CPM Group

Market Commentary

No. 6 ■ 28 June 2012

*The following **Market Commentary** is an excerpted from CPM Group's **Precious Metals Advisory,** which was distributed to our clients on 7 June 2012. If you would like to learn more about CPM Group's research products or to subscribe to the **Precious Metals Advisory**, please contact Matt Taub at 212.785.8320 or mtaub@cpmgroup.com.*

Deteriorating Economics

Economic conditions deteriorated in most parts of the world over the course of May and into early June. Growth has weakened in the United States, although it has not stalled. Chinese output weakened. European economic activity ratcheted downward. Financial market conditions were mixed, but were suffering from the commensurate decline in investors' opinions about economic prospects.

Further declines in growth are expected over the next three months, in line with the seasonal and cyclical weaknesses that occurred in 2009, 2010, and 2011 during the third quarter. As was the case in these three immediate past years, the seasonal and cyclical weaknesses will be latched on to by precious metals investment product marketing groups, media demagogues, and politicians, who will seek to generate greater economic concerns than probably are warranted by the underlying economic realities, warning that the world and individual economies are on the precipice of a new recession or even economic depression, the monetary system will fail, and worse.

The key question will be how gold, silver, and the platinum group metals markets, investors in particular, react to the underlying economic realities, and the hysteria that should be expected from the groups mentioned above. The most likely outcome is that some investors will succumb to the fear mongering, but most precious metals investors will remember that they have been misled by such warnings for the past three years, and will maintain a more measured interest in buying and holding precious metals. The gold section discusses the price outcomes under this scenario and one in which things get worse for the world.

Events that will emerge in June and beyond will heavily influence investors' price expectations. The upcoming Greek run-off election on 17 June and the Federal Reserve Board's Open Market Committee meeting on 19 and 20 June each could either add to investors' concerns or calm markets and restore some semblance of rationality to expectations. Either or both could drive another round of buying in gold, or could ease investment markets' concerns. Other factors should be expected to emerge. As this was being written the U.S. Defense Secretary was saying in public that the U.S. government was "reaching the limits of our patience" with the Pakistan government over efforts to hunt terrorists. While it would seem ludicrous to think that the U.S. government would launch a third war against a southern Asia Muslim nation, his comments speak for themselves. In an election year that promises to be rude and peculiar, all sorts of things could emerge to put fear and panic into the hearts and minds of investors. Our view is that much of these developments will be avoided, and that investment markets already have decided to react to such further political and economic developments with more moderate buying of precious metals, but a few bad turns could reverse the trends that have been in place since late last September.

U.S. Monetary Accommodation, The Dollar And Gold Prices

The Great Recession of 2008-2009 prompted the U.S. Fed to reduce its target interest rate to near zero, which it did in a phased manner between September 2007 and December 2008. The Fed's target interest rate was bought down from 5.25% in August 2007 to 0.25% in December 2008. This reduction in interest rates was not sufficient to help prop up economic growth, however.

On 24 November 2008 the Fed therefore announced a bond buyback program. The Fed called this monetary accommodation, pumping dollars into circulation by purchasing bonds, Quantitative Easing. This term then became shorted to QE1 and stuck as a label for this form of monetary accommodation in market lingo. This program was put into effect on 1 January 2009. The Fed was to

Deteriorating Economics (cont.)

purchase $500 billion in mortgage-backed bonds.

Economic conditions continued to deteriorate nonetheless, which resulted in the Fed expanding its bond buying program to $1.25 trillion in the middle of March 2009. This program came to an end at the end of March 2010. By that time economic conditions had improved somewhat in the United States.

It should be noted that the Fed's stated goal in undertaking such monetary policies was not to generate real economic growth and recovery, but rather to stop or reduce the contraction of U.S. economic conditions. The view was, and continues to be, that monetary policy cannot drive real economic growth; it only helps stanch the bleeding, stop the deterioration of economic activity, and to try to keep recessionary economic trends from worsening.

By July and August 2010 U.S. economic growth was deteriorating once again, as consumers and businesses pulled back from consumption and investment out of fear of renewed recession. In this environment the Fed put into effect a second round of Quantitative Easing or QE2 in November 2010, which ended on 30 June 2011. The prospect of QE2 was formally announced at the annual meeting hosted by the Kansas City Federal Reserve Bank in Jackson Hole, Wyoming, in late August 2010. The Fed agreed to purchase $600 billion in treasuries in this round of monetary easing.

Fragile economic growth in the United States coupled with deteriorating external factors resulted in the Fed putting into effect Operation Twist on 21 September 2011. The Fed exercised this policy with the intention reducing longer term interest rates by purchasing long-term Treasury bonds and selling shorter_term Treasury bills and notes. The Fed has also kept open the door to another round of bond buying or QE3, if needed.

Some investors view the present easy monetary policy of the U.S. Federal Reserve as a great reason to purchase gold, seeing the current monetary policy as likely to result in higher inflation and the dollar losing value. When viewed over the longer term, much to the contrary has happened since the Fed began to ease monetary policy. Investors pursuing this strategy point out that the inflationary pressures will be felt inevitably, even if their appearance in the real economy are delayed for years.

The Fed and other economists counter that the seemingly inevitable inflationary consequences of these policies in fact are not foregone conclusions, since the Fed might adopt anti-inflationary policies at the appropriate time to counter these. It wishes to fight the current economic weakness at present, and states that it will deal with inflationary pressures later, if and when they appear.

The Effects On The U.S. Dollar

The U.S. dollar has held up fairly well since September 2007, when the Fed began to cut its target interest rates, through the present day. The trade-weighted U.S. dollar index was at around 85 in September 2007 and was at 84 at the beginning of June 2012. Not to mention that the index had risen to 96.1 on 3 March 2009, which was three months into the first quantitative easing program.

There are multiple reasons why the U.S. dollar has managed to hold up so well. In today's monetary system there is no real alternative for the U.S. dollar, not gold and not any other currency. No other currency or gold has the level of liquidity or depth as the U.S. dollar to be able to support the global economy.

Furthermore, other reserve currencies such as the euro, British pound, and Japanese yen are in no better state, with their economies facing some of the same problems as the United States. Currencies of countries like Switzerland which have good economic fundamentals cannot be considered as an option for becoming the primary reserve currency of the world because the size of the Swiss economy is too small and the global stock of Swiss francs available to investors too small to bear the burden associated with the demand for the Swiss franc, if it were to be treated as a primary reserve currency.

The Chinese yuan is being touted by many as the next reserve currency to replace the U.S. dollar. If this were to occur it could take several decades and would require the Chinese government to take several steps to develop a strong, liberal domestic banking system before they may allow their exchange rate to float. Furthermore, most countries resist the use of their currency as a reserve because it increases the currency's value which could potentially hurt domestic demand and exports. The export-to-gross domestic product ratio for China stood at around 30% in 2010. An extremely liquid and therefore efficient market for U.S. dollars both in the United States and globally make it a preferred choice in times of crisis.

Deteriorating Economics (cont.)

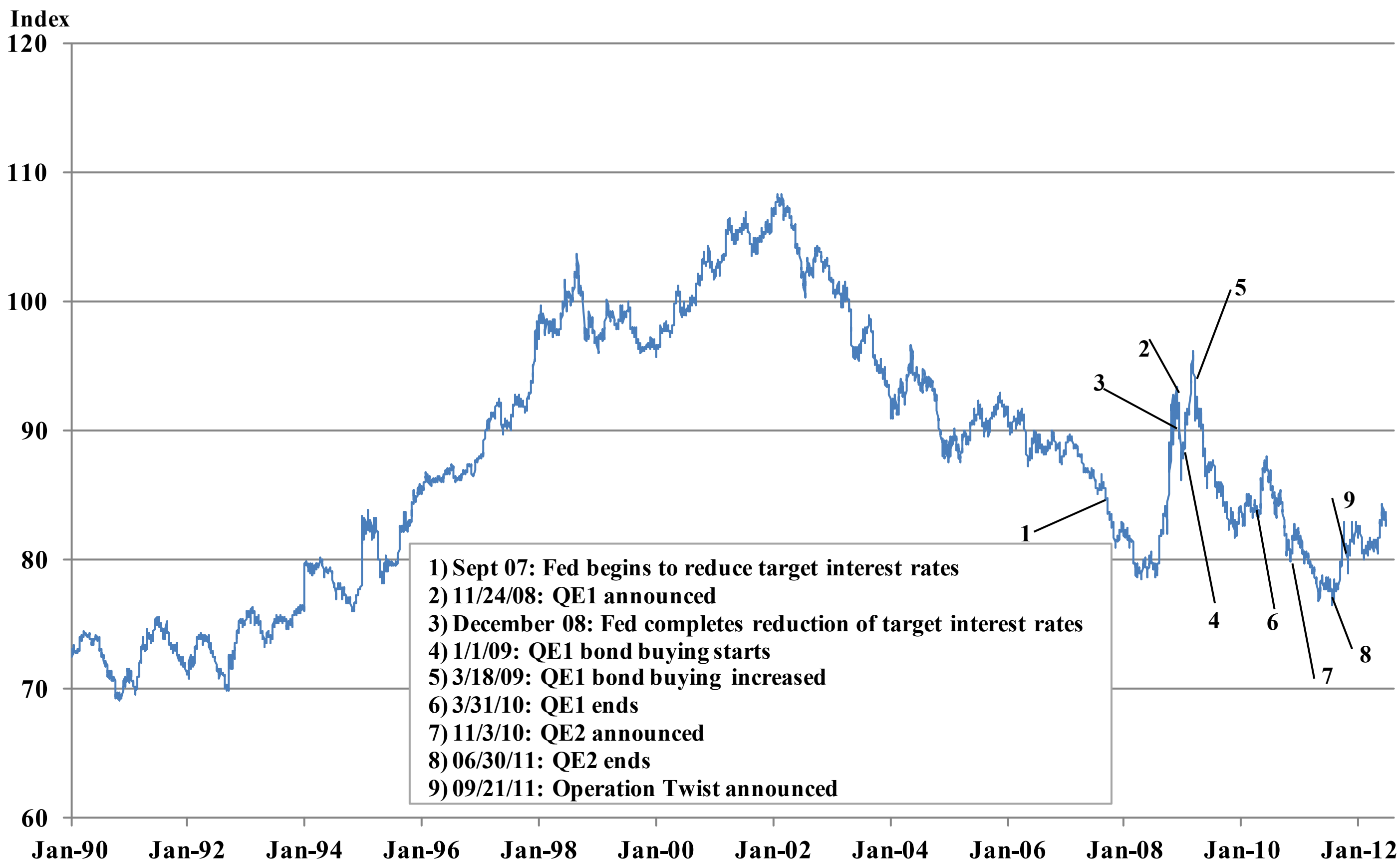
That said, the dollar has suffered when the Fed has taken additional steps to ease monetary policy. When the Fed began cutting its target rate in September 2007 the U.S. dollar index did decline from 85 in that month to 78 in July 2008. It also declined when QE1 was announced and when QE2 was announced and rose when those two programs were ended as can be seen in Chart 1. It should be noted, however, that these additional steps taken by the Fed to ease monetary policy have not resulted in the U.S. dollar tanking the way it is popularly proposed by some in the market. The importance of the U.S. dollar to the international financial markets, explained above, is largely responsible for this. The dollar index had risen between August 2008 and December 2008 when the Fed was still cutting its target rate. At this time the financial markets were at the height of their concerns regarding economic growth and investors had turned to the U.S. dollar, selling other assets including gold. The dollar index had also risen between January 2009 and March 2009, when the Fed had begun to make bond purchases under its QE1 program. The dollar has also remained fairly strong following the implementation of 'operation twist' since September 2011.

The Effects On Gold

The price of gold has been on a rising trajectory since 2001. During this period the U.S. Fed increased its target rate between June 2004 and August 2007. Nonetheless the price of gold continued to rise. This is because investors have been purchasing gold for a multitude of political and economic reasons besides monetary easing or tightening by the Fed. As mentioned above, during the period between August 2008 and December 2008 when the Fed was still reducing its target rate the price of gold was declining.

Similarly, the reverse was seen between July and early September 2011. Prices spiked higher, reaching record high levels during this period. This increase in prices had

Chart 1: JP Morgan Trade-Weighted U.S. Dollar Index and U.S. Monetary Policy
Through 22 June 2012



Deteriorating Economics (cont.)

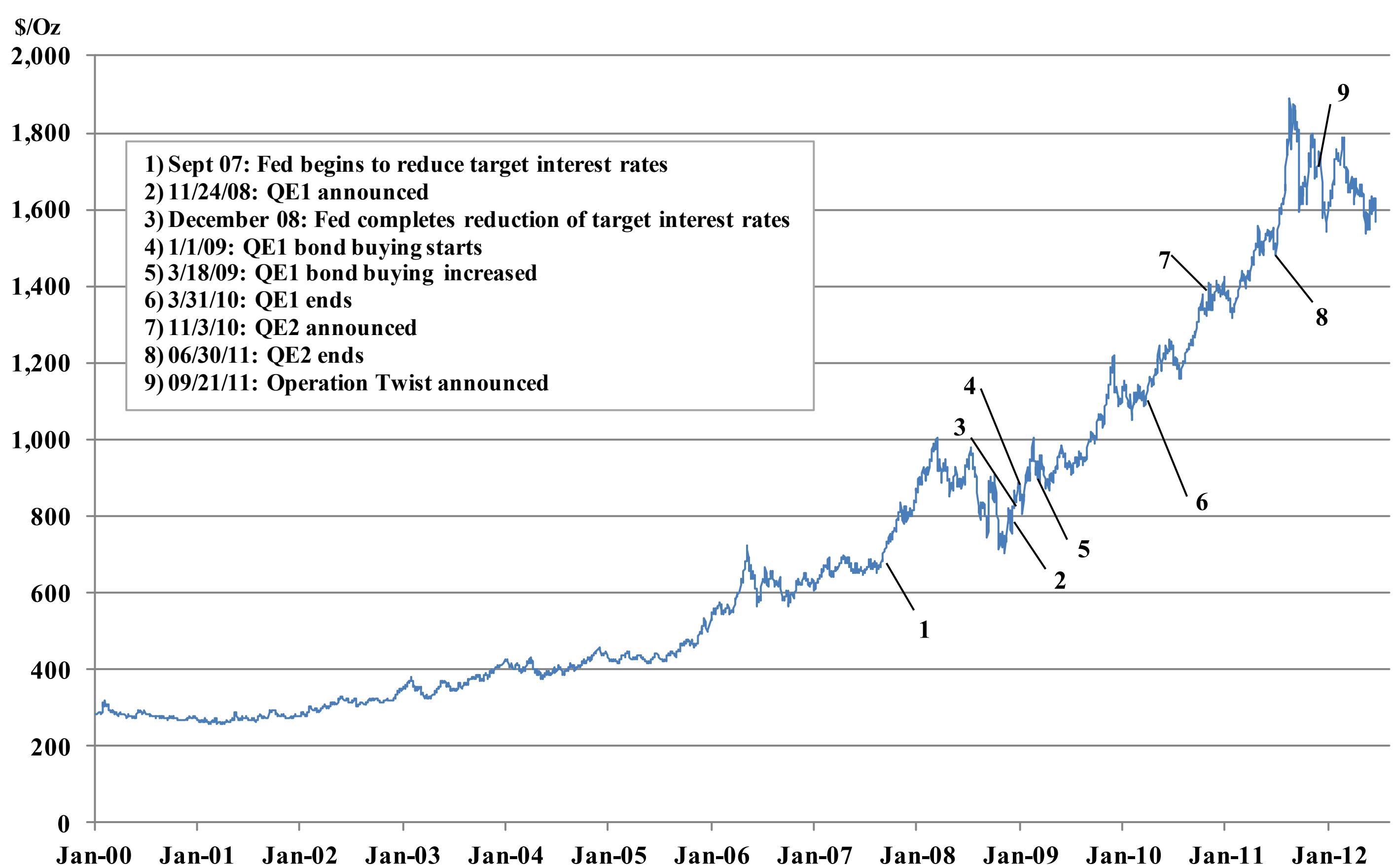
occurred following the end of QE2 on 30 June 2011. This increase in prices, which was the sharpest increase seen in prices at one stretch, was unrelated to any monetary easing but was related to the fiscal debt ceiling issues in the United States and the intensifying debt problems of Europe. It should also be noted that at this time the value of the U.S. dollar also rose. This, despite the downgrade of U.S. treasury debt on 5 August 2011, drives home the degree of respect that global financial markets place on the dollar, especially in times of crisis.

The other concern among market participants is that the current monetary easing will result in high inflation in the future. These investors purchase gold as a hedge against this future inflation. The general expectation is that these funds ultimately will flow into the economy fueling potential future inflation, which would be supportive of gold demand as a hedge against this inflation. This scenario is unlikely to pan out, however.

Monetary authorities are aware of this danger and plan to sop up the excess liquidity if and when these funds begin being mobilized. When that happens, it will by definition coincide with a broader economic recovery, which will allow monetary authorities to be less accommodating and more restrictive. The plan is to sell bonds to absorb the excess money supply, thus keeping inflationary pressures in check. This is a plan that has worked repeatedly since 1983, giving monetary authorities confidence that they can use bond sales once more to sterilize the inflationary implications of earlier monetary easing. Given that interest rates are low and are expected to remain so over the medium term, perhaps through the middle of 2014 for the United States, it provides enough arsenal for central banks to sterilize higher levels of inflation if monetary factors begin to appear to be fueling future inflation.

Going forward, the Fed may provide yet another round of monetary easing. Central banks will do what they have to in order to sustain economic growth. If the Fed makes

Chart 2: Daily Comex Gold Prices and U.S. Monetary Policy
Through 22 June 2012



Deteriorating Economics (cont.)

such a move it could have a short-term negative impact on the U.S. dollar and a positive impact on the price of gold. Gold prices should not be expected to rise to an astronomical level, however, and the U.S. dollar should not be expected to sink significantly either. The price of gold rose from $819.50 on 24 November 2008, the day QE1 was announced, to $1,113.30 on 31 March 2010, when QE1 ended. This was an increase of $293.80. The price of gold rose from $1,337.60 on 3 November 2010, the day QE2 was announced, to $1,502.50 on 30 June 2011, when QE2 ended. This was an increase of $164.90. The declining increase in gold prices in response to quantitative easing suggests that investors are becoming less sensitive to such measures by the Fed. Also they are not interested in buying large volumes of the metal at current high prices.

U.S. Monetary Policy and its Impact on Gold Prices

					Price Appreciation		
Fed Policy	Announcement Date	End Date	Price at Start	Price at End	Dollars	Percent	Price Range
Reduction in Target Rates	Sept. 2007	Dec. 2008	$711	$837	$125	18%	$705 - $1,004
QE1	11/24/2008	3/31/2010	$820	$1,113	$294	36%	$752 - $1,218
QE2	11/3/2010	6/30/2011	$1,338	$1,503	$165	12%	$1,318 - $1,557