



Precious metal rally continues - 13.03.14

Gold prices moved sharply higher overnight, at one point testing USD \$1370 per ounce, as escalating tensions in the Crimea and some short covering, saw the entire precious metal complex rally.

The move started in Asia yesterday, when the Nikkei opened solidly lower. This led to buying on Tocom (the Tokyo Commodity Exchange) by Japanese investors, helping push prices toward USD \$1350 per ounce, with buying stepping up even further once China entered the market.

Part of this was undoubtedly linked to additional rumours regarding corporate bond defaults in China, but the impact on gold was significant. Once prices moved into the mid USD \$1350 per ounce range, shorts unwound their positions, sending gold a few dollars higher immediately. For those keen on a read into the days trading, [click here to read the MKS Groups Daily Asia Wrap](#), which covered it nicely

Strength continued for the rest of the day despite the odd pullback, with gold looking strong here, around USD \$1365 per ounce. The following chart (courtesy of Greg Mckenna - @gregorymckenna for those who use twitter) shows that Gold is still in an uptrend. Famous last words of course, but I think a rally to test USD \$1400 per ounce can't be ruled out.



If gold can even hang onto the gains of the past two and a half months, precious metal investors will have enjoyed a very solid quarter, with gold now up nearly 15% for the year, whilst silver is up closer to 10%.

Although this is worrying some precious metal bulls (as silver usually outperforms gold when precious metals are rising), it could be due to the quasi-industrial nature of silver at the moment, and the fact it's a less pure precious metal play than gold.

Remember that many commodities are falling sharply right now (think iron ore for Australians in particular), including copper, and perhaps some of that has helped hold back silver in a relative sense.

The gold stocks on the other hand continue to impress, with seniors on average up nearly 30% this year and juniors up a touch under 40% (using GDX and GDXJ as the proxies).

Australia's gold miners and explorers/developers have also enjoyed the bounce, and their resilience, alongside the performance of physical gold having more than ever justified the inclusion of these assets in a well-diversified portfolio.

Having said that, we'd caution investors against building up excessive exuberance around a sustained rally, pushing gold back up above \$1500 per ounce (and circa \$25 an ounce for silver). We think we'll go many multiples higher than that before the end of the decade, but patience is important here.

Part of this rally is undoubtedly linked to the Ukraine situation and fears of a slowdown in China (alongside potential liquidity issues there). Some of that 'fear' premium may come out of the spot price in the next few weeks.

A word on Corporate Profitability

Equity market cheerleaders have constantly been beating the 'corporate profits have never been higher' drum for some time now, using it as a way to justify record high stock prices even in the face of what is an, at best, lukewarm economy.

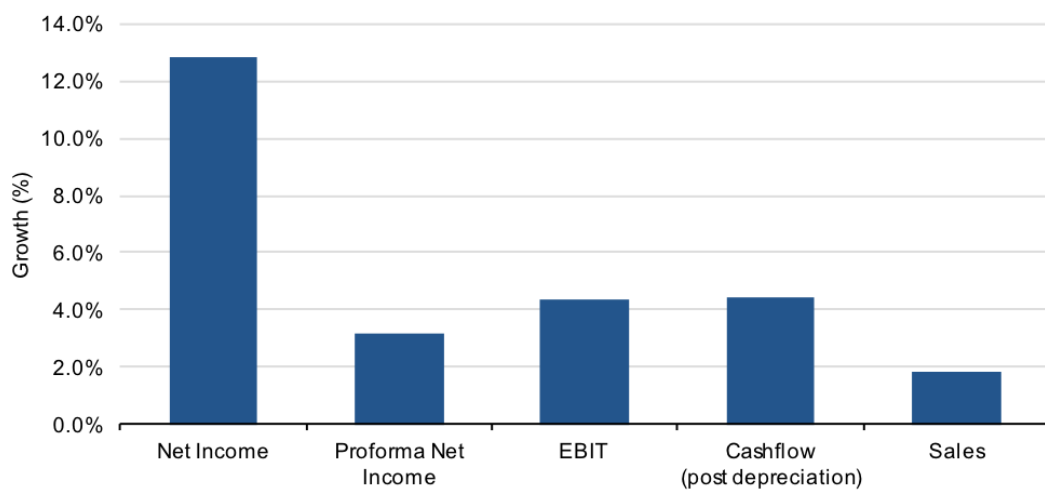
On this note, Business Insider carried an excellent article quoting research by Societe Generale's Andrew Laphorne. The headline "US Profit Growth is Much Weaker Than Reported" was definitively attention grabbing, and the charts in there were highly instructive.

As you can see from the below, net income growth was particularly strong in 2013, leading many analysts to proclaim that the bull market in stocks has much further to run, based on strong bottom line earnings.

The problem is that the bottom line can, and is influenced by a whole heap of factors, many of which have little to do with the actual income or sales growth a company is experiencing.

Asset write downs, gains on asset sales and restructuring charges all impact net income and in 2013, the big one was a goodwill write down, with Lapthorne stating; *“Looking behind these headline numbers we see that the biggest increase in reported net income in 2013 came from Hewlett Packard. This improvement was courtesy of the large 2012 \$19bn goodwill write-down (from the EDS and Autonomy acquisitions) dropping out of the 2013 figures. Indeed if we compare the biggest positive contributors to reported net income the list is very much different to the pro-forma net income figures. The top 10 biggest positive net income contributions are dominated by companies affected by write-downs in 2012.*

What to believe – non financial sector growth in the US in 2013



Source: SG Cross Asset Research/Equity Quant, Thomson Reuters I/B/E/S, Company report and accounts

When we look at other measures of growth for US companies, one can see clearly that the outlook and the results are not nearly as bright, in that things like EBIT, cash-flow post depreciation, and especially sales growth were all very weak.

This is something that is likely to drag on business investment going forward, (the article has a great chart on the correlation between cash-flow growth and growth in capital expenditure) which many are hoping will lead to much stronger overall GDP and employment growth in the USA.

This is not just a trend that is in place in America, but Australia too, where analysis from Credit Suisse showed that only 22% of companies missed expectations on dividends per share, fully 35% missed on earnings and 50% on free-cash flow.

That's what happens in an environment where sales growth is weak, but boards feel pressured to maintain, if not increase, dividends to satisfy the demands of understandably yield hungry investors.

The Business insider and the Credit Suisse report (via Macrobusiness) can be accessed here for those who'd like to read them in full.

<http://www.businessinsider.co.id/us-profit-growth-weaker-than-reported-2014-3/>

<http://www.macrobusiness.com.au/2014/02/the-vulnerabilities-of-profit-season/>

A Bond Guru Speaks

Jeffrey Gundlach, the Chief Executive Officer of DoubleLine Asset Management is one of the globes leading lights in the fixed income space. He is also an incredibly well respected macro commentator.

He recently gave a speech titled "What hath QE wrought", and the slides accompanying that presentation were posted online this week (also at Business Insider).

[Here is the link](#) and you can click through the slides at the bottom (there are 39),

It's worth spending 10 minutes to go through the slide deck. My favourites, and my thoughts on them are as follows;

Slide 3: Medicare and Social Security Deficit

Even though the government was running trillion dollar deficits in the past few years, social security and Medicare are only just now starting to really wreak havoc on public finances. Obamacare will only make this worse.

Slide 8: Federal Reserve Bond Buying Program

As the slide shows only too clearly, the Federal Reserve is clearly the largest funder of Washingtons largesse, buying well over 50% of Treasury Debt. If the Fed fully tapers QE, either bond yields are going to explode, or the private sector will have to divert hundreds of billions of dollars to Washington. That will crush growth.

Slide 20: US Household Debt

As the slide shows, for the first time in 5 years, quarterly debt levels rose substantially (there were 2 minor increases previously). Some commentators see this as a good sign, in that consumers are willing to re-leverage. I'm not so sure. I think that in an environment with few jobs, minimal wage growth and real inflation running much higher than official figures, means consumers may be turning to debt merely to maintain lifestyles.

Slide 21: Income Share of the Top 5%

This is probably my favourite of the lot. Since the 1970's, and since the 80's in particular when the largest rally in the history of financial assets began, a disproportionate share of wealth has gone to a tiny, well-connected elite. This has occurred alongside a change in our monetary system, from gold backed money to paper backed money, and in an environment where government intervention in the economy, and in our lives, has almost constantly grown.

Never has government 'done more' to 'create equality'. Never have things been so unequal.

Slide 26: Fed deflation in One Picture

Being a bit cheeky here, but as the chart shows, each Fed Governor has been shorter than their predecessor, with the fall in height from Paul Volcker to Janet Yellen nearly 2 feet in total.

Interestingly, the falling height of the Fed Governor correlates pretty well to falling bond yields in the US. With that in mind, if the Fed is to maintain its control of the bond market, the only two people in the running when it comes time to replace Yellen are either going to be Yoda, or Tyrion Lannister from Game of Thrones

Until next week

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