Fed Waking Up To Inflation Problem

You have probably heard a lot more worrying about inflation reflected lately in the comments from Fed officials. There is good reason for them to worry, and they should have been worried long before now. The point which has to be understood about gold and inflation is that gold is a leading indicator, by about 14 months, for what inflation WILL do in the future. Thus, if gold turns down now, it does not mean that inflation is over now. It means that inflation will begin to wane 14 months from now. We are pretty sure that few people inside of the ivory halls of the Federal Reserve really understand this.

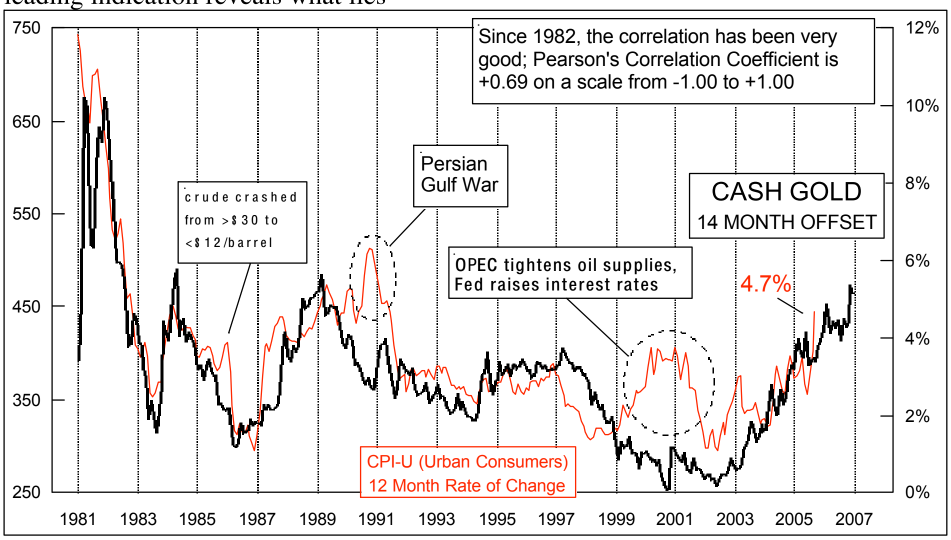
The two charts on this page help to illustrate this point. The first one shows gold prices versus the annual growth rate in the CPI-U. Gold's price pattern has been shifted forward by 14 months on the chart to show how its leading indication reveals what lies ahead for inflation. The correlation is very good most of the time, and when the two don't work out quite right, there is usually somebody (Saddam, OPEC, the Fed, etc.) with his thumb on the scale. Once the temporary exogenous force gets removed, the relationship gets back to working correctly once again.

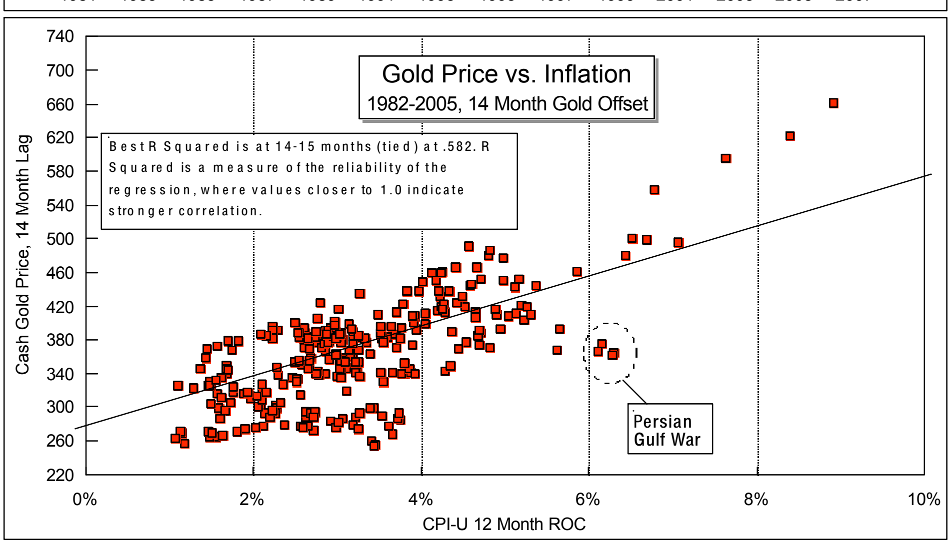
The "core rate" of inflation does not show the same acceleration that we are seeing lately in the headline numbers, because a lot of the price inflation we are seeing is directly attributable to the higher cost of petroleum products. Higher gas and plastic prices have not yet flowed through into the prices for other things, but that's coming. Truckers, ships, and airlines that haul stuff cannot keep operating at a loss for very long, and higher costs eventually have to get passed along.

To get a better understanding of just what this predictive ability of gold is all about, lets dig deeper into the numbers. The second chart shows the same time offset relationship, but in this case we have portrayed the forward-offset gold price with the inflation rate on an X-Y scatter diagram. If their relationship were perfect, then all of the dots would line up on a straight line, and the R-squared would be 1.0. As you can see it is not a perfect relationship, but it is still arguably a linear one, with a linear regression line added to the chart to help us visualize it. A linear regression line is a mathematical way of drawing a line through the data such that if you added up the distance of all the dots away from the line, that distance would be minimal for the linear regression line as opposed to any other line you might like to draw through the data.

For the lower values of gold prices and inflation, it appears as though the linear regression line might be skewed too high. This is due in part to the mathematical effect from upper right values in the chart, which are well above the line. Those dots stemmed from the high inflation seen during the early 1980s. There are also some dots above the linear regression line at lower values which you cannot see because they are being masked on the chart by the other dots. You can't see them due to the limitations of the graphics, but they still count toward the math. It might also be that the real relationship is not actually linear, but rather some mathematical version of curvilinear (parabolic, hyperbolic, etc.), with that curvature only becoming noticeable at the sort of upper extreme values for inflation that we hope never to have to live through again.

Let's assume for the moment that it is a linear relationship, or at least close enough to being linear at the lower values. Let's also assume that this linear regression line is the precise and proper median line for the sample population of values in our data. The implication is that if you know today's gold price, then you can reliably forecast the inflation rate for 14 months from now. It does not work out quite that perfectly in real life, but it does give us a rough target band of what to shoot for. Thus, a $470/oz gold price right now should equate to just above a 6% inflation rate in December 2006, plus or minus some amount of tolerance for the





imprecision of measuring inflation, and for gold's inability to perfectly model the future. Even if the regression line is wrong, and the actual inflation we see turns out to be only 4.5% to 5.0%, that would still be a problematic development for investors counting on the current 4.5% yield on 10-year T-Notes.

Why does this gold-inflation relationship work? There are a couple of reasons. First, gold's price is sensitive to the dollar's value. If the dollar loses value versus other currencies, that drives up the cost of goods and services if purchased in dollars, and that shows up as price inflation on the CPI. Second, if too much money gets created, by the Fed keeping interest rates too low to stimulate economic recovery, then all of that extra money sloshing around in the economy has to go somewhere, and much of it goes into gold. Eventually, that excess money works its way through the economy into real stuff, and leads to pricing pressure with more money chasing the same or fewer amounts of goods and services.

But there is a lag in how that flow takes place, and in how such pricing pressures can finally be noticed in consumer prices. Pricing decision makers don't want to raise prices too early and risk losing sales volume, so they hold off until they see that they can get away with it, or until they have to do it to keep from going broke from the pressure of their own purchases being made at higher prices. This explains, in part, why gold prices lead oil prices by 11 months, instead of 14 months like the CPI, because it takes a while for oil price changes to show up in other goods' prices.

So now that you know all of this, pretend for the moment that you wake up one morning and discover that you are Alan Greenspan, or even his replacement in February, and you want to achieve a stable money supply and inflation situation. You would realize that the 1.0% Fed Funds target that you had imposed was a bit too stimulative to the money supply, and that it has brought about this $470/oz price in gold. You have already raised the target Fed Funds rate all the way up to 3.75%, and now some of your fellow FOMC members are trying to convince you that rates are high enough to have done the job of quelling inflation. Are they right? Probably not, since the rates have not been raised high enough to push gold prices back down. If we want to have inflation down around 2%, like many of us got used to seeing just a short time ago, then gold has to be pushed down to somewhere below $340/oz. That's going to take a lot more pushing than a 3.75% Fed Funds rate is going to do.

Does that mean that the Fed is not going to stop? Well, that's a different question. If you get 12 guys together who are professional bureaucrats, and who are trained in the standard understanding of economics and inflation, there is no telling what they might collectively decide to do while sitting inside of the conference room in the Marriner Eccles building. What they decide to do is often different from what they should do. They might really think that they are done raising rates, and they might act accordingly at some of the upcoming FOMC meetings. But gold says that they have not yet licked inflation, and the risk here is that the dog might run away faster than the Fed can chase it to get a leash back on.

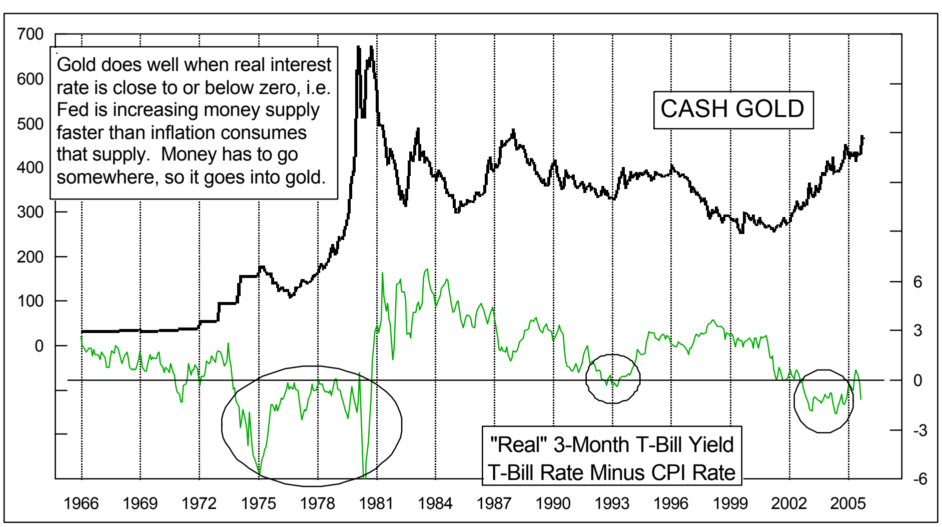
This point is best illustrated in the chart on this page, which looks at the "real" 3-month T-Bill yield. T-Bills are very sensitive to the Fed's manipulated interest rates, and have a longer track record in the data than the current practice by the Fed of using the Fed Funds target as its instrument of monetary policy (remember they used to use the Discount Rate for many years). When T-Bill yields are higher than the CPI inflation rate, this "real" yield is a positive number. That tends to be a condition that is not stimulative to gold prices, especially if the spread between T-Bills and inflation gets to be too high.

But if the Fed cuts rates too far, and pushes short term yields down below the inflation rate, that is a condition which is enormously stimulative to gold prices, because of that aforementioned excess money needing someplace to go.

The circled areas in the chart show periods when the Fed failed to keep short term rates ahead of inflation, and the result in each case was a strong period for gold prices. Only after the Fed raises rates enough to get ahead of inflation does gold finally top out and head downward. It appeared a couple of months ago as though the Fed had finally accomplished that, but now the higher oil prices have kicked the CPI up and the Fed is once again behind the power curve. Given the rate of ascent in the CPI numbers, we have serious doubts about whether the Fed can catch that runaway dog with only their recent quarter point rate hikes every 6-7 weeks.

Greenspan is not going to want to ride off into the sunset at a moment in history when inflation is just beginning to perk up again, and so he has several bad choices. First, he could stay in denial about whether there actually is a problem, and cite other measures of pricing pressure as evidence that the CPI is wrong. Second, he could increase the pace of rate hikes, in hopes of solving the problem quickly before he leaves office in February 2006. But we know that won't work because rising inflation is baked into the cake at least through December 2006. Third, he could decide to stick around a while, just until things settle down. We'd hate to have to handicap any of these.

Whatever happens, we are all going to be stuck dealing with higher inflation for a while.



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