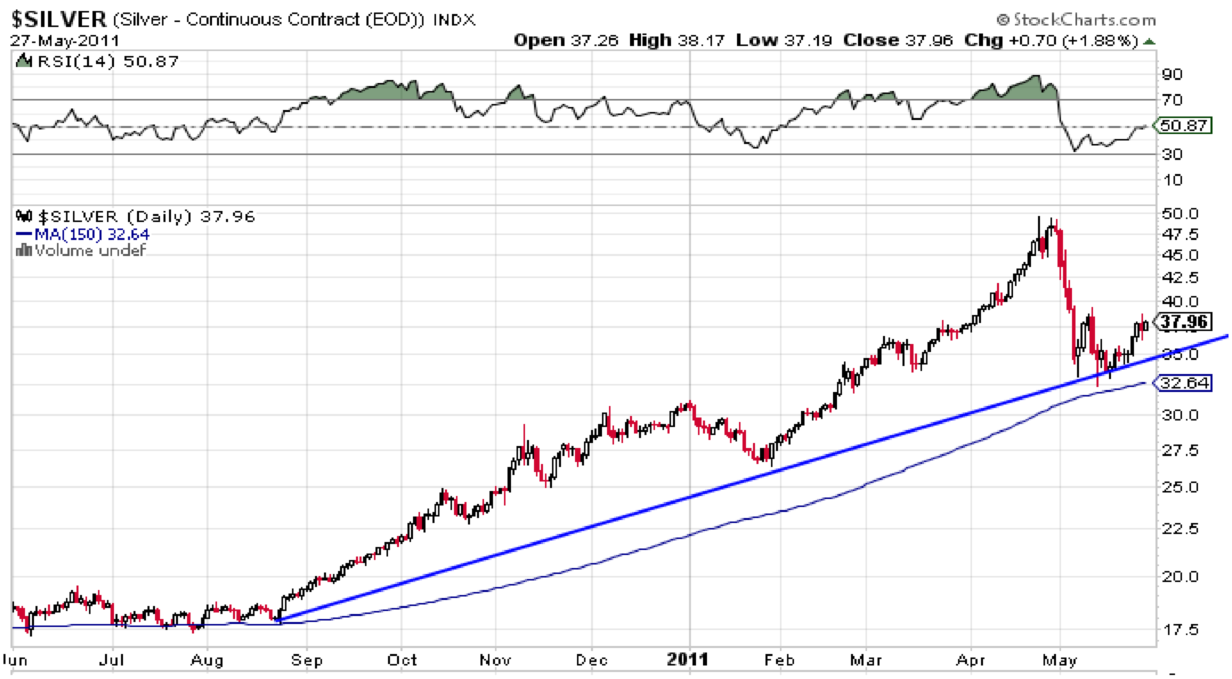
June 2011

Precious Metals Update

The most talked about commodity during the month of May was definitely silver. It had been on an historic rise from $18.97 on August 27, 2010 (the day Bernanke preannounced quantitative easing II) to $49.75 on April 25, 2011. After a 162% rise in eight months, it was definitely due for a correction and that is exactly what happened during the week of May 2. As you can see from the chart below the price of silver collapsed 35% from $49.75 on April 25 to $32.32 on May 12.



Source: StockCharts.com

Since then silver has found support above its 150 day moving average and the blue trend line pictured above. As long as silver stays above these two levels, I don't see anything for silver bulls to worry about.

The media has made a huge deal about silver's price drop and some analysts are already claiming that the top of the silver bull market was $50 just like the old Hunt Brother's high back in 1980. Why the celebration for a collapse in an asset price? I can't remember anyone cheering during the NASDAQ collapse or at the top of the Housing Market in 2006. It just doesn't feel right to see people cheering for commodity collapses. Perhaps those celebrating were angry with themselves for having missed one of the best bull markets over the last decades and were still kicking themselves for having not bought silver at $4.

One of the most touted stories in the precious metals community was that George Soros had sold most of his position in GLD, an ETF that tracks the price of gold. This news was released on May 16 via Form 13F, a quarterly form that requires money managers with assets above $100 million to disclose their long positions in stocks. During the first quarter of 2011, Soros sold just over 95% of his position in GLD.[1]

It is worth noting that another famous hedge fund manager, David Einhorn, sold his holding in the GLD in favor of owning physical bullion stored in a vault for his Greenlight Capital fund. This would not show up on the Soros Fund Management LLC 13F form. Although Soros sold his position in GLD, he also purchased shares of Freeport McMoran Copper and **Gold** (FCX) and Goldcorp (GG).[2]

The silver bears have been spotted salivating at the chart below. It overlays the recent price of silver with the price of silver at the last major top in 1980. Bears note the similarities in the peaks and corrections and are watching very anxiously to see if this pattern continues to hold up.

Source: Marketfield Asset Management, Bloomberg

[1] http://www.bloomberg.com/news/2011-05-16/soros-sold-most-of-his-gold-etp-holding-during-first-quarter-filing-shows.html
[2] http://www.goldcore.com/goldcore_blog/soros-sells-gold-etf-while-paulson-buys-pimco-favour-gold-%E2%80%9Cprotection-against-what-can

Throughout May I have been asking myself if anything has changed in the precious metals market beyond margin requirements at the CME. Silver did collapse 35% to $32, but it is now over $38. It was only $30.75 at the beginning of the year and is up 25% year to date. Even post crash, silver is handsomely beating all of the major stock indexes in 2011.

Silver is still used in jewelery, photography, electronics, and solar cells. As oil becomes more and more expensive, I think you will continue to see large demand for silver in green technology. I also still see large investment demand for the metal throughout the world. Soros may have sold his GLD ETF during the first quarter, but the Central Bank of Mexico bought 93.3 metric tons of gold during just February and March. Before that the central bank's reserves were primarily US dollars and they only owned 6.9 tons of gold before. Russia and Thailand both added to their gold reserves as well in the first quarter.[3]

Precious metals also tend to do well when you have negative real interest rates. According to the ~~Ministry of Truth~~ Bureau of Labor Statistics, the consumer price index increased 3.2% from April 2010 to April of 2011.[4] A two year treasury note is currently yielding only .46%. When you get paid .46% per year to sit in a money market and the cost of things you buy is going up at 3.2%, that is a negative real interest rate. According to www.shadowstats.com, the real cost of living in the US went up 11% during the last 12 months. That is called *really* negative real interest rates. Even when interest rates rise, I do not expect them to rise above the real inflation for a very long time.

The last fundamental factor that hasn't changed for precious metals is the amount of government debt that can not possibly be paid. As I write, there are even more rumors of a second "bailout" of Greece. This is getting so old. There is no way that these countries can pay off their debt or "grow their way out of this." The only sensible solution is to restructure the debt and let the people/banks who knowingly took risk by buying government bonds lose some money. Until Europe gets rid of its "No Banker Left Behind" policy and allows bankers to lose money on bad bets, we do not have a sustainable solution. I will turn bearish on precious metals when I see the US , European, and Japanese governments implementing such deep austerity that they are no longer adding to their national debts. That would be change I could believe in.

To be a precious metals bear here, you have to be a dollar or Euro bull. These currencies may rise and fall against each other, but what is to like about these currencies and the destructive central banks behind them? Legendary investor Jim Grant's statement about why he is bullish on gold on resonated with me:

> To me the gold price takes the form of a very uncomplicated formula, and all you have to do is divide one by ‘n.’ And ‘n’, I’m glad you ask, ‘n’ is the world’s trust in the institution of paper money and in the capacity of people like Ben Bernanke to manage it. So the smaller ‘n’, the bigger the price. One divided by a receding number is the definition of a bull market.

[3] http://www.marketwatch.com/story/bank-of-mexico-buys-100-tons-of-gold-in-two-months-2011-05-04
[4] http://www.bls.gov/news.release/cpi.nr0.htm

> You'll notice that this had nothing to do with security analysis. This is conceptualizing, brainstorming, nothing to do with price/earnings ratios, other valuation methods like cash flows. It is a proposition or a hypothesis on what is driving the gold market. So the gold market is necessarily a speculative piece of business. It's not to be confused with the kind of investment that Ben Graham wrote about. Anyway, I happen to be bullish on it, but not for reasons that I can readily defend before a member of the fraternity of chartered financial analysts.[5]

I don't know a lot about Steve Forbes, but I was very surprise to read his prediction in a May 11 HUMAN EVENTS article:

> A return to the gold standard by the United States within the next five years now seems likely, because that move would help the nation solve a variety of economic, fiscal, and monetary ills, Steve Forbes predicted during an exclusive interview this week with HUMAN EVENTS.
>
> "What seems astonishing today could become conventional wisdom in a short period of time," Forbes said.
>
> "People know that something is wrong with the dollar," Forbes concluded. "You cannot trash your money without repercussions."[6]

That is an astonishing prediction. If it comes true, rest assured that the ruling elite will be fighting it every inch of the way.

Precious metals bulls have been very disappointed with the recent underperformance of the stocks that mine the metals from the ground. The stocks have dramatically underperformed the metals this year. Below is a chart of the HUI Gold Bugs Index divided by the price of gold. Every time you see the line dropping down, gold is outperforming gold mining stocks. Since Mid-April, the stocks have gone down a lot more than the price of gold. In my estimation, the shares are very cheap relative to the metals. If precious metals prices stay where they are or continue to rise, this will translate into much better earnings for these companies.

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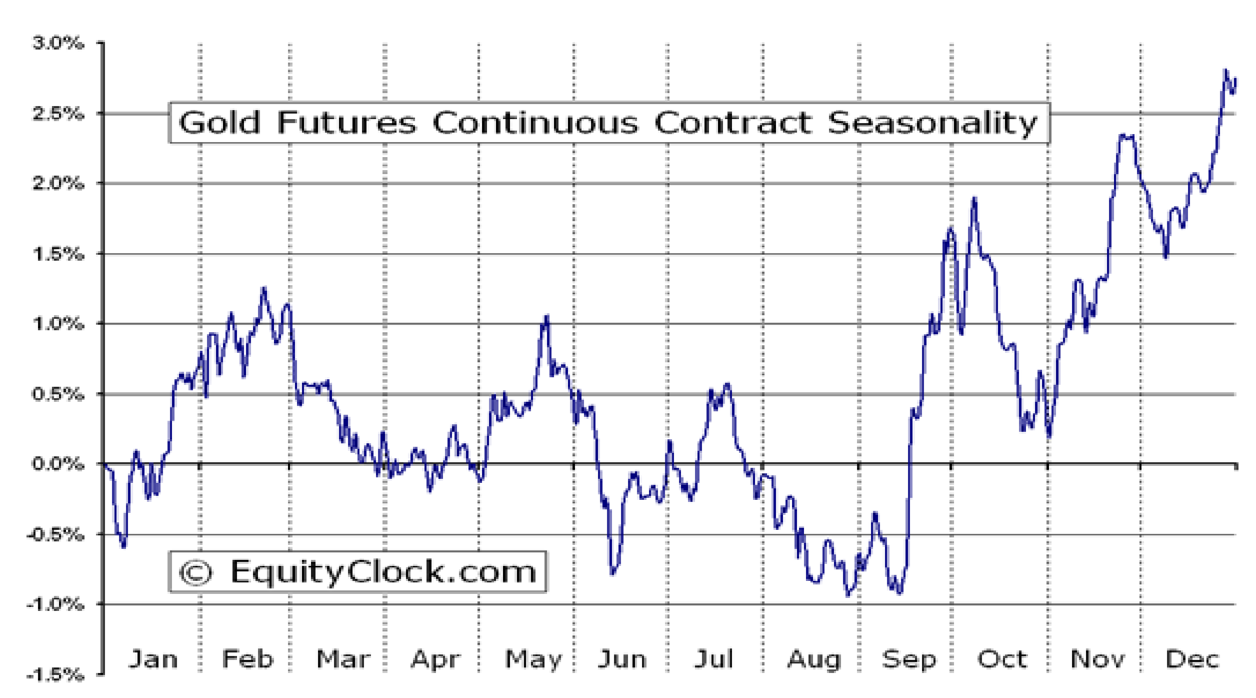
[5] http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2011/4/14_Jim_Grant_-_US_Will_Resolve_Debt_by_Returning_to_Gold_Standard.html
[6] http://www.humanevents.com/article.php?id=43439

Source: StockCharts.com

All investors need to recognize that no bull market goes straight up. Markets get frothy like silver did this spring and need to correct. Even the great stock bull market needed a rest in 1987 before moving on to its all time peak in 2000. I don't see the case for this being the end of the bull market in precious metals. There will be corrections and I can envision a correction this summer when Quantitative Easing ends for the metals. Below is a chart of how gold has performed each month during the last twenty years. As you can see, the summer months are seasonally weak for gold before you get into the Indian Wedding Season in the fall.

Every year will not follow the seasonality pattern, but it is important to be aware of the pattern if



Source: EquityClock.com

you are looking to add to your precious metals position. In the end, the decisions of central bankers and politicians will greatly affect the price of precious metals. So far they have demonstrated that they want asset prices to rise and will do almost anything to save their handlers at the large multinational banks. I think the path of least resistance for the ruling class is to continue to print. Until I see actions to the contrary, you will not see me turn bearish on gold and bullish on paper currencies.

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