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First Trust

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Monday Morning Outlook

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Fed Ignores Gold, Targets Higher Inflation, and Plays With Fire

In the early 1900s, economist Irving Fisher proposed a commodity rule to guide monetary policy. His idea was to create a stable value for the dollar by using monetary policy to keep a basket of commodity prices stable.

Maintaining a stable value for money is one of the most important tasks a government has. Cost overruns are commonplace during inflationary times. And someone who invests millions to produce a good in one country, expecting to export it to another, can see all his plans ruined because currency values change.

Many have followed in Fisher's footsteps. Jack Kemp, Jude Wanniski, and the reliably-thoughtful Steve Forbes have proposed targeting the price of gold. Senator Connie Mack pushed a proposal to focus exclusively on price stability (using multiple signals like the dollar, CPI, gold, and other commodities). But the Federal Reserve resisted all of these ideas…every last one of them.

Now the Fed is considering a price target that would generate higher inflation. In recent communiqués and speeches, the Fed has let it be known that it wants to target an inflation rate of 2%. According to the London Financial Times, Chicago Fed President Charles Evans backs a plan in which "the Fed would promise to generate enough extra inflation to make the price level the same as if prices had risen by 2 percent a year since December 2007, which was the peak of the last business cycle according to the NBER. As soon as the Fed reached that goal it would abandon the price level target and go back to targeting inflation of about 2 percent a year."

So after years of resisting a target of stable prices, the Fed is now promoting actual inflation. Part of this is because the Fed thinks the economy is in trouble. The Fed has expanded its balance sheet by $1.4 trillion and yet the money supply and bank assets are not rising apace. At the same time, the Fed and most politicians want faster economic growth.

Unfortunately, the Fed is myopic when it comes to the economy. It only sees money, when there are other things going on. The Fed is pumping money in with one hand, while the banking regulators are raising capital standards and marking assets down in value with the other. At the same time, government spending and regulation is retarding growth, which offsets the impact of easy money.

Nonetheless, many economic indicators show Fed policy is having an impact. Nominal GDP is rising again, up 3.9% in the past year and 4.3% at an annual rate in the past two quarters. Gold and other commodity prices are up substantially, while the value of the dollar has fallen sharply. The models of Fisher, Forbes, Mack, Kemp, and Wanniski are all screaming – "stop, enough already!" And, the First Trust model of using nominal GDP as a target for the federal funds rate is suggesting that a zero percent interest rate is too low.

If the Fed would have listened to gold (or the nominal GDP model) over the past 15 years, the US would probably not be in the mess it is in today. Gold prices fell from $400 per ounce to $255 an ounce between 1996 and 1999. This signaled deflation, but the Fed chose to ignore the signal and raised interest rates anyway in 1998 and 1999. Deflation, recession and a stock market crash were the result.

In the wake of the stock market crash, the Fed started cutting rates because it feared deflation. Gold started to rise and by late 2003 it was back above $400/oz. But the Fed held rates at 1% anyway, which created a housing bubble. When that bubble burst, the Fed started cutting rates again and gold prices have now moved to more than $1300/oz. At this point, one would think the Fed would pause before pumping even more money into the system and targeting higher inflation.

But it isn't. The Fed continues to hold interest rates at zero, proposes another round of "quantitative easing" and plans to target 2% inflation. All because it won't listen to gold and it's unable to see that banks are afraid to use the money the Fed is pumping in because, down the road, the Fed will be forced to take it out or face serious inflation.

That's what gold is saying. By signaling that it won't quit anytime soon, the Fed is trying to force banks to change their behavior. If it works, look out for inflation to reach multiples of 2% in the years ahead. The Fed hasn't been successful yet, when it ignores gold and commodity prices.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-18 / 8:15 am	Industrial Production – Sep	+0.2%	**+0.3%**		+0.2%
8:15 am	Capacity Utilization – Sep	74.8%	**74.9%**		74.7%
10-19 / 7:30 am	Housing Starts – Sep	0.580 Mil	**0.590 Mil**		0.598 Mil
10-21 / 7:30 am	Initial Claims - Oct 16	455K	**455K**		462K
9:00 am	Philly Fed Survey – Oct	2.0	**-2.9**		-0.7
9:00 am	Leading Indicators – Sep	+0.3%	**+0.5%**		+0.3%