



Outlook; July 2010

As we reach the end of June and the first half of 2010 the predominant question on investor's mind is whether or not we will see a double-dip recession. I just don't see overwhelming evidence for that argument. Look at the recent data. The ISM Manufacturing Survey (measuring manufacturing activity) is high and in clear expansion territory. (May 2010 survey released on 6/1/2010). Consumer sentiment, which is still low, also is rising. And even though the May employment report was weaker than expected, it still showed job growth.

We haven't seen classic signs of impending recession, such as an unexpected decline in demand and a rise in inventories. Raw industrial prices, oil prices, and commodity prices in general—yes, they're down, but they are not plunging as they have in prior recessions. I'm looking at these glasses in front of me and I think they look half-full, not half-empty.

You typically get the strongest spurt off the bottom of recession. And we saw that with the index of leading indicators. It was up strongly in March, 11.6% year-over-year. In May the pace of ascent moderated and it was up 9.2%. When the indicator bottomed last spring, it signaled that the economy was moving from recession to recovery. Now it appears it is signaling, through this moderating growth rate, that the economy is moving from recovery to expansion. But here's my point: Since 1958, we've never had a double dip when the leading indicators have been up this much on a year-over-year basis. I'm not saying a double-dip recession is an unreasonable concern, but I think the indicators I look at are still pointing to expansion

As the 10 year yield on the U. S. Treasury dips below 3% I reflect on one of the last foreign crisis periods. Remember the Southeast Asian crisis back in 1997 and 1998? At that time, the worry was because Southeast Asia accounted for a fair portion of global GDP and it was falling into a deep recession. Well, here's what happened: As Asia slumped, oil prices fell; our cost of capital also declined sharply because international investors flocked to risk-free U.S. Treasuries. The Federal Reserve, which had begun considering a tightening cycle in 1997, fully reversed course as the Long-Term Capital Management (LTCM) crisis unfolded in 1998. So the Southeast Asia crisis, Russian default, and LTCM crisis that followed basically became a stimulus to the U.S. economy. The same thing may happen this time around—already interest rates are heading down as overseas money flocks into Treasuries for a safe haven. [Past performance is no guarantee of future results.]

I believe that going forward we are entering into the part of the cycle that most benefits good stock pickers. Over the past 12 months, it was a bit hard to be a stock picker because we were getting a lot of what they call junk rallies, where the worst companies did best. That's now over, in my opinion. In the next 12 months, as the economy shifts into expansion mode, I believe there will be a lot of emphasis on evaluating whether a company is able to generate a high level of growth and sustainability in earnings.



With regards to the Fed and whether or not they will raise rates anytime soon I see this part of the recovery as very similar to 1998 and 2003, when the Fed was getting its ducks in a row to start changing monetary policy. The Fed has been positioning to tighten, but the Euro zone crisis put that on hold. You don't need to raise rates to combat inflation if others are doing the heavy lifting for you. With the Euro zone crisis, the higher dollar has sent U.S. import prices down. A downturn in Euro zone growth will also reduce demand for raw materials, acting as another brake on inflation. So that gives the Fed more latitude to hold steady. Here in the U.S.

I am finding good value in the bond market currently. Long-term government debt has had a very good run, but that looks the riskiest to me right now. I would consider high-yield corporate debt. Those bonds are "pricing in" a high level of default, but if you look at the leading indicators of default in that market, they are all turning positive, indicating default rates are coming down.

Let's discuss gold for a moment. Gold historically has been quite volatile and over the past 8 or 9 years there have been a number of sharp pullbacks in the price of gold. The ride from \$300 per ounce to over \$1200 per ounce has not been without its ups and downs. The larger question is not whether gold is in the 8th or 9th inning or its secular bull run as many television and radio commercials advertise but rather the broad view of gold. Looking at the World Gold Index chart (XAND) we see gold bottomed out in 1999 and began its current upward trend which continues today. No one has a crystal ball but the chart suggests there is still adequate time to buy gold for investors whose portfolio is suitable for this holding.

From 1982 to 2000, we saw the greatest bull market for financial assets such as stocks, bonds, and currencies in history, and a corresponding secular bear market for hard assets including gold. Since the financial asset bull market ended in 2000 with the dot-com bust, we have been in a bull market for gold and other commodity investments as the reasons for the financial bull market reversed and a strong set of tailwinds for the commodities asset class emerged including globalization and reflationary monetary and fiscal policies.

This back and forth between the different asset classes is quite consistent with history. But while the financial asset bull market had 18-year duration, we are only in the ninth year of absolute and relative outperformance for gold. What's more, when adjusted for inflation, gold is still well below its historic real record price last seen in 1980. **[Past performance is no guarantee of future results.]**

I believe the long-term fundamentals indicate that gold has room to rise as long as the key drivers for its ascent continue to be in place but it is not suitable for every portfolio. I will be happy to discuss it with you individually if you wish.

In my opinion, there are really two price dynamics that drive the price of gold. The first is its traditional end market, which is jewelry demand. The other is gold's investment appeal as a strategic reserve currency or store of value. It is the investment appeal of gold that has been its chief price determinant over the past nine years, and I believe it is likely to be the key driver in the foreseeable future.

Conceptually, investors might think of the investment demand for gold as providing its price ceiling, and jewelry demand its price floor. Regarding gold's strategic investment appeal, the gold asset class (bullion and gold equities) has historically done very well in periods when many financial assets haven't.



I see three fundamentals supporting higher gold prices: 1) macroeconomic imbalances, 2) geopolitical tensions, and 3) a favorable supply-demand balance.

First, macroeconomic imbalances will most likely not get resolved unless China and other "peggers" (whose currencies are pegged to the dollar) allow their currencies to appreciate and be market-determined. If this happens, I believe the U.S. dollar would likely weaken and gold could continue to move higher.

Second, the world is rife with geopolitical tensions—ranging from the conflicts in Iraq, Afghanistan, Israel/Palestine, and North Korea, to the growing threat of protectionist trade policies. In times of global conflict, investors have historically demanded gold as a safe haven, as gold is the only commodity that is a currency, and it is the only currency that is not someone else's liability.

As for supply and demand, there's been a lot of spending on gold exploration over the last few years, but little has been found. As a result, world mine production has declined as the price of gold has risen. In addition, central bank selling has been relatively muted of late, while some central banks, namely Russia, China, and India have increased gold as a component of their foreign exchange reserves.

Investment demand for bullion has been strong in recent years, driven largely by the aforementioned drivers and investors' concerns about protecting their global purchasing power. And I believe jewelry demand should remain strong as long as new emerging-market middle classes continue to be built in countries such as China and India where there is a strong affinity for and capacity to own gold.

It's true that gold historically has had at times, a strong inverse correlation with the U.S. dollar. But, gold's price recently has been rising in all currencies; so it's more than just a "weak U.S. dollar" story. What's more, the price of gold has historically had a positive relationship with the growth of overall global currency reserves, which have increased from roughly \$2 trillion to over \$8 trillion [U.S. dollars] over the last decade as almost every country around the world has had to pursue reflationary monetary and fiscal policies. The last point is that gold has historically risen in price when real interest rates (after inflation) were below 3%. Recently, real interest rates were actually below negative 2%.

When you think about your allocation to gold, I believe that it is useful to think of it like a financial asset insurance policy. When you buy insurance, you don't necessarily want all of the events you're insuring against to take place. That's true here as well. We hope that a sustainable recovery is taking place, and that the markets, credit, economic imbalances, and investor confidence all get repaired. In addition, we hope that inflation doesn't accelerate as a result of the worldwide stimulus being applied to various financial and credit problems. However, should some of the world's issues not work out smoothly or favorably, maintaining a small allocation to gold in an overall diversified investment portfolio could potentially be beneficial.

In most cases I prefer the gold stocks. When gold prices are rising, the stocks of gold mining companies have typically outperformed gold itself. That's because gold producers can provide operational and financial leverage in a rising gold price environment. Because many of the costs of producing gold are fixed, when producers' top line revenues go up, earnings can go up even more. This is what we've seen over the last 10 years in a low inflation environment, as well as during the inflationary 1970s.

In conclusion I would like to say that as beautiful as a bar of gold is it doesn't generate earnings, generates no cash flow, doesn't pay dividends and tends to be very volatile in the short term with swings of hundreds of dollars, per ounce, per day, not being uncommon. In short gold is not for every investor.

Because of each investor's unique time horizon, tolerance to risk and financial objectives gold should be closely examined before adding it to any portfolio. Please call for a phone or in person appointment to review your portfolio and your suitability for investing in gold..

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