



“ On T h e M o n e y R e p o r t ”

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Is It Time To Buy Gold?

It is a well known fact that in times of uncertainty, gold is looked upon as a safe haven. Furthermore in times of extraordinary financial stress, gold is thought to be an investment which will hold its value better than most paper assets. The problem is that no one ever knows how dire the financial economic consequences will ever be, so investing in anticipation of that type of an event can turn into an investment disaster.

How does one know when to own this metal and when to avoid it? According to Dr. John P. Hussman's report "Going for the Gold" (www.hussman.net), over the past 25 years, gold stock prices have gone nowhere overall, rising at less than 1% annually.

Below is a synopsis of his report.

First, U.S. investors see the price of an ounce of gold in U.S. dollars. Therefore, any time you see the price of gold rise, one of two things must be true. Either the foreign price of gold has increased, or the value of the dollar must have declined (i.e. foreign currencies have become more expensive.

As a result, huge and sustained moves in the price of gold require either:

- 1) worldwide inflation, or
- 2) a plunging U.S. dollar.

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Unquestionably, rising inflation - particularly worldwide inflation, is a plus for gold prices, but the real action comes when inflation rates are rising worldwide and the dollar is under pressure.

Secondly, the main factor that moves the dollar is not the action of inflation itself, but the action of long-term real interest rates. When long-term real interest rates are trending down (relative to long-term real interest rates in other countries), the dollar typically declines. When long-term real interest rates are trending up, the dollar typically rallies.

The reason is simple. There are two objectives to holding a dollar: one is to buy goods and services, and the other is to earn interest. Higher interest rates are good for the value of the dollar, since they make holding dollars more profitable. But higher inflation is bad for the value of the dollar, since it deteriorates the purchasing power in terms of real goods and services.

The bottom line:

- the dollar does best when interest rates are rising, or when inflation is declining, or preferably both. The longer the term over which these trends are expected to persist, the stronger the action of the dollar.
- The dollar does worst when real interest rates are trending lower.

Stated again if we're looking for a rally in gold, we're really looking for;

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- 1) World inflation, particularly in the U.S., and
- 2) 2) falling long term Treasury bond yields.

This combination is most frequently seen early in a recession. Inflation is generally rising at the time the economy enters a recession. At the same time, it turns out that long term interest rates stagnate or fall as the economy enters a recession. The net result is that as the economy softens, long-term real interest rates tend to decline, and the value of the dollar typically plunges. **That's the time you want to own gold.**

Trend Following

What doesn't work.

- 1) If you want to define a useful "trend" in gold stocks, you just don't get much useful information by looking at gold stock prices themselves. Since 1975, when the XAU (Philadelphia Exchange Gold Index) has been above its level of 6 months earlier, it has continued to advance at an annual rate of 0.65%. When the XAU has been below its level of 6 months earlier, it has advanced at an annual rate of 0.73%. That's as close as you can get to an indicator being perfectly **uninformative**.
- 2) Gold bullion prices have somewhat better information. When the price of gold is higher than 6 months earlier, the XAU has followed by advancing at a 6.87% annual rate, on average. When the price of gold is lower than 6 months earlier, the XAU has declined at a -4.31% annual rate. While that seems like a big performance difference, it is statistically insignificant

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because gold stock prices are wildly volatile. One can't tell if this is the volatility talking or if these numbers have any real meaning. Interpretation: **uninformative**.

- 3) Ditto for inflation trends. When the rate of inflation has been higher than 6 months earlier, the XAU has advanced at an 8.18% annualized rate, compared to a -5.02% annualized loss when the rate of inflation has been lower than 6 months earlier. As a "tendency" this information is useful, but as a guide to investing, the volatility still overwhelms this predictable component of price movements. Interpretation: **uninformative**

What works

- 1) The trend of long term interest rates is actually more important than the trend of inflation. When the 30 year Treasury yield has been below its level of 6 months earlier (as it is now), the XAU has advanced at an annualized rate of 19.17%, compared to an annualized loss of -17.51% when Treasury yields have been rising.
- 2) Since economic weakness tends to produce falling real interest rates, we also get a strong difference in performance based on whether the economy is expanding or contracting. When the NAPM (now called the ISM) Purchasing Managers Index has been below 50, indicating a contracting economy, the XAU has surged at an annualized rate of 23.48%, compared to an annualized loss of -9.66% when the PMI has been above 50. (The index is 50.5 for August, 2002)



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- 3) When the ratio of gold prices to the XAU has been above 4.0, the XAU has advanced at an average annualized rate of 24.82%, compared to a -13.34% annualized loss when the Gold/XAU ratio has been below 4.0.

As of this writing, gold is approximately \$320.00 per ounce. The XAU index is 72. The ratio, therefore is 4.44

This means that you generally want to buy gold stocks when they are lagging the price of the metal. And it also means that you are better off buying gold stocks on dips than to buy upside "breakouts".

Not surprisingly, the combination of all of these is rare but extremely powerful. In the rare instances when 1) The rate of inflation has been higher than 6 months earlier, 2) Treasury bond yields have been lower than 6 months earlier, 3) the NAPM Purchasing Managers Index has been below 50, and 4) the Gold/XAU ratio has been above 4.0, the XAU has soared at an astounding rate of 123.63% annualized. In contrast, when none of these have been true, the XAU has plunged at -53.21% annualized. That's a gaping difference.

Steve

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