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Commentary

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Worth the Risk?

Would you accept a 25% risk for 100% upside?

That is the question we are facing with gold today. Gold, like the stock market has gone “straight up” this year. The difference between the two is that gold’s fundamentals are improving while the stock market’s and US Economy are not.

From a strictly technical perspective, gold’s move has been too far, too fast. This means it should pull back in the short run. Whether it will or not is a different story.

The charts show that gold’s first line of support should be around $1,000. If this level is broken, then 985 could be the next stop. Stronger support is in the 940 – 960 area. If it were to break below $900/oz, then a revisit of the cycle lows of $865 would not be out of the question.

That’s the downside. Now the good news.

Inflation Hedge
Gold is considered an inflation hedge, so if one adjusted the price of gold for inflation since it’s previous cycle high of over $800/oz in 1982, gold would be about $2,100 – $2,600, depending on how you measure inflation. John Williams, from Shadow Government Statistics, measures inflation according to the way the government used to do it before the formula was changed during Greenspan’s tenure at the Fed. According to Williams, the inflation adjusted price of gold would top $6,000. So no matter how you slice it, gold could go a long way to catch up to where it belongs, inflation adjusted.

Hedge on Dollar
Fundamentally, gold is also used as a hedge on the US Dollar. As the US Dollar declines, gold appreciates. But it is not a perfect hedge. For instance, in 2005, both gold and the US Dollar rallied. They also rallied together in 2001. (If they both could go up together, might they also come down together, in the short run at least?)

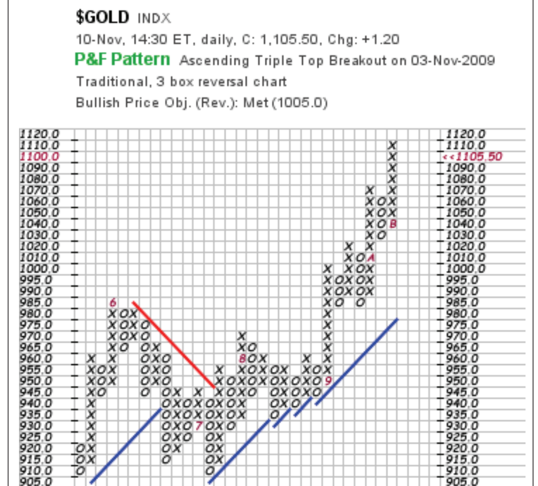
There is widespread concern that the US Dollar is as oversold as gold is overbought. This makes sense. The US Dollar could rally. Although fundamentals are against the Dollar, nothing drops straight down forever. Just as bull markets have pullbacks, bear markets can rally. There is no doubt that the Dollar is in a bear market. But a rally wouldn’t be abnormal. It should be expected.

It would be short term and is very likely to rally less than 10%. But a rally in the Dollar could have widespread implications for many asset classes. Gold, commodities, oil, foreign investments and even US stocks have benefited from the declining dollar. If it started to rally, these asset classes would be expected to come down. 10%, 20%, 40%? It would be hard to say. Hard assets are in a bull market though, so any pullback should be a buying opportunity. This could limit any downside they have. US stocks, however, are in a long term bear market. Rallies are selling opportunities. Declines should be avoided.

The Fed has given us a reprieve on the Dollar rally. The minutes of the most recent Fed meeting indicate that the Fed has no plans to raise rates anytime soon. Raising short term interest rates is one of the primary tools the Fed has to fight inflation. It also protects the Dollar. Raising rates can slow or reverse a declining Dollar. With

Stock market and Gold markets are due for a correction

The S&P 500 has had a terrific run off its low in March. Normally, you would expect to see a correction after such a run. A 20% decline would not be out of line. A re-test of the March lows would be a decline of more than 35%.



Gold also has had a great run this year. Major support is in the 985 to 1,000 area. A Dollar rally could bring gold back down to the cycle lows, possibly breaking below 900.

The key difference is that Gold is in a bull market and the stock market is in a bear market. Gold’s long term prospects look good, while the equity markets have rallied in the face of deteriorating fundamentals.

Fed intervention out of the way, the Dollar's direction is up to the markets, and so far, they want to send it lower.

With all of the talk (and action) of replacing the US Dollar as the World's reserve currency, it is just a matter of time before it is officially announced what the replacement will be. Many countries are not waiting. China has announced international trade with many countries will be done in their own currency and their trading partners don't seem to mind.

So if the Dollar does rally, it will very likely be a short term event and the impact on other asset classes will also be short term. Dr. Marc Faber has said he didn't think gold would go below $1,000/oz again. So if it does, it could be a great buying opportunity.

The Dollar bear continues...

After a 26% rally in 2008, the US Dollar peaked in March and has been dropping back towards previous lows. This has helped gold's rally.

If the Dollar were to start to head back up, it would likely be only a short term move since its fundamentals are still deteriorating.

Foreign buyers

India and China have shown they understand the value of gold and in November, India shocked the investing world by buying half of the IMF's gold reserves. It had long been expected that the Chinese would be buying all of what the IMF had for sale. India stepping in front of the Chinese now adds another big buyer of gold to the mix.

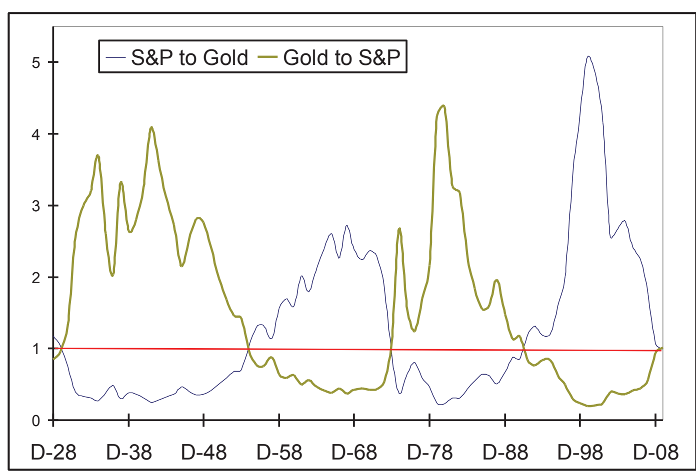
Central Banks in emerging markets are recognizing the need to diversify out of US Dollars. China made a big splash with the announcement that they had doubled their gold holdings earlier this year. India's purchase is a signal that other countries are stocking up on gold. Countries as diverse as Russia to Sri Lanka have announced they are buying gold for diversification purposes.

To put the potential for central bank purchases into perspective, the World Gold Council reports that China has only 2% of its reserves in gold. Russia has 4% and Brazil only 0.5%. 10.3% is the world average for gold reserves. This means that China's recent gold purchase would have to be increased by 5 times to get close to the average.

Limited Supply

According to Aaron Regent, the president of Barrick Gold, production from mines has been declining about 1m ounces per year for the past 9 years. This equates to a decline of almost 10% since 2000. Goldline International reports that South Africa's production has declined by more than 70% since 1970.

Gold vs Stocks



Gold vs the S&P 500 is about to crossover a significant point. It is the point at which gold outperforms relative to the stock market. Each time these lines have crossed, gold has gone on to outperform stocks for significant periods of time.

Will history repeat? With gold's fundamentals improving and US equities fundamentals deteriorating, it appears likely that gold will be the place to be instead of US Equities for some time to come. .

With so many large buyers of gold, (countries around the world) and a limited supply of physical gold, traders are worried about a short squeeze, pushing prices into a spike up. The limited supply of physical gold has been an issue for dealers for most of the year with long delays in delivery of the precious metal.

US Government Actions

Doug Noland from Prudent Bear says: "We don't see an end anytime soon to massive deficits and ultra-loose monetary policy. Such a course of policymaking essentially translates into ongoing dollar devaluation — which is good for gold." We couldn't agree more.

What he neglected to include was higher taxes and increased government spending, along with rising unemployment. Not to mention not a single new regulation, rule or law - nothing has changed in the derivatives arena, the main cause of the financial crisis in the first place. It is business as usual for the big banks.

We already know from the White House that they intend to run deficits into the trillions, running up the public debt to almost

double current levels. Letting inflation run is the easiest way to solve a debt problem and this appears to be the course set by the Administration and the Fed.

Riley's Rules

Hold assets during bull market corrections. It can be painful. It can seem like it will never end. You will ask yourself why you (I) didn't sell when it was way up at $XXX.XX. But in the long run, holding during a bull market correction is the right thing to do. (Not the same as holding onto assets during a bear market – that is dumb.)

The risk of getting out of investments that are in a bull market ahead of a potential correction is that you may time the correction wrong and the market doesn't correct – (whoops!) or it corrects, only after tacking on an additional 10% or 20%. You get the pleasure of watching the investment go up without you and if you are lucky, buying it back where you sold it.

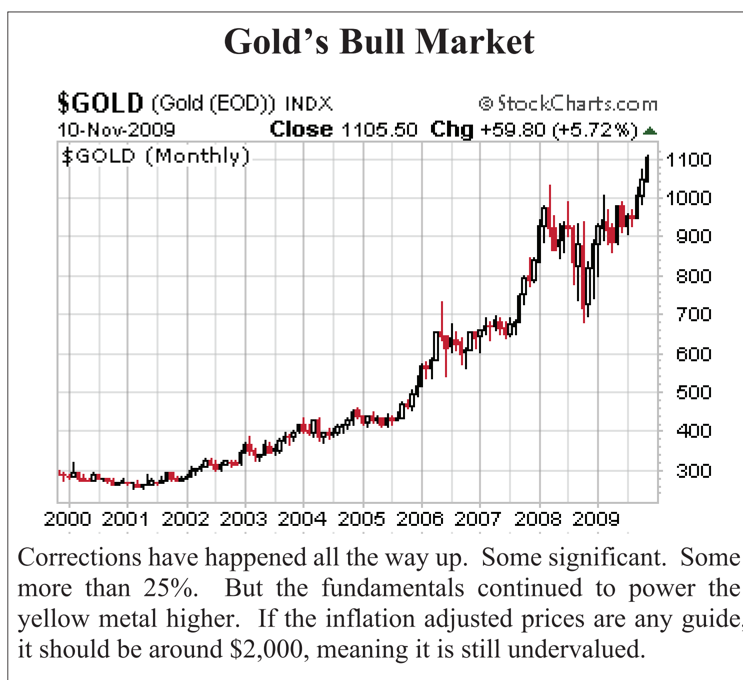
Even if you have great timing and you get out just in time, now you have to figure out when to get back in. This is much more difficult than you think. Maybe it will not go down as far as you originally assumed. Maybe it trades sideways for a long time, thus satisfying the technical need of a correction. The bull could easily resume without you. Whoops!

Summary

With so much on gold's side at this point, from US Government economic policy to foreign buyers to an historic hedge against inflation and currency devaluations, gold's long term looks great. Short term it could have a significant correction though.

Market corrections are designed to shake investments from weak hands. Instead of selling, we intend to be buyers of gold at lower prices. If people are going to panic and sell gold, we will be willing buyers, helping them unload their investments and getting our clients what may be the last great opportunity to buy gold. To us, it isn't a matter of if gold drops, but when. But the upside may have so much potential, that the drop shouldn't get anyone upset. (I doubt the Chinese and Indian central bankers would be upset if gold prices drop.)

When you take a long term perspective and you look at things objectively, 25% downside for potentially 100% upside is well worth the risk.



Corrections have happened all the way up. Some significant. Some more than 25%. But the fundamentals continued to power the yellow metal higher. If the inflation adjusted prices are any guide, it should be around $2,000, meaning it is still undervalued.

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