

# Gold Down, Equities Up

Gold has fallen over \$115 since its \$1431 intra-day peak on December 7 while the 10-year Treasury yield has risen to 3.4% from a low of 2.4% on October 7. In effect, money is flowing out of bonds and gold and into equities, and that reflects the improving growth outlook. Our September 29 piece “Bubble in Gold and Bonds: When Will the Barbell Trade Unravel” discussed our negative view of both assets given the strengthening growth outlook.

## Gold Prices (last obs. January 28, 2011)



Source: Wall Street Journal; Encima Global

At a recent conference of investors we attended, large gold nuggets were passed around the conference table reflecting the current fascination with the precious metal.

- While some participants were constructive on the U.S. outlook, citing tightness in blue-collar labor markets and heavy investments now going into U.S. commodity production, most of the room seemed bearish on the dollar and the U.S.
- In favor of gold, they cited China's inflation, the risk of a euro breakup, gold demand in Asia and constraints on gold supply in South Africa and elsewhere. There were strong concerns about the national debt.

- Above all, the gold bulls were worried about the Fed and the QE2 precedent. Paul Volcker pointed out that a rising gold price is a negative assessment of a central bank, an insight that helped usher in two decades of dollar strength and fast U.S. growth as gold prices and bond yields fell steadily from 1980 through 2000.

The 2010 barbell trade enjoyed the odd situation in which the price of both Treasury bonds and gold went up. Markets were investing in opposite extremes – bonds as protection from the tail risk of a severe deflation and gold out of fear of Fed policy, recognizing that the Fed has caused major inflations (1970s, 2000s) as the value of the dollar was allowed to evaporate.

### **10 Year US Treasury Yields (last obs. January 28, 2011)**

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Source: Federal Reserve; Encima Global

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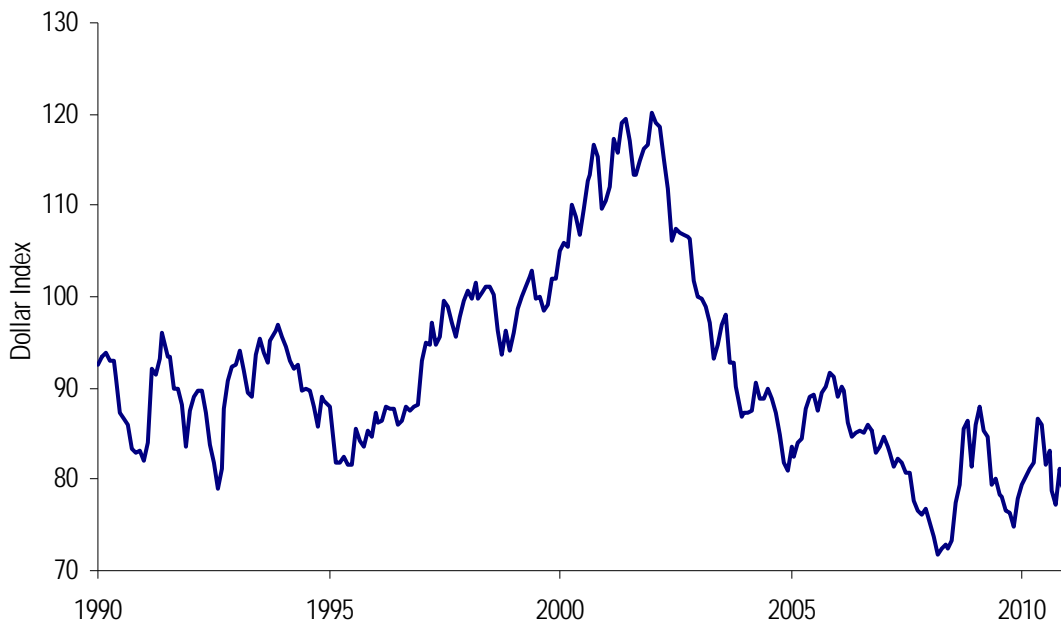
- Countering the inflation concern, we don't think the Fed is as inflationary as it looks. Money supply is not a useful indicator when credit is being rationed by regulators. The Fed is paying above-market interest rates on excess reserves, meaning it is operating like a SIV (structured investment vehicle) for the U.S. government. Treasury is able to claim a certain maturity for its bond issuance, but the Fed is buying back the longer maturities and funding them with overnight deposits from commercial banks.
- We think QE2 is not very stimulative from a monetary standpoint because there's no throughput through the banking system. The Fed's buying of long maturities causes a severe conflict of interest for future Fed policy, but not much growth. For that reason, we think QE2 could be wound down early with positive, not negative, market repercussions, though the latest FOMC statement gives no sign of that happening.
- Countering the deflation concerns that caused investors to pile into bonds in mid-2010, we note the lagging nature of inflation indices, the Fed's many past inflationary

mistakes, rising TIPS inflation, the weak dollar and inflation in emerging markets, even ones like China, India and Brazil where currencies have appreciated against the dollar. Recent developments (SOTU and the FOMC statement) have made clear that there is little risk of a contractionary fiscal or monetary policy.

- Our conclusion: Both gold and bonds have weakened somewhat as the risks of severe inflation and deflation lessen. However, with information on debt problems still coming out – yesterday’s daunting CBO report on the U.S. fiscal deficit, today’s S&P downgrade of Japanese debt, Tuesday’s FOMC board acquiescence to plowing ahead with QE2 – we think both gold and bond prices will have rebounds in 2011 if growth in the U.S. falters.

### **DXY – Dollar Index (last obs. January 28, 2011)**

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Source: Bloomberg; Encima Global

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