

2010 GOLD OUTLOOK

Gold May Lose Its Luster in 2010

Summary Outlook: Gold prices surged higher in 2009 as part of broad commodity rally and USD decline, culminating in a classic parabolic advance in October/November, followed by a 10+% collapse in December. Given ongoing concerns over sovereign and corporate debt burdens globally, we think gold prices are most likely to remain relatively elevated, and we do not expect gold prices to see much below the \$850/900/oz. level. By the same token, we anticipate an extremely benign inflation environment in 2010 together with a broadly stable, though relatively weak, USD, which should work to limit gold's upside to the \$1200/1250 zone.

Economic Analysis: The traditional drivers of gold prices are inflation, inflation expectations and the perceived value of the USD and other fiat currencies. Gold is also frequently viewed as a safe haven refuge in times of financial market turmoil, though that effect failed to materialize during the worst of the 2008 upheaval, but was apparent during the 1Q 2009 market relapse. Overall, on inflation we think a weak global recovery, undercut by consumer deleveraging and high and rising unemployment across most of the G-10, will restrain inflationary pressures throughout 2010. In the US, the December Univ. of Michigan consumer sentiment survey foresaw a 2.1% inflation rate over the next 12 months and a 2.6% inflation rate over the next five years. European and UK inflation forecasts are similarly benign while Japan has recently slipped back into deflation. Only in the event of an unexpectedly stronger global recovery would inflationary pressures come into play.

Fiscal and credit concerns are likely to be the most supportive factors for gold prices, but even here, we expect them to be less of a factor as 2010 wears on. In the second half of 2009, speculators focused on the high level of deficits and overall debt in major economies and began to question the inherent value of major currencies and gold appreciated steadily. However, recent events (credit rating downgrades to Greece, the Dubai debt standstill and the nationalization of a regional Austrian bank) coincided with a sharp drop in the price of gold. Rather than propelling gold to further heights, increased risk aversion had the opposite effect on gold, suggesting speculative forces were primarily behind the run-up in the yellow metal. Indeed, according to the COTR for Dec. 15, 2009, speculative gold net longs were only slightly below all-time highs of 262,000 contracts, despite a nearly 10% decline in price. As stimulus efforts wind down in early 2010 and governments move to more fiscally sustainable policies into the end of the 2010 and into 2011, the appeal of gold as an alternative to currencies will continue to diminish. As well, global central banks will move to withdraw extraordinary accommodation and eventually tighten lending rates later in the year, raising the relative cost of carry of gold vs. currencies (it costs to own gold, while FX investors can earn once rates begin to rise, eliminating gold's free ride vs. zero interest rate currencies.) As such, we think gold supportive factors will fade into the second half of the year, and so we would bias the risk to greater downside potential for gold prices.

In terms of supply and demand, high nominal gold prices continue to see scrap gold add to overall supply, in addition to mines and refineries working in overdrive. Conversely, demand for jewelry remains under pressure due to high relative prices and restrained consumer spending. Demand is still strong among speculative and physical investors, but the risks here are biased lower should the global economic recovery prove more resilient

than expected. Finally, near-record high speculative long gold positioning also biases the risks to the downside, as there has been only minimal reduction in the face of an 11.4% price retreat in December, leaving open the potential for a larger position exodus.



Technical Analysis: Gold made a significant medium term high in early December just above \$1225/oz and has since retreated over 10% from that high. Immediate resistance is in the 1125/30 area, followed by 1150. Initial support comes in at 1070/73 October market highs, which coincides with the base of the Ichimoku cloud at 1067 (but rises sharply in coming weeks). Below 1065/70 exposes the 1020/25 September highs, and then the 1000 psychological support level, which sees the 200-day sma just below at 988 currently. We think there is further downside corrective potential to the 1020/25 area early in 2010 as overstretched longs exit. From that level, we would look for some consolidation and perhaps for a new base to build, but we would not hold longs should price drop below the 975/980, as that would suggest a further decline to the lower end of our expected range at 850/900.

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