

Fear of Flying

Traders haven't stayed comfortable for long about the Fed's rate intentions and that unease will lead to more volatility for gold. Markets reacted strongly in their usual "bad news is good news" fashion to weaker than expected Q2 growth of 2.5%. Wall St. made happy because it looked like that weak number would put paid to the Fed's rate raising ways.

Trader's hopes seemed dashed a few days later when the markets sold off on the news of a 2.4% PCE deflator – an inflation measure that is near and dear to the Fed. The reaction was a little odd, since the number was embedded in the earlier GDP number that caused the earlier market run up, but such is the attention span of Wall St. However this may play out for Wall St., it's likely to be good for precious metals markets. We are either going to see a sharply slowing economy, which will stall the rate increases and sink the Dollar, or we're headed for (mild) stagflation which is also permissive of higher gold prices but could be accompanied by further rate increases that would make for some wild swings in metals prices.

We don't envy Fed chief Bernanke. Like anyone who lived through the 1970's we find it a bit tough to get agitated by inflation "leaping" to a mere 2.4% but anyone who survived that decade also knows the dangers of ignoring inflation until it's too late for relatively painless solutions. Even with that caution in mind it's hard to see how the Fed would be prompted to panic given the GDP numbers. The US growth rate slowed more than 50% in one quarter. Unless the economy quickly pulls out of its dive the landing could be anything but soft.

Consumer spending is slowing and though business investment has taken up some of the slack no one, Bernanke included, can ignore that 800 pound gorilla - the housing market. Slowing in housing sales and prices has been dramatic and this sector has been the lifeblood of the US economy for years. Given how much roll over there will be in cheap mortgages in the coming six months and the impact of higher energy prices on household incomes we don't see this situation improving soon and it could get much worse before it gets better. We think the Fed is tempted to add one more rate increase next week to prove its serious but it's hard to believe increases continue after that unless the housing market turns around immediately, which it won't.

The economy is in a dangerous place and that has to give the Fed pause. Even if the Fed raises rates this month the language of the announcement will probably make it clear that that will be it for a while.. That will make the traders happy but don't fall for their enthusiasm until there are more economic stats out that define the trajectory of the economy better. Most of the old stalwarts in the major markets that will be touted by Wall St. if the Fed takes a break won't do well unless the economy stops slowing quickly. If the Fed pauses and there is no immediate sign that economic growth has picked up one of the main victims

will be the US Dollar. In fact, until the situation resolves itself one way or the other there are very few asset classes that can give you coverage. If this kind of uncertainty, precious metals are likely to be one of the few winning sectors. A wilting Dollar will drive gold higher and so will stagflation. If its stagflation we get there will be another 2-3 rate increases and each one will be accompanied by drops in the gold price, short lived though they would be. That would be the best time to be accumulating the yellow metal and/or the share of companies that produce it. Either way, gold should fulfill one of its most important tasks - acting as portfolio insurance that will give you options in and uncertain world.

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