ASPERA UPDATE

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September 2011: Did The Gold Bull Market Just End?

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"Prediction is very difficult, especially if it's about the future."

Niels Bohr

Executive Summary

Q: Is this the end of the gold bull market?

A: I seriously doubt it.

Exhaustive Exposition

I had a rough start to the day. My oldest dog was tip-toeing around the bedroom early this morning before anyone was awake – a sure sign that she had a full bladder. I grabbed my robe, opened the bedroom door, and followed her down the stairs. As she hustled to the back door, I could just make out her outline in the darkness. It looked like the kind of stooped squat-walk an older person with a bad back and oxygen tank does when rushing toward an early-bird buffet in Vegas (or how I walk after a long run). Fearing she really had to go, I quickened my pace, but alas, her need to relieve herself was rapidly diminishing. I slipped in her urine, my feet flew out from under me, I jammed my foot on a door, and I landed square on my backside in a puddle of dog pee. Fortunately, my head took the brunt of the impact. At least I knew what the gold market felt like this past week.

The price of gold took a pretty good hit over the last few days, falling $155 dollars. Since the high of September 5th, the price has dropped about $260. I received an email yesterday that concisely asked what some of you may be thinking: "Healthy correction or something to be concerned about?" It's a good question. I'll begin a much less concise answer with some self-quoting from the last few Quarterly Reviews. Let's begin with the Q4 2010 Review:

> With our largest bet still being in the precious metals space, we should expect the performance of gold, silver, and the mining stocks to be the key driver of our portfolio performance. This group has had a very nice run, but as I often emphasize, bull markets don't go straight up. I've been expecting a profit-taking pullback in this group now for a few months, but the metals have proven resilient. Still, a pullback should be expected.

In the Q1 2011 Review, I wrote:

> As I've been saying for some time, our performance will be heavily dependent on these precious metals positions. When

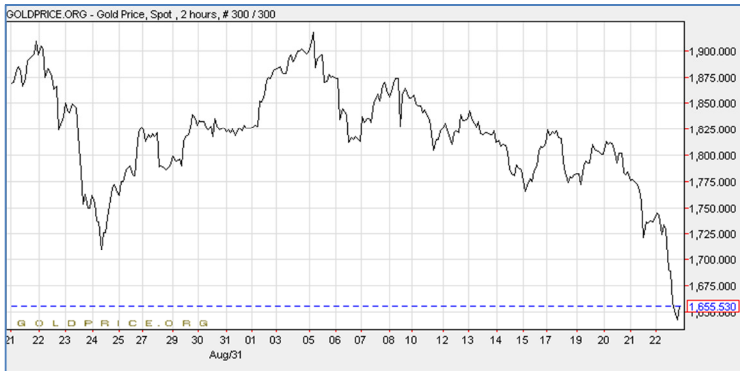
> they retrench, we'll decline as well. When they rise, we'll benefit. The pattern for some time has been for us to post nice gains in a relatively short time period as the metals and miners break out to the upside. We then give some of that back on the ensuing pullback. Next, we tend not to do much of anything as the metals consolidate for some number of months, and then we start all over again.

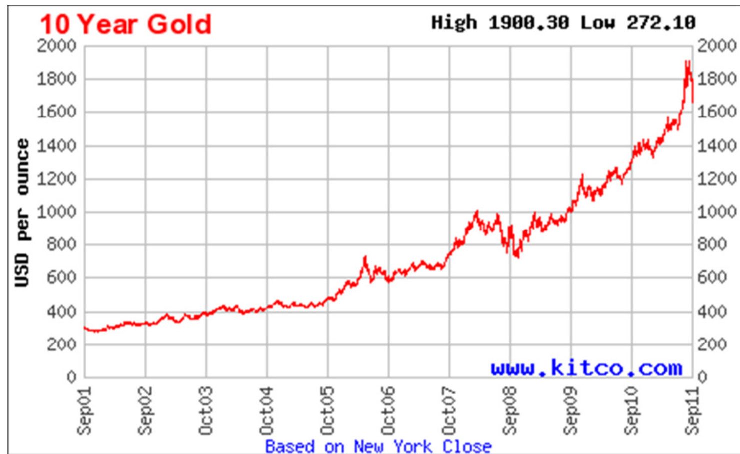
Finally, in the most recent Quarterly Review I wrote the following:

> Our returns are likely to be a bit more volatile moving forward given our higher net exposure. The miners, in particular, are a very volatile group. This has worked to our advantage over time, but it does expose us to more short-term volatility in returns. You all know how irrelevant I think short-term performance is, but I want to be sure that you've been forewarned – again.

These quotes are just from the last three Reviews, but you can find similar quotes in almost every Review I've written. No one can claim that they haven't been warned of a correction! The only surprise is that we went so long without a pullback. The longer an asset climbs without much of a pullback, the more surprising that inevitable pullback is to most folks.

The Gold Price Cycle





Now that we're finally having the overdue correction, let's take a look at it so far and add some perspective. The chart to the left shows the price of gold over the last month. We see that gold twice tested the $1,900 level and failed. We had a steep and rapid decline to $1,700 after the first failure and a slower but deeper decline after the second failure.

As ugly as the chart is, it covers a very short time period from our perspective. The second chart shows the price of gold over the past decade. The current decline is clearly visible, but we can also see the parabolic move in the price of gold this year from $1,400 to $1,900. Looking at the chart, we can see similar parabolic moves all the way back to 2006.

Every parabolic move has a similar pattern. The price of gold rockets higher over a short period of time (weeks or months), a significant pullback then occurs, the price consolidates for some period of time, and then the price starts moving higher again.

I've explained this pattern in the past, but it's worth reviewing. In very simplified terms, you can think of gold buyers as belonging to one of two general categories. The first is longer-term investors (that's us). We have a long-term investment horizon and own gold due to the mismanagement of global monetary and

fiscal policy as well as an expectation of continued competitive devaluation of fiat (paper) currencies. This is a multi-year phenomenon and lends itself to a buy-and-hold and buy-on-the-dips approach.

The second group of buyers encompasses short-term traders, momentum investors, some hedge funds, lobotomized CNBC guests, and other lemming-like groups. These folks have no interest in the long-term fundamental thesis for owning gold nor do they understand it. 70% of them have trouble even spelling the word gold, and most of them long ago sold their gold pinky rings to their local "We Buy Gold" kiosks to pay for hair plugs and spray-on tans.

Buying pressure from both groups drives the price of the metal well above trend at times as we saw during the recent rapid rise to $1,900. However, when the price rise inevitably slows and starts to reverse, the lemmings are quick to sell. They're just trying to make a quick buck and have no appetite for riding the price down 10% or more. You've heard me talk about the "weak hands," and this is the group I'm referring to. Their selling is a key part of what drives the price back down after a parabolic move higher.

Following the decline, we have a period of consolidation during which the price of gold remains relatively flat for some period of time. This is a very important phase as the gold that is sold by any remaining weak hands gets bought by longer-term holders. This is what I mean when I refer to gold moving to stronger hands. Once the weak hands have been shaken out of the market, gold is once again ready to make its next move higher. Wash, rinse, repeat. The only question is how long each phase will last.

Is It Different This Time?

Now that we understand the cycle, we need to recognize that this cycle will end at some point. Eventually, the pullback won't be temporary. Instead, it will mark the end of the gold bull market. Of course, we'll only know this with certainty in hindsight, but every time we get a pullback in the price of gold, we do need to ask ourselves if our thesis has changed and whether it's time for us to head for higher ground.

To answer this question, we simply have to examine whether global monetary and fiscal policy is now being managed responsibly and prudently. In other words, has anything changed? I still struggle to find much sympathy for the view that now is the time to put our faith in global politicians and central bankers. Can kicking is still the order of the day. The following is just a flavor of what we face:

- Europe is a mess with some type of default/dissolution/restructuring inevitable.
- Key banks in the U.S. and Europe are grossly undercapitalized and are technically insolvent.
- Debt levels throughout much of the developed world and in key developing countries preclude strong future growth until the debt is substantially reduced.
- The debt rating of the U.S. was justifiably downgraded.
- The fiscal debate in the U.S. doesn't even begin to address the roughly $100 trillion of funded and unfunded debt that is smothering us.
- China's strong growth is likely to slow as the country deals with a coastal real estate bubble and excessive spending in fixed investment.
- Fiscal stimulus of any size is unlikely (fortunately) throughout much of the world given current debt levels and the state of political discourse. This will put more pressure on central banks to print money and maintain low interest rates.
- Currency devaluation remains one of the few tools available to spur economic activity. I can't think of one country that wants a strong currency. This will be a key issue going forward.
- The Swiss recently devalued their franc and pegged it to the euro. The Swiss franc had been one of the safe havens in the world, but that's no longer the case.
- Japan remains a basket case with too much debt and strong internal pressure to lower the value of the yen.

For us to change our thesis, we would need to see the debt crisis conclusively dealt with both here and abroad. In addition, we'd need to see an end to loose monetary policy. We'd need to see countries enacting policies that defend their currencies. That would mean higher interest rates and smaller central bank balance sheets. I do believe this day will come, but as of yet, there is no evidence of it.

What Specifically Caused this Pullback?

I'm always wary of speaking too definitively as to why a market or any asset class moved higher or lower over short time frames. No one can read the mind of the market, and investors and traders have diverse motivations. Still, there are a number of factors which helped precipitate and exacerbate this current pullback in the price of gold.

1. Gold was overbought. Gold had a big run to $1,900 in a short period of time. On a short-term basis, the metal got ahead of itself and was ripe for a pullback.
2. Fed disappointment. There was certainly some anticipation that the Fed would announce another big money-printing quantitative easing (QE) program after its recent meeting. The Fed did announce further intervention, but this round doesn't include new money printing, so those hoping for a big QE3 were left disappointed.
3. Rumors of hedge fund selling. With the markets getting whacked, there were rumors of underperforming hedge funds selling their precious metals positions. We won't know if this is true for some time, but it's plausible. The rumors alone were likely a factor.
4. Potential central bank intervention. Central banks have an incentive to hold down the price of gold as it serves to mask the debasement of currencies. This is a tough one to prove, and there are varying views on this, but it isn't hard to imagine that key central bankers aren't exactly embracing the idea of gold breaking through $2,000.
5. Margin hike on futures contracts. We found out late Friday afternoon that margins on gold and silver futures contracts were hiked yet again. This forces holders of these futures contracts to post more collateral (cash). Those who can't or won't are forced to sell their contracts, putting downward pressure on prices in the short-term.

These are all short-term negatives for the price of gold, but they don't change the fundamental reason we own it. Importantly, I believe that people are misinterpreting the latest Fed action. A number of pundits are claiming that the Fed is signaling that it's out of ammunition and that QE3 won't be coming. I seriously doubt this. In the last Quarterly Review, I laid out what I believe needs to happen before a big QE3 program could begin. The Fed would need falling commodity prices, weak employment, weak GDP, and a significant drop in the equity market. All of these are currently unfolding, but we haven't seen enough weakness (particularly in the equity market) to give the Fed the cover it needs for QE3 -- yet.

Furthermore, it isn't just our central bank that can enact QE. Any central bank with control over its own currency can do so. We know from the minutes of the Bank of England's most recent meeting that they were biased toward more QE if their economy weakened further. Their economy has clearly weakened further since that meeting. We also know that the Bank of Japan is under intense pressure to lower the value of the yen. The European Central Bank (ECB) has been roundly criticized for raising interest rates earlier this year. They are almost certain to lower rates soon and possibly print serious money in 2012 as part of a broad European rescue program. China has actually tightened policy somewhat, but we'll see if they can stick to that in the face of slowing growth. A weaker global economy will certainly impact the commodity-exporting countries like Australia and Canada. I expect to see looser monetary policy from them as well.

In sum, the notion that central banks have found religion and are about to start defending their currencies and reduce their balance sheets seems a bit far-fetched. I expect the market to come around to this view in the weeks and months ahead. It probably won't be long until Bernanke and his minions are talking up the prospects of more significant easing (money printing).

What's Next For Gold?

You don't seriously expect a straight answer to that question, I hope. In the short-term, little would surprise me. Gold and silver may continue to be under pressure as long as there are weak hands that haven't liquidated, hedge funds that need to raise cash, and fears that the Fed is done easing. If the futures

exchange enacts multiple margin hikes in the short term (as they did earlier this year with silver), we certainly could see more downside.

At some point, the selling pressure will abate, and I expect investors to once again focus on the merits of gold ownership in a world of competitive currency devaluation, counterparty risk, and political ineptitude. As investors become more convinced that central bank spigots will remain open, I expect them to return to buying gold.

Let's Wrap It Up

Here are the key takeaways:

- Our thesis for owning gold hasn't changed.
- The current sell-off is overdue and normal so far.
- I have no idea when the sell-off will end since it hinges on a number of factors.
- Central bank money printing is one of the last tools left, and we haven't seen the last of it.

What are we doing during the pullback? Well, not a lot. We certainly aren't going to make any emotional decisions. I like our long-term positioning, so there isn't much to do. We have done a little trading in the last week. Some trades were done to capture losses for tax purposes in taxable accounts. Others trades were done to high grade portfolios, swapping out of lower quality names into higher quality positions – all within the precious metals sector. You may see more of this type of activity in the days and weeks ahead if the sell-off continues as well as some incremental additions to names we like that go on sale.

It's never enjoyable to give some gains back, but it's an unavoidable part of the process. We aren't entitled to steady monthly and quarterly gains in the price of gold. Periodic pullbacks are a healthy part of a long-term bull market. I've been expecting a pullback, and as ugly as the past week has been, I'd much rather have the pullback occur rapidly and get it over with than drag it out for months. I heard a great comment recently that owning gold and silver is like playing football. If you're not prepared to get knocked down, you don't play.

Best,

Ken Bell, CFA, CFP
President
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