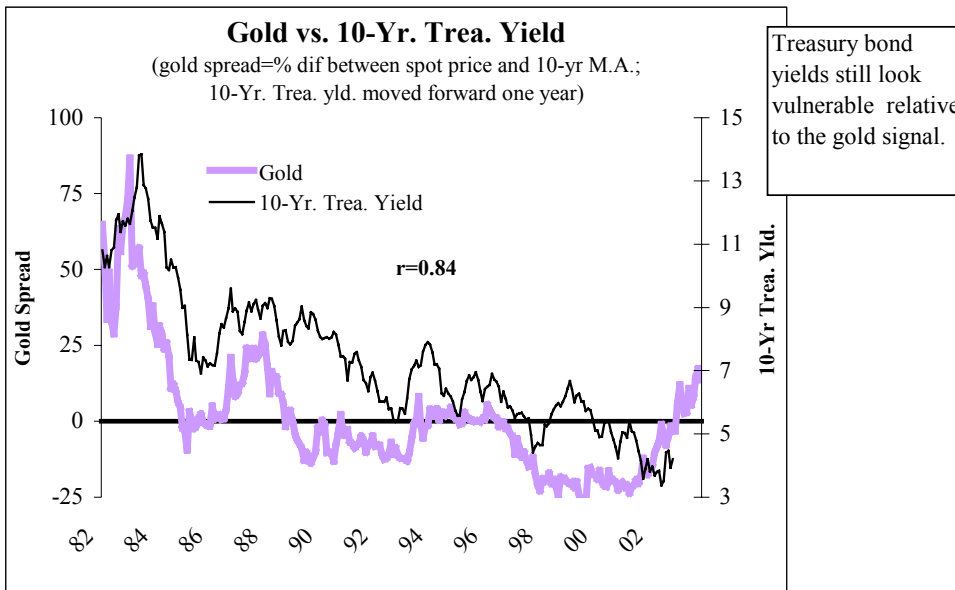
We have pointed out two new dynamics that could be pushing down on the dollar despite better growth expectations:

- **Rapid money growth by the Fed.** The Fed is a passive actor when it is targeting interest rates. In essence, the Fed sets its target on overnight rates and supplies exactly that amount of liquidity that keeps overnight rates on target. This means that it is theoretically possible to have an inflation or a deflation at any given level of overnight rates, depending on banks’ reserve demand and the "pressures" that are being exerted on the targeted interest rate. The spread between the funds rate and other markets rates (one proxy for pressure on the overnight rate) have widened dramatically while reserves growth has accelerated. As we noted before, the April-September gold surge occurred against the backdrop of double-digit growth in the Fed's reserves base. Reserve bank credit (essentially the Fed's balance sheet) has been growing at an average 9.8% YoY rate since January 2003.
- **Verbal signals from the Fed and Treasury that they would welcome a weaker dollar.** FOMC members have made it unambiguously clear that despite the decline in the dollar, they are much more concerned about deflation risk than inflation risk and are willing to take drastic action if necessary to stamp out deflationary impulses. Oddly, the FOMC’s new awareness of deflation risk, which began in April 2003, occurred after the dollar's value had receded from a deflationary high against gold and commodities. Treasury Secretary John Snow clearly has signaled a shift away

from the Clinton/Rubin strong dollar policy that served to compound the Fed's deflationary impulses in the late 1990s.

THE END OF DISINFLATION

At \$375/oz., the price of gold now is about 14% above its 10-year *moving* average. As a leading inverse proxy for the value of the dollar, the gold signal tells us that "disinflation" has ended. The current level of the dollar relative to gold also suggests that investors should expect *some* upward pressure on core statistical inflation and interest rates during the next 12-18 months.



Our 2004 forecasts for inflation and interest rates are based on the current spread between the spot price of gold (one way of looking at the future price level discounted to the present) and its 10-year moving average (the current price level). If the value of the dollar relative to gold deviates materially from its current level against this moving average, we will alter our inflation and interest-rate forecasts accordingly.

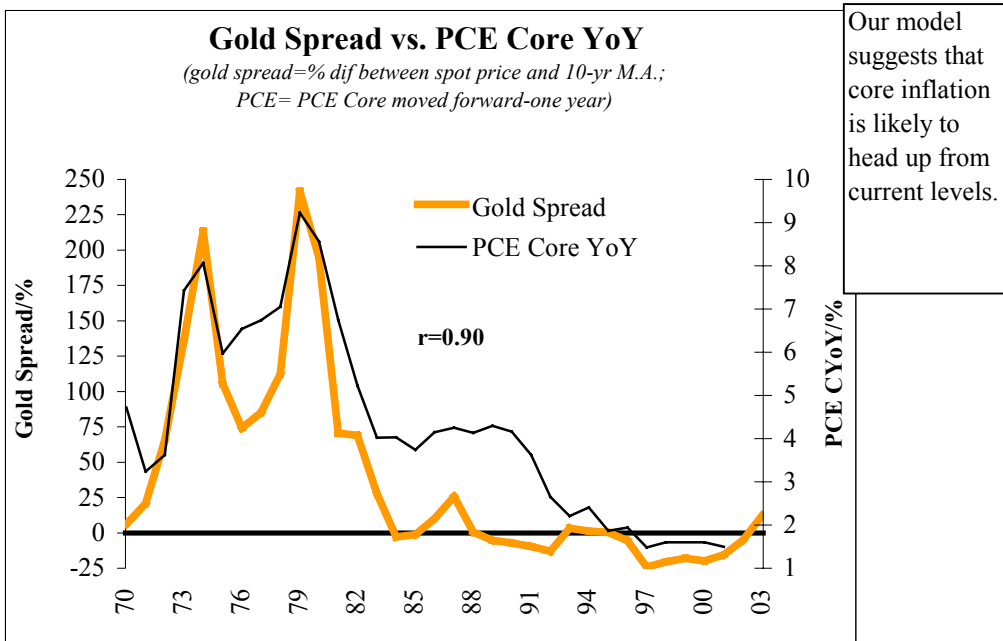
2004 Inflation, Bond and Yield Curve Forecasts				
Annual %	Core PCE	CPI	10-Year Trea.	30yr./2yr. Trea. Sprd.
Current	1.3	2.2	4.33	3.57
Oct-04	2.5	3.5	5.8	2.0

- 1) **Core inflation is likely to rise toward the 2.5% YoY level by the end of next year from the 1.3% YoY level currently.** The dollar/gold signal suggests that economy wide-pricing power will return. If the dollar's value is below its long-term average, higher costs no longer will take a whack out of margins and profits, but will instead get passed on in the form of higher finished goods prices.

- 2) **Long-term Treasury yields are likely to move up** as growth expectations are confirmed and core inflation rises. In addition, the spread between inflation and interest rates remains 25-50 bps below the historical mean (i.e., real interest rates remain depressed). As a result, long-term Treasury yields could rise by 50 bps or more as growth and rate-hike expectations firm *even if there is no additional upward pressure on statistical inflation.*

- 3) **The Treasury yield curve is likely to flatten from current levels.** The last time the Treasury yield curve got as steep as it is now was in late 1992, after the Fed wound up a long rate-cutting cycle. If history is any guide, recovery and rate-hike expectations should place the 2-year and 5-year Treasury notes under considerable selling pressure relative to longer maturity issues.

Our model for assessing inflation risk takes the percentage point spread between spot gold and its 10-year moving average. In order to gauge optimum value for the dollar, we use the price of gold, since gold is an auction-market indicator with more monetary properties than other spot market commodities¹. Since it takes time for changes in the value of money to waft through the price stream (contracts can take up to a decade to unwind) we use the spread between the spot price of gold against its 10-year moving average as a leading indicator of monetary pressures. Large deviations in this spread have led nearly every significant directional move in statistical inflation over the last 32 years. The model shows the highest significance with both statistical inflation and interest rates when both are pushed forward by one year. In other words, the spread between the dollar's spot value against gold and its 10-year moving average leads both inflation and interest rates.

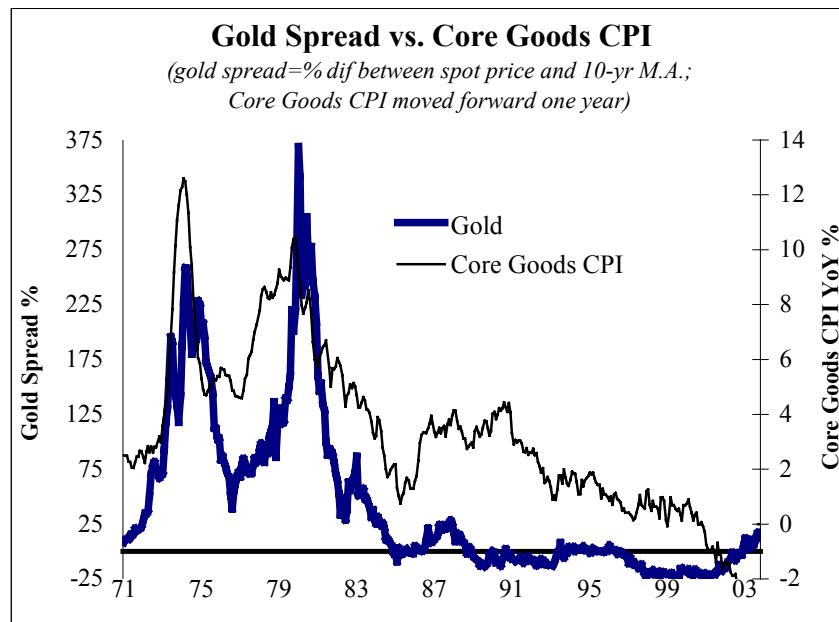


Putting the dollar fall in perspective. In order to recreate the inflationary forces triggered by the breakdown of the Louvre Accord, the dollar would need to fall to \$410/oz. relative to

¹ Gold is more useful than any other commodity as a price-level indicator because its stock of around 135,000 metric tons is so massive relative to its annual flow of about 3,000 metric tons.

gold. At that level, dollar weakness almost surely would have a negative influence on equity valuations and the economic recovery, as effective tax rates on capital bear a direct relationship to inflation risk. While it is likely that we will see some upward pressure on core statistical inflation in the quarters ahead, we are nowhere near the zones of destructive hyperinflation that wreaked havoc on the U.S. and world economies during the 1970s. In order to mimic the dollar fall that swept the U.S. into double-digit inflation in 1974 and 1979-1980, we would need to see the dollar fall below \$1,174/oz. and \$1,325/oz. relative to gold respectively. In other words, spot gold jumped 257% above its 10-year moving average in 1974 and more than 368% above its 10-year moving average in 1979-80.

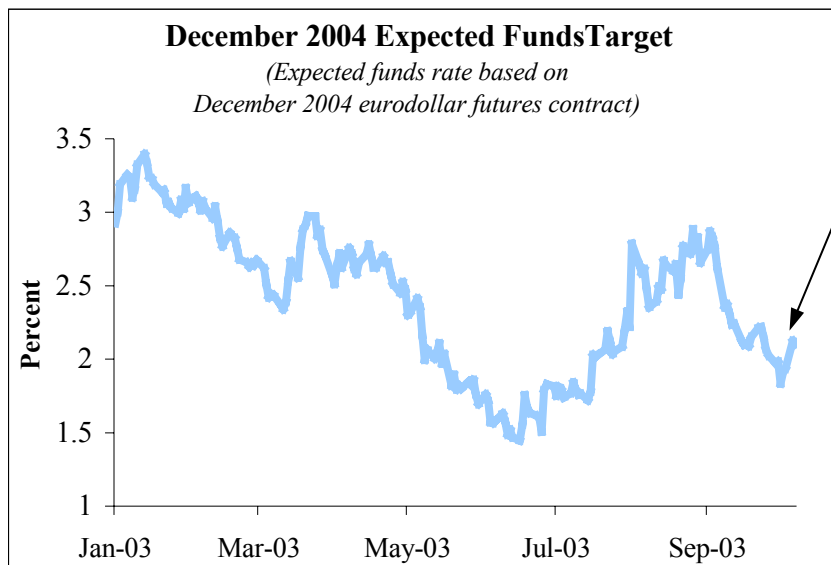
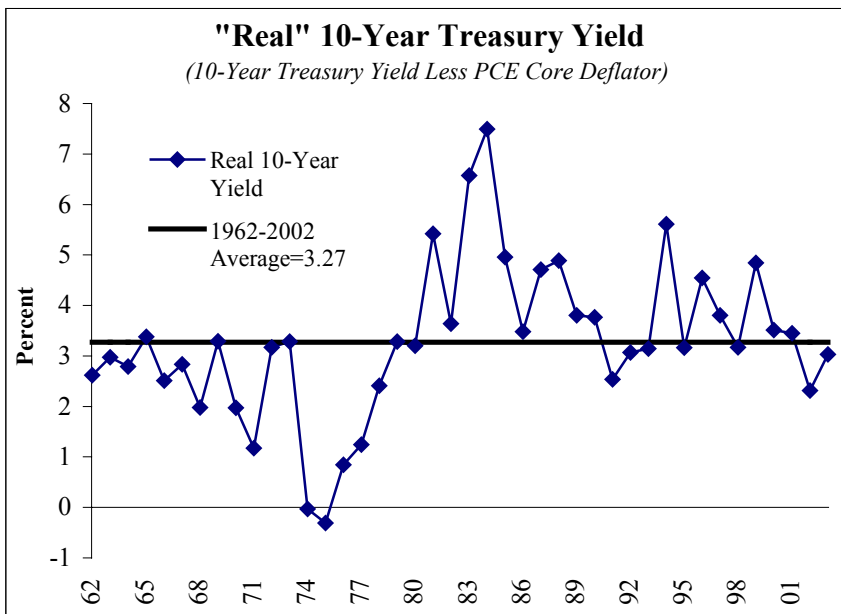
Both the core personal consumption expenditures deflator and the CPI are likely to head higher -- possibly by one-or-two hundred basis points from current levels -- during the course of the next 12-18 months². While it has its flaws, we think the core personal consumption expenditures deflator probably is the best measure of statistical inflation available. It also is highly regarded by members of the FOMC who believe that it gives a more accurate representation of core price pressures. If the spread between the dollar's current value relative to gold and its average value over the last decade remains within current ranges, the core personal consumptions expenditures deflator likely will rise into the 2.5% YoY range from 1.3% YoY currently. The CPI, which can be biased up and down by swings in energy prices, is a much more difficult call. If our so-called price level spread remains near current ranges, our model pegs CPI inflation near the 3-4% range. However, this may not come to pass, as energy commodities remain significantly overvalued in our model. As such, we could very well see a situation develop where the ordinary CPI begins to understate true inflation after having dramatically overstated it in the late 1990s.



² The Federal Reserve could head this off with a return to a market-based monetary policy, where forward-looking commodity signals would guide the Fed's liquidity stance. Inflation and deflationary mistakes would not occur if the Fed operated within the confines of this framework.

Statistical deflation in core goods prices also should reverse during the next 12-18 months. Core goods prices are deflating by 2.1% YoY and have been in decline since November 2001. By contrast, core services prices are rising by 2.74% YoY, but have been "disinflating" since April 2002. Our model essentially shows that deflation in core goods should reverse and that the gap between the two should narrow, as core services prices tend to take longer to react to changes in the value of money.

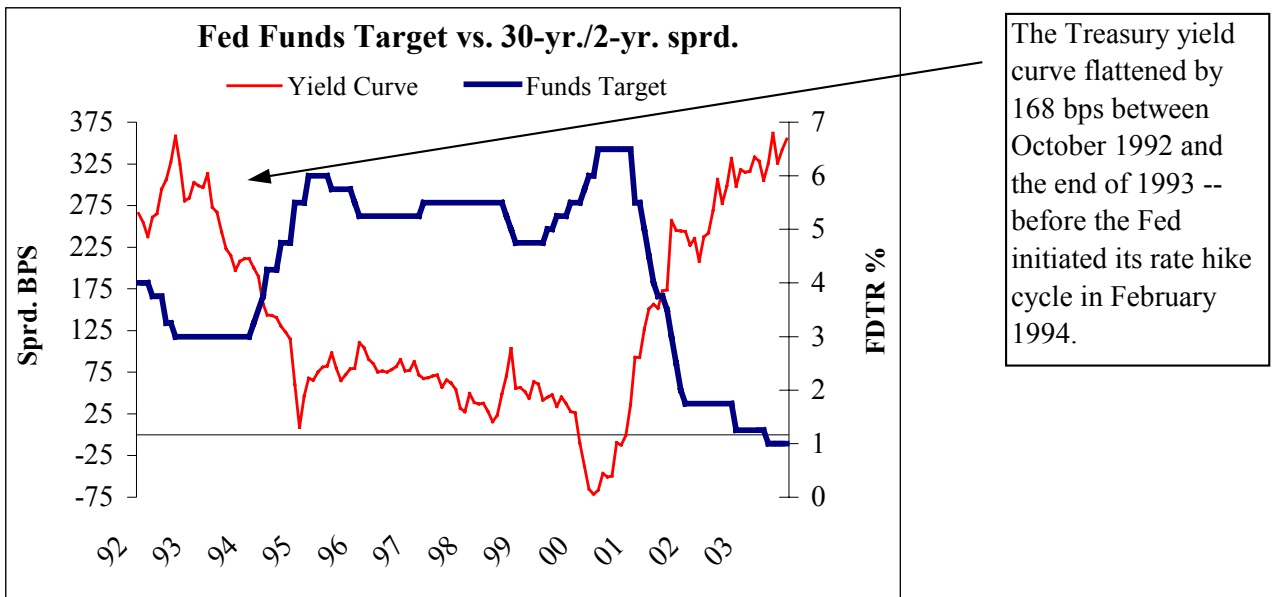
We think long-term Treasury yields could move up by 150 bps or more from current levels. The average 40-year "real" rate on the 10-year Treasury bond is 3.27%. That is, the average spread between the core personal consumption expenditures deflator and the 10-year Treasury yield has been 3.27% during the last 40 years. If the core PCE moves to 2.5% or so over the next 12-18 months from its current 1.3% level, the 10-year Treasury yield could eventually head toward the 6% mark.



The eurodollar futures market only is pricing for about 100 bps of rate hikes between now and December 2004.

Fed rate-hike expectations are likely to rise as growth accelerates. Most FOMC members have made it very clear that they want to economy to grow "above potential" for a period of time so that employment begins to pick up. Potential is defined as the simple mathematical sum of labor force productivity plus growth in the organic labor force itself. Most Fed officials think that this would be around 3.5-4.0% per year. Despite the dovish rhetoric out of the Fed, we think that several quarters of solid growth and a sustained turn in payroll employment will have the effect of ratcheting up 2004-2005 rate-hike expectations. In other words, we think FOMC members will tweak their Phillips Curve and Output Gap models as capital spending spreads and payroll growth resumes in a more convincing way. This should result in a steeper eurodollar futures curve and outsized pressure on the short end of the Treasury yield curve.

If 1994 is any guide, the 30-yr./2-yr. Treasury spread should flatten considerably from its current 357 bps levels before the Fed actually begins to lift rates. By way of comparison, the 30-year/2-year Treasury spread collapsed to about 200 bps in October 1993 from a high of 368 bps in October 1992. *This curve flattening occurred before the Fed commenced its rate-hiking cycle in February 1994.* The 30-yr/2-yr Treasury spread eventually narrowed to just 8 bps by the end of 1994, as the Fed's rate-hiking cycle neared completion. What is noteworthy, though, is that 46% of the flattening in the Treasury yield curve *actually occurred before the Fed even began to lift rates.* If we are even in the ballpark with respect to our growth and inflation targets, the gap between the long and short end of the Treasury yield curve will narrow significantly over the course of the next year.



The Treasury yield curve flattened by 168 bps between October 1992 and the end of 1993 -- before the Fed initiated its rate hike cycle in February 1994.

Conclusion: We think monetary reflation -- the decline in the dollar's value from an excessive level -- is an unambiguous positive for global asset prices and economic growth. However, if the value of the dollar relative to gold remains near current ranges, we expect some upward pressure on core statistical inflation, possibly by one-or-two hundred basis points over the next 12-18 months. If the dollar begins a sustained rise against forward-looking price-level indicators as growth and inventory building picks up, we will revise down our estimates for core statistical inflation and interest rates. However, even if the dollar

moves safely into a zero-inflation band near \$350/oz. relative to gold, we think that market interest rates are likely to tend up from current levels as Fed rate-hike expectations intensify with faster nominal growth. Real interest rates also remain depressed relative to their historical norm, which also suggests that long-term Treasury yields could rise by another 25-50 bps or so even in the absence of additional price-level pressures.

Michael T. Darda