Domestic Research
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The Anatomy of the Gold Move

The dollar price of gold, now brushing up against the $333 level, has jumped nearly $10 in the last two trading sessions to its highest level since 1997. The move began yesterday around 11:00 a.m., and intensified after the Fed minutes from the FOMC's November 6 meeting were released at 2:00 p.m. The dollar also continued its weakening trend against G6 currencies.

We think there are several catalysts behind the gold move and that gold should retain an upward bias going forward. This also means that commodities will retain an upward bias and that the dollar should continue to glide down against foreign exchange. Major catalysts behind the gold move are:

- **On-going tension over the Iraqi arms report.** The Bush administration has exacerbated geopolitical risks by insisting that Iraq is in material breach regarding WMD. Higher war risk increases the risks to commerce and reduces the demand for dollar liquidity.
- **The OPEC decision to increase quotas** in order to hold crude prices above market-clearing levels is a depressant to growth. This cuts into the demand for dollar liquidity.
- **President Bush's appointment of Stephen Friedman to Chairman of the Whitehouse Economic Council** likely will result in a poor fiscal stimulus plan. Friedman, who has long been committed to fiscal austerity economics, has been involved with the deficit-obsessed Concord Coalition. Incoming Treasury Secretary John Snow seems to have a slightly better record, as he was a member of the Kemp tax commission, which endorsed a flat tax. Overall, the markets are disappointed in the selections and not gearing up for a pro-growth change in tax policy. A less pro-growth tax policy at the federal level means an automatic "tightening" of the overall fiscal noose as states hike tax rates to recover revenues and maintain spending in 2003. This will continue to depress dollar demand.
- **The FOMC minutes.** Despite the claim that deflation risk is "remote" in the U.S., members of the FOMC seem to be worried about it. The November 6 FOMC minutes, which were released at 2:00 p.m. yesterday, made clear that members are more concerned than previously stated about the risk of deflation. "*A failure to take action.....would increase the odds of a cumulative weakening economy and possibly even attendant deflation*," the minutes said. With virtually the entirety of the FOMC dominated by academic Keynesians, there is almost no chance that excess monetary liquidity would be reeled in if the dollar fall goes too far. This increases the appeal of gold relative to the paper greenback.

- **More supply, less demand.** If the Fed were on a "price rule," or gold standard, it would be subtracting liquidity as the demand for it sank; instead the Fed is adding to its reserve position to maintain its 1.25% target on overnight "funds." The monetary base is up 7.6% YoY, with adjusted reserves growing by a modest 3.1%. Less demand and more supply means that the "price" of money, or its value against forward-looking spot indicators, falls.

On balance, we think this is a *bearish* re-flation, as the rise in gold is occurring largely for negative, growth-inhibiting reasons. This means that even though the deflation is unwinding, and may be fully unwound next year, it is coming at the expense of an extended period of economic weakness and a poor profit outlook. This is why the rise in gold to date has accompanied widening risk spreads and a soggy equity market. As a result, we would not begin to worry about the long bond unless gold skipped over the $350/oz. level and remained there for a sustained period. On a positive note, most *commodities* outside crude oil continue to show double-digit upside potential with gold at current levels.

2003 Commodity and Metals Forecasts

	Current Level	14-Year Equilibrium Price Based on $300 Gold	**Implied Upside at $300 Gold**	14-Year Equilibrium Price Based on $325 Gold	**Implied Upside at $325 Gold**	14-Year Equilibrium Price Based on $350 Gold	**Implied Upside at $350 Gold**
Commodities							
CRB	243.9	243.9	**0.0%**	264.2	**8.3%**	284.6	**16.7%**
DJ AIG (softs)	74.8	87.7	**17.3%**	95.0	**27.0%**	102.3	**36.8%**
DJ AIG (grains)	52.7	77.7	**47.5%**	84.2	**59.8%**	90.7	**72.1%**
Metals							
CRB Indust Metals	187.4	232.6	**24.1%**	251.9	**34.5%**	271.3	**44.8%**
Silver ($/oz.)	$4.70	$4.29	**-8.7%**	$4.65	**-1.1%**	$5.01	**6.5%**
Aluminum ($/lb.)	$0.68	$0.97	**43.3%**	$1.05	**55.3%**	$1.13	**67.2%**
Copper ($/lb.)	$0.76	$0.88	**16.1%**	$0.96	**25.8%**	$1.03	**35.5%**
Lead ($/ton)	$438.30	$504.12	**15.0%**	$546.13	**24.6%**	$588.14	**34.2%**
Nickel ($/lb.)	$3.52	$3.27	**-7.1%**	$3.54	**0.7%**	$3.82	**8.4%**
Forest Products							
Mkt Pulp ($/ton)	$445.00	$542.20	**21.8%**	$587.38	**32.0%**	$632.57	**42.2%**
Newsprint ($/ton)	$458.40	$544.27	**18.7%**	$589.62	**28.6%**	$634.98	**38.5%**

Source: Bloomberg/Polyconomics, Inc. as of 12/13/2002

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