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Economic Commentary

The Supply-Side Scuffle

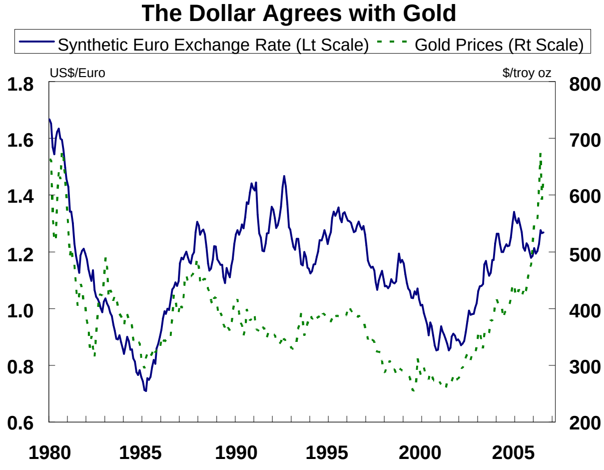
There is a huge debate taking place today amongst supply-side economists about the Fed, inflation and the economy. For the most part this debate is about arcane monetary theory. But, cutting through all the noise leaves us with just one important, but simple, question. Do you believe gold or do you believe bonds?

The answer to this question is important for the Fed as well. In the minutes from the August 8th meeting the Fed said that following "…seventeen consecutive policy firming actions, members generally saw limited risk in deferring further policy tightening that might prove necessary, as long as inflation expectations remained contained."

The key words here are "inflation expectations." What are these expectations? How does the Fed measure them? Chairman Bernanke has mentioned the TIPS spread (the spread between inflation-indexed and nominal Treasury bonds), but for the most part the Fed remains silent about what it really means.

This has typically been an easy question to answer for supply-siders. Gold, commodity prices, the value of the dollar and bond yields – in other words, markets that are sensitive to the changing supply of dollars – are the best measures of inflation expectations. They typically move in lock-step.

The Dollar Agrees with Gold

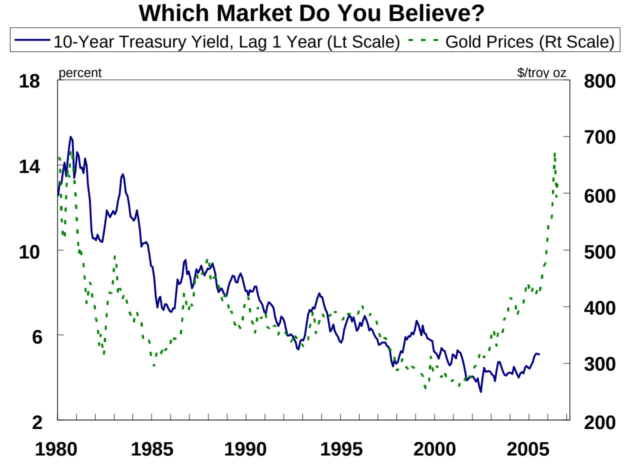


For example, between 1996 and 2001, when the Fed was tight, gold prices fell from $400/oz to $260/oz., the dollar rallied from $1.3 per euro to 85 cents and bond yields fell. All of this was a sign of tight money and supply-siders began to fear deflationary pressures.

Lately, however, these markets have begun to diverge. Despite having fallen from its recent peak of over $725/oz., gold prices have more than doubled from 2001 lows and stand at $610/oz. While somewhat stronger than it was in late 2004, the dollar has still fallen sharply and each euro now costs $1.28. Nonetheless, the 10-year Treasury bond yield, currently 4.79%, is well below the levels predicted by either current inflation rates or the price of gold.

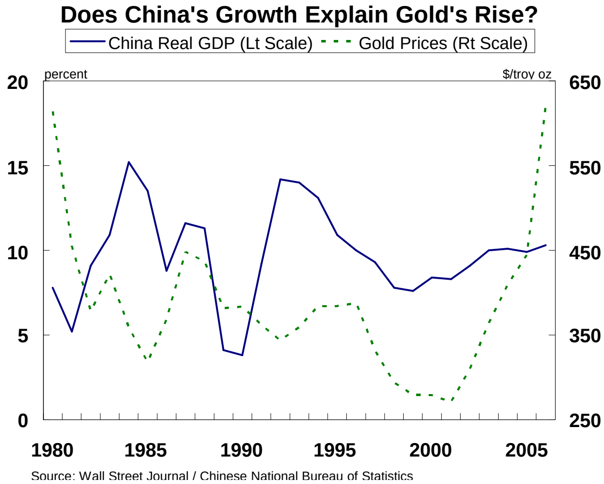
As can be seen in the chart below, between 1980 and 2002, with a lag of one year, bond yields have followed gold prices very closely. In fact, this has been one of the most highly correlated relationships in economics for years. But this correlation has now failed.

Which Market Do You Believe?



Some say that because the supply of commodities is relatively fixed, a surge in global growth (as we have seen in the past four years) will push prices up. In addition, many argue that the bond market is much larger than the gold market and is therefore a better indicator.

There are at least three problems with these theories. First, while bigger markets can help facilitate more accurate pricing, the gold market is vast by most standards. If you can believe that grocery prices are kept in line by the six grocery stores within your community, then you should not be questioning the gold market.



Second, US and global growth accelerated sharply between 1994 and 1998 (before the Asian financial crisis), but gold and other commodity prices fell anyway. Moreover, China has experienced average real GDP growth of 9.5% over the past 20 years. While some argue that China hit a "critical mass" in 2002/2003, which turbo-charged demand for commodities, we find it interesting that this market-changing, step-up in growth occurred at the same time the Fed cut interest rates to 1%. From our point of view, the commodity story is a Fed story, not a China story.

Commodity prices fell in the late 1990s when the Fed was tight, but soared when the Fed became accommodative starting in 2001. China grew strongly throughout the entire time period and there is no consistent relationship between its growth and commodity prices during the past 25 years (see chart).

Third, bond yields have been wrong before. In the mid-1970s, when gold was soaring, bond yields did not fully appreciate the extent to which inflationary pressures had imbedded themselves in the economy. Anyone who bought a 10-year Treasury bond between 1964 and mid-1973 (except for three months in 1970), and held it to maturity, received a yield that was less than the actual CPI inflation rate during the life of the bond. Similarly, in the early 1980s, real yields were the highest on record because the bond market did not accurately forecast the decline in inflationary pressures during the 1980s and 1990s.

History shows that the bond market has mis-estimated the duration and extent of inflationary pressures many times. As a result, we cast our lot with gold and the dollar. Higher inflation and bond yields are in the cards.

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