



Gold Review

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Gold, Oil and Inflation.

The market has been fully focused on the economic consequences of a high oil price. Of concern are its effects on prices then ultimately inflation. Commentators in particular the Federal Reserve (Fed) are saying that the recent surge in Oil prices will do little to effect the long-term expectations for inflation;

FED'S SANTOMERO SAYS LONGER-RUN EXPECTATIONS ARE THAT U.S. INFLATION IS WELL CONTAINED

However, the market is sending different signals to the Fed, as indicated by the recent strength in US Bonds yields and strength in the USD. Yet it seems content to stick to its core rhetoric of inflation being contained.

Is the Governor in the above statement looking at "demand pull" or "cost push" inflation? The following report outlines the difference between the two, then provides a summary on what we could expect for inflation over the coming quarters. In doing, we outline our preferred scenario, which provides for a brief analysis for Oil, the USD and Gold. We then summarise a preferred trading strategy.

Inflation and the markets

Generally, inflationary scenarios fall into two main camps: Cost-Push or Demand-Pull.

Cost-Push is inflation caused by a decrease in aggregate supply and can be caused by either:

An increase in the wage rates (as experienced in the late 1980s)

An increase in the prices of raw materials (as experienced in the Oil shocks of 1970s and maybe smouldering at the moment)

Demand-Pull inflation is caused by an increase in aggregate demand and can be caused by either:

Increases in money supply

Increases in government purchases

Increases in the price level in the rest of the world

It is interesting to note that with Oil at current levels the

markets are looking at the prospects of inflation. The sustained price increase in the cost of Oil potentially can open the way for the emergence of a **cost-push** inflationary environment. So far, in the context of the price rise the increase has not been passed onto the consumers. Instead, it has been absorbed by industry looking to maintain market share. However, the fact that industry commentators are suggesting that this price rise will be sustained is causing companies to slowly pass on the increase. This is clearly evidenced by airlines companies such as Virgin Blue and Qantas recently placing a levee, attributable to the oil price increase on tickets for travel. This might just be the first case of a cost-push scenario emerging. However, the levee idea might be passed onto other consumerables therefore cementing the emergence of the cost-push environment.

As the price of Oil has been so high for so long we are evidencing Companies looking to pass on the increase; what would happen if supply meet demand and the price came off?

This is also our preferred view for Oil. We anticipate that Oil is currently expensive given the current state of global economic growth and supply for the commodity. However, what would happen if a sustained price decrease would occur?

In this case we would see a relief rally in economic sentiment which potential sees an up-tick in aggregate demand. This sees the potential for **demand-pull** inflationary pressures to emerge. If this is the case what sort of scenario should we be looking at?

As the US is expecting inflationary pressures of sorts to emerge we are seeing pre-emptive measures by the Federal Reserve to offset this potential. By adopting a tighter monetary policy and gradually tightening interest rates the Fed is looking at slowing the economy to offset the emerging inflationary pressures. This in itself gives the USD an investment edge over other currencies and so we would anticipate an increase in the value of the USD. This form of rhetoric is not new to us, as we have been advocating a strong USD over the next couple of quarters for sometime now. However as Gold is valued in USD shouldn't an increase in the USD sees Gold under pressure, as it is valued in USD?

Gold - good value until 408 then 397 is broken



Overall we continue to see Gold and Silver being steady performers over the year. We feel that the US trade deficit will continue to be a concern, that we have to prepare ourselves for continued geopolitical problems, that global growth will be disappointing and that the USD will represent the better valued currency. However, the key to Gold and Silvers absolute performance is to choose which currency to buy it in and this is where our strategy play comes into action.

USD - Good value and good value on dips

(USD Dollar Index - weekly)



Strategy:

We believe that having some Gold and Silver in the portfolio is still the correct way to go. However, as we feel that US interest rates will continue to increase to stave of inflationary pressures that Gold price against the USD will not be a higher performer. In addition, as US interest rates kick up so does the cost of carrying Gold against the USD. Instead we are looking at buying Gold and paying for it in CHF's, as we see the Gold price as being cheaper against the CHF and more acceptable to bullish moves. This will essentially give us a long Gold short CHF position, with low maintenance costs and greater potential for a price rise if our case for Gold and the USD is on track. How do we put this trade on?

Weekly Gold/USD and Gold/CHF

(Gold/USD RHS, Gold/CHF LHS)



Buy Gold or Silver against the CHF.

Step 1:

Buy Gold against the USD in the usual manner

Step 2:

Buy USD/CHF for the same amount of USD value worth of Gold.

If positions are of market parcels then do forwards. We reduce the size of the trades if 510 is broken on a daily basis then exit positions on a break 495. Our target is 540 then 600.

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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