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Gold in the Ascendancy 2004-2007

by Bob Ward

Gold has been in a bull market for the last three years or five years -- depending on which part of the double bottom, 1999 or 2001, you prefer to use. In the summer of 1999 an extremely negative announcement by the Bank of England prompted a selloff to new 20 year lows ($250). We rallied shortly thereafter but revisited the $250 area again two years later in the spring of 2001. Since then the market has been working irregularly higher and peaked about $430 a few months ago. Yesterday the Comex closed at $387 after having sold off some $20 in the past two weeks. While the zigs and zags and rationales of the market are fascinating to traders, it bores most investors to tears. What they want to know now, and always, is: Where are we going from here?

Our answer is: A lot higher. We believe that Gold is in a secular bull market that will last for at least several more years and easily break through the all-time highs. The necessary long term fundamental conditions required to set up the market for a huge bull run were put into place over the past 15 years by the increasingly deteriorating fundamentals. The plunge to new 20 year lows in 1999, the double bottom, and the increasingly broad based rally since then have firmed up the technical picture.

To use an analogy from nature: There has been a long drought, the forest has had no fires of consequence in 24 years, and the fire fighters have become sure of themselves and smugly complacent. All that need happen now is that the warm winds keep blowing the way they are and the right spark be lit. Economically speaking the script has been written and the stage has been set. There are half a dozen situations that might spark the market and are in the process of arraying themselves for showtime right this moment.

We describe our reasons and rationales below, followed in Part II with some long term trading strategies.

Long Term Investors are the Key

To accurately predict large price moves you must be able to foresee a “sea change” in long term investor philosophy. It always comes back to supply and demand. It is the changing and shifting of future supply and demand that impacts markets the most. These changing fundamentals help shape new investor viewpoints and the investors adjust their holdings accordingly. Something has to be largely different than it has been in the past or it will have no lasting impact on investors. This is known as a “paradigm shift”. We believe a major paradigm shift is underway in the public’s perception of the Dollar and, largely because of this, the precious metals.

Ultimately it is a major change in fundamentals that attracts or discourages the longer term investors. It is the increase or decrease of long term investor positions that adds major upside or downside impetus to markets. The big question to be answered is always: If certain events take place will these events encourage or discourage more long term investing?

In a bear market that lasts as long as the Gold market's has, the ranks of the long term investors have been decimated long ago. The battle was won decisively on the downside and so every right-thinking investor has fled the Gold market years ago. However, it's the coming-back of old investors that puts the zip in a market's step again. And the Gold market's potential for this has no parallel in financial markets today.

On a day to day basis the markets gyrate up and down in a manner that seems to have meaning at the time, but turns out, after the fact, to be largely random in nature. After a while these daily short term trading battles become overshadowed and then overpowered by the accumulated buying and selling of long term investors. The long term accumulation (or liquidation) of positions creates the imbalances which drive prices for more than merely a day or two.

It is the long term investors that ultimately determine the long term trend. When there is no interest by the long term investors, the locals and day traders and scalpers end up merely standing in a circle picking each others pockets -- it is not a pretty sight. What the long term investors are always trying to foresee is a changing mindset in the marketplace and the timing thereof. They are trying to identify the next paradigm shift.

The Market Paradigm of the '90s

In the late 1980's Gold producers re-discovered one of the wondrous alchemies of finance: how to turn tons of ore buried miles underground into cold cash in their hands. They had become increasingly aware that they could sell their next several years of production right now by tapping into the forward markets. And if they wanted the cash today (to finance exploration projects, say) they could borrow Gold from the dealers to use in the delivery of metal promised but not yet in hand.

The pressure of all this added supply did not go unnoticed by the market. As other major mines joined in and sold more and more years of future production the price of Gold stagnated. Rallies were muted and sell-offs lasted longer and went deeper than would otherwise have happened.

Some of the biggest and most appropriate long term holders of Gold, the central banks, couldn't defend tying up their assets in one of the worst performing monetary classes. In today's "hot money" environment only the last year or the last quarter matters to investors and thus to Boards of Directors. And Gold had been a cold asset for quite some time. To earn a little return on their assets the central banks started lending more and more Gold to dealers, who lent it to producers and speculators, and the prices continued lower. Eventually the central banks could no longer stand idly by as they watched the endless dripping lower of Gold prices and they began dumping their long term holdings. At first they did it gingerly, but after a few years they started selling in earnest. By 1999 the gloves were off and the Bank of England announced that Gold stunk and they were getting out. The first "vee" of the double bottom was made shortly thereafter.

During this period we had producers over-selling, central banks dishoarding, and hedge funds doing "carry trades" wherein they borrowed spot Gold and sold it short – a trade that stayed profitable seemingly forever. Long term buyers were battered year after year and rewarded never at all.

Compare this to the other financial markets where investors were not merely happy, they were in ecstasy. The stock market was soaring as were bonds. The U.S. Dollar was the happy recipient of both a booming economy and a massive investment inflow since foreigners needed Dollars to buy U.S. stocks and bonds. Foreigners gladly held Dollars because the value of the Dollar was going up and they could always turn Dollars into other types of U.S. paper, that is, U.S. stocks and bonds. In fact, if you weren't up to your eyeballs in "paper" during the '90s you were missing out entirely. Call it the decade of "paper envy" and the "loathing of Gold".

The New Paradigm

For lovers of paper and haters of Gold, a major change began soon after the year 2000 rolled in and it's a long term change. Even Warren Buffet, the shrewdest investor in history, thinks so, or he wouldn't have accumulated over $12 billion in Forex contracts for Berkshire Hathaway in 2003 – and he's never been a believer in foreign currencies or hard assets. He's become the second richest man in the world precisely by understanding the true value of paper assets better than anyone in the history of the world. This is no small recommendation.

Buffet's alarm is focused on the huge and growing U.S. trade deficit and it has put him into a decidedly anti-Dollar bias. He is extremely worried that the claims on our economy (our Dollars) are being spread far and wide around the globe in gargantuan amounts as we pay them out for the trinkets and electronic gizmos Americans can't seem to live without. He is afraid that one day soon the consequences of our overspending will come home to haunt us. As other investment advisors slowly accede to his view and re-invest their portfolios, as they always do, it is likely that this will grow into the decade of "loathing the Dollar". Fear of a continuously devaluing Dollar is largely what has set the stage for the new resurgence in Gold.

So far the rally in Gold has been largely dependent on the falling Dollar. The rally in Gold from $250 to $400, has been a 60% up-move. Comparing Gold to the newly created Euro currency (an inverse proxy for the Dollar) we can see that the Euro has also rallied from roughly $0.85 to $1.25, a 47% up-move. The Gold rally in terms of Euros has thus been muted by comparison to the Gold rally in Dollars. For Gold to kick into its next gear, overdrive, it will have to be rallying in all the major currencies. This will attract a far wider audience of investors and pull money from all over the globe. But we aren't there yet.

We believe, like Warren Buffet, that the Dollar is merely in the early stages of its journey on a southbound train. While a declining Dollar is a necessary lynchpin in propping up the price of Gold, it still can't turn Gold into a red hot market until a few other stressors fall into place simultaneously (we give a list of likely candidates below). The real bull market in Gold doesn't truly begin until later in the cycle when the pervading mood in the financial marketplaces becomes one of creeping dread and foreboding. Unfortunately, the actions of our Federal Reserve in holding interest rates artificially low for so long and their disdain of the Dollar have made this outcome all too likely.

Candidates, Catalysts, and Confluences

We are witnessing the greatest upswell of global trade in the history of the world. And, sad to say, <u>the competition is beating the living daylights out of us</u>. We send them Dollars and they send us VCRs and DVDs and High Definition TVs and Color Cell Phones. We send them Dollars and they send us stay-prest clothes and luxury automobiles and new subway cars and metro buses. We outsource our computer software programming to them because they are cheaper and they toil long and hard and smile and take our Dollars. Then they buy our stocks and bonds. Foreigners now own 51% of all US Government Bonds, more than ever in history. We spend our Dollars and they invest their Dollars. If this sounds amazingly like an Aesop's fable about the Grasshopper and the Ant, well that's because it is. And, as the grasshopper learned to his dismay, frolicking in the summer is sweet, but the cold, hungry winter is never very far away. The high days of summer are over for the Dollar and autumn has set in.

<u>Forex</u> - So far foreign investors have been very patient with the deterioration of the Dollar and other U.S. paper assets (stocks and bonds). In fact, it is foreign investment that has propped up our bond markets with their endless buying of Treasury bonds. They do this because it is the best "sure return" they can find on the many, many Dollars they now have. They desperately need a place to park the flood of Dollars we send them. They receive most of these Dollars when they ply their trade advantage (send us their stuff, take our Dollars), but recently they have gathered another excess of Dollars from Forex operations wherein they try to support our currency and hold theirs down (to keep their trade advantage).

They desperately want to keep doing business with us because Americans are the best- paying, biggest consumers of their products in the world. Without American buyers their production of goods and services would come to a screeching halt. To maintain a positive trade balance, which they heartily believe in (but our government sneers at), they want their currency cheap and ours expensive. But over the past two years the Dollar has started to fall out of bed despite their wishes and their hundreds of billions of Dollars of accumulated Forex support operations. Without a balanced demand between two currencies (for trade and/or investment) the *unwanted currency collapses*.

Our drowning them in Dollars stopped being acceptable at the prevailing Dollar exchange rate because their appetite for Dollars was getting sated. This was partly because their willingness to re-invest the Dollars into the U.S. was waning as they choked on our falling stocks and bonds. Something had to give eventually and it was the exchange rate of the Dollar that gave first. This is what traders are always in search of -- the well-defined path of least resistance. As Jesse Livermore pointed out in his "Reminiscences of a Stock Operator", the path of least resistance for prices is often unclear, but when it clearly shows itself you've got the "house edge" going your way for a change.

Over the last few years there has been relatively little panic as the Dollar exchange rate dropped 30% from its highs. Because the long term deterioration in our trade continues and we've paid away far too many Dollars already to foreign trade partners, this fall in the dollar is likely to continue. The Dollar will likely devalue in the same orderly fashion until foreign investors start to fear that their invested Dollars are in danger. At that point a dumping of Dollars will ensue, and this will prompt other markets to dislocate as well.

What might spark foreigners into believing that their investments here are in danger? Stagnating or falling prices in U.S. markets (bonds or stocks), rising inflation, rising interest rates, a slowing economy, a cooling off of the U.S. housing market, mini-panics in emerging market bonds – Russia and South America, crude oil at $50. Take your pick.

Bond Carry Trade – Given the fact that we now have upwards of 8000 hedge funds managing almost a Trillion dollars in cash, which they usually over-leverage, there is an enormous amount of "hot money" running around and desperately seeking the next sure bet. One of the "sure things" of the past several years has been the "bond carry trade". Over the years we've seen carry trades blow up spectacularly in the Dollar/Yen and the Gold market, and now it's the U.S. Treasury Bond market's chance. And this trade is reputed to be held in amounts many multiples bigger than anything ever seen before, almost a Trillion dollars worth of bond carries if the rumors are accurate.

The concept is simple. Short term rates have been running below 2% for quite some time and the long Treasury Bonds have, say, a 6% coupon. Buy the bonds and make 4% per annum *plus any gain as the bond continues its bull run*. Unfortunately, such theorizing and buying is what helped push bonds to their high last year and they have fallen from roughly 126 to 102 before bouncing to 108 today. The devil is in the details. And the details are that you need the bond market to *not go down*. At some point this "sure thing" becomes a very bad trade and a de-leveraging and unwinding begins. Some of this has occurred already and caused the steep drops in bond prices this year. If it continues the foreign holders, *who hold 51% of US Treasury Bonds*, will get indigestion at some point and bonds, which were once the ultimate "flight to quality" asset will have lost that status entirely. The bond market is having a very hard time deciding whether the Fed must raise rates or whether we've slipped into the beginning of a recession. When the bond carry trade finally unravels it is a mini-disaster waiting to happen.

Stocks Here is an interesting stock market tidbit. For the past ten years, from 1994-2003, the public pumped an average of $150 Billion a year into equity mutual funds (not bonds, not money markets, just stocks). It was this swell of liquidity that forced fund managers to buy, even if they didn't want to, and pressed p/e's to alltime highs. The fever pitch increased month by month through Jan 2000 when in a single month they poured a whopping $44 Billion into equities and then topped it in Feb 2000 with a gargantuan $55 Billion! This was right before the market's fever broke whereupon we plunged ever lower for the next 2½ years. An overenthusiastic public is a great "reverse indicator" as long as you wait 'til the turn finally comes.

Well, the public is very enthusiastic again. At the beginning of this year, January 2004, the public net bought a mind boggling $43 Billion of equity mutual funds in a single month. That is the third largest monthly inflow in history topped only by Jan and Feb 2000 as described above. Just as these monies were being fed into the market the Nasdaq peaked at 2150 (mid-Jan 2004). Those anticipating the celebrated "January Effect" were once again denied a free lunch unless they bailed out quickly. The Nasdaq is now 14% below those mid-January highs and down about 7-8% YTD. This adds up to a lot of not-so-happy-campers. But they are still calm. They've stopped mailing in quite as many checks to the mutual funds however – in May they net invested only 1% as much in January (June might hit just 25%of January). The enthusiasm is waning.

Looking back over the past ten years there are only three occasions when the public poured more than $20B each month (on average) into equities for the preceding 12 months (that is, more than $240B cumulatively over 12 months). The first time was April-June 1998 just before the mini-panic of July-October 1998 (this added fuel to the LTCM meltdown). The second time the public invested over $240 Billion was in 2000 -- which presaged the Nasdaq collapse of 80% and the S&P fall of 50%. The third time has occurred just now, in March-May 2004. On each occasion when the $240B+ momentum in public money ebbed, the market stagnated and then headed lower. The first two times were unmitigated disasters for many. What will this time hold? What will foreign investors do if it happens? Selling stocks gives them Dollars. What do they do with the Dollars? Too many unwanted Dollars might cause a Forex implosion.

Houses as Piggybanks The "re-fi" craze, led by extraordinarily low interest rates and constantly increasing home prices has become the savior of the American consumer and thus of the economy. Homes have become the piggybanks of first resort for many homeowners. Chanting that "debt is good" the American consumer is borrowing more and more. In fact there are so many loan companies dying for fees that new homes can be arranged on 100%+ financing by taking out a first mortgage, a home equity loan, and an unsecured line of credit simultaneously.

Such over-borrowing on mortgages sounds faintly reminiscent of the mid-1980's. You might recall the S&L bust of 1986 – 1990? The single biggest government bailout in US history estimated at over $500 Billion. It was caused by precisely such overlending on real estate. And the typical real estate cycle is 18 years long peak to peak. Do the math.

When the re-fi craze is over so is the consumer binge of spending. As interest rates rise (and even if they sit here) there is a slowdown in new applications to refinance. The impact of the new-found borrowed money stops flowing through the economy and stagnation sets in. The consumer slows a step and the economy stumbles.

Inflation There is no inflation, there is no inflation, there is no inflation. That's why the government has to keep knocking the CPI numbers down with "hedonic adjustments". If your car is 10% faster and your air conditioning 20% cooler than ten years ago – they'll define their prices to be "unchanged" if they are up only 10-20%.

The excess Dollars that are out there have been chasing the U.S stock and bond markets for ten years and are now chasing real estate instead. Inflation occurred in those markets with a vengeance. When that is finished there will be a lot of Dollars with no major asset to chase. Maybe collectibles will come back. Ricky Martin posters anyone?

Oil at $50 The single most incredible market event taking place today is $43 crude oil – without a threat of nuclear war in sight! It used to be that a major shooting war was required to pop oil as high as $35 where it would tantalize the bulls until plunging once the threat of "nuking the oil fields" was past. Today we have theoretical control of Iraq and yet the oil prices are hitting all time highs daily. The SUV drivers moan at the gas pump, but keep filling up the tanks. Oil is a pervasive and expensive cost of doing business through our entire economic system. Higher oil prices are the equivalent, some say, of a massive tax increase. But the stock and bond markets largely ignore it. For now.

Like many things, it doesn't matter 'til it matters. And then everyone focuses on it and gets crazy all at once. What is the price that gets everyone's attention and scares the bejeebers out of them? Is it $50 oil or $3.00 a gallon gas at the pump? No matter, it doesn't bode well for the economy. And recession leads to lower stocks and a lower currency. As Soros has proven often enough, ultimately it's a strong economy that keeps a currency strong. Or as the political buzz phrase goes: "It's the economy stupid."

Conclusion

Now it's true that markets are notoriously devious and resistant to prediction. And none of our "spark-accelerants" may occur or even have the expected effect. But just remember this: if a market is steadily eroding over several years, such as the Dollar has been doing, there is always, always, always a phase where the long term investors' fears overwhelm their commitment and a panic, temporary at the very least, ensues. This is the stuff that breakaway gaps, running gaps, and exhaustion gaps depend upon. Gaps are part and parcel of every trending market in history. Whenever a trend becomes observable to even the most untrained eye, sooner or later the die is cast. If it looks like a trend, moves like a trend, and it gaps like a trend, then some traders are going to try to outdo the competition and outrun the trend. They conclude: Why wait for the obvious, get out now. Such is the logic of markets and the self-prophesying action of the crowd.

There is a lot of Gold out there and it takes quite a long time to absorb it all. One key question is: Will the bullish market forces continue long enough to absorb it all? The longer the market stays in bull mode the more the resistance has been thinned out and absorbed, making spurts on the upside more likely.

The Fed has held a fire sale on Dollars over the past four years as they've lowered interest rates to attract all comers. The public took them to be saying "Borrow all you can at 1%" and "It's time you re-fi and move up to a new SUV". Isn't it sort of alarming that the greatest financial power on earth would have to resort to this? Sort of like Wal-Mart having a 50% off sale – every day for years. There's a whiff of those deceitful "Going Out Of Business" signs on so many rundown storefronts. And it smells bad.

You want to know how it ends? Just ask your local car retailer. Big discounts and rebates worked well until everybody got their fill. Now bigger and bigger discounts and financing must be offered to attract the wised-up crowd hardened to the "Final Sale Day" pronouncements. As the expression goes "You can put on lipstick, but it's still a pig".

No parallels in history ever seem to work exactly, but try this one for kicks. In the late 1960's the U.S. stock market had just finished a fantastic 20 year run and suddenly the world became fed up with the Dollar. Foreigners, led by the French and the Swiss, caused a run on the Gold offered by the Federal Reserve at $35 an ounce. After many raids and shipping hundreds of tonnes of Gold to Europe from New York the physical gold supply of the U.S. was in threat of running dry. Nixon slammed the gold window shut in 1968 and devalued the price from $35 to $38 and then later again to $42. Ten years later in 1980 it was 20 times higher.

During this period, the 1970's, we had a falling Dollar, falling stock markets, falling bonds, rising interest rates, rising prices, and flat corporate earnings – in short, stagflation. The economy suffered and no foreigner ever thought there would be an end to it. Personally speaking we remember being abused by every visiting Swiss banker who just had to tell us how stupid and wasteful Americans were and how the answer to our problems was thrift and forbearance. This period was the best run ever for Gold and currencies, and one of the worst ever for stocks, bonds, and the Dollar. Finally, the escalating panic of both foreign and American investors propelled Gold from star to superstar in the very last months of the tortured 1970's (Sept – Dec 1979). In mid January 1980 Gold exploded to $875 and silver to $51 as the bull market reached its peak.

There is a long term paradigm shift occurring in Gold right now and the higher market prices show that the long term investors are betting on it. One of George Soros' leading theories is to "identify the economic premise that is false and bet against it." The Fed has been betting that they can give away dollars forever and beggar their neighbors by borrowing everything the neighbors have. This is certainly a false economic premise and has been proven false time and again. Warren Buffet is betting against this false premise - and so should we.

End Part I - Bob Ward July 30, 2004