

## WHY THE GOLD SECTOR, WHY NOW?

As we completed yet another period of growth in the gold price and financial markets start to look increasingly fragile, we are getting the inevitable influx of new investors into the precious metals sector. I often find myself wondering: **“What’s the predominant driving force for these investors?”** Why now and not 2 years ago? Why now and not 8 years ago? I also start to question whether many of these people genuinely understand why they are investing in gold or gold stocks in the first place. Their conviction will be tested soon enough with the gut wrenching volatility many of us longer term players have had to grow accustomed to. Enemy number one for any gold investor in my opinion is ignorance. This ignorance forces many who enter the sector with stars in their eyes to buy high and sell low. Without a shadow of a doubt, I am convinced of many investors who entered this gold bull market relatively early who to this day have failed to make a rate of return commensurate to risk. Today I will attempt to answer the simple question as to why.

## IS A POOR CHOICE OF GOLD STOCKS TO BLAME?

The most common way investors play this sector is to buy gold stocks. The first thing they invariably do is find a reputable newsletter writer. Generally speaking, there is nothing wrong with the companies many newsletter writers recommend. If the newsletter writer is especially good, they will also have a solid understanding of why the gold sector is in a bull market. They will importantly possess the courage of their convictions to recommend to their subscribers that they do the bulk of their buying when prices are falling and depressed. They know the bull market will inevitably resume its run. How about the new subscriber who is not fully convinced of why he or she is even investing in this sector? Fresh in the back of their minds may be the stern warning they received from a close associate or their stock broker telling them that this is a “very risky” sector. Pretty good advice actually! Having bought their newsletter subscription when the gold price was surging higher, the investor buys 5 recommended stocks. Newsletter writers are paid to make recommendations all of the time. Especially when the gold price is surging and new subscriptions are plentiful. These 5 stocks go up for the next 4-5 weeks along with the gold price. The investor feels vindicated by their decision. All of a sudden all hell breaks loose and these gold stocks fall along with the gold price. They fall first to the entry price and then 20-30% below the entry price. The investor looks to the newsletter writer for direction. The newsletter writer casually explains that these companies have excellent fundamentals and subscribers should hold existing positions while taking the opportunity to add more. For most investors there is something psychologically difficult about buying more of a stock when you are losing on your original position. Fear and doubts start to cloud your judgment. Perhaps this newsletter writer isn’t all that he or she was cracked up to be? I’ll cut my losses and put this down to an expensive lesson. I’ll never invest in the gold sector again, it’s too risky. That is until gold starts rising again. Like a moth to the naked flame!

## WHAT WENT WRONG? WHO’S TO BLAME?

The common question asked is how can one get the sector right, the stocks right and yet still get things so wrong? There is only one person at fault in the above scenario and that is obviously the investor. The newsletter writer is getting paid to do what he or she does. When someone lacks conviction about what they

are doing, they require increasing levels of positive reinforcement and assurance. When it comes to investments, nothing provides this more effectively than rising prices. These investors would only ever feel comfortable enough to enter the gold sector when it is surging higher. Unfortunately, more often than not, this is precisely the time professionals in the sector are taking profits and selling these investors a portion of their stock. There is nothing wrong with the companies. It just comes down to poor timing and a lack of conviction. Without the positive reinforcement of rising prices, these investors have nothing. They find themselves constantly second guessing the market and more importantly themselves. They have the sector right, they invariably have the stocks right, it's just the conviction they lack. What's the solution?

## WHY AM I INVESTING IN THE GOLD SECTOR?

Answer this question satisfactorily and in my humble opinion you will go a long way towards becoming a profitable participant in this bull market. An investor which can genuinely answer this question may still have bought those 5 stocks recommended by the newsletter writer. The difference is, they would have held them while taking the opportunity to buy more on the downturn. So why are we investing in the gold sector? How about significantly above average returns in a market which is not exactly blessed with viable alternatives? This is a common answer but not one which will give you the courage of your convictions when push comes to shove. In essence, what are the core fundamental reasons for investing in the precious metals sector?

In a nut shell:

1. Poor fiscal management by governments globally;
2. Extremely loose monetary policies employed by central banks globally;
3. A lack of political will to resolve the problems created from 1 and 2.

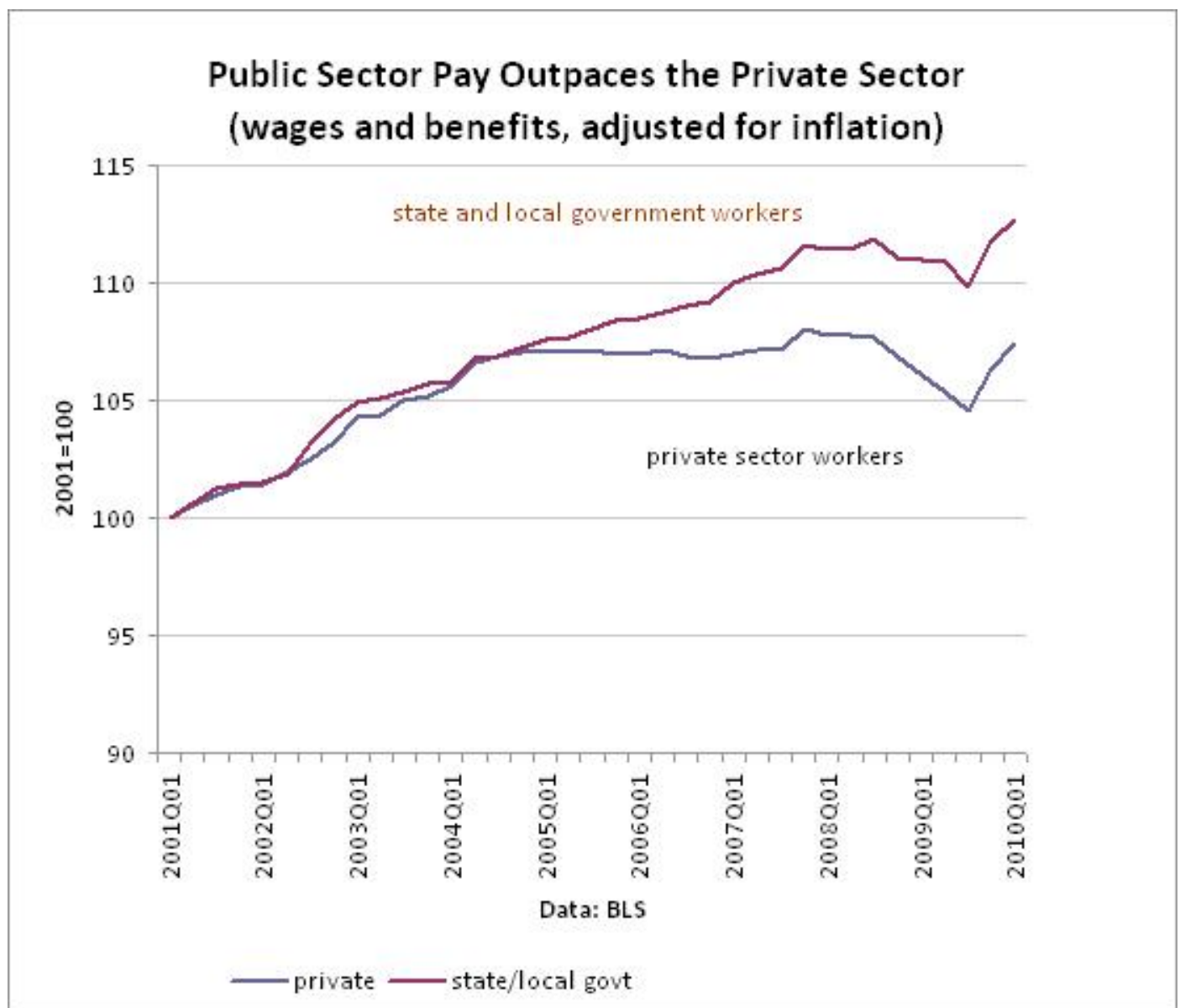
The 3 problems stated above are happening to varying degrees globally. Government deficits and public debt levels are accelerating rapidly as tax receipts become eroded by declining economic activity. What should governments do in this situation to make up for the shortfalls?

1. Cut spending and reduce the size of government.
2. If possible reduce tax levels.
3. Central banks should leave interest rates at a level which maintain a reasonable cost of capital in order to weed out the weak and unviable businesses.

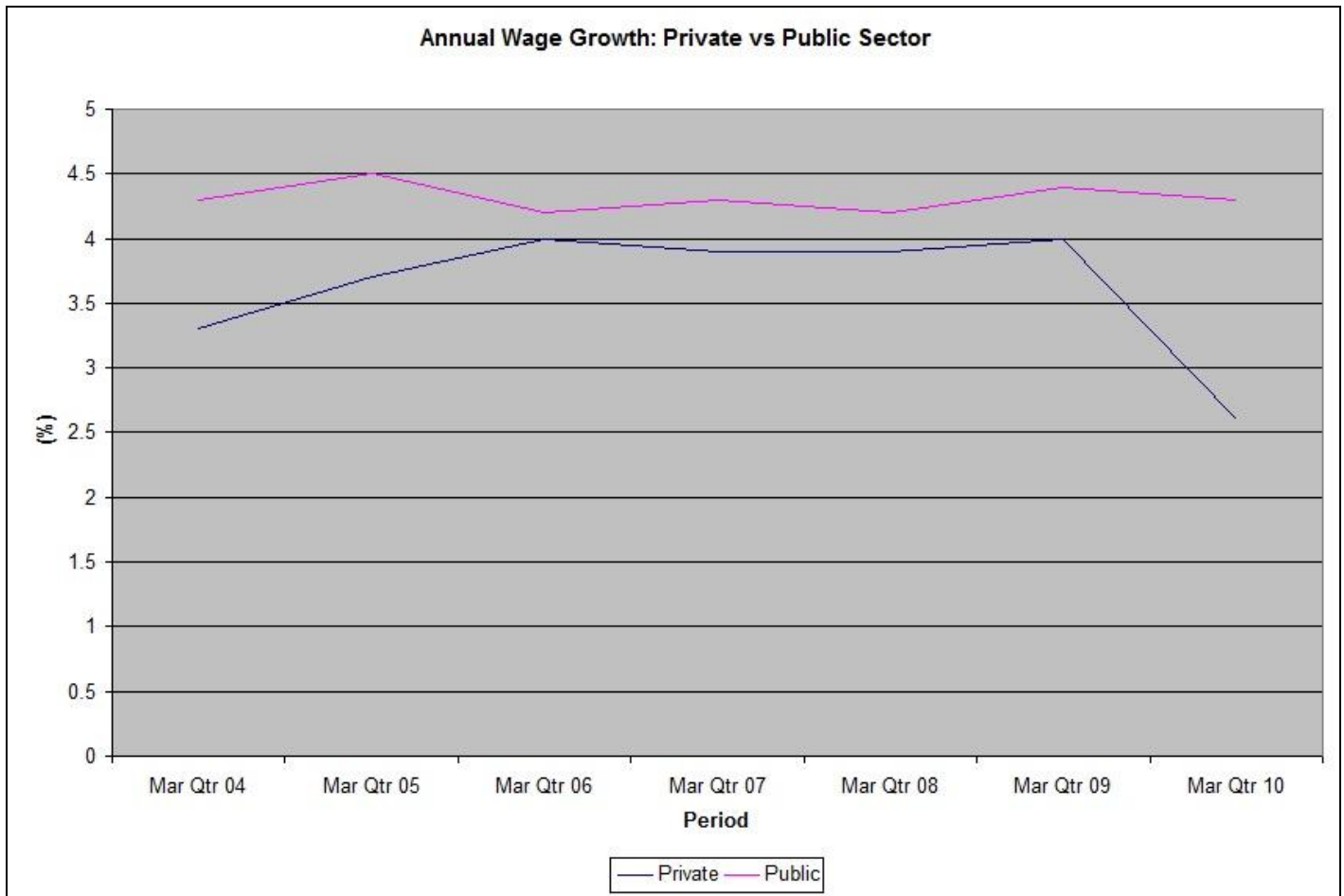
What are governments and central banks around the world typically doing?

1. Increasing spending to artificially stimulate economic activity.
2. Increasing taxes and public borrowing to fund this spending, or alternatively get the central bank to print the money.
3. Central banks in most countries have cut interest rates to the bone to help sustain unviable commerce.
4. Government has gone one step further and even bailed out many unviable businesses.

It is common knowledge to most that the engine room for tax revenue in any economy is the private sector. Money is spent more efficiently in the private sector. If you think about it, it has to be. If you fail to manage your resources in the private sector you go out of business (unless you are lucky enough to have the government bail you out). If you fail to manage your resources in the public sector, you run a “budget deficit”, increase public debt levels but still remain in business. This point is made obvious when you look at wage growth figures for the private sector versus the public sector in light of the recent economic downturn. The first chart below looks at the US situation. Despite several states staring down the barrel of bankruptcy, the public sector still finds room for wage increases! As the private sector wage growth recovers from a sharp fall, public sector wage growth makes new highs.



Here in Australia the picture is not all too dissimilar. The recent 12 months to Mar 2010 saw a steep fall in wages growth in the private sector given the tough economic conditions. In the Public sector it was business as usual as deficits sky rocket.



**Source: ABS Labor Price Index data**

During good times, poor government stewardship is largely concealed in the glow of ever increasing tax receipts. Governments, during these times, are largely looked after (there are embarrassing exceptions) and “appear” to be less of a burden on the private sector. When downturns inevitably arrive, this is when poor government management comes to the forefront. During these times, fiscally responsible governments become less of a burden on the productive private sector. This in turn facilitates a swift recovery. The bigger the drain a government is on a country’s resources, the worse off that country is invariably going to be over the long term. The more government intervention there is, the more inefficient the allocation of capital, plain and simple.

Why are so many of the major economies around the world presently in such a mess? The answer is actually very simple. Over time, Western governments have had a larger influence on economies. Via quasi government organizations such as central banks, they have intervened heavily in capital markets strongly

influencing interest rates. This has in turn led to an inefficient use of capital and poor investments being made in the private sector. Rather than allowing economies to go naturally into a politically untenable recession, governments in 2000/2001 increased stimulus and central banks in turn slashed interest rates in a desperate attempt to re-inflate rapidly contracting economies. Sounds good right? Who wants to endure a recession? Unfortunately it is not that simple. A recession has gone from being a rather regular occurrence decades ago to something that should now be avoided at all costs. A recession is actually a necessary evil for every economy. It ensures that balance is restored to an overheated economy, where bad investments and a misallocation of resources become prevalent. Whilst politically inconvenient, recessions are necessary to pave the way for “sustainable” economic growth in the future. When governments and central banks intervene in the markets with fiscal and monetary policy designed to avoid recessions, they create bigger and longer term dislocations. Unsustainable business practices are given a life line to continue unabated for an extended period of time. The longer this occurs, the worse the delayed recession will inevitably be. Recession, thanks to government intervention, has mutated from being a somewhat mild and inevitable reality of the business cycle to something more sustained and financially destructive.

## **WHAT DOES ALL THIS HAVE TO DO WITH THE GOLD PRICE?**

The gold price, if you like, is a barometer on how well governments and central banks around the world have been managing their activities in their respective economies. The other indicator is interest rates. The more capital a government drains from its economy, the less capital there is available for the productive private sector. This puts upward pressure on interest rates. If this is true, many of you may be wondering why interest rates in the US remain so low despite ballooning government deficits and debt levels. Enter the US Federal Reserve. The US Fed has been buying large quantities of US government paper with freshly printed money to ensure interest rates remain low. They hope these lower rates will help facilitate a swift recovery in the US economy and keep debt serviceability manageable. Longer term, this is not a sustainable practice and will only serve to undermine the future viability of the US dollar. At some point interest rates must rise. This will of course result in more economic pain and larger government deficits due to less tax receipts and increasing debt serviceability costs.

## **WHEN WILL THE BULL MARKET IN GOLD END?**

In my opinion, gold will start to look less attractive after we see the fallout caused by either governments making tough decisions (unlikely) or forced action as a result of the system breaking down (much more likely). At this regrettable point, alternative investments to gold are going to be selling for next to nothing in terms of gold ounces. In the mean time, governments are doing more of the same in the insane hope that the results will somehow be different. The currency markets are where we will continue to see the biggest fallout. A currency is only as strong as the state of the country or union which issues the paper. Currencies all around the world are losing value in terms of gold. The interest rates being offered to compensate savers for this risk is laughable and should strengthen anyone’s resolve for protecting at least a portion of their wealth in gold and silver. Use inevitable corrections as an opportunity to add to your holdings. When corrections occur, ask yourself this simple question in the context of what I have outlined today: “Has anything fundamentally changed which could justify liquidating your portfolio of precious metals assets?” If the answer is no, buy more. If the answer is yes, then by all means look for better opportunities elsewhere.

For anyone interested, I write a free monthly newsletter on the precious metals markets. Pay us a visit at the website below. Alternatively, for all the latest fundamental information on gold stocks and sophisticated tools in which to utilize it, I invite you to visit GoldNerds. Many articles demonstrating how we have employed the product to identify undervalued gold stocks are available at The Global Speculator website.

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