Fed Policy and Other Distractions

While the Fed declared that it would continue its purchases of US treasuries under so-called QE2 until the end of June, it also waffled and said that it would maintain its balance sheet going forward until inflation forced their hand to tighten. Breakevens rose, gold rose, stocks rose, US treasuries hardly budged.

Fed Funds will be anchored at 0.25% indefinitely unless inflation numbers force the hand of the Fed. This means that at long as housing doesn't recover, the Fed will be free to create effective inflation to erode the US government's debt.

A lot hinges on central bank policy these days and the Fed is still the most influential central bank in the world. As long as the Fed is pursuing a policy of creating inflation for as long as it does not manifest in official inflation data, that is as long as there are large balancing items like housing which are in deflation, investors must prefer anything to cash. In nominal terms, one would expect stocks to continue to rise. The same applies to commodities and gold.

Gold is interesting because of it is quite useless apart from being a universal yardstick of value. It is illustrative if not instructive to look at the time series of other assets in terms of gold.

Here we have the S&P 500, in terms of gold.

Moving off the gold standard in 1971 marked a long term peak in the S&P in gold terms as the real value of nominal assets came to be eroded by inflation. Stocks in gold terms continued to fall all the way until 1980 where Volcker’s Fed was able to tame the inflation that had been allowed to surge during Burn’s Fed tenure. From that point on, stocks rallied in gold terms all the way through Greenspan’s Fed. The 1997 – 2002 period looks like an aberration. New technology coupled with new finance (option compensation schemes) fuelled a bubble in tech stocks. This folly was reversed very quickly. It can be argued that Greenspan’s error was to attempt asset reflation at the cost of abandoning prudent inflation fighting policy. Inflation rose from 2002 to 2008 despite 9 rate hikes from 2004 to 2007. Arguably the rate hikes came too late and the asset reflation policy had allowed the shadow banking system’s credit creation machine to take hold and confound Fed policy. While stocks rallied from 2003 – 2007, in gold terms, they lost some 24%.

Here with the PE ratio of the S&P 500 in terms of gold

The derating of stocks as the US came off the gold standard is illuminating. The internet bubble of 2000 is hardly a molehill once PE’s are calculated in gold terms.

Bonds have done well in the last 30 years. Let’s look at what the Barclays Aggregate looks like in gold terms versus in nominal terms.

All we have done here is used gold as a proxy for inflation or currency debasement. There is no science or analysis whatsoever, merely pointing out a phenomenon. We do not recommend gold neither do we not recommend gold. We have merely used it as a numeraire.

The questions one has to ask looking at these charts is where are we in the inflation cycle? What will the Fed do to address inflation? What can the Fed do to address inflation? If the answers are don't know, nothing and nothing, then gold is still a good bet. Otherwise, one might say that stocks are cheap in gold terms both in levels and earnings adjusted.

Motivation: Unless CPI perks up the Fed will sit on its hands and perhaps even stoke effective inflation so as to erode the real value of Treasury's debt. This is good for gold and bad for all other assets. It is, however, good for equities relative to cash.

Ability: There is a whole essay in this. I will limit myself to the more trivial and naive and often thus more probable scenarios. If the Fed raised rates it could potentially wipe out its own capital. If the Fed raised rates, there is a rather complicated argument that it might actually further stoke inflation unless it could simultaneously reduce its own leverage. Another concern is the exposure of the commercial banks to US treasuries. Throughout 2009 and 2010, driven by necessity and opportunism and not a little collusion with the Fed, commercial banks bought US treasuries. With the Fed pinning short rates at zero and with 10 year yields at around 3.5%, the yield curve carry trade was a lucrative as well as capital efficient one. The Fed has to be careful that it does not precipitate a second banking crisis in US Treasuries. Apart from raising interest rates, the Fed may want to shrink its balance sheet. It can do this by doing nothing and allowing its assets to mature. But an end to buying of treasuries will put pressure on long rates and might potentially hurt other holders of treasuries such as the commercial banks.

It appears that the Fed has neither the will nor the ability to reverse course. Buy gold at 1530 USD per troy ounce and pray hard. You won't even know what to ask for…