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Gold's New Friends

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Press rumors of planning meetings to shift crude pricing away from the US\$, plus a 0.25% increase in Australia's bank rate, has put some serious bounce in **gold** and **silver** prices. The yellow metal has convincingly moved past its old high, in US\$ terms, and we expect that move to continue. Whether the details of the meetings reported in London's *The Independent* are accurate in every detail or not, markets have had no problem accepting the basic point that the greenback cannot expect long term support as the globe's reserve currency.

Commodity prices, especially gold and silver, are very much currency stories. The US Dollar continues to lose face for a variety of reasons, with more rapid growth in the creditor and resource producing nations being the latest. This, not inflation concerns, has been our focus. Australia's increase in its bank rate may be duplicated in a number of other economies before Washington gets around to it. This would continue the downtrend in the Dollar and uptrend in precious metals no matter what inflation looks like.

Lack of high yield alternatives, plenty of frustrated money on the sidelines and the potential for "good" earnings (at least by comparison with the past 12 months) may drive the major bourses higher yet. This will add more strength to the already outperforming metals sector.

The biggest potential short term risk is that Dollar Distaste reaches the bond market and drives yields higher. That could turn the Dollar and the stock markets around quickly. Be happy, but keep an eye on those Treasury yields.

Copper stocks continue to pile up while the red metal sustains price against US\$ weakness. Over half the stockpile taken down earlier in the year has now come back into the market. Some of the stock on offer would likely disappear on a price decline, or if the current Dollar weakness turns into a rout. But that has to happen before we are comfortable with this year's price gains. The message since mid July has clearly that users think the price move has been "too far—too fast".

That remains the case for most commodities. Traders are playing musical chairs to a tune of weak Dollar fundamentals against a melody of uncertainty for demand sustainability. Notwithstanding our belief that the greenback's decline is a longer term phenomenon, we don't look for anything to trade in one direction permanently and this move will be to a new trading level. We doubt the guy in the last chair of this round will celebrate for very long before shifting direction with the herd.

We should note again the continuing calls by the government for closure of Chinese smelters. This is due to both inefficiency and overcapacity. Current stockpiles aside, excess smelting capacity is not the same as excess metal producing capacity. The two roughly equate for some metals, such as aluminum for which there is a ready supply of input minerals in coastal regions that could use development funding.

Foundry capacity, or overcapacity, will not govern iron ore supply for the time being. Most prospective ore regions need infrastructure to coastal shipping ahead of any expansion. Longer term iron ore supply will come from regions that put that infrastructure, and longer term contracts, in place. We do still see opportunity in iron ore, partially because of the politics that surrounds it.

Medium and longer term copper capacity will be governed by mine supply, and the long time frames for large copper mines to come on stream. Smelters can't process concentrates unless mine supply is sustained. The same holds for zinc and to a lesser extent nickel. We don't view China's push to reduce smelting capacity as a sign the metals bull has run out of steam. It simply makes sense for China to shut in costly, polluting smelters when there is capacity next door in more efficient Korea and Japan.

Japan's new government has referenced abandoning the weak Yen policies of its predecessor several times now. Given it is supposed to be part of the talks cited by *The Independent* and that the Yen (along with gold and the Yuan) are supposed to be part of a new "basket" for oil settlement, that stance is making more sense.

More importantly, Japan's new leadership has stated it favors stimulating domestic spending in order to end a deflationary malaise the country has lived with for most of the past two decades. Cheaper inputs for its resource poor citizens are therefore more important to it than cheapening the exports market of its high end producers by devaluing its currency.

These pronouncements have aided the cause of price support for Dollar denominated global goods. But, markets are and will continue to have a tough time with deflation's poster child righting itself in the current environment. That is entirely reasonable given deflation's shadow slowly creeps over the western landscape. However, PM Hatoyama is quite deliberately shifting sentiment away from a western focus of the past half century.

At worst this is pragmatic recognition that the customer base for Japan's goods has ended its buying spree. The real message is that Japan is wealthy and able to chart its own course, once it has detoxified its bureaucracy from spinning funds into their retirement companies. There will be no quick fix from this policy shift, but it makes more sense than a failed policy requiring western sales points for its goods.

We can't overstate the potential importance of these moves in Japan. This is the second largest economy on the planet in nominal terms, and yet one for which concern that a lack of raw materials supply could hamper its growth spurt is very much a living memory. It has also seen a massive growth in ore processing to meet this concern overtaken in large measure by neighboring South Korea. We believe a shift is building in Japan to a much greater emphasis on its domestic economy, and equally to more focus on its regional economy. That should mark a major shift in the geography of country risk, and a greater acceptance that "Asia rising" is the global boon we perceive it to be.

So, how does that impact the current gold boom? It should simply give it a greater head of steam. Missing from the weakening Dollar equation was how the other side of that equation shapes up. Much of Europe was happy to jump on the cheap debt = housing boom bandwagon, and so is in no better shape than the US. So the Euro can sustain only so much upward pressure. Currencies in the less weakened industrialized “west” — AUS, CDN, NZ— simply don’t have the scale for the job. There has been only one sensible answer.

We have said in the past that the only equation that made sense was Yen strength as a proxy for Asian growth economies. Most wrote off the notion because of Japan’s export model. Now that Japan has a government that is willing to play that card, the pieces are truly in place for quick shifts in the FX market. Gold and silver will benefit smartly from that, and no the world is going to end as part of the process.

Right now we are seeing a major catch up going for undervalued asset based companies in the precious metals space. This part of the up tick could surprise even rabid bulls. Some more speculative companies that had been strong gainers appear to be flagging because of this, but that won’t be permanent. Speculative gains should be moved to companies with more solid outlines, but as the asset based companies get closer to full price funds will flow back to specs.

If you are a trader, the shift from one play to the next could get dizzying. If you aren’t, then view this as a “stay the course” moment for precious metals. Expect some significant pull backs as traders take gains, but these will be in the context of a rising market for some while yet. Ω

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