

Gold: New Money

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The gold market is spreading both joy and fear lately. Those who have followed it for some time are more than pleased to see it working its way convincingly above the September Dollar price highs and out of a down trending channel that it has been bouncing around in since making all time highs last March. Both of those marks were cleared easily today and trading is stable in overseas markets, itself a good sign as gold is notorious for giving back gains from large price spikes. As predicted earlier, this latest move seems to be generating technical buying and we imagine those holding the significant short interests in the market are feeling increasingly uncomfortable. Longs are uncomfortable too however. The gold market doesn't seem to be reacting to things the way its "supposed" to. We find this unsurprising, for the reasons outlined below.

There has been plenty of ink on the gold market lately, much of it from newcomers. While we have a contrarian's nervousness about that we also recognize that this is a different precious metals market than any in our memory. While that raises a couple of flags it also opens up the potential for more large gains if things go our way. At the very least, it's likely to ensure a level of volatility that will generate trading opportunities even in periods when the trend might not be our friend. Some of the important ways this market has changed in the past few months are:

1. It's (not) all about US:

The gold price most people watch is the US Dollar price. One of the most common and reliable explanations for movements in the gold price is inverse price movements against the greenback. We've talked about this often enough ourselves and our renewed bullishness early this decade was based on our expectation the Dollar would fall. All that said gold has had many periods where its correlation with the Dollar was only weakly negative or even positive. Lately, gold has moved with the dollar as often as not. This partially reflects the fact that buying is coming from non US sources and that it is being treated as a currency (i.e. store of value) in its own right, not just an "anti-dollar". We still think the Dollar has downside and that gold's negative correlation to the dollar will return but its relative currency neutrality is giving comfort to buyers until that happens.

2. Its not "gold bugs":

We don't think most, or even much, of the current buying is based on hard money apocalyptic beliefs. Yes, there are plenty of financial calamities to go around and that is a good reason for some insurance. Still, we classify most recent buying as "portfolio allocation" by larger investors with broader holdings who have decided it's a good value store in a world with enormous volatility. In short, it's being driven by new investment demand. We realize there is a lot of hand wringing over this and plenty of concern that jewellery and other traditional buyers were pulling back from the market. They usually do when the price runs, but that's not the point. While gold bugs have been precious metals staunchest defenders they were never going to be the reason for gold to see dramatically higher prices. We'll probably get some hate mail for that one but, really, its just common sense. If a group of investors fervently, completely believe the gold price should be and will be (pick your favorite number)

then it will be a self fulfilling prophesy if they have the capability to dominate the market. Gold and silver have not yet reached anything like the heights gold and silver bugs expect because, as a buying group, they don't have the necessary firepower to make it happen themselves. The money being directed at the gold and silver markets right now is coming from capital pools at least a couple of orders of magnitude larger than "traditional" buyers. If gold and silver are ever to see the lofty heights gold and silver bugs hope for those new buyers had to arrive. For now at least, it appears they have.

3. Long Live Paper:

There is not much doubt that, somewhat ironically, the rise of gold and silver ETFs are behind some of the newfound respectability of bullion. Traditionalists are suspicious of ETFs because it's an indirect form of ownership but the simplicity and low transaction costs have helped draw in a lot of new players. ETF's are simply easier for most traders who do not and never will want to deal with things like storage and security. With daily dollar volumes in the biggest ETFs now running at several billion a day, they are also a way for the big boys to play. That's another reason those new pools of capital are now on the scene.

4. Hard to Carry:

With so many assets deflating, gold is suddenly a preferred central bank asset again. Central banks only sold 75% of the gold they could have under the central bank selling agreement in 2008 and they may do even less this year. With countries in a race to zero with interest rates one of the main rationales for central bank selling – opportunity cost of a non interest bearing asset - has quickly faded. On the other hand, gold lease rates have been rising, with the one year lease rate at about 1%. This makes the margins too small for carry trades to be profitable enough to justify the currency risk so more of the central bank bullion is staying in the vaults.

One could add up all the above reasons and boil it down to gold being a momentum play. Indeed, we have seen many dismissive comments recently suggesting precious metals should be avoided because there are more momentum buyers showing up. That is just another way of saying people are buying it because it's what has worked in this market. We're more bemused about the momentum comments than anything. Last time we checked "buying it because it worked" explains about 80% of the trading on the world's stock markets and is the basic concept that underpins virtually the entire mutual fund business.

Admittedly, momentum plays don't come with timetables so one has to be vigilant and watch for major turns in the gold price but that is nothing new. This still looks like a move with legs and we have seen little in the markets to convince us some portfolio insurance is a bad thing or that the Dollar will suddenly go from strength to strength. As long as gold is trading on its own merits and its own accord it matters less what the Dollar does anyway. Gold is getting support because new players recognize it was a good move to have some, whatever their beliefs may be about fiat currencies. There will be plenty of price movement both ways but the fun's not over. One only has to consider markets like tech and housing to realize momentum buying can go on for a very long time. That comment too may be disquieting to some. Doesn't that mean a bubble could form some day? It possible, but a bubble is not a horrible outcome – if you own it first and have the sense to take profits along the way. Ω

Regards for now – David Coffin and Eric Coffin

David Coffin and Eric Coffin are the editors of the HRA Journal, HRA Dispatch and HRA Special Delivery; a family of publications that are focused on metals exploration, development and production companies. Combined mining industry and market experience of over 50 years has made them among the most trusted independent analysts in the sector since they began publication of The Hard Rock Analyst in 1995. They were among the first to draw attention to the commodities super cycle and the disastrous effects of massive forward gold hedging backed up by low grade mining in the 1990's. They have generated one of the best track records in the business thanks to decades of experience and contacts throughout the industry that help them get the story to their readers first. Please visit their website at www.hraadvisory.com for more information.

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