



## Gold Review

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### Has Support for Gold Given Way? - An Update

In our last report we suggested that gold would find it hard to trade through to new highs, in particular to break 450 in the first quarter of this year. So far this prediction has been paying dividends. However, after several months of consolidation we feel that the market is getting ready for a test to the topside.

This report will provide a brief overview of the reasons we believe gold will find support in the 370 to 380 range and why we suggest that it is set for a test to the topside. In addition, we provide details on how to take advantage of this forecast.

### Why gold will find support between 370 and 380

The fundamental reasons we feel that we are close to forming a base are derived from:

our expectations for the \$US;

the potential for inflationary concerns in the US and

the smouldering emergence of new geopolitical concerns.

All of these reasons have the potential to put the shine back into the metal. In addition, the technical picture and subsequent price action have added cogency to our suggestion that a good base is forming. So what are the current fundamentals and technicals that suggest we are getting close to a low for the metal?

Expected weakness of the US dollar

At the beginning of the year we suggested that the \$US would strengthen. However, the recent spate of economic data from the US and comments from Greenspan concerning the high costs of energy suggest the potential for \$US strength to subside. The two main concerns we hold for the continuing bull \$US trend are related to increased costs in production

caused by higher costs in energy and a slowdown in export activity due to loss of comparative trade advantage. Both factors have the potential to halt the growth phase we are currently enjoying.

For some time we have been talking about the high cost of factor inputs hampering the ability of the US to keep its recovery going. It was good to hear Greenspan, in his remarks before the Centre for Strategic and International Studies at the end of April, agree with our sentiment. Although his speech was more of an historical retrospective on the price of crude, the underlying theme suggested that the recently - found economic growth in the US could stall in the long run as a result of higher prices for energy (see correlation in figure 1). Moreover, in an attempt to keep up with market share US corporates have failed to pass on these increased costs, opting to offset them by making efficiency calls from within their structure. A high proportion of corporate returns made over the last two quarters have been through these gains, not via induced demand for goods. The end result is an immediate slowdown in economic activity. Currently, US firms are working in a high-cost environment with little consumer demand and burgeoning inflation. This is a concern, particularly when the market is now looking for a hike in interest rates. Increasing interest rates at this stage will only further dampen expectations for spending.

### S&P500 over crude oil



On the back of last year's weak \$US and as depicted in US company profit and loss reports so far this year, US corporates have seen an increase in revenue as a result of an increase in exports. This is primarily due to the weak \$US environment they had been trading under at the close of last year and beginning of this year. The effect of the recent 9.25 percent \$US reversal in the first quarter of this year has not yet filtered into the export sector, but it will be on its way. In figure 2 we can see the correct correlation between the value of the \$US and the performance of the S&P500. The important element to note is, prior to 'buy \$US, buy US equity' or 'sell \$US, sell US equity' stories, we have a period of comparative advantage/disadvantage. So with the continued high cost of inputs and the lack of genuine demand this time around for both domestic and foreign goods, there is an argument that suggests that the economy may stall. Alternatively, we should see a retracement designed to keep the \$US under pressure or in a tight trading range. If the \$US continued to strengthen then this would act only as a further brake on the recovery. If there is a decline in the \$US, we see investors leaving it again in favour of other assets such as gold.

**Fig.2. Correlation between value of \$US and S&P performance**



### Inflationary prospects

On the back of Greenspan's comments concerning the demise of deflation, the market will be focusing on the potential for inflation. Recent positive employment data from the US suggests that with more jobs and

more people employed there is potential for a spending increase, which potentially results in inflationary pressures and the need to increase interest rates. Although we suggest that any move will be marginal, the mere expectation of an increase in rates potentially opens the way for more asset declines, as the level of income required for debt servicing slowly becomes an issue. On the back of this inflationary pressure people will once again look to invest in gold as an inflation fighter and an alternative to asset-market weakness.

### Smouldering geopolitical concerns

Smouldering geopolitical concerns have always been regarded as a wild card for the metal and remain one. However, the growing number of global flare-ups and potential hot spots suggests re-weighting in gold would be prudent. For example, we have peace negotiations in the Middle East between Israel and Palestine openly stalled, with the US backing Israel. In Iraq, the coalition continues to disappoint, with more US body bags coming home. The problem looks to be escalating, with more anticipated terrorist attacks in the wings, in Iraq and beyond. In Spain it appears that the terrorists won the campaign when the left-wing Government opted to withdraw its forces from Iraq. With emotions riding high on their victory, we can only suspect that activity based on this style of campaign could potentially occur again when other coalition governments go to the polls. So, on the back of this we would anticipate that the market would look to hedge its bets once again and seek to buy the metal based on these geopolitical concerns.

### Technical picture looking healthy

Gold has traded off critical support at 370 and with a rally through to 380 we suggest that dips will be supported. Traders have been following the critical trendline support at 370 and 380 and, with this having been tested and holding, feel that longs can be entered into with stops below 360. In addition we see that daily momentum studies have bottomed. This should give us a signal that imminent price rises are just around the corner. Looking further afield, the weekly charts still suggest that the market is happy trading in a 370-430 range, so until we see a break here we will conclude that we are still in the range.



So what does it all mean? Overall, we see the fundamental and technical picture for gold looking bullish over the coming quarter, and suggest that long positions can be entered into. We see significant trend line support at 370, where we have placed our stop loss orders. A realistic target for this move would be 400, then 415. A daily break above 400 sends our models bullish and opens the way for a move through to the 450 level. At the moment we see that 430 should cap any strength; however, we would prefer to be long with the potential to break to new highs rather than wait to take shorts at these levels.

### How best to take advantage of this trade

The best way to take advantage of this move is via the spot deferred physical market. This market requires a small margin deposit equal to 3 percent of the face value of the contract. The advantages are that positions can be tailor-made to suit investment, and stop loss orders are watched 24 hours a day.

Alternatively, if you are more risk averse you can purchase call options with a strike of 400 with an expiry in 3 months. They will cost you \$US3.50 (times the number of ounces). However, we are finding that many investors with a greater understanding of the dynamics of the options markets are taking advantage of the higher volatility and instigating call spreads.

Please do not hesitate to call concerning any of the above. I can be reached on direct call 1300 660 734.

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