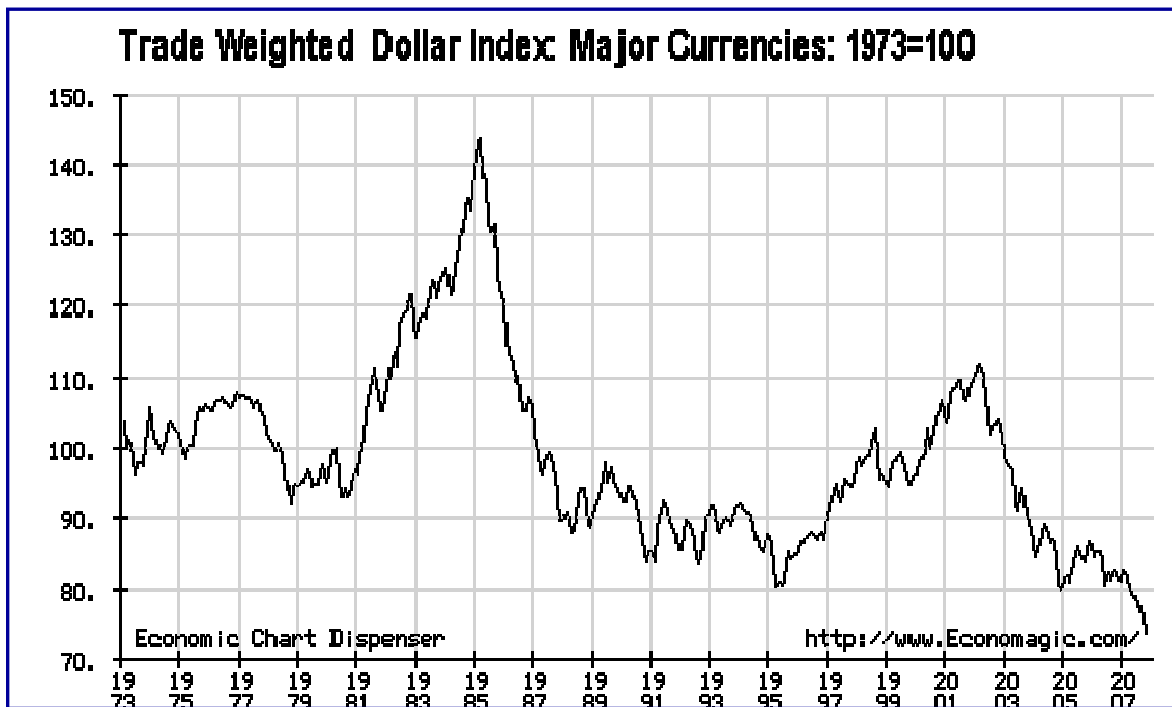


The Long View

The housing market just keeps getting uglier and profits for many sectors are flattening. While we haven't yet changed our view that the US can skirt a recession it is easier to see the pessimistic case than the optimistic one.

In addition to ever weaker housing stats we have oil prices hitting all time highs and, of course, gold looking like its poised to do the same sometime soon.



Oil's price is partially political, but recent announcements from OPEC that it is not ramping up production as quickly as hoped just added to the upward momentum. The obvious ill effects on the US Current Account from a \$94 oil price combined a rate cutting Fed has created a *historically* weak Dollar.

We use the term "historic" advisedly, as the chart above shows. This is a 34 year Dollar Index chart, stretching all the way back to the end of the Vietnam War and the gold standard. Even allowing for new weightings from creation of the Euro and emerging market gains would not change the reality the Dollar Index has **never** been this low in modern terms.

That concept bears thinking about for a couple of reasons. First, it starkly highlights just how serious a mess the US currency is in. As we've emphasized for years, this is not a short term phenomena. It's very much part of a very long term trend. Though the greenback may take some

“oversold bounces”, there have been no recent fundamental changes in US fiscal behavior, public or private, that strengthen the Dollar.

Secondly, from a technical perspective we have entered *terra incognita*. We take a fundamental view but realize currency and commodity markets are rife with chartists who shouldn't be ignored. There are no obvious support levels on the chart now that the long term 80 weighting has been so convincingly breached. Rallies will create new near term bottoms, but don't expect them to hold.

The sub prime issue isn't over by any means. Washington and Wall St. are proposing Super SIVs (aka “Project Flushaway”), and the Canadian ABCP market is still frozen. Most of this will get fixed — somehow —but not easily or cheaply.

All the “fixes” we've seen have one thing in common: they are designed to avoid price discovery in the structured debt markets. Super SIVs have the advantage of moving as much of the mess off balance sheet as possible. The irony of proposing the sort of accounting gimmickry that made Enron famous is apparently lost on Treasury officials. The Fed's largest liquidity injection, over \$40 billion, was made *after* the October rate cut. We're obviously not out of the woods yet.

There have also been rumblings from the Far East about China and others selling dollars. We're skeptical about that even though we know it will happen at some point. The August numbers did show large investment flows out of the US currency, but much of that was related to the credit crunch.

Currency comments out of Asia are political, warning shots across the bow of a US Congress talking China trade sanctions again. But they DO have plenty of dollars to sell, as do others. A very real move away from the US currency is underway, but it will be paced, at least until there is an Asian currency with enough strength to underpin a larger move. Ugly if you are long the greenback, but friendly to gold.

GOLD PRICE SUPPORT

As this article was started, gold traded through \$800 for the first time in 28 years. Notably, silver joined the party for the first time in weeks and closed solidly above the \$14 level not seen since April, and appears ready to make a new long term high.

The yellow metal has looked overbought several times in the past few weeks and does look stretched now, but pullbacks have been small and quickly reversed. We wouldn't be surprised or alarmed if gold consolidated again before creating an \$800 base, but that base is for practical purposes already made.

Oil is an important part of the story, as gold appears to be shadowing it again. Both are really reacting to the dollar's demise, and to politics. The markets had a big sell off the day after the Fed's last 25 point cut. This underscores another important point on market sentiment. The latest Wall Street rally was all about rate cuts. Traders, assuming Bernanke is now done, sold into the announcement.

The liquidity injections by the Fed and "solutions" aimed at the debt markets tell us there will be a lot more bad news from the banking and investment banking sector over the next couple of quarters.

And the good news? Precious metals should continue their uptrend, and other metals will continue to be supported by a weakening Dollar, in Dollar terms. Washington will sacrifice the dollar to stave off a recession, and so they should. Expect more US rate cuts.

Despite the start of moving away from it in the oil sector, the greenback is still the world's pricing currency. This means US policymakers can effectively savage their own currency without seeing a broad bump in inflation. That is why the US has not seen the "Banana Republic" scenario some bears fear (hyperinflation and rocketing interest rates). Since a falling currency is relatively painless for American homebodies, it is expedient for politicians.

How long will this lopsided arrangement last? Until the mighty US consumer can't afford to buy imports. What are most likely to hasten that day would be continued gains to oil's price. Much more than any place else on the planet, North American lifestyle is greased by oil. The more that costs, the less there is for anything else. That has helped check broader inflation, but is not a solution.

Oil's price will peak soon. It is becoming unaffordable. The only question is whether it does enough damage on the way up to cause a US recession rather than economic flat lines for a couple of years. We doubt it will since the reality of high commodity prices are finally sinking in, which should be followed by lesser dependence on debt based consumption. Or so we hope. So does gold's price drop with oil's? We think not.

In fact we think oil price decline will signal the real start of gold's gains, across the currency index. Euro or "commodity \$" holders, as well as newly wealthy Asians, will be more likely to buy the yellow metal with energy costs covered off. So too will Americans looking for a neutral currency hedge. We expect a continued focus on base metal equities, simply because they are not yet expensive. But gold's relative weakness as a hard-asset will become more attractive as both hedgers and wealth accumulators look for ways to weather storms in this millennial economic shift. **Ω**

David Coffin and Eric Coffin are the editors of the HRA Journal, HRA Dispatch and HRA Special Delivery; publications focused on metals exploration, development and production stocks. They were among the first to draw attention to the current commodities super cycle and have generated one of the best track records in the business thanks to decades of mining industry and financial experience and contacts throughout the industry that help them get the story to their readers first. Please visit their website at www.hraadvisory.com for more information.