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Gold Price Signals Fear of Inflation

Should policy makers succeed in preventing the global economy from sliding into a depression, this will probably be possible only at the price of higher inflation over the medium term. While this scenario has already been factored into the price of gold, it plays no role yet for German bonds. Should it become evident over the next few weeks that the first indicators showing a slight improvement were no flash in the pan, we expect this to weigh on bond markets, while stock markets should profit from the gradual improvement in the growth outlook. The likelihood for this scenario is strong, since every additional weak economic number will presumably trigger further 'stimulus packages.'

High uncertainty

Uncertainty in the markets continues to be high. Although the first leading indicators have started to point upward, there is still a fear that the global economy could slide from a deep recession, which has now been priced in, into a depression. Even the continuing monetary and fiscal policy measures have not yet been able to ease the fear of such a downturn. As a result, not only the recession scenario, but also the deflation scenario has played itself out most recently in the stock as well as bond markets, a situation from which the German bond market, in particular, has profited.

German bond market as a winner

Yields on 10-year Bunds fell below the 3% level again, while the risk premiums remained high for the other Euro zone countries. Fear about the potential insolvency of many of these countries weighed on their government bonds.

US Dollar as a winner

But it is not only German government bonds that are currently acting as a safe haven, the same is also true for US treasuries. Already the uncertainty over possible weaknesses in Euro zone countries helped the US Dollar to post gains. This development was accelerated most recently by the escalation of the economic crisis in Eastern Europe. Here the economic interconnections of the Euro zone with Central and Eastern Europe is the decisive factor. Both the real economic dependency as well as the links between the banks are much more pronounced here than in relationship with the US, for example.

Fear of deflation

While the updraft in German government bonds thus resulted presumably from fear of recession and deflation, the US Dollar has proved a winner from the growing structural instability in Europe.

Gold as a winner

But there is another winner of the crisis, one that is acting out a very different theme than recession and deflation: gold. Since the beginning of this year, the price of gold has risen 11% in Dollars, and no less than 22% in Euros. What theme is being played out here?

Gold as an indicator of crisis?

Speculations about this abound: they range from the supposed flight to safety in general times of crisis, to most recently the search for safe haven in times of inflation. I have my doubts about the first argument, for in case of a complete collapse of the economic systems, it would surely be better to own a piece of land on which to grow the basic necessities than to hoard gold.

Anticipated fear of inflation

It thus stands to reason that the rise in the price of gold could be an indicator that the markets are in fact looking at the current deflationary phase as rather temporary and are already looking at possible inflationary tendencies over the medium to long term. This medium-term fear is not entirely unjustified. To be sure, in the current year the strong decline in the price of oil, combined with the deflationary effects of the recession and the financial crisis, will keep inflation rates low. For the US, we actually expect a decline in inflation of around 45% on average for 2009. In Germany, with less flexible markets, the decline will be accordingly less pronounced. We expect a rate of inflation of -0.2% in the US and +0.7% in Germany.

Basis effects will run their course this year

To begin with, the basis effects from the oil price trend will run their course. In addition, the very expansionary monetary and fiscal policy measures will tend to have an inflationary effect, even if the rise in consumer prices will presumably still be fairly moderate next year. However, the medium term risks are already inherent in the expansionary measures that are undoubtedly necessary under the current circumstances.

Medium-term inflation risk

Should policy makers thus succeed in preventing the global economy from sliding into depression, this will presumably be possible only at the price of higher inflation over the medium term. While this scenario has already been factored into the gold price, it has not yet reached German bonds. If it became apparent during the coming weeks that the first indicators showing a slight improvement were no flash in the pan, we expect this to weigh on bond markets, while stock markets should profit from the gradual improvement in the growth outlook. The likelihood for this scenario is strong, since every additional weak economic number will presumably trigger further 'stimulus packages.'

Contribution for "Die Welt," 21 February 2009. ■

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