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## **GOLD AND THE DOLLAR**

Gold is a complicated trade. I do not mean the actual dynamics of playing a position—traders have many ways to do that, including buying physical gold, trading gold ETFs, trading gold stock mutual funds and trading futures to name a few. Gold is a complicated trade because it is not just a simple commodity that trades off supply-and-demand fundamentals. It is also a currency, a safe-haven investment vehicle and an inflation hedge.

Prior to the current gold mania, which saw prices of gold futures hit new all-time highs above \$1,070 per ounce in mid-October, the last significant runup was to \$850 in 1980.

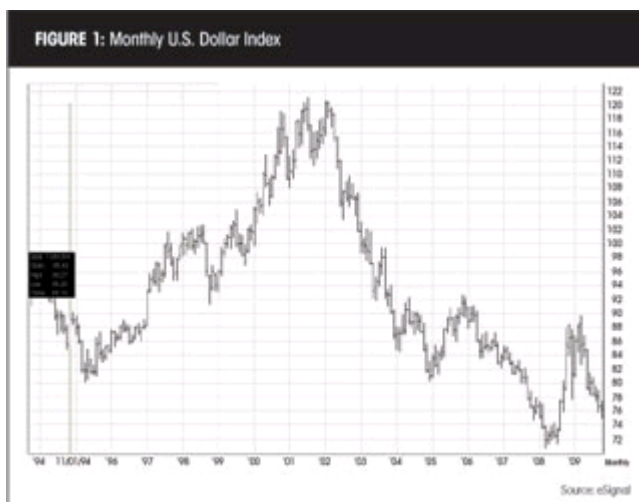
Fast forwarding to the early 1990s from roughly 1994 to 2004, gold traded in a sideways range between roughly \$250 to \$425 an ounce. At that time, central banks were selling portions of their gold reserves, as many thought that the metal no longer had any value in the modern financial system.

“During the 1980s and 1990s, a new breed of central bankers emerged who said [that] gold was a relic and had no real value,” says Andrew Montano, director of precious metals at Scotia Mocatta in Toronto, a bullion bank. “They started liquidating their reserves, and prices went down to \$250 an ounce.”

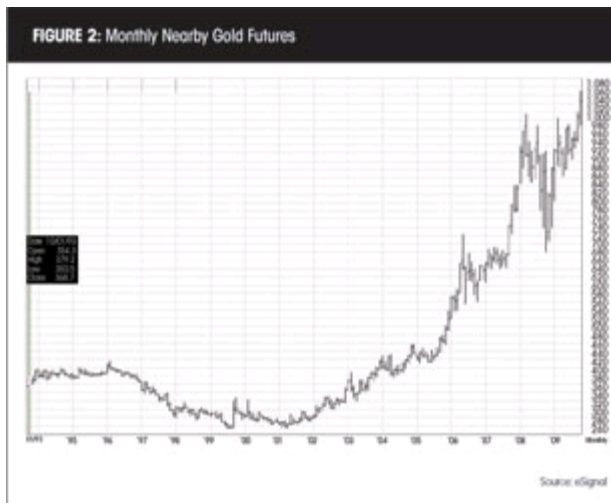
Amid concerns that central banks would flood the world’s gold market and depress prices even further, in 1999 the Central Bank Gold Agreement was signed, which said that annual sales would not exceed 400 tonnes for five years. Different versions have been signed in subsequent years.

## **THE DOLLAR CONNECTION**

A monthly chart for nearby gold futures reveals that the current rally in gold actually started early this decade. Compare this to a monthly chart of the U.S. Dollar Index, and one sees an almost identical inverse pattern.



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*click image for larger view*

The dollar began its latest long-term bear market move in early 2002. Basically, gold has been on an upward climb since then. Simply, gold is a dollar-denominated commodity, and when the U.S. currency weakens, it takes more dollars to buy that same ounce of gold. So, gold has been rallying for years now on the back of a weakening dollar.

Jumping to the current global recession, gold rallied further throughout 2007 as the crisis began to unfold. March 2008 saw the beginning of a major retreat in gold to \$681, basis nearby futures.

Gold experts say at that time, money managers were forced to basically liquidate any and all positions amid efforts to raise cash, including gold positions.

From October 2008 to this writing in late October 2009, the precious metal has once again been on an upward tear, breaking through the psychologically significant \$1,000 an ounce level to score new record highs once again.

## **WHY?**

To dissect the latest upswing in gold, let's walk through a variety of factors.

Is there a shortage of gold? "Gold is not that rare. There is about two-thirds of an ounce above ground for every man, woman and child on this planet," says Leonard Kaplan, president of Prospector Asset Management and a gold trader for 36 years.

Is there inflation? In September, the U.S. Consumer Price Index rose 0.2 percent, while the Producer Price Index fell by 0.6 percent. Nope, no inflation around right now.

Is there tremendous demand for gold usage? Jewelry demand is down 22 percent in the second quarter of 2009. In fact, looking across the categories of gold demand, which includes jewelry, industrial and dental, electronics, coin and bar investment and ETF investment, the only categories that had positive numbers were retail demand (in the form of bars and coins) and ETF investment, according to World Gold Council data.

In second quarter 2009, investment demand showed a 46 percent rise over the same period in 2008, while ETF demand revealed a whopping 1,315 percent rise. Bingo—the answer is investment demand.

The way gold ETFs work is when individuals buy shares in, say, the SPDR Gold Shares ETF (GLD), the fund company actually has to buy bullion for each share. Paul Justice, ETF strategist at Morningstar, tells me that GLD, which is the second-largest ETF on the market today worth \$40 billion, is the "sixth-largest holder of gold in the world, with five sovereign governments ahead of it."

Mom and pop have been buying gold and a lot of it lately.

## FEAR

"We are at all-time highs for a single reason. It is a result of the financial crisis, the economic collapse and the complete erosion of many risk investments," says Bill O'Neill, principal at LOGIC Advisors. "Gold is a big psychological commodity. In a sense, gold has become a currency proxy."

Interestingly, central banks have slowed their own gold sales. According to the October 2009 Gold Investment Digest, published by the World Gold Council, "There has been an undeniable shift in the behavior of the official sector [central banks]. Net sales in the first half of 2009 amounted to just 38.7 tonnes, down 73 percent from the first half of 2008 and the lowest half yearly figures since the first half of 1997."

## LACK OF CONFIDENCE

Carlos Sanchez, associate director of CPM Group, a long-time commodities research firm says a big part of the latest gold move is "a concern that the dollar is losing its status as the currency accepted worldwide and ... that inflation could become a problem in the future."

Experts warn that the quantitative easing that, in essence, saw the Federal Reserve turn on the printing presses to flood the U.S. economy with liquidity during the financial crisis will continue to devalue the dollar—which, let's not forget, has been in a bearish long-term trend since 2002.

With the skyrocketing levels of U.S. borrowing and deficits, foreign governments have begun to question the suitability of the dollar as the reserve currency. China and some oil-producing nations have been making noise. Market rumors have circulated about pricing oil on the global markets in terms of euros, rather than dollars.

Tom Winmill, portfolio manager at Midas Fund, notes, "Since the beginning of the Obama Administration, there has been a 12 to 15 percent increase in the money supply. That will translate into inflation two to three years out. If you create a bunch of new dollars, those dollars have less purchasing power."

He points to recent Office of Management and Budget projections that imply the U.S. "money supply will be more than doubled over the next 10 years."

Going back to the dollar and gold connection, that means "you will essentially devalue the dollar by 50 percent, and the price of gold will almost double," says Winmill who has a 10-year target for gold near \$2,200 per ounce.

O'Neill adds, "We've seen a debasing of currencies pretty much across the board" as central banks around the world pumped liquidity into their economies in an effort to stem global recession.

Scotia Moccata's Montano says, "What happens if the dollar does depreciate significantly because of continuing deficits? What is the best safety mechanism? Gold has been thrust forward to play its historic role. There are real concerns over the value of the U.S. dollar and the U.S. economy. At the end of the day, gold is a currency. It is a physical currency, not a fiat currency. There are a number of investors who believe that holding gold is the best way to survive through the recent and upcoming economic turmoil. It is your ultimate insurance policy against doom and gloom and total collapse."

## WEALTH PRESERVATION

"The long-term picture for gold is an inflation story. It doesn't appreciate in value—it holds value," concludes Winmill.

Montano says, "If you have wealth, what is it other than deferred consumption? If you want to preserve the amount of consumption you are deferring, you want to put it in an instrument that will preserve that wealth."

Maybe this gold rally is just gathering steam.

Kira McCaffrey Brecht has been writing about the financial markets for 18 years. Posts during her career include Chicago bureau chief at Futures World News, market analyst at Bridge

News and technical analyst at MMS International. She has passed Level I and Level II of the MTA's CMT exams.

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## PERFORMANCE HIGHLIGHTS

According to Morningstar, the Midas Fund (MIDSX) posted year-to-date returns through Oct. 27 of a 60.38 percent gain. Total return over one year was 171.31 percent. Looking out further, the five-year annualized return saw an 11.01 percent gain.

Looking at the SPDR Gold Shares ETF (GLD), year-to-date performance through Oct. 23, according to Morningstar, is a 17.72 percent gain, and a 19.69 percent gain annualized over three years.

## WHO'S GOT IT?

**FIGURE 3: Figure 3: Top 12 Central Bank Holdings of Gold**

COUNTRY/REGION	TONNES	% OF RESERVES
U.S.	8,133.5	77.4%
Germany	3,408.3	69.2%
International Monetary Fund	3,217.3	
Italy	2,451.8	66.6%
France	2,445.1	70.6%
China	1,054.0	1.9%
Switzerland	1,040.1	29.1%
Japan	765.2	2.3%
Netherlands	612.5	59.6%
Russia	568.4	4.3%
European Central Bank	501.4	18.8%
Taiwan	423.6	3.9%

Source: World Gold Council as of September 2009

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