Why We Still Like Gold

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- **We think stocks have limited upside potential (0% to 5%) over the next few months, but do not currently expect sufficient downside to warrant a significant increase in our cash position.** In that light, last week we brought emerging market stock exposure back to neutral in our portfolios that were overweight. We used the proceeds to increase our overweight to large-cap US stocks with relatively stable earnings and dividend growth. Emerging markets underperformed US stocks in March after outperforming by nearly 9% in January. **While we still believe in emerging markets' long-term growth prospects, we regard US dividend growth equities as the more attractive near-term risk/reward alternative, especially given recent fears of a China-led economic slowdown.**
- The S&P 500 is up 28% from October 2011 through early last week, with sentiment reaching an optimistic extreme of 70.7% bullish, as measured by NDR's Crowd Sentiment Poll. This is the same level of bullishness that accompanied the S&P 500's April 2010 peak, which was followed by a 16% decline. We do not expect that much of a pullback this year because central banks have been pushing down global short-term interest rates significantly for the past six months (don't fight the Fed), unlike 2010 and much of 2011 when global short rates were rising. **Thus we think that stocks will have either a sideways consolidation period or a correction of 5% to 8% to work off the optimistic sentiment.**

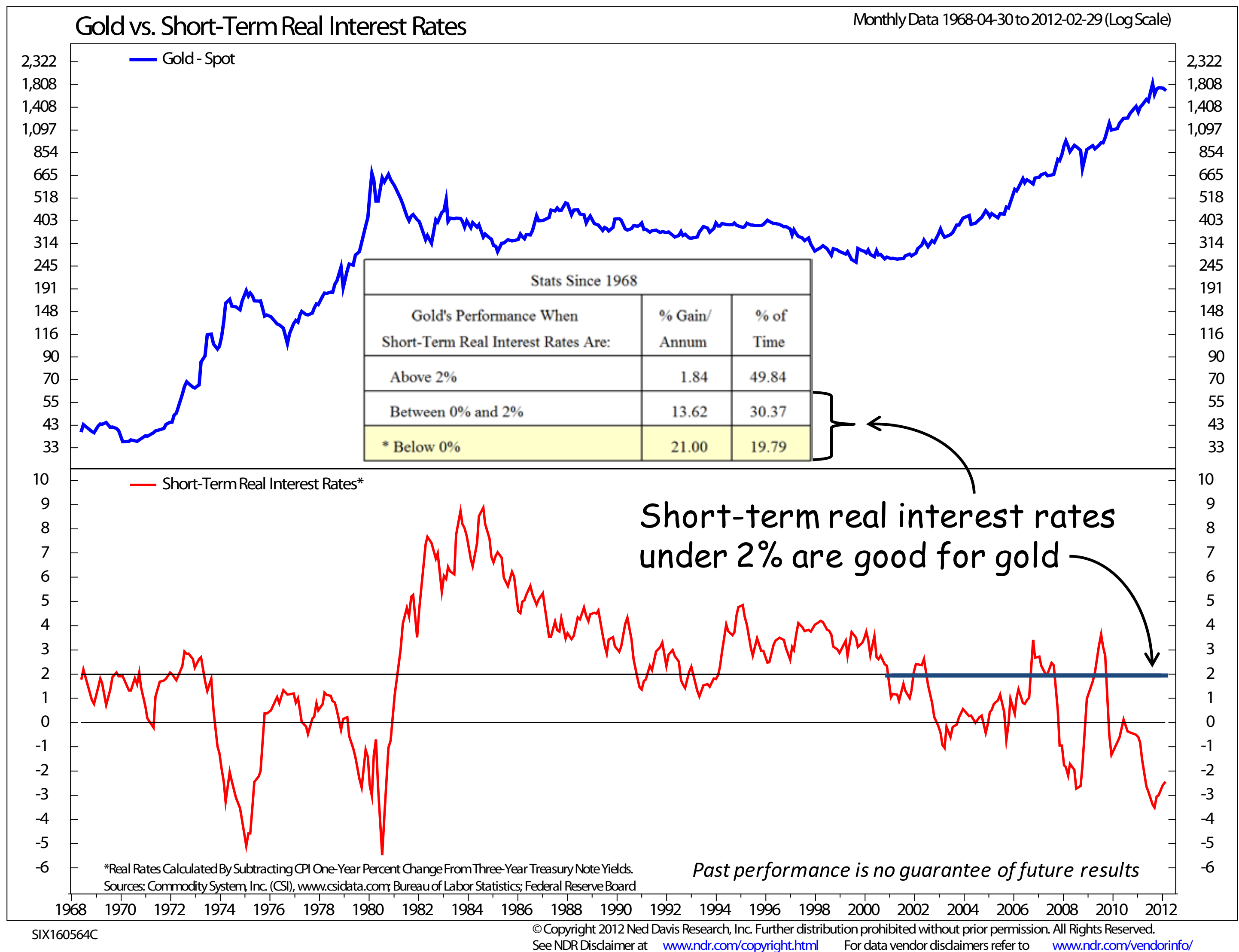
Gold: Bull market not over; a break below $1550 would require reassessment

The current bull market in gold began in 2002 at around $250/oz and rose to its 2011 summer peak of $1830/oz with only one meaningful correction, which lasted for about nine months in 2008 (see Weekly Chart). Gold has not only risen in dollar terms, as one might expect during a 10-year period of dollar weakness, but has also risen in terms of all major currencies. We have been persistent gold bulls for much of its assent, and still are. However, we recognize that, following a seven-fold increase, gold is vulnerable to a change in the fundamentals that have driven its assent.

In our view, the most significant long-term fundamental driver of gold is the interest rate paid on short-term deposits (i.e., the short-term interest rate) minus the prevailing inflation rate. This is known as the '*real* short term rate' and is shown in the bottom clip of the chart. Gold's best price gains come when real interest rates are below zero, and so an investor who is holding cash is losing purchasing power every month. According to Ned Davis Research (NDR), since the US abolished the gold standard in 1971, real interest rates have been below zero about 20% of the time and during those periods, gold has risen at a 21%

annual rate (see table within chart). When real short rates have been between zero and 2% in the past, gold has risen at a 13.6% annual rate. In the last 40 years, it has taken real rates of more than 2% to stem the rise in gold, and we urge readers to note that gold's 1981 peak occurred during an era of high inflation, and was triggered by the Fed's decision to push interest rates through 2% and ultimately to nearly 9%. During the 20-year bear market in gold from 1981 to 2001, real rates were persistently positive and mostly above 2%. **Since the current real rate is -2.5%, we believe that the recent pull back in gold is temporary and that the uptrend will resume.** We think negative sentiment will also provide support for higher gold prices, from a contrarian perspective. NDR's Crowd Sentiment Poll for gold is 16.1% bullish, well into 'extreme pessimism' territory, which has historically been positive for gold.

THE WEEKLY CHART: GOLD MOVES IN LONG CYCLES



Stats Since 1968

Gold's Performance When Short-Term Real Interest Rates Are:	% Gain/ Annum	% of Time
Above 2%	1.84	49.84
Between 0% and 2%	13.62	30.37
* Below 0%	21.00	19.79

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. Buying gold allows for a source of diversification for those sophisticated persons who wish to add precious metals to their portfolios and who are prepared to assume the risks inherent in the bullion market. Any bullion or coin purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, precious metals should not represent a significant portion of an individual's portfolio.