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MARKET STRATEGY

INVESTMENT RESEARCH

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Gold – the wall of worry will keep it going.

Source: DATASTREAM

Growing unease over fiscal austerity and what it means for growth is being reflected in exchange rate weakness for the euro and sterling. It's also being reflected in the gold price. Its sudden move to new highs, prompted in part by the eurozone's troubles, reflects its 'all-weather' hedge on the wall of worry. Fiscal consolidation accompanied by loose monetary policy, which now looks to be a given, mean that exchange rate pressure will persist.

Looking back, policy makers went to extraordinary and unprecedented lengths to stem the contractionary and deflationary forces released by the financial crisis. The collective effort stabilized the financial system and supported the global economy but not without a recession that proved to be one of the worst on record. More to the point, it left governments with huge fiscal imbalances, mounting debt to GDP ratios and the sovereign debt crisis a number are now being forced to tackle.

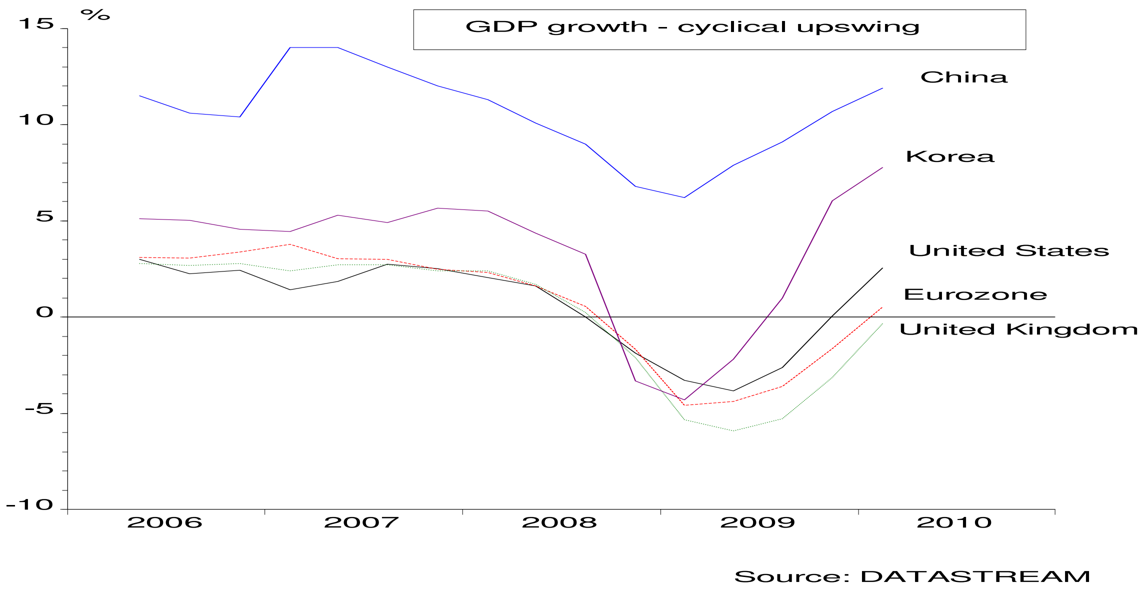
There are two worries; first, that the sovereign debt crisis transfers back to the private sector via the banks. A failure to contain contagion would set up the forces of contraction and deflation all over again, thus taking us full circle. The intention behind the eurozone's collaborative (EU, IMF and ECB) stabilization package was partly to see this does not happen.

A second worry is that a demanding programme of fiscal consolidation – soon to be delivered to the UK – restrains recovery and inhibits or even prevents the development of a sustainable expansion from taking root. There lies the double dip, a prospective outcome that would saddle the banks with a prolonged phase of bad and doubtful debts and restrict lending. On it could go.

Disinflation – falling rates of inflation – could soon turn into deflation – negative rates of inflation. Good news for core bond markets which even now impress by their behaviour. What could the policy makers do? Spend? Cut taxes? Cut interest rates? The conventional policy response has been exhausted. What remains is quantitative easing. Now there's a case for gold – a recovery through hyper-reflation induced by all out QE on a scale far in excess of what has been tried thus far.

If you're this bearish you buy gold! But is being so bearish justified? Not really. The eurozone may be troubled but the contagion is limited. Libor is rising but the usual spread on 3-month interbank dollar fixings over something like the Federal Funds rate is around 25 basis points – just about where it's at. Also, instead of contagion the dash to core bond markets helped them gain at the eurozone's expense.

The United States and Asia are still likely to drive the global economy. As the following chart shows with a few examples, they continue to lead the cycle. In addition, the Federal Reserve does not yet think the time has come to raise interest rates even though employment is now rising and, while Asia is tightening, China is managing to take some of the heat out of the economy without raising interest rates.



Against this backdrop, the international competitive position for the UK and the eurozone is enhanced by their weak currencies. This should help their recoveries. The extent to which fiscal austerity can be accommodated might therefore surprise and it wouldn't be the first time. In the UK there is the oft cited example of Geoffrey Howe's 1981 spring budget. No sooner had he imposed a stringent dose of fiscal medicine on the economy than it started what was to become a long expansion from one of the deepest post-war recessions. It happened before, it could happen again.

Fiscal austerity is unlikely to derail the earnings recovery for the big internationals wherever they may be and to repeat, for those in the UK and the eurozone, a weak currency suits. Importantly, the earnings recovery is no longer just about cost cutting and restructuring. It's also now about top line growth for the big internationals. This should encourage a pick up in investment and employment, a combination that should lay the basis for a sustained expansion.

All this won't stop the bullion price from rising. The wall of worry, which serves as a reminder of the risks to growth, will provide gold with its sustenance. But gold just won't be the only game in town. Equity markets still have their wall of worry to climb.

IMPORTANT NOTES