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RECORD OIL: Bullish for gold

The oil price keeps hitting new record highs. High oil prices reflect two things. The enormous appetite the world has for oil, especially with China adding to the demand side since it's now the second largest consumer of oil after the U.S. The second factor is the supply side. Any act that might disrupt or limit the oil supply causes the oil price to rise. That's what recently happened when Yukos, Russia's largest oil exporter, was ordered to halt production. Plus, oil disruptions in Iraq have added more fuel to the fire.

It all boils down to uncertainty. As long as we have uncertainty in the supply or demand side, we'll continue to see higher oil prices. And since the oil price strongly affects inflation, this means inflation is headed higher too. This in turn will be good for gold since gold is the maximum inflation hedge.

INFLATION ALREADY PICKING UP

Keep in mind, even though inflation slowed this month, consumer prices have increased at the fastest rate in 13 years in the past six months. Import prices are up nearly 9% annualized in the first half of 2004, which is the most in 16 years. And with the oil price currently at record highs, this will continue in the months ahead.

Meanwhile, we know Bush has been spending massive amounts for defense and the war on terror. This has resulted in huge deficits and unprecedented government spending, which has helped boost the economy following the bursting of the stock market bubble in 2000. To put this into perspective, Marc Faber points out that the amount of money issued from 2000 through 2003 exceeded the entire amount of currency printed in U.S. history from George Washington to 1980. That's another good reason why we're now seeing inflation.

But deflation pressures also persist. The bubble never really deflated as it normally would. All that money has kept things rolling and the bubble has shifted from stocks to real estate, thanks also to super low interest rates. But consumers are heavily in debt and they have little savings. Their savings is in their homes, which is fine as long as real estate prices hold up. The economy, however, has underlying, fundamental problems and if Kerry wins the election and reduces spending, which is possible, it would be like closing the bar as the party's getting underway and the economy could then slow quicker than most expect since it's grown dependent on all this stimulus.

INTEREST RATES: Also headed higher

If interest rates are rising even moderately at the same time, it would also hurt real estate prices and consumer spending. Already, the first small hike in interest rates turned the stock market bearish and it's begun to slow the fragile economy. Nevertheless, interest rates are going higher due to current inflation pressures, which is a greater concern than deflation.

Note the T-Bill interest rate has now risen above its 65-week moving average for the first time in over three years (see **Chart 1**). This confirms the major interest rate trend has now turned up and rates are going higher in the months and likely years ahead.

GOLD & INTEREST RATES MOVE TOGETHER

Popular Wall Street wisdom has it that gold would become unattractive if interest rates rise. The reason being, gold doesn't pay interest and it wouldn't be able to compete with the higher yielding dollar, which would be in greater demand and move higher as interest rates rise, pushing gold down.

Well, let's set the record straight... Rising interest rates are NOT bearish for gold and they never have been. On the contrary, so even if interest rates keep rising, it's unlikely to affect gold in a negative way.

Chart 2 shows the historical record. As you can see going back to 1970, which was shortly after gold began trading in the free market (the price was fixed prior to that), gold and interest rates have moved up together. In some cases, gold led the way up and interest rates followed because inflation was usually also rising, especially in the 1970s.

At that time, inflation soared and so did interest rates, with some rates peaking near 20% in 1980. Since gold is very sensitive to inflation, it soared too, reaching its peak in 1980 near \$850. So if anyone says rising rates would be bad for gold, they don't understand this historical relationship and that's even more important now that inflation's picking up and the U.S. dollar remains bearish.

GOLD'S BULLISH STEPS INTACT

From a technical viewpoint, gold is a cyclical and seasonal market and it moves in what we call steps. **Chart 3** shows these steps since 1980 and it helps put the overall action in perspective.

Gold moves in a 1 through 4 movement and depending on these movements, it will determine the strength or lack of strength a bull market has. The number 1 rises are the best bull market rises and the #4 declines are the worst bear market declines. Since gold's major peak in 1980, the steps were down for over 20 years because the best bull market rises were unimpressive (see #1). These rises failed to rise above the prior peaks (see #3) like they did in the 1970s.

But the steps changed in 2001 because gold didn't fall to a new low when it formed its #4 low as it had before. This was the first change in the over 20 year pattern and it coincided with the 8 year cycle low area. Gold then closed above its 65-week moving average where it has stayed since then. From there, the #1 rise began (best bull market rise) and gold soared above its prior #3 peak in December 2002, again for the first time in over 20 years. This was a milestone because gold rose into the second step of the bull market and the 1996 high then became the next target level (see horizontal line). Gold completed this target last January and again in April.

Since April, gold has stayed near the upper side of this bullish second step and above its 65-week moving average, which shows good strength. On the upside, if gold breaks clearly above \$430, it'll be another milestone because it'll be breaking above the prior #1 peak and it'll be entering the third bullish step where the 1987 high near \$500 would then be the next target. This could happen later this year assuming the bull market stays intact.

For now, we're watching the all important 65-week moving average at \$385 since it identifies the major trend and gold will remain bullish above that level.

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Mary Anne & Pamela Aden are internationally known analysts and editors of The Aden Forecast, a market newsletter providing specific forecasts and recommendations on gold, gold shares and the other major markets. For more information, go to <http://www.adenforecast.com>