

## Commodity Comments



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When Mr. Butler asked me a few weeks ago to speak about gold, my first reaction was negative: after all everyone today is an expert on the subject. The once unthinkable \$175/oz. had already taken place and \$200 and \$300/oz. are being bandied about with the least hesitation. In the one-way-street for gold mood prevalent in financial circles, there was little for me, a Gold-Bull, to add.

To gain my confidence, and perhaps some of yours, I reviewed our firm's recommendations on the subject with a view of finding some rationale for our past bullishness and some forecasting clues. On Dec. 8, 1971, when the Smithsonian Agreement was being forged and rumors coming out of Rome indicated a willingness on the part of the U.S. to devalue by as much as 10%-we commented: "it is all too obvious that the official price of gold will rise by only 5-10%" But will it rise by only 5-10?? If so, why is the market price flirting with the \$44/oz. level a monstrous 25% plus premium??

We do not profess to know the answer but we call to the attention of our chart readers the massive 4 months high level triangle with a flat top at 44 and an uptrend at 42.80. Rarely will one see such a high level bullish formation... We regret immensely not being able to explain in fundamental terms the reason for our bullishness. Only time will tell, perhaps less than 6 weeks." And we went on to recommend the purchases of gold bullion at those levels (44/oz).

Here then lies the first secret: the technical behavior of gold prices was betraying the thought of a smooth and orderly upvaluation of gold. We will find again and again in the subsequent 2½ years, that trend analysis and contrarian thinking superimposed on a basic belief that convertibility and commodity inflation were at stake, was the key to forecasting gold prices.

By January 4th, 1972, with gold rising above its \$44/oz resistance area, we proclaimed that the great gold nightmare of the 70's had begun. The amount of the change, 5, 10, or even \$100/oz in the price of gold would have been irrelevant to the question of currency realignment so long as everyone adjusted its own currency to the predetermined master plan. The amount of the change was highly relevant to the future of convertibility. This the U.S. and for that matter all other politicians, did not comprehend.

Once again, on March 7th, 1972, with gold already at \$48.25/oz we noted that a positive technical formation had been formed and that long commitments were once again justified. This despite the fact that rumours were circulating financial circles that the USSR would be forced to sell roughly 190 tons of gold (at \$48/oz) to cover recent purchases of U.S. corn and Canadian wheat -- an amount equivalent to total speculative net purchases for all of 1971, as reckoned by Samuel Montagu and Co., London Bullion Dealers.

By the end of September of 1972, gold prices after seeing \$70/oz, had reached what we considered, temporary plateau: A pattern of descending tops and a speculative pause in other commodity markets were the prime tip-off. The real reason was discussed by us in some detail but its main rationale was simply the reduced need for convertibility. At the time we said that the strengthening of the U.S. dollar "is slowly removing the imperativeness for restoring gold convertibility.

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In fact, the degree of gold undervaluation would be irrelevant in a world of dollar shortage, such as existed in the late 40's and early 50's. Although this situation does not exist at the present time, the direction towards increasing dollar acceptability takes the pressure off the convertibility issue, which, in the long run, cannot be attained except by gold at between \$70 and 140/oz." We concluded that the bloom was off the gold bull market and a retracement to the \$50-\$55/oz. was a likely possibility. This point bears remembering as it will affect any intelligent forecast we might want to make in today's market. By the third week of November, (1972) Gold had touched \$59.20/oz. and the downtrend was continuing. The U.S. Dollar was still gaining ground vis a vis major European currencies and our previously stated position was still valid. The Winnipeg commodity exchange gold contract had come into being and we suggested sales on \$2½ - \$3/oz. rallies from any lows on the April '73 contract, then selling at roughly 200 points over its London counterpart. Being technically oriented, however, we advised buying back gold positions if April '73 moved over \$65.50/oz. as convinced as we were of the improving fundamentals-the reduced need for convertibility in view of the U.S. Dollar strength - we would still let the market show us the way.

By early December '72, a strong increase in short term deutsche marks money market rates began to provide some support to the faltering DM; our raison d'etre for being out of gold was dissipating. Not surprisingly, the middle of December '72 saw gold break its 4½ months long downtrend and prices climbed above \$65/oz to stay there until the beginning of February 1973. We had witnessed the first correction in a bull market - this one measuring only 16.8%. In addition, it took almost 7 months before gold broke through its old \$70/oz. high: in terms of a contango market - one which reflects full carrying charges - it meant an additional 5-5½% loss. Our comment at the time (Dec. 29, 1972), is worth repeating as it again bears on the present situation: "for the past few weeks we have experienced a strange feeling as 'consensus; (Public statements by Zurich Bankers, London Bullion Dealers and Commission Houses) has tended to favor the short side of the market. If gold has not knuckled down under \$58/oz. by now (when there is good reason for it) we suspect a short squeeze is in the making. Buy April '73 at market (then \$65.40/oz)". The word of the experts VS the action of the market; indeed, if everyone is bearish, why aren't prices collapsing?

By early February 1973, a new gold bull move got underway as a minor currency crisis in Italy triggered a speculative movement out of the dollar. For domestic reasons, Switzerland suspended its dollar buying operations which had been swelling its money supply. No sooner had that taken place, when a massive speculative raid was launched on the U.S. Dollar knocking it down to the currency floors in Frankfurt, Amsterdam, Brussels, Tokyo and Paris. Gold was once again sailing on the upside and breaking the once magic \$70/oz. By the end of February 1973, gold had touched \$95/oz in hectic prefixing trade; it then settled down slowly into the \$80-85 range until well past the middle of April 1973. Once again, the dollar was still weak and convertibility was just not in sight - the Bull Market was intact.

By the early summer of 1973, gold prices had reached an historic fixing high of \$127/oz. but a general contraction of credit initiated by the Federal Reserve in early May, was beginning to take its toll on commodity prices. Also, at about that time, European currencies were reaching new highs on enormous speculative buying waves. Sooner or later, rising U.S. interest rates and credit contraction would firm up the U.S. dollar and weaken commodity prices, at which point, gold would follow. We recommended stops on our long positions, first @ 104.00, later @ 112.00 (June 27th, 1973) and finally @ 114/oz. (July 24th). These were chart points. We were going by "tape", knowing that a substantial correction was in the making. Our stop loss sale was triggered the second week of August, 1973. An uptrend going back to the early part of the year had been broken and regardless of sentimental feelings towards gold, long positions had to be closed out.

For the remainder of the year, the U.S. dollar gained back a good deal of the lost ground and by early January 1974 the Deutsche Mark had gone down to 34½¢ (from almost 44¢) and the Swiss Franc to 28½¢ (from over 37¢). By late November 1973, gold had touched an intra-day low of \$85/oz., thus retracing almost exactly 50% of its major Bull move, from \$42/oz. in late 1971 to 127/oz. in mid-1973. It was a severe correction but still well within a major Bull market.

In late November of 1973, we were treated to a new monetary mirage: Dr. Arthur Burns, chairman of The Federal Reserve, announced that the governments of Belgium, Germany, Netherlands, Italy, Switzerland, the U.K. and the U.S. had agreed to end the two-tier gold market in existence since 1968.

proportion of gold and foreign currencies. This was so because gold, their largest single reserve asset, was in effect frozen in their coffers at the official price of \$42.20/oz., no one willing to part with it at half price. Curiously enough, this new agreement forestalls the possibility of European Central Banks selling gold on the free market to de-frost a reserve asset: they are now able to transact among each other at the prevailing free market price. It also carries some extraordinary (by modern standards) implications:

- A) It recognizes the free market price as the sole arbiter of values, despite official pronouncement that the free market is small, thin and insignificant.
- B) Returned gold to its former role of a settlement asset, if only for the EEC:
- C) Forces upon the EEC a deflationary economic policy vis a vis the rest of the world; this is so as a payments imbalance of one member must be settled with some gold, an asset that under the present rules (as viewed by the U.S. ) cannot be reacquired in another way except by running a payments surplus.
- D) Forces the U.S. to follow partial convertibility lest it runs the risk of seeing its greenbacks delegated to secondary money.

A corollary to (A) and (B) is an eventual recognition by market participants that convertibility and international settlement is still the real force behind a rise in price-and, of course, full convertibility cannot be achieved even at \$150/oz. A corollary to (C) is the necessity to establish channels for official purchases of gold for the purpose of adding to real world liquidity and thus avoid competitive deflation-this virtually guarantees that gold will be supported on any significant price dips, if a worldwide or just European, recession developed.

In short, the recent agreement to end the 1968 two-tier market of gold was a major step forward in remonetizing gold. Since this process requires a much higher price for the yellow metal, one is forced to conclude that a new and significant rise is in the making."

Again our technical orientation dictated that gold purchases should be undertaken only once the 5-months downtrend was penetrated: the signal would come when gold rises above the \$100 level. The first week of December 1973, saw gold trade above \$100/oz thus signalling the resumption of the bull trend. The rest is recent history. By the first week of April, 1974, gold hit \$180/oz an all-time historic high. Predictions of \$200/oz and even as much as \$1000/oz were the order of the day but prices began churning lower and by the third week of April, gold had broken its steep uptrend connecting the November 1973 and the January 1974 lows. A new top had been made, one of certain significance. The seeds of the correction were being laid by a new rise in worldwide interest rates, epitomized by the 6 months European rate touching 12%. By late last week, the U.S. dollar, though weak, was beginning to firm up-the classical response to a tightening monetary grip.

What is in store for gold? In the short run, we believe that a substantial correction is taking place, one that will see gold prices either (A) break, sharply lower over a short period of time, perhaps 4-8 weeks or, more likely, (B) trend down slowly but in an orderly fashion over an extended period of time and then settle at a lower level--this cycle may last as much as 1-1½ years. We do not like to venture a specific target but we feel that the following statistics should be watched closely in attempting to gauge the timing of a new purchase (A) The Eurodollar rate for 6 months--- is it still trending higher (bearish) or has it begun to move down (bullish); (B) a new emerging weakness of the U.S. dollar vis a vis European currencies-not likely to happen in a period of rapidly rising U.S. interest rates; (C) A resumption of rapid growth of commercial bank credit as an indication of aggressiveness on the part of the FED. in trying to push money down the throat of consuming units in the U.S. Economy---not always reflected in lower interest rates as the latter may be building into it an inflationary premium; (D) most important of all, a clear upside penetration of the present downtrend, preferably on weekly bar charts.

It has been suggested by a widely publicized financial commentator, that the recent informal meeting of EEC finance Ministers at Zeist, Netherlands, concluded sell gold over a wide trading band. In this scheme, the buffer manager, if you will, sells from \$150. up to \$175/oz and buys from \$150 down to \$125/oz. Since gold can now be traded among foreign central banks at prevailing market prices, without having to actually sell on the market (as Italy is been rumoured to have done), this scheme can only mean that a new attempt is being made to hold gold prices down below \$175/oz.

One should note that the first gold pool began in 1960 and was formed to hold below \$36/oz. The artificiality of the price finally overwhelmed the gold pool and he withdrew his offers by early 1968. One can argue that the former gold pool was doomed to collapse as prices were unrealistically low and ultimately the pool would become the only seller. One could then further argue that the present gold pool's chances of success in maintaining a ceiling of \$175/oz. must be viewed in relation to its pricing vis a vis other commodities (A guideline to the artificiality of present levels). Very roughly, since September 1931, Reuters index of leading 22 commodities has risen from 100 to presently 1350, a 1350% appreciation. Since in the interim, however, sterling has been devalued by over one-half, the resulting dollar appreciation is 600-700%. When applied to gold at \$20/oz. (the 1931 level), one arrives at \$130-140/oz as a realistic Commodity level. Since, eventually, one form or another of convertibility must be reached--and usually it involves a premium price (to induce selling to central banks), the \$159-\$175/oz price may be deemed realistic given inflation to date. with the industrial world slowly sinking into a recession, we can safely assume that monetary ease will be forthcoming, somewhere beginning next month. Growth in banking reserves, albeit large, do not translate immediately into an expansion of the money supply and therefore a new inflationary surge may be more than a year away. Given these parameters, and bearing an unforeseen war or sudden financial catastrophe, the ceiling imposed by the gold pool may last as much as 1½-2½ years, depending on their willingness to sell at the upper limit.

In concluding, we foresee a substantial downward correction in gold prices and consolidation period (defined by a refusal of prices to break into new high ground) lasting as much as 1-2½ years.