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Market Insights

The Fed, Tightening, & Gold

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Yesterday, in his eagerly awaited re-appointment testimony in Congress, Federal Reserve Chairman Jerome Powell tried to act tough, saying the Fed "could raise rates more over time", and emphasized that the Fed felt people's pain on inflation.

This of course is the same Fed chairman that only a few months ago was insisting that inflation was only "transitory", all the fault of supply shocks, and further that inflation affected the wealthy more than ordinary people. Inflation was a good thing, the Fed had said for some time, aiming to increase inflation, and saying that the Fed would aim for inflation above its 2% target for a while to offset the period when inflation was below 2%.

Different Fed spokesmen, joined by large banks, have each been trying to outdo each other in their predictions for more tightening. President of the Atlanta Fed, Raphael Bostic said the Fed "could easily pull $1.5 trillion of excess liquidity". It was intended to sound like a lot. But given that the Fed's $9 trillion balance sheet was less than $4 trillion only two years ago, it really is not a lot at all. He went on to add that the Fed could then watch the market reaction to decide on further reductions. Mmm…I didn't realize that propping up the stock market was one of the Fed's mandates.

Goldman is now calling for four interest rate hikes this year and an earlier than scheduled balance sheet reduction (a trial balloon leaked to Goldman?). Raise you, says Morgan's Jamie Dimon. "I would be surprised if there are just four interest rate hikes this year."

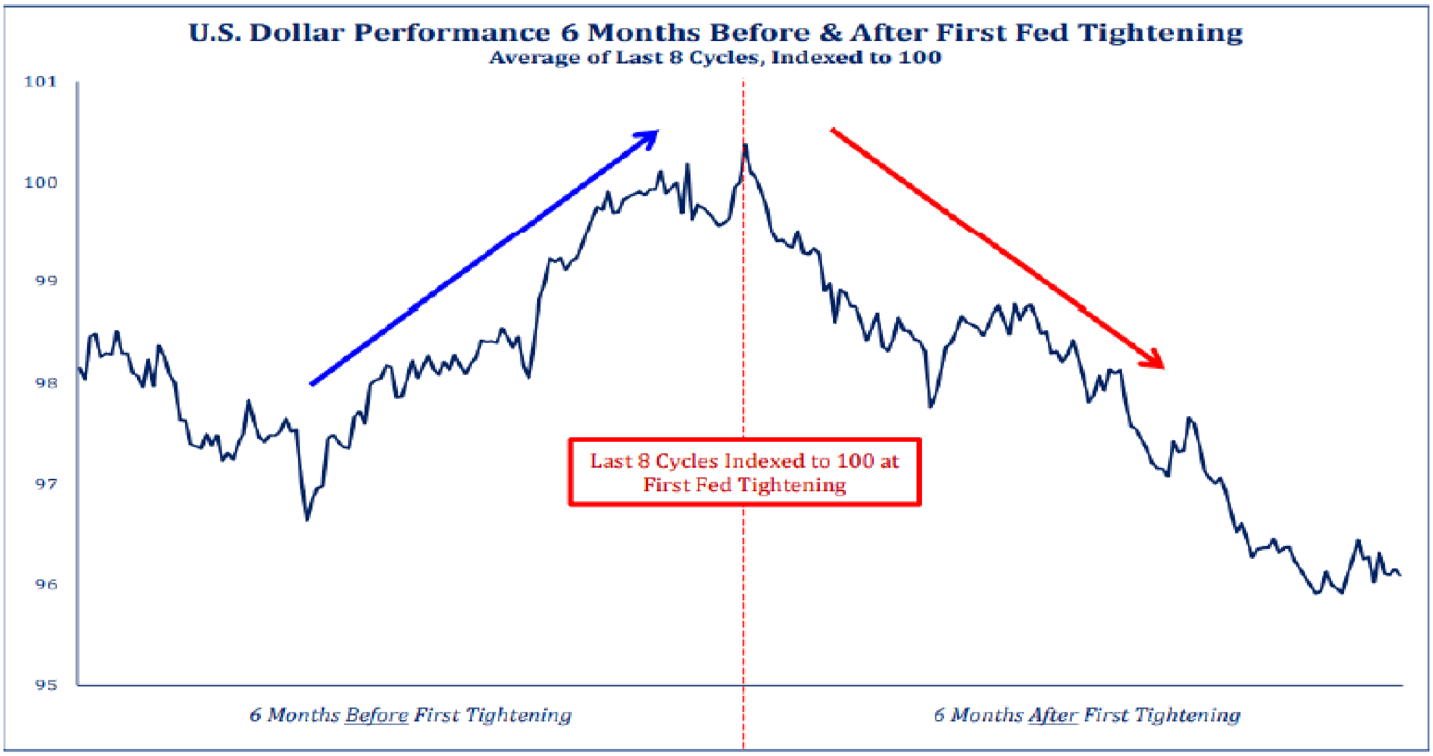
Dimon says that this year is going have the best growth ever, since after the Great Depression. Separately, he noted that consumer loan growth—something presumably he actually knows about—would take up to nine months to return to normal. In the best economy in 100 years? Mmm…

All this is bluff. Let's not forget that even under the most aggressive "tightening" that's been bandied around, the Fed's balance sheet will still be higher at year end than it was last year and interest rates will still be negative in real terms.

The market is laughing at the Fed. After Powell's tough-guy act, stocks are up, gold is up, bond yields are down, and the dollar is down.

We have noted before that gold has fallen for months ahead of any taper or rate cut, but risen for the period after the Fed actually started. (See for example our 3Q Portfolio Review.) This is because the Fed can threaten all it wants but when it actually starts, it's too little too late. In this cycle, the Fed is massively behind the curve on inflation.

The same phenomenon holds for the dollar. The below graph, courtesy of analyst Larry McDonald, is stunning.



The market, after seemingly believing the Fed's narrative for the past six months, has finally called its bluff. However, if the Fed tries to move more meaningfully to tackle inflation—it still won't get ahead of it, the way Paul Volker did in 1980—the stock market will have another hissy fit and the Fed will back down. That would be the most bullish signal yet for gold.

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If you are interested in discussing the possibility of a managed account, please contact our office. It would be our pleasure to serve your investment needs.