



# MARKET STRATEGY

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## *The gold price - what's driving the bandwagon?*



Source: DATASTREAM

If it's not one thing it's something else but whatever it is, it's a reminder that the policy makers still face great difficulty in their attempt to restore the functioning of the financial system.

Last week the gold price nudged up against resistance before surrendering a bit of its gain but it is now rising with a vengeance. Is fear in this market? Like the fear we saw last autumn when the financial system was as close to meltdown as anyone could imagine?

Maybe, but maybe not! One thing is for sure though. Each bombshell that goes off renews the doubt over whether policy makers are getting it together in dealing with a financial system that needs attention. The markets become that much more expectant and demanding - and hence prone to disappointment, as was the case with the announcement of the US Financial Stability Plan last week.

Rightly or wrongly, its delivery reflected poorly on an Administration whose error lay in misjudging, in one particularly important area, the steer or insight the markets were looking for. Such mishaps do little to reassure equity markets and, although government bond markets do well out of them, the discouragement is just the sort of thing that can also feed the momentum underlying the gold price.

Maybe the gold market reckons the dollar is heading for a crash. However, it has tended to be firmer rather than weaker on a trade weighted basis these past months, benefiting from currency weakness elsewhere. So maybe the weakness elsewhere is driving the gold price.

On the other hand, maybe the gold price is not responding to any of this. Maybe it detects deflation ahead. Expansionary fiscal policies stretch far and wide. UBS Investment Research estimates that in total, the fiscal stimulus announced by governments thus far in the developing as well as in the developed world is approaching 3 percent of global GDP, a third of which is down to the US.

On monetary policy, the scope for lowering interest rates has been exhausted or nearly so by several of the major central banks. This has eased the burden of debt servicing considerably. The action now is

quantitative easing, or credit easing as the Fed Chairman prefers to call it. With the exception of the Bank of Japan, this is not yet being effected through the purchase of government bonds, though the Fed is considering buying US Treasuries and, aside from its Asset Purchase Facility, the Bank of England looks set to start buying gilts. These efforts are not confined to the major central banks either. The Bank of Korea has very recently discussed buying government bonds.

In China, Premier Wen's commitment to achieve 8 percent GDP growth for this year may lack credibility but let's not underestimate the Chinese. The authorities still exercise a large element of control in the economy through state owned enterprises. Also, credit growth is now expanding rapidly. China's expansionary fiscal and monetary policies could prove to be a significant stimulus not just for China but for the global economy. Watch the Mining sector - this sector will be the judge of whether China can pull off 8 percent GDP growth this year.

And finally, let's not forget the stimulus from lower inflation which is helping to boost real incomes and ease the squeeze on profit margins.

There is a lot going on. The thrust of the fiscal stimulus that is building up worldwide is hugely positive for growth. Conventional monetary policy is as loose as it can be in places. Quantitative or credit easing is not just intended to substitute money for other assets in the economy - like government or corporate bonds - but the intention is also to bring down credit yields and spreads and if it does this, which is likely, it will deliver a very powerful stimulus for the global economy. Indeed, it may end up being too powerful, maybe too inflationary and perhaps the gold price is reacting to this.

So what's pushing the gold price? Perhaps it's the fear that policy makers will fail to rescue the financial system and that it will flounder for ever more. That is doubtful. We think reflation lies ahead, meaning not only that that we will see our way through the recession by this time next year, if not before, but also that the pressures will be ultimately upward on inflation. Watch this space - we will pick up on these points in a forthcoming note.

Finally, if you are into gold watch the shares. They tend to outperform the bullion price.

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