



The Fed, Stocks & Those Wonderful Metals

By Ned W. Schmidt CFA, CEBS
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fictional HEADLINE from the future:

MASSIVE PENSION PLAN SHIFT

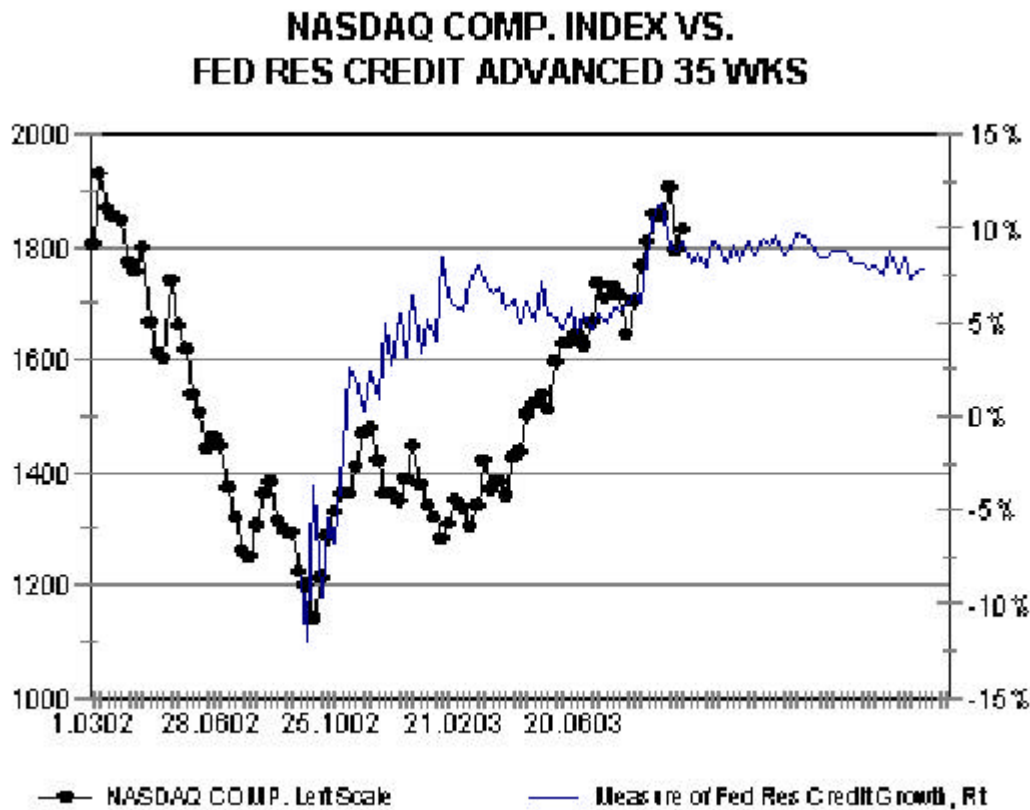
Sacramento: The pension plan for employees of California announced a major restructuring of its investment strategy. Since the state was required to file for bankruptcy two years ago, contributions to the plan have been below the level needed. Additionally, retirements are now causing distributions to exceed funds flowing into the portfolio. Stocks will no longer be permitted to exceed 15% of the portfolio. "With NASDAQ continuing to trade below 1000, stocks have provided poor returns," said the Executive Director, "We have been reducing the risk of the portfolio for some time by adding Gold through those wonderful ETFs. This move simply makes that shift more formal. Stocks are just too risky."

A few weeks ago we wrote some of the implications of the Federal Reserve's actions. As with anyone, what they do is more important than what they say. Such is especially true whenever considering ramifications of the actions of the current board. What happens in economic and financial terms often is different from its stated goal. Unfortunately it is in denial regarding this reality.

The Federal Reserve's policy of ease has different meanings depending on the demand for funds. Heavy demand for funds with a fixed interest rate requires that heavy amounts of reserves must be rapidly fed into the system. That liquidity influx tends to ultimately flow into the speculative sectors of the economy and markets. The NASDAQ, being the center of speculative forces, has received plenty of money fuel in recent months. That beneficial flow, now waning, suggests serious caution appropriate in the speculative components of the equity market.

These developments were portrayed in the following graph in a recent email. In that graph is plotted the weekly closing price of the NASDAQ Composite, using a line of connected circles. The second line is the rate of change in Federal Reserve Credit, right axis, indexed to a beginning date consistent with the Fed's latest era of easing moves. The actual date is not materially important.

When the Federal Reserve eases a process much like pressing on the gas peddle of your car occurs. To accelerate, more gas must be provided the car. Once the car's speed gets to the desired level, we pull back from the gas peddle somewhat. The Federal Reserve to get rates to a new lower level had to accelerate the rate of growth of Federal Reserve credit. Once the desired level of interest rates was achieved, the Fed Res backed off the "money accelerator."



Federal Reserve Credit is the base from which money is created. Essentially it is the Federal Reserve's balance sheet. To ease rates the Federal Reserve must expand the size of its assets by buying securities from the market. This burst of new liquidity has had a tendency in recent years to be the monetary juice that has fueled speculative stock market conditions, sending it higher.

As you can observe significant divergence developed between the rate at which liquidity was being provided the monetary system and the response of the stock market. In large part this situation was due to the highly negative mind set that had developed. As is usually the case, surplus liquidity overcame good sense and the NASDAQ moved higher in rapid fashion. This situation is very similar to that in late 1999 and early 2000.

In recent months the rate of increase of Federal Reserve credit has stopped accelerating. In our earlier writing we suggested that a lateral pattern for the NASDAQ was most likely. That any further reduction in the rate of growth of Federal Reserve credit would lead to a serious collapse of the speculative excesses in the NASDAQ. We were early in that writing, but monetary conditions increasingly suggest a high risk environment for the NASDAQ, and perhaps Gold stocks..

In that original graph we found that a lead time of 35 weeks gave the best fit. Admittedly that time period is too long to be of much use in the future. The reason such a long time period was necessary was the high level of pessimism that had existed in the stock market. Liquidity had to grow longer than normal to get the speculative juices going. The contraction phase does not have the same problem, and works more directly.

Current events suggest that it is time to revisit this data, using a more current starting point and a shorter lead time. What are those events? The biggest change is the collapse of demand for home refinancing loans. When this demand was rising the Federal Reserve had to be more accommodative, pushing down on the "money accelerator." Such was the case during the time prior to the

millennium, when cash demands exploded. With the demand for refinancing collapsing, the Federal Reserve is being less accommodative. A new index base and a shorter lead time are now more appropriate.

For those with an interest in monetary policy, this situation is the classic failure that develops when the central bank fixes interest rates. A focus on setting interest rates rather than on the growth rate of the monetary base results in actions that are pro cyclical. The amplitude of economic swings is greater, and so is the amplitude of speculative surges.



In the graph immediately above we are looking again at the NASDAQ Composite Index and the growth rate of Federal Reserve Credit. That growth rate is now decelerating and the implications for the stock market are ominous. The divergence between the stock action and the decelerating rate of expansion in Fed Res credit suggests serious risk. As the acceleration of speculative liquidity dissipates, the latest rally will falter in dramatic fashion.

The growth rate for Federal Reserve Credit points the way for the NASDAQ's future path. The immediate downside is to something below 1,600 on the NASDAQ. Timing of such a move would be by the end of October. By that time the economic implications of the closing of the mortgage refinancing ATM will be fairly obvious. Momentum is already weakening and the aggressive sector of stock speculators are booking 2003 profits, and not likely to risk them in the months ahead.

Recent performance on the NASDAQ has tended to inflate expectations of economic growth. Rising stock prices are easily transformed into rosy forecasts for the economy. Any reported growth in the U.S. economy will be recognized as transitory, an illusion created by the mortgage refinancing bubble. Foreign investors will become increasingly skeptical of investing in securities related to housing in the United States. Wall Street will have increasing difficulty explaining to foreign investors the problems in the three major players, Freddie, Fannie and the Federal Home Loan

System. Global financial markets will begin pushing U.S. interest rates higher. The air is coming out of the Mortgage & Housing Bubbles. Bubbles only create an illusion of growth that disappears when the bubbles are gone.

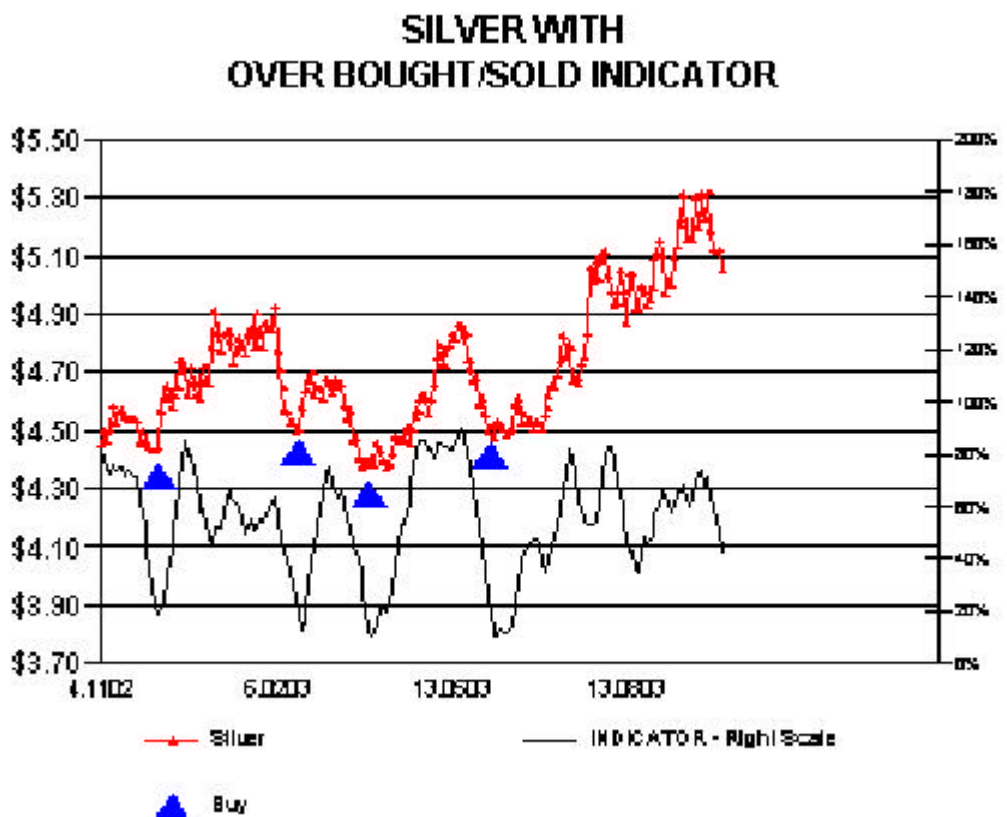
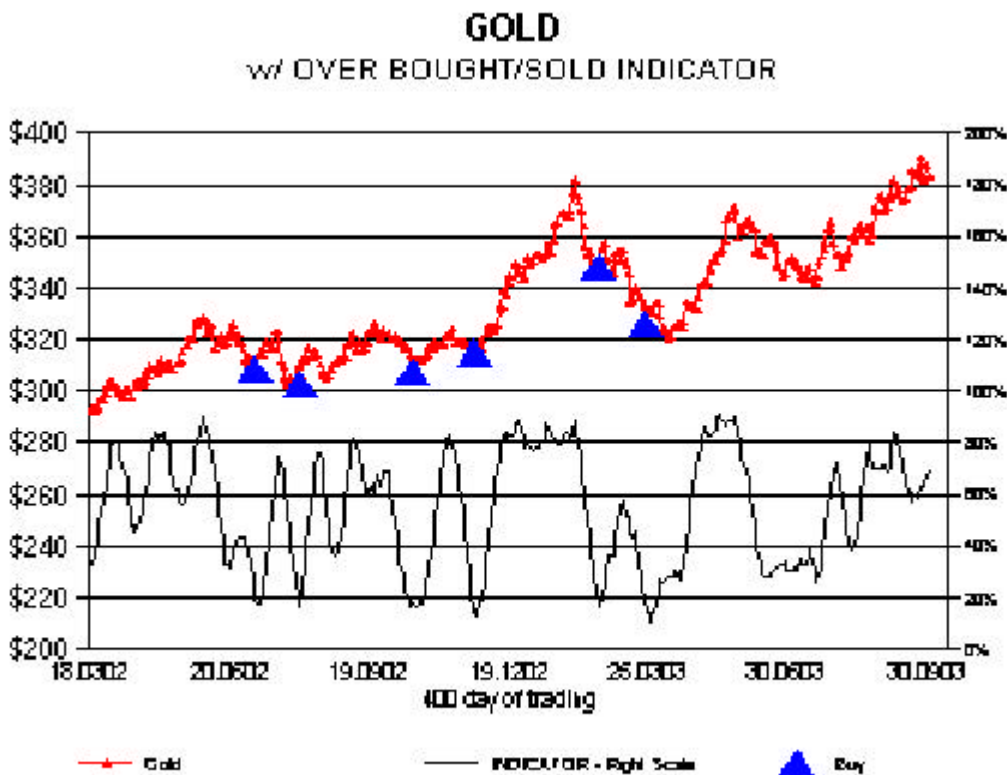
The U.S. dollar will enter a period of extremely high risk as the illusion of growth fades and the NASDAQ withers. The Federal Reserve may be forced to raise interest rates in January to support the dollar. Nearly the entire improvement in the U.S. economy has been due to the refinancing of mortgages and new mortgages. Problems at the major sources of finance for the U.S. housing market are resulting in the closing of the ATM. The "cash machine" for the U.S. economy is being turned off. Economic reality will return. No cash, no economic growth.

When not if central banks around the world reduce purchases of U.S. debt is the question. How high will U.S. interest rates be pushed? How bad will be the housing collapse in the U.S.? How much trouble will Freddie Mac and Fannie Mae and Federal Home Loan Bank create? Is the current account deficit about to matter? How low can the U.S. dollar go when the U.S. economy plunges into a deeper recession induced by the collapse of the Housing/Mortgage Bubbles? How much money will investors in bond mutual funds lose? Those are the questions we wished CNBC addressed?

Gold will continue to shine as the NASDAQ Composite heads to a new low in late 2003, early 2004. Gold prices will be well above \$400 during early 2004 with a collapsing U.S. economy as a background. With the current makeup of the Board of the Federal Reserve continuing, Gold will be seen as a global hedge against their policies. President Bush may be forced to replace the entire board shortly after the election next year.

That all said, the Gold market has been doing nicely. And the Silver boys are hooting their horns loudly. We probably should not let price action alone determine our state of mind. How much of the recent rally is real and how much is induced by the same liquidity driven speculation that has propelled the NASDAQ higher. The appropriate answer is probably that some is due to that source.

With the dollar collapsing back into bear market mode these concerns may not be important. As shown in the two following charts, both Gold and Silver are over bought. Serious investors in these two metals may want to wait for a correction to add further to holdings. Buying late into speculative runs is not wise.



Gold stocks have been enjoying the recent market action. Two concerns arise though. How much of this rally is the result of the same juice as pushing the NASDAQ higher? I would have to conclude that a considerable portion is the same. Second, the quality of recommendations and the quality of those being bought may not be all that would be desirable. With the birth of the first U.S. Gold ETF only weeks away,

owners of Gold stocks may want to convert some of their profits into cash.

While noting that a bit of caution is appropriate, the longer term case for Gold, and Silver, has never been stronger. When not if central banks reduce purchases of U.S. debt is the question. How high will U.S. interest rates be pushed? How bad will be the housing collapse in the U.S.? How much money will be lost in Fannie and Freddie? How high can the Euro and yen go? How low can U.S. stocks go? Anywhere you look, with the exception of CNBC, one finds sound bullish fundamentals for Gold. Just imagine telling your grandchildren about once getting to buy Gold below \$400. They will look at you with a question on their face, "What was a dollar?"

Gold is on the way to over \$1,200, and you should be participating!

Ned W. Schmidt, CFA, CEBS is publisher of THE VALUE VIEW GOLD REPORT. His monumental report, "\$1,265 GOLD", with 255 pages and 98 graphs, has now been released. Previous editions of this work have been read by hundreds, probably saving their portfolios countless millions of losses. Ned welcomes your comments and questions. His mission in life is to rescue investors from the abyss of financial assets and the coming collapse of the U.S. dollar. He can be contacted at nwschmidt@earthlink.net. To obtain a copy of "\$1,265 GOLD" while subscribing to THE VALUE VIEW GOLD REPORT by e-mail each month click on the button below.

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1. All housing price data is the Freddie Mac conventional mortgage housing price index.