THE GLOBAL SPECULATOR

08 June 2006

www.globalspeculator.com.au

1970 – 1982:- A POSSIBLE ROADMAP PART 1

Recently I conducted some economic research on the last bull market we experienced in precious metals from 1970-1982. Given the economic similarities we are faced with today, I did this in an attempt to gain a better understanding of where we are presently placed and what we could potentially expect going forward.

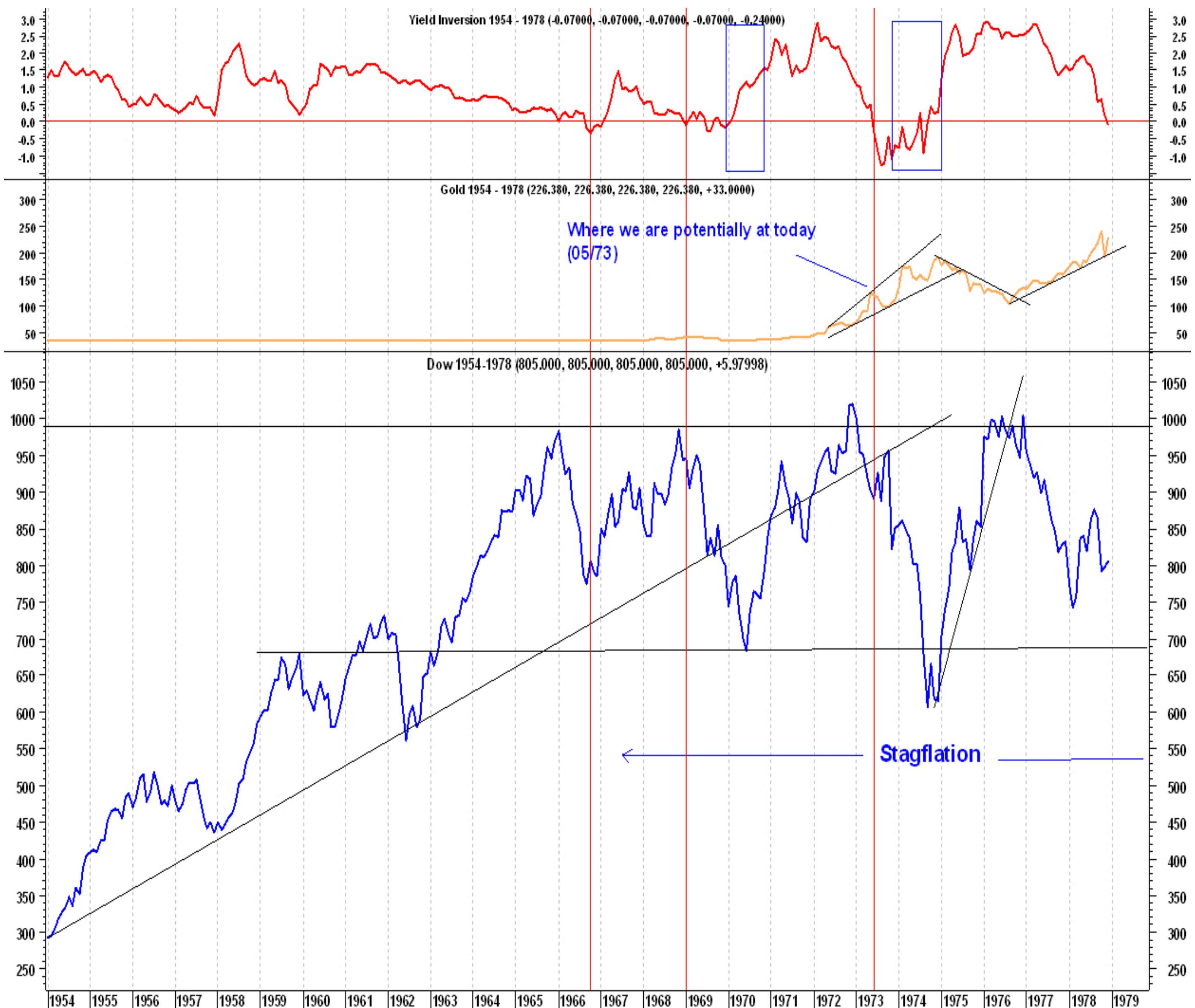
The three areas I investigated included the following:

> **The Dow Jones Index:** With a look at how it behaved in the lead up to the 1970's and during the extended period of stagflation that was experienced right up until 1982.
>
> **The Gold Price:** I looked at how it moved and reacted to various market conditions experienced during this period.
>
> **Yield Differential:** This is calculated by taking the Yield difference between US 10 year Treasury bonds and US 3 month Treasury bills. There have been some excellent articles written that clearly demonstrate the reliability of **Yield Inversion** in forecasting a recession within a 6-12 month period. The basic theory is that when the shorter term rate exceeds the longer term rate (Yield Inversion) this implies the Federal Reserve's interest rate policy is too tight in relation to inflation expectations (Indicated by the 10 Year Bond rate). This consequently leads to a recession.

PART 1: 1954 – 1978 VS 1982 - PRESENT

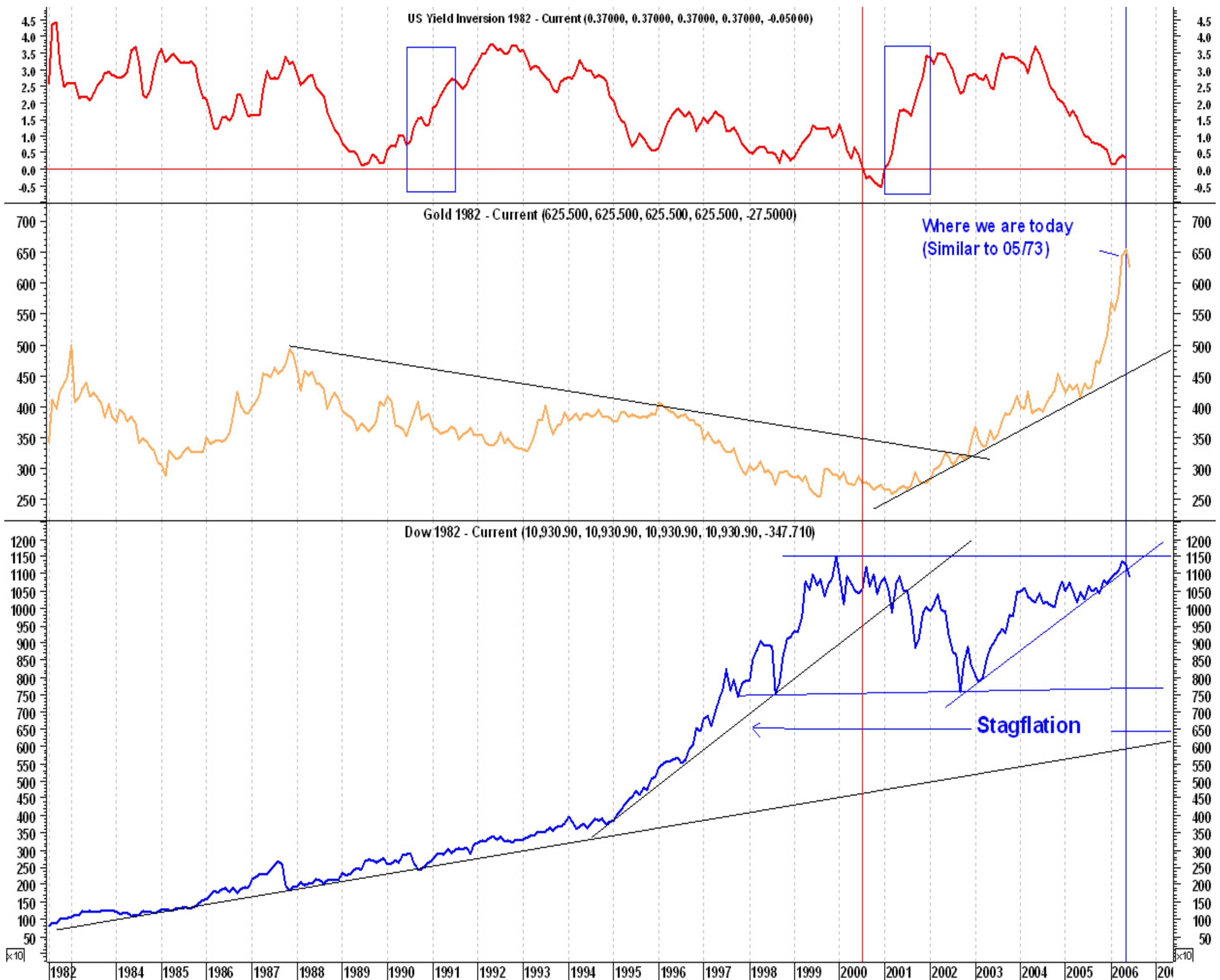
I want to share with you today the first part of my findings, which will be a brief look at the years leading up to the 1970's with a closer look at the first 8 years of the precious metals bull market that took us up to the end of 1978. I will then compare this to the present bull market and demonstrate what I believe are some useful similarities. The first chart below is a look at the three areas I mentioned above in relation to the period of **1954 – 1978**.

1954 - 1978:



A quick look at this chart shows how the Dow Jones Index surged strongly right up to the beginning of 1970 before it started to hit problems. The top section of the chart demonstrates the Yield Differential. When this line dips below zero (Indicated by the red horizontal line) we experience Yield Inversion. As you can see, two out of the three times this occurred (Indicated by the Red vertical lines) in the period under examination, a recession occurred within the following 6-12 months (Indicated by the Blue Rectangles). The Dow Jones index during and leading up to these recessions sold off (as you would expect). Now the thing that caught my attention when looking at the Dow Jones Index during this period was the similar pattern it had formed to the chart we presently look at today. After the extended rally through the 50's and 60's the Dow leveled off and started to consolidate in a range between its peak and about 30-40% below. The next chart is the same look at the Dow Jones Index but from **1982 to the Present**.

1982 - PRESENT:



The first thing you will notice is the Dow Jones Index rallies strongly into 2000 where like 1970 it also hits a brick wall. A quick look at the Yield Differential shows that this inverted during the middle of 2000 (Red Vertical line) before the US economy went into a recession (Indicated by the blue rectangle). When you compare these two periods of time, I believe they look very similar. The Dow Jones Index lost 30%+ during the recessionary period of 1970 as it did between 2000 and 2002. The resulting Federal Reserve Policy during this period was a predictable aggressive easing of short term rates. Here lies the beginning of the problem as you start to enter a Stagflation environment. You have a period in time where economic growth stagnates but an inflationary problem is born due to the extended period of low interest rates and easy money. Therefore interest rates have to rise periodically to deal with the resulting inflation problem. Each time the short term rates are raised this puts pressure on the economy and another recession occurs. As you can see in the first chart, two recessions were experienced in the first 8 years between 1970 and 1978. I can tell you two more occurred in the short space of time between 1979 and 1982 (We will look at this period in a future article down the track).

Your response at this point may be to simply say: **"that's fine but that was then and this is now!"** Well you might have a point but when you look at the yield differential we are presently faced with (Indicated by the blue vertical line) and the way the Dow Jones Index is currently behaving, you like me might get a rather strong sense of Déjà vu. The Dow Jones pretty much reached its highs of 1999/2000 recently but did not stay there for very long. Federal Reserve Chairman Ben Bernanke in a recent statement hinted that short term rates would probably rise again later this month due to inflation fears. This next rate rise may be enough to invert the yield curve again which would spell out a pretty ominous warning sign to financial markets.

WHAT DOES ALL THIS MEAN FOR GOLD?

It is my belief that we are at a very similar stage to June 1973. The Dow Jones Index is potentially topping out after recovering from the stock market falls associated with the previous recession in 2000/2001. The Gold price is in the process of taking a well earned breather much like the 22% fall that was experienced during the period of April-September 1973. In my opinion this is a healthy consolidation in preparation for a much larger rally which could come with the easing of interest rate rises at some point later this year. The dollar is presently struggling in the midst of several interest rate hikes. The big question is what will happen when the interest rate rises are put on hold or even worse loosened to accommodate a falling stock market and a slowing economy? One potential answer lies in what happened post September 1973.

During 1973 short term rates increased right up until the end of August when they temporarily peaked at 8.67%. They had been steadily increasing since February 1972 (When they were 3.2%). Does this sound familiar? In response to a slowing economy and a looming recession they then spent the next 12 months to August 1974 in a tight range between 8.67% and 7.12%. During this time Gold rallied strongly from US$105 an ounce to US$152.50, an increase of 45% (It got as high as US$172.25). It remained strong until the stock market consolidated again towards the second half of 1974 after a lengthy fall. From August 1974 to December 1976 interest rates eased from 8.96% back down to 4.35%, during which time the stock market embarked on another post recession rally (Similar to the one following the first recession in 1970). Gold's rally continued until the 31/12/74 when it peaked at US$193 before embarking on a massive correction that took it as low as US$104.38 as at the 31/08/06 (Using Monthly Gold figures), a fall of close to 46%.

CONCLUDING COMMENTS

I don't believe what happened in the seventies and early eighties will be all that dissimilar to how things may pan out in the present bull market in precious metals. When I look at the challenges the Federal Reserve is faced with today in juggling inflation with a slowing economy, things look more or less the same. What ever happens, you can see that things are not likely to be plain sailing. It is true that trying to compare two times in economic history and claim that history will repeat itself is fraught with danger. However I don't think it hurts to have a quick look back and see the challenges one could potentially face given similar market conditions. It was not all one way traffic for the Gold price, nor was it all doom and gloom for stock markets either. In order to devise an effective strategy to invest and trade in these times I found the above exercise to be extremely useful. It is fair to say that the Gold Bull market to this point has been a fairly structured and predictable affair. As this bull market matures I think things are going to become a lot less predictable and obviously a lot more volatile. Those fortunate enough to have been investing during the 70's and early 80's have already had a useful insight as to how things might unfold. For the rest of us, the best we can do is research this period and at least get a sense of what to expect.

Troy Schwensen

DISCLAIMER

This publication has been prepared from a wide variety of sources which the editor to the best of his knowledge and belief considers accurate. The editor does not warrant the accuracy of the information and forecasts contained in this publication. This information is provided for educational purposes and nothing written should be construed as a solicitation to buy and sell securities.

© The Global Speculator