Thinking notes for October 28 2022

Title: Be careful what you wish for
Subject: The Fed’s next move
Theme: The Fed's next move will be to continue raising interest rates, and the Fed will not backtrack until something pretty bad happens in the US or the world economy.
Contrast: The Fed will slow its tightening pace soon, and this is reflected in the recent stock market rally

MAIN PRESENTATION:

Hello everyone, welcome to Finance Friday, our “sometimes, almost” weekly podcast discussion of money creation and its consequences. I’m HardmoneyJim trying to stay warm here in Jackson Hole where it’s 20 F outside (that’s about minus 7 Celsius for my English and European friends) after getting down to nearly zero last night. (That’s about minus 18 Celsius). We’ve had our first snowfall, it’s cold and it will get a lot colder in the coming weeks.

Winter is definitely upon us and I expect to start seeing some migrating elk show up in my backyard pretty soon. They are not here yet, but here’s a photo from last spring after the snow started melting to give you an idea of what I see outside my office window. They have yet to arrive, but will probably start showing up before Thanksgiving.

It is also winter in the stock market, as it has been declining since January. Still, the last two weeks, we had a false spring, meaning a fairly substantial stock market rally, and the probable reason for it is interesting, and I'll use that as a backdrop to kick off our discussion today.

The subject for today is the Fed's next move or moves, and the theme is that the Fed's next move will be the same as their last move; that is, they will either continue raising interest rates until they reach their objective of reducing CPI inflation to 2% or (and this is more likely in my

view) they will raise interest rates until something goes very wrong in the financial markets, in which case they will again resort to some form of money-printing to relieve the emergency, whatever that turns out to be.

This view is in contrast to the view being signaled by the recent stock market rally, a view among investors that seems to think the Fed has changed its mind and may stop raising interest rates after the December meeting, and that rates might not go as high as people previously thought. What the Fed ends up doing could be very important to investors because if the current market sentiment is right and the Fed takes the Fed funds rate to only 4.50 per cent or so and then stops raising rates, that could ignite a rally in longer-term bonds and be very positive for stock prices.

But I doubt that is the case. So let's explore why the market might think this.

This a chart of the SP500. You can see from the chart that we are in a strong downtrend ever since January of this year. It is a typical bear market pattern, a jagged sawtooth pattern downward, with higher highs and lower lows as we grind lower. On the far right, you can see the uptick, which has been a two-week rally of about 7%, and that is the opening for our discussion today.

The background for the bear market is the Fed's tightening policy, their inflation-fighting policy. Up until this week, we had 12 consecutive weeks of rising interest rates and declines in bond prices. This kind of persistent move is rarely seen in history; we have not seen this for many decades.

Two weeks ago today, on Friday October 14, Janet Yellen started a small rally when she said the Treasury Department might intervene in the Treasury market to repurchase less liquid (the so-called 'off the run") bonds even as the Treasury continues to issue new current coupon bonds. The bond market got a little excited and rallied, but I saw this as a courtesy to bond traders, allegedly to help with the smooth functioning of the market, but with no real long-run effect on interest rates. But Yellen floated the idea and bonds rallied a little anyway, even though they were down a little again the following week.

But next, on October 21, one week ago, Chairman Nick Timiraos (remember him?) of the Wall Street Journal came out with this tweet. Note the second paragraph: the Fed could be considering how to "step down to 50 basis points" at their December meeting. It is a given that they will raise the fed funds rate from its current 3% to 3.75% at their November 2 meeting. Nick is talking about the fact that the Fed might be considering raising interest rates by only 50 basis points in December. Before this tweet, the fed funds future betting put the odds of a 75-point December rate hike above 90%. Almost immediately after this tweet, those odds fell to 50%. The bond market moved up a little, but the stock market moved up very sharply and went on to rise 5% this week, a pretty big rally for one week.

Remember, "Chairman Nick" is considered the mouthpiece of the Fed. Someone at the Fed regularly uses him as a mouthpiece to convey Fed intentions. And as far as I know, Chairman Nick has never been wrong.

In his column, he wrote:

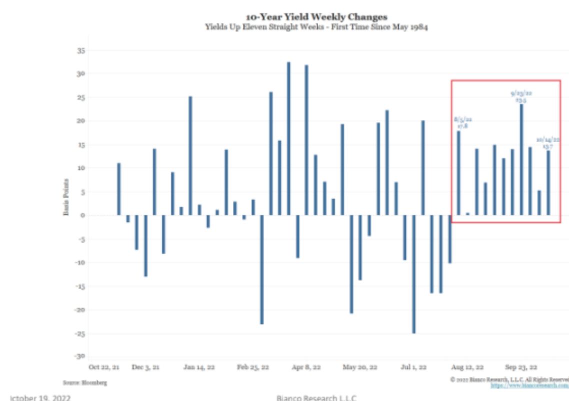
……Some officials have begun signaling their desire both to slow down the pace of increases soon and ***to stop raising rates early next year to see how their moves this year are slowing the economy*****.**
[Nick was referring to Charles Evans of Chicago and Lael Brainard, the Fed's Vice Chair]

And this news apparently comes from officials at the Fed, whomever Nick TImiraos usually talks to. Simply put, Timiraos is saying that some Fed officials are concerned about being too aggressive in their rate hikes, even in the face of severe inflation reports. Their concern is that

rate hikes take time to have an effect. So immediately, the stock market popped up, and interest rates on the Treasury 2-year declined.

On the same day (October 21) Mary Daly, chair of the San Francisco Fed, added fuel to the rally, and she also used the new term "step down." Daly said a slowdown to more incremental increases of 50 or 25 basis points will be appropriate as the Fed's benchmark rate gets closer to its terminal level for this hiking cycle. She also added that it is not yet time to "step down" the rate of rate hikes. So that left investors wondering, would a 50-basis point hike in December mean they are closer to their ultimate peak interest rate?

These two communications, coupled with an apparently widespread belief in the market that inflation is not a big systemic problem but only a short-term problem that will soon revert to the Fed's 2% magic number, ignited a rally in the stock market. The market seemed to see these comments as a potential "all clear" signal from the Fed.



On these comments, the SP500 rallied and is now up a full 7% in the last two weeks.
And bonds stopped their 12-week decline. Prior to this week, we saw 12 consecutive weeks of declines in the bond market. According to Bianco Research, this has not happened since 1984.

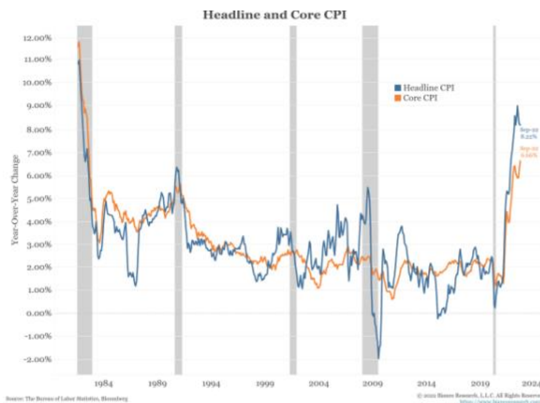
Recall that the reason for this relentless downward movement in the prices of both bonds and stocks is the Fed's tightening policies which consist of higher interest rates and decreasing the assets on its balance sheet (also known as QT). The 7% up move apparently reflects a market belief that the Fed is changing its tune and it's time for a pivot, time to "step down" the pace of their rate hikes and maybe not hike as much as the market previously thought. After all, Chairman Tim is the Fed's mouthpiece and Mary Daly is a Fed governor, so this seems like good information.

Now, I agree that the Fed will definitely "step down" … someday. But I think they have made no decisions yet because CPI inflation (even though it may have peaked) is a long way from 2 percent, which is their self-imposed "stable prices" mandate. So maybe they will go up 50 basis

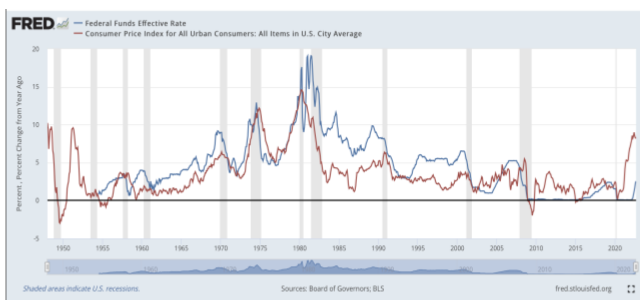
points in December, or maybe they will do 75 basis points, but that doesn't matter very much. What matters is how much they ultimately raise rates and how long they hold them high. And as I'll explain today, the thing that will ultimately, someday, cause the fed to loosen policy, or pivot, or reset, or "step down" or whatever you want to call it, will probably not be anything the Fed can foresee or plan, and it will likely not be a very pretty or a very happy circumstance.

In other words, if you are hoping for a change in Fed policy, be careful what you wish for.

So, what do I think the Fed will do? Let's look first at the Fed's guidepost, the measuring tools they use to calibrate their next move. Their main yardstick is core CPI inflation or their version of it, core CPE. (My usual disclaimer: Once again, I am using the word "inflation" in relation to consumer prices, even though I think a proper definition of inflation is an excessive increase in the money supply. I am using the Fed's terminology, their concept of inflation.)



So here we have our regular CPI inflation graph. The orange line is core cpi, or CPI, less food and energy. The latest number (September) is at an all-time high for this cycle. The raw CPI number (blue line) went down a little, to 8.3%, because gas prices declined a bit, but core CPI has not yet peaked and shows no sign of decreasing. Gas price increases are included in the raw CPI number, and gas price increases are not what the Fed considers inflation.



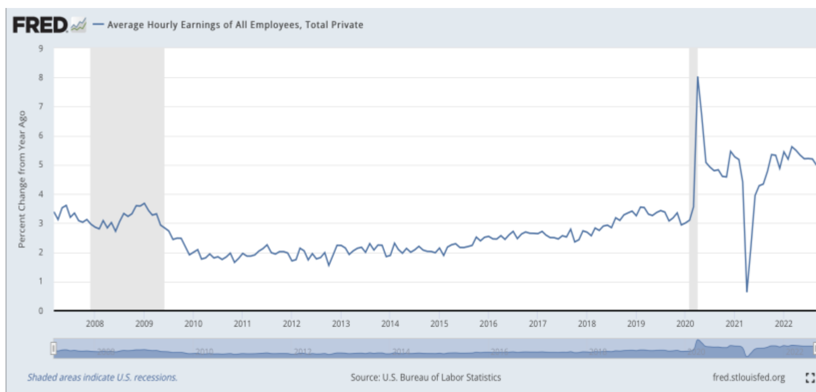
Now, look at this complicated looking chart, which shows the fed funds rate, and the annual rate of change in the consumer price index. The blue line is the effective federal funds rate, the key short-term rate the Fed sets directly and uses to benchmark its policy. The red line is the core consumer price index. That's the blue line that trends above the red line. Look at the

history from 1980 to about 2000, and see what the Fed had to do to get CPI down to their magic number of 2%. They had to keep the fed funds rate much higher than the CPI for a long time.

Notice that they kept the fed funds rate well above the CPI and had to keep it there for an extended period. Notice also that the CPI fluctuated in its general downward trend, and the fed had to raise its fed funds target repeatedly as CPI inflation raised its ugly head. In other words, it was a long battle with skirmishes along the way, and it was not clear at the time if the Fed would prevail over CPI inflation.

Now look to the far right of the chart and notice how much higher CPI is today than the fed funds rate. The Fed funds rate today is 3.08%. Core CPI is 6.7%. The Fed is talking about a .75 rate hike in November and another .75 rate hike (or maybe 50?) in December. That gets you to a Fed Funds rate of 4.25 to 4.5%, obviously well short of the core CPI of 6.7%. Recall that we have to get the short-term interest rates above the core CPI to avoid the perverse incentive of borrowing to spend on consumption. Does anyone think core CPI will fall from 6.7 to 4.5 or lower by the end of the year?

So it seems many, by their behavior in the investment markets, are counting on the core CPI to decline fairly soon. But how fast can CPI really drop? Remember that most of the prices in the core CPI are housing and services. How quickly can they decline? It's true that the rate of increase in the cost of shelter is slowing somewhat and will slow further, but recall that these costs take months to show up in the CPI, and the CPI is what the Fed is targeting.



The other large component of core CPI is services of various kinds. The cost of labor is the key component of all service costs, so let's look at the cost of labor. This is average hourly earnings in the USA, courtesy of the Labor Department. Notice that pre-pandemic, the annual increase in the cost of labor was around 2-3%, but now it has risen (after some pandemic fluctuations that canceled each other out) to a solid 5%. Even when hourly earnings plummeted during the Pandemic, they went down to a 1% rate of increase for only a month or two. Earning increases never went negative. So it seems we have 5% increases in labor costs built into the economy for a while. So I suspect you will not get the service components of the CPI down to 2% unless you get labor cost increases down to that level, the same level they were when the CPI was at 2%.

But a slowdown in labor cost increases is not in the cards for now because the labor market looks pretty strong. Unemployment is steady at a very low 3.5%. Applications for unemployment relief are not going up. There is some indication that job openings are declining, but there are still a lot more job openings than there are people to fill the jobs. So far there is no stress in the labor market. So the labor market is telling us the economy is not slowing down soon.

How much employment does the Fed have to kill to get wages to stop rising at 5 per cent? Unemployment is the lowest it has been since 1969. If the Fed causes enough suffering to get it to 5 or 6 percent unemployment, will that make the job market competitive enough to get wage growth to moderate? Remember, higher unemployment does not necessarily mean lower inflation. During the inflationary 1970s, we saw very high unemployment rates and this was still insufficient to kill enough demand to get CPI inflation down. For example, in both 1979 and 1980, we had unemployment at 6 to 7% and CPI inflation at 12 to 13%.

That was true stagflation – a slow economy and high CPI inflation, a situation we could easily enter as the Fed continues hiking rates.

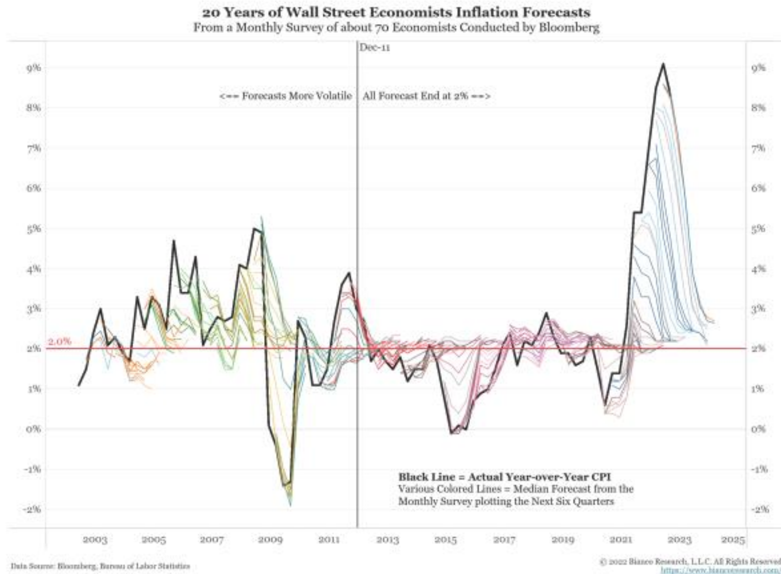
In addition, real GDP growth came in a few days ago above expectations at a positive 2.6% year-on-year. Does that sound like an economy in which the labor market is going to weaken any time soon?

Then there is the problem that the recent stock market rally actually undermines the Fed's efforts to reduce demand in the economy. If the market stays high, the Fed believes the "wealth effect" (the feeling of being wealthy because stock prices and house prices are high) goes up and, so their theory goes, people spend more. But the Fed wants the opposite Remember, the wealth effect was specifically cited by Ben Bernanke when QE started. He wanted to raise asset prices to cause people to feel richer so they would spend and invest more. The wealth effect is "stimulus" in the Fed's view. So now they want to do the opposite, that is, generate a negative wealth effect to induce people to spend less, thus lowering prices. When the stock market rallies like it has the last 2 weeks, this only increases the Fed's resolve to maintain tight monetary conditions.

So how high will the Fed have to raise the fed funds rate before higher rates start to destroy demand? I would guess a lot higher than 4.5%. And an equally important question is, once they reach their target rate, whatever that turns out to be, how long will they hold rates high before they start loosening conditions?

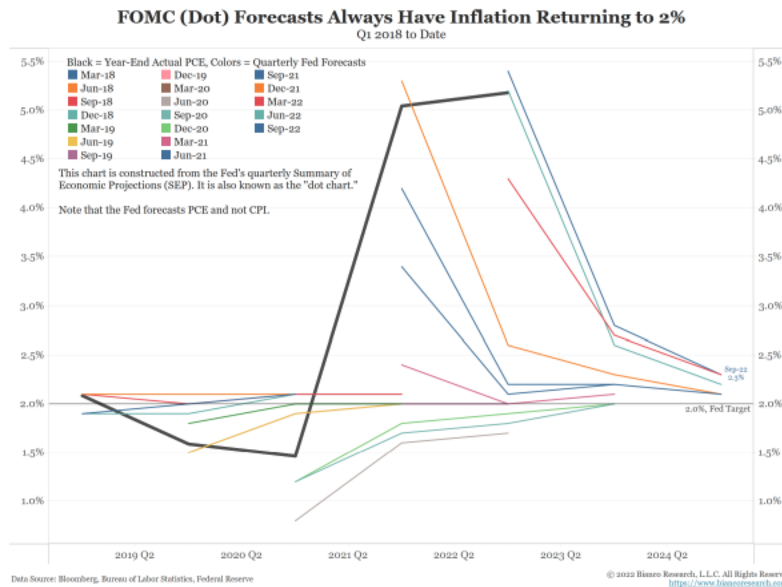
No one, not even the Fed, knows. If core CPI stays persistently high and comes down slowly, as it did in the 1970s, it would be easy to see the Fed getting fed funds up to at least 5 or 6% and keeping it persistently high for a long time. That is my thinking. But this is obviously not the thinking that has driven this week's rally in stocks and even bonds.

On the contrary, there is evidence that many investors think the Fed is in control of inflation, that we are going right back to 2% CPI inflation, and in a year or two everything will be like 2019 again, with low CPI inflation, low interest rates, and a booming stock market.



I've shown you charts like this before, but it is worth revisiting. This excellent chart from Bianco Research shows 20 years of inflation forecasts by wall street economists. Notice that since 2012, when 2% CPI became the Fed's explicit target, these economists always forecast a rapid reversion to around the 2% CPI inflation mark. No matter how wrong they are and how high the CPI goes, they persist in forecasting CPI inflation back to 2%. In effect they are always saying that today's inflation rate is the highest it will ever be.

Today, they are saying that even with CPI inflation at 8-plus percent, and core inflation at 6.7 percent, that it is going right back to the 2-3% range by the end of 2024, only about 2 years from now.



And amazingly, the majority of Fed economists think the same thing. This chart is the result of what is called the “dot plot,” where members of the Federal Reserve Board periodically forecast and publish their inflation expectations. Their individual forecasts vary a little bit, but in general they think CPI inflation will converge to 2% within a couple of years. Whether they all actually believe this or not is questionable, in my view, but what is important is that they publish this and act on it as if it were true.

So I suspect that most economists still think CPI inflation is transitory. In my view this is classic groupthink by designated experts, something we see a lot. They think inflation is serious, but they also think it can be fixed very soon. Recall that these same geniuses did not see inflation coming in early 2021 until well after the fact, and they denied it was a problem until very recently.

So why do they think CPI inflation is transitory? I guess they think the recent surge in CPI is mostly due to supply disruptions from the Pandemic, the China lockdown zero covid policy, the Ukraine war, and energy supply disruptions. On top of that, there was a one-time demand shock from the sudden reopening of the economy post-pandemic. I’m guessing this is what they think. And there is some truth in this line of thinking

But what if the supply disruptions are more permanent than they think? Is China going to be the same trading partner it was during the period up to 2019, supplying us with tons of cheap consumer goods, or is China now in a more militaristic, less commercial mood? What does the zero-covid lockdown in China say about their willingness to trade and supply us with cheap goods? Will we be re-shoring a lot of manufacturing to the USA with all the costs that entails?

And can the world supply chain just re-establish itself like it was in 2019, or have there been so many changes in supply and demand patterns that we need major revisions to the supply chain, and this takes time?

What about the labor cost situation? Doesn't there appear to be a change in what people will do, how much they will work, and at what price? What if there is a permanently higher labor cost built into the economy?

What about energy? Isn't energy showing signs of a multi-year cycle where costs will remain high? Green energy alone, if it persists, will keep energy costs very high. And as we know, higher energy costs affect most manufactured goods in a profound way. So in all these areas, it seems costs could remain persistently high for a long time.

Another factor, perhaps more important, that I think many investors are missing is the effects of monetary policy. As a result of years of QE, which was used to pump up asset prices and insert lots of new money into the banking system, there is too much money chasing the goods. Short and intermediate term, the Fed can reign this in somewhat. But long term, our government is approaching a point where the required expenditures – basically the entitlements and the interest on the treasury debt – could overwhelm the government's ability to collect enough money to pay for it all. So there will have to be some kind of reckoning in which the debt is paid down in cheaper dollars. Until that happens, we will be prone to inflation.

The spendable money in the system still far outweighs the supply of goods and services. This is only partly due to product shortages that come from supply chain issues, energy shortages, and disruptions in trade. Much of the pricing problem is due to too much money. But the Fed has repeatedly said they do not think the money supply has anything to do with pricing. Simple logic tells me they are wrong about this. So if they are wrong about that, and they completely missed the emergence of consumer price inflation, how do we know they will not miscalculate the economy's reaction to their tight money policies? To the Fed, everything will be fine, until one day it isn't fine. Then something will break, something they cannot foresee from their ivory tower in the Eccles Building.

For the present, the biggest issue for investors in my view is the complacency of the stock market. Yes, the market is down a full 20% from its peak in January, so its tempting to think it has corrected adequately from its lofty highs. Still, the downward movement has been orderly

and surprisingly not volatile. A real bear market (the kind I have been through as a professional portfolio manager managing the money of widows and orphans) should show more panic, more volatility, and more fear. But this market is orderly and calm.

Meanwhile, as interest rates keep rising, the financial system seems more and more vulnerable to some kind of systemic event, some kind of shock, something like what happened to the UK pension funds and the Bank of England a few weeks ago, but bigger. I think it is nearly impossible to know where the next shock will come from, as the financial system is just too big and too complex and too opaque to predict in detail.

But look what always happens. This chart from Merrill Lynch shows how fed tightening cycles with rising rates usually end, and it is not usually pretty. Volker hikes rates and crashes the market in 82. Greenspan hikes rates and crashes the market in 1987 and again in 1994. Then there is the Long Term Capital Management crisis, the tech bubble and the tech stock crash of 2002. Then the well-known subprime crisis of 2008. What generally happens is that the Fed hikes rates until something breaks, meaning some crisis interrupts their orderly systematic plan, then they have to immediately intervene with lower rates.

Mike Tyson said everybody has a plan until they get punched in the face. That is the Fed today. They have a plan for systematic rate hikes, a gradual cooling off of the economy, small increases in unemployment, lower CPI to 2%, then everything goes back to normal. The plan looks great in their simulations. But the chances of things happening according to plan are very small, in my view.

So I think it is unlikely that we will have a smooth rate hike, an orderly decline in the stock market, a gradual rise in unemployment, and a symmetrical decline in the CPI. The Fed is going to feel compelled to fight inflation the good old-fashioned way – by killing demand. But they will wreck something – some firm, some industry, some foreign central bank – along the way, inducing a panic selloff of financial assets that spreads into the entire financial system. Or if the fed doesn't wreck something, we could have an exogenous event like a war that our financial system is not equipped to handle.

What I suspect will happen is that, seemingly out of the blue, financial bodies will start floating to the surface and the Fed will react by printing money, most likely to the central bank or to the industry or the systemically important company that needs to be saved. When they do this, they will say it's an emergency action and not part of their monetary policy. That is what the Bank of England said when they intervened to save the British pension system a few weeks ago. But that will not be true, because their expansive monetary policy is what causes the asset bubbles to get too big and the debt (the leverage) to get too high in the first place. Whether they like it or not, all of the boom and bust that characterizes modern central banking is part of their policy, it is inherent in their actions.

Now I am speculating, but in the end, my guess is that some emergency will intervene so they cannot complete their inflation-fighting program, they will have to inflate again by lending new money to some troubled entity or industry and accept a higher rate of CPI inflation as their new normal. I suspect they will not be able to hold CPI inflation at their magic 2 per cent, but will have to accept higher CPI inflation and higher interest rates for years to come. That probably means slow or negative growth in many countries. So yes, I think, and I am speculating, here comes stagflation.

So to summarize: The Fed will eventually pivot, but not because it is happy with the CPI numbers or because it is afraid of stocks going down too much. As I pointed out, the Fed wants and needs stocks to go down because a negative wealth effect is key to their strategy. The Fed is going to execute the plan laid out in Jackson Hole in August until they can no longer execute the plan. Powell was unequivocal in that short speech, stressing such points as:

- The FOMC's overarching goal is to bring consumer price inflation back down to a 2 percent annual rate of increase.
- This will require a prolonged restrictive policy.
- History teaches us not to ease monetary conditions too early.
- We understand this policy will cause unemployment and pain to businesses and households.
- We will “keep at it” until the job is done.

So they will continue to push interest rates up and slow down money creation. This will continue to cause stock prices to fall, increasing the negative wealth effect. Higher interest rates will lower business investment. Lower levels of investment will reduce the demand for labor and increase unemployment. Lower investment and higher unemployment will generally slow economic activity, meaning we will have less consumer demand, less money spent, and slower price increases.

At least, that's the Fed’s plan. And all of this has to show up in core CPI because that is the metric the Fed uses to gauge its success, that is their guiding star, and that is the number they have bet their careers and reputation on. It doesn’t matter if they slow the economy and don’t get the core CPI number they want. They will keep banging on it until they get their number.

Because if they don't reach their 2% core CPI goal they are failures by their very own standards; they are self-proclaimed losers. And that is not an option for them.

So they will keep pushing up interest rates until some big surprising event intervenes, as it almost always does. Then they will resume QE but call it something else, and say their resumption of QE is not monetary policy, but a necessary response to a "financial emergency."

The bottom line, and here is why I titled this discussion "Be careful what you wish for" is this: The Fed is boxed in by its own policies because it will stay committed to its policies until something bad happens. So if you are wishing for a pivot, a "step down," be careful what you wish for, because I believe when the pivot or change in policy comes (and it will come), it could be in response to a serious crisis that nobody wanted to happen. And at that point the pivot will not be enough to save the stock market from further declines.

[stop for Q&A and comments]

COMMENTS ON GOLD

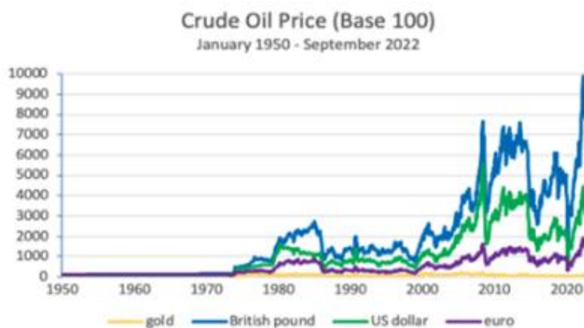
You probably know I'm in favor everyone owning gold, in some amount. Nearly 40 years ago, when I started as a stockbroker working for Merrill Lynch, the company recommended that all investors put 5 to 10 percent of their investment assets into gold. That was in 1984 when CPI inflation was receding but was still strong in the memories of everyone. I think that is still good advice today, and perhaps even too conservative, but I won't pound that drum too hard. Your mileage may vary, so you need to decide for yourself if you want to put some savings into gold.
https://mises.org/wire/gold-natural-money

As I said at the beginning of this talk, the markets are pricing in a lot of faith that the Fed is going to get inflation under control without a big blowup. And as we saw, as the Fed has tightened, the expectations for long-term inflation have remained pretty low. We can see that in the economists' forecasts I showed earlier and in the performance of stocks with very high PE ratios, meaning those stocks that will not pay off in cash earnings until way out in the future. These high-priced stocks, mostly tech stocks, are long-duration assets that only do well if expected future inflation is moderate and expected future real interest rates are low. Stated another way, expectations of high inflation are not yet deeply embedded in the minds of the majority of investors.

When and if that expectation of embedded inflation takes over, that should be when you see gold go up in dollar terms. Gold will do well once people realize that inflation won't come down to pre-2020 levels but will settle higher, maybe between 4% and 6%.

The disappointing performance of gold this year is somewhat clouded by the strong dollar. In yen, for example, gold is at its all-time high, so if you were looking to hedge against the decline in the yen, you would have done well owning gold. Since 2019 gold has gone up over 70% against the yen. That is roughly twice as good as the price of yen in dollars.

So if you think of gold as a currency, you can think of it as a hedge against other currencies.



I ran across a pretty good article on gold on the Mises Institute website called “Gold as Natural Money” by veteran gold analyst James Turk. I recommend you read the article, and I’d like to highlight a few of Turk’s points here. (So again, go to Mises.org, the article "Gold as Natural Money," by James Turk).

Modern money production is a system of pure credit creation, meaning there is no physical commodity underlying our monetary system. In its best form, money production today, pure credit creation, can be productive if it is done by the free market decisions of entrepreneurial bankers. And if it could be kept that way, I believe we could have continued economic progress and growing prosperity. But money production by the banks is easily abused or even controlled outright by ambitious politicians. They get away with their policies of money production for cronies or money production to support some collectivist ideology because we, you and I, the population, the voters, do not know enough about the banking system to vote them out of

office. So, as I have said many times, we can only have sound money once we understand how the current system works and it is unsound.

So the recurring bank and currency crises throughout history, like the one it seems we are going into now, result from human error and other human frailties that inevitably undermine or even destroy fiat currency, like the unwillingness to “take away the punchbowl” after a period of prolonged credit expansion. These problems are inherent in fiat currency, but gold is different.

Gold does not need a central bank. Gold money's proper relationship to the government is that government should enforce contracts written and settled in gold. Unlike fiat currency, gold needs no other government involvement. Gold is money that manages itself because growth in the gold stock (the money supply) is controlled by two natural facts: profitable mining and the physical attributes of gold. Together these forces impose discipline on the production of gold that prevents the quantity of gold money from getting to high relative to economic production. I'm saying that gold production – mining – competes for the same resources as industrial production, so in a market economy, its value relative to other commodities and industrial products always stays in check. This is a key factor explaining why gold preserves purchasing power over time.

Paraphrasing the author, James Turk, this reliable interconnection between gold’s supply and demand sets gold apart from national fiat currencies. Gold is tangible; national currencies are an intangible financial promise. Unlike fiat currencies, gold has no counterparty risk. This risk arises because fiat currencies are promises, and promises do get broken, as was demonstrated in the 2008 financial crisis and countless other banking and fiat currency crises that devaluate our money.

Gold is natural money that has served humanity well throughout history by enabling people to achieve an ever-higher standard of living. We don’t really know when gold began to be used as money because its use actually predates written history, but it is hard to deny that denied that gold was the money preferred by a free market and still would be if governments had not invented fiat money and imposed it on the population.

This chart from Turk’s essay illustrates the consistent value of gold over time. The analysis records the price of crude oil since 1950, priced in gold as well as the dollar, the pound and the Euro. (note, the Euro did not actually exist before the 1990s, but it's value was initially defined by the German Mark, so that was the preceding currency for the Euro)

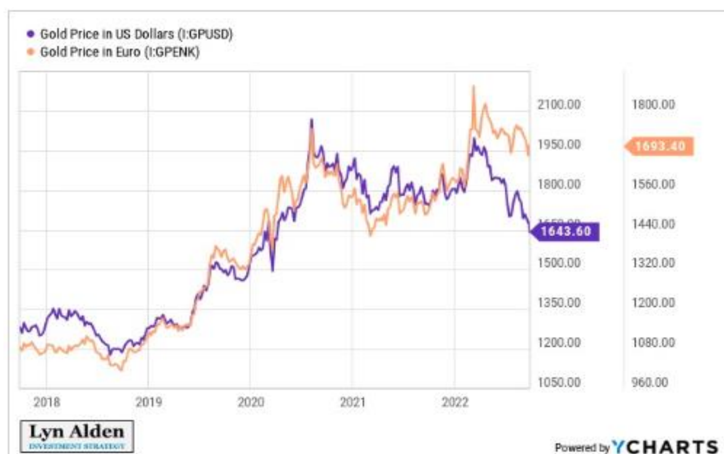
I want to emphasize two things about this graph. First, it illustrates the consistent long-term value of gold over time. Second, it prices what is perhaps the world's most valuable industrial commodity – crude oil – in a truly stable currency. As you can see, both commodities, oil and gold, are stable in relation to each other. You can see that compared to these major currencies of the world, gold still buys as much oil as ever, or stated another way, the price of oil has hardly changed in terms of gold.

Some people have been disappointed that gold hasn't risen more in price recently. After all we are getting big CPI inflation, but gold is actually down versus the dollar since CPI inflation has become a big problem this year. Don't let what might appear to be short-term weakness discourage you from investigating gold as a way to save wealth. I believe gold is likely to remain modestly priced in dollar terms as long as the Fed continues to tighten monetary policy aggressively, but should do better relative to the dollar when the Fed has to pause or pivot or "step down," whatever the popular terminology is.

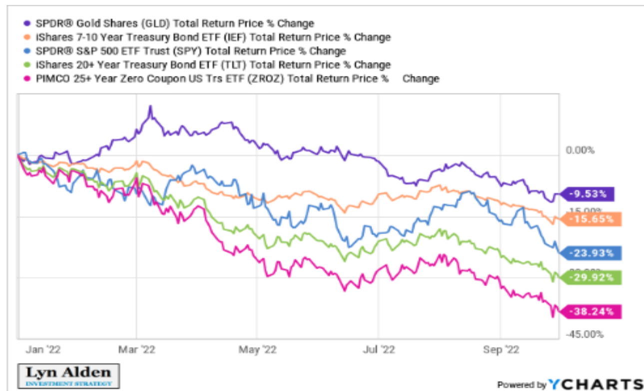
Gold is a currency, but it also competes against other investments. Environments with strong corporate earnings growth, with or without Fed tightening, are usually good for stocks but not usually good for gold. That was the stock market in 2021. Earnings were strong and stock prices reflected those high earnings, while gold was pretty flat for the year.

Today in late 2022 and most likely into 2023, the economy is decelerating (good for gold), the Fed is tightening monetary policy (not really good for gold). Still, corporate earnings are declining (not good for stocks). If the US economy develops severe recessionary conditions and the Fed eases monetary conditions, that's when earnings will still be bad, but people should begin to prefer gold.

Eventually I think we will see financial repression in the form of high inflation and low interest rates (meaning low or negative real interest rates) and that would likely be the best environment for gold to appreciate versus the dollar.



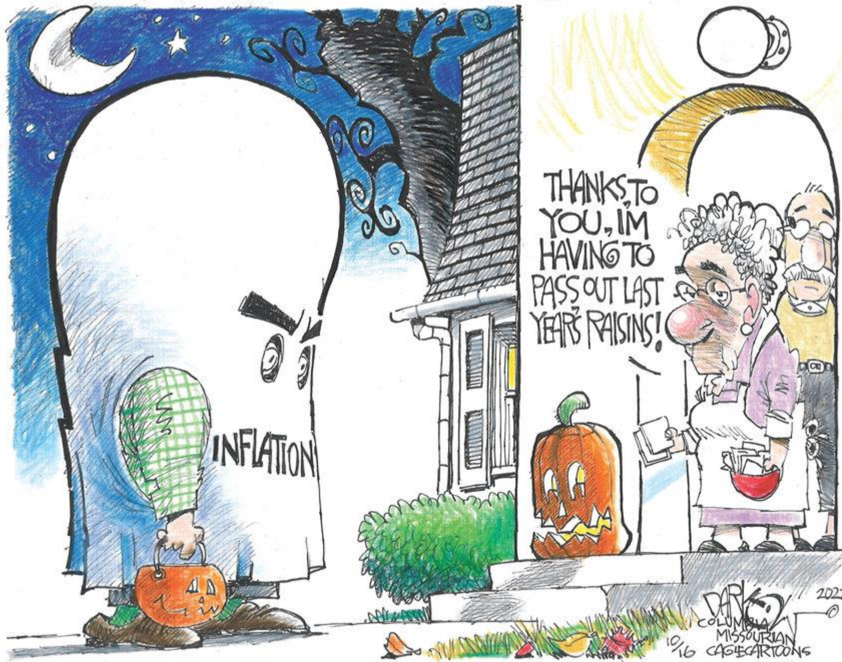
These next two charts come from Lyn Alden's newsletter. This one shows a situation similar to the yen-gold relationship. You can see the gold price in US dollars is down from its peak by about 15% this year so far, versus the price of gold in Euros being down only about 6%. So if your currency is Euros, you haven't done too badly in your savings by being in gold. The gold price in GBP looks similar, though it is not shown here.



And here is the gold ETF GLD in its year-to-date performance compared to other active investments. You can see that GLD, which mirrors the price of gold bullion, has outperformed both treasury bonds and the S&P500, so which would you rather have owned going into the downturn? Remember no price goes straight up, at least not for very long.

Just a final shoutout: I mentioned Lyn Alden before and will do it again. In addition to her comprehensive view on the economy and investing, Lyn has a good perspective on gold investing. She, like me, likes gold royalty companies for the long term, as these companies have no risk in operational costs, such as high fuel costs, which can eat into miners' profits. These companies' revenues consist of a right to be paid based on a percentage of the sales of a gold miner, so you get all the exposure to the upside in the gold price with no risk related to the profitability of the mine.

I will not be offering specific advice here on individual compay names. Still, I recommend you 1) investigate gold ownership to decide if it is right for you and 2) subscribe to Lyn Alden's newsletter, which is some of the most valuable investment advice available at a very reasonable price. So that is LynAlden.com. Some of her stuff is free so you can try before you buy. Her regular newsletter is very reasonably priced – lots of bang for the buck.



By the way, I have no relationship with Lyn other than the fact that I subscribe to her newsletter. I don't know her personally and she does not know I am recommending her letter.

Ok, let's wrap up and take questions and comments?

Check out my latest Substack letter at HardmoneyJim, it's easy to find. The most recent post before today is a video conversation with Keith Weiner, CEO of Monetary Metals & Co, at the recent New Orleans Investment Conference.

Thanks for listening, and we will meet again soon.

HardmoneyJim

October 27, 2022