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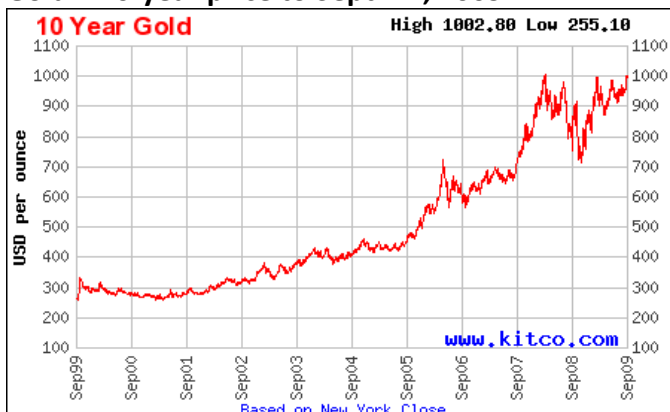
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The gold standard

Resources' price spike boosts TSX

September 11, 2009 – The price of gold spiked up to over US\$1,000 per ounce last week, testing its highs of the summer of 2008, when the financial apocalypse seemed imminent. Extreme fiscal stimulation combined with extreme money printing and extreme banking bailouts saved the day, but didn't prevent the recession, of course. After slipping back to near US\$700 per ounce last fall, gold tracked upward again, finding a range roughly between US\$900 and US\$1,000 for most of this year. So is it apocalypse now all over again?

Gold – 10-year price to Sept. 11, 2009



Courtesy Kitco.com

One thing's for certain: We're not on the brink of catastrophe again. So this time, we can rule out gold's traditional crisis hedge attributes as a cause of its current price strength. The price of the chameleon-like metal is in fact currently driven by more traditional supply and demand fundamentals.

India and China, in that order, are the biggest buyers of gold in the world. In the first half of the year, Chinese domestic gold purchases rose to 446.6 tonnes, a 14% increase over the previous year. (China also happens to be the world's largest producer of gold.) Whether or not rising Chinese consumer and central bank purchases of gold are part of a concerted, but subtle, effort by Chinese authorities to insulate its currency from the vagaries of the ever-weakening US dollar is open to debate. There have been no overt policy announcements along these lines, but the circumstantial evidence certainly seems to be mounting. For instance, China is close to becoming the first investor in a new series

of notes issued by the International Monetary Fund, and has consistently been at the vanguard of nations agitating for a new internationally-based reserve currency to replace the almighty buck.

And the steady waning of US dollar strength adds weight to the argument. The greenback sank to its lowest level of the past 12 months against most major currencies, including the euro, which ratcheted to a nine-month high against the buck last week. The US dollar index has declined steadily since early March (see accompanying graph). The index tracks the value of the greenback against a basket of major currencies comprising the euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc. No wonder the Chinese, who hold vast quantities of US Treasury notes, want to hedge their bets a little!

US dollar index – 1 year to Sept. 11, 2009



Courtesy Bloomberg LP.

Reasons for this include the growing appetite for risk as hot money flows away from US Treasuries and into assets that are perceived to generate higher yields. These include Asian markets, which are poised to outperform the US in the GDP growth sweepstakes next year. And they also include commodities and commodity-related stocks, which are seen as beneficiaries of rising demand as the global economy recovers.

In addition, the anticipated snail's-pace recovery in the US economy is stimulating capital flows away from US dollar assets. The US Federal Reserve Board reported last week that consumer lending dropped again in July for the sixth straight month, as consumers focus on paying down debt and saving. If the trend continues, it dampens the prospects for a strong holiday shopping season and sets the stage for a lacklustre US recovery. And that all goes into the calculus for the weakness of the US dollar and the strength in gold.

Of course, gold wasn't the only commodity to jump last week. Copper, silver, oil – even natural gas – rose last week, with copper and silver closing at new 2009 highs. Naturally, this has been a boon for Canadian resource stocks, which helped boost the S&P/TSX Composite Index to a 2.1% week-over-week gain last week.

The TSX energy subindex soared 8% on the week as crude oil and natural gas prices climbed to as high as US\$71 per barrel and US\$3.256 per million British thermal units

respectively. The metals and mining index jumped 5.4% on the week, as Canadian miners, including the golds, got a boost from the surge in commodity prices.

Will the trend continue? That's always the 64-thousand-dollar question. There are some solid arguments to suggest it will, owing to the trend towards developing inflationary pressures globally. Already monetary authorities in India have warned of an imminent tightening of monetary policy (that is, an interest rate hike) sooner than expected owing to steadily rising price levels. Ditto for China, where similar rumblings have been heard for the past few months.

In the US, price pressures haven't appeared in the consumer price index, despite a rapid increase in M2 (a broad indicator of money supply). Economists have been puzzling about this for awhile, with the consensus view being that most of the stacks of newly minted money are being held by banks. Thus, the so-called "velocity" of money (the speed with which it circulates and a key determinant of inflationary pressure) has slowed to a crawl, and pricing pressure has not appeared in the wider economy. Which is not to say that it won't at some point down the road – just that it's not there now.

It may well be, then, that gold and other metals are being priced with a future inflationary component. But this isn't the main driver right now. Fundamental factors of supply and demand, levered on brighter growth prospects ahead, especially in emerging Asian and South American economies, are the main drivers. And this is likely to continue to support resource stocks – and resource-based currencies like Canada's and Australia's – for the foreseeable future. But it won't necessarily be a non-stop trip to the top.

As mentioned, Toronto's benchmark S&P/TSX Composite advanced 2.1% on the week as of Friday's close, boosted by those materials, mining, and energy issues. The Dow Jones Industrial Average gained 1.7%, while the broader S&P 500 Composite Index closed the week 2.6% higher than the previous week's close.

S&P 500 Composite Index – 6 months to Sept. 11, 2009



Courtesy CTVGlobemedia

For those who follow such things, it's a matter of keen interest that the S&P 500 is now valued at about 19 times reported earnings, and is up 54% from its March low without a

major correction. Average for the S&P 500 is about 15 times earnings. The TSX is up 49% from its March low, also with no major correction.

So despite the runup in commodities, and its salutary effect on the Canadian stock market, caution is still warranted, the gold standard notwithstanding. ■

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