Gold Needs More Irresponsibility

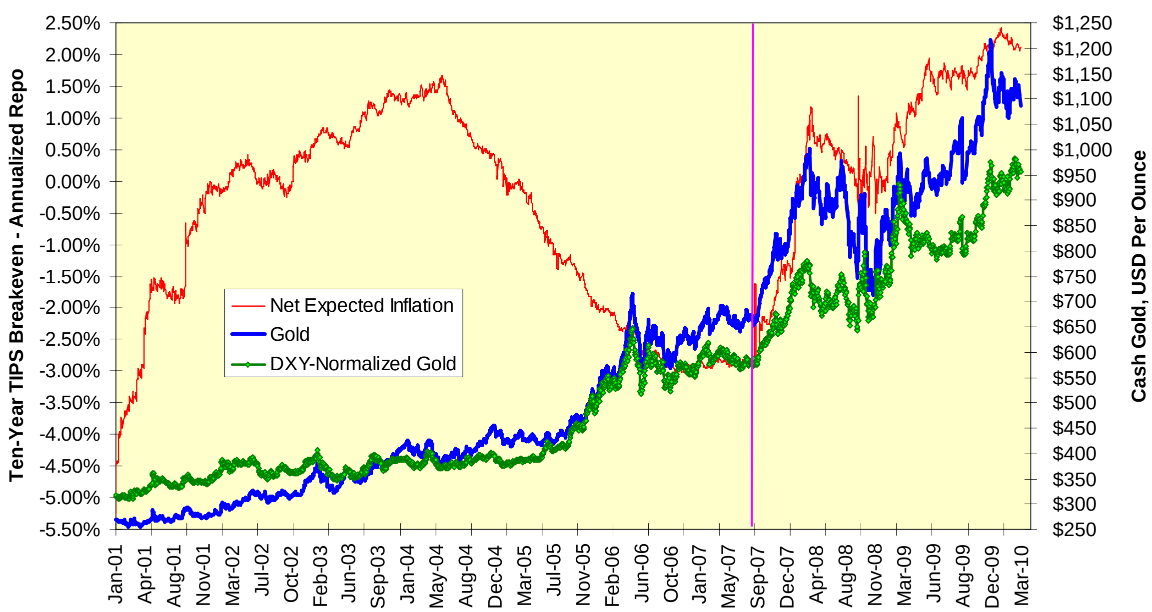
The comedienne Anne Stiller, wife of Jerry and mother of Ben, had a signature line loosely remembered as, "If I knew you were miserable, I'd be the happiest woman on earth!" I have no idea what her position on gold is, if any, and I though better of contacting her publicist for fear of winding up on one of those stalker lists, but her attitude towards others' miseries always has struck me as redolent of gold bugs' attitude toward the rest of humanity.

When we strip gold of all the mysticism, gold as a financial asset is really a very simple market: When expected inflation rises faster than the short-term interest rate costs of holding it, its price will apparently rise. A more accurate way of saying this is gold remains constant while the purchasing power of the currency measuring it declines.

Gold is an actual physical market replete with supply/demand balances as well. One of the great propellers of gold's move higher between 2004 and 2008 was the income effect in India, Dubai and other markets where gold was purchased, as it always had been, with newly acquired paper money.

This last factor allowed gold to rise during the period between 2004 and 2006 when short-term interest rates were rising. We can map the excess of expected inflation as derived from the TIPS market over the three-month repo rate against the price of gold both in U.S. dollar terms and in dollars adjusted for changes in the dollar index. Once the Federal Reserve began its loose-goose response to the financial crisis in August 2007, marked with a magenta line, gold began to track the net expected inflation measure closely.

Cash Gold Tracking Net U.S. Inflation Expectations After August 2007



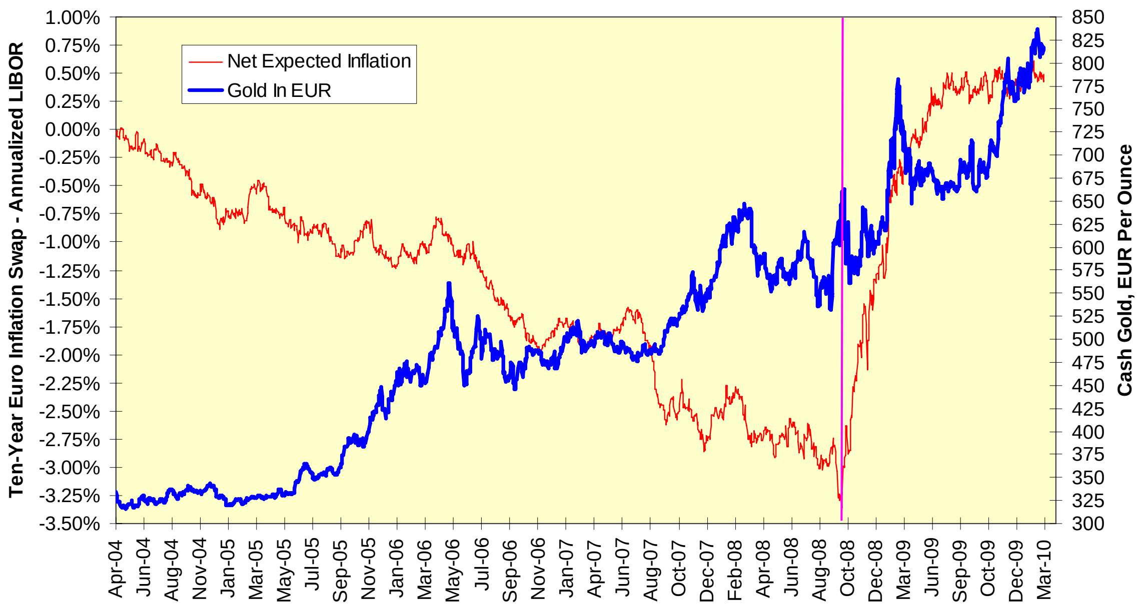
The net expected inflation measure peaked on January 11, 2010 at 2.415%, and has lost almost 30 basis points since then. Gold peaked on December 2, 2009 in USD terms; in dollar index-adjusted terms, it peaked much later, March 2, 2010.

The implications are astonishing: Years of ultra-low interest rates, global competitive devaluation of currencies, sovereign debt crises and fiscal policy out of a Fellini movie have pushed gold so far but have been unable to push it further. The yellow metal needs an exponentially greater level of irresponsibility. Will you do your part?

Euro Gold

The picture changes if we look at gold priced in euros and construct a similar net expected inflation measure for the Eurozone. Here gold rose along with the aforementioned increase in physical demand even as net expected inflation declined into the financial crisis of 2008, once again marked with a magenta line. Interestingly, the pace of gold's ascent did not change materially before and after September 29, 2008: The two periods are identical at 80.6% confidence.

Gold Exceeding Net Eurozone Inflation Expectations



Gold's recent rate of ascent in euro terms exceeds the change in net expected inflation. The idea that Europeans eager to hedge their Continent's woes are fleeing to gold and not to those once-scorned dollars is not supported in the data. Both measures have declined in recent weeks; net expected inflation peaked on February 19, 2010 and gold on March 5, 2010. The dollar has gained more than 2.05% against the euro on a full-carry basis since February 19, 2010.

Yes, we need more irresponsibility here in our global village. Some real Bugs Bunny, Zimbabwe numbers on inflation will do the trick. But then why would you ever sell your gold to get the paper money to buy food; were you planning on carrying your stash around with you?