

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

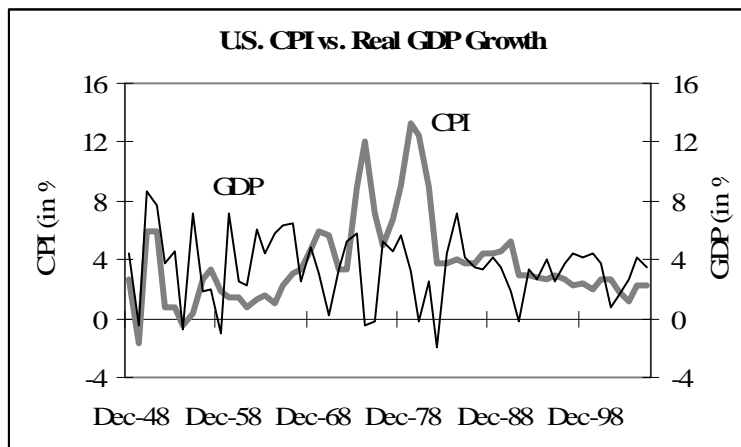
Classical Insights Afternoon Bullet Points September 20, 2007

We've been getting a lot of questions about what the Fed "should" have done on Tuesday.

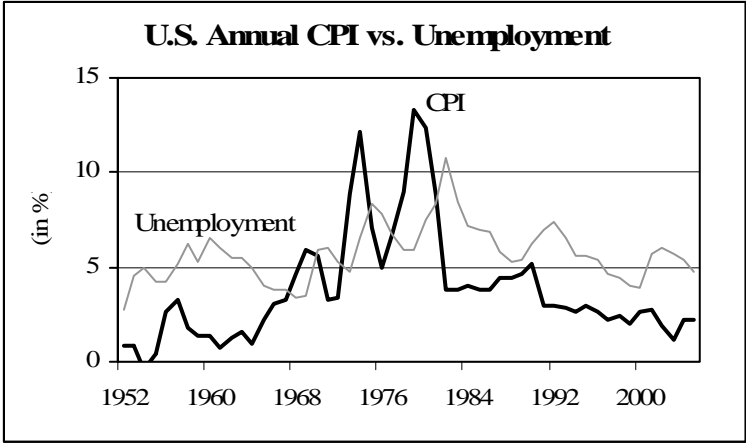
These are excruciating questions, for the simple reason that the core principles upon which Fed decisions are based are, in fact, false. At the risk of sounding like a conspiracy theorist, the Fed's model has been overtly corrupt since 1997. Having a meaningful conversation about what the Fed "should" or "shouldn't" do at any particular meeting has become extremely difficult as a result. Bottom line: The Fed is making an inflationary error. Gold at \$733/oz. is great for commodities, but bad for CPI. (Note: This is a long and dense piece. For the conclusions, skip to point #6.)

Points:

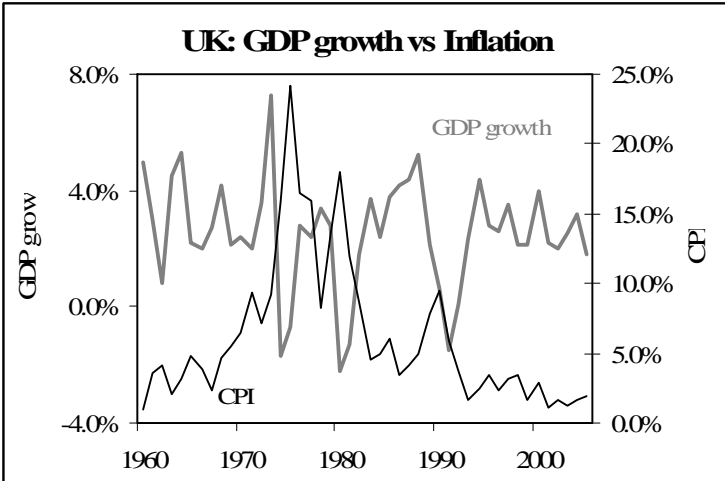
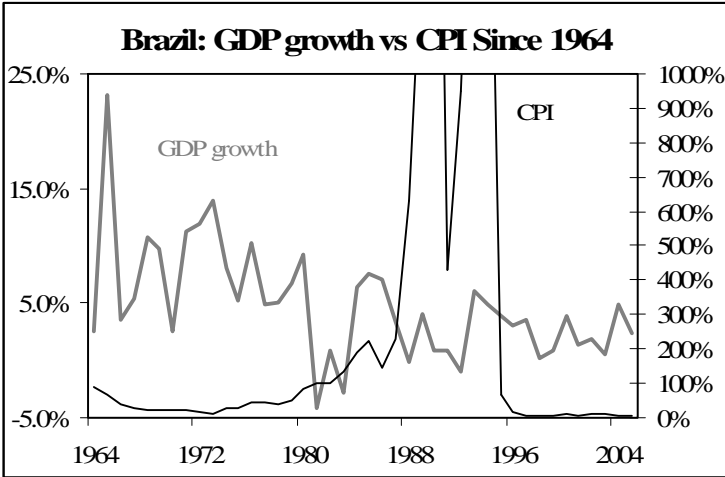
1) In the face of all empirical evidence, the Fed believes that growth causes inflation – and from this false premise have come virtually all the Fed's errors. If anything, strong GDP growth correlates with low inflation, not high inflation. The real cause of inflation, of course, is decline in the real value of money (which shows up first as an increase in the gold price). But the Fed never talks about changes in the value of money. The issue is totally off its radar screen. This is an absurd situation, and all discussions about what the Fed should or shouldn't do necessarily risk veering into absurdity as a result. Here is growth vs. inflation in the U.S. Do you see a positive correlation? I don't:



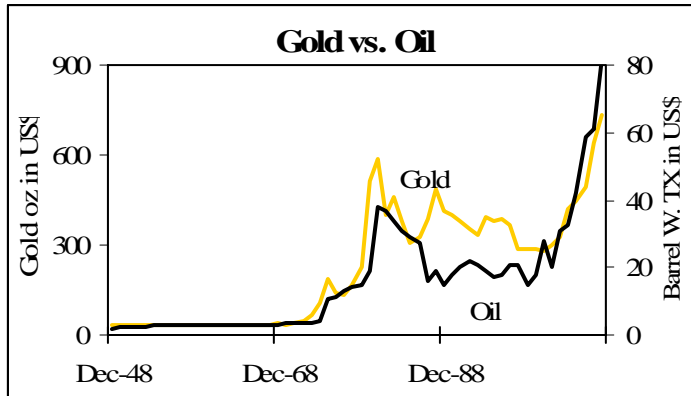
The chart of unemployment vs. inflation (below) is even worse. If the Fed's intellectual model were correct, there would be an inverse correlation between these two lines. Low unemployment would correlate with high inflation and vice versa. But the two lines actually track each other quite nicely. In other words, low unemployment correlates with low inflation – the exact opposite of what the Fed believes:



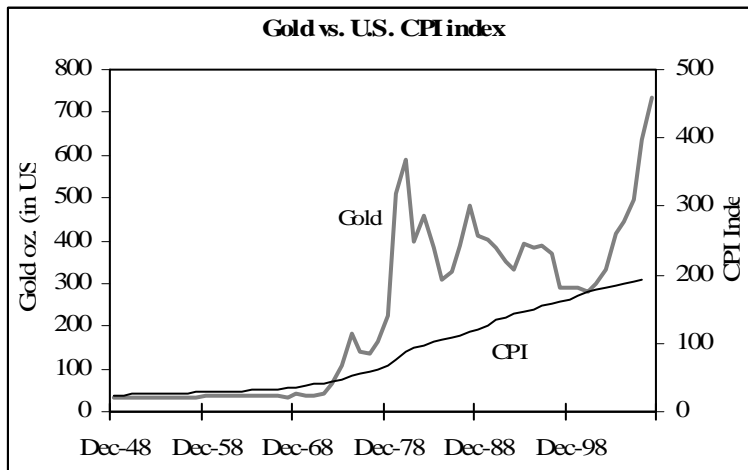
You can plot the same data series for whatever country you like and the charts will come out roughly the same. One will never, ever find a positive correlation between GDP growth and CPI, and there is usually an inverse correlation. (Data sources: IMF and Bloomberg):



2) The actual cause of inflation -- decline in the real value of money -- is quite easy to illustrate. Here is the 60-year chart of gold/oil. Note that both gold and oil spike in 1971 (the year the U.S. left the gold standard):

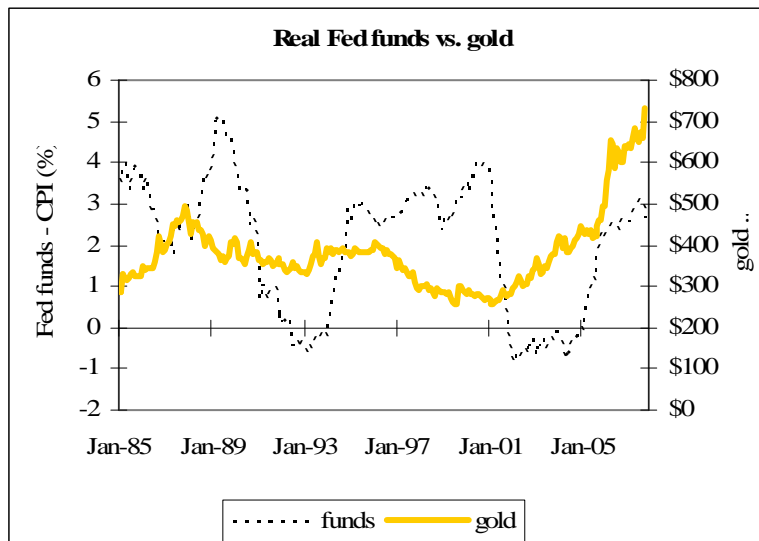


Here is gold vs. the CPI index. Note that CPI started rising in the late '60s, when the U.S. began the process of breaking the dollar's link to gold. During the periods when gold was really leaping (1974, 1979-1980) CPI broke into double digits.



3) One a person realizes that growth doesn't cause inflation, it becomes impossible to read Fed statements with a straight face. They become overtly nonsensical. At that point, an investor only wants to know the following: What impact will a particular Fed decision have *on the gold price*? This, then, becomes the key question – and it's the question supply-siders have been wrestling with (and arguing over) for the last decade.

The strongest candidate as to what moves gold is the real fed-funds rate – and historical data *do suggest* that the gold price moves inversely to the real funds rate. Here are the series back to 1985:



One really has to go through this chart segment-by-segment in order to get comfortable with the relationship. (Note: sorry in advance if the following discussion seems like a digression into minutiae. But the chart above represents *THE* key area of debate among supply-side economists now, and one has to be precise when working with it.)

- The relationship works fine from 1985-1990. The lines move inversely, more or less. (In 1989-90 the real funds rate fell hard and gold didn't move, but that was probably because the real funds rate was coming down from a very high level.)
- The relationship also works nicely from 1995 to 2005. In the late '90s, the real funds rate was increased to 4% (Greenspan's vendetta against the Nasdaq) and gold fell from about \$385/oz. to \$250/oz. Beginning in January 2001, real rates started falling hard, and gold bottomed three months later. Real rates were negative from October, 2001 to January, 2005, and during that period gold rose from \$274/oz. to \$438/oz.
- The period from October 1990 to February 1993 is somewhat problematic. The real rate fell from 2.7% (a neutral-ish rate historically) to -0.6% during this period -- yet gold actually declined (from \$380/oz. to \$329/oz.). However, gold's subsequent behavior suggest it may simply have been responding with a lag: Gold rose \$62/oz. between February 1993 and December 1993 to finish the year at \$391/oz;
- The 2004-2007 period is also a bit tricky. From June 2004 to June 2006 the Fed raised the funds rate 17 times. By June 2006, the real funds rate was roughly at a neutral level (about 2.55%) yet gold was \$200/oz. higher than it had been two years previously (\$585/oz. vs. \$385/oz). From June of 2006 through early September 2007 (pre-rate-cut), gold rose yet another \$100/oz., despite the real funds rate (as conventionally defined) still being neutral-ish;
- Why did gold keep rising even after the real funds rate got up to the 2.5% level in 2006? There are two possible explanations. The most convincing explanation is that conventional measures of CPI have been incorrect in recent years and that "true" CPI actually has been running higher than official indices show (due to increases in the gold price post-2002). For instance, if CPI is "really" 3.5% now, then the real funds rate is

“really” only 1.25% (i.e. 4.75% minus 3.5%). That’s quite a low number by historical standards. This line of reasoning (which is fairly convincing to me) also would explain why gold has risen so much since Tuesday’s rate cut (which pulled down the real funds rate 50 bps). The other potential explanation for gold’s post-2006 rise would be that other factors are fueling gold now, such as heightened political risk, tax-hike risk, and the risk of trade sanctions on China. *One can’t rule these factors out*, but one can’t really *quantify* how these forces might affect the gold price over time, either. (How does one put a number on political risk?) So it’s impossible to have a truly informed discussion about their potential impact on gold.

4) There is one absolutely crucial twist in this story: Back in 1995 and 1996, Alan Greenspan routinely talked about the gold price during his Humphrey-Hawkins testimonies. I was working for Jude Wanniski at Polyconomics during this period. Jude used to sit in the office of Polyconomics’ then-chief economist David Gitlitz (who had a TV) to watch Greenspan speak. Questioners would sometimes press Greenspan to raise the funds rate, and Greenspan (who didn’t want to raise it) would say things like, “Well, the gold price is stable at \$380/oz., which suggests low inflationary pressures.” At these moments Jude would leap out of his chair, point a finger at the TV set and say, “He did it again. He mentioned the gold price!” Jude felt that Greenspan was quietly targeting the gold price during this period, even though gold was not one of the Fed’s official indicators.

That all changed in April, 1997, when Greenspan raised the funds rate to 5.5% from 5.25%. Gold, which had been in the \$350-400/oz. range, started to fall. By August, 1998, gold was down to \$275/oz. *As gold fell, Greenspan stopped talking about it. It was no longer supporting the case he wanted to make.* Jude began bombarding Greenspan with memos and phone calls during this period, telling him he was creating a monetary deflation via excessively-high rates (which, in fact, he was). Greenspan’s response was silence. Eventually, Greenspan’s secretary called Jude’s secretary and told her to please stop faxing memos over.

By 2001, deflation of the U.S. dollar (defined as a falling gold price) began to suck the life out of the mainstream U.S. economy (after decimating commodity industries and emerging markets in the late ‘90s). Greenspan finally began to cut rates. Gold bottomed out when the funds rate fell to about 5%, and then gold began to rise. Gold *kept* rising as the funds rate was cut further. The ensuing economic expansion prompted the Fed to undertake 17 rate hikes between June 2004 and June 2006.

5) Speaking of those 17 rate hikes, Jim Cramer made an important point during his CNBC rampage last month: “Alan Greenspan told everyone to take a teaser rate and then raised the funds rate 17 times.” There is a lot of truth in this statement – *and to the extent that it is true, the Fed bears responsibility for all those people now defaulting on their mortgages due to interest-rate re-sets.*

6) Connecting the dots, we can say that the trail of intellectual corruption at the Fed traces directly back to Greenspan’s 1997 decision to willfully ignore the gold signal when it stopped saying what he wanted it to say. He created the deflationary downturn (by raising rates when he knew he shouldn’t have), he created the ensuing need to cut rates to 1% (by creating a deflationary contraction in the late ‘90s and early ‘00s), and he thereby created the subsequent need to raise rates to 5.25%;

7) Given the Fed’s morally-compromised track record over the past decade, Ben Bernanke’s decision on Tuesday was by no means an obvious one. Here’s one way to think about it: If you lie to people, and if people take out big mortgages based on your lies, *why is it okay to suddenly start telling those people the truth – if the truth means they might now lose their houses?* On the contrary, the “ethics” of intellectual corruption would, in this case, appear to necessitate still more intellectual corruption. The Fed is debasing the dollar in part because it realizes its culpability in triggering the housing bubble in the first place.

8) With gold at \$733/oz., the obvious thing to do now is buy commodity stocks. The monetary equilibrium price of all commodities has gotten a nice boost from the recent gold pop. We are keeping our long-term commodity-price forecasts unchanged for now, but we might lift them a bit before long. Our copper forecast could go to \$2.85/lb. (from \$2.70/lb. now) and our nickel forecast could go to \$14/lb. (from \$13/lb. now). We will probably keep our zinc forecast unchanged at \$1.40/lb. (We had been thinking about cutting it to \$1.25/lb.) The new equilibrium price of oil is \$66.50/bbl.

9) That said, please be cautious about following us into these small oil E&P names. This is a new sector for us and we're learning as we go. One issue we're confronting is that the reliability of management claims regarding their companies' potential oil and gas reserves appears to be a lot more, er, nebulous than is the case in mining. The bearish case on these small E&Ps is that they need to tell investors a big story in order to raise money. It's easier to get away with spinning tall tales in oil and gas because you're always talking about *potential* reserves ... about reserves you *might* find. In oil and gas, there are no reserves until the drilling crews hit something. In mining, by contrast, the companies really do have the reserves. The bottleneck in mining is raising the dough to get the rocks out of the ground. What we haven't really figured out yet is how to gauge the credibility of E&P managements with respect to their early-stage oil-and-gas prospects. One name in particular where we've gotten some pushback is Bayou Bend. One client who knows the Marsh Island area questions whether Bayou Bend's project there is really as promising as management says it is. That being said, another feature of the E&P world is that competitors tend to say bad things about each others' projects. One solution to the challenge of analyzing small E&Ps is to buy a basket of them. That's what we're doing.

The Classical Insights portfolio and Classical Insights Fund LP both hold Bayou Bend.

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