

Market Update

Gold reacts to a profound Change in Credit Markets

Market Observations

Changes in credit markets are usually reliable indicators of important market shifts. Rising credit spreads in May 2007 have culminated in the panic of 2008. This time around, credit spreads also narrowed into May and widened into July which triggered a new wave of forced liquidation in August. Despite the FED meeting this Tuesday, whereas interest rates will be kept near zero through mid-2013 and other policy tools to bolster the economy “as appropriate” will be implemented, our view is that these measures will fail once more to bring back long-term economic prosperity. However, a relief stock market rally from the current oversold levels is expected.

Quantitative easing, low interest rates and trillions of stimulus dollars spent and lent did next to nothing to restore economic growth. Given the mounting sovereign debt problems and negative real interest rates, the IMF, ECB and the FED have no financial cards left to reverse the irreversible contraction in the credit markets.

The already hopeless sovereign debt situation will worsen as governments will be facing another drop in tax revenues. Consequently, we expect higher debt/GDP ratios in the western hemisphere. Bankrupt governments and perplexed central banks will continue to deliberate currency depreciation as their oldest means of funding the state. Eventually, voluntary funding by the free market for reckless governments on both sides of the Atlantic is coming to an end.

In today's fiat monetary system, financial markets depend on the FED's ability to depreciate the Dollar in order to lift asset prices. Since 1913 the FED has destroyed 98% of the purchasing power of the US Dollar. This does not prevent this (private) institution from proclaiming its mandate to ensure “economic prosperity” and “price stability”.

When the depreciation of the Dollar has been the panacea of all problems in the past, then a temporary strengthening of the Dollar (Dollar-Index) and the outbreak of gold as sound money is the worst thing for policymakers that could happen.

This time, the Dollar Index started to appreciate in May ([see chart 1](#)) and the collapse in credit markets followed in July/August ([see charts 2](#)) which has culminated in the liquidation of the “hot items”, namely commodities including base metals. As a consequence commodity currencies went into capitulation mode as the CAD/USD or AUD/USD demonstrate.

Using past examples as a guide, the start of a cyclical bear market in commodities in May and the change in the credit markets in July suggest that the next (greater) recession is around the corner.

As credit markets get trashed, gold's role as the most liquid and safest item will continue to increase its relative price next to other commodities and paper currencies. Another important feature of imploding credit markets is that not only gold but also interest rates go up on real terms in the long run.

Fundamentals for Gold Stocks Improving

Fundamentally, this deflationary environment wherein gold is becoming chronically stronger versus commodities is very favourable for gold mining companies. As an example, the lower price of oil which accounts for many mines between 30-50% of production costs and the strength of the gold price will lead to an ongoing expansion of profit margins ([chart 3](#)). In addition, gold properties which were previously uneconomic when the gold price was lower are becoming potentially economic assets and will be re-rated by the market as they are being progressed towards PEA (Preliminary Economic Assessment) or Feasibility Status.

Gold stocks could not resist the latest liquidity drain and were sold off, leading to a widening disconnect between bullion and equities. The gold equity sector is currently trading at very low multiples on all metrics. In addition, the collapse in the USD/CHF (YTD -22.5%), CAD/CHF (YTD -21.8%), AUD/CHF (YTD-22.1%) and GBP/CHF (YTD -19.5%) have largely erased any gains in CHF-terms.

Senior gold stocks are likely to lead the rebound with the intermediate producers following.

Looking back, gold stocks have shown net gains since the credit markets climaxed in May 2007 while the overall equity market (S&P 500) has suffered net losses ([chart 4](#)). As the credit situation will worsen, our view remains positive for the whole gold sector in the long run. Nevertheless, gold stocks are likely to correlate also in the future during the intermediate swings with the NYSE regardless of the solid fundamentals of the industry.

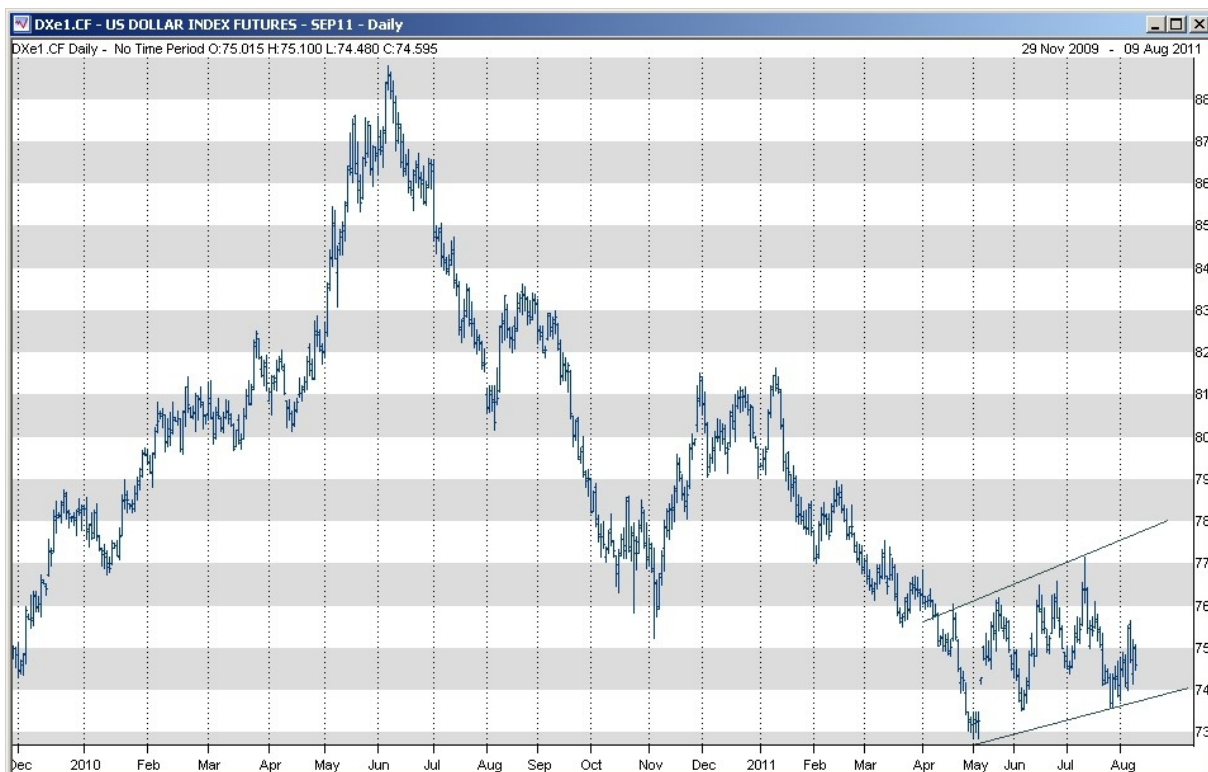


Chart 1: Dollar Index (DX) rising since May 2011



Chart 2: High Yield Bonds collapsing in July/August 2011

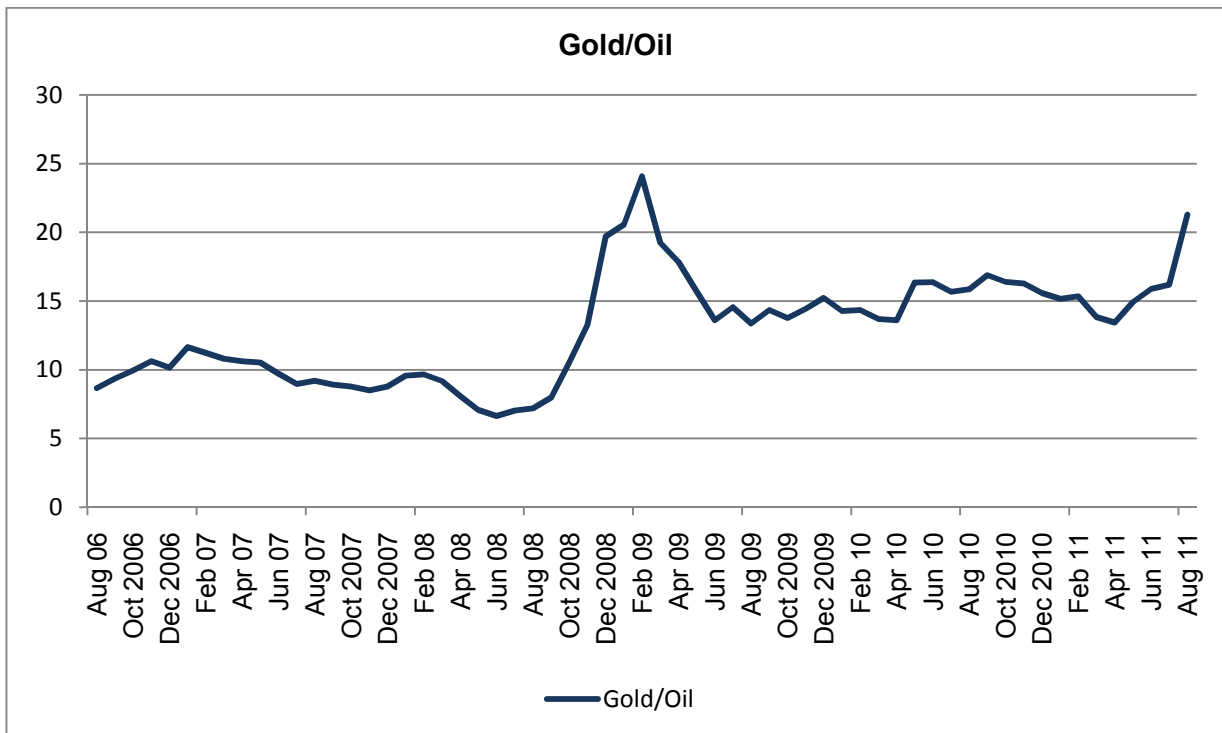


Chart 3: Gold's purchasing power compared to WTI oil over the last five years

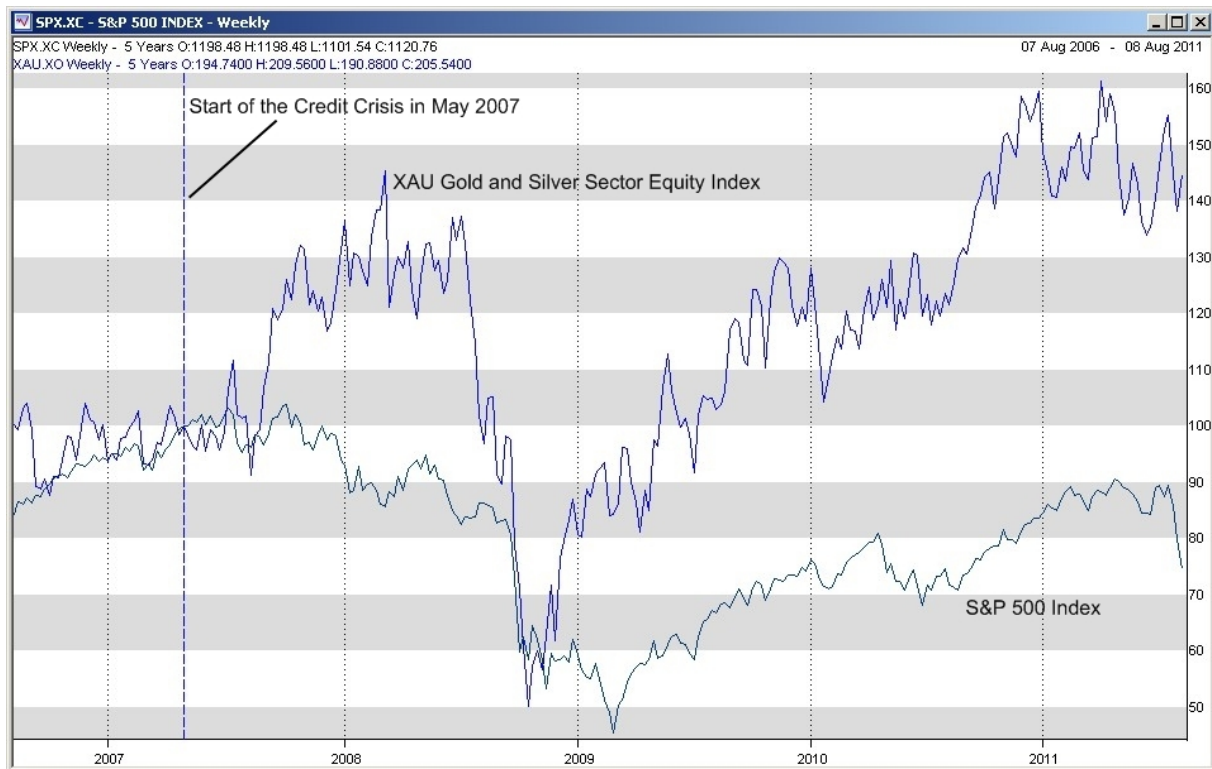


Chart 4: Gold stocks (XAU) versus S&P 500 since beginning of credit crises in May 2007

Florian Siegfried
 CEO, Precious Capital AG
 Zurich, August 10th, 2011