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Gold at $475: What Does This Mean?

If the Fed continues raising rates, the inflationary pattern will continue, becoming a "vicious cycle" as the Fed suppresses the economy below a 3% growth rate.

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Polyconomics & SupplySideInvestor were founded by Jude Wanniski.

An institutional client recently emailed us with the question: "Gold at $475, what does this mean?" In a nutshell, it means the Fed's interest rate targeting strategy is ineffective in maintaining the right amount of money supply relative to that demanded by the economy. If raising and lowering the funds rate could effectively control the amount of liquidity being pumped into the economy, then the Fed could conceivably move rates just enough to cause the desired effect in gold. Moving the funds rate up or down would be much like loosening or tightening the sink faucet. This sounds simple enough and is the heart of the popular argument on Wall Street, especially among our supply-side colleagues who understand the inflationary implications of $475 gold, that the Fed must continue raising rates in order to ultimately thwart any further rise in the gold price.

The problem with their argument first and foremost is that moving the funds rate does not necessarily have the desired effect on money supply growth. Probably the best indicator of how much liquidity is being pumped into the economy is reserve bank credit, which is essentially the asset side of the Fed's balance sheet. This is the source of all money creation. Reserve bank credit growth was declining early in 2004 until the Fed started raising interest rates.

THE TREADMILL EFFECT

Essentially, this means that once the Fed began its goal of "tightening" the money supply, money supply actually started growing faster! Former Fed Governor Henry Wallich (who served at the Fed in the late 70's) is the first person we know who publicly brought to light this phenomenon. And the FOMC members today are well aware of this problem. The minutes of last November's FOMC meeting state that the Manager of the System Open Market Account testified to this:

> "The Manager also discussed the pressures on the federal funds rate prior to, and volatility in the rate that has ensued at times after, recent FOMC meetings as depository institutions sought to satisfy a larger portion of their reserve requirements before anticipated increases in the FOMC's target funds rate."

We call this phenomenon the "treadmill effect", which occurs when banks rush for cheap reserves before they become more expensive. You can see how this treadmill plays out: the Fed raises rates causing credit growth to expand even faster, thus requiring another rate hike which only causes another burst in credit growth, and on and on.

Clearly, money supply is not being properly managed today, but this is only half of the monetary equation. The Fed must consider how much money the economy is demanding. The law of supply AND demand always determines the value of the dollar. As the Fed embarks on raising interest rates, it is slowing the economy. Since a slower economy requires less money, the Fed is dampening money demand while it is increasing money supply! An increase in the supply of dollars even though consumers demand less causes the value of the dollar to fall, which means the gold price will rise. After eleven quarter-point rate hikes, gold has risen from $390 to $475 today, breaking decades-old records. If the Fed continues raising rates, the inflationary pattern will continue, becoming a "vicious cycle" as the Fed suppresses the economy below a 3% growth rate.

Since the Fed has been steadfast in its rate-hike strategy, our best hope over the last year has been that President Bush and the Republican Congress could pass supply-side tax reforms which would increase the amount of capital relative to the existing supply of labor, spurring productivity and investment, and most importantly reinvigorating money demand to offset the Fed's unintended increase in excess liquidity.

Over the last month, the dollar has been hit hard by a number of factors affecting the demand for dollars. President Bush's foreign policy continues to drag on his popularity and the GOP domestic legislative agenda. Damage control on Katrina forced President Bush to call for one of the largest reconstruction projects in US history, just when Congress was negotiating an estate tax repeal and extensions of the dividend and capital gains tax cuts, which decreases the chances of fiscal relief. The House of Representatives seems to be doing its job in supporting this legislation while working with Democrats to help those hurricane victims who are so poor they don't even pay taxes. But members of the Senate who were already on the fence look like they may abandon a tax cutting, pro-growth agenda. Over the next month, we will be watching for potential variables that will spur economic activity - a break in the clouds.

RE: *WALL STREET JOURNAL* EDITORIAL "The Anxiety Market"(Oct. 10, 2005)

Dear Editors:

In your assessment of who's been right and wrong in proposing the correct Fed policy during the past two years, you omitted one much smaller group of economists. Those at Polyconomics have been alone in concluding since April, 2004, that the Fed's proposed funds rate hikes would weaken economic growth and would weaken the dollar rather than strengthen it.

You name our former colleague, Michael Darda, as "right all along" that the Fed should have been raising the funds rate faster and higher. While Mr. Darda is an able economist, we respectfully urge that the Fed should have been, and should now be, doing the opposite.

By raising its funds rate target, the Fed seeks to slow economic growth to reduce job creation and increase unemployment, theoretically reducing wage-push inflationary pressures. In reality, the rate hikes (and currently threatened rate hikes) discourage investment in the productive economy, reducing demand for dollars and creating excess liquidity. The Fed does nothing to remove the excess liquidity newly created, and thus is actually producing by the rate hikes the inflation it professes to be combating.

Since Polyconomics first advised against the Fed's rate hike regimen in the Spring of 2004, the dollar has lost 25% of its value. Before the rate hikes, the dollar was actually getting stronger as the then-robust economy soaked up liquidity for use in production. That was while the funds rate remained at 1%. Jobs, the economy and the dollar would have fared far better if the Fed had done nothing at all. A gold price at $380 or below, as it was then, would be far superior to the present $475.

Although the Fed chairman is unwilling to admit or defend it, the Fed continues to follow Phillips Curve theory as amended by Milton Friedman in 1968, attempting a trade-off of unemployment against inflation "in the short-run." This has never worked, and it won't succeed now. Its attempt can produce only another recession.

The nation needs the Journal's leadership towards better economic analysis and a virtuous cycle instead of a vicious one. A stronger economy produces a stronger dollar, ultimately enabling a stable one.

Respectfully,
Wayne Jett
Representative in the West

SUPPLYSIDEINVESTOR EXCHANGE TRADED FUND (ETF) LIST

Given the macroeconomic and political environment, we consider the following exchange traded funds among the most attractive investments within the ETF universe. For your reference, this list will be updated with each issue of SupplySideInvestor.

OPEN POSTIONS	TICKER	Name	Date Rec.	Rec. Price	Last Price*	Gain/ Loss
		Sector - Longs				
	IYW US EQUITY	ISHARES DJ US TECHNOLOGY SEC	7/11/2005	47.66	46.65	-2.12%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**	**7/11/2005**	1219.44	1187.33	**-2.63%**
	IYM US EQUITY	ISHARES DJ US BASIC MATERIAL	11/29/2004	50.48	46.32	-8.24%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**	**11/29/2004**	**1178.57**	1187.33	**0.74%**
	SMH US EQUITY	SEMICONDUCTOR HOLDRs TRUST	9/27/2004	29.8	34.54	15.91%
	SWH US EQUITY	SOFTWARE HOLDRs TRUST	9/27/2004	34.1	34.91	2.38%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**	**9/27/2004**	**1103.52**	1187.33	**7.59%**
		Global - Longs				
	CEE US EQUITY	CENTRAL EUROPE & RUSSIA FUND	7/25/2005	34.00	43.80	28.82%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**	**7/25/2005**	**1499.70**	**1581.47**	**5.45%**
	IIF US EQUITY	MORGAN STANLEY INDIA INVEST	11/29/2004	26.16	40.53	54.93%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**	**11/29/2004**	**1459.73**	1581.47	**8.34%**
	EWO US EQUITY	ISHARES MSCI AUSTRIA Index	9/27/2004	17.7	26.36	48.93%
	EWZ US EQUITY	ISHARES MSCI BRAZIL	9/27/2004	17.94	31.25	74.19%
	EWW US EQUITY	ISHARES MSCI MEXICO Index	9/27/2004	20.13	31.31	55.54%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**	**9/27/2004**	**1300.57**	1581.47	**21.60%**

CLOSED POSITIONS	TICKER	Name	Date Rec.	Rec. Price	Last Price*	Gain/ Loss
		Sector				
CLOSED 7/11/05	IAH US EQUITY	INTERNET ARCHITECT HOLDRs TR	12/23/2004	37.68	34.24	-9.13%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**	**12/23/2004**	**1194.20**	1187.33	**-0.58%**
CLOSED 11/29/04	RKH US EQUITY	REGIONAL BANK HOLDERS TRUST	9/27/2004	132.15	139.09	5.25%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**	9/27/2004	**1103.52**	**1178.57**	**6.80%**
CLOSED 12/10/04	OIH US EQUITY	OIL SERVICE HOLDRS TRUST	9/27/2004	81.08	81.12	0.05%
CLOSED 12/10/04	IXC US EQUITY	ISHARES S&P GLBL ENERGY SECT	9/27/2004	69.56	72.48	4.20%
Benchmark Index	**SPX INDEX**	**Standard & Poors 500 Index**		**1103.52**	**1188.00**	**7.66%**
		Global				
CLOSED 7/25/05	TKF US EQUITY	TURKISH INVESTMENT FUND	12/23/2004	15.95	17.36	8.84%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**	**12/23/2004**	**1493.64**	1581.47	**5.88%**
CLOSED 12/9/04	TRF US EQUITY	TEMPLETON RUSSIA & EAST EURO	9/27/2004	37.28	37.62	0.91%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**		**1300.57**	**1439.81**	**10.71%**
CLOSED 12/23/04	EWC US EQUITY	ISHARES MSCI CANADA	9/27/2004	15.07	16.76	11.21%
Benchmark Index	**MXEA INDEX**	**Morgan Stanley Capital International EAFE Index**		**1300.57**	**1493.64**	**14.85%**

* Last Price reflects the last available closing price on the date of issue publication (10/10/2005).

Note: The SupplySideInvestor 'ETF List' is not a model portfolio. It is a list of ETFs that are believed to be among the most attractive investments through ETF investing, based on Polyconomics' assessment of the economic and political landscape. The trade results posted for SSI are hypothetical but reflect changes and positions with the last available prices. SupplySideInvestor staff may hold positions in some or all of the funds listed.

Note to Investors

With the recent changes to our portfolio recommendation service, we are highlighting the advantages of Exchange-Traded Funds (ETF's), and how they can be effectively used in conjunction with our macroeconomic and political analytics.

ETF's are baskets of securities that are traded like individual stocks on an exchange. They can be country-specific, sector-specific, or broad-market specific. Unlike traditional open-end mutual funds, ETF's can be bought and sold anytime during the trading day, and generally have much lower expense ratios.

We believe exchange-traded funds can be especially suited for individual subscribers as our research primarily focuses on the macroeconomic and political effects on countries and industries, rather than specific companies. If our recommendations are bullish or bearish, for example on Brazil or semiconductors, subscribers can easily long or short those general investment themes via Brazil iShares (EWZ) or Semiconductor Holder's (SMH). By their nature, ETF's mitigate company-specific risk while enhancing industry-specific reward. Yahoo! Finance's ETF Center -- http://finance.yahoo.com/etf -- is an excellent source for ETF news and information. ETF information can also be found in the pages of the Wall Street Journal and Barron's.

We believe that ETF investing fits in well with our investment philosophy and provides SupplySideInvestor subscribers with a superior approach to investing via our analytical framework. Where corresponding ETFs do not exist, bellwether companies within given sectors can often be located through Yahoo! Finance http://biz.yahoo.com/ic/ and for information relating to ADRs, in conjunction with our global macro research, www.adr.com is an excellent online resource.

THE ETF UNIVERSE

SECTOR/INDUSTRY

HOLDRs

Ticker	Name
BHH	B2B INTERNET HOLDRs TRUST
OIH	OIL SERVICE HOLDRS TRUST
HHH	INTERNET HOLDRs TRUST
IIH	INTERNET INFRASTRUCTURE HOLD
SWH	SOFTWARE HOLDRs TRUST
WMH	WIRELESS HOLDRS TRUST
UTH	UTILITIES HOLDRS TRUST
TTH	TELECOM HOLDRs TRUST
BDH	BROADBAND HOLDRs TRUST
RTH	RETAIL HOLDRS TRUST
RKH	REGIONAL BANK HOLDERS TRUST
SMH	SEMICONDUCTOR HOLDRs TRUST
IAH	INTERNET ARCHITECT HOLDRs TR
BBH	BIOTECH HOLDRs TRUST
PPH	PHARMACEUTICAL HOLDRs TRUST

iShares

Ticker	Name
IGE	ISHARES GOLDMAN SACHS NAT RE
IYE	ISHARES DJ US ENERGY SECTOR
IGV	ISHARES GOLDMAN SACHS SOFTWA
IYT	ISHARES DJ US TRANSPORT INDX
IYM	ISHARES DJ US BASIC MATERIAL
IYZ	ISHARES DJ US TELECOMMUNICAT
IDU	ISHARES DJ US UTILITIES SECT
IYW	ISHARES DJ US TECHNOLOGY SEC
ICF	ISHARES COHEN & STEERS RLTY
IYR	ISHARES DJ US REAL ESTATE
IYC	ISHARES DJ US CNSMER SERVICE
IGW	ISHARES GOLDMAN SACHS SEMI
IYJ	ISHARES DJ US INDUSTRIAL SEC
IGN	ISHARES GOLDMAN SACHS NETWOR
IYF	ISHARES DJ US FINANCIAL SECT
IBB	ISHARES NASDAQ BIOTECH INDX
IYK	ISHARES DJ US CONSMR GOODS
NEW!!	
GLD	STREETTRACKS GOLD TRUST

Fixed Income

iShares

Ticker	Name
AGG	ISHARES LEHMAN AGG BOND FUND
TIP	ISHARES LEHMAN TRES INF PR S
SHY	ISHARES LEHMAN 1-3YR TRS BD

iShares

Ticker	Name
IEF	ISHARES LEHMAN 7-10YR TREAS
TLT	ISHARES LEHMAN 20+ YR TREAS
LQD	ISHARES GS$ INVESTOP CORP BD

INTERNATIONAL

Closed-End Funds	
Ticker	**Name**
TRF	TEMPLETON RUSSIA & EAST EURO
MXE	MEXICO EQUITY AND INCOME FD
SOA	SOUTHERN AFRICA FUND INC
LDF	LATIN AMERICAN DISCOVERY FD
RNE	MORGAN STANLEY EAST EUROPE
LAQ	LATIN AMERICA EQUITY FD INC
MXF	MEXICO FUND INC
BZF	BRAZIL FUND INC
SNF	SPAIN FUND INC
KF	KOREA FUND
IRL	NEW IRELAND FUND INC
SGF	SINGAPORE FUND INC
KEF	KOREA EQUITY FUND
CEE	CENTRAL EUROPE & RUSSIA FUND
BZL	BRAZILIAN EQUITY FUND
JOF	JAPAN SMALLER CAPITALIZATION
APF	MORGAN STANLEY ASIA PACIFIC
GF	NEW GERMANY FUND
TKF	TURKISH INVESTMENT FUND
EF	EUROPE FUND INC
CH	CHILE FUND
SWZ	SWISS HELVETIA FUND
ISL	FIRST ISRAEL FUND INC
IFN	INDIA FUND INC
GRR	ASIA TIGERS FUND INC
TWN	TAIWAN FUND INC
MF	MALAYSIA FUND INC
APB	ASIA PACIFIC FUND INC
JEQ	JAPAN EQUITY FUND
SAF	SCUDDER NEW ASIA FUND INC
TFC	TAIWAN GREATER CHINA FUND
GER	GERMANY FUND
IF	INDONESIA FUND INC
TDF	TEMPLETON DRAGON FUND INC
IIF	MORGAN STANLEY INDIA INVEST
TTF	THAI FUND INC
TF	THAI CAPITAL FUND INC
GCH	GREATER CHINA FUND
CHN	CHINA FUND INC
JFC	JF CHINA REGION FUND INC

iShares	
Ticker	**Name**
EWZ	ISHARES MSCI BRAZIL
EWA	ISHARES MSCI AUSTRALIA INDEX
EWC	ISHARES MSCI CANADA
ILF	ISHARES S&P LATIN AMERICA 40
IXC	ISHARES S&P GLBL ENERGY SECT
EWD	ISHARES MSCI SWEDEN INDEX FD
EPP	ISHARES MSCI PACIFIC EX JPN
EWW	ISHARES MSCI MEXICO
EWO	ISHARES MSCI AUSTRIA INDEX
EWK	ISHARES MSCI BELGIUM
EZA	ISHARES MSCI SOUTH AFRICA IN
EWI	ISHARES MSCI ITALY INDEX FD
EWP	ISHARES MSCI SPAIN INDEX FD
EWG	ISHARES MSCI GERMANY INDEX
EWU	ISHARES MSCI UNITED KINGDOM
EZU	ISHARES MSCI EMU
IEV	ISHARES S&P EUROPE 350
EFA	ISHARES MSCI EAFE INDEX FUND
EWY	ISHARES MSCI SOUTH KOREA IND
EWQ	ISHARES MSCI FRANCE INDEX FD
IXG	ISHARES S&P GLBL FINL SECTOR
EWS	ISHARES MSCI SINGAPORE
IXN	ISHARES S&P GLBL TECH SECTOR
EWN	ISHARES MSCI NETHERLANDS INX
EWH	ISHARES MSCI HONG KONG INDEX
EWT	ISHARES MSCI TAIWAN INDEX FD
ITF	ISHARES S&P/TOPIX 150 INDEX
EWJ	ISHARES MSCI JAPAN INDEX FD
EWM	ISHARES MSCI MALAYSIA
IOO	ISHARES S&P GLOBAL 100
EWL	ISHARES MSCI SWITZERLAND IND
IXJ	ISHARES S&P GLBL HEALTHCARE
NEW!!	
FXI	ISHARES FTSE/XINHUA CHINA 25

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